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Federal Securities Exchange Act of 1934

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A. A. SOMMER, JR. General Editor [1982-2002] Originally Authored by Edward N. Gadsby
2010



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1 Federal Securities Exchange Act of 1934 Foreword

Foreword

Foreword

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1 Federal Securities Exchange Act of 1934 Preface

Preface

For over thirty years "Sowards" has been the ultimate authority on the Securities Act of 1933 and "Gadsby" on the Securities Exchange Act of 1934. The treatises were originally the product of their talented hands and enormous experience - Sowards as a preeminent teacher and scholar, Gadsby as a former SEC chairman and outstanding practitioner. As the laws of which they wrote so well changed, and particularly after their deaths, their treatises increasingly reflected the work of the talented authors and editors at Matthew Bender & Co. and other outstanding lawyers and scholars who undertook to rewrite or update parts of the original treatises. While the original excellence of the books continued to reflect the pioneering work of Hugh Sowards and Ned Gadsby, the work of other capable hands became increasingly visible.

As the Securities and Exchange Commission rounded out its efforts to integrate the 1933 and 1934 Acts, a work commenced just about the time the original treatises were published, the distinction between the acts diminished, thus compelling the conclusion that there was little reason to distinguish the two treatises as sharply as had been done in the past. The volumes increasingly constituted an all-embracing "encyclopedia" of the two acts, an encyclopedia rounded out by *Securities Law Techniques* and the more recently published *Regulation of Investment Companies*. This integration of the core federal statutes, and recognition of the increased role of other authors, made it only fit and proper to integrate Sowards and Gadsby and their primary source volumes into the *Securities Regulation Series*.

So identified, they continue to be the unique resource for the practitioner they have always been: the one source in which he or she can find authoritative, up-to-date information about every aspect of the two acts. By combining the primary source volumes that have been discrete parts of each treatise, the recognition of the now integrated statutes and the treatise volumes is complete. Some tidying will continue, but the "heavy lifting" is done.

It is the continuing desire and determination of the editors and authors who are now and will in the future be responsible for these works to preserve the tradition of excellence, reliability and authoritativeness established by the two distinguished original authors. The debt which now more than one generation of securities law practitioners has to the original authors is monumental; it can only be repaid by their successors on behalf of those who use these volumes through continued adherence to the standards to which they so faithfully hewed when they write the original works.

Many of us who practiced through most of our careers with "Gadsby" and "Sowards" at our elbows may feel a sense of

loss when those familiar names no longer identify the volumes so long associated with them. But we can be confident their dedication to quality scholarship will continue unabated.

A. A. Sommer, Jr.
General Editor
July 1997



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What's New

1 Federal Securities Exchange Act of 1934 Scope

Scope

and related publications

Federal Securities Act of 1933 Securities Primary Law Sourcebook

HIGHLIGHTS

Release 108 November 2010

Federal Securities Act of 1933

Chapter 1, *Introduction to the Securities Act of 1933 and to the Securities and Exchange Commission*

Chapter 10, *SEC Enforcement Practice*

Federal Securities Exchange Act of 1934

Chapter 9, *SEC Enforcement Legal Considerations*

Securities Primary Law Sourcebook

Volumes A, B, D and E have been revised and updated.

Federal Securities Act of 1933. Chapter 1, *Introduction to the Securities Act of 1933 and to the Securities and Exchange Commission*. Chapter One has been significantly revised to expand topics of discussion and reflect important legislative and regulatory developments since 2004. In particular, the discussion of the function and organization of the SEC has been broadened, including a new section on the structure of the SEC and an enhanced discussion of the roles of the Division of Corporation Finance and the Division of Enforcement. A new and in-depth discussion of the securities offering reform rules promulgated in 2005 has been added, including information on the categories of issuers, various reforms to the process of communicating with shareholders before, during and after registered securities transactions,

1 Federal Securities Exchange Act of 1934 Scope

the use of research reports and shelf registration reforms. Finally, an updated discussion of the enactment of the Sarbanes-Oxley Act of 2002 and developments under that Act since the prior update has been included.

Chapter 10, *SEC Enforcement Practice*. The chapter has been updated to reflected initiatives that the SEC took in 2009-2010 under the leadership of Chairman Schapiro and Enforcement Director Khuzami. These initiatives include delegating to the Staff authority to issue a Formal Order empowering the Staff to issue subpoenas, an extensive restructuring of the Enforcement Staff, and initiatives to encourage cooperation.

Federal Securities Exchange Act of 1934. Chapter 9, *SEC Enforcement--Legal Considerations*. Regulation of Market Manipulation Chapter 9 provides an overview of the SEC's power to investigate and initiate legal proceedings against the entities and individuals it regulates. This chapter reviews the investigative process and related legal issues. This chapter has been revised to reflect the legislative responses to the 2008 Financial Crisis, as well as to the revelation of Bernard Madoff's massive fraudulent Ponzi scheme. In particular, the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Obama in July 2010, represents perhaps the largest overhaul of the enforcement powers of the SEC since its creation in the 1930s. Dodd-Frank has broadened not only the jurisdictional reach of the SEC and the federal securities laws, but also granted the SEC new enforcement powers. Furthermore, Dodd-Frank enhances whistleblower protection and rewards whistleblowers who supply new information to the SEC with ten-to-thirty percent of any fines recovered in excess of \$1 million. In addition to Congressional action, the SEC itself has demonstrated its intention to be a more forceful watchdog of the securities industry through the reorganization of its subdivisions in order to be more expeditious in the prosecution of securities violations. The SEC has already created specialized enforcement units staffed by professionals with extensive experience in specialized areas and has begun seeking and obtaining increased monetary penalties against wrong-doers. Accordingly, as a result of these recent legislative and administrative developments, it can be expected that individuals and entities subject to the federal securities laws will face a more vigorous and rigorous regulatory and investigatory regime for the foreseeable future.

Securities Primary Law Sourcebook. Some of the highlights in The Securities Primary Law Sourcebook update includes new Sections to the Securities Exchange Act 1934 such as § 4D-Additional Duties of Inspector General, § 4E-Deadline for completing enforcement investigations and compliance examinations and inspections, § 4F-Report and certification of internal supervisory controls, § 4G-Triennial report on personnel management, 4H-Annual financial controls audit and § 4I-Report on oversight of national securities associations. There are also new sections 15F and 15G, pertaining to Registration and regulation of security-based swap dealers and major security-based swap participants and Credit Risk Retention. There is also a new rule to facilitate interim Commission review of Public Company Accounting Oversight Board inspection reports under Section 104(h) of the Sarbanes-Oxley Act of 2002, and its Rules of Organization and Program Management and Rule of Practice to delegate authority to the Chief Accountant related to these reviews. Regulation P is established to include procedural rules relating to the Public Company Accounting and Oversight Board.



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§ .syn Synopsis to Chapter : GENERAL EDITOR'S SPECIAL ALERT

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§ I. Introduction to the National Securities Markets Improvement Act of 1996

§ II. Provisions of the Act Affecting the Securities Act of 1933 and the Securities Exchange Act of 1934

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[B] Commission Exemptive Authority

[C] Broker Dealer Margin Requirements

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§ IV. Provisions of the Act Affecting the Investment Company Act of 1940

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[B] Fund-of-Funds -- Amendments to Section 12(d)(1) of the 1940 act

[C] Registration of Indefinite Amount of Securities -- Amendments to Section 24(f) of the 1940 Act

[D] Advertising Flexibility -- New Section 24(g) of the 1940 Act

[E] Modification of Attribution Rule for Private Investment Companies -- Amendments to Section 3(c)(1) of the 1940 Act

[F] Exclusions for "Qualified Purchaser" Private Investment Companies -- Amended Section 3(c)(7) of the 1940 Act

[G] Expansion of Exclusion for Brokers and Financial Intermediaries -- Amendment to Section 3(c)(2) of the 1940 Act

[H] Exemption from Unit Investment Trust Requirements for Variable Insurance Contracts -- Amendments to Section 26 of the 1940 Act

§ V. Analysis and Conclusions by A. A. Sommer, Jr.



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**THE NATIONAL SECURITIES MARKETS IMPROVEMENT ACT OF 1996 _and_@_)_and_footnotes(n1);.vk
n1**

FOOTNOTES:

(n1)Footnote 1. This Special Alert was written by A.A. Sommer, Jr., the General Editor of the ***Securities Regulation Series***. Part IV, discussing the amendments to the Investment Company Act of 1940, was written by the co-authors of *Regulation of Investment Companies*, Thomas P. Lemke, Gerald T. Lins, and A. Thomas Smith III.

This Special Alert is not intended to be a complete summary or statement of all of the provisions of the National Securities Markets Improvement Act of 1996. Reference should be made to the text of the Act and the Conference Committee Report.



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1- Federal Securities Exchange Act of 1934 § I

§ I. Introduction to the National Securities Markets Improvement Act of 1996

On October 11, President Clinton signed into law the National Securities Markets Improvement Act of 1996 (H.R. 3005 -- "The Act") proclaiming it the "most significant overhaul of the securities regulatory structure in decades." The Act effected significant changes in the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940, and removed many anomalies and inefficiencies from securities regulation that had been discussed and sought for a long time.

The Act originated with two bills introduced in 1995 by Representative Jack Fields, chairman of the House Commerce Committee's Subcommittee on Telecommunications and Finance. The first would have amended the Investment Company Act of 1940; the second would have amended the 1933 and 1934 Acts. The latter, while containing in different form many of the provisions eventually enacted, also contained a number of highly controversial provisions that were omitted from the Act as enacted.



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§ II. Provisions of the Act Affecting the Securities Act of 1933 and the Securities Exchange Act of 1934

The following is a summary of the principal provisions of the Act affecting the Securities Act of 1933 ("the 1933 Act") and the Securities Exchange Act of 1934 ("the 1934 Act").

[A] Preemption of State Authority Over Securities Offerings

Perhaps the most significant change effected by the Act is the near total preemption of state authority over offerings of securities. Under amended Section 18 of the 1933 Act, no state may prohibit an offering or sale in the state, oppose additional disclosure requirements, impose "merit" standards, require the registration or qualification of a security or transaction, or prohibit or limit the use of any offering document prepared by or on behalf of an issuer in connection with an offering (including proxy statements and reports to shareholders required to be filed under Section 15A of the 1934 Act unless the issuer is incorporated in the state) if the security offered is a "covered" security. A "covered security is defined as:

- a security listed, or authorized for listing, on the New York Stock Exchange, the American Stock Exchange, the Nasdaq National Market System, and @ II) and footnotes(n1);vk n2 or listed or authorized for listing on a national securities exchange which the Securities and Exchange Commission ("Commission") determines has listing standards substantially similar to those of the named markets;
- a security that is equal in seniority or senior to a securities described in the preceding paragraph;
- a security issued by an investment company registered under the Investment Company Act;
- a security offered or sold to a "qualified purchaser" as defined by the Commission -- presumably the Commission will define such purchasers in a manner similar to the definition of "accredited investor" in Rule 501 under the 1933 Act;
- securities offered or sold pursuant to most of the exemptions contained in 1933 Act Sections 3(a) and 4 (in the case of Sections 4(1) and 4(3) the issuer must be a reporting company under the 1934 Act), the principal exceptions being the intrastate exemption in Section 3(a)(11) and the exemption in Section 3(a)(4) for securities issued by non-profit religious and eleemosynary institutions; and

1- Federal Securities Exchange Act of 1934 § II

- a security that will become a covered security under any of the foregoing definitions of covered security upon completion of the transaction.

The states may continue to impose filing requirements for documents filed with the Commission and for certain annual and periodic reports. The states may also require filing of consents to service of process and may impose filing fees (except for listed or to be listed securities and securities senior to them) in the amounts provided by state law on the day before the Act became effective. Moreover, the states under the Act continue to have the authority to investigate and bring enforcement actions for fraud and deceit or unlawful conduct by a broker or dealer.

With regard to brokers and dealers, while the states retain the power to require the registration of brokers and dealers subject to their jurisdiction, states may not impose requirements with respect to capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operating requirements that differ from or are in addition to those provided by federal law. In addition, the Act provides an exemption from registration in a state by an associated person of a broker or dealer if he or she makes an occasional sale in the state to a previous customer who is visiting for a short period in the state.

[B] Commission Exemptive Authority

The Act gives the Commission the authority to exempt by rule or regulation any person, security or transaction, or class of such, from any provision of the 1933 Act or rule or regulation thereunder "to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors." It is believed that this latter clause, which qualifies all of the Commission's rulemaking power, would preclude the Commission from exempting a security, person or transaction from the anti-fraud provisions of the federal statutes.

The Act gives the Commission a similar exemptive authority, expanded to include the authority to exempt by order, with respect to the 1934 Act.

[C] Broker Dealer Margin Requirements

The Act permits broker-dealers to borrow from sources other than banks. It also exempts from the margin requirements credit extended, maintained, or arranged to or for a member of a national securities exchange or other broker or dealer: (1) a substantial portion of whose business consists of transactions with persons other than brokers or dealers (e.g., a retail broker), or (2) to finance its activities as a market maker or an underwriter.

[D] Promotion of Efficiency, Competition, and Capital Formation

The Act requires the Commission in its rulemaking and other actions to take into account whether its action promotes efficiency, competition, and capital formation.

[E] Coordination of Supervision

The Act requires that the Commission and the self-regulatory organizations, through cooperation and coordination of their activities and sharing of information, eliminate unnecessary and burdensome duplication of examinations. Somewhat in anticipation of the adopted of this provision, in late 1995 the Commission, state regulators, and the SROs entered into a memorandum of understanding with respect to the coordination of activities.

[F] Commission Reports

Congress mandated that the Commission undertake to make studies and submit to it reports with respect to a number of matters.

1- Federal Securities Exchange Act of 1934 § II

- Congress directed the Commission to examine proposals for the privatization of the EDGAR system and to report on such examination within 180 days after adoption of the Act, and to include in such report recommendations for legislative action to implement any Commission proposals for privatization.
- Congress directed the Commission to make a study of the impact of technological advances, the use of on-line information systems on securities markets, and related matters and to make a report within one year after the adoption of the Act of the steps the Commission has taken to address such matters.
- Congress directed the Commission to study whether shareholder access to proxy statements by the submission of shareholder proposals had been impaired by recent statutory, judicial or regulatory changes, and the ability of shareholders to have proposals relating to corporate practices and social issues included as a part of proxy statements, and to report within a year, including recommendations for regulatory or legislative changes to improve shareholder access to proxy statements. This proposal stemmed from the 1992 Commission staff decision allowing corporations to exclude shareholder proposals regarding corporate employment practices.
- Congress directed the Commission to study "preferencing," i.e., the practice of a broker as a dealer on a national securities exchange directing a customer order to itself for execution as principal under rules that permit the broker to take priority in execution over same-priced orders or quotations entered prior in time, and to report within 6 months after adoption of the Act.
- The Commission was directed to report to Congress within one year on progress in the development of international accounting standards and the outlook for the successful completion of a set of international standards that would be acceptable to the Commission for offerings and listings of foreign corporations in U.S. markets. Earlier, the Commission had indicated its support for the effort of the International Accounting Standards Committee to develop suitable standards and indicated the characteristics they would be required to have to be acceptable to the Commission.

[G] Foreign Press Conferences

Responding to the complaints of financial writers that they were often excluded from the press conferences of foreign companies proposing to offer securities in the United States because of concerns with the registration and prospectus requirements of the 1933 Act, Congress directed the Commission to develop, within a year, rules concerning the status of foreign press conferences and foreign press releases under the registration provisions of the 1933 Act.

[H] Fees

The Act contains provisions with respect to the fees that the Commission may charge. It directs the Commission to collect registration fees under the 1933 Act that are designed to recover the costs to the government of the securities registration process and the costs related to that process. It also sets forth a new schedule of such fees under which the registration fees are reduced each year until 2007. For the first time, pursuant to the Act, security transactions off an exchange are subjected to the same fees to which transactions on exchanges have been subject.

FOOTNOTES:

(n1)Footnote 2. The text of the Act does not appear to include as a "covered security" a security offered for listing on the Nasdaq National Market System; this appears to have been a drafting error. 142 Cong. Rec. E1928 (October 4, 1996) (statement of Rep. Bliley).



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1- Federal Securities Exchange Act of 1934 § III

§ III. Provisions of the Act Affecting the Investment Advisers Act of 1940

Title III of the Act contains the Investment Advisers Supervision Coordination Act, which amends the Investment Advisers Act of 1940.

The principal effect of the Act on the Investment Advisers Act of 1940 is the partial federal preemption of the regulation of investment advisers. The Act accomplishes this by providing that no investment adviser regulated or required to be regulated in the state in which it maintains its principal office and place of business may register with the Commission unless it manages assets of not less than \$25 million (or such higher figure set by the Commission) or is an adviser to an investment company registered with the Commission under the Investment Company act of 1940, and that no state may require an investment adviser registered with the Commission to register, secure a license, or qualify under any state law. This formulation was apparently adopted to assure that no small investment advisers located in states that do not regulate investment advisers would be required to register with the Commission.

States may continue to require the registration of investment adviser representatives (broadly defined in the Act) if they have an office in the state.

States may not impose books and records, minimum capital, or bond requirements on advisers licensed in other states in addition to those required by the licensing state if the adviser is in compliance with those requirements. In addition, states may not require the licensing, registration, or qualification of anyone exempted from registration under the Investment Advisers Act of 1940 or of any investment adviser that does not have a place of business in the state and during the preceding twelve months has had fewer than six clients resident in the state.

Consistently with other provisions of the Act, the states' authority to investigate and bring enforcement actions with respect to fraud and deceit is preserved, and states may require the filing of anything filed with the Commission for notice purposes and continue to impose the fees in effect on the day before adoption of the Act.

In recognition of the Commission's frequent complaint about its ability to regularly examine investment advisers, the Act authorizes \$20 million in each of 1997 and 1998 for enforcement of the Investment Advisers Act of 1940.



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1- Federal Securities Exchange Act of 1934 § IV

§ IV. Provisions of the Act Affecting the Investment Company Act of 1940

Title II of the Act contains the Investment Company Act Amendments of 1996. The most important of the amendments affecting investment companies are set forth below.

[A] Partial Preemption of State Registration Requirements -- Amendments to Section 18 of the Securities Act of 1933

One of the most important aspects of the National Securities Markets Improvement Act of 1996 is the partial preemption of state "blue sky" registration and disclosure requirements for mutual funds. Under amended Section 18 of the Securities Act of 1933, states may no longer impose registration or qualification requirements on certain sales of securities, including shares of registered investment companies. States are also precluded from reviewing mutual fund prospectuses and advertising.

However, states retain the authority to require investment companies to file, for notice purposes, any documents filed with the SEC and to continue to collect filing fees. States also retain jurisdiction to investigate and bring enforcement actions for fraud and deceit.

[B] Fund-of-Funds -- Amendments to Section 12(d)(1) of the 1940 act

The Investment Company Act amendments permit fund-of-fund structures within an investment company without an exemption from the SEC. Under amended Section 12(d)(1)(G) of the 1940 Act, a registered open-end investment company or unit investment trust (an "upper-tier fund") may acquire shares or units of other open-end funds or unit investment trusts ("lower-tier funds") within the same group of investment companies without percentage limitations, as long as:

- the shares or units are the only investments held by the upper-tier fund (other than government securities and short-term paper):
- distribution-related fees or charges are not charged by both the upper-tier and lower-tier funds, or, alternatively, the aggregate distribution-related charges at both levels are not excessive under SEC rules; and

- the lower-tier fund may not itself invest in shares or units of registered investment companies or unit investment trusts.

[C] Registration of Indefinite Amount of Securities -- Amendments to Section 24(f) of the 1940 Act

Under amended Section 24(f), commencing in October 1997 (or earlier if the SEC adopts rules), registered open-end investment companies and unit investment trusts will be deemed automatically to have registered an indefinite amount of securities and will pay registration fees based on the net amount of new shares or units sold (i.e., purchases less redemptions).

[D] Advertising Flexibility -- New Section 24(g) of the 1940 Act

Under new Section 24(g) of the 1940 Act, mutual fund advertising restrictions will be eased. Section 24(g) directs the SEC to adopt rules and regulations to permit advertising that includes information "the substance of which is not included in a [Section 10(a)] prospectus"

[E] Modification of Attribution Rule for Private Investment Companies -- Amendments to Section 3(c)(1) of the 1940 Act

The amendments significantly reduce the need for a private investment company to look through and count the underlying owners of an entity investing in it as its beneficial owners. Under amended Section 3(c)(1)(A) of the 1940 Act, the ownership of the private investment company is attributed to the underlying owners of the investing entity only if the investing entity itself is an investment company or an entity relying on the exclusion from the definition of an investment company in Sections 3(c)(1) or 3(c)(7).

[F] Exclusions for "Qualified Purchaser" Private Investment Companies -- Amended Section 3(c)(7) of the 1940 Act

The amendments provide an exclusion for a new type of private investment company. Under amended Section 3(c)(7) of the 1940 Act, effective October 1997, a company is excluded from the definition of an investment company if its outstanding securities are owned only by "qualified purchasers" and it is not making or proposing to make a public offering of its securities.

A "qualified purchaser" is defined in new Section 2(a)(51)(A) of the 1940 Act to include the following categories of persons:

- a natural person with at least \$5,000,000 in investments;
- certain family-owned companies owning at least \$5,000,000 in investments; and
- any person who, for its own account or for other qualified purchasers, owns and invests on a discretionary basis at least \$25,000,000 in investments.

[G] Expansion of Exclusion for Brokers and Financial Intermediaries -- Amendment to Section 3(c)(2) of the 1940 Act

In recognition of the growing number and complexity of financial instruments, Congress expanded the class of intermediaries entitled to rely on the exclusion from the definition of an investment company in Section 3(c)(2) of the 1940 Act. Under amended Section 3(c)(2), in addition to certain underwriters, distributors, and brokers, a "market intermediary" is excluded from the definition. A "market intermediary" is a person who holds itself out as being willing to engage in transactions on both sides of individually negotiated financial contracts, such as swaps, repurchase

agreements, and options.

[H] Exemption from Unit Investment Trust Requirements for Variable Insurance Contracts -- Amendments to Section 26 of the 1940 Act

Under new Section 26(e) of the 1940 Act, the trustee and custodian requirements governing unit investment trusts do not apply to any registered separate account funding variable annuity contracts, or the sponsoring insurance company and principal underwriter of the account, provided:

- the various fees and charges for the contract are reasonable; and
- the insurance company files annual financial information with the appropriate state insurance authority evidencing a combined capital and surplus of \$1,000,000.



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CHAPTER SA-1 GENERAL EDITOR'S SPECIAL ALERT

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§ V. Analysis and Conclusions by A. A. Sommer, Jr.

The National Securities Markets Reform Act of 1996 accomplished numerous reforms which virtually all practitioners and people in the securities industry regarded as long overdue without endangering investor protections. As capital markets have become increasingly global, the necessity of multiple state registration in addition to federal registration has become increasingly anomalous. The original scheme which carefully preserved state jurisdiction was the fruit of an age in which "states rights" were accorded deep respect and during which the national nature of the capital markets was less clear. The dual system of registration endured as long as it did because of the adoption of a number of devices designed to ease the burdens of the system (e.g., registration by coordination and notification, exemptions for offerings of securities to be listed, etc.).

In the final analysis, the states preserved perhaps their most important power which was imperiled in the first draft of the eventually enacted Act, namely, the undiminished power to pursue fraud committed within their jurisdictions. In addition, they continue to share concurrent jurisdiction over offerings of securities registered with the Commission which are not going to be listed. Thus, limited partnerships public offerings, initial public offerings of securities that will be traded in the NASDAQ Small Cap Market or in the "pink sheets," and offerings of numerous other types of "exotic" securities will continue to be subject to the full authority of the states where the offering is made.

Perhaps the main beneficiaries of the preemption are the investment companies that have historically been restrained because of the sometime vagaries of state regulation, many of which were recounted during the course of Congressional testimony on the Act.

The states retain considerable, if somewhat attenuated, authority with respect to brokers and dealers. However, the signals are clear in the Act and the dialogue leading to its enactment that failure by the states to use their authority in a less burdensome manner may result in the forfeiture of virtually all authority with respect to brokers and dealers.

The Commission received enhanced power to adopt rules and regulations providing exemptions under the 1933 and 1934 Acts. This eliminates the awkward necessity of using questionable "definitions" and other circuitous means to achieve needed exemptions, such as those included in Regulation D and Rule 144. The enhanced power opens the door to a more comprehensive and conceptually consistent overhaul of the disclosure system such as that reflected in the proposals of the Commission's Advisory Committee on the Capital Formation and Regulatory Processes.

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The division of jurisdiction over investment advisers between the states and the Commission is a sensible way of assuring better policing of an activity that has never received the attention it should receive and which poses increasing peril to investors. Hopefully, the overall quality, quantity, and effectiveness of investment adviser will be considerably enhanced with the Act's direction that the SEC focus attention on the larger advisers and that the states retain unfettered opportunity to regulate small advisers.

The requirement in the Act that the Commission, in rulemaking, take into account efficiency, competition, and capital formation is unlikely to affect the Commission's rulemaking since the Commission would undoubtedly deny that any of its rulemaking ever mandated inefficiencies or hampered competition or capital formation.

Absent from the final version of the Act were some of the more controversial provisions of the original Fields bill, such as a provision that would have sharply reduced the ability of institutional investors to assert lack of suitability claims against broker-dealers. Apparently, the initiative of the National Association of Securities Dealers in adopting a rule governing suitability for institutional investors prompted Congress to drop this proposal. However, if Congress believes that the NASD rule, in practice, has not struck a fair balance, it may revisit the issue down the line.

The reports the Commission is directed to make after the numerous mandated studies may constitute the agenda for future legislation. However, it is doubtful that Congress will revisit the fundamentals of securities regulation in the near term. In the Act, Congress has addressed the most troublesome problems in the current securities regulation scheme and has given the Commission significantly increased power to deal with future problems. Perhaps the most pertinent question until the end of this century and somewhat beyond is how the Commission will use its enhanced powers.



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CHAPTER 1 The Securities Exchange Act of 1934 and the SEC *

1-1 Federal Securities Exchange Act of 1934

SUMMARY OF THIS CHAPTER

The Securities Exchange Act of 1934 ("Exchange Act") is the foundation of the collection of Federal laws governing the nation's securities markets. It created the Securities and Exchange Commission ("SEC") as the primary Federal regulatory body for the nation's capital markets. The Exchange Act provided the SEC with broad authority in two areas: (1) to register and regulate stock exchanges and broker-dealers and the conduct of business in the purchase and sale of securities in the secondary market; and (2) to establish continuing public disclosure requirements for public companies listed on a stock exchange. The Exchange Act augmented this authority by transferring responsibility for administration and enforcement of the Securities Act of 1933 from the Federal Trade Commission to the SEC. In future years, as Congress passed new complementary laws, responsibility for these laws was assigned to the SEC. Congress provided the SEC with broad anti-fraud powers to effectively enforce compliance with these laws.

The capital markets of the United States have grown dramatically and Congress has periodically amended the Exchange Act, and the other Federal securities laws, to provide the SEC with greater authority as needed to fill gaps and to regulate an increasingly complex, sophisticated and, now global, market. Since its enactment, the Exchange Act has been amended or augmented by new laws, for example:

- The Maloney Act of 1937 permitted the organization of national securities associations to provide self-regulation of brokers and dealers;
- The Reorganization Plan 10 of 1950 fundamentally changed how the SEC functions by transferring administrative and decisional authority from the five member Commission to the Chairman of the Commission;
- The 1964 Amendments extended the Exchange Act's periodic disclosure system and other requirements to over-the-counter securities and provided authority necessary to enable the SEC to effectively regulate the OTC market;
- The Williams Act expanded the Commission's authority to require persons and institutions to disclose significant acquisitions of stock in a company and to regulate cash tender offers and other

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change in control transactions;

- The Securities Investor Protection Act of 1970 created the Securities Investor Protection Corporation ("SIPC") to provide federal insurance for customers' deposits of cash and securities in the hands of broker-dealers;

- The Securities Acts Amendments of 1975 expanded Commission authority over exchanges and SRO's to facilitate the adoption of a national market system and increase competition through the elimination of fixed commission rates;

- The Foreign Corrupt Practices Act of 1977 provided Commission authority to regulate internal corporate activities concerning creation of books and records and internal systems for preparing financial statements and to make it unlawful for domestic business concerns to engage in certain corrupt practices involving foreign officials;

- The Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988 established money penalties for unlawful trading on the basis of material nonpublic information and created liability for control persons;

- The Securities Enforcement Remedies and Penny Stock Reform Act of 1990, greatly expanded the Commission's enforcement powers of the Commission by expanding the penalties and remedies that could be imposed upon violators and strengthened regulation of the penny-stock market;

- The Market Reform Act of 1990, enhanced the power of the Commission to address market volatility problems and the Securities Acts Amendments of 1990, expanding the authority of the Commission to cooperate with foreign securities regulators;

- The Private Securities Litigation Reform Act of 1995 enabled public companies to expand disclosure of forward-looking information and reduced the likelihood of private class action lawsuits based on fraud;

- The National Securities Markets Improvement Act of 1996 limited state authority to regulate issuers of securities, investment companies and investment advisers;

- The Gramm-Leach-Bliley Act of 1999, repealed the Glass-Steagall Act which prohibited banks, securities firms and insurance companies from affiliating; and

- The Sarbanes-Oxley Act of 2002 created the Public Company Accounting Oversight Board and implemented a wide range of new restrictions and requirements on corporations and their officers and directors designed to increase the quality of corporate disclosure and to enhance public investor confidence in the integrity of the financial markets.

The Securities and Exchange Commission administers the Exchange Act, as well as the Securities Act of 1933, the Public Utility Holding Company Act of 1935 (repealed in 2005), the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisors Act of 1940. In addition, the Commission serves as advisor to federal courts in corporate reorganization proceedings under Chapter 11 of the Bankruptcy Code. The Commission consists of five members, no more than three of whom may belong to the same political party. Members are appointed by the President, with the advice and consent of the Senate, for five-year terms, one term ending each year. The President designates the Chairman of the Commission. See § 1.02 *infra*

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The Commission exercises its regulatory authority by adopting rules and regulations appropriate to implement the provisions of the statutes that it administers. In addition, the SEC performs informal assistance to the public and companies subject to SEC regulation through the issuance of interpretations and "no action" letters to inform the public of the Commission's position regarding the applicability of such statutes and to guide prospective registrants and others in complying with those laws. Furthermore, the Commission exercises its regulatory authority by registering, regulating and inspecting exchanges, SRO's, broker-dealers, investment companies and investment advisers, including affiliated persons; and by investigating possible violations of the federal securities laws. Finally, the SEC institutes enforcement proceedings either in an administrative proceeding or in federal district court. See § 1.03 *infra*

* This chapter has been updated by Jonathan G. Katz. Mr. Katz served as the Secretary of the U.S. Securities and Exchange Commission from 1986 until his retirement in 2006.



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CHAPTER 1 The Securities Exchange Act of 1934 and the SEC *

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§ 1.01 Securities Exchange Act of 1934

The Securities Exchange Act of 1934 n1 has two general purposes. First, the 1934 Act augments the disclosure requirements of the Securities Act of 1933 ("1933 Act") by compelling publicly held corporations to periodically furnish to the record holders and prospective purchasers of their securities information about their corporate affairs substantially comparable to that required of issuers under the 1933 Act. n2 The second purpose of the 1934 Act is to regulate broker-dealers and the markets for post-distribution purchases and sales of securities. n3 The 1934 Act, unlike the 1933 Act, is not a cohesive and unified piece of legislation; rather, it sets forth, section by section, the areas within the securities industry and securities markets which Congress believed required regulation and the means by which that regulation was to be imposed.

The scope of the 1934 Act was substantially broadened by amendments in 1964 and 1975. n4 The 1964 amendments imposed on issuers of securities traded in the over-the-counter market the requirements formerly applicable only to issuers of exchange listed securities. The 1975 amendments significantly enhanced the oversight function of the Securities and Exchange Commission with respect to the securities markets and their related self-regulatory organizations and services.

In 1977 the Foreign Corrupt Practices Act prohibited issuers subject to the jurisdiction of the SEC from paying bribes to foreign officials, n5 and imposed accounting standards upon reporting companies to insure the integrity of accounting records and reports and to require the establishment and maintenance of internal accounting controls.

The Exchange Act also was amended by the Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988, which created money penalties for persons who unlawfully traded on the basis of material nonpublic information and strengthened the enforcement of the laws against securities fraud. The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 significantly expanded the authority of the Commission to enforce compliance with the securities laws and strengthened regulation of the penny-stock market; the Market Reform Act of 1990 gave the Commission new powers to address problems of market volatility; and the Securities Act Amendments of 1990 expanded the authority of the Commission to cooperate with foreign securities regulators, and sought to improve communications between investment companies and their shareholders. In 1996 the Private Securities Litigation Reform Act imposed various restrictions on private litigation under the securities laws. The Sarbanes-Oxley Act of 2002 increased management accountability for their company's financial statements, prohibited loans to management, improved disclosure of management's securities transactions in their company's securities and

created a new SRO for the accounting profession, the Public Company Accounting Oversight Board.

[1] Historical Background

The possibilities of broker-dealers defrauding their customers in securities transactions in general are as old as the concept of the corporation. In his treatise the late Professor Loss pointed out that there were attempts to regulate such activities in England as far back as 1285. n6 The problems associated with the purchase and sale of corporate securities had been recognized in this country long before the 1934 Act was enacted, and there had been numerous attempts at the state level to deal with the problems by enactment of the so-called Blue Sky laws. n7 Many of these laws required and still require a broker or dealer to register in a state before doing business there and generally required a screening process involving a showing of character and ability on the part of an applicant. Most Blue Sky laws also required the filing of statements of financial responsibility and provided for control of the distribution of securities sold within the state, with differing measures of control and criteria for approval.

As the national economy grew in complexity, complicated questions of conflict of laws in interstate transactions became rather common because the different states' securities laws varied greatly in their approach to securities fraud. Thus the Blue Sky laws alone proved ineffective as a method of control. n8

Following the stock crash of 1929, the report of the Pecora Committee, n9 revealed how easily the general public could be victimized when purchasing an exchange-listed security. n10 The report demonstrated that there was a great need to regulate the post-offering purchase and sale of securities in addition to the regulatory scheme for the initial offering of securities created by the Securities Act of 1933.

There was no consensus initially on the breadth of the regulatory scheme for the secondary market or on which Federal agency should have the responsibility. The New York Stock Exchange and securities industry strongly opposed Federal regulation in general and particularly if the Federal Trade Commission, the agency administering the Securities Act, became the regulatory body. Creation of a separate agency devoted exclusively to securities regulation was the compromise that prevailed.

[2] Coverage of the Exchange Act

The Exchange Act was enacted to address two broad regulatory goals -- creating a system of registration, regulation and oversight of securities exchanges, broker-dealers and the business of engaging in the purchase and sale of securities in the secondary market; and establishing a continuing disclosure obligation for public companies with securities listed on a stock exchange. Initially the SEC's authority regarding the same activity in the over the counter market was extremely limited. This authority would not be provided for thirty years with Congressional enactment of the Securities Act amendments of 1964.

To regulate the stock markets, the Exchange Act originally authorized the Commission to:

- Require stock exchanges to register with the Commission and subsequently file changes in any rules;
- Require broker-dealers to register with the Commission;
- Adopt rules governing trading;
- Suspend trading in a security for up to ten days;
- Enforce prohibitions on fraudulent and manipulative conduct.

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The Exchange Act authorized the Board of Governors of the Federal Reserve Board to set limits on margin loans by broker-dealers to customers and authorized the SEC to enforce these limits. The Federal Reserve also had authority to regulate borrowing by broker-dealers.

To ensure that the investing public had access to current information on public companies with securities trading in the secondary market, the Exchange Act authorized the Commission to adopt rules requiring companies to periodically release reports containing information about the company's operations, including annual audited financial statements. The Act also authorized the SEC to adopt national accounting standards for public companies; a responsibility that the Commission deferred to the accounting profession.

The Exchange Act created specific disclosure requirements for reporting trades by officers and directors and major investors in public companies and imposed a minimum holding period of six months on these persons, enforceable by private action. It also provided the Commission with the authority to mandate disclosure for proxy solicitations. Since the enactment of the Exchange Act and the creation of the SEC, there have been numerous amendments to the law greatly expanding the SEC's authority to achieve these two initial goals.

Today the Commission authority over exchanges and broker-dealers extends to almost every area of the securities industry and imposes obligations and prohibitions on its constituents, including issuers of securities, stock exchanges, brokers and dealers, municipal securities dealers and brokers, securities associations, clearing agencies and depositories, transfer agents and registrars, institutional investment managers, securities information processors and most recently credit rating agencies.

The 1934 Act's reporting provisions require a corporation with a security registered with the Commission to file with the Commission and each stock exchange on which the corporation has a listed security, periodic reports of its activities (including financial statements), and to prepare and distribute an annual report to its stockholders. To keep the information current, the registrant corporation must also file frequent periodic reports concerning important corporate events. n11 Commission authority pursuant to the Exchange Act over corporate reporting also encompasses:

- Soliciting proxies for voting in corporate elections and on other matters, which is made subject to SEC control. n12
- Acquiring corporate control by means of a tender offer which also is subject to Commission control. n13
- Limiting profits from short term trading by insiders in securities of their corporation. n14

Under the Exchange Act the Commission has broad authority to regulate the securities markets, broker-dealers and associated persons in a variety of ways:

- The stock exchanges and securities associations are required to register with the Commission n15 and their rules must be consistent with the requirements of the Exchange Act and the rules thereunder and are subject to Commission approval. In addition, the Commission conducts examinations and exercises supervisory authority over activities on registered exchanges and in the over-the-counter markets. n16
- Brokers and dealers are required to register n17 with the SEC and to furnish in connection therewith certain financial information, to maintain books and records required by Commission and SRO rules, n18 and to maintain sufficient liquid reserves as determined by Commission rules. n19 Provision is made for

a measure of self-regulation. n20 However, the exchanges, the Municipal Securities Rulemaking Board, and registered clearing agencies are also significant self-regulatory bodies.

- Certain activities by brokers or dealers which would interfere with an honest and free and open market are proscribed. n21
- Fraud in the purchase and sale of securities is generally proscribed. n22
- Control over the use of credit in securities transactions is vested in (a) the Federal Reserve Board for the establishment of standards, and (b) in the SEC for enforcement. n23

[a] Reorganization Plan 10 of 1950.

James Landis had a greater role in developing the Federal securities laws and outlining the operation of the SEC than any other one person. He, Benjamin Cohen and Thomas Corcoran were the principal authors of the Securities Act of 1933, the Exchange Act and the Public Utility Holding Company Act of 1935. He was one of the original five members of the Commission and was its second Chairman. In 1949 President Truman enlisted his services to conduct a comprehensive review of the operations of independent regulatory agencies (a task he would perform a second time in 1960 for President-elect Kennedy). His report to President Truman resulted in Congress enacting the Reorganization Plan 10 of 1950, n24 which fundamentally changed the role of the Chairman and the division of responsibility of the Chairman and the Commission as a decisional body.

Under the Plan the President was provided with formal authority to designate which of the five commissioners would be Chairman. While appointment as a Commissioner would continue to be for a fixed term, the designation of Chairman would be discretionary with the President. The Chairman would become a true executive function. Responsibility for the selection of staff, assignment of duties, allocation of budget and control over the agenda of Commission actions was transferred to the Chairman. n25

[b] The 1964 Amendments.

In 1964 Congress enacted a comprehensive series of amendments to the Federal securities laws. The focus of the 1964 amendments was the expansion of the basic Exchange Act regulatory system to the over the counter market. For the first time, the SEC could broadly regulate both the activities of the OTC market and impose disclosure requirements on companies with stock trading OTC.

A new section 12(g) of the Exchange Act extended the provisions of Section 12 (the security registration requirements), Section 13 (the periodic reporting requirements), Section 14 (the regulation of proxies), and Section 16 (the regulation of insider trading), with some modifications concerning banks, insurance companies and other designated exempt entities, to all corporations doing an interstate business and having assets over \$1 [now \$10] million and more than 500 stockholders. n26

Prior to 1964, few banks were listed on any stock exchange and such securities were (and still are) specifically exempted from the registration requirements of the 1933 Act by Section 3(a)(2) of that Act. n27 The 1964 amendments extended the periodic disclosure and other disclosure reporting obligations to banks. However regulatory authority for compliance with these requirements was assigned to the appropriate bank regulatory agency. n28 The Act also transferred to those agencies all administration and enforcement powers that the Commission possesses under the Exchange Act with respect to other corporations. n29

Rules and regulations applicable to banks and bank securities have been adopted by all the federal agencies involved.

The 1964 Act amendments created an analogous disclosure regulatory scheme for registration of insurance companies (but, again, not to a holding company owning an insurance company). Under Section 12(g)(2)(G) of the Exchange Act insurance company securities were exempted from the registration requirements of Section 12(g) if the company filed an annual statement with its domiciliary insurance commissioner conforming to a standard form prescribed by the National Association of Insurance Commissioners, was subject to proxy regulations conforming to those prescribed by the same Association, and was domiciled in a state that had adopted insider trading restrictions substantially similar to those contained in Section 16 of the 1934 Act. n30 They continued to be covered by the periodic disclosure requirements of the Act.

The 1964 amendments also extended many of the Commission's powers over trading on an exchange to trading OTC, such as the power to suspend trading in a security for up to ten days and the power to grant or deny unlisted trading privileges in an OTC stock on an exchange. The Commission's enforcement powers were also expanded. A new provision, section 15(c)(4) of the Exchange Act empowered the Commission to bring administrative proceedings against an issuer to determine whether it has failed to comply with the Act or a regulation thereunder and to issue an order requiring compliance. n31 A new provision of far greater significance was section 15(b)(7) [subsequently section 15(b)(6)]. This enabled the Commission to bring administrative proceedings against persons associated with a broker-dealer who violated the securities laws. Through this proceeding, the Commission could censure, suspend for up to twelve months or bar the individual from association with any broker-dealer. The Commission was also authorized to impose lesser sanctions, censures or suspension of up to twelve months, on broker-dealers. The grounds for denying or revoking a broker-dealer registration or other disciplinary sanction were also expanded. These new bases included willful violations of the Investment Company Act, the Investment Advisers Act, willful aiding or abetting violations, and, importantly, a broker-dealer's failure reasonably to supervise another person who commits a violation.

In an effort to improve the self-regulatory process, the 1964 amendments required the NASD, as the only registered securities association, to develop a system for training, testing and qualifying persons seeking to become associated with a broker-dealer. The NASD was also required to develop rules and regulations for the fair reporting of quotations and to develop procedures for collecting and publishing these quotations. This was the beginning of what would become NASDAQ.

[c] Williams Act Amendments.

Prior to 1968, if a corporation sought control of another by a stock-for-stock exchange, the offer was required to be registered under the Securities Act of 1933. Each shareholder was furnished a prospectus containing all material facts about the offer. Where corporate control was sought through a proxy contest, Section 14 of the 1934 Act also required that shareholders be informed of the identity of the participants and of their plans for the acquired company. When shares were purchased with borrowed funds, the lender's identity had to be disclosed if the funds were obtained otherwise than through a bank loan or margin account. In both the exchange offer and proxy fight, the information was required to be filed with the Commission and was subject to statutory requirements and sanctions. n32

In contrast, when a cash tender offer was made, no information was required to be filed or disclosed to shareholders. Since a cash tender offer was similar to a proxy contest, there appeared to be no justification for the exclusion of cash tender offers from the disclosure provisions of the securities laws. By the enactment of legislation to close the gap in 1968, Congress eliminated the process that allowed a person to acquire corporate control by a cash tender offer without any disclosure. Popularly known as the Williams Act, n33 after the sponsor, Senator Harrison Williams, it added subsections (d) and (e) to Section 13 of the Exchange Act and subsections (d), (e), and (f) to Section 14 to provide for full disclosure of corporate ownership of securities when a person or group of persons seeks to acquire a substantial block of securities of a corporation by a cash tender offer, alternatively called a "takeover bid," or when a corporation purchases its own securities. n34

In December 1970, the provisions of Sections 13(d) and 14(d) were extended by legislation to acquisitions of and tender

offers for securities of insurance companies. n35 Sections 13(d)(1) and 14(d)(1) were also amended to require full disclosure of acquisitions of and tender offers for over 5 percent of a company's stock. n36 In addition, the legislation subjected stock-for-stock exchange offers made pursuant to a registration statement under the Securities Act of 1933 to the tender offer requirements of Section 14(d) of the 1934 Act. n37 Further, Section 14(e) was amended to give the Commission additional rulemaking power to deal with certain types of fraudulent, deceptive, and manipulative practices. n38 Finally, the Commission was authorized to adopt rules and regulations to permit it to differentiate between control persons and issuers in filings required under Section 13(e). n39

Three other amendments to the Exchange Act were enacted during this period:

- (1) The Securities--Credit--Regulation Act amended Section 7 of the Exchange Act to extend margin requirements to over-the-counter securities. n40 See § 3A.02 at n.5 *infra*
- (2) The Securities--Institutional Investors--Effect on Markets Act added a new subsection(e) to Section 19 of the Exchange Act authorizing the Commission to investigate the effect of the operations of institutional investors on the securities markets. n41
- (3) The Bank Records and Foreign Transactions Act extended the applicability of the margin requirements to purchasers of stock, including American companies, their subsidiaries and others who make foreign purchases of U.S. corporate stock, broker-dealers, and financial institutions that lend money for such purposes. n42 See § 3A.02[1] *infra* for discussion of margin requirements pursuant to Section 7.

[d] Securities Investor Protection Act of 1970 ("SIPA").

In the latter part of the 1960s large increases in daily trading volume in the securities markets overwhelmed the capacity of many broker-dealers to clear and settle daily trading. The largely manual processes and the reliance on physical transfer of paper certificates caused some firms to be unable to accurately balance their books and properly record customer transactions. Several major brokerage firms failed. n43 The "paperwork crisis" of the late 1960s led to substantial losses for investors and securities firms, and the failures of more than 100 brokerage firms jeopardized the continued operation of the securities markets.

Prior to 1971, stock exchanges assumed liability for the obligations of an insolvent member firm to its customers and established guaranty funds to cover the obligations. Customers of insolvent broker-dealers who were not members of the stock exchange that established the fund, however, received no protection. Moreover, because the fund was voluntary and not required by law, there was no legal obligation for the exchange to protect the customers of its own members, and the desired protection was at best uncertain.

In response, Congress enacted the Securities Investor Protection Act of 1970, n44 which provided for the establishment of the Securities Investor Protection Corporation ("SIPC"). Congress sought to provide greater protection for customers by insuring their cash and securities in the custody of broker-dealers. The SIPA was amended in 1978 n45 to enhance investor confidence in the securities markets by addressing limitations on the SIPC's ability to adequately provide protection for customers and by responding to some problems arising in SIPA liquidation proceedings. Section 9(a) of the Securities Investor Protection Act was amended by the Securities Investor Protection--Right to Financial Privacy Act Amendments of 1980 n46 to increase the SIPC coverage on customers' assets maintained with broker-dealers from \$100,000 to \$500,000 (but not more than \$100,000 with respect to cash assets). n47 For a detailed discussion of the SIPA, see § 3.07[2] *infra*.

[e] Securities Acts Amendments of 1975.

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The Special Study of the Securities Markets completed its multi volume report to the SEC and Congress in 1963. It provided a comprehensive picture of the problems that existed in the nations securities markets and regulatory system and offered an extensive array of recommendations to address these problems. The paperwork crisis of the late 1960's provided the catalyst for Congress to eventually act by passing the Securities Act amendments of 1975. The Securities Acts Amendments of 1975 n48 contained the most significant and comprehensive legislation affecting the securities markets since the enactment of the Exchange Act itself. n49

The three principal purposes of the Exchange Act amendments in 1975 were:

- developing a national market system to modernize the securities industry and securities markets;
- coordinating clearance and settlement of securities transactions; and
- regulating municipal securities dealers and brokers.

The Senate Committee Report n50 characterized the securities industry as operating in 1975 by the same methods employed in the 1930's, resistant to modernization, and unresponsive to radically altered economic and technological conditions. The Senate Committee Report stated:

The Securities Industry Study Report of the Subcommittee on Securities (S. Doc. No. 93-13, 93d Cong., 1st Sess. 1973) identified a number of causes for the securities industry's languor in the face of great change and great opportunity: price fixing with respect to commission rates, artificial restrictions on market making activities, unjustified barriers to access to markets and market makers, opposition to market integration from powerful vested interests, monopoly control of essential mechanisms for dissemination of market information, and the absence of effective control of market developments and operations by the Securities and Exchange Commission ... n51

In place of the existing fragmented and inefficient markets, the 1975 amendments contemplated a national securities market system utilizing modern communication and data processing equipment. The efficiency of existing markets would be improved by the elimination of the undesirable practices and restrictions referred to by the Senate Committee.

[i] Fixed Commission Rates.

Schedules and fixed rates of commissions, allowances, discounts, and other fees of national securities exchanges were eliminated, with limited exceptions. However the amendments permitted fiduciaries to pay for research services with brokerage commissions (so-called "soft dollars"), but not in the form of "give-ups." n52

[iii] Self-Regulatory Organizations; Commission Oversight.

The 1975 amendments fundamentally altered the relationship between the SEC and the SROs. It made explicit the responsibilities of the SRO's to: adopt procedures for corporate governance and the selection of directors; adopt rules that are not a burden on competition; prevent fraudulent and manipulative acts and practices and to promote just and equitable principles of trade; remove impediments to a national market system; and protect investors and the public interest. n53

The Commission's power to oversee the rulemaking, disciplinary, and other functions of self-regulatory organizations (securities exchanges, the NASD, registered clearing agencies, and the Municipal Securities Rulemaking Board) was increased and made unequivocal. All SRO rules must be filed with the Commission and could be disapproved by the Commission. Additionally, the Commission was authorized to amend the rules of any self-regulatory agency (other than

a clearing agency) in any respect consistent with the 1934 Act. n54

The Commission was also empowered to take enforcement action against an exchange or SRO for a violation of the securities law or regulations or the rules of the SRO. The SEC could also take action to enforce the rules of an SRO.

[iii] National Market System.

The 1975 amendments created section 11A of the Exchange Act, which states:

(1) The Congress finds that--

(A) The securities markets are an important national asset which must be preserved and strengthened.

(B) New data processing and communications techniques create the opportunity for more efficient and effective market operations.

(C) It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure--

(i) economically efficient execution of securities transactions;

(ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;

(iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;

(iv) the practicability of brokers executing investors orders in the best market; and

(v) an opportunity, consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors' orders to be executed without the participation of a dealer.

(D) The linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders.

(2) The Commission is directed, therefore, having due regard for the public interest, the protection of investors, and the maintenance of fair and orderly markets, to use its authority under this title to facilitate the establishment of a national market system for securities.

Section 11A directed the Commission to create a National Market Advisory Board to recommend actions that the Commission should take to facilitate the implementation of a national market system, and to study the need for a new self-regulatory organization to administer the system. The Board was required to submit its report to Congress no later than December 31, 1976. Section 11A also created a registration requirement and regulatory system for Commission oversight of securities information processors. The national market system for securities and the Commission's oversight role in its implementation and operation are discussed in § 2.05 *infra*.

[iv] Self-Dealing and Combination of Money Management and Brokerage.

With certain exceptions, members of national securities exchanges were prohibited, n55 from effecting transactions on their exchanges for:

- (a) their own accounts,
- (b) the accounts of associated persons, or
- (c) accounts with respect to which they or associated persons exercise investment discretion.

The commission was empowered to regulate or prohibit such self-dealing and combination of money management and brokerage:

- (a) by exchange members in transactions exempted from the prohibition described in the preceding sentence:
- (b) in transactions executed in the over-the-counter market by exchange members, brokers, or dealers; and
- (c) in transactions effected on a national securities exchange by brokers or dealers who are not members of the exchange. n56

[v] Registration and Regulation of Brokers and Dealers.

The 1975 Amendments made various changes in the provisions concerning brokers and dealers, including those dealing with registration, sanctions, capital rules, financial statements, and minimum standards of training, experience, and competence. n57 Effective December 1, 1975, brokers and dealers who conducted all their trading on the floor of an exchange (such as specialists, floor traders, and floor brokers) were required to register under Section 15. The Commission's power to regulate specialists and other market-makers was increased.

[vi] Municipal Securities Dealers and Brokers.

When the Exchange Act was adopted in 1934, the market for municipal securities (debt securities of the states and their political subdivisions) was thought to be dominated by institutional investors who would not need the protection accorded individual investors. Brokers and dealers in municipal securities, therefore, were exempted from the registration and regulatory provisions of the 1934 Act.

Because individual investors actually constitute a very significant part of the market for municipal securities, Congress concluded that the complicated nature of trading in municipal securities justified eliminating the exemption accorded to municipal securities brokers and dealers. The 1975 amendments created the Municipal Securities Rulemaking Board ("MSRB") n58 to act as a non-member controlled SRO with authority to regulate the municipal securities market and industry. Congress did not eliminate the exemption for issuers of municipal securities, however, which continue to be exempt from direct regulation under the federal securities laws. n59

Effective December 1, 1975, municipal securities dealers and brokers became subject to registration and regulation under the Exchange Act. n60 Municipal securities dealers include persons engaged in the business of buying and selling municipal securities for their own account, including banks (or separately identifiable bank departments or divisions). Excepted from that provision are (a) persons who buy and sell municipal securities for their own account, but not as part of a regular business and (b) banks that buy and sell such securities for their own account, but do so only in a fiduciary capacity. Inspection and enforcement functions for municipal securities dealers were granted to the banking regulatory agencies and the Commission, depending upon the nature of the dealer. n61

[vii] National System for Clearance and Settlement of Securities Transactions.

The inability of the securities and banking industries to handle the increased volume of trading in the securities markets during the late 1960s had very serious consequences for investors and securities firms and jeopardized continued operation of the securities markets. The "paperwork crisis" demonstrated that brokers, dealers, clearing agencies, depositories, transfer agents and registrars would have to coordinate their activities, and that a national system for clearance and settlement was a basic requirement for a healthy securities industry. The 1975 amendments provided for such coordination, contemplated establishing a national system for clearance and settlement, and subjected the various entities involved to registration and regulation under the Exchange Act.

The Commission was directed to facilitate the establishment of a national system for prompt and accurate clearance and settlement of transactions in securities and to provide for the registration and regulation of clearing agencies and transfer agents with the Commission or other appropriate regulatory agencies. Special provisions concerning missing, lost, counterfeit or stolen securities were added as Section 17(f). n62

[viii] Reporting by Institutional Investment Managers.

Institutional investment managers who exercise investment discretion with respect to accounts holding an aggregate fair market value of \$100 million or more of equity securities registered under Section 12 of the Act (and equity securities of certain insurance and investment companies) were required under new Section 13(f) to report to the Commission the quantity of each such security held, the aggregate fair market value of each such security, and other prescribed information.

[ix] Allocation of Regulatory Functions Among Government Agencies.

Because some entities that are subject to the requirements of the 1934 Act are state or national banks or bank holding companies, various administrative and inspection functions, and responsibility for the imposition of sanctions and other matters, were allocated between the Commission and the federal banking agencies by means of the "appropriate regulatory agency" concept. n63 Notwithstanding that allocation, the Commission possesses the dominant policy-making function under the 1934 Act.

[x] Judicial Review of Commission Rules.

A person "adversely affected" by a Commission rule promulgated pursuant to designated

sections of the Exchange Act n64 may obtain review of the rule in the Circuit Court of Appeals. n65

[xi] Miscellaneous Amendments.

The Securities Acts Amendments of 1975 also:

- Made uniform the criminal penalties for violation of the six statutes administered by the Commission. n66

- Amended Section 21 of the Exchange Act to exempt Commission instituted actions "for equitable relief" from consolidation or coordination with other actions not brought by the Commission unless the Commission consents. n67 The exemption paralleled the exemption provided for the Justice Department by **28 U.S.C. § 1407(g)**, and overruled the action of the *Judicial Panel on Multidistrict Litigation* (368 F. Supp. 1311 (J.P.M.L. 1973)) consolidating the Commission's *National Student Marketing* case with seven related private damage suits pending in other districts for pretrial discovery.

- Required the Commission, the Board of Governors of the Federal Reserve System, and the "appropriate regulatory agencies" enumerated in Section 3(a)(34) of the Exchange Act to report annually to the Congress on various matters within their respective areas of responsibility. n68

- Amended Section 31 of the Exchange Act to require, in addition to transaction fees paid to the Commission by exchanges for transactions on such exchanges, payment of transaction fees by brokers and dealers for trades in listed securities off a national securities exchange. The transaction fee was raised to one penny per three hundred dollars of the aggregate dollar amount of sales, but transactions in debt securities were excluded. Rule 31(f) has made most transactions in NASDAQ securities subject to the same fee. n69

- Authorized the Commission to promulgate rules concerning arrangements in which brokers and dealers loan securities held for the account of their customers. n70

- Amended Section 28(b) of the Exchange Act, with respect to arbitration proceedings, to include all self-regulatory organizations and their members, participants, municipal securities dealers and brokers, and persons who agree to be bound thereby. This amendment was not intended to change existing law, as stated in *Wilko v. Swan*, between members or participants in self-regulatory organizations and persons dealing with such members or participants. n71

- Directed the Commission to make a study of the practice of recording the ownership of securities in a name other than that of the beneficial owner (registration in "street name") and to determine

(i) whether the practice was consistent with the purposes of the Exchange Act, and

(ii) whether steps could be taken to facilitate communications between issuers and the beneficial owners while retaining the benefits of the practice. The Commission was to submit its preliminary findings in six months, and its final conclusions and recommendations within a year of enactment of the Securities Acts Amendments of 1975 (June 4, 1975). n72

- Prohibited the imposition of state or local taxes on securities, or upon the transfer of securities, merely because the facilities of a clearing agency or transfer agent are physically located in the state or locality. The provision preserves state taxing powers where the state has a traditional jurisdictional basis for taxation. n73

[f] Foreign Corrupt Practices Act of 1977.

[i] Accounting Standards; Foreign Corrupt Practices.

The Watergate investigation into illegal campaign contributions publicized the extensive practice of corporations making campaign contributions and using corporate funds to bribe government officials in countries worldwide. A report by the staff of the SEC cataloged the number and size of these corporate expenditures, which typically were not accounted for properly on company financial statements. Congress responded to the problem by passing the Foreign Corrupt Practices Act of 1977 ("FCPA") n74. Title I created Section 13(b)(2) of the Exchange Act to require every issuer which has a class of securities registered pursuant to Section 12 of the 1934 Act and every issuer which is required to file reports pursuant to Section 15(d) of the 1934 Act to:

(A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that--

(i) transactions are executed in accordance with management's general or specific authorization;

(ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets.

The FCPA represented a significant expansion of Commission authority. n75 It empowered the Commission to regulate an important internal activity of a public corporation; the maintenance of its books and records and internal accounting systems. Furthermore the Commission could bring enforcement actions against companies and officials for violations, and the Justice Department could bring criminal actions for these violations under section 13(b)(5).

The Act was in many ways the precursor to the Sarbanes-Oxley Act of 2002 and, at the time was equally controversial. The accounting standards provisions of the FCPA apply to all Exchange Act reporting companies and are not limited to foreign corrupt practices. Section 104 of the FCPA, n76 which is administered by the Department of Justice, prohibited domestic concerns not covered by new Section 30A of the Exchange Act from engaging in the same type of conduct prohibited by Section 30A.

The FCPA makes it unlawful for both reporting companies and any domestic concern not subject to the Exchange Act to engage in certain corrupt practices involving foreign officials. n77 Specifically, a new Section 30A was added to the Exchange Act, making it unlawful for a reporting company, any of its officers, directors, employees, or agents, or any shareholder acting on behalf of the company, to corruptly make payments to a foreign official to influence an act or decision of the foreign official, including a decision not to act, or to induce such person to use his influence to affect any government act or decision, to assist the company in obtaining or retaining business or directing business to, any person. n78

[ii] Domestic and Foreign Investment Improved Disclosure Act of 1977.

Title II of the FCPA, the Domestic and Foreign Investment Improved Disclosure Act of 1977, n79 amended Section 13(d) of the Exchange Act to require additional disclosure of the residence, citizenship, and nature of beneficial ownership by any person who acquires beneficial ownership of more than 5 percent of, and added a new paragraph (g) to Section 13 requiring disclosures by any person who is the beneficial owner of more than 5 percent of, any equity security of a class which is registered pursuant to Section 12 of the 1934 Act; of an insurance company, which would have been required to be so registered except for the exemption contained in Section 12(g)(2)(G); or issued by a closed-end investment company registered under the Investment Company Act of 1940. n80

[g] Securities Investor Protection---Right to Financial Privacy Act Amendments of 1980.

A new Section 21(h) was added to the Exchange Act by the enactment of legislation n81 to reflect the applicability of the Right to Financial Privacy Act of 1978 n82 to the Commission. Under Section 21(h), the Commission is subject to the Right to Financial Privacy Act of 1978 except in specified cases where the Commission must have prompt access to financial records to permit the Commission to exercise its investigatory functions under the federal securities laws. In such cases, and subject to prior *ex parte* court approval, the Commission is entitled to subpoena financial records of a customer from a bank without prior notice to the customer. After obtaining the records, the Commission must give notice to the customer that it has obtained access to his records.

The customer can bring suit against the Commission for civil penalties and injunctive relief if the Commission's access was not for purposes authorized by the federal securities laws. n83

In addition, Section 21(h) contains provisions governing the transfer of financial records by the Commission to other governmental authorities, and requiring the Commission to report annually to Congress the occasions on which it obtains access to financial records pursuant to Section 21(h).

[h] Small Business Investment Incentive Act of 1980.

Section 3(a)(12) of the Exchange Act was amended by the Small Business Investment Incentive Act of 1980 ("SBIA") n84 to

- clarify the status as "exempted securities" under Section 3(a)(12) of contracts issued by insurance companies in connection with employee benefit plans qualified under **Section 401 of the Internal Revenue Code**, annuity plans that meet the requirements for deduction of an employer's contributions under Section 404(a)(2) of the Code, and certain governmental plans defined in Section 414(d) of the Code, regardless of whether the contracts are funded by a separate account or the insurer's general account; n85
- provide an exemption from registration under the 1934 Act for bank and insurance company funding of public employee retirement plans defined in **Section 414(d) of the Internal Revenue Code**
 - (a) that exclusively provide retirement benefits to employees or their beneficiaries and
 - (b) whose funds are segregated and cannot be diverted to other purposes; and
- (3) clarify that the exemption for interests or participations in a single trust fund does not depend upon whether the fund is maintained by a bank. n86

[i] Securities-Commodities Accord Amendments of 1982.

From the time it was established in 1934, the Commission has regulated trading in options on securities. Following the creation of the Commodity Futures Trading Commission ("CFTC") in 1974 and the subsequent development of standardized options and widespread trading in these options on exchanges, several factors created doubt regarding the Commission's jurisdiction over options trading.

First, the definitional sections of the securities laws did not expressly include "option" within the definition of "security," although the definition did include the 'right to purchase a security. Second, the development of innovative investment and trading instruments in the 1970's designed to aid in speculation on and hedging against inflation, fluctuations in interest and exchange rates, stock market movements, and related economic changes tended to confuse previously drawn lines of regulatory responsibility for these financial instruments and the markets on which they were traded.

Third, the act creating the CFTC provided it with exclusive jurisdiction over trading in commodity futures, and the expansion of the definition of "commodity" by the Commodity Exchange Act amendments of 1974 to include "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in" contained the potential for a jurisdictional conflict or an interpretation of the term "commodity" which would include anything that becomes the subject of futures trading, including securities options. n87

In *Board of Trade of the City of Chicago v. SEC*, n88 the Commission's authority to regulate options on exempted

securities was successfully challenged when a court held that exchange-traded standardized put and call options on Government National Mortgage Association (GNMA) mortgage-backed securities were not securities. The court also concluded that the sole authority of the Commission to regulate put and call options on securities exchanges is derived from Section 9 and that since Section 9 does not apply to an exempted security, options on GNMA securities were subject to the exclusive jurisdiction of the CFTC. n89

The decision raised the concern of securities industry members and legal experts that it could have disruptive ramifications far beyond the Commission's ability to regulate GNMA options.

In response to these developments and concerns, the Commission and the CFTC decided to seek an agreement ("The Shad Johnson Accord") on the meaning of inconsistent provisions in the securities acts and the Commodity Exchange Act. The two agencies jointly submitted to Congress amendments to the statutes that would clarify the allocation of authority over options and futures between the agencies.

The Securities-Commodities Accord Amendments of 1982 n90 substantially codifies this jurisdictional agreement. The Amendments expanded the definition of the term "security" in Section 3(a)(10) to include any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof) or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency. n91

The Amendments also added a new paragraph (g) to Section 9 that expressly grants the Commission authority to regulate options on exempted securities and clarifies that the Commission's authority extends to trading on options on all securities, securities groups and indices, certificates of deposit, and options relating to foreign currency if such options are traded on an exchange, except for options on a contract for future delivery. In addition, Section 28(a) was amended to provide a limited preemption of state antigaming and "bucket shop" laws for options contracts approved by the Commission for trading on an exchange. n92

[j] Insider Trading Sanctions Act of 1984.

Congress enacted the Insider Trading Sanctions Act of 1984 (ITSA) to increase the penalties for unlawful trading on the basis of material nonpublic information. n93

The most important provision of ITSA became Section 21(d)(2) of the Securities Exchange Act. Section 21(d)(2) authorized the Commission to seek a penalty of up to three times the amount of profit gained or loss avoided by a person who unlawfully purchased or sold a security while in possession of material nonpublic information, or who aided and abetted an unlawful transaction by tipping material nonpublic information to another person. Section 21(d)(2) was repealed, and replaced by Section 21A of the Exchange Act, when Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988. n94

Another provision of ITSA became Section 20(d) of the Exchange Act. Section 20(d) establishes that a person who possesses material nonpublic information violates the Exchange Act by trading in options if he would violate the Act by trading in the securities underlying the options.

ITSA also increased the maximum criminal fines imposable on willful violators of the Exchange Act. n95

Finally ITSA amended § 15(c)(4) of the Exchange Act to authorize the Commission to bring administrative proceedings to require compliance with Section 14, relating to proxy solicitations and tender offers. n96

[k] Insider Trading and Securities Fraud Enforcement Act of 1988.

In the wake of widespread publicity about a number of massive insider-trading schemes, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) "to enhance deterrence against insider trading and... to augment the current methods of detection and punishment of this behavior." n97 ITSFEA replaced Section 21(d)(2) of the Exchange Act, which had been enacted in 1984, with Section 21A of the Exchange Act. Section 21A authorizes the Commission to seek a court order imposing a civil penalty on any person who violated the Exchange Act by purchasing or selling securities while in possession of material nonpublic information, or by tipping material nonpublic information to another person who purchased or sold securities while in possession of that information. In addition, Section 21A provides for the imposition of a civil penalty on any person who directly or indirectly controlled a person who engaged in unlawful trading or tipping, if the controlling person failed to take appropriate steps to prevent the controlled person's violation of law.

Section 21A provides that the amount of any penalty imposed on a primary violator of the rules barring unlawful trading and tipping cannot exceed "three times the profit gained or loss avoided" as a result of the illegal activity. The maximum penalty that may be imposed on a controlling person is "the greater of \$1,000,000, or three times the amount of the profit gained or loss avoided as a result of [the] controlled person's violation" Penalties assessed under Section 21A are to be paid into the United States Treasury, except that the Commission can award up to ten percent of the amount of any penalty to a person who provided information leading to the imposition of the penalty. n98 ITSFEA also amended the Exchange Act by adding a new Section 20A, which grants an express private right of action to investors who traded "contemporaneously" with, but on the opposite side of the market from, defendants who violated the Exchange Act by trading while in possession of material nonpublic information. The total amount of damages that can be awarded under Section 20A is limited to the profit gained or loss avoided as a result of the defendants' unlawful activity.

ITSFEA increased the maximum criminal penalties not only for insider-trading offenses, but for virtually all willful violations of the Exchange Act or the rules and regulations thereunder. n99

Other provisions of ITSFEA authorize the Commission to assist foreign governments in investigating violations of their securities laws, n100 and direct the Commission to undertake a major study of the U.S. securities laws and the adequacy of their enforcement. n101

[I] The 1990 Legislation.

During 1990, Congress adopted three important sets of amendments to the federal securities acts. The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 n102 significantly increased the authority of the Commission to enforce compliance with the securities laws, and strengthened regulation of the penny-stock market. The Market Reform Act of 1990 n103 enhanced the power of the Commission to address problems of market volatility. And the Securities Acts Amendments of 1990 n104 effected miscellaneous improvements in the scheme of securities regulation.

[i] Securities Enforcement Remedies and Penny Stock Reform Act of 1990.

During the decade of the 1980's the stock markets experienced a level of dramatic growth that had not been seen in a generation. The United States also witnessed a series of high profile SEC enforcement actions that was unprecedented in the history of the federal securities laws. SEC actions, combined with criminal prosecutions by the Justice Department through the U.S. Attorney for the Southern District of New York, against Dennis Levine, Ivan Boesky, Michael Milken and Drexel Burnham Lambert attracted front page attention. Less publicized but also important were SEC enforcement actions against First Jersey Securities and Blinder, Robinson & Co.. Both of these firms were broker-dealers that actively underwrote, offered and sold penny stocks, very low priced stocks in extremely small and obscure public companies. Often these companies were so-called "blank check" offerings, involving companies with no operations or business activities at the time of the offering.

1-1 Federal Securities Exchange Act of 1934 § 1.01

With the public's attention came questions regarding whether the SEC had sufficient resources and powers to regulate and police the nation's capital markets. Congress responded by appropriating the largest increases in agency budget in its history. In 1990, through SERPSRA, Congress greatly expanded the penalties for violations of the Federal securities laws and provided the SEC with unusually powerful authority to regulate the offering and sale of penny stocks n105 and secondary market trading in penny stocks, in particular blank check offerings.

The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("SERAPSRA") provided the Commission with "new remedial authority ... to operate its enforcement program in a more flexible manner." n106 SERPSRA added Sections 21(d)(2) and 21(d)(3), 21B, and 21C to the Exchange Act, and analogous provisions to other federal securities statutes:

- Expanding penalties in civil injunctive actions;
- Expanding penalties against registered entities and associated persons in administrative proceedings; and
- Creating a new cease and desist proceeding, with jurisdiction over any person or entity.

Section 21(d)(2) of the Exchange Act authorizes a federal court, in an injunction proceeding brought by the Commission, to issue an order prohibiting any person who violated Section 10(b) from acting as an officer or director of any reporting company; n107 and Section 21(d)(3) authorizes the Commission to seek a court order imposing a civil monetary penalty on any person who violated any provision of the Exchange Act or the rules thereunder. n108

Section 21B authorizes the Commission to impose a civil monetary penalty, or to order an accounting and a disgorgement, in an administrative proceeding against a broker-dealer, investment adviser, or other regulated person who "willfully violated" any provision of the securities acts or "failed reasonably to supervise" a subordinate who violated such a provision. n109

Section 21C authorizes the Commission to enter an order, after an administrative proceeding, requiring any person "to cease and desist from committing or causing" any violation of the Exchange Act and "to take steps to effect compliance" with the law. n110 This provision also empowered the Commission to order a temporary cease and desist order against registered entities and associated persons.

Such an order shall be entered only after notice and opportunity for a hearing, unless the Commission determines that notice and hearing prior to entry would be impracticable or contrary to the public interest. A temporary order shall become effective upon service upon the respondent and, unless set aside, limited, or suspended by the Commission or a court of competent jurisdiction, shall remain effective and enforceable pending the completion of the proceedings. n111

The second major purpose of SERPSRA was to curb "the pervasive fraud and manipulation in the penny stock market." n112 Title V of SERPSRA amended Section 15(b)(6) of the Exchange Act to authorize the Commission to bar certain persons from participating in an offering of "penny stock," n113 and added Section 15(g) to the Exchange Act to require the Commission to adopt rules imposing special disclosure obligations on brokers and dealers who carry out transactions in penny stocks. Title V also added to the Exchange Act a new Section 17B, which mandates the establishment of an automated quotation system for penny stocks. Finally, Title V amended Section 15A of the Exchange Act to require the NASD to establish a toll-free telephone listing to receive customer inquiries concerning the disciplinary histories of NASD members. n114

The Commission's rules on broker-dealer sales of penny stocks are unusually detailed and impose explicit disclosure

requirements on a broker-dealer selling such stocks. For example, under rule 15c-2 a customer must be provided with and sign a disclosure document providing information identified in SEC Schedule 15G; n115 must disclose the inside bid-offer quotations; n116 and must disclose the aggregate amount of compensation received on the transaction. n117

[ii] Market Reform Act of 1990.

Just as the scandals of the eighties provided the catalyst for Congressional passage of SERPSRA, the stock market break of 1987 and the studies which identified conditions and practices which had contributed to it provided a rationale for enactment of the Market Reform Act of 1990. n118 The Market Reform Act of 1990 was designed to provide the Commission "with enhanced powers to prevent manipulation that affects market volatility and to prohibit or constrain practices reasonably likely to engender extraordinary volatility, and with increased access to information critical to effective financial oversight of the securities markets."

The Act amended the Exchange Act in several ways, including:

- amending Section 12(k) of the Exchange Act to authorize the Commission to suspend all trading on any national securities exchange or otherwise for not more than 90 days n119 and to take appropriate actions to respond to market emergencies n120;
- adding Section 13(h) to the Exchange Act to require "large traders" n121 to provide the Commission with information concerning their trading;
- adding Section 17(h), which authorizes the Commission to require registered brokers and dealers to keep records and report information concerning the financial and other risks under which they operate as a result of the activities of their associated persons;
- amending Section 17A(a)(2) of the Exchange Act to direct the Commission to facilitate the establishment of a coordinated clearance system for transactions in securities and related financial instruments; and
- adding Section 9(h) to the Exchange Act to authorize the Commission to prescribe means reasonably designed to prevent manipulation of the market for equity securities, and to prohibit certain trading practices during periods of extraordinary market volatility.

[iii] Securities Acts Amendments of 1990.

One of the major purposes of the Securities Acts Amendments of 1990 was to streamline and modernize the Trust Indenture Act of 1939. Two titles of the Amendments, however, made significant changes in the Exchange Act.

Title II, the International Securities Enforcement Cooperation Act, revised various provisions of the Exchange Act to increase the ability of the Commission and foreign regulators to exchange information and to cooperate in the enforcement of their nations' securities laws. At the request of a foreign securities authority conducting an investigation to determine whether its securities laws are being or have been violated, the Commission may authorize the division to provide assistance to the foreign authority, even if the conduct in question would not constitute a violation of U.S. law. This assistance may include the issuance of an SEC formal order permitting the staff to issue subpoenas. When deciding to honor such a request, the Commission must consider whether the requesting authority has agreed to provide reciprocal assistance and whether providing the assistance would prejudice the public interest. n122

Title III, the Shareholder Communications Improvement Act, amended Section 14 of the Exchange Act to eliminate gaps that existed and ensure that proxy materials are delivered in a timely fashion to the shareholders of investment

companies and that company information statements are distributed even if a proxy is not solicited.

[m] The Government Securities Act Amendments of 1993.

The U.S. government securities market is generally considered the largest, most efficient and liquid securities market in the world. Because trading in this market is largely done by professionals, it has generally been exempt from the regulatory system that applies to other U.S. markets. Yet it has not been immune from scandal. In 1991, a manipulative trading scheme by a professional trader at Salomon Brothers demonstrated a need for greater regulation. In 1993 Congress passed the Government Securities Act Amendments of 1993. n123 This Act expanded on the Government Securities Act of 1986, which had been enacted following the failure of Bevill, Bresler and Schulman, a small government broker, to improve regulation of this market.

While the Department of Treasury has primary regulatory responsibility over the government securities market, the SEC plays an adjunct role. This Act amended the Exchange Act in several important areas.

Section 15C(d)(3) requires all government securities dealers to provide transaction records to the Commission, as may be required "to reconstruct trading in the course of a particular inquiry or investigation." n124 However the new section requires the Commission to minimize the burden placed on small government broker-dealers and the Commission may not use this authority to impose regular reporting requirements on government securities broker-dealers. Section 15(c)(1) of the Exchange Act was amended to subject government securities broker-dealers to its authority to adopt and enforce rules prohibiting manipulative, deceptive or other fraudulent device or contrivances. The Exchange Act was also amended to eliminate restrictions on the ability of the NASD to regulate its members activities in the government securities markets, including the authority to apply its sales practice rules and just and equitable principles of trade.

This Act also amended the Exchange Act in a completely unrelated area. Title III, entitled the Uniform Partnership Rollup Reform Act, added section 14(h) to the Exchange Act directing the Commission to adopt special proxy solicitation and tender offer rules in connection with limited partnership rollup transactions. A companion addition to the Exchange Act, section 15A(b)(12) required the NASD to apply its just and equitable principles of trade rules to prohibit member firms from participating in limited partnership rollup transactions that do not protect the rights of limited partners.

[n] The Private Securities Litigation Reform Act of 1995.

In 1995, Congress enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA") which fundamentally changed the role of private litigation under the Federal securities laws. For much of its history the SEC had actively supported and promoted the role of private litigation as an essential adjunct of the Commission's enforcement program. n125 Through its *amicus* program the Commission had historically and routinely supported an expansive view of the availability of implied rights of private action under the securities laws.

Increasingly, this viewpoint was no longer consistently adhered to by the Commission and the courts had become increasingly wary of the plethora of class action law suits under the securities laws. There was a widespread perception that too many such class action lawsuits were frivolous and of dubious merit. Based on studies and its hearings Congress concluded that private securities class action litigation had become abusive in many respects and that a common practice was to file securities class action "strike suits" against issuers with the hope of settling these lawsuits based on their nuisance value.

The PSLRA fundamentally altered the law as it applied to class action law suits alleging a violation of the Federal securities laws. It created special rules of procedure and pleading standards for these actions that differed from the rules applicable to other class actions. The PSLRA added Section 21D to the Exchange Act-- Private Securities Litigation. This section provides for certification of certain matters by each plaintiff seeking to serve as a representative party on

behalf of a class and requires that, not later than 20 days after the date on which the complaint is filed, the plaintiff notify, by publication, all other members of the purported class of the pendency of the lawsuit. Section 21D also provides that not later than 90 days after notice is published, the court in which the complaint is brought shall appoint a lead plaintiff for the class and consolidate separately filed class action lawsuits under certain circumstances.

Section 21D(b) imposes a significant pleading requirement for allegations of fraud. Subparagraph (1) requires that:

the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.

Subparagraph (2) further provides that:

In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged... state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.

Subparagraph (3) provides a special procedure for motions to dismiss and provides for a stay of discovery during the pendency of the motion to dismiss. Subparagraph (b)(4) established a clear loss causation requirement for the recovery of damages. Paragraph (d) created a system for submitting written interrogatories to the jury concerning findings of state of mind and proportionate liability

The PSLRA also amended Section 15(c) of the 1934 Act to prohibit referral fees from attorneys to brokers, dealers or persons associated with brokers or dealers in connection with obtaining the representation of any person in any private securities litigation. The PSLRA amended Section 20 of the Exchange Act including a subsection concerning liability of controlling persons and persons who aid and abet violations of the 1934 Act.

The PSLRA also added section 21E to the Exchange Act explicitly creating a safe harbor from litigation for forward-looking statements made by issuers of securities in reports filed with the Commission. The safe harbor also applies to persons acting on behalf of issuers, outside reviewers retained by issuers and underwriters. To receive the safe harbor the forward-looking statements must be identified as such and be accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement. This safe harbor provision also covers all oral forward-looking statements under certain circumstances. Interestingly, the Commission held a series of public hearings in 1994 on the topic of whether to create a safe harbor provision by regulation. Because of the possibility of Congressional action, the Commission took no action on the concept.

If the purpose of the PSLRA was to substantially reduce the number of private class actions alleging violations of the securities laws, then the law must be considered a success. n126

Three year later Congress enacted the Securities Litigation Uniform Standards Act of 1998 n127 to eliminate an unintended consequence of the PSLRA, the shift of securities class action law suits into state courts. This Act added section 28(f)(1) to the Exchange Act, and parallel section 16(b) to the Securities Act of 1933 preempting such state actions. The Act also addressed, without completely resolving, uncertainties over whether the PSLRA altered the scienter standard required to establish fraud.

[o] The National Securities Markets Improvement Act of 1996.

The regulatory system for financial services is a highly complex structure with multiple Federal regulators and

additional regulation by state regulatory agencies. The National Securities Markets Improvement Act of 1996 ("NSMIA") attempted to improve the efficiency of capital markets by lessening some duplicative regulation on issuers of securities, investment companies and investment advisers.

The primary purpose of NSMIA was to preempt state regulation of securities issued by companies listed on a national stock exchange or on NASDAQ/NMS and securities issued by registered investment companies, as well as certain limited offerings under Regulation D under the Securities Act. However, it also contained provisions that amended the Exchange Act. While states could continue to require broker-dealers to register, NSMIA added Section 15(h) to the Exchange Act limiting the ability of states to impose additional capital, margin, books and records, bonding and reporting requirements for broker-dealers. In addition, NSMIA amended Section 7(c) of the 1934 Act concerning to unlawful credit extensions to customers, amended Section 8, eliminating one of the provisions relating to restrictions on borrowings by members, brokers and dealers and added Section 17(i) requiring the SEC and other examining authorities to eliminate any unnecessary and burdensome duplication in the examination process of entities regulated under the 1934 Act.

Another provision of NSMIA added section 3(f) requiring that:

whenever the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. n128

Section 36 of the Exchange Act, added by NSMIA, provides the Commission with broad authority to grant exemptions under the Exchange Act.

[p] Gramm-Leach-Bliley Act of 1999.

The Securities Act of 1933 and the Securities Exchange Act of 1934 were only two of many laws passed in response to the stock market crash of 1929 and the ensuing great depression. In 1933 Congress also passed the Glass-Steagall Act which, while directed at banking, had a profound impact on the development of the securities industry in the United States. Glass-Steagall formally separated commercial banking and investment banking functions in the United States.

Through the 1980s and 1990s the separation of these activities steadily eroded through banking deregulation and judicial interpretation of the law. In 1999, Congress passed the Gramm-Leach-Bliley Act ("GLBA"), repealing Glass-Steagall. Banks could engage in underwriting securities and other securities activities through securities affiliates or by creating a financial holding company, which owned subsidiaries engaged in any form of financial services.

While most of the GLBA relates to federal banking laws, a portion of that act also amended the 1934 Act in connection with the regulation of brokers and dealers. In particular, the GLBA amended Section 3(a)(4) (definition of broker) and Section 3(a)(5) (definition of dealer) to provide a specific exemption for certain bank activities that might otherwise result in a bank being considered a securities broker-dealer. Specifically, the GLBA allows banks to enter into third party brokerage arrangements with brokers or dealers registered under the 1934 Act. The GLBA also made other technical amendments to certain 1934 Act definitions.

[q] Sarbanes-Oxley Act of 2002.

The Enron and Worldcom financial scandals, following closely after the "tech bubble" collapse in 2000, created a national crisis of lost public confidence in financial markets and in the effectiveness of the regulatory system. Congress responded in July 2002 when it passed the Sarbanes-Oxley Act of 2002 (the "SOX"), a sweeping overhaul of the Federal securities markets. SOX expanded securities law regulation on a wide array of topics - corporate governance,

disclosure, reporting, accounting requirements and penalties for violation. The law was written so broadly that it applied not only to domestic public companies filing reports with the SEC, including investment companies, but also to foreign companies that have securities publicly traded on domestic securities exchanges or the NASDAQ Stock Market. n129

SOX required the SEC to undertake a massive program to draft, propose and adopt implementing regulations in virtually every area of securities regulations. This expansion and revision of SEC rules as a result of a single Congressional action was virtually unprecedented in the Commission's history. Less than two years after enactment of SOX the Commission had completed a total of 19 final regulations n130:

- Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date (Release Nos. 33-8400, 34-49424; File No.: S7-22-02; March 16, 2004)
- Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports (Release Nos. 33-8392, 34-49313; IC-26357; File Nos.: S7-40-02; S7-06-03; February 24, 2004)
- Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports (Release Nos. 33-8238, 34-47986; IC-26068; File Nos.: S7-40-02; S7-06-03; June 5, 2003)
- Improper Influence on Conduct of Audits (Release Nos. 34-47890; IC-26050; FR-71; File No.: S7-39-02; May 20, 2003)
- Mandated Electronic Filing and Website Posting for Forms 3, 4 and 5 (Release Nos. 33-8230; 34-47809; 35-27674; IC-26044; File No.: S7-52-02; May 7, 2003)
- Standards Relating to Listed Company Audit Committees (Release Nos. 33-8220; 34-47654; IC-26001; File No.: S7-02-03; April 9, 2003)
- Filing Guidance Related to: Conditions for Use of Non-GAAP Financial Measures; and Insider Trades During Pension Fund Blackout Periods (Release Nos. 33-8216; 34-47583; IC-25983; FR-69; File Nos.: S7-43-02 and S7-44-02; March 27, 2003)
- Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002 (Release Nos. 33-8177A; 34-47235A; File No.: S7-40-02; March 26, 2003)
- Strengthening the Commission's Requirements Regarding Auditor Independence (Release Nos. 33-8183A; 34-47265A; 35-27642A; IC-25915A; IA-2103A; FR-68; File No.: S7-49-02; March 26, 2003)
- Implementation of Standards of Professional Conduct for Attorneys (Release Nos. 33-8185, 34-47276, IC-25919; File No.: S7-45-02; January 29, 2003)
- Strengthening the Commission's Requirements Regarding Auditor Independence (Release Nos. 33-8183, 34-47265, 35-27642, IC-25915, IA-2103, FR-68; File No.: S7-49-02; Jan. 28, 2003)
- Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations (Release Nos. 33-8182, 34-47264, FR-67, International Series No. 1266; File No.: S7-42-02; January 28, 2003)

1-1 Federal Securities Exchange Act of 1934 § 1.01

- Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002 (Release Nos. 34-47262, IC-25914; File Nos.: S7-33-02 and S7-40-02; January 27, 2003)
- Retention of Records Relevant to Audits and Reviews (Release Nos. 33-8180, 34-47241, IC-25911, FR-66; File No.: S7-46-02; January 24, 2003)
- Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002 (Release Nos. 33-8177, 34-47235; File No.: S7-40-02; January 23, 2003)
- Insider Trades During Pension Fund Blackout Periods (Release Nos. 34-47225, IC-25909; File No.: S7-44-02; January 22, 2003)
- Conditions for Use of Non-GAAP Financial Measures (Release Nos. 33-8176, 34-47226, FR-65; File No.: S7-43-02; January 22, 2003)
- Certification of Disclosure in Companies' Quarterly and Annual Reports (Release Nos. 33-8124, 34-46427, IC-25722; File No.: S7-21-02; August 29, 2002)
- Ownership Reports and Trading by Officers, Directors and Principal Security Holders (Release Nos. 34-46421, 35-27563, IC-25720; File No.: S7-31-02; August 27, 2002)

The Act also mandated that the Commission undertake and complete six studies and submit them to Congress n131:

- Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers (June 15, 2005)
- Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System (July 25, 2003)
- Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets (January 24, 2003; in PDF format)
- Study and Report on Violations by Securities Professionals: Section 703 of the Sarbanes-Oxley Act Of 2002 (January 24, 2003; in PDF format)
- Report Pursuant to Section 308(c) of the Sarbanes-Oxley Act of 2002 (January 24, 2003; in PDF format)
- Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002 (January 24, 2003; in PDF format)

While it is difficult to neatly summarize all of the substantive changes that SOX effected, they can grouped into four general categories:

- Corporate disclosure, internal operations; and restrictions on management and directors;

- SEC enforcement;
- Regulation of accountants and auditors;
- Miscellaneous changes in the securities laws.

[i] Corporate Disclosure, Internal Operations, and Restrictions on Management and Directors

SOX directed the Commission to undertake rulemaking to improve the quality, accuracy and speed of corporate disclosure. Specific provisions addressed the following:

- § 401 - Disclosure of material correcting adjustments identified by an auditor and disclosure of all material off-balance sheet transactions;
- § 401 - Rules requiring pro forma financial information to be not misleading and consistent with GAAP;
- § 302 - CEO/CFO certifications;
- § 404 - Internal controls requirements;
- § 404 - Disclose code of ethics or explain why the company does not have one;
- § 409 - Faster 8-K reporting;
- § 403 - § 16 ownership reports must be filed within 2 days and electronically;
- § 303 - Prohibits officers and directors from fraudulently influencing auditors; and
- § 301 - Exchanges must adopt listing standards on independent audit committees.

The law also mandated that the Commission must review disclosure filings of all listed issuers on a three-year rotation cycle (§ 308).

Other provisions of SOX prohibited corporations from making personal loans to corporate executives (§ 402); and established blackout periods on trading in company securities by corporate insiders (§ 306).

While each of these provisions was significant, two of the most significant provisions have been the § 302 CEO/CFO certifications and § 404 internal controls requirements. CEOs and CFOs are required to certify in annual and quarterly reports filed with the SEC that, to their knowledge, the filed report does not contain any untrue statement or omission of a material fact, and fairly presents the company's financial condition and results of operations. This certification also covers that company's internal controls as well as specified communications between officers and the audit committee of the board of directors. An additional certification requires that CEOs and CFOs certify that the specific period report fully complies with the requirements of Sections 13(a) and 15(d) of the 1934 Act and that the information contained in that report fairly presents, in all material respects, the financial condition and results of operations of the company.

The SOA sets forth penalties for a knowing violation of the certification requirement of up to a \$1,000,000 fine, ten year imprisonment or both. The penalty for willful violation is a fine of up to \$5,000,000, 25 year imprisonment or both. Included in these certifications are representations by the CEO and CFO that they are responsible for establishing and

maintaining internal controls. In addition, each annual report on Form 10-K or 10-KSB and quarterly report on Form 10-Q or 10-QSB is required to contain disclosure concerning their conclusions regarding the effectiveness of the company's internal controls. Each such report also is required to disclose whether there were significant changes in internal controls that could significantly affect internal controls subsequent to the date of their evaluation.

The internal controls requirements under § 404 have become the most well-known and controversial aspects of SOX. In 1977 when Congress passed the Foreign Corrupt Practices Act, it required public reporting companies to make and keep books and records fairly reflecting transactions and activities, and to develop a system internal accounting controls. Section 404 built upon this requirement by requiring that annual reports must contain a section describing responsibility for establishing and maintaining its internal control system and including an assessment of the effectiveness of the system, Section 404(b) required auditors to attest to the discussion.

Interpretation, application and compliance with this requirement quickly became so controversial that it overshadowed virtually every other provision in the Act. In response to the outcry, the Commission delayed compliance with the Act for years. In fact in 2008, six years after passage of Sarbanes-Oxley, all covered companies have still not fully complied and, as recently as 2007 the Commission was continuing to examine the costs of compliance and was still issuing interpretive guidance. n132

[ii] SEC Enforcement.

Congressional action on SOX provided the Commission with an opportunity to obtain Congressional action on a series of Exchange Act amendments that the Commission's Division of Enforcement had been seeking as well as additional remedies that Congress believed necessary. These changes included the following:

- § 304 - CEO/CFO forfeiture of bonuses, incentive-based compensation and profits from stock sales that occurred in year prior to accounting restatements resulting from material non-compliance with financial reporting requirements resulting from misconduct;
- § 305 - The standard for obtaining an officer and director bar was reduced from "substantial unfitness" to "unfitness";
- § 602 - Explicit statutory authority for § 102(e) administrative proceedings against professionals;
- § 603 - District judges may impose penny stock bars;
- § 604 - Commission administrative proceedings to discipline associated persons of broker-dealers or investment adviser can be based upon violations of state law;
- § 308 - Civil money penalties may be transferred into a FAIR fund for the benefit of investors.

[iii] Regulation of Accountants and Auditors.

While § 404 internal controls reporting has received the most publicity and engendered the most controversy, Title I of the Act, which creates the Public Company Accounting Oversight Board ("PCAOB") n133, may ultimately be the most significant piece of the law. SOX created the PCAOB to act as a non-member controlled regulator of the accounting and auditing profession, under the strong control and oversight of the SEC. The five member Board is appointed by the Commission and funded by public companies, with oversight by the SEC. It is authorized to set auditing, quality control and ethics standards for public accounting firms; inspect and investigate account firms; and impose disciplinary and remedial sanctions.

Sarbanes-Oxley also made significant changes in the relationship between auditors and the client corporation. It substantially increased the role of the audit committee of the Board of Directors as the link with the auditor. Each audit committee member must be unaffiliated with the company and no audit committee member may accept any compensation (including consulting, advisory or other compensatory fees) other than for services as a director (including fees for services as a member of the audit committee or any other board committee). Public companies are required to disclose in their annual and quarterly reports whether their audit committee includes at least one member who is a "financial expert" (and, if not, why not).

Under SOX, audit committees are now required to assume certain additional responsibilities. Audit committees must now pre-approve all audit and non-audit services by the company's independent auditor. The audit committee is also required to consider reports from the company's auditor relating to (i) the company's critical accounting policies and practices; (ii) all alternative treatments of financial information permitted under Generally Accepted Accounting Principles ("GAAP") that have been discussed with management, the ramifications of the use of such treatments and the preferred treatment by the auditor; and (iii) all other material written communications between the auditors and management of the company. The audit committee is also directed to resolve disagreements between the auditor and management of the company concerning the company's financial reporting. Furthermore, the audit committee is required to become involved in analyzing any internal controls deficiencies, as well as management or employee fraud identified in the CEO/CFO certifications made to the SEC. Finally, the audit committee is required to establish procedures for the receipt, retention and treatment of complaints received by the company regarding accounting, internal account controls or auditing matters and for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

The law also expanded upon Commission regulations adopted in 2002 concerning auditor independence. SOX prohibits auditors from performing specific non-audit services, including: bookkeeping or other services related to the accounting records or financial statements of the audit client; financial information systems design and implementation; appraisal or valuation services, fairness opinions or contribution-in-kind reports; actuarial services; internal audit outsourcing services; management functions or human resources; broker-dealer, investment advisor or investment banking services; legal services and expert services unrelated to the audit; and any other service that the newly created Public Company Accounting Oversight Board determines, by regulation, to be impermissible.

Finally section 303 of SOX prohibits a director or officer of a public company from taking any action to fraudulently influence, coerce, manipulate or mislead any independent auditor of the company's financial statements for the purpose of rendering the financial statements materially misleading.

[iv] Miscellaneous changes in the Securities Laws.

Sarbanes-Oxley also included several miscellaneous changes in the securities laws that were of great significance. Section 804 extends the applicable statute of limitations for securities fraud to the earlier of two years after discovery of the facts constituting the violation or five years after such violation and provides for federal administrative and court proceedings and remedies to protect whistleblower employees.

Section 307 required the Commission to adopt rules providing that attorneys who represent public companies are required to report evidence of a material violation of the securities laws or breach of a fiduciary duty or similar violation by the company or any agent of the company to the company's chief legal officer and chief executive officer. If there is not a proper response to the notification provided by legal counsel, the attorney is required to report this information to the audit committee of the board of directors. Similarly, section 501 of SOX required the Commission to adopt rules governing securities analysts' potential conflicts of interest.

[r] The Credit Rating Agency Reform Act of 2006.

The failures of Enron and WorldCom, which were catalysts for the passage of Sarbanes-Oxley highlighted the failure of the nation's credit rating organizations ("NRSRO's") to identify the companies financial weaknesses when rating debt securities. In 2006 Congress enacted the Credit Rating Agency Reform Act ("CRARA") n134 to provide the Commission with explicit statutory authority to register and regulate NRSRA, replacing an informal Commission practice based upon the issuance of a staff no-action letter. The practice of identifying NRSROs through staff no-action letters was criticized for its lack of transparency and for creating a barrier to entry for new or specialized entrants.

The Act added definitions to Section 3 of the Exchange Act, created a new Section 15E of the Exchange Act, and amended Section 17 of the Exchange Act. These new statutory provisions provided Commission rulemaking authority to establish a registration and regulatory program for credit rating agencies opting to have their credit ratings qualify for purposes of laws and rules using the term NRSRO. The Act required NRSRO's to register with the Commission, make public certain information to help persons assess their credibility, make and retain certain records, furnish the Commission with certain financial reports, implement policies to manage the handling of material non-public information and conflicts of interest, and abide by certain prohibitions against unfair, coercive, or abusive practices. Section 15E(c)(2) of the Act specifically directed that any Commission rules could not "regulate the substance of credit ratings or the procedures or methodologies by which an NRSRO determines credit ratings" n135

NRSRO's that previously had received staff no-action letters were prohibited from continuing to rely on the letter following the effective date of Commission implementing regulations. n136

FOOTNOTES:

(n1)Footnote 1. The Securities Exchange Act of 1934 is contained in **15 U.S.C. Section 78a et seq.** The Securities Exchange Act of 1934 is reprinted in the Securities Primary Law Sourcebook, Volume B, Section F.

The references in this work are to Sections of the 1934 Act, not to Sections of 15 U.S.C.

(n2)Footnote 2. For discussion of the objectives and scope of the Securities Act of 1933, see Federal Securities Act of 1933 § 1.02 (Matthew Bender).

(n3)Footnote 3. See Levinson, *The Role of the SEC as a Consumer Protection Agency*, 27 *Bus. Law.* 61, 63-64 (1971):

The dominant purpose of the Securities Exchange Act of 1934 is, as you know, disclosure of current information on the securities of publicly held companies and the regulation of broker-dealers and the public trading markets in which they operate. In contrast to the 1933 Act's theory of registering only the actual quantity of securities proposed to be offered, the 1934 Act contemplates registration of an entire class of securities as when registering on an exchange. Moreover, unlike the requirements of the 1933 Act which are potentially applicable to any company but only on the occasion of a public offering, the disclosure requirements of the 1934 Act are applicable only to those with securities listed and traded on an exchange or over-the-counter securities held by at least 500 persons and having at least 1 [now 10] million dollars in assets--but on a continuous basis. The importance of the trading markets in this country has grown substantially in the last two decades and with such growth has come an increasing Commission emphasis on the disclosure in periodic reports in terms of quality, frequency and availability. Material information periodically and currently provided regarding a company's affairs, both corporate and financial, is of the utmost importance when we consider the enormous increase in the size of the investing public...

(n4)Footnote 4. For a brief discussion of all the amendments to the Exchange Act beginning in 1964, see § 1.01[2][a]-[k] *infra*.

(n5)Footnote 5. The Foreign Corrupt Practices Act also prohibits domestic concerns not subject to the jurisdiction of the SEC from paying bribes to foreign officials, see §§ 1.01[2][e][i], 9.05[1] *infra*.

(n6)Footnote 6. 1 Loss & Seligman, *Securities Regulation* 3 (3d Ed. 1989)

(n7)Footnote 7. For a definitive account of state securities regulation, see *Blue Sky Regulation* (Matthew Bender).

See also Loss & Cowett, *Blue Sky Law* (1958); 1 Loss & Seligman, *n. 6 supra*, pp. 41, 148-152.

Even in the absence of specific legislation on the federal level, some securities frauds were prosecuted under the federal mail fraud statute. See *United States v. Maze*, 414 U.S. 395, 94 S. Ct. 645, 38 L. Ed.2d 603 (1974) .

For discussion of criminal prosecutions, see § 9.04 *infra*.

(n8)Footnote 8. See Federal Securities Exchange Act of 1934, A.A. Sommer, Jr., General Editor, (Matthew Bender). *Historical Development of the S.E.C.--The Government View*, 28 Geo. Wash. L. Rev. 6, 8 (1959):

It is difficult to evaluate the effect of the blue-sky laws. Certainly, strict fraud legislation, such as that adopted by Kansas, was successful in preserving the savings of many investors. For instance, in the first eighteen months under the Kansas statute only 100 out of 1500 companies which applied for clearance to issue securities were given such licenses. It was estimated that 75 percent of the offerings were potentially fraudulent and that half of the remaining proposed offerings were dangerously speculative. On the other hand, it is perfectly clear that the state regulatory scheme was ineffective to cope with the overall situation. The period in which there was no federal legislation, but when almost every state had some form of blue-sky law, has been described as, "an era in which disclosures in financial circles had shaken public confidence to its very foundation, and in which a considerable number of issues were found to have grossly misrepresented values and concealed essential facts--often in fraudulent or criminal transactions." The local statutes were inadequate not only because of the wide variations between states in their approach to securities regulation, but also because, with the growth of large corporate enterprises, state lines were coming to be of little importance, and state authorities were unable to cope with the dextrous interstate activities of promoters and manipulators. (Footnote omitted.)

To prevent evasion of state securities laws, it was originally proposed that the bill which became the Securities Act of 1933 contain a provision prohibiting a person from selling securities within a state from outside its boundaries if the sale would be a violation of the state's securities laws had it taken place wholly within its boundaries. H.R. Report No. 85, 73d Cong., 1st Sess. pp. 10, 11. That provision was not contained in the Senate bill and was eliminated by the Committee of Conference. H.R. Report No. 152, 73d Cong., 1st Sess. However, many states and the Uniform Securities Act take this approach. See *Blue Sky Regulation* (Matthew Bender).

(n9)Footnote 9. Actually, a subcommittee of the Senate Banking and Currency Committee to which Mr. Ferdinand Pecora (later a Commissioner on the SEC and Justice of the New York Supreme Court) was appointed counsel.

(n10)Footnote 10. Loomis, *The Securities Exchange Act of 1934*, 28 Geo. Wash. L. Rev. 214, 217 (1959):

The final report of the Committee pointed out that between September 1, 1929 and July 1, 1932, the total market value of stocks listed on the New York Stock Exchange dropped from approximately \$89 billion to approximately \$15 billion, a decrease of \$74 billion, or 83 percent. The report describes certain abuses in the securities markets to which it attributes a considerable share of the responsibility for the financial disaster of 1929. Primary among these was the excessive use of credit in the stock market resulting in speculation on small margins and the sale of securities on a mass scale to meet margin calls upon any decline in the market. Another matter considered in the report was the extensive manipulation of prices on the exchanges by pools, options, and particularly the participation in such pool operations by issuers and their management and short-swing trading by officers and directors in the stock of their own

companies, often on the basis of inside information. The report discussed the failure of listed corporations to provide adequate information as well as defects in the operation of the market itself. These are the principal problems with which the Exchange Act was designed to deal.

The Report of the Pecora Committee, S. Rep. No. 1455, 73rd Cong., 2d Sess. (1934), entitled "Stock Exchange Practices," is reprinted in the Securities Primary Law Sourcebook, Volume C, Section I of the 1934 Act.

(n11)Footnote 11. The Exchange Act reporting requirements are discussed in ch.4 *infra*.

(n12)Footnote 12. Regulation of proxies under Section 14 is discussed in ch.7 *infra*.

(n13)Footnote 13. Regulation of tender offers is discussed in § 7A.03 *infra*.

(n14)Footnote 14. Insider trading restrictions pursuant to Section 16 of the 1934 Act are discussed in ch.8 *infra*.

(n15)Footnote 15. For discussion of registration of exchanges and of securities associations, see § 2.02 *infra*.

(n16)Footnote 16. Exchange self-regulation and Commission oversight of exchanges and securities associations are discussed in § 2.03 *infra*.

See also § 4.01[6] *infra* for discussion of Commission authority to summarily suspend trading in a nonexempt security for up to 10 days in the over-the-counter market or on a national securities exchange.

(n17)Footnote 17. Registration of brokers and dealers is discussed in § 3.03[1],[2] *infra*.

(n18)Footnote 18. Post-registration record keeping requirements pursuant to Section 17(a)(1) are discussed in § 3.04[1] *infra*.

(n19)Footnote 19. Net capital requirements pursuant to Rule 15c3-1 are discussed in § 3.03[4] *infra*. The rules under the Securities Exchange Act of 1934 are reprinted in the Securities Primary Law Sourcebook, Volume B, Section G.

(n20)Footnote 20. Self-regulation has principally taken the form of the Financial Regulatory Agency, FINRA, which was created through a merger of the self-regulatory units of the NASD and the New York Stock Exchange, discussed in § 3.05 *infra*.

(n21)Footnote 21. Regulation of broker-dealer market activities is discussed in § 6.02 *infra*.

(n22)Footnote 22. Liability under *Rule 10b-5* is discussed in § 5.04 *infra*.

(n23)Footnote 23. Regulation of credit under Section 7 is discussed in ch.3A *infra*.

(n24)Footnote 24. 64 Stat. 1265

(n25)Footnote 25. 15 U.S.C. 78d-2

(n26)Footnote 26. The asset test has always been applied to total rather than net assets.

(n27)Footnote 27. Section 3(a)(2) of the 1933 Act exempts any security issued or guaranteed by a bank from the registration and prospectus delivery requirements of Section 5 of that Act. Section 3(a)(2) also defines the term "bank" for purposes of the exemption, see Federal Securities Act of 1933 § 3.03 (Matthew Bender).

(n28)Footnote 28. Bank Holding companies would be subject to SEC regulation.

(n29)Footnote 29. See Securities Acts Amendments of 1964, H.R. Rep. No. 1418, 88th Cong., 2d Sess. (1964), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I of the 1934 Act.

See also Depository Institutions--Insurance Act, P.L. 93-495, 88 Stat. 1500 (Act of October 28, 1974), § 105(b) which transferred responsibility for the regulation of securities issued by institutions insured by the Federal Savings and Loan Insurance Corporation from the SEC to the Federal Home Loan Bank Board.

Commission administration and enforcement of the 1934 Act are discussed in ch.9 *infra*.

(n30)Footnote 30. See Securities Acts Amendments of 1964, P.L. No. 88-467, 78 Stat. 565, Sec. 3(c) (Act of August 20, 1964.)

See also H.R. Rep. No. 1418, n.28 *supra*, at 5-681.

The insider trading restrictions of Section 16 of the Exchange Act are discussed in ch.8 *infra*.

A new subparagraph (H) was added to subsection 12(g)(2) by Sec. 28(c) of the Investment Company Amendments Act of 1970, P.L. 91-547, 84 Stat. 1413 (Act of December 14, 1970). New Section 12(g)(2)(H) exempted from the registration requirements of Section 12(g) any interest or participation in any collective trust fund maintained by a bank or in a separate account maintained by an insurance company. The interest or participation must be issued with respect to an employer benefit plan that meets the requirements for qualification under **Section 401 of the Internal Revenue Code** or an annuity plan meeting the requirements for deduction of the employer's contribution under **Section 404(a)(2) of the I.R.C.**

The exemptions from registration under Section 12(g)(2) are discussed in § 4.01[2][a][iv] *infra*.

(n31)Footnote 31. Section 15(c)(4) proceedings have become moribund following the creation of cease and desist proceedings in the Remedies Act of 1990.

(n32)Footnote 32. S. Rep. No. 550, 90th Cong., 1st Sess. (1967) and H.R. Rep. No. 1711, 90th Cong., 2d Sess. (1968), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I of the 1934 Act.

Until 1968, obtaining control of a corporation by means of a tender offer or other type of stock purchase was not specifically regulated under the federal securities laws. However, *Rule 10b-5* promulgated in 1943, prohibited fraud in the purchase or sale of any security, including purchases made to acquire corporate control. *Rule 10b-5* is discussed in § 5.05 *infra*.

Proxy regulation under Section 14 is discussed in ch.7 *infra*.

(n33)Footnote 33. P.L. 90-439, **82 Stat. 454** (Act of July 29, 1968).

(n34)Footnote 34. For detailed discussion of the provisions of the Williams Act, see ch.7A *infra*.

The Commission's Institutional Investor Study Report was issued in March 1971 as H.R. Doc. No. 64, 92d Cong., 1st Sess. (1971) (8 volumes).

(n35)Footnote 35. Investor Protection Act, P.L. 91-567, **84 Stat. 1497** (Act of December 22, 1970).

The Investor Protection Act did not disturb the decision reached by Congress in 1964 to leave periodic reporting, proxy solicitation, and regulation of insider trading with respect to securities of insurance companies to the appropriate state authorities. However, because most tender offers are nationwide and, prior to 1970, were not regulated by state

insurance commissions, it appeared appropriate to bring tender offers for securities of insurance companies within the purview of Sections 13(d) and 14(d). *See* Memorandum of the Securities and Exchange Commission on S. 3431, which became P.L. 94-567, 3 U.S.C.C. & A.N. 5031-5034 (1970).

(n36)Footnote 36. Prior to the amendment, the disclosure provisions applied only to acquisitions and tender offers of over 10 per cent. Secs. 1(a)(2), 3(2), P.L. 91-567, 84 Stat. 1497 (Act of December 22, 1970); S. Rep. No. 91-1125, 91st Cong., 2d Sess. (1970). *See* § 7A.01 n.11 and related text *infra*.

(n37)Footnote 37. S. Rep. No. 91-1125, 91st Cong., 2d Sess. (1970); H.R. Rep. No. 91-1655, 91st Cong., 2d Sess. (1970).

(n38)Footnote 38. Section 14(e) is discussed in § 7A.03[3] *infra*.

(n39)Footnote 39. *See* text at n.34 *supra*.

(n40)Footnote 40. P.L. 90-437, 82 Stat. 452 (Act of July 29, 1968); S. Rep. No. 1264, 90th Cong., 2d Sess. (1968); H.R. Rep. No. 1663, 90th Cong., 2d Sess. (1968).

(n41)Footnote 41. P.L. 90-438, 82 Stat. 453 (Act of July 29, 1968); S. Rep. No. 1237, 90th Cong., 2d Sess. (1968).

(n42)Footnote 42. Sec. 301, P.L. 91-508, 84 Stat. 1114 (Act of October 26, 1970).

(n43)Footnote 43. For a comprehensive description of the "back office" crisis on Wall Street and the fundamental changes in the industry that resulted from it, *see* *The Year They Sold Wall Street*, Tim Carrington. 1985, Houghton, Mifflin Co.

(n44)Footnote 44. P.L. No. 91-598, **81 Stat. 1636** (Act of December 30, 1970).

(n45)Footnote 45. P.L. No. 95-283, 92 Stat. 249 (Act of May 21, 1978).

(n46)Footnote 46. P.L. 96-433, **94 Stat. 1855** (Act of October 10, 1980).

For discussion of the Securities Investor Protection--Right to Financial Privacy Act Amendments of 1980 that added a new Section 21(h) to the Exchange Act, *see* § 1.01[2][f] *infra*.

(n47)Footnote 47. *See* H.R. Rep. No. 96-1321 Part 1, 96th Cong., 2d Sess. at 5 (1980).

(n48)Footnote 48. P.L. No. 94-29, 89 Stat. 97 (Act of June 4, 1975) ("1975 Amendments").

(n49)Footnote 49. Although the amendments were chiefly concerned with the Exchange Act, they also effected limited changes in other federal securities laws.

(n50)Footnote 50. S. Rep. No. 94-75, 94th Cong., 1st Sess. (1975); H.R. Rep. No. 94-123, 94th Cong., 1st Sess. (1975), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I of the 1934 Act.

(n51)Footnote 51. S. Rep. No. 94-75, n.43 *supra*, at 1.

(n52)Footnote 52. Section 28(e), added in 1975.

(n53)Footnote 53. For discussion of the subjects of the rules of self-regulatory organizations under the 1975 Amendments, *see* § 2.03[1] *infra*.

(n54)Footnote 54. For discussion of Commission oversight of self-regulatory organizations, *see* § 2.03 *infra*.

(n55)Footnote 55. Sec. 19, P.L. 95-283, **92 Stat. 249** (Act of May 21, 1978) amended Section 11(a)(3) by extending the effective date of Section 11(a) with respect to securities transactions of persons who became members of a national securities exchange before February 1, 1978 to November 1, 1979. The extension was made to avoid unnecessary disruption in the trading markets, the securities industry, and in the prudent investment of billions of dollars in pension and other managed funds. H.R. Rep. No. 95-746, 95th Cong., 2d Sess. (1978); S. Rep. No. 95-763, 95th Cong., 2d Sess. (1978).

(n56)Footnote 56. For discussion of the separation of broker-dealer functions pursuant to Sections 11(a) and (b), *see* § 3.02 *infra*.

(n57)Footnote 57. Registration of broker-dealers pursuant to Section 15(a) is discussed in § 3.03 *infra*.

(n58)Footnote 58. For discussion of the Municipal Securities Rulemaking Board, *see* § 3.06[5] *infra*.

(n59)Footnote 59. The SEC in the early 1990's used its regulatory authority to create an indirect system for mandating offering and updated disclosure by issuers of municipal securities. *See* 17 C.F.R. § 240.15c2-12.

(n60)Footnote 60. Registration and regulation of municipal securities dealers and brokers are discussed in § 3.06 *infra*.

(n61)Footnote 61. For discussion of the allocation of inspection and enforcement functions for municipal securities dealers between the SEC and the banking agencies, *see* § 3.06[4][d] *infra*.

(n62)Footnote 62. For discussion of the program for missing, lost, counterfeit, or stolen securities, *see* § 3.07[1][c] *infra*.

(n63)Footnote 63. *See* n.54 *supra*.

(n64)Footnote 64. The designated Sections are: Sections 6 (securities exchanges), 9(h)(2) (prohibition of certain trading practices in periods of extraordinary volatility) 11 (trading by members, brokers, and dealers), 11A (national securities market system), 15(c)(5) (regulation of market makers), 15(c)(6)(regulations of brokers and dealers concerning clearance and settlement), 15A (securities associations), 17 (accounts, records, reports and examinations), 17A (national system for clearance and settlement) and 19 (self-regulatory organizations). Section 25(b)(1).

(n65)Footnote 65. Judicial review of the rules of the SEC pursuant to Section 25(b) is discussed in § 9.02[2][c] *infra*.

(n66)Footnote 66. Criminal prosecutions for violation of the Exchange Act are discussed in § 9.04 *infra*.

(n67)Footnote 67. Section 21(g).

(n68)Footnote 68. Section 23(b).

(n69)Footnote 69. Section 31.

(n70)Footnote 70. Section 8(c), which is discussed in § 3.07[1][a] *infra*.

(n71)Footnote 71. Conf. Rep., H.R. Rep. No. 94-229, 94th Cong., 1st Sess. (1975), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I of the 1934 Act.

See 5.05[6][f] *infra* for discussion of *Wilko v. Swan*, 346 U.S. 427, 74 S. Ct. 182, 98 L. Ed. 168 (1953), and the Supreme Court's later decision in *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 107 S. Ct. 2332, 96 L. Ed.2d 185 (1987).

(n72)Footnote 72. Section 12(m), since repealed.

The Commission's Preliminary Report of the Street Name Study, entitled *The Practice of Recording the Ownership of Securities in the Records of the Issuer in Other Than the Name of the Beneficial Owner of Such Securities*, pursuant to Section 12(m) of the 1934 Act, was published on December 4, 1975. Fed. Sec. L. Rep. (CCH) No. 619 (Part II 1975).

The Final Report of the Securities and Exchange Commission on the Practice of Recording the Ownership of Securities in the Records of the Issuer in Other Than the Name of the Beneficial Owner of Such Securities, 94th Cong., 2d Sess. (Committee Print 1976), was forwarded to Congress by the SEC in December 1976. *Sec. Exch. Act Rel. No. 34-13719, Fed. Sec. L. Rep. (CCH) P 81,221 n.4 (1977)*.

The Commission has adopted Rule 14a-13(a) which requires issuers to take certain measures to assure that beneficial owners receive proxy materials. This rule is discussed in § 7.02[3][a] *infra*.

(n73)Footnote 73. Section 28(d).

(n74)Footnote 74. Title I, P.L. No. 95-213, **91 Stat. 1494** (Act of December 19, 1977).

(n75)Footnote 75. *Sec. Exch. Act Rel. No. 34-14478, 6 Fed. Sec. L. Rep. (CCH) P 72, 264 (1978)*.

The accounting standards provisions of the Foreign Corrupt Practices Act are discussed in § 4A.02 *infra*.

Section 13(b) of the Exchange Act was amended previously in 1976. Section 308(b) of the Railroad Revitalization and Regulatory Reform Act of 1976, P.L. 94-210, **90 Stat. 31** (Act of February 5, 1976) amended Section 13(b) by repealing the provision permitting carriers to file Interstate Commerce Commission (ICC) reports with the SEC in lieu of reports otherwise required pursuant to Section 13(b). *See Sec. Exch. Act Rel. No. 34-13477, Fed. Sec. L. Rep. (CCH) P 81,133 (1977)*.

(n76)Footnote 76. **15 U.S.C. § 78dd-2**.

(n77)Footnote 77. *Sec. Exch. Act Rel. No. 34-14478, 6 Fed. Sec. L. Rep. (CCH) P 72,264 (1978)*.

(n78)Footnote 78. For discussion of the antibribery provisions of the Foreign Corrupt Practices Act of 1977, see § 9.05 *infra*.

(n79)Footnote 79. P.L. No. 95-213, **91 Stat. 1498** (Act of December 19, 1977).

(n80)Footnote 80. Or any equity security issued by a Native Corporation pursuant to section 37(d)(b) of the *Alaska Native Claims Settlement Act*. *Sec. Exch. Act Rel. No. 34-14478 n. 1, 6 Fed. Sec. L. Rep. (CCH) P 72,264 (1978)*.

Title II of P.L. 95-213 also added a new Section 13(h) to the 1934 Act, see § 7A.02 n.6 *infra*, directing the SEC to report to Congress on:

(1) the effectiveness of the Exchange Act ownership reporting requirements (the Commission found them "generally effective"), and 2) the desirability and feasibility of reducing or otherwise modifying the 5% threshold in Sections 13(d) and 13(g) (SEC conclusion: "not presently feasible or desirable" to do so).

See Report of the Securities and Exchange Commission on Beneficial Ownership Reporting Requirements Pursuant to Section 13(h) of the Securities Exchange Act of 1934, June 28, 1980, full text reprinted (without Appendix) in *Fed. Sec. L. Rep. (CCH) P 82,616*.

(n81)Footnote 81. Securities Investor Protection--Right to Financial Privacy Act Amendments of 1980, P.L. 96-433, **92 Stat. 265** (Act of October 10, 1980).

(n82)Footnote 82. Title XI of the Financial Institutions Regulatory Act of 1978, P.L. 95-630, **92 Stat. 3697** (November 10, 1978); effective title date 120 days after enactment, except as otherwise provided; codified at **12 U.S.C. § 3401 et seq.**

(n83)Footnote 83. H.R. Rep. No. 96-1321 Part I, 96th Cong., 2d Sess. 2 (1980).

(n84)Footnote 84. P.L. 96-477, **94 Stat. 2275** (Act of October 21, 1980).

The amendment to Section 3(a)(12) is in Sec. 702, Title VII--Employee Benefit Plan Exemptions, P.L. 96-477, **94 Stat. 2295**.

Section 3(a)(12) and the rules adopted pursuant thereto are discussed in § 4.01 n.3 *infra*.

Section 3(a)(12) had been amended twice in 1970 by:

(1) Sec. 401(b) of the Employment Security Amendments of 1970, P.L. 91-373, **84 Stat. 695** (Act of August 10, 1970) to provide, in effect, that industrial development bonds, the interest on which is excluded from gross income under **Section 103 of the Internal Revenue Code of 1954**, are to be exempt securities. Industrial development bonds are discussed in § 4.01 n.3 *infra*.

(2) Sec. 28(a) of the Investment Company Amendments Act of 1970, P.L. 91-547, 84 Stat. 1413 (Act of December 14, 1970) to expand the definition of the term "exempted securities" to include interest or participations in certain bank common trust funds, certain bank collective funds, and certain insurance company separate accounts. As with other securities exempted under Section 3(a)(12), the amendment did not exempt broker-dealers dealing in such interests or participations from Section 15(c) antifraud and antimanipulation liability or Section 10(b) liability.

The Investment Company Act Amendments of 1970, Sec. 28(b), P.L. 91-547, 84 Stat. 1413 (Act of December 14, 1970) also added a new Section 3(a)(19) to the Exchange Act providing that the terms "investment company," "affiliated person," "insurance company," and "separate account" have the same meaning as those terms are defined in the Investment Company Act (15 U.S.C. § 80a-1 *et seq.*).

(n85)Footnote 85. Contracts issued in connection with tax-deferred annuity loans defined in *Section 403(b) of the Internal Revenue Code*, which are adopted primarily by public school systems and departments of education, however, are excluded from the exemption and must be registered under the Exchange Act, unless some other exemption is available. Memorandum of the SEC on S. 2975, reprinted in 126 Congressional Record S 13465, 13466 (September 25, 1980). This codifies a prior Commission staff interpretation regarding the Securities Act Section 3(a)(2) exemption. *Sec. Act. Rel. No. 34-6281, Fed. Sec. L. Rep. (CCH) P 1052* (1981).

(n86)Footnote 86. This codifies a prior staff interpretation of identical language in the Securities Act Section 3(a)(2) exemption. *Sec. Act Rel. No. 34-6281, Fed. Sec. L. Rep. (CCH) P 1051* (1980) for a summary of the staff's position.

(n87)Footnote 87. H.R. Rep. No. 97-626, Pt. 1, 97th Cong., 2d Sess. (1982), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I of the 1934 Act.

(n88)Footnote 88. 677 F.2d 1137 (7th Cir. 1982).

The case was decided while Congress was reviewing legislation proposed by the Commission and the CFTC to clarify the Commission's jurisdiction over options, discussed *infra*.

(n89)Footnote 89. 677 F.2d at 1160 .

(n90)Footnote 90. P.L. 97-303, **96 Stat. 1049** (Act of October 13, 1982).

(n91)Footnote 91. The Commission retains, under the amended Section 3(a)(10), its authority to treat put and call options as exempted securities. H.R. Rep. No. 97-626, Pt. 1, 97th Cong., 2d Sess. (1982), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I of the 1934 Act.

(n92)Footnote 92. These options contracts are, however, subject to all applicable state antifraud securities laws. P.L. 97-303, **96 Stat. 1049** (Act of October 13, 1982).

Antigaming provisions apply to bets on the future prices of securities or commodities.

A "bucket shop" is a place where bets are made on the fluctuations of the market price of securities or commodities. "The customer may think he is effecting a legitimate purchase, but the broker "buckets" the order instead of executing it. If the market goes down, as the broker hopes, he purports to sell the customer out and pockets the difference; if it goes up and the broker is not able or willing to cover from profits on other transactions he either defaults or decamps." 1 Loss & Seligman, Securities Regulation 72, n. 165 (3d ed.1989).

(n93)Footnote 93. Insider Trading Sanctions Act of 1984, P.L. 98-376, 98 Stat. 1264 (Act of August 10, 1984).

Insider trading is discussed in § 5.05[2][a][ii] *infra*.

(n94)Footnote 94. Insider Trading and Securities Fraud Enforcement Act of 1988, P.L. 100-704, **102 Stat. 4677** (Act of November 19, 1988).

The 1988 legislation is discussed in § 1.01[2][j] *infra*.

(n95)Footnote 95. For a discussion of criminal penalties under the Exchange Act, see § 9.04 *infra*.

(n96)Footnote 96. For a discussion of the enforcement of the proxy rules, see § 7.09 *infra*.

For a discussion of the regulation of tender offers, see § 7A.03 *infra*.

(n97)Footnote 97. H.R. Rep. No. 910, 100th Cong., 2d Sess. 7 (1988), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I of the 1934 Act.

(n98)Footnote 98. For additional discussion of Section 21A, see § 9.03[3] *infra*.

(n99)Footnote 99. For discussion of criminal penalties under the Exchange Act, see § 9.04 *infra*.

(n100)Footnote 100. As amended by ITSFEA, Section 21 (a)(2) of the Exchange Act provides that the Commission may give investigatory assistance to a "foreign securities authority" which requests such assistance, regardless of "whether the facts stated in the request would also constitute a violation of the laws of the United States."

(n101)Footnote 101. Section 7(b) of ITSFEA requires the SEC, subject to the availability of appropriated funds, to "make a study and investigation of the adequacy of the Federal securities laws... for the protection of the public interest and the interests of investors." No money has ever been appropriated for the study.

(n102)Footnote 102. P.L. 101-429, 104 Stat. 931 (Act of October 15, 1990).

(n103)Footnote 103. P.L. 101-432, 104 Stat. 963 (Act of October 16, 1990).

(n104)Footnote 104. P.L. 101-550, **104 Stat. 2713** (Act of November 15, 1990).

(n105)Footnote 105. SERPSRA added section 7(b) to the Securities Act which provided the Commission with broad authority to require blank check companies to notify investors at the time of acquisition of an operating company and provide investors with a right of rescission and restricting the use of offering proceeds until disclosure of the proposed acquisition.

(n106)Footnote 106. H.R. Rep. No. 616, 101st Cong., 2d Sess. 13 (1990).

(n107)Footnote 107. The person can be barred from service as an officer or director "if [his or her] conduct demonstrates substantial unfitness to serve" in such a capacity.

(n108)Footnote 108. Section 21(d)(3) also authorizes the imposition of a civil penalty on any person who violated a cease-and-desist order entered by the Commission under Section 21C. It does not authorize the imposition of a civil penalty on a person for engaging in insider trading that is subject to a penalty under Section 21A.

The potential amount of the civil penalty increases with the seriousness of the violation, up to a maximum of the greater of (1) \$100,000 for a natural person or \$500,000 for any other person, or (2) the gross amount of the defendant's pecuniary gain.

(n109)Footnote 109. Section 21B also allows the Commission to assess a monetary penalty, ranging up to \$100,000 for an individual or \$500,000 for an entity, against a regulated person who "willfully aided, abetted, counseled, commanded, induced, or procured" a violation of the securities laws by another person, or who willfully made false or misleading statements in any application or report filed with the Commission or a similar regulatory agency.

(n110)Footnote 110. Besides entering a cease-and-desist order, the Commission may "enter an order requiring accounting and disgorgement, including reasonable interest."

(n111)Footnote 111. *15 U.S.C. § 78u-3(b)(1)*. Since the law was enacted the Commission has brought just one temporary cease and desist proceeding. See *In the Matter of A.R. Baron*, Proceeding 3-9010. Release No. 34-37240 / May 23, 1996. The Division of Enforcement's experience in this proceeding apparently persuaded them that it was easier and faster to obtain a TRO from a Federal Judge.

(n112)Footnote 112. H.R. Rep. No. 617, 101st Cong., 2d Sess. 7 (1990).

(n113)Footnote 113. The term "penny stock" is defined in Section 3(a)(51) of the Exchange Act. In common parlance, "[p]enny stocks are low-priced, highly speculative stocks generally sold in the over-the-counter (OTC) market and generally not listed on an exchange." H.R. Rep. No. 617, 101st Cong., 2d Sess. 8 (1990).

(n114)Footnote 114. FINRA, the successor to the NASD self-regulatory program subsequently created an internet system enabling the public to access the disciplinary history or registered persons. This is available on the FINRA website at <http://www.finra.org/InvestorInformation/InvestorProtection/ChecktheBackgroundofYourInvestmentProfessional/index.htm>

(n115)Footnote 115. *17 C.F.R. § 240.15g-2*

(n116)Footnote 116. *17 C.F.R. § 240.15g-3*

(n117)Footnote 117. 17 C.F.R. § 240.15g-4

(n118)Footnote 118. H.R. Rep. No. 524, 101st Cong., 2d Sess. 8 (1990).

(n119)Footnote 119. Before the Commission may take this extraordinary action, it must "notifies the President of its decision and the President notifies the Commission that the President does not disapprove of such decision. If the actions described in subparagraph (A) or (B) involve a security futures product, the Commission shall consult with and consider the views of the Commodity Futures Trading Commission." Before the Marke Reform Act, only the President had the authority to suspend trading on an exchange.

(n120)Footnote 120. The Commission's authority in an emergency is extremely broad. "The Commission, in an emergency, may by order summarily take such action to alter, supplement, suspend, or impose requirements or restrictions with respect to any matter or action subject to regulation by the Commission or a self-regulatory organization under the securities laws, as the Commission determines is necessary in the public interest and for the protection of investors." 17 U.S.C. § 78l(k)(2). The Commissio relied pon this authority when it responded to the emergency of September 11, 2001. See SECURITIES EXCHANGE ACT OF 1934 ☐ RELEASE NO. 44791 / September 14, 2001.

(n121)Footnote 121. Section 13(h)(8) of the Exchange Act defines a "large trader" as a person who "effects transactions for the purchase or sale of any publicly traded security or securities ... in an aggregate amount equal to or in excess of the identifying activity level." The same section defines "the identifying activity level" to mean "transactions in publicly traded securities at or above a level of volume, fair market value, or exercise value as shall be fixed from time to time by the Commission."

(n122)Footnote 122. 15 U.S.C. § 78u(a)(2).

(n123)Footnote 123. P.L. 103-202, 107 Stat. 2344, (Act of December 17, 1993)

(n124)Footnote 124. 15 U.S.C. § 7878o-5(d)(3)

(n125)Footnote 125. "The Commission's enforcement program is designed to secure as broad a regulatory impact as possible with the limited resources available. To this end, the Commission relies heavily upon private civil damage actions." 45 SEC Ann. Rep. 37 (1979).

(n126)Footnote 126. Shortly after enactment of the PSLRA Professor Joseph Grundfest, a former SEC Commissioner, created a securities class action clearinghouse to monitor all class action lawsuits under the securities laws. His periodic reports have revealed a dramatic reduction in the number nationally. Current information is available on the clearinghouse website at <http://securities.stanford.edu/>

(n127)Footnote 127. P.L. 105-353, 112 Stat § 3227 (October 13, 1998).

(n128)Footnote 128. § 106 of public law 104-290 amended the relevant sections of each of the securities laws.

(n129)Footnote 129. The breadth of the law required the SEC to adopt exemptive rules for foreign countries to eliminate certain incompatibilities between SOX and foreign laws. See for example 15 C.F.R. § 240.10A-3(c)(3) which addressed Board audit committee independence conflicts for foreign companies listed in the U.S.

(n130)Footnote 130. SEC website at Spotlight on Sarbanes-Oxley Rulemaking and Reports.
<http://www.sec.gov/spotlight/sarbanes-oxley.htm>

(n131)Footnote 131. SOX also directed that the General Accounting Office ("GAO") undertake and complete three more studies.

(n132)Footnote 132. For a discussion of the continuing controversy over the costs see Testimony?Sarbanes-Oxley Section 404: New Evidence on the Cost for Small Companies by Chairman Cox December 12, 2007 available at <http://www.sec.gov/news/testimony/2007/ts121207cc.htm>. For a recent Commission release on interpretation see Definition of the Term Significant Deficiency (Release Nos. 33-8829, 35-56203; File No.: S7-24-06; August 3, 2007)

(n133)Footnote 133. For information on the activities of the PCAOB see its website <http://www.pcaob.org/>

(n134)Footnote 134. P. L. No. 109-291 (2006). enacted September 29, 2006.

(n135)Footnote 135. *15 U.S.C. 78o-7(c)(2)*

(n136)Footnote 136. See the SEC release adopting the final rules, Release No. 34-55857; File No. S7-04-07.

* This chapter has been updated by Jonathan G. Katz. Mr. Katz served as the Secretary of the U.S. Securities and Exchange Commission from 1986 until his retirement in 2006.



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Federal Securities Exchange Act of 1934

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CHAPTER 1 The Securities Exchange Act of 1934 and the SEC *

1-1 Federal Securities Exchange Act of 1934 § 1.02

§ 1.02 The Securities and Exchange Commission

[1] THE SEC

The Exchange Act is administered by the Securities and Exchange Commission. n1 The Commission consists of five members, no more than three of whom may belong to the same political party. Members are appointed by the President, with the advice and consent of the Senate, for five-year terms, one term ending each year. The President designates the Chairman of the Commission.

When Congress created the SEC, with the enactment of the Exchange Act, it transferred to the Commission the administration of the Securities Act of 1933, formerly administered by the Federal Trade Commission. Subsequent laws assigned to the Commission for administration include the Public Utility Holding Company Act of 1935 (repealed in 2005), the Trust Indenture Act of 1939, the Investment Company Act of 1940, and the Investment Advisors Act of 1940. In addition, the Commission serves as advisor to federal courts in corporate reorganization proceedings under Chapter 11 of the Bankruptcy Code.

[a] Commission Decision-Making

The Commission acts officially by a majority vote of a quorum of Commissioners. The Commission's rules provide that "a quorum of the Commission shall consist of three members; provided, however, that if the number of Commissioners in office is less than three, a quorum shall consist of the number of members in office." n2 If fewer than three Commissioners may participate, due to recusals, then the quorum is two. If only one Commissioner is eligible to vote, emergency actions may be taken by one Commissioner through the duty officer procedure. Each week, one Commissioner, other than the Chairman, is designated the duty officer. If, in the duty officer's opinion, "action is required to be taken which, by reason of its urgency, cannot practicably be scheduled for consideration at a Commission meeting" the duty officer is delegated to take action on behalf of the full Commission. n3 All duty officer actions are reported to the Commission's Secretary and are circulated to the other Commissioners eligible to vote for ratification.

The full Commission typically meets weekly to consider staff recommendations for action. These meetings are governed by the Government in the Sunshine Act n4 which requires that all Commission meetings must be conducted publicly, after advance notice of the agenda, unless the subject of the meeting fits into one of a series of exemptions. While the Sunshine Act establishes a presumption that Commission meetings will be public, in fact most Commission meetings are non-public. This is because the majority of the actions considered by the Commission pertain to

recommendations for action submitted by the Division of Enforcement, and are thus exempt from the public meeting requirement. Public meetings are typically conducted when the Commission considers a recommendation to propose or adopt a regulation, or when the Commission hears an oral argument concerning an appeal of an initial decision from one of its administrative law judges.

The Commission also takes formal action on staff recommendations through its *seriatim* process. n5 When matters are routine in nature and do not require joint deliberation by the Commission, the staff may submit a written recommendation for *seriatim* action. Each Commissioner, beginning with the duty officer, reviews the matter and votes to approve or disapprove the recommendation. When all eligible Commissioners have voted, the action is final. Because the *seriatim* process is limited to routine matters not requiring joint deliberation, any one Commissioner is entitled to have the matter heard at a Commission meeting. This halts the *seriatim* process, even when a quorum of commissioners has already voted.

[b] Commission Delegations of Authority

While the Commission is the ultimate decisional authority, it never considers the overwhelming majority of final agency actions. The Commission has delegated decisional authority for these routine actions to its staff. Under section 4A of the Exchange Act, the Commission may delegate its authority to its staff to take any action, other than the proposal, adoption or amendment of a rule or regulation. However any action taken by the staff pursuant to delegated authority may be reviewed by the Commission, at the request of one Commissioner or if the action is appealed to the Commission by an aggrieved party. The Commission may decline to consider such appeals, except in certain limited areas when review is mandatory, as specified in section 4A. n6

The Commission has delegated a wide range of authority to its staff. These routine delegations of authority have been adopted as Commission rules. n7 After the Commission has voted to delegate authority to its staff, the Chairman then determines which persons or categories of persons within an office or division may act under delegated authority. Typically these "sub-delegations" are made to categories of persons defined by reference to a job title, such as assistant director or branch chief, or by specifying the salary grade level required to take action. The Commission may also delegate authority on specific actions to its staff by order, without adoption of a Commission rule. This has occurred infrequently, typically in the context of a delegation to the division of enforcement to settle pending litigation.

Similarly, most of the Commission's formal and informal advisory procedures are the responsibility of the staff. n8 These include issuance of: staff no-action letters; staff frequently asked questions documents, or FAQs; staff legal bulletins or accounting bulletins; or staff comment letters.

[2] Functional Responsibilities and Organization

The staff of the Commission is organized into four operating divisions and nineteen offices located in the Washington, DC headquarters. Eleven regional offices located throughout the United States work under the direction of the Division of Enforcement. Regional Office staff work in the enforcement program or work in the examination and inspection program of the Office of Compliance, Inspections and Examinations (OCIE).

The four operating divisions are organized along functional lines:

- The Division of Corporation Finance administers the regulation of financial reporting and disclosure and the standards regarding debt securities indentures under the Trust Indenture Act of 1939;
- The Division of Trading and Markets (formerly Market Regulation) is responsible for regulating securities exchanges, the securities industry and the over-the-counter market;

1-1 Federal Securities Exchange Act of 1934 § 1.02

- The Division of Enforcement investigates possible violations of the securities laws and, where appropriate, institutes administrative proceedings and injunctive actions; and
- The Division of Investment Management is responsible for the administration of the Investment Company Act of 1940 and the Investment Advisors Act of 1940

The nineteen offices of the Commission vary greatly in size and responsibilities. For example, the OCIE is one of the largest groups in the SEC, with more staff (if the regional office examination groups are included) than either the Division of Trading and Markets or the Division of Investment Management. The Office of General Counsel is the primary legal advisor to the Commission and the staff. It has broad responsibility in virtually every area of the Commission's responsibilities. The Office of the Chief Accountant is the primary voice for SEC accounting and auditing policy. Each of the remaining offices performs one or more essential functions at the SEC, as described below.

[Click here to view image.](#)

[a] Division of Corporation Finance.

The Division of Corporation Finance administers the Commission's full disclosure program, which regulates the information that public companies must provide to investors and the market. The division establishes financial disclosure requirements for public companies that offer securities publicly and that have securities traded in the U.S. It has primary responsibility for recommending Commission action on the proposal, adoption and amendment of regulations in these areas and for the interpretation of these regulations. It selectively reviews issuer filings to monitor compliance and, to the extent possible, detect fraudulent statements. With the exception of companies registered under the Investment Company Act of 1940, the Division develops Commission standards and examines issuer compliance with these standards in the following areas:

- business and financial disclosure standards for securities offered for public sale pursuant to the registration requirements of the Securities Act of 1933 or available exemptions;
- registration, reporting and disclosure standards for securities traded on national securities exchanges or required to be registered pursuant to Section 12(g) of the Exchange Act or whose issuers are required to file reports pursuant to Section 15(d) of that Act n9;
- disclosure and procedural standards in soliciting proxies for electing directors and other corporate actions n10;
- disclosure standards for reporting beneficial ownership and transaction statements pursuant to Sections 13(d), (e), and (g) and 16(a) of the Exchange Act;
- Disclosure standards and substantive and procedural obligations relating to tender offers; and
- Disclosure and reporting standards for compliance with the Trust Indenture Act of 1939 regarding indentures covering debt securities.

Organization of the Division of Corporation Finance

The Division is organized into two broad groups, Disclosure Operations and Disclosure Support. The Disclosure Operations Group consists of eleven offices. Each office is supervised by an Assistant Director and has the responsibility for reviewing disclosure documents filed by companies in specified industry categories:

- Health Care and Insurance
- Consumer Products
- Computers and On Line Services
- Natural Resources and Food
- Structured Finance, Transportation and Leisure
- Manufacturing and Construction
- Financial Services
- Real Estate and Business Services
- Beverage, Apparel and Health Care Services
- Electronics and Machinery
- Telecommunications

The Disclosure Support Group consists of ten offices responsible for legal, accounting and technical questions, drafting and interpreting regulations, responding to questions from the public and industry professionals, assisting the Disclosure Operations staff and setting disclosure policy for the Division. The ten offices are:

- Office of Chief Counsel
- Office of Chief Accountant
- Office of Rulemaking
- Office of Mergers and Acquisitions
- Office of International Corporate Finance
- Office of Small Business Policy
- Office of Enforcement Liaison
- Office of Disclosure Support
- Office of Global Risk Security
- Office of Information Technology

Functions performed by the Division of Corporation Finance Disclosure Review

The primary function of Corporation Finance is to oversee the filing and review of disclosure documents by public

companies. Approximately 15,000 companies file documents with the SEC. Even though roughly 75% of all Division staff work in Disclosure Operations, it is impossible for the staff to review every document that is filed with the SEC. Instead the Division utilizes a process of selective review to determine which documents will be scrutinized and the level of review that will be conducted.

Historically the Division has placed the highest priority on reviewing documents from new registrants (typically companies engaged in an initial public offering, or IPO), third party tender offers, contested solicitations for shareholder proxies, going-private transactions and filings by small business companies. Beginning in 2002 the Division introduced a new policy of reviewing the 1000 public companies with the largest market capitalization on a three-year cycle. This informal experiment was expanded to create a three-year review cycle for all reporting companies and codified into law in the Sarbanes-Oxley Law in 2002. n11 Each Disclosure Operations industry group selects other company disclosure documents, based upon a series of screening criteria. There are three levels of review -- Full review, financial statement only review, and monitor. Occasionally the Division will conduct a systematic review of a large number of companies and focus on a specific area of disclosure. For example, in 2007, the Division conducted a broad review of company disclosure required by amended regulations on executive compensation.

When a securities registration statement filed under the Securities Act of 1933 is reviewed, the staff will typically send a series of questions to the company concerning areas in which accounting or disclosure requirements are incomplete, unclear, inconsistent or require clarification. The registrant must respond to these questions and it may be necessary that to file an amended document. The Division's goal is to send this letter within 30 days after the registration statement has been filed. Traditionally these comment letters were not disclosed to the public except in response to a Freedom of Information Act request. Beginning in 2005, the SEC revised this policy and it now posts comment letters on the EDGAR database no later than 45 days after the registration statement is declared effective. n12

While there is no comparable deadline for the registrant to respond to these questions, the staff will not declare a registration statement effective until a satisfactory response has been submitted. Authority to declare a registration statement effective has been delegated to the Division of Corporation Finance and sub-delegated to the Assistant Director responsible for the relevant industry group n13.

In instances when a filing does not meet basic technical requirements (e.g., if it has missing or unaudited financial statements) or is so carelessly prepared that it is unintelligible, the staff can issue a "bedbug" letter. A bedbug letter notifies the registrant that the staff will not review the filing until it meets the technical requirements of the form and/or is comprehensible. Such letters can identify major categories of deficiencies.

The disclosure review process for periodic filings, such as annual reports on Form 10-K, is different. Because these documents do not require SEC action to be effective, the staff cannot require companies to correct or revise the contents. Instead the staff will send its comments in a letter and request the issuer to address its concerns in a subsequent periodic filing. If the disclosure review identifies problems that may rise to a violation of SEC rules or represent fraud, the staff of the Division of Corporation Finance will refer the filing to the Division of Enforcement for investigation.

Functions of the Disclosure Support Offices

The *Office of Chief Counsel* provides legal advice to the Operations Groups to ensure uniform interpretations and applications of regulatory requirements. It also responds to questions and requests for interpretive guidance from registrants, professionals and the general public. The Office assists these groups by providing telephone responses to inquiries and by preparing no-action letters in response to technical legal or disclosure questions. When a request for a no-action letter is submitted, the staff has the discretion to decline to respond. Persons submitting a request may withdraw the request rather than receive a negative response. All no-action letters issued by the staff are made public, along with the incoming request, and are available on the SEC website. n14 The largest category of no-action letters

issued annually by the Division of Corporation Finance respond to companies seeking to exclude shareholder proposals from an annual proxy statement. n15 The office is responsible for granting or denying any application for confidential treatment of information filed with it pursuant to Section 24(b) and Rule 24b-2 of the 1934 Act, and for revoking requests previously granted. n16

The *Office of Chief Accountant* provides accounting advice to the Operations Group to ensure uniform treatment and application of accounting standards. It also responds to questions and requests for interpretive guidance from registrants, professionals and the general public. When a question involves significant, complex or original accounting issues, the Office solicits the views of the SEC Office of the Chief Accountant, the agency authority on accounting interpretations and policy.

The *Office of Rulemaking* is responsible for the drafting of SEC regulations pertaining to the SEC full disclosure program (excluding regulations under the Investment Company Act or Investment Adviser Act). While certain special categories of rulemaking are the responsibility of other Disclosure Support Offices, such as Mergers and Acquisitions and International Corporate Finance, the Office has overall responsibility for coordinating rulemaking activities within the Division and with the rulemaking activities performed by other Divisions of the Commission.

The *Office of Mergers and Acquisitions* is responsible for compliance with disclosure laws and regulations pertaining to mergers and acquisitions, tender offers, going-private transactions, proxy contests, and beneficial ownership reporting. The Office reviews all disclosure filings concerning these transactions, performs rulemaking and responds to questions or requests for interpretive guidance, exemptive orders, or no-action letters on these areas.

The *Office of International Corporate Finance* is responsible for disclosure compliance by foreign companies planning to register in the U.S. It provides informal assistance to foreign companies prior to filing with the SEC, reviews foreign company disclosure filings jointly with the Disclosure Operations Group, performs rulemaking and responds to questions or requests for interpretive guidance, exemptive orders, or no-action letters from foreign companies.

The *Office of Small Business Policy* is responsible for disclosure compliance by small public companies and SEC disclosure and securities offering regulations pertaining to limited, private, and intrastate offerings of securities, and offerings of securities by shell companies and blank check companies. The Office reviews disclosure filings from small public companies, performs rulemaking and responds to questions or requests for interpretive guidance, exemptive orders, or no-action letters in these areas.

The *Office of Enforcement Liaison* provides legal analysis and interpretive assistance to the Division of Enforcement on investigations or litigation involving violations of SEC full disclosure regulations. The Office reviews all Enforcement recommendations submitted to the Commission for action and provides advice to the Commissioners and their staff on these recommendations.

The *Office of Disclosure Support* is responsible for administrative functions of the Division and for records management and control.

The *Office of Global Risk Security* was created 2007 at the direction of Congress to work closely with Disclosure Operations staff to monitor whether the documents public companies file with the SEC include disclosure of material information regarding global security risk-related issues.

The *Office of Information Technology* is responsible for assisting issuers and the public filing documents electronically on the SEC EDGAR computer system. It serves as the Division's liaison with the SEC Office of Information Technology, which manages the EDGAR system.

[b] Division of Trading and Markets.

The Division of Trading and Markets (formerly the division of Market Regulation) is responsible for supervising and regulating securities markets pursuant to the Securities Exchange Act of 1934 (Exchange Act). The division's mission is to maintain fair, honest, and efficient securities markets. It oversees exchanges, securities associations, securities self-regulatory organizations (SROs), brokers and dealers, clearing agencies, transfer agents, alternative trading systems, municipal securities dealers, the Municipal Securities Rulemaking Board, and securities information processors.

The Commission has delegated decisional authority to the Division in a wide range of areas pertaining to oversight of the securities markets and entities operating in these markets, including the authority to: publish for comment and to approve rule filings from the exchanges, SROs, and joint industry plans; approve or revoke broker-dealer registrations; grant or withdraw unlisted trading privileges in securities; and grant exemptive relief to broker-dealers under the capital adequacy rules or the registration requirements. n17

Organization and Functions of the Division of Trading and Markets

A Director and two Deputy Directors head the division, which is organized into five offices, each headed by one or more Associate Directors:

- Office of Market Supervision
- Office of Trading Practices and Processing
- Office of Broker/Dealer Finances
- Office of Chief Counsel.
- Office of Market Operations

Office of Market Supervision

The Office of Market Supervision ("OMS") is responsible for national market system policy regulation and oversight of the securities industry SROs. Its principal duty is the review and approval of all SRO rule filings, as required by Section 19(b) of the Exchange Act. n18 These rules range from non-controversial fee filings, which are effective upon filing with the SEC, to significant market structure initiatives. In addition, the office has responsibility for regulation and oversight of alternative trading systems and electronic communications networks and for the review of applications for registration of exchanges. These market participants are hybrids, combining some features of exchanges with some features of broker-dealers. The office is also responsible for reviewing applications for registration, many of the rulemaking and interpretive issues related to securities futures and is the principal liaison to the Commodity Futures Trading Commission.

The OMS also includes the Office of Municipal Securities, which oversees the activities of the Municipal Securities Rulemaking Board and provides interpretive guidance on SEC regulations pertaining to the offer and sale of municipal securities.

Section 19(b)(1) of the Exchange Act requires each SRO to file proposed rule changes with the Commission, accompanied by a concise general statement of the basis for, and purpose of, the proposed change. The rule filing process under the Exchange Act allows the Commission to ensure that SRO rules and practices are consistent with the Exchange Act and the goals of the national market system, including promotion of fair competition among markets, transparency of prices, best execution of customer orders, fair and orderly markets, and most importantly, investor

protection. SRO rules also must be designed to prevent fraudulent and manipulative acts and practices, and promote just and equitable principles of trade. Finally, the Exchange Act contains a public notice and comment procedure to ensure that interested persons have an opportunity to provide input into SRO actions that may have a significant impact on market participants and individual investors.

Office of Trading Practices and Processing

The Office of Trading Practices and Processing ("OTPP") is responsible for regulating secondary market trading, including institutional trading activities, and for securities market clearance and settlement operations. The Office also acts the division's liaison with the Division of Enforcement.

The OTPP administers numerous trading rules concerning trading during initial distributions of securities, broker-dealer publication of stock quotations, issuer repurchases, and certain tender offer practices. Because most of these rules are transaction-based and prophylactic, the office is responsible for providing no-action, exemptive, or interpretive guidance to industry professionals. This often requires close coordination with the Division of Corporation Finance on underwriting activity, and staff regularly reviews issuer registration statements and other disclosure documents referred by Corporation Finance.

The Office also is responsible for oversight of the SROs operating the national system for the prompt and accurate clearance and settlement of securities transactions and for regulatory functions of securities transfer agents. The Depository Trust Company, the National Securities Clearing Corporation, the Options Clearing Corporation, and the Government Securities Clearing Corporation are SROs regulated by this office. Staff of this office review proposed rules and rule amendments ranging from non-controversial fee filings to major clearance and settlement initiatives. The process also is governed by section 19(b) of the Exchange Act. The office is also responsible for Commission rulemaking relating to clearance and settlement matters, as well as providing interpretive guidance and no-action relief.

Office of Broker/Dealer Finances

The Office of Broker/Dealer Finances is responsible for SEC customer protection rules, commonly referred to as the net capital rules, for the regulation and inspection of consolidated supervised entities ("CSEs"), for the regulation and registration of nationally recognized statistical rating agencies, and for the division's programs pertaining to prudential supervision and risk analysis.

The Office administers a comprehensive program that includes: drafting regulations, providing interpretive guidance, exemptive orders and no-action letters; and reviewing the largest broker/dealers' financial reports. The Commission's net capital rules govern all broker-dealers' financial responsibility to maintain adequate liquid capital reserves for the protection of customer assets, to create and maintain books and records, and to regularly report on the adequacy of these reserves. The group also oversees the Securities Industry Protection Corporation, the private company that ensures customer accounts against broker/dealer failures.

The Office is also responsible for regulation, oversight and inspection of a special category of certain broker-dealer holding companies on a consolidated basis, or "consolidated supervised entities." In this capacity, Commission supervision extends beyond the registered broker-dealer to the unregulated affiliates of the broker-dealer and the holding company itself. The office focuses on the financial and operational condition of the CSE to reduce the likelihood that weakness in the holding company or an unregulated affiliate endangers a regulated entity or the broader financial system. Like other consolidated supervisors overseeing internationally active institutions, the Commission requires CSEs to compute capital adequacy measures consistent with the Basel Standard. A broker-dealer becomes a CSE by applying for an exemption from the standard net capital rule, and the broker-dealer's ultimate holding company consenting to group-wide Commission supervision (if it does not already have a principal regulator). n19

This office is also responsible for implementing the Credit Rating Agency Reform Act of 2006, enacted on September 29, 2006. Under this act and the Commission's regulations, nationally recognized statistical rating organizations must apply for registration with the Commission. n20 To receive Commission approval, the rating agency must disclose in its application information to help persons assess its credibility; its procedures to manage the handling of material non-public information and conflicts of interest. The Commission has adopted rules on recordkeeping, financial reporting, and disclosure of conflicts of interest. n21 The registration process formalizes an informal SEC program through which rating agencies could obtain the nationally recognized designation via a division no-action letter.

Office of the Chief Counsel

The Office of Chief Counsel provides legal assistance to the division, other Commission divisions and offices, and Congress on a myriad of topics, including questions of what is a security and who is a broker. In addition, the office administers and interprets numerous rules that govern such diverse areas as customer transaction confirmations, the extension of credit on new issues, anti-money laundering, and the regulation of foreign broker-dealers with a U.S. presence. The office also works with the SROs on securities industry arbitration issues, and reviews requests by brokerage firms to employ someone who is barred from association, or "statutory disqualifications."

Office of Market Operations

The Office of Market Operations is responsible for the division's market surveillance and market continuity functions. In addition to real-time surveillance of secondary market operations, the office is responsible for the division's automation review program. This program was created in 1989 following completion of the division's study of the causes of the 1987 market decline. A Commission policy statement in November 1989 called for the SROs to establish voluntarily comprehensive planning and assessment programs. These assessment programs were formed to determine systems capacity and perform periodic stress testing of these systems and obtain annual independent assessments of their systems' capacity and future capacity requirements, as well as the adequacy of protection against physical threats. In 1991, the Commission issued a second statement that provided additional guidance on the independent review process and created a voluntary process for SROs to provide reports to the SEC.

[c] Division of Enforcement.

The Division of Enforcement is responsible for investigating possible violations of all laws administered by the Commission and conducting all enforcement actions brought by the SEC, either in civil litigation in Federal court or in administrative proceedings heard by an administrative law judge. n22 The Director of the Division has supervisory responsibility over the Commission's eleven regional offices in which more than half of all SEC enforcement staff is resident.

Because the SEC has only civil enforcement authority, the Division works closely with the Department of Justice when investigations uncover misconduct that warrants a criminal prosecution. The Division also coordinates its investigations with foreign regulatory authorities when misconduct involves persons or activities that occurred in another country. The Division is authorized to use its investigative powers to assist a foreign regulator in its investigations if the foreign regulator has an agreement with the SEC to provide reciprocal assistance. n23

While enforcement of the Federal securities laws involves a wide range of misconduct, the majority of enforcement actions fall into one of five categories: (1) issuer financial reporting, (2) unregistered securities offerings, (3) broker-dealer violations, (4) insider trading, and (5) market manipulations.

In addition, the Division brings subpoena enforcement proceedings to demand compliance with its investigative subpoenas and institutes follow-up civil contempt cases if a party has failed to comply with an injunction or other court order. On occasion the Department may request that the Department of Justice commence a criminal contempt action to

compel a party to obey a court order or subpoena. n24

In civil actions, the Commission seeks injunctions, civil money penalties, and

the disgorgement of ill-gotten gains. A federal district court may also bar or suspend individuals from acting as corporate officers or directors.

Organization of the Division of Enforcement

With the inclusion of the enforcement staff of the Commission's regional offices, the Division of Enforcement is the largest unit of the SEC, approximately 1000 employees. The Director and two Deputy Directors manage the division. In the Washington "home office," there are:

- Four Investigative Groups, each supervised by Associate Directors
- Office of the Chief Counsel
- Division Trial Unit, headed by the Chief Litigation Counsel
- Office of the Chief Accountant
- Associate Director for Regional Office Coordination

The four Associate Directors each oversee 3-5 investigating groups. The Chief Counsel is responsible for coordinating Division policy, reviewing all activities of the regional office enforcement staff, supervising the division's administrative staff. The Chief Litigation Counsel supervises the division's litigators and the Chief Accountant supervises the Division's accounting staff. The Associate Director for Regional Offices manages the operation of the eleven regional offices.

The basic investigative unit within the Division is a branch of four attorneys supervised by a branch chief. The staff attorneys and the branch chief are primarily responsible for performing an investigation's core functions - including issuing subpoenas, taking testimony, reviewing documents, analyzing evidence, and preparing recommendations for action to the Commission. An Assistant Director supervises two or three branches. Each Associate Director supervises three or four Assistant Director groups.

One Associate Director group also includes the Office of Market Surveillance. The Office of Market Surveillance acts as the primary point of contact between the division and the surveillance operations of the various SROs.

The Office of Chief Counsel ("OCC") acts as direct liaison between the regional offices and the Commission. The OCC also provides guidance to division staff on legal issues and policy concerns. It researches, reports, and coordinates the tracking of the division's workload, manages budget and administrative staff, acts as ethics liaison for the division, reviews all Freedom of Information Act requests related to the division and oversees the process of closing investigations and archiving investigative files.

The Chief and Deputy Chief Litigation Counsels manage the Trial Unit, comprised of all litigators in the home office. After an investigation has been completed and the Commission has authorized an administrative proceeding or civil injunctive action, if the investigating attorneys do not negotiate a settlement, the matter is assigned to an attorney in the Trial unit who is responsible for litigation of the matter. This includes any appeal to the Commission of an administrative law judge's initial decision, but does not include the appeal of a Federal District judge's decision in a civil injunctive action.

All accountants in the home office report to the Chief Accountant, who oversees all accounting matters within the division. Accountants in the office are assigned to work with investigating attorneys on any investigation that entails technical questions about the application of generally accepted accounting principles ("GAAP") or generally accepted auditing standards, or possible accounting or auditing violations. The division's Chief Accountant also works closely with the Commission's Office of the Chief Accountant and the Chief Accountant in the Division of Corporation Finance ("Corp Fin") on accounting policy and technical issues.

The eleven regional offices have an enforcement staff that performs the same duties as the home office, investigating any matter they deem appropriate. Regional offices are not limited in the types of investigations they may conduct, and no explicit geographic limitations are placed on any particular office, although in practice, the majority of investigations done by the regional offices are within their geographic territory. The size of the regional offices varies greatly, with New York being the largest and Salt Lake the smallest.

Functions of the Division of Enforcement

The Commission has a broad mandate to investigate any matter of interest related to enforcement of the Federal securities laws. Within the division, any attorney may initiate an informal inquiry (with the approval of his or her immediate supervisor) and generally, the first attorney to identify the matter conducts any ensuing investigation. SEC investigations are considered non-public events and the SEC has a policy of neither confirming nor denying the existence of an investigation. *See § 1.03 infra.*

Upon completion of the investigation, if the staff believes that formal enforcement action should be recommended to the Commission, the parties to be named will be notified and provided an opportunity to make a written statement to the Commission explaining why the facts, circumstances or legal theories do not justify Commission enforcement action. This document is known as the "Wells statement." When persons or entities receive a "Wells notice," it is common for the party to engage in settlement negotiations with the staff. n25 If a settlement of the matter is negotiated, it will be submitted to the Commission at the same time as the recommendation for action. The Commission, in its discretion, may approve the recommended action and the recommended settlement, or it may approve the recommendation for action and reject the proposed settlement.

SEC Enforcement Actions

SEC enforcement may be brought as an injunctive action in U.S. Federal Court or as an administrative proceeding, heard by an administrative law judge. The choice of proceeding reflects a combination of factors, including the type and severity of the alleged violation and the person or entity to be charged. However, the most significant factor is the type of penalty or relief sought.

Injunctive actions

The SEC may bring civil injunctive actions in the proper Federal district court against any person who is "engaged or is about to engage in acts or practices constituting a violation" of the Federal securities laws, SEC regulations or the rules of any securities self-regulatory organization. n26 In addition to seeking the entry of an injunctive order prohibiting future violations of the applicable provisions of the law, the S.E.C. may seek: an order of disgorgement; an order barring the person from serving as an officer or director of a registered, public company; an order barring a person from participating in an offering of penny stock; or an order directing the payment of a civil money penalty. The SEC obtained the authority to obtain money penalties, officer and director bars and penny stock bars in 1990 when Congress enacted the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("Remedies Act"). n27

Administrative Proceedings

Since the creation of the SEC, it has had the authority to bring administrative proceedings to address violations of the securities laws. The scope of its authority to bring an administrative proceeding and the sanctions that can be ordered in an administrative proceeding has grown dramatically over time.

The Remedies Act dramatically expanded the nature of SEC administrative proceedings. It authorized the Commission to enter a cease and desist order against any person who is violating, has violated, or is about to violate any provision of the securities laws or any rule or regulation thereunder.ⁿ²⁸ In a cease and desist proceeding the Commission can order a party to take steps to effect compliance with its rules, to provide an accounting and to disgorge profits gained or losses avoided. The Sarbanes-Oxley Act further expanded the remedies available in a cease and desist proceeding by authorizing the SEC to bar an individual from serving as an officer or director of a public company if they violated the antifraud provisions of the 1933 Act or Exchange Act.ⁿ²⁹ This Act also created a proceeding to enable the SEC to issue a temporary cease and desist order. While the Commission has used its cease and desist authority extensively, it has brought only one proceeding under its temporary cease and desist authority.ⁿ³⁰

The Remedies Act also expanded the remedies that the SEC can order in an administrative proceeding against broker-dealers, investment advisers, investment companies and persons associated with these registered entities. The SEC can order disgorgement and civil penalties comparable to those available in an injunctive action.ⁿ³¹

A third form of administrative proceeding is a proceeding to deny a person, temporarily or permanently, from appearing or practicing before the Commission as an attorney, accountant or other professional. While the Commission has brought "rule 102(e)" proceedings (until 1992 they were known as rule 2(e) proceedings) throughout its history, based upon rules adopted under its general rulemaking authority, its authority to take action against persons licensed to practice by applicable state authorities was periodically questioned and challenged. Any uncertainty over this authority was eliminated by section 602 of the Sarbanes-Oxley Act, which added section 4C to the Exchange Act, incorporating the Commission's rule 102(e). While the Commission may initiate a proceeding under this provision against an attorney, an accountant, or other professional such as an engineer or geologist, the Commission's Office of General Counsel litigates such proceedings if the professional named is an attorney.

All administrative proceedings are heard by an administrative law judge (ALJ). Administrative law judges operate in a quasi-autonomous status. The SEC hires ALJs from a list of eligible candidates determined by the U.S. Office of Personnel Management and is obligated to pay the ALJ's salary and provide office and support services. To ensure the independence of the administrative process, once hired, the SEC has no authority to promote, reward or discipline an ALJ. After the institution of an administrative proceeding, the Chief Administrative Law Judge assigns it to one of the ALJs. The ALJ presides over the administrative hearing, taking testimony, reviewing briefs and issuing an initial decision containing findings of fact, conclusions of law and, if violations have been found, a proposed sanction. All ALJ initial decisions are appealable to the Commission, which conducts a *de novo* review. An initial decision is not final until the Commission has completed its review and issued its opinion and order, or if not appealed, until the Commission issues a finality order.

Other enforcement proceedings

Under section 12(k) of the Exchange Act, the Commission may issue an order suspending trading in a security for a period of up to ten business days if it finds that "the public interest and the protection of investors so require."ⁿ³² A trading suspension order takes effect at a day and time specified by the Commission in the order, typically the beginning of trading on the day of issuance. No hearing is required prior to the order's effectiveness. The Commission often issues a trading suspension in a security when it identifies an ongoing market manipulation. Frequently at the expiration of the trading suspension, secondary market trading will not resume in the stock, as the commission may have succeeded in obtaining a temporary restraining order against the perpetrators of the fraud or because market makers in the security are unable to satisfy the current information requirements of Exchange Act rule 15c2-11.

Prior to 1978, the SEC frequently would issue a new trading suspension order at the expiration of the ten-day period. This practice was discontinued following the Supreme Court's decision in *SEC v. Sloan*.ⁿ³³ The Commission has on rare occasions issued a second trading suspension against a security when it found a new factual basis for suspending trading.ⁿ³⁴

Occasionally, the Commission will decline to bring a formal enforcement action and will, instead, issue a report of its investigation under section 21(a) of the Exchange Act.ⁿ³⁵ These administrative orders describe the results of the staff's investigation and articulate the Commission's interpretation of applicable law to the conduct. The Commission often issues these reports in circumstances when it believes that a violation of the law has occurred but that the legal theory supporting its conclusion is novel or untested. The purpose of the report is to advise the public and the industry of the Commission's views and provide guidance. These reports are normally issued with the consent of the parties identified in the order.ⁿ³⁶

Criminal Enforcement Actions

The SEC enforcement authority is limited to civil actions. When conduct is sufficiently egregious it may warrant criminal prosecution by the Department of Justice; frequently through the Office of the U.S. Attorney for the Southern District of New York. The Division of Enforcement actively coordinates its investigations with criminal authorities. In some cases this is done at the beginning of the investigation, with the criminal authorities using the powers of a Federal Grand Jury to obtain testimony and evidence. In other instances, the division will complete its investigation and provide the appropriate criminal prosecutor with access to the investigative record compiled by the division. In exceptional circumstances, the Commission may formally vote to refer a matter for criminal prosecution.ⁿ³⁷

[d] Division of Investment Management.

The Division of Investment Management ("IM")ⁿ³⁸ has primary responsibility for SEC regulation under the Investment Company Act of 1940 and the Investment Advisers Act of 1940. It regulates investment companies, investment advisers, and variable insurance products. IM is responsible for the application of the disclosure reporting requirements of the Securities Act and Exchange Act to investment companies and reviewing disclosure documents filed by these entities, such as mutual fund prospectuses. It also has delegated authority in a wide range of activities, such as declaring mutual fund prospectuses effective and responsibility for considering and providing exemptive relief to regulated companies and individuals as permitted under the Investment Company Act.ⁿ³⁹

Organization and functions of the Division of Investment Management

A Director and Deputy Director head the division, which is organized into five groups, each headed by an Associate Director. Each of these groups has several offices, headed by one or more Assistant Directors. The organization generally is structured along functional lines:

- The Office of Investment Company Regulation
- The Office of the Chief Counsel
- The Office of Disclosure and Review
- The Office of Investment Adviser Regulation
- The Office of Insurance Products

- The Office of Regulatory Policy
- The Office of Disclosure Regulation

Office of Investment Company Regulation

The Office of Investment Company Regulation reviews and grants applications for exemptive orders. It also responds to requests for no-action positions and interpretive advice concerning previously issued exemptive orders. The Investment Company Act provides the SEC with broad authority to grant exemptions from compliance with specific provisions in the law. n40 Through exemptive relief, the SEC has responded flexibly to innovations in the mutual fund industry; such as the creation of money market funds and exchange-traded funds. Exemptive orders have dealt with a wide variety of issues, from complex trading vehicles that do not necessarily fit within the regulatory parameters of the Investment Company Act, to new sales and distribution practices in the mutual fund industry, as well as relatively minor operational matters affecting investment companies. Although most applications are "filed" with the Commission, amendments to these applications may be submitted in draft form. Once the staff has completed its review of an application, the Investment Company Act requires the Commission to publish a notice in the Federal Register outlining the requested relief and giving interested persons an opportunity to object to the application and request a hearing. The notice provides extensive information about the relief requested and the conditions for the exemptive relief. After a notice period of approximately 25 days, an order is issued granting the requested relief, unless a hearing is requested by an interested party or is ordered by the Commission on its own motion.

Office of the Chief Counsel

The office functions as "in-house" lawyer for the division. It is also the primary contact for others in the Commission, as well as for the industry, bar, and public seeking interpretive guidance on the Investment Company Act. The office performs a variety of functions, including: (1) responding to no-action and interpretive requests, (2) providing informal guidance to the public, the industry, and others in the Commission, (3) reviewing and commenting on registration statements filed under the Securities Act of 1933 and referred from Corp Fin that raise investment company issues, as well as requests from foreign governments, (4) reviewing and approving requests for confidential treatment of information concerning securities holdings of money managers, (5) commenting on proposed enforcement actions involving investment companies and investment advisers, and (6) preparing congressional testimony and comments on legislative proposals, and responding to letters from Congress.

Office of Disclosure and Review

The Office of Disclosure and Review examines and analyzes disclosure and accounting information in registration statements, proxy solicitation materials, and other reports filed with the Commission by investment companies. The disclosure review function of Investment Management differs from the disclosure review program of the division of Corporation Finance. In Investment Management the staff examines how a fund will comply with the Investment Company Act and the rules under the Act. It reviews disclosure of expenses, investment policies, and a fund's compliance and operational matters, including certain back office operations. In contrast, Corp Fin focuses primarily on the adequacy and clarity of the issuer's disclosure of material information that an investor may require in making an investment decision. In addition to reviewing the registration statement of all new funds and new portfolios, the staff conducts comprehensive reviews of active funds, called "integrated reviews."

This Office also includes the Division's Office of Chief Accountant and Office of Financial Analysis. These units provide support to the division's disclosure operations.

Office of Investment Adviser Regulation

The Office of Investment Adviser Regulation is responsible for regulatory functions that apply to investment advisers. The office reviews exemptive applications submitted by advisers seeking relief from compliance with specified statutory requirements, provides applicants with written and oral comments on applications, issues notices of applications that are published in the Federal Register, and issues orders. The office also prepares all rulemaking proposals under the Investment Advisers Act and participates in other special projects relating to investment adviser regulation.

Office of Insurance Products

The Office of Insurance Products is responsible for the regulation of insurance products that are registered as securities under the Federal securities laws. While the insurance industry has traditionally been regulated by the states, certain insurance products, such as variable annuities and variable life insurance contracts, are viewed as securities. In addition to regulating variable annuities and variable life insurance, the Office of Insurance Products regulates mutual funds that serve as funding vehicles for insurance products. Staff members (1) review and comment on registration statements, proxy statements, and other disclosure documents filed in connection with insurance products; (2) process requests for exemption from provisions of the Investment Company Act; (3) handle no-action requests; (4) develop rulemaking recommendations and advise other division offices on rulemaking projects that may affect insurance products; and (5) respond to inquiries from investors, the industry, and others.

Office of Regulatory Policy and Office of Disclosure Regulation

These two offices are responsible for developing recommendations to the Commission for new rules or amendments to existing rules, as necessary under the Investment Company Act. The Office of Regulatory Policy is responsible for developing regulations to standardize issues raised by multiple exemptive applications. The Office of Disclosure Regulation has responsibility for regulations pertaining to mutual fund disclosure, accounting and reporting requirements, companies and pooled investment funds.

[e] Office of the General Counsel

The General Counsel is the Commission's chief legal officer. The Office of the General Counsel provides legal analyses and advice to the Commission and its operating divisions on all recommendations submitted to the Commission for action and on any other matters that raise novel or important legal issues. It works closely with the staff of other offices and divisions on proposed rulemakings and all recommendations for enforcement actions. OGC also represents the Commission and its staff in federal court and administrative litigation as a plaintiff, defendant, or friend of the courtⁿ⁴¹; oversees the Commission's bankruptcy program; prepares draft opinions for the Commission when decisions of ALJs and SROs are appealed to the Commission and acts as the final decisional authority for the agency on appeals of denials of action under the Freedom of Information Act and Privacy Act.

The office also advises the Commission and its staff on matters arising out of the agency's procurement, contracting, fiscal, personnel, and other administrative activities; counsels the Commission and its staff regarding conflicts of interest and other ethics questions; and provides technical assistance to the Congress in matters involving Federal securities laws and regulations. The Commission has delegated to the General Counsel final agency authority in a broad range of areas.ⁿ⁴²

Organization and functions of the Office of General Counsel

The Office of General Counsel is headed by the Commission's General Counsel, a Deputy General Counsel and the Commission's Solicitor. OGC has five offices, each of which performs a distinct function:

- Office of Legal Policy

- Office of Adjudication
- Office of Appellate Litigation and Bankruptcy
- Office of General Litigation and Administrative Practice
- Ethics Office.

Office of Legal Policy

The Office of Legal Policy reviews all recommendations submitted by agency staff to the Commission. It provides the Commissioners with an analysis of the legal, regulatory, and legislative interests raised. The Office reviews all staff certifications to consider a matter at a closed meeting under the Government in the Sunshine Act before to certification by the General Counsel. The office also has responsibility for reviewing all legislative proposals considered by Congress and provides technical assistance to Congress in the drafting of legislation. The staff in the office also reviews all staff speeches, articles and other publications prior to release.

Office of Adjudication

The Office of Adjudication (Adjudication) is responsible for preparing draft Commission opinions when initial decisions by administrative law judges or disciplinary actions by SROs are appealed to the Commission. Adjudication also drafts the Commission's rulings on all procedural and substantive motions made in connection with such appeals.

By law, the Commission must conduct a *de novo* review. In other words, the Commission must independently review the facts of the case and the legal analysis and determine, by a preponderance of the evidence, whether the violations have been proven. The Commission has full discretion to impose a different sanction on appeals from an ALJ initial decision.

Section 19(d) of the Exchange Act authorizes the Commission to review SRO actions that impose disciplinary sanctions on members or associated persons or persons seeking to become associated with a member, denies membership or participation to any applicant, or prohibits or limits access to services offered by the SRO or a member of the SRO. n43 While Commission review is *de novo*, the Commission may only affirm the action taken by the SRO, modify the sanction or remand the matter for further proceedings. It may not increase the sanction. One other important procedural difference concerns oral arguments before the Commission. Commission rules presume a right to oral argument when requested in appeals of ALJ decisions unless "exceptional circumstances make oral argument impractical or inadvisable," n44 but provide discretion to deny oral argument requests on appeals of SRO actions.

In an effort to improve the timeliness of its review, the Commission has adopted non-binding guidelines providing that final decisions:

should be issued within seven months from the date the petition for review, application for review, or mandate of the court is filed, unless the Commission determines that the matter presents unusual complicating circumstances, in which case a decision by the Commission on the matter may be issued within 11 months from the date the petition for review, application for review, or mandate of the court is filed. The Commission retains discretion to take additional time to dispose of an appeal. n45

Office of Appellate Litigation and Bankruptcy

The Office of Appellate Litigation and Bankruptcy represents the Commission in actions pending in the U.S. Courts of

Appeals and (in conjunction with the Solicitor General of the United States) the U.S. Supreme Court. Cases include appeals from enforcement cases, petitions for review of Commission opinions and *amicus curiae* briefs filed by the Commission in private litigation. Appellate also oversees the Commission's bankruptcy program. The Commission is the only federal agency with the responsibility and right to participate in bankruptcy cases. It acts as a statutory advisor to the courts to protect the interests of public investors. This program is conducted by bankruptcy staff in four regional offices, with oversight by Appellate.

Office of General Litigation and Administrative Practice

The Office of General Litigation and Administrative Practice represents the Commission in a wide variety of cases brought against it in district court, such as contractual disputes, claims by employees and applicants for employment before the Equal Employment Opportunity Commission and the Merit Systems Protection Board. General Litigation attorneys also represent current and former Commission employees who are subpoenaed to testify in private and criminal actions. The office has delegated authority to issue decisions on Freedom of Information Act appeals.

General Litigation includes a contracting group that advises the Commission's administrative staff on procurement, contracting, fiscal, personnel, and other administrative activities, including operation of the Commission's EDGAR system, legal issues surrounding operation of its information technology systems, intellectual property matters, and procurement of goods and services for the SEC. This group also litigates any resulting disputes in these areas.

Ethics Office

The Ethics Office counsels the Commissioners and the staff on day-to-day ethics issues (e.g., securities transactions, gifts, foreign travel, etc.), providing training to all Commission employees on ethics issues, and ensuring that all staff make the financial disclosures required in light of their positions at the Commission. The Ethics Office acts as the agency liaison with the Department of Justice on the application of government-wide rules of ethical conduct.

The Ethics Counsel is responsible for oversight of compliance with the Commission's conduct regulations, n46 and investigation of allegations of violations of that Regulation; the Commission's Canons of Ethics, n47 and the Code of Behavior concerning Ex Parte Communications. The Ethics Counsel is also responsible for referring complaints that appear to involve a violation of federal criminal statutes, after a preliminary investigation has determined that the complaint is not frivolous, to the Chairman or most senior Commissioner, for transmission to the Department of Justice in accordance with the provisions of **28 U.S.C. 535** ; and acting as liaison with the Department of Justice on referral.

[f] Office of Compliance, Inspections and Examinations

The Office of Compliance, Inspections and Examinations ("OCIE") was created in 1995 when the inspection programs of the Division of Market Regulation (renamed the Division of Trading and Markets) and the Division of Investment Management were consolidated into this new office. OCIE administers the SEC's examination and inspection program with examiners in Washington DC and in the Commission's 11 regional offices. The program has responsibility for examining securities self-regulatory organizations, broker-dealers, transfer agents, investment companies and investment advisers. n48

To promote uniformity among its examination staff, OCIE has developed a series of examination "modules." A module has been developed for virtually every function of the securities industry that may be the subject of an examination. OCIE uses these modules to conduct an examination and as the basis for preparing staff reports. Following completion of an examination, OCIE staff routinely provide an oral assessment to the firm in an "exit interview." If information has been obtained suggesting a regulatory violation, OCIE may issue a "deficiency letter" notifying the firm examined of the deficiencies found and identifying necessary corrective action to be taken. Findings of more egregious violations may be referred to the Division of Enforcement. OCIE also provides its examination findings to the Commission or

other divisions or offices to assist in the development of policy or for rulemaking. On occasion OCIE may issue a public report addressing broad regulatory issues affecting a significant segment of the industry. n49

Organization and Functions of the Office of Compliance Inspections and Examinations

A Director and Deputy Director head the office, which is organized into four groups:

- Office of Chief Counsel
- Office of Broker-Dealer Examinations
- Office of Investment Company/Investment Adviser Examinations
- Office of Market/SRO Oversight

Office of Chief Counsel

The Office of Chief Counsel provides legal advice to OCIE staff in Washington and the eleven regional offices. The office also conducts selected special compliance examinations, typically in new areas. A Training Branch is responsible for planning and implementing staff training programs for new and experienced OCIE staff. A Registrations Branch reviews applications, amendments and withdrawals submitted by investment advisers, broker-dealers, transfer agents, and municipal securities dealers (regulated entities). The office also coordinates the Chief Compliance Officers Outreach seminars that OCIE conducts for personnel employed by regulated entities n50 and periodically publishes on the SEC website "compliance alert" letters providing advice to industry compliance personnel on timely regulatory issues. n51

Office of Broker-Dealer Examinations

The Office of Broker-Dealer Examinations is responsible for examining the approximately 6,900 broker-dealers in the United States n52 as well as non-mutual fund transfer agents, and clearing agencies. In addition, examiners from the BD examination group assist the SRO inspection group on inspections of FINRA's 14 District Offices. The BD examination program closely coordinates its examination program with the broker-dealer examination program of FINRA.

OCIE conducts four categories of examination -- oversight, cause, internal control, and surveillance/sweeps. Oversight exams represent the largest number of OCIE examinations of broker-dealers. These examinations evaluate both the broker-dealer's compliance with the Federal securities laws and the quality of FINRA's most recent examination. In general, an oversight examination includes a review of the broker-dealer's compliance with operational, financial, and sales practice requirements. A cause examination is made when OCIE has received credible information indicating a firm is not in compliance with Commission regulations. Unlike oversight examinations, the scope of cause examinations typically is limited to those areas that gave rise to the examination. Firms may also be selected on the basis of a "risk matrix" system that reviews available information to identify firms that have a higher likelihood of regulatory failure. Internal controls examinations differ from normal sales practice and financial/operational examinations. They examine a firm's overall control and supervisory systems in areas such as credit, liquidity, funding, and other risk areas. These examinations focus on the largest broker-dealers holding a significant proportion of investor assets. Finally the office periodically conducts "surveillance" or "sweep" examinations of a sample of firms to assess industry practices in a discrete area or program. These examinations often result in an internal or public report describing the staff's findings.

Office of Investment Company/Investment Adviser Examinations

The Office of Investment Adviser/Investment Company Examinations is responsible for the examination of approximately 10,600 investment advisers ("IAs") and 940 investment company complexes ("ICs") registered with the Commission with total assets of approximately \$32.3 trillion dollars. "During 2003-2006, the Office's staff conducted reviews focused on market timing and late trading, investment company pricing procedures, payments to obtain business, fund expenses, anti-money laundering prevention, disaster recovery planning, proxy voting and selective disclosures, among other areas." n53

Office of Market SRO Oversight

Unlike the other OCIE examination programs, the Market/SRO examination program is conducted exclusively by OCIE staff in the Washington headquarters; although examiners from the regional/district offices assist in performing examinations of the District Offices of FINRA. The program is designed to conduct inspections of the SROs (including all registered exchanges, FINRA and the Municipal Securities Rulemaking Board), and approximately 70 alternative trading systems. The SRO examination group is divided into two offices. One group focuses on market oversight and the second group focuses on listings, arbitration, and sales practice oversight.

OCIE's SRO groups conduct routine and risk-based inspections of SRO regulatory programs, including: market surveillance, investigation, disciplinary, broker-dealer examination, listing and arbitration programs, among others. In the market surveillance area, OCIE staff examine whether the stock markets have systems and procedures in place to uncover possible market manipulation and other violations. In the listing area, staff examine whether stock markets are ensuring that listed companies satisfy all applicable financial and corporate governance listing standards. n54

[g] Office of the Chief Accountant

The Chief Accountant is the Commission's principal advisor to the Commission and the Commission's staff on accounting matters. The Chief Accountant has general supervisory authority over the execution of Commission policy concerning the accounting and auditing principles and practices that public companies must follow in the preparation of financial statements filed with the Commission. The Chief Accountant works closely with the Chief Accountants in each division to resolve difficult questions and to ensure consistency in the positions taken. The Chief Accountant is responsible for recommending the institution of administrative proceedings related to the disqualification of accountants to practice before the Commission, for assisting counsel in the conduct of such proceedings. The Office has primary responsibility for overseeing the activities of the Financial Accounting Standards Board and the Public Company Accounting Oversight Board ("PCAOB").

The Chief Accountant, in conjunction with the Division of Corporation Finance, has responsibility for the drafting of rules and regulations establishing the requirements as to the form and content of financial statements to be filed with the Commission and for the general administration of those accounting requirements. To this end, the Commission has adopted a basic accounting regulation (Regulation S-X, 17 C.F.R. Part 210) that, together with a number of opinions entitled Accounting Series Releases and Staff Accounting Bulletins, governs the form and content of most of the financial statements filed with it. n55 These accounting rules, along with SEC decisions and opinions concerning auditing issues, in conjunction with authoritative pronouncements by professional accounting societies and by other governmental agencies, have achieved a substantial clarification and improvement in the accounting and auditing principles and practices generally followed in the preparation of financial statements.

The Office of the Chief Accountant is organized into three groups:

- Accounting Group
- Professional Practice Group

● International Affairs Group

The *Accounting* group works closely with the Financial Accounting Standards Board on the development, application and interpretation of GAAP and questions concerning SEC financial disclosure requirements. These functions require close coordination with accounting staff in the Division of Corporation Finance, Investment Management, and Enforcement.

The *Professional Practice* group works closely with the PCAOB on matters concerning auditing policies and procedures. This group also manages the resolution of auditor and preparer independence and ethical matters that have been brought to the attention of the Commission.

The *International Affairs* group works with international accounting, auditing, and regulatory organizations on the development of consistent and uniform international accounting standards. Convergence of U.S. GAAP with the International Financial Reporting Standards (IFRS) adopted by the International Accounting Standards Board (IASB) is a priority for the SEC.

In 2007, the SEC created an Office of Interactive Data under the supervision of the Office of the Chief Accountant. This office is charged with identifying and applying the latest innovations in information technology to the Commission's EDGAR system. A primary objective of this program is the application of XBRL programming to corporate disclosure documents.

[h] Office of International Affairs

The Office of International Affairs (OIA) acts as the principal liaison with foreign capital markets regulators and international organizations such as the International Organization of Securities Commissions. The office has direct responsibility for making requests on behalf of the division of enforcement to foreign regulators for investigation assistance and receives similar investigation requests from foreign regulators seeking investigation assistance from the SEC. The Office represents the SEC on multinational bodies advancing the development of global best practices and regulatory standards and actively negotiates international cooperation and cross-border information sharing agreements. It coordinates these activities with staff in the relevant offices and divisions of the Commission.

OIA conducts training and technical assistance programs in the United States and overseas for foreign securities and law enforcement authorities. Every year it hosts a regulatory training conference for regulatory officials from developing market economies. In addition its staff, and staff from other offices and divisions, provides direct technical assistance to foreign regulators.

OIA analyzes the impact of SEC rules and actions upon foreign market participants active in US markets, and advises the Commission regarding the manner in which SEC and non-US initiatives affect the cross-border activities of US issuers and US financial service providers.

[i] Office of Economic Analysis

The Office of Economic Analysis is responsible for advising the Commission and its staff on economic issues associated with the SEC's regulatory activities. Whenever the Commission proposes a regulatory action the Office prepares a cost analysis that is published in the regulatory release. These analyses are used in the consideration of whether to take action on the proposal and also to satisfy legal requirements of the Small Business Regulatory Enforcement Fairness Act. The Office also assists the Division of Enforcement by analyzing the market impact of illegal conduct and quantifying the profits made or losses avoided by persons engaged in insider trading. The Office analyzes the likely consequences of proposed regulations, and engages in research in support of longer-term SEC policy initiatives and plans. This includes research into the causes and consequences of significant developments in the

securities markets, in prevailing financial practices among issuer firms, and in SEC policy. Findings from staff research are disseminated to internal decision officials through oral and written presentations and may also be disseminated to external audiences through attendance at academic conferences and publication.

[j] Office of Investor Education and Advocacy

The Office was established in May 1976 as the Office of Consumer Affairs to consolidate several functions into a coordinated office. The Office acts as the principal link with individual investors and as the representative of their interests at the Commission. The Office focuses its attention on creation of educational publications explaining the U.S. capital markets, investment alternatives and alerting the public to frauds and questionable practices.

The office receives and reviews all correspondence and complaints submitted to the SEC. Matters requiring enforcement investigation or regulatory action are referred to the appropriate office or division of the Commission. When a letter concerns a private dispute with a broker or other regulated entity, the office will often request a written response from that organization.

The office reviews all proposed regulatory initiatives and advises the Commission and staff on the impact the initiative may have on individual investors. The office also assists the Division of Trading and Markets in oversight of the securities industry dispute resolution program.

[k] Office of Risk Assessment

The Office of Risk Assessment (ORA) is responsible for coordinating the SEC's risk management program. ORA was formed in 2004 to help the SEC anticipate, identify, and manage risks. ORA focuses on risk issues across the corporate and financial sector, including issues relevant to corporate disclosure, market operation, sales practices, new product innovation, and many other activities of financial market participants.

ORA's responsibilities can be grouped into three general categories:

- Information Analysis on new industry trends and risks from a variety of sources, such as external experts, domestic and foreign agencies, industry and financial services, empirical data and other market data.
- Managing the agency's risk assessment process by defining relevant risk frameworks and common risk language.
- Serving as the agency's risk management resource by coordinating with other offices and divisions of the Commission.

[l] Secretary of the SEC

The Office of the Secretary is responsible for coordinating the deliberations of the Commission. The Office has responsibility for scheduling Commission meetings and preparing the calendar of items for action. The Office also coordinates staff requests for Commission action by seriatim action or duty officer action. The Office is responsible for drafting the Commission's official minutes and for reviewing all Commission orders, releases and other statements prior to issuance. The office is responsible for agency compliance with the Government in the Sunshine Act and the Federal Advisory Committee Act.

The office also manages the Commission's library, online reference services and the SEC Internet website and internal intranet. In 2007, the records management functions performed by the Office of Filings and Information Services

(OFIS) were transferred to the Office of the Secretary when OFIS was dissolved.

The office has primary responsibility for the administration of Commission administrative proceedings. It is responsible for service of all actions and for receipt of all filings in these proceedings. It prepares the official record of action for the administrative law judges and for the Commission, in the event of an appeal. It performs the same function on SRO actions that are appealed to the Commission. In the event that an order of disgorgement is entered in an administrative proceeding, the Commission has delegated to the office the responsibility to review and approve all proposed plans of disgorgement.

[m] Office of Administrative Law Judges

The Office of Administrative Law Judges is headed by a Chief Administrative Law Judge who supervises the administrative law judges assigned to hear administrative proceedings brought by the SEC. To maintain the integrity of the administrative process, all ALJs must be qualified by the Office of Personnel Management, which provides the SEC with a list of eligible candidates. Once hired by the SEC, the Commission is obligated to pay the ALJ's salary and provide office and support services. However, the SEC has no authority to promote, reward or discipline an ALJ.

After the institution of an administrative proceeding, the Chief Administrative Law Judge assigns it to one of the ALJs. The ALJ presides over the administrative hearing, taking testimony, reviewing briefs and issuing an initial decision containing findings of fact, conclusions of law and, if violations have been found, a proposed sanction. All ALJ initial decisions are appealable to the Commission, which conducts a *de novo* review. An initial decision is not final until the Commission has completed its review and issued its opinion and order, or if not appealed, until the Commission issues a finality order.

[n] Office of Public Affairs

This Office is the Commission's chief public information officer. It communicates the Commission's actions to the public and the news media. An SEC News Digest is published daily highlighting all public actions taken by the Commission. n56 When newsworthy events occur, the Office prepares a Press Release announcing the action and distributes the Press Release to the media and through the SEC website.

[o] Office of the Inspector General

The Commission established the Office of Inspector General in March 1989 as required by the Inspector General Act of 1978. Under this act, the Office is independent of Commission management and has freedom to determine what it will investigate or audit. The Chairman, however, appoints the Inspector General and appraises his/her performance.

The Office's primary functions are to (1) perform audits of Commission operations, programs, activities, functions, and organizations, and (2) conduct investigations of alleged staff (and contractor) misconduct. A final report is prepared at the completion of an investigation. These reports are distributed to the SEC officials responsible for taking corrective actions and the audit reports are available to the public on the SEC website, as are required semiannual reports to Congress, and other documents generated by the Office. n57

[p] Office of Equal Employment Opportunity

The primary mission of the EEO Office is to prevent employment discrimination, including discriminatory harassment. The Office investigates complaints from Commission employees and applicants for employment to determine if a violation of law may have occurred. The Office also provides training and counseling to SEC staff and management. It also sponsors events celebrating diversity and heritage.

[q] Office of Legislative Affairs

This office serves as the principal liaison between the SEC and members of Congress and their staffs and advises SEC Commissioners on legislative strategy and response to Congressional requests and provides information about SEC actions to Congress. This office also organizes briefings given to Congress by SEC staff members and coordinates the testimony of SEC officials before Congressional committees. In addition, this office works closely with other government agencies regarding legislation that might affect the SEC.

[r] Regional Offices

Staff of the eleven regional offices perform two functions. One group in each office is responsible for conducting enforcement investigations and litigating any legal actions arising from these investigations. The second group performs examinations and inspections of regulated entities under the direction of OCIE.

A regional director and two or more deputy directors manage each regional office. The Division of Enforcement oversees the enforcement programs in each regional office and the Director of Enforcement has supervisory authority over regional office management and administration. The Director of OCIE provides program supervision over the examination and inspection program in each region.

[s] Executive Director.

The Executive Director functions as the chief operating officer of the Commission on matters of budget, staffing and administration. The Office is responsible for advising the Chairman on preparation of the annual agency appropriation request to Congress and on all decisions regarding staffing, personnel and administrative services. The office also supervises SEC staff that respond to public requests under the Freedom of Information Act. To accomplish these responsibilities the Executive Director supervises the operations of the following offices:

[i] Office of Financial Management

The Office of Financial Management is headed by the Commission's Chief Financial Officer. The office manages the expenditure of funds by the agency, monitors the utilization of agency resources, and develops, oversees, and maintains SEC financial systems. These activities include cash management, accounting, fee collections, travel policy development, and oversight and budget justification and execution.

[ii] Office of Human Resources

This Office develops and implements the personnel programs of the Commission, including recruitment, placement, and staffing; position classification and wage administration; employee career development and training; labor management relations including representing management on labor relations matters; personnel management evaluation; employee performance evaluation; insurance and health benefits; and incentive awards. The Office also serves as liaison with the Office of Personnel Management, professional organizations, and other government agencies on personnel matters

[iii] Office of Administrative Services

The Office of Administrative Services manages the agency's facilities and related support services. The office services headquarters and regional office locations, and includes services such as procurement and contracting, physical security, emergency management, property management, office lease acquisition and administration, space renovation, supplies and office equipment management, transportation, mail distribution, publications, printing, and desktop publishing.

[t] Office of Information Technology.

The Office has overall management responsibility for the Commission's IT program including application development,

infrastructure operations and engineering, user support, IT program management, capital planning, security, and enterprise architecture. The Office operates the EDGAR system through which public companies and other regulated entities file more than 750,000 documents annually.

FOOTNOTES:

(n1)Footnote 1. For discussion of the work of the Commission in administering and enforcing the 1934 Act, see § 1.03 *infra*.

(n2)Footnote 2. 17 C.F.R. § 200.41.

(n3)Footnote 3. 17 C.F.R. § 200.43.

(n4)Footnote 4. 5 U.S.C. 552b.

(n5)Footnote 5. 17 C.F.R. § 200.42.

(n6)Footnote 6. 15 U.S.C. § 78d-1.

(n7)Footnote 7. 15 C.F.R. § 200.30 contains the full list of formal delegations of authority, grouped by Division or office.

(n8)Footnote 8. *See, e.g.,* 17 C.F.R. § 202.2, reprinted in the Securities Primary Law Sourcebook, Volume D, Section Q.

For discussion of Interpretive Advice and "No-Action" Letters, *see* § 9.01[1] *infra*.

(n9)Footnote 9. Registration of securities pursuant to Section 12(b) or (g) is discussed in § 4.01[1],[2] *infra*. 17 C.F.R. § 200.18(b)(1). Periodic reporting requirements are discussed in § 4.02 *infra*. 17 C.F.R. § 200.18(b)(2).

(n10)Footnote 10. Proxy solicitation is discussed in § 7.02 *infra*; information material filed pursuant to Section 14(c) is discussed in § 7.06 *infra*. See also SEC Staff Legal Bulletin 14C, issued June 28, 2005.

(n11)Footnote 11. In its 2007 Annual Report, the SEC reported that it completed reviews of more than 1/3 of all reporting companies in that year. SEC 2007 Performance and Accountability Report, page 37.

(n12)Footnote 12. SEC press release 204-89, available at <http://www.sec.gov/news/press/2004-89.htm>.

(n13)Footnote 13. 17 C.F.R. § 200.30-1

(n14)Footnote 14. All Corporation Finance no-action letters issued after January 15, 2002, and selected older letters are available on the SEC website at <http://www.sec.gov/divisions/corpfin/cf-noaction.shtml>. In 1980, the Commission issued explanatory releases on requesting no-action letters, Sec. Act. Release Nos. 33-6269, 33-6253. For discussion of Interpretations and "No-Action" Letters, *see* §§ 1.03[1][c]

(n15)Footnote 15. 17 C.F.R. § 14a-8. *Discussed in* Volume 2, Chapter 7.

(n16)Footnote 16. *See* SEC Staff Legal Bulletin No.1, issued February 28, 1997, updated July 11, 2001; available at <http://www.sec.gov/interp/legal/slbcf1r.htm>, Requests for confidential treatment of information obtained by the Commission but not publicly filed, including records obtained during Commission inspections and investigations and records (other than those required to be filed and made publicly available) submitted in connection with the Commission's review of applications and filings, are covered by 17 C.F.R. § 200.83. *See* Sec. Exch. Act. Rel. No. 34-17149. This is discussed in § 9.02[1][c][iv] *infra*.

(n17)Footnote 17. The complete list of delegations of authority to the Division of Trading and Markets is codified at 17 C.F.R. § 200.30-3.

(n18)Footnote 18. 15 USC § 78s(b).

(n19)Footnote 19. This description of consolidated supervised entities regulation is extracted from the SEC website description of consolidated supervised entities contained at <http://www.sec.gov/divisions/marketreg/hcsupervision.htm>. A comprehensive description of the regulation and program is available as well.

(n20)Footnote 20. 15 U.S.C. 78o-7

(n21)Footnote 21. SEC Release No. 34-55857.

(n22)Footnote 22. The Office of General Counsel, not the Division of Enforcement, is responsible for conducting investigations and bringing enforcement actions pertaining to improper professional conduct or violations of the securities laws by attorneys in circumstances where the misconduct occurred in the context of an Enforcement investigation

(n23)Footnote 23. 15 U.S.C. § 78u(a)(2). At one time the Commission relied heavily upon bilaterally negotiated memoranda of understanding with foreign securities regulators to satisfy the reciprocity requirement. In recent years, the Commission has looked to whether the requesting authority is a signatory to the multilateral memorandum of understanding drafted and overseen by the International Organization of Securities Commissions (IOSCO).

(n24)Footnote 24. The Commission has delegated authority to the Division to bring a subpoena enforcement action, 17 CFR § 200.30-4(a)(10)200.30-4(a)(10). Criminal contempt proceedings have been brought to compel a party to produce assets covered by an order of disgorgement in an SEC civil proceeding. Under criminal contempt, a party may be incarcerated to coerce compliance.

(n25)Footnote 25. The relevant Commission regulation provides that "the staff, with specific authorization, may discuss with persons involved the disposition of such matters by consent, by settlement, or in some other manner." 17 CFR § 202.5(f). While this provision appears to require the staff to obtain authorization from the Commission before engaging in settlement negotiations, this has not been standard practice. Recently it has been reported that the Commission has begun an experimental process of requiring the division to advise the Commission of settlement negotiations involving the payment of a large money penalty by a public corporation. See Bloomberg News Service, "SEC Penalties Fall Amid 'New Ethos' on Company Fines". November 19, 2007.

(n26)Footnote 26. *For example*, 15 U.S.C. § 78u(d). Comparable provisions are contained in the Securities Act of 1933, the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

(n27)Footnote 27. P.L. 101-429, 104 Stat. 931 (Act of October 15, 1990).

(n28)Footnote 28. 15 U.S.C. § 78u-3. The same authority was added to the Securities Act of 1993, 15 U.S.C. § 77h-1; the Investment Company Act of 1940, 15 U.S.C. § 80a-9(f); and the Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(k).

(n29)Footnote 29. Section 1105 SOX XXXX

(n30)Footnote 30. In the Matter of A.R. Baron, Proceeding 3-9010. Release No. 34-37240 / May 23, 1996

(n31)Footnote 31. 15 U.S.C. § 78u-2.

(n32)Footnote 32. 5 U.S.C. § 78l(k).

(n33)Footnote 33. 98 S.Ct. 1702 (1978) . This case also is significant as it was the last case in which a unanimous Supreme Court ruled against the U.S. government and in favor of a *pro se* litigant.

(n34)Footnote 34. *See, for example*, two successive trading suspensions in the securities of Struthers Industries Inc., Exchange Act release No 34-39531 / January 9, 1998 and Exchange Act Release No. 39578 / January 26, 1998.

(n35)Footnote 35. "The Commission is authorized in its discretion, to publish information concerning any such violations." 15 U.S.C. § 78u(a).

(n36)Footnote 36. *See, for example*, In the Matter of Donald Fuerstein. Exchange Act Release No. 34-31554 / December 3, 1992.

(n37)Footnote 37. Because the division has delegated authority to provide access to its files to criminal authorities, 17 CFR § 200.30-4, it rarely requests that the Commission vote on a formal criminal referral.

(n38)Footnote 38. In June 1976, the Division of Investment Management Regulation was renamed the Division of Investment Management. Sec. Exch. Act Rel. No. 12568 (1976). Between January 1973 and June 1976, the Division was known as the Division of Investment Management Regulation. 39 SEC Ann. Rep. 133 (1973). From August 1972 to January 1973, it was called the Division of Investment Company Regulation. Before that, it was part of the Division of Trading and Markets, previously called the Division of Trading and Exchanges. *See* 1 Loss & Seligman, Securities Regulation 300, n. 25 (3d. ed 1989).

(n39)Footnote 39. The delegation of authority to the Division of Investment Management is contained at 17 C.F.R. § 200.30-5.

(n40)Footnote 40. *See, for example*, sections 6(c), 12(d)(1)(J), 17(b) and 17(d) of the Investment Company Act of 1940.

(n41)Footnote 41. In cases between private parties involving statutes administered by the Commission, the Office of the General Counsel represents the Commission where the case presents legal issues of great importance, participating therein as a friend of the court. 17 C.F.R. § 200.21.

(n42)Footnote 42. 17 C.F.R. § 200.30-14.

(n43)Footnote 43. 15 USC § 78s(b).

(n44)Footnote 44. 17 CFR § 201.451(a).

(n45)Footnote 45. 17 CFR § 201.900.

(n46)Footnote 46. 17 C.F.R. § 200.735-1 *et seq.*

(n47)Footnote 47. 17 C.F.R. § 200.50 *et seq.*

(n48)Footnote 48. The Division of Trading and Markets is responsible for examinations of consolidated supervised entities, nationally recognized statistical rating organization and for the automation review program. The Office of the Chief Accountant is responsible for examination of the Public Company Accounting Oversight Board.

(n49)Footnote 49. All OCIE special reports are publicly available on the SEC website at http://www.sec.gov/about/offices/ocie/ocie_guidance.shtml

(n50)Footnote 50. Information for industry compliance personnel interested in learning more about this program or interested in registering for a program is *available at* <http://www.sec.gov/info/iaicccoutreach.htm>.

(n51)Footnote 51. The July 2007 compliance alert letter is *available at* <http://www.sec.gov/about/offices/ocie/complialert.htm>.

(n52)Footnote 52. See SEC website at http://www.sec.gov/about/offices/ocie/ocie_offices.shtml.

(n53)Footnote 53. Statistics and description obtained from SEC website. http://www.sec.gov/about/offices/ocie/ocie_offices.shtml#bd.

(n54)Footnote 54. This description is taken from the SEC website description located at http://www.sec.gov/about/offices/ocie/ocie_offices.shtml#bd.

(n55)Footnote 55. Regulation S-X, Accounting Series Releases, and Staff Accounting Bulletins are discussed in § 4A.01[2][a][i]-[iii] *infra*. Regulation S-X is reprinted in the Securities Primary Law Sourcebook, Volume D, Section M.

(n56)Footnote 56. The SEC News Digest is available at <http://www.sec.gov/news/digest.shtml>

(n57)Footnote 57. Inspector General documents can be found at <http://www.sec.gov/about/oig/oigauditlist.htm>

* This chapter has been updated by Jonathan G. Katz. Mr. Katz served as the Secretary of the U.S. Securities and Exchange Commission from 1986 until his retirement in 2006.



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Federal Securities Exchange Act of 1934

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CHAPTER 1 The Securities Exchange Act of 1934 and the SEC *

1-1 Federal Securities Exchange Act of 1934 § 1.03

§ 1.03 The Work of the SEC in Administering and Enforcing the 1934 Act

The Commission exercises its regulatory authority by adopting rules and regulations necessary or appropriate to implement the provisions of the statutes that it administers; by informal assistance to the public and companies subject to SEC regulation through interpretations and "no action" letters discussing the Commission's position regarding the applicability of such statutes; by investigating possible violations of the federal securities laws; and by instituting enforcement proceedings.

[1] Regulatory Policy

[a] Rulemaking.

Section 23(a) authorizes the Commission to prescribe rules and regulations necessary or appropriate to implement of the Exchange Act and to execute the functions vested in the Commission under the 1934 Act. n1 All Commission rulemaking activities must be conducted in accordance with section 553 of the Administrative Procedures Act. n2 The Commission must also comply with a variety of other requirements which Congress has imposed. These include:

- Regulatory Flexibility Act ("RegFlex Act"); n3
- Paperwork Reduction Act; n4
- Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA"); n5
- Federal Advisory Committee Act; n6
- § 23(a)(2) of the Exchange Act;
- National Securities Markets Improvements Act of 1996 ("NSMIA"). n7

The APA establishes the core requirements for all Federal agency rulemaking. It requires, with two limited exceptions, that "the agency shall give interested persons an opportunity to participate in the rulemaking through the submission of written data, views, or arguments with or without opportunity for oral presentation" n8 Written comments are public documents unless the Commission grants confidential treatment, upon request. n9

In 1980 Congress enacted the RegFlex Act which requires agencies to consider the impact of regulations on small business and other small entities. Under the act, unless the Chairman certifies that the proposed action "will not have a significant economic impact on a substantial number of small entities" n10 an agency must prepare, make available for public comment, and publish in the Federal Register, an initial regulatory flexibility analysis ("IRFA") of every proposed rule for which a notice of proposed rulemaking is issued. The IRFA is a preliminary SEC assessment of the effect of the proposed rule on individuals, small businesses, small organizations, and small governmental jurisdictions. n11 If a rule is adopted, the Commission must include in the adopting release a final regulatory flexibility analysis that includes a statement concerning less burdensome alternatives that were considered and explaining why the less burdensome alternatives were not adopted. n12

The RegFlex Act also requires all agencies to publish in the Federal Register a plan to review all existing rules that have a significant impact on a substantial number of small entities. The agencies then must to publish in the Federal Register twice annually, in October and April, a regulatory flexibility agenda that identifies all rules under development that may have a significant impact on a substantial number of small agencies. n13

The Paperwork Reduction Act was also enacted in 1980. The Act requires Federal agencies, including the Commission, to obtain prior approval from the Office of Management and Budget ("OMB") for any collection of information from ten or more persons. This includes SEC use of questionnaires and surveys and all SEC forms. Any proposed agency collection of information from 10 or more persons must be published for notice and comment in the Federal Register. The notice must explain the purpose and need for the collection and the burden to be imposed. The agency must provide an estimate of the burden and the cost of compliance, including initial and ongoing or annual compliance costs. Comments must be requested on whether collection of information is necessary and will have practical utility; whether the agency estimate of burden is accurate; suggestions on improving the quality, utility and clarity of information to be collected; and suggestions on how to minimize the burden. The PPRA approval must be renewed every three years, through notice and comment and OMB review.

In 1996 Congress enacted SBREFA, which created a procedure for Congressional review of agency regulations. All regulations must be submitted to both houses of Congress and the General Accounting Office ("GAO") upon adoption. The act provides two review processes, based on whether a rule is a "major rule." It defines a major rule n14 as one that is likely to have an annual effect on the economy of 100 million; both costs or benefits; or result in a major increase in costs or prices for consumers or individual industries or have significant adverse effects on competition, investment or innovation. The Commission's internal analysis of this is not required to be included in the release but the Commission's determination may be the subject of public comment. If a rule is a major rule it may not take effect for sixty days. Minor rules may take effect sooner than sixty days, subject to Congressional action. The GAO must provide Congress with a written report on all major rules within 15 days of receipt. Disapproval of a rule requires a joint declaration of Congress. n15

Many suggestions for rule modification follow extensive consultation with industry representatives and others affected. n16 The Federal Advisory Committee Act governs creation by the Commission of an advisory committee to provide advice on important policy questions, such as the development or amendment of regulatory policy.

In making rules and regulations, the Commission must consider their effects on competition. n17 The National Securities Markets Improvements Act further amended the securities laws to require that "whenever the Commission is engaged in rulemaking, or in the review of a rule of a self-regulatory organization, and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation." n18 These provisions are often believed to have created a requirement that the Commission conduct a formal cost-benefit analysis for a proposed rule. While the Commission has voluntarily conducted such analyses, they are not mandated. However costs, benefits and alternatives must be considered as part of the public interest analysis. n19

[b] Self-Regulatory Organization Rulemaking

Section 19(b) of the Exchange Act requires that:

each self-regulatory organization n20 shall file with the Commission... any proposed rule or any proposed change in, addition to, or deletion from the rules of such self-regulatory organization (hereinafter in this subsection collectively referred to as a "proposed rule change") accompanied by a concise general statement of the basis and purpose of such proposed rule change. The Commission shall, upon the filing of any proposed rule change, publish notice thereof together with the terms of substance of the proposed rule change or a description of the subjects and issues involved. The Commission shall give interested persons an opportunity to submit written data, views, and arguments concerning such proposed rule change. No proposed rule change shall take effect unless approved by the Commission or otherwise permitted in accordance with the provisions of this subsection. n21

The rule filing process under the Exchange Act allows the Commission to ensure that SRO rules and practices are consistent with the Exchange Act and the goals of the national market system. These goals include promotion of fair competition among markets, transparency of prices, best execution of customer orders, fair and orderly markets, and most importantly, investor protection. SRO rules also must be designed to prevent fraudulent and manipulative acts and practices, and promote just and equitable principles of trade. Finally, the Exchange Act contains a public notice and comment procedure to ensure that interested persons have an opportunity to provide input into SRO actions that may have a significant impact on market participants and individual investors.

The Exchange Act provides two alternative procedures, for SEC action. Under Section 19(b)(2), once an SRO files a proposed change, the Commission must publish notice of the filing in the Federal Register, typically for a 21-day period, seeking public comment (this period can be extended for complex filings). Within 35 days of publication (or up to 90 days for good cause or with the consent of the SRO), the Commission must either issue an order approving the proposal or an order instituting proceedings to determine whether the proposal should be disapproved. If a proceeding is ordered, it must be concluded within 180 days from publication of the original notice (subject to a 60-day extension for good cause or a longer period if agreed to by the SRO). Under Section 19(b)(2) the Commission must approve a proposed rule change if it finds that the proposal is consistent with the requirements of the Act and the applicable rules and regulations. Commission approval of an SRO rule change confers implied antitrust immunity.

The Section 19(b)(3) process is an expedited procedure. Certain types of rules, such as changes in fees, may become effective upon filing with the Commission. n22 These filings are published for notice and comment and the Commission has 60 days from filing to summarily abrogate a filing. If abrogated, the SRO must re-file under Section 19(b)(2). The division, however, rarely abrogates filings under this section (in part because SROs typically withdraw the filing rather than have it abrogated by the division).

While section 19(b) contains explicit time periods for acting upon SRO rule filings, in practice these time frames are not applied rigidly. Instead, the process has evolved into one that is both highly flexible and more time consuming. Because the statutory time limits are triggered by Federal Register publication and the division controls that decision, it can minimize the impact of the time limits by delaying publication. Similarly, an SRO can control the process by initially providing the filing as an informal draft, and then, after the official filing, voluntarily agreeing to extend the deadlines. Or it can file amendments to an application, with each amendment restarting the statutory time frame. Although Commission review of SRO rulemaking requires an opportunity for public notice and comment, it is not a process subject to the APA or the other procedural requirements enacted by Congress and applicable to Federal agency rulemaking. However, the requirement under NSMIA to consider "in addition to the public interest whether the action will promote efficiency, competition and capital formation" applies to SEC consideration of SRO rule filings. n23

[b] Interpretations, "No-Action" Letters and Informal Guidance.

As part of its activities, the Commission, through its divisions and offices, provides informal guidance and administrative interpretations of the securities laws and the regulations thereunder to members of the public, prospective registrants, and others. n24 This informal guidance may take several forms, including an informal telephone response, a "no-action" letter, a public statement containing answers to "frequently asked questions" ("FAQ"), a Staff Legal Bulletin ("SLB") or a Staff Accounting Bulletin ("SAB"). On more than one occasion the public has been informed of staff or Commission interpretations through a public speech by a Commissioner or senior member of the staff or through the issuance of a press release n25. While the Commission has been occasionally criticized for its frequent use of informal guidance to create a body of "informal regulations," it has become an important vehicle for advising the public and regulated industries of Commission positions and interpretations.

Requests for no-action letters are frequently used by the private bar on behalf of a corporate or individual client, to obtain informal advice from the SEC staff. In the request, the writer generally is seeking advice, interpretations, opinions or assurances that no enforcement action will be recommended to the Commission in regard to a particular transaction prior to its consummation. The response by the SEC staff to such a request is known as a "no-action" letter. The advice, for example, may include an informal expression of opinion about whether the a particular security is subject to the registration requirements and, if so, advice as to compliance with the disclosure requirements of the applicable registration form. Because the response usually contains the words "we will not recommend that the Commission take any action" they are referred to as a "no-action" letter.

When a request for a no-action letter is submitted, the staff has the discretion to decline to respond. Persons submitting a request may withdraw the request rather than receive a negative response. All no-action letters issued by the staff are made public, along with the incoming request, and are available on the SEC website. n26

The Commission is not bound by these staff-written letters, and the letters are not to be considered rulings of the Commission on questions of law or fact and are not dispositive of the legal issues raised as to the applicability of the federal securities laws to a given transaction. n27 The staff responses in no-action letters only purport to represent the views of the officials who give them. As Professors Loss stated in an earlier edition of his treatise, the official says, in effect: "this is my view based on the facts as you describe them. You may not rely on it as if it were a Commission decision. If you don't like it, you are at liberty to disregard it and follow your own construction, subject to the risk that I may recommend appropriate action to the Commission and the Commission may institute proceedings or take other steps if the Commission agrees with my view." n28

The Commission's staff increasingly relies upon published compilations of answers to "frequently asked questions," or FAQs, to efficiently respond to repeated questions for general interpretations of a rule. When the staff publishes a list of FAQs, it typically begins with a standard disclaimer reading: "the answers to these frequently asked questions represent the views of the Division of Corporation Finance. They are not rules, regulations nor statements of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved them." n29

Staff Legal Bulletins and Staff Accounting Bulletins are more authoritative statements of staff interpretive positions on important or complex questions. While they represent interpretations and policies followed by the division or office issuing it, they are not considered legally binding because they represent the views of the staff rather than the Commission. n30

Recently the Commission has made public another source of guidance on the views of its staff. Since 2004, the Commission has posted to its EDGAR system the comment letters prepared by the staffs of the Divisions of Corporation Finance and Investment Management in the review of securities registration statements and periodic reports. n31

[2] Enforcement Program

[a] Investigations

One of the core responsibilities of the Commission is investigating complaints or other indications of possible violations of the Federal securities laws. Explicit authority to investigate violations is contained in each of the Federal securities laws. n32 Since its creation in 1972, virtually all investigations are conducted by the Division of Enforcement and the enforcement staff resident in each of the Commission's eleven regional offices. The Commission's rules provide that all investigations are to be non-public. n33

The Commission has a broad mandate to investigate any matter of interest related to enforcement of the Federal securities laws. Within the division, any attorney may initiate an informal inquiry (with the approval of his or her immediate supervisor) and generally, the first attorney to identify the matter conducts any ensuing investigation. SEC investigations are considered non-public events and the SEC has a policy of neither confirming nor denying the existence of an investigation.

An informal inquiry or matter under investigation ("MUI") entails the analysis of publicly available information and information provided on a voluntary basis by persons or entities. At the informal inquiry stage, the staff does not have the authority to issue subpoenas to compel testimony or to produce documents. While some investigations are completed through the MUI process, typically the staff will convert a MUI into a formal investigation. This requires the staff to submit an action memorandum to the Commission requesting the authority to issue a formal order of investigation. The staff memo describes the information they have obtained that indicates that a violation of the Federal securities laws may have occurred. While the memorandum often identifies the individuals or entities who may have violated the law, as a matter of policy the Commission does not consider these persons to be "targets" of the investigation.

Following Commission approval, a formal order is issued. The formal order provides basic factual information defining the scope of the investigation, specifies the provisions of federal law or regulation that may have been violated and lists the staff who are authorized to conduct the investigation and issue subpoenas to compel testimony or the production of documents. Any person or entity receiving a subpoena may request to see the formal order to confirm that the subpoena is consistent with the scope of the formal order. n34 While a person may review the formal order, they are not entitled to retain a copy of it, without the approval of an Assistant Director or Assistant Regional Director. If a transcript of testimony is created, the person providing the testimony is entitled to receive a copy of the transcript, upon written request. The Commission may deny such a request only for good cause.

If a person or entity refuses to comply with a subpoena issued by the division, the staff may initiate an action in Federal district court to compel compliance. The decision to bring a subpoena enforcement action does not require a vote of the Commission. The Director of the Division of Enforcement has been delegated the authority to authorize such an action. n35

At the request of a foreign securities authority conducting an investigation to determine whether its securities laws are being or have been violated, the Commission may authorize the division to provide assistance to the foreign authority, even if the conduct in question would not constitute a violation of U.S. law. This assistance may include an SEC formal order permitting the staff to issue subpoenas. When deciding to honor such a request, the Commission must consider whether the requesting authority has agreed to provide reciprocal assistance and whether providing the assistance would prejudice the public interest of the U.S. n36

Following completion of its investigation the division may submit a recommendation for action to the Commission. The action memorandum must provide a detailed description of the individuals or entities to be charged with violations, the specific violations that will be alleged to have occurred, the evidence obtained proving that the violations occurred, as well as an analysis of any legal issues raised.

Persons or entities to be charged with violations are typically notified prior to submission of a staff recommendation to the Commission and provided with the opportunity to make a written submission to the Commission responding to the staff allegations. n37 These statements are commonly called "Wells" submissions, named after John Wells, the Chairman of an SEC Advisory Committee that recommended creating the procedure. The process is not mandatory however. The division staff is not required to notify persons prior to requesting Commission authority. Also, if the Commission authorizes an enforcement action, the Wells statement is not considered a privileged document and may be used as evidence in litigation by division staff.

When persons or entities receive a "Wells" notice, it is common for the party to engage in settlement negotiations with the staff. n38 If a settlement of the matter is negotiated, it will be submitted to the Commission at the same time as the recommendation for action. The Commission, in its discretion, may approve the recommended action and settlement, or it may approve the recommendation for action and reject the proposed settlement.

[b] Enforcement Actions

SEC enforcement actions may be brought as an injunctive action in a U.S. Federal Court or as an administrative proceeding, heard by an administrative law judge. The choice of proceeding reflects a combination of factors, including the type and severity of the alleged violation and the person or entity to be charged. However, the most significant factor is the type of penalty or relief sought.

[i] Administrative Proceedings.

Since the SEC's creation, it has had the authority to bring administrative proceedings to address violations of the securities laws. The scope of its authority to bring an administrative proceeding and the sanctions that can be ordered in an administrative proceeding has grown dramatically over time.

Early in the history of the SEC, the administrative proceeding was limited to proceedings to halt an offering of securities to the public, or a "stop order," under section 8 of the Securities Act, n39 and proceedings to reject an application for or revoke the registration of a broker-dealer n40 or investment adviser n41.

In 1964, Congress amended the Exchange Act n42 and provided the Commission with the authority to institute administrative proceedings to bar or suspend associated persons of broker-dealers or investment advisers. This authority has become a staple of the SEC enforcement program.

For a time the SEC occasionally brought administrative proceedings under section 15(c)(4) of the Exchange Act. n43 This provision enabled the SEC to institute administrative proceedings against "any person subject to the provisions of section 12, 13, 14, or subsection (d) of section 15," the corporate registration provisions. Under section 15(c)(4) the Commission could "publish its findings and issue an order requiring such person, and any person who was a cause of the failure to comply due to an act or omission the person knew or should have known would contribute to the failure to comply... to comply, or to take steps to effect compliance." For approximately ten years the Commission used this avenue to address corporate violations that did not warrant an injunctive action, frequently as a settled negotiated order. In 1987 an initial decision by an SEC administrative law judge in 1987 concluded that an order under this section could not require prospective relief. n44 While the authority still exists, in 1990 the passage of the Remedies Act created new forms of administrative proceedings that superceded and obviated proceedings under section 15(c)(4).

The Remedies Act dramatically expanded the nature of SEC administrative proceedings. It authorized the Commission to enter a cease and desist order against any person who is violating, has violated, or is about to violate any provision of the securities laws or any rule or regulation thereunder n45. In a cease and desist proceeding the Commission can order a party to take steps to comply with its rules, to provide an accounting and to disgorge profits gained or losses avoided. The Sarbanes-Oxley Act further expanded the remedies available in a cease and desist proceeding by authorizing the

SEC to bar an individual from serving as an officer or director of a public company if they violated the antifraud provisions of the Securities Act or Exchange Act. n46 This Act also created a proceeding to enable the SEC to issue a temporary cease and desist order. While the Commission has used its cease and desist authority extensively, it has brought only one proceeding under its temporary cease and desist authority. n47

The Remedies Act also expanded the remedies that the SEC can order in an administrative proceeding against broker-dealers, investment advisers, investment companies and persons associated with these registered entities. The SEC can order disgorgement, and civil penalties comparable to those available in an injunctive action. n48

A third form of administrative proceeding is a proceeding to deny a person, temporarily or permanently, from appearing or practicing before the Commission as an attorney, accountant or other professional. While the Commission has brought "rule 102(e)" proceedings (until 1992 they were known as "rule 2(e)" proceedings) throughout its history, based upon rules adopted under its general rulemaking authority, its authority to take action against persons licensed to practice by applicable state authorities was periodically challenged. Any uncertainty over this authority was eliminated by section 602 of the Sarbanes-Oxley Act, which added section 4C to the Exchange Act, incorporating the Commission's rule 102(e). While the Commission may initiate a proceeding under this provision against an attorney, an accountant, or other professional such as an engineer or geologist, the Commission's Office of General Counsel litigates such proceedings if the professional named is an attorney.

All administrative proceedings are heard by an administrative law judge. Administrative law judges operate in a quasi-autonomous status. The SEC hires ALJs from a list of eligible candidates determined by the U.S. Office of Personnel Management and is obligated to pay the ALJ's salary and provide office and support services. To ensure the independence of the administrative process, once hired, the SEC has no authority to promote, reward or discipline an ALJ. After the institution of an administrative proceeding, the Chief Administrative Law Judge assigns it to one of the ALJs. The ALJ presides over the administrative hearing, taking testimony, reviewing briefs and issuing an initial decision containing findings of fact, conclusions of law and, if violations have been found, a proposed sanction. All ALJ initial decisions are appealable to the Commission, which conducts a *de novo* review. An initial decision is not final until the Commission has completed its review and issued its opinion and order, or if not appealed, until the Commission issues a finality order. All final Commission decisions may be appealed to the relevant U.S. Circuit Court of Appeals.

Other enforcement proceedings

Under section 12(k) of the Exchange Act, the Commission may issue an order suspending trading in a security for a period of up to ten business days if it finds that "the public interest and the protection of investors so require." n49 A trading suspension order takes effect at a day and time specified by the Commission in the order, typically the beginning of trading on the day of issuance. No hearing is required prior to the order's effectiveness. The Commission often issues a trading suspension in a security when it identifies an ongoing market manipulation. Frequently at the expiration of the trading suspension, secondary market trading will not resume in the stock, as the commission may have succeeded in obtaining a temporary restraining order against the perpetrators of the fraud or because market makers in the security are unable to satisfy the current information requirements of Exchange Act rule 15c2-11.

Prior to 1978, the SEC frequently would issue a new trading suspension order at the expiration of the ten-day period. This practice was discontinued following the Supreme Court's decision in *SEC v. Sloan*. n50 The Commission has on rare occasions issued a second trading suspension against a security when it found a new factual basis for suspending trading. n51

Occasionally, the Commission will decline to bring a formal enforcement action and will, instead, issue a report of its investigation under section 21(a) of the Exchange Act. n52 These administrative orders describe the results of the staff's investigation and articulate the Commission's interpretation of applicable law to the conduct. The Commission often

issues these reports in circumstances when it believes that a violation of the law has occurred but that the legal theory supporting its conclusion is novel or untested. The purpose of the report is to advise the public and the industry of the Commission's views and provide guidance. These reports are normally issued with the consent of the parties identified in the order. n53

[iii] Judicial Actions.

The SEC may bring civil injunctive actions in the proper Federal district court against any person who is "engaged or is about to engage in acts or practices constituting a violation" of the Federal securities laws, SEC regulations or the rules of any securities self-regulatory organization. n54 In addition to seeking the entry of an injunctive order prohibiting future violations of the applicable provisions of the law, the SEC may pursue an order of disgorgement, an order barring a person from serving as an officer or director of a registered, public company, an order barring a person from participating in an offering of penny stock or an order directing the payment of a civil money penalty. The SEC obtained the authority to obtain money penalties, officer and director bars and penny stock bars in 1990 when Congress enacted the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("Remedies Act"). n55

The Insider Trading Sanctions Act of 1984 ("ITSA") had previously provided the SEC with the authority to seek civil penalties for insider trading violations. ITSA penalties differ from Remedies Act civil penalties for other violations of the law. Under section 21A of the Exchange Act, a person engaged in insider trading (as a buyer, seller or tipper) may be required to pay a penalty up to a maximum of three times the amount of the profit gained or loss avoided. n56 However the maximum penalty is rarely imposed. As an informal practice, the Commission typically has agreed to accept a one-time penalty, plus disgorgement in settled cases. The Commission has also considered the defendant's ability to pay a penalty and or disgorgement in seeking these orders.

SEC authority to obtain civil penalties in injunctive proceedings for other violations of the securities laws is governed by section 21(d)(3) of the Exchange Act. n57 Rather than establishing a maximum penalty of three times the profit gained or losses avoided, there is a three-tier penalty scale.

- Tier one imposes a maximum penalty of "the greater of (I) \$ 5,000 for a natural person or \$ 50,000 for any other person, or (II) the gross amount of pecuniary gain to such defendant as a result of the violation."
- Tier two increases the maximum penalty to "the greater of (I) \$ 50,000 for a natural person or \$ 250,000 for any other person, or (II) the gross amount of pecuniary gain to such defendant as a result of the violation, if the violation described in subparagraph (A) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement."
- Tier three increase the maximum penalty to "the greater of (I) \$ 100,000 for a natural person or \$ 500,000 for any other person, or (II) the gross amount of pecuniary gain to such defendant as a result of the violation, if--
 - (aa) the violation described in subparagraph (A) involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; and
 - (bb) such violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons."

Historically all civil penalties were to be made payable to the U.S. Treasury. In 2002 the Sarbanes-Oxley law created an alternative use of money paid to satisfy these civil penalties. Section 308 of that law provided for the creation of a "Fair Fund" for investors. If the Commission obtains an order of disgorgement, it may request that all money penalties be

paid into the Fair Fund and be distributed to eligible investors along with disgorged funds. Since enactment of that law, it has been standard practice for the Commission to request creation of a Fair Fund and transfer into it all penalty funds collected. In some settled cases, where disgorgement would not have been ordered, the Commission has obtained orders of a nominal disgorgement to enable creation of a Fair Fund. n58

Imposition of civil money penalties against public companies that violated the securities laws has been a difficult philosophical problem for the Commission. Although the Commission has consistently sought money penalties against public companies since passage of the Remedies Act, the size and frequency of the penalties has varied greatly. In 2006, the Commission issued a public policy statement articulating the factors that it would consider when seeking a money penalty from a public company. n59

[iii] Criminal Prosecution.

The SEC enforcement authority is limited to civil actions. When conduct is sufficiently egregious it may warrant criminal prosecution by the Department of Justice; frequently through the Office of the U.S. Attorney for the Southern District of New York. The Division of Enforcement actively coordinates its investigations with criminal authorities. In some cases this is done at the beginning of the investigation, with the criminal authorities using the powers of a Federal Grand Jury to obtain testimony and evidence. In other instances, the division will complete its investigation and provide the appropriate criminal prosecutor with access to the investigative record compiled by the division. In exceptional circumstances, the Commission may formally vote to refer a matter for criminal prosecution. n60

FOOTNOTES:

(n1)Footnote 1. The Commission has the same general rulemaking authority under each of the other Federal securities laws. See § 19(a) of the Securities Act, § 38(a) of the Investment Company Act and § 211(a) of the Investment Advisers Act.

(n2)Footnote 2. 5 U.S.C. § 553.

(n3)Footnote 3. 5 U.S.C. § 601 *et seq.*

(n4)Footnote 4. 44 U.S.C. § 3501 *et seq.*

(n5)Footnote 5. 5 U.S.C. 801 *et seq.*

(n6)Footnote 6. 5 U.S.C. App. 2.

(n7)Footnote 7. Public Law 104-211 amended various sections of the securities laws.

(n8)Footnote 8. 5 U.S.C. § 553(c).

(n9)Footnote 9. 15 U.S.C. § 78w(a)(3). Comment letters are available on the Commission website in a file attached to the pertinent rule proposal

(n10)Footnote 10. 5 U.S.C. § 605(b).

(n11)Footnote 11. 5 U.S.C. § 603.

An example of the certification of the Chairman is as follows:

REGULATORY FLEXIBILITY ACT CERTIFICATION

I, Harold M. Williams, Chairman of the Securities and Exchange Commission, hereby certify,

pursuant to **5 U.S.C. 605(b)**, that the proposed amendments published in Release No. 34-17517 (February 5, 1981), "PROPOSED AMENDMENTS TO PROXY RULES AND PROVISIONS RELATING TO SHAREHOLDER COMMUNICATIONS GENERALLY" will not, if promulgated, have a significant economic impact on a substantial number of small entities.

The reasons for such certification are that the proposed amendments will apply only to those entities (including small entities) that already are subject to the Commission's rules and regulations, and that these proposed amendments are expected to result in a minor net reduction in costs to all registrants. It is anticipated that the effects of the proposed amendments will not be significant for any class of registrants. Thus, the proposed amendments will not have a significant economic impact on any small entities.

February 5, 1981 Harold M. Williams

Date Chairman

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Docket 1551 (1981).

(n12)Footnote 12. *5 U.S.C. § 604*.

(n13)Footnote 13. *5 U.S.C. § 602(a)*. The Commission's agenda typically includes all rulemaking projects under consideration.

(n14)Footnote 14. *5 U.S.C. § 804(2)* contains the definition of major rule.

(n15)Footnote 15. *5 U.S.C. § 802*.

(n16)Footnote 16. The Administrative Procedures Act ("APA") requires agencies to provide "an interested person the right to petition for the issuance, amendment or repeal of a rule". *5 U.S.C. § 553(e)*. The SEC procedure for submission of a petition for rulemaking is contained in *17 C.F.R. § 201.192*. The Commission posts all such petitions on its website at <http://www.sec.gov/rules/petitions.shtml>.

(n17)Footnote 17. *15 U.S.C. § 78w(a)(2)*.

(n18)Footnote 18. § 106 of public law 104-290 amended the relevant sections of each of the securities laws.

(n19)Footnote 19. A recent opinion by the D.C. Circuit highlights the burden on the Commission of assessing these facts. See *Chamber of Commerce v. SEC*, *412 F.3d 133* (D.C. Circuit).

(n20)Footnote 20. 1 The Sarbanes-Oxley Act applies the § 19(b) process to the PCAOB. *15 U.S.C. § 7217*.

(n21)Footnote 21. *15 U.S.C. § 78s(b)(1)*

(n22)Footnote 22. *17 C.F.R. § 19b-4*

(n23)Footnote 23. *15 U.S.C. § 78c(f)*.

(n24)Footnote 24. *17 C.F.R. 202.2*

(n25)Footnote 25. In 2006 the Commission issued a press release explaining its policy on when to seek money penalties in Enforcement actions against public companies. See Statement of the Securities and Exchange Commission

Concerning Financial Penalties. Press Release 2006-4. January 4, 2006.

(n26)Footnote 26. All Corporation Finance no-action letters issued after January 15, 2002, and selected older letters are available on the SEC website at <http://www.sec.gov/divisions/corpfin/cf-noaction.shtml>. In 1980, the Commission issued explanatory releases on requesting no-action letters, Sec. Act. Release Nos. 33-6269, 33-6253. For discussion of Interpretations and "No-Action" Letters.

(n27)Footnote 27. The Division of Investment Management takes a different position than the Division of Investment Management on the question of whether a third party may rely upon a no-action letter provided to another party. Investment Management occasionally issues no-action letters that explicitly state that third parties may rely upon the staff's position contained in the letter.

(n28)Footnote 28. 3 Loss, Securities Regulation 1895 (2d ed. 1961 Supp. 1969).

(n29)Footnote 29. FAQ on Sarbanes-Oxley Law, published November 8, 2002 (revised November 14, 2002), available on the SEC website <http://www.sec.gov/divisions/corpfin/faqs/soxact2002.htm>

(n30)Footnote 30. Even though they are staff positions, it is typical for an SLB or SAB to be distributed to the Commissioners for review and comment prior to issuance.

(n31)Footnote 31. All Corporation Finance no-action letters issued after January 15, 2002, and selected older letters are available on the SEC website at <http://www.sec.gov/divisions/corpfin/cf-noaction.shtml>. In 1980, the Commission issued explanatory releases on requesting no-action letters, Sec. Act. Release Nos. 33-6269, 33-6253.

(n32)Footnote 32. *See, for example* section 9(c) of the Securities Act, section 21(a) of the Exchange Act, Section 42 of the Investment Company Act or Section 209 of the Investment Advisers Act.

(n33)Footnote 33. 17 C.F.R. § 202.2

(n34)Footnote 34. 17 CFR § 203.7.

(n35)Footnote 35. 17 CFR § 200.30-4(a)(10).

(n36)Footnote 36. 15 U.S.C. § 78u(a)(2).

(n37)Footnote 37. 17 CFR § 202.5(c)

(n38)Footnote 38. The relevant Commission regulation provides that "the staff, with specific authorization, may discuss with persons involved the disposition of such matters by consent, by settlement, or in some other manner" 17 CFR § 202.5(f). While this provision appears to require the staff to obtain authorization from the Commission before engaging in settlement negotiations, this has not been standard practice. Recently it has been reported that the Commission has begun an experimental process of requiring the division to advise the Commission of settlement negotiations involving the payment of a large money penalty by a public corporation. *See* Bloomberg News Service, "SEC Penalties Fall Amid 'New Ethos' on Company Fines," November 19, 2007.

(n39)Footnote 39. 15 U.S.C. § 77h.

(n40)Footnote 40. 15 U.S.C. § 1578o.

(n41)Footnote 41. 15 U.S.C. § 80b-3.

(n42)Footnote 42. Securities Acts Amendments of 1964. Public law 88-467.

(n43)Footnote 43. This authority was also contained in the 1964 Amendments.

(n44)Footnote 44. In re George C. Kern, Jr. (1991) 50 SEC 596 .

(n45)Footnote 45. 15 U.S.C. § 78u-3. The same authority was added to the Securities Act of 1993, 15 U.S.C. § 77h-1; the Investment Company Act of 1940, 15 U.S.C. § 80a-9(f); and the Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(k).

(n46)Footnote 46. § 1105 of Sarbanes-Oxley Law.

(n47)Footnote 47. In the Matter of A.R. Baron & Co., Inc., Proceeding 3-9010. Release No. 34-37240 / May 23, 1996

(n48)Footnote 48. 15 U.S.C. § 78u-2.

(n49)Footnote 49. 5 U.S.C. § 78l(k).

(n50)Footnote 50. 98 S.Ct. 1702 (1978) . This case also is significant as it was the last case in which a unanimous Supreme Court ruled against the U.S. government and in favor of a pro se litigant.

(n51)Footnote 51. See, for example, two successive trading suspensions in the securities of Struthers Industries Inc., Exchange Act release No 34-39531 / January 9, 1998 and Exchange Act Release No. 39578 / January 26, 1998.

(n52)Footnote 52. "The Commission is authorized in its discretion, to publish information concerning any such violations". 15 U.S.C. § 78u(a).

(n53)Footnote 53. See, for example, In the Matter of Donald Fuerstein. Exchange Act Release No. 34-31554 / December 3, 1992.

(n54)Footnote 54. For example, 15 U.S.C. § 78u(d). Comparable provisions are contained in the Securities Act of 1933, the Investment Company Act of 1940 and the Investment Advisers Act of 1940.

(n55)Footnote 55. P.L. 101-429, 104 Stat. 931 (Act of October 15, 1990).

(n56)Footnote 56. 15 U.S.C. § 78u-1.

(n57)Footnote 57. 15 U.S.C. § 78u(d)(3).

(n58)Footnote 58. See, for example SEC Litigation Release No. 19280 / June 23, 2005 *HEALTHSOUTH CORPORATION ET AL.* Civil Action No. CV-03-J-0615-S. in which the company was ordered to pay \$100.00 in disgorgement and a civil penalty of \$100 million.

(n59)Footnote 59. Statement of the Securities and Exchange Commission Concerning Financial Penalties. Press Release 2006-4. January 4, 2006.

(n60)Footnote 60. Because the division has delegated authority to provide access to its files to criminal authorities, 17 CFR § 200.30-4, it rarely requests that the Commission vote on a formal criminal referral.

* This chapter has been updated by Jonathan G. Katz. Mr. Katz served as the Secretary of the U.S. Securities and Exchange Commission from 1986 until his retirement in 2006.



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Appendix 1A: SEC Regional Offices *

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§ 1A.syn Synopsis to Appendix 1A: SEC Regional Offices *

Scope



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Appendix 1A: SEC Regional Offices *

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Northeast Region: Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, Vermont, Virginia, West Virginia

Southeast Region: Alabama, Florida, Georgia, Louisiana, Mississippi, North Carolina, Puerto Rico, South Carolina, Tennessee, Virgin Islands

Midwest Region: Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Missouri, Ohio, Wisconsin

Central Region: Arkansas, Colorado, Kansas, Nebraska, New Mexico, North Dakota, Oklahoma, South Dakota, Texas, Utah, Wyoming

Pacific Region: Alaska, Arizona, California, Guam, Hawaii, Idaho, Montana, Nevada, Oregon, Washington

* Current as of December 1, 2002



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CHAPTER 2 Regulation of Securities Markets *

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§ 2.05 Directions of Future Change in the Regulation of Securities Markets



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CHAPTER 2 Regulation of Securities Markets *

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SUMMARY OF THIS CHAPTER

After the initial sale or other distribution of securities, the securities are traded on "secondary" markets. Secondary securities markets serve two general purposes: to facilitate capital formation for businesses and government and to provide a system through which investors can profitably utilize assets. The most efficient markets do this by providing a means by which buyer and seller interest efficiently establishes a market price and liquidity is available at a low cost. Secondary markets also serve as important leading indicators of economic trends and as a source of diversity of investment and hedging vehicles.

Conceptually, there are two primary types of securities markets: centralized "auction" markets and "negotiation" or "dealer" markets. While none of the established United States securities markets are pure auction or pure dealer markets, historically exchanges have functioned as auction markets and over-the-counter, or "OTC" and the Nasdaq Stock Market ("Nasdaq"), markets have functioned as dealer markets. There are ten national securities exchanges: the American, Boston, National, Chicago, New York and Philadelphia Stock Exchanges, NYSE Arca (formerly the Pacific Exchange), the International Securities Exchange, the Chicago Board of Options Exchange and the Nasdaq Stock Market ("Nasdaq"). The OTC market encompasses all non-exchange traded securities, including corporate and government bonds, debentures, and mutual funds. The OTC market was long dominated, at least in terms of public perception, by Nasdaq, which grew out of a simple inter-dealer quotation system operated by the National Association of Securities Dealers, Inc. ("NASD").¹ However, in January 2006 Nasdaq became a registered national securities exchange. As a result, the formal components of the over-the-counter market are the Over-the-Counter Bulletin Board, which is operated by, but not part of Nasdaq, and stocks quoted on a less formal quotation system known as the "pink sheets." Alternative trading systems, securities markets which operate with some characteristics of exchanges and some of the OTC market, rose in prominence at the end of the 20th century.

Alternative trading systems in some cases established relationships with national securities exchanges as a means of gaining direct access to the national market system. In October 2001, the Archipelago ECN effectively became subject to exchange regulation by becoming a facility of the Pacific Exchange. In August 2002 the Island ECN began disseminating its orders through the National Stock Exchange, then known as the Cincinnati Stock Exchange.

The late 20th and early 21st century had seen the rise of alternative trading systems, particularly electronic trading

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systems, or "ECNs," which typically function as electronic auction markets. The rise of ECNs had fostered dramatically greater competition between markets. However, by 2006, the proliferation of securities markets had largely been reversed through mergers and acquisitions. In April 2005, Archipelago, one of the last independent ECNs, agreed to be acquired by the NYSE. The lasting legacy of ECNs, however, was the expansion of electronic trading at the expense of floor-based markets. As a result of massive consolidation in the industry, this electronic trading was increasingly taking place on national securities exchanges. This trend culminated in the granting of Nasdaq's exchange application in January 2006.

In adopting the Securities Exchange Act of 1934 ("Exchange Act"), Congress intended the securities exchanges to be responsible for enforcement of the Exchange Act against exchange members, and persons associated with members, while the exchanges would be subject to regulation by the Securities and Exchange Commission ("SEC" or the "Commission"). Accordingly, Section 6 of the Exchange Act requires all national securities exchanges to be registered with the Commission. Similarly, the Exchange Act requires an "association" of brokers and dealers, such as the FINRA (previously the NASD), which regulates much of the OTC market, to be registered pursuant to Section 15A. Congress designated all registered national securities exchanges and securities associations as "self-regulatory organizations" ("SROs").

Transactions on national securities exchanges have historically been effected through brokers and dealers eligible to trade on an exchange, and were generally confined to securities listed on the exchange and to OTC securities that meet certain standards. Customers' buy and sell orders were traditionally executed on the exchange floor through a continuous auction system in which bids to buy and offers to sell are made by brokers on behalf of their customers. Prices of completed transactions are reported by the exchange through electronic systems.

Sales and purchases of securities on the OTC market have historically been executed through negotiation, rather than auction, by dealers buying and selling for their own account, with a mark-up or "spread" charged to investors. Nasdaq, which until 2006 was technically part of the OTC Market, is a highly-developed system through which customer orders and broker-dealer quotes interact in a central facility. Reports of transactions effected on the OTC market are made via NASD-sponsored trade reporting facilities.

The Securities Acts Amendments of 1975 directed the Commission to facilitate the development of a "national market system" integrating the various securities markets, and clarifying and strengthening the Commission's authority to promote the achievement of such a system. These amendments imposed stringent and explicit requirements and limitations on the exchanges and greatly increased the Commission's oversight functions. Congress granted the Commission unequivocal powers over the rules of SROs and imposed mandatory affirmative and negative requirements on SRO rules designed to assure that the SROs' self-regulatory role was fulfilled. *See § 2.01 infra.*

Under its new authority, the Commission adopted Rule 6a-1, enumerating the requirements for registration as a national securities exchange. Section 15A and the rules thereunder apply substantially the same requirements to the registration of securities associations such as FINRA. Both securities exchanges and FINRA are subject to periodic reporting requirements. Section 19(a)(1) prescribes the procedures the Commission must follow in processing an application for registration filed by an exchange or securities association. For an exchange or securities association to be so registered, the Commission must be satisfied that it has the capacity to comply and enforce its members' compliance with the provisions of the Exchange Act. These include standards governing the admission and discipline of members, and rules prohibiting the fixing of commission rates and establishing procedures for the reporting of securities quotations. *See § 2.02 infra.*

SROs are required to file all proposed rule changes with the Commission for approval. The Commission also is empowered on its own initiative to make certain changes to SRO rules in furtherance of the purposes of the Exchange Act. Any registered broker-dealer meeting applicable capital and competency requirements may be admitted to membership. Although Section 6(e)(1) prohibits national securities exchanges from unilaterally imposing fixed

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commissions and other charges, the Commission may permit the setting of reasonable fixed rates if such practice is reasonable in relation to the cost of providing the service and does not impose undue burdens on competition. In those instances in which the Commission lacks express authority to regulate SRO practices, any practices of an SRO that, in the absence of an exemption, would violate the antitrust laws could give rise to antitrust liability of the SRO and its member. Sections 6(d) and 15A(h) require SROs to provide fair procedures for disciplining members, denying membership, barring persons from becoming associated with members or barring access to services of the SRO. Any of these actions imposed by an SRO are reviewable by the Commission, and the Commission may modify or set aside any such action if it finds such actions inconsistent with the provisions of the Exchange Act to impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Commission's orders, in turn, are reviewable in the appropriate Court of Appeals.

The Commission is charged with overseeing the activities of an SRO on a continuing basis. In furtherance of this regulatory mandate, the Commission may conduct on-site inspections of the daily operations of the SRO and require the SRO to submit periodic reports. The Commission also may allocate regulatory responsibilities among SROs for the purpose of easing the burdens on the individual SROs. Pursuant to Rule 17d-2 under the Exchange Act, any two or more SROs may file a plan of allocation of regulatory responsibilities for the Commission's approval. The Commission may under certain circumstances censure, suspend or expel any member of an SRO. Under Section 21, the Commission may seek injunctive relief to enforce not only the provisions of the Exchange Act and the rules thereunder, but the SRO rules as well. Under Section 19(h), the Commission may suspend or revoke the registration of an SRO if it finds that the SRO has violated the Exchange Act or the rules thereunder or has unreasonably failed to enforce its own rules. *See § 2.03 infra.*

Section 11A of the Exchange Act, added by the 1975 Amendments, contemplates the development of a national securities market system linking all securities markets through data processing and communications facilities and making available current information on quotations and transactions to brokers, dealers and traders. The Commission is required to facilitate the establishment of a national market system and to designate the securities or classes of securities that will be qualified for trading in the national market system ("NMS"). Rule 600 of Regulation NMS, adopted in 2005 as part of a reorganization of the Commission's market regulation rules to replace former Rule 11Aa2-1, designates as NMS securities all OTC or exchange-listed securities for which transactions are reported pursuant to an effective transaction reporting plan approved by the Commission pursuant to Rule 601 of Regulation NMS [former Rule 11Aa3-1]. This includes all securities listed on the NYSE, Amex and Nasdaq and those listings of the smaller exchanges that substantially meet NYSE or Amex listing criteria.

In Rule 602(b) of Regulation NMS [former Rule 11Ac1-1(c)], the "Quote Rule," the Commission adopted a procedure for collecting, processing and disseminating bids, offers, and quotation sizes that may be relied upon by traders placing orders for the quoted securities. Brokers and dealers communicating bids and offers under the Quote Rule are obliged to publicly display their best bid and offer, including those placed in ECNs, and to honor the prices bid or quoted unless the bid or quote is revised before an order is presented. In furtherance of a National Market System, the Commission also has adopted Rule 602(a) of Regulation NMS [former Rule 11Ac-1(b)], which provides for a consolidated quotation (CQ) plan for making quotations available to vendors of market information on a current and continuing basis; Rule 601 of Regulation NMS [former Rule 11Aa3-1], which provides for a Consolidated Transaction Reporting System (CTRS) for the collection and dissemination of last sale information; Rule 603 of Regulation NMS [former Rule 11Ac1-2], governing the format in which quotations and transaction data must be displayed; and Rule 604 of Regulation NMS [former Rule 11Ac1-4], requiring the display of certain customer limit orders in broker-dealer quotations. The Commission also has adopted Rule 609 of Regulation NMS [former Rule 11Ab2-1], which enumerates the requirements for registration of exclusive securities information processors under Section 11A(b)(1). *See § 2.04 infra.*

The ten-year period beginning in 1995 was characterized by dramatic changes in the structure and ownership of securities markets, driven primarily by the increasing importance of electronic trading. Alternative trading systems, aided by favorable regulation and featuring electronic trading platforms with cutting edge technology, garnered

significant market share, primarily in Nasdaq stocks. While there were initially numerous alternative trading systems with significant market share, by 2005 there had been major consolidation both among alternative trading systems and between alternative trading systems and national securities exchanges. The consolidation occurred to such a degree that it appeared that the NYSE and Nasdaq would remain the two dominant markets, with the major effect of the growth of alternative trading systems being the increased importance of and changes in the nature of electronic trading.

In 2005 the SEC, at the end of a lengthy process, completed a highly controversial overhaul of its regulations governing securities markets by adopting Regulation NMS. In part, Regulation NMS was a reorganization of existing rules governing the securities markets into a single regulation. In addition, however, it involved four major substantive components. First, it extended a prohibition on "trade-throughs," or execution of orders on one exchange while a better price exists on another exchange, to Nasdaq, in addition to exchange-listed, stocks, though limiting "protected" quotes to those against which automatic executions are immediately available. See § 2.04[2][b][iii] *infra*. Second, Regulation NMS included a rule designed to improve access to quotations in NMS stocks, which includes a limit on fees that markets can charge for access to their quotations. See § 2.04[2][c][ii] *infra*. Third, the Commission adopted a rule prohibiting pricing in increments of less than one cent for all stocks priced at \$1.00 or more. See § 2.04[2][c][iii] *infra*. Fourth, Regulation NMS included amendments to the rules governing market data, designed to improve the availability of market data and allocate market data revenues in a manner that would reward markets that produce the most valuable data. See § 2.04[2][f] *infra*. In January 2006 Nasdaq became registered as a national securities exchange, eliminating the distinction between Nasdaq and exchange-listed securities. By 2008 the degree of competition between markets had subsided from its peak, and a major issue was whether electronic trading would eventually replace all floor-based trading. See § 2.05 *infra*.

FOOTNOTES:

(n1)Footnote 1. In July 2007, the NASD merged with certain functions of the New York Stock Exchange to become the Financial Industry Authority ("FINRA"). For general purposes of this chapter, the NASD and NYSE will be referred to as such if the reference is to a time prior to the merger.

* This chapter was revised and updated by Madeleine J. Dowling, a partner at Sidley Austin LLP in New York, New York. Ms. Dowling represents investment banks, broker-dealers and hedge funds in connection with a variety of regulatory, enforcement and compliance matters. She received her BA in English Literature at St. Lawrence University and her J.D. at Fordham University School of Law. Ms. Dowling thanks Bracha Pollack, Donna Tumminio, Jessica Hirsh, and Cindy Feng of Sidley Austin LLP for their contributions to this chapter.



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CHAPTER 2 Regulation of Securities Markets *

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§ 2.01 The National Market System

[1] The National Market System for Securities--General

On June 9, 2005, the SEC adopted Regulation NMS, a sweeping reform of regulations governing the national market system. Regulation NMS had a long, tortuous and controversial history. It was first proposed in February 2004. n1 The initial Regulation NMS release contained four substantive proposals: the adoption of a uniform rule to prevent "trade-throughs," i.e., the executions of orders on a marketplace where a superior price is displayed on another market, subject to two major exceptions; the adoption of a rule governing the terms of access under which markets grant access to quotations for purposes of execution against them; a prohibition of "subpenny pricing," i.e. displaying quotations in increments of less than one cent; and amendments to the rules and joint industry plans governing dissemination of market data to change the manner in which revenues were allocated among markets. On April 21, 2004, the Commission held a Regulation NMS hearing at which various representatives of market participants and institutional customers discussed the four proposals. n2 The Commission then, based on the opinions expressed at the Regulation NMS hearing, issued a supplemental request for comment, on May 20, 2004. n3

On December 16, 2004, as a result of proposed significant modifications to the initial Regulation NMS proposal, the Commission published a new Regulation NMS release and established a new comment period. n4 The debate on Regulation NMS was particularly contentious, both within and outside the Commission. Commissioners Cynthia Glassman and Paul Atkins filed a dissent to the Regulation NMS adopting release, focusing on the extension of the trade-through rule to the Nasdaq market, which they believed was based on a flawed analysis and, further, would "limit competition and stifle innovation." n5 Several members of Congress also harshly criticized Regulation NMS, primarily because of its trade-through provisions, and the Senate Banking, Housing and Urban Affairs Committee went so far as to hold hearings between the time Regulation NMS was approved and before the Adopting Release was published. n6

Though most of the attention and debate on Regulation NMS understandably centered on the above substantive proposals, Regulation NMS also included a major reorganization of the regulations governing the national market system. While the substantive provisions of the final Regulation NMS received a decidedly mixed reception, the reorganization of the regulations, which had become riddled with inconsistencies, outdated references and unnecessary repetition, was an unqualified success. All regulations directly governing the national market system are now contained within Regulation NMS, which consists of Rules 600 through 612. n7 In addition, multiple and inconsistent definitions of the same term have been eliminated. In one extreme example, the key term "covered security" was defined

differently in the Quote Rule, the Limit Order Display Rule and Rule 11Ac1-6 [now Rule 606]. n8 The term "reported security" was separately defined in four rules--consistent definitions appeared in the Limit Order Display Rule, Rule 11Ac1-2 [now 603] and Rule 11Aa3-1 [now 601], but a different definition appeared in the Quote Rule. n9 The terms "covered security" and "reported security" have both been eliminated in favor of the terms "NMS security" and "NMS stock." n10 The adopting release for Regulation NMS includes a detailed discussion of the manner in which definitions under the national market system regulations were modified, moved or eliminated in Regulation NMS.

Appendix 2C has a detailed chart cross-referencing the provisions of the national market system regulations prior to Regulation NMS with the provisions of Regulation NMS. The chart identifies whether a particular provision has been moved to Regulation NMS or eliminated and, if moved, the corresponding provision of Regulation NMS.

Although the Securities Acts Amendments of 1975 (the "1975 Amendments") n11 added Section 11A to the Securities Exchange Act of 1934 ("Exchange Act") in a manner designed to ensure the development of a national securities market system linking all securities markets through data processing and communications facilities n12 the history extends back well before the 1975 Amendments. Pursuant to the 1975 Amendments, the Securities and Exchange Commission (the "SEC" or the "Commission") was directed by Congress to facilitate establishment of the national market system and given broad authority in Sections 11A(a) and (c) to oversee its implementation and operation. n13

While the concept of a "national market system" is not defined in the Exchange Act, n14 the national market system was intended to encompass all segments of the corporate securities markets n15 to fully realize the goals of Congress. n16 The two "paramount" objectives cited by the Committee on Banking, Housing and Urban Affairs of the United States Senate in the development of a national market system are:

- (1) the maintenance of stable and orderly markets, with maximum capacity for absorbing trading imbalances without undue price movements, and
- (2) the centralization of all buying and selling interest to enable each investor to have the opportunity for the best possible order execution, wherever the order originates in the system. n17

The problem of how to encourage the development and implementation of a national market system was approached in Senate Bill 249, as modified by the Conference Report, as n18

- (1) preserving the competing markets for securities that had developed,
- (2) breaking down all barriers to competition not serving a valid regulatory purpose, and
- (3) encouraging maximum reliance on communication and data processing equipment consistent with justifiable costs. n19

[a] The Origin of the Concept of a National Market System

The Commission traditionally has been compelled to devote most of its limited resources "to correcting abuses and responding to fundamental change as it occurred" in the secondary securities market. n20 The Special Study of the Securities Markets in the early 1960s, n21 the commission rate hearings in the late 1960s n22 and the Institutional Investors Study of 1971 n23 gave the Commission a factual predicate upon which regulatory analysis could be made of the efficiency and effectiveness of secondary securities markets. In particular, the Institutional Investors Study verified that multiple trading of stocks on more than one exchange tended to "fragment" the marketplace which, in turn, could impair the auction-agency character of the secondary securities markets. n24 Concerned about the continued efficacy of these markets, the Commission in its letter of transmittal accompanying the Institutional Investors Study first endorsed

the concept of a strong central market system for securities of national importance, in which all buying and selling interest in these securities could participate and be represented under a competitive regime n25

Shortly after the Commission issued its statement in connection with the Institutional Investor Study, the New York Stock Exchange (NYSE) n26 released a special study on the organization and operation of the securities industry. n27 This NYSE report called for the development of a "central market system" comprised of the New York, American, and certain regional securities exchanges to cure market fragmentation, to promote market efficiency, and to assure best execution of transactions. n28

The Commission in the fall of 1971 held extensive hearings that culminated in a "white paper" issued in early 1972 entitled "Policy Statement on the Future Structure of the Securities Markets." This statement was a broad, wide-ranging outline of many of the major problems the Commission had observed in the operation and structure of the secondary securities markets and announced certain major policies to deal with those problems.

The statement outlined four goals of a central market system:

- (1) implementation of a nationwide system for disclosure of market information designed to make price and volume information in all markets and quotations from all market makers universally available;
- (2) elimination of artificial impediments to dealing in the best available market created by exchange rules or otherwise;
- (3) establishment of terms and conditions upon which any qualified broker-dealer can negotiate access to all exchanges; and
- (4) integration of third market firms into the central market system while subjecting them to appropriate market responsibilities and other regulatory requirements commensurate with the benefits they may realize. n29

The Commission in this Statement, however, did not attempt to propose a detailed plan for the achievement of these goals. Instead, the Commission established three advisory committees to report to the Commission on the optimum method of implementing these objectives: the Advisory Committee on Corporate Disclosure; the Advisory Committee on a Central Market System; and the Advisory Committee on Block Transactions.

The Commission also announced two proposed rules--Rules 17a-14 and 17a-15 n30--to implement the first of its policy goals: the creation of a nationwide disclosure and market information system, the so-called composite tape and quotation systems, which would be the core of a new and efficient nationwide securities market system.

In March 1973, following receipt of reports from the three advisory committees, n31 the Commission issued another "white paper" in which the Commission concluded that the adoption of a central market system would foster more efficient, effective allocation of one of the nation's "most precious resources--investment capital." n32

To achieve this objective, the Commission proposed the formation of a central market system at the heart of which "will be an efficient and comprehensive communications linkage between market centers consisting of a real-time composite transaction reporting system and a composite quotation system displaying the bids and offers of all qualified market makers and listed securities." n33

Recognizing that "the implementation of an operational communication system, without more, would necessarily precipitate some restructuring of the way securities are traded," n34 the Commission identified certain problem areas to be resolved, including:

- (1) preservation of the principle of best execution;
- (2) nonmember access to exchange trading facilities;
- (3) off-board trading restrictions then imposed by exchange rules;
- (4) direct dealing between specialists and institutions;
- (5) the role of "upstairs market makers";ⁿ³⁵
- (6) regulation of market makers; and
- (7) implementation of a composite quotation system.

The policy statement concluded with a proposal by the Commission of a plan for implementation of a central market system. This plan involved, in substance, republication, revision, or revocation of Commission and self-regulatory organization (SRO) rules pertaining to membership, short sales, manipulative practices, regulation of third market makers, trade reporting, and anti-manipulative acts and practices.ⁿ³⁶

While the Commission was formulating its views on the central market system, members of both houses of Congress were advocating enactment of new legislation that would affect the duties and responsibilities of the Commission and, in some instances, mandate implementation of the regulatory proposals then espoused by the Commission. Subcommittees in both houses of Congress held extensive hearings that resulted in numerous Congressional reports.ⁿ³⁷ In addition, eighteen bills were introduced in the Senate over a four-year period.

The regulatory and legislative efforts culminated in the enactment of the Securities Acts Amendments of 1975, which specifically directed the formation of a national market system and charged the Commission with responsibility for facilitating that goal. In hindsight, the Commission has characterized its promotion of a national market system as an "unusual if not unique ... attempt by a federal agency to influence the evolutionary forces which shape the market place in order to stimulate the exploitation of technological advancements and to insure a fair field of vigorous competition."ⁿ³⁸

[b] Goals and Objectives of a National Market System

Section 11A(a)(1), enacted as part of the Securities Acts Amendments of 1975, sets forth the goals and objectives of a national market system for qualified securities,ⁿ³⁹ in the form of the following Congressional findings:

- (1) the securities markets are an important national asset to be preserved and strengthened;ⁿ⁴⁰
- (2) new data processing and communications techniques create the opportunity for more efficient and effective market operations;ⁿ⁴¹
- (3) it is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure
 - (a) economically efficient execution of securities transactions,
 - (b) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets,

(c) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities,

(d) the practicability of brokers executing investors' orders in the best market, and

(e) an opportunity, consistent with the preceding four provisions, for investors' orders to be executed without the participation of a dealer; n42 and

(4) the linking of all markets for qualified securities through communication and data processing facilities will foster efficiency, enhance competition, increase the information available to brokers, dealers, and investors, facilitate the offsetting of investors' orders, and contribute to best execution of such orders. n43

[c] Underlying Principles

The Senate Committee on Banking, Housing and Urban Affairs, in its report to accompany Senate Bill 249, specified the basic underlying principles that should govern the establishment of a national market system. n44 First, the Committee expressed a clear preference for auction trading principles:

[W]ith respect to securities which are suitable for auction trading, the Committee believes that every effort should be made to design the national market system in such a way that public investors in these securities receive the benefits and protections associated with auction-type trading. n45

The second major national market system principle is that the types of securities qualified to be included in the national market system n46 should depend primarily on their characteristics n47 rather than the market, *i.e.*, exchange or over-the-counter, in which they happen to be traded. n48

The third principle was a refusal by Congress to achieve a nationwide centralized auction-type market for qualified securities by abolishing over-the-counter trading in listed securities, *i.e.*, the "third market," n49 unless the Commission found that "the maintenance or restoration of fair and orderly markets in such securities may not be assured through other lawful means" under the Exchange Act. n50

[d] National Market Advisory Board

Congress added a provision to the Exchange Act in 1975 that required the Commission to establish, within 180 days after the date of enactment of the 1975 Amendments, a National Market Advisory Board of fifteen members. n51 The members were to serve for a term specified by the Commission of at least two and not more than five years. n52 The members of the National Market Advisory Board were required to be from different geographical areas of the United States and had to consist of:

(1) persons associated with brokers and dealers, who were to be a majority of the members, and

(2) persons not so associated who were to have been representative of the public, and, to the extent possible, also to have knowledge of the securities markets of the United States. n53

The National Market Advisory Board was given the responsibility of formulating and furnishing to the Commission its views on significant regulatory proposals made by either the SEC or any self-regulatory organization concerning the establishment, operation, and regulation of the securities markets in the United States. n54

The National Market Advisory Board was directed to study and make recommendations to the SEC concerning appropriate steps to facilitate the establishment of a national market system. n55 The National Market Advisory Board was also directed to study the possible need for modifications to the scheme of self-regulation under the Exchange Act to adapt such scheme to a national market system. n56 This study was to include the Board's views on the need for establishment of a new self-regulatory organization, the National Market Regulatory Board, to administer the national market system. n57 Congress directed the National Market Advisory Board to report to it, on or before December 31, 1976, the results of its study of possible modifications of the scheme of self-regulation under the Exchange Act, with recommendations for legislation. n58

On December 6, 1977, the National Market Advisory Board presented its final report to the Commission. After more than two years of debate, the Board members were unable to make any specific recommendations concerning the development of the National Market System. The December 1977 report provided the Commission with a statement of major alternatives, but did not make any specific recommendations. In his transmittal letter to the Commission, John J. Scanlon, Chairman of the National Market Advisory Board, admitted that the Board members could not agree on any one course of action to follow to achieve the objectives of a functional national market system. n59

In its 21-page report, the Board considered four alternative courses of action, with several Board members endorsing each alternative. These alternatives were:

- (1) No Commission action beyond continuing involvement in the development of a composite quotation system. n60
- (2) Commission involvement in the development of a composite quotation system in addition to regulatory action to encourage establishment of intermarket linkage. n61
- (3) Commission action to encourage establishment of a composite limit order book designed to protect limit orders on a system-wide basis, which would be in addition to, or supplement, a composite quotation system and intermarket linkage system, but that would permit execution of orders left in the system only by specialists and qualified market makers.
- (4) Commission action to encourage establishment of a composite limit order book with orders in the book always having priority at a price over any other orders in the system at that price. n62

Upon submission of this final report to the Commission, the National Market Advisory Board became dormant. The terms of the original Board members expired and no new Board members were appointed.

[e] Commission Response to the National Market Advisory Board Report

Shortly after the release of the National Market Advisory Board (NMAB) final report, members of Congress demanded that the Commission announce a specific timetable and plan for the development of a national market system. n63 In response to this pressure and to fill the void left by the board's report, the Commission:

- (1) adopted Rule 11Ac1-1 [now Rule 602], which requires every securities association and exchange to collect, process, and disseminate to vendors certain market information for inclusion in a composite quotation system, n64 and
- (2) announced a program and timetable to facilitate the development of a functional national market system. n65

In summary, the Commission's program called for

- (1) the implementation of Rule 11Ac1-1 [now Rule 602] by May 1, 1978;
- (2) the "prompt" development of market linkage and order routing systems n66 with specific plans to be submitted to the Commission by the SROs by April 15, 1978;
- (3) the "prompt" development of SRO systems to effectively protect public limit orders, n67 with specific plans to be tendered by September 30, 1978;
- (4) the evaluation by the Commission of the effect of Rule 19c-1 which prohibited certain SRO off-board trading restrictions n68 and a determination by September 30, 1978 whether further regulatory action was appropriate;
- (5) a Commission determination by April 30, 1978 whether additional regulatory action was required to facilitate the development of a consolidated transaction reporting system; n69 and
- (6) the commencement of rule-making proceedings by the Commission no later than June 30, 1978 to determine what categories of securities would be eligible for trading in the national market system. n70

Finally, the Commission identified five "additional issues" relating to a national market system that, according to the Commission, had to be resolved. n71

[2] Components of a National Market System

The 1975 Amendments n72 contained broad goals for the national market system n73 and provided that detailed operational questions were to be resolved by the Commission and the securities industry. n74 The development of the national market system was essentially open-ended: no specific trading system has been mandated as the target toward which the securities markets are evolving. n75

The Commission's January 1978 policy statement on the development of a national market system for "qualified securities" n76 sets forth, among other things, the Commission's view of the elements of a national market system. Such a system includes: market linkage and order routing systems, a composite quotation system, a consolidated transaction reporting system, and nationwide limit order protection. n77

[a] Designation of "Qualified Securities" for the National Market System

Section 11A directs the Commission, by rule, to designate the securities or classes of securities that will be qualified for trading in the national market system ("NMS"). n78 "Exempted securities," such as U.S. Treasury bills and municipal securities, are not eligible for NMS trading. n79

After soliciting public comment on the issue of what securities should be included in the NMS, n80 the Commission concluded that both listed equity securities and certain OTC securities possess characteristics, such as national investor interest and substantial asset and earnings history, that justify their inclusion in the NMS. Before designating OTC securities for the NMS, however, the Commission would require the implementation of certain technical elements of the NMS, specifically the development of a system for reporting current quotes and last sale information. n81

In 1976, the Commission released proposed Rule 11Aa2-1 [now replaced by Rule 602], which would establish two "quantitatively different sets of standards" to determine whether an equity security would be designated as an NMS security. n82 Securities satisfying the first standards (Tier 1 securities) would automatically be deemed to be NMS securities. Other securities (Tier 2 securities) could be designed NMS securities if they satisfied less-stringent criteria

upon application of the issuer or two or more current or prospective market centers. n83

In making this proposal, the Commission announced certain informal policy conclusions that re-enforced the two-tier concept of proposed Rule 11Aa2-1:

- (1) Issuers should not be permitted to avoid the inclusion of their securities in the NMS.
- (2) Designation of equity securities as NMS securities should be made on the basis of their individual characteristics such as trading volume, price, and number of shareholders, and not on whether the securities had previously been traded on an exchange or through the OTC market.
- (3) The NMS should be restricted to securities traded in two or more market centers.
- (4) Trading of a particular security in the NMS should not commence until "investors in that security receive the benefits and protections inherent in the system as a whole." n84 Therefore, OTC securities should be required to be participants in both the consolidated quotation system and the consolidated transaction reporting system before such securities, even if satisfying the Tier 1 criteria, could trade in the NMS. n85
- (5) There should be some sort of nationwide price protection for OTC NMS securities. n86

By 1981, many of the regulatory concerns voiced by the Commission had been resolved. The securities industry, for example, had implemented an apparently effective consolidated transaction reporting system and consolidated quotation system. The NASD had upgraded its Nasdaq trading system. n87 Significant progress had been made in the automatic linkage of multiple trading markets. n88 Finally, off-board trading restrictions had been eased, n89 and nonmember access to exchange trading facilities had been enhanced. n90

As many of its regulatory concerns had been addressed, the Commission adopted Rule 11Aa2-1 and its two tier criteria for designation of NMS securities, n91 which focused on a company's financial status and the trading characteristics of its securities. These standards applied to OTC stocks only. n92 Rule 11Aa2-1 was amended several times n93 to broaden the definition of national market system securities. In 1987 the Commission amended Rule 11Aa2-1 to abandon the two-tier system for OTC securities n94 and adopt instead a new standard n95 designating as national market system securities all "reported securities," defined in former Rule 11Aa3-1(a)(4) [now eliminated] as "any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan." n96 With the adoption of Regulation NMS in 2005, Rule 11Aa2-1 was eliminated, and the term "national market system security" was preserved only to define the term for purposes of Section 11(a)(2) of the Exchange Act. Under Rule 600(a), the term "national market system security" means "NMS security." n97 This latter term, along with the term "NMS stock," are used to identify the securities subject to the various provisions of Regulation NMS. The term "NMS stock," which excludes listed options, is needed because some of the national market system regulations do not apply to listed options. n98

In February 1998, the NASD amended its "Designation of Nasdaq National Securities." n99 The plan called for the NASD to review Nasdaq securities to determine their eligibility for NMS status, but also permitted issuers to petition the NASD for voluntary designation. A standing committee of the NASD Board of Governors would decide whether any such petition met the voluntary designation criteria.

Originally, if Nasdaq determined that a security qualified for NMS status, it could be included on the Nasdaq National Market. n100 However, because NMS securities are defined by reference to whether they are included in a transaction reporting plan filed with the Commission, and because the UTP Plan since 2001 has included all Nasdaq securities, a distinction arose between "NMS securities," which include all Nasdaq securities, and "Nasdaq National Market

Securities," which are only those securities satisfying Nasdaq's more stringent National Market listing standards. n101

[b] Market Linkages and Order Routing

An important component of a national market system for securities is a market linkage and order routing system. Such a system would permit the efficient transmission of orders

(1) among the various markets for qualified securities, whether on an exchange or over-the-counter ("qualified markets"), and

(2) from brokers and dealers to all qualified markets. n102

To link qualified markets effectively, two components are needed, at a minimum:

(1) an intermarket order routing system to permit orders for the purchase and sale of multiple-traded securities to be sent directly from any qualified market to another such market promptly and efficiently, and

(2) a universally available message switch to permit any broker or dealer to route orders for the purchase or sale of qualified securities from the offices of the broker or dealer to any qualified market trading that security. n103

Following enactment of the Securities Acts Amendments of 1975, the securities industry developed several competing market linkage and order routing systems: the Intermarket Trading System ("ITS"), the Regional Market System ("RMS"), the National Securities Trading System ("NSTS") of the Cincinnati Stock Exchange, n104 and the Computer Assisted Execution System ("CAES"), n105 a part of the Nasdaq system.

By 1981, the ITS and CAES n106 had emerged as the dominant systems. n107 In that year, the Commission ordered the members of ITS n108 and the NASD to implement an automatic interface between the ITS and CAES to provide, among other things, a market linkage and order routing system with automatic execution capability. n109

[i] Evolution of Competing Market Linkage Systems

The major problems to be remedied by the adoption of the NMS arise from market fragmentation. n110 Accordingly, while the Commission addressed various regulatory issues, such as fixed commission rates n111 and off-board trading restrictions, n112 a major focus was to mandate the securities industry's development of market linkage systems.

[A] The Intermarket Trading System

In 1978, five securities exchanges, under the leadership of the NYSE, n113 obtained Commission authorization to initiate on an experimental basis an electronic market linkage system to be jointly funded and operated. n114 This system was designated the Intermarket Trading System ("ITS") and was touted by its members as "the" pivotal element of an NMS. n115

The primary function of ITS is to link geographically separated market centers by routing messages between them. n116 The ITS enables a trading participant physically present on the floor of an exchange to transmit his own or a customer's order in an ITS-traded security to another market center.

An ITS transaction is initiated by the entry of an order, known as a "commitment to trade," into a computer terminal

located on the floor of the exchange. At that moment, the commitment is time stamped, validated, assigned a unique identification number, and logged by ITS.

In a matter of seconds, the commitment is delivered on queue for delivery to the destination market center, where the commitment is printed on an ITS printer.

A "commitment to trade" is a firm obligation to either buy or sell an ITS security for either one minute (a "T-1" option) or two minutes (a "T-2" option). The originator elects which option to apply, and the commitment is irrevocable during that period.

If the "commitment to trade" is accepted by a broker or dealer at the designated market, an abbreviated message is entered into the system and ITS reports an execution to the originating market center.

Accordingly, the ITS preserves the exchange floor as the prime focus of the auction process, and facilitates the flow of orders from brokers and specialists on one floor to specialists on another. The ITS functions with a separate order execution system from the quotation display system. n117

ITS commenced operations in 1978 with 11 securities. n118 By 2004, approximately 5,041 securities were being traded in the ITS network. n119 During 2004, there were 13.4 million trades through ITS, totaling 17.9 billion shares. n120

The Commission has monitored closely the operation, efficiency, and effectiveness of the ITS. n121 The Commission has expressed some concern over the possibility of "trade-throughs." n122 In 1981, the Commission approved a "trade-through" rule, outlining procedures for corrective action in the event of a trade-through. n123 The Commission's staff has concluded that less than one percent of the ITS trades involve potential trade throughs. n124 Moreover, ITS has significantly reduced execution costs. Accordingly, the Commission terminated the experimental classification of ITS and approved the system for an indefinite period. n125

While the ITS has been an important component of the National Market System since its introduction in 1978, advances in technology and the changing structure of markets led to questions as to whether it is even necessary. n126 The implementation of Regulation NMS was widely expected to spell the end of the ITS system, which at the time Regulation NMS was adopted did not even provide the functionality demanded by the new Trade-Through Rule. n127 In August 2005, Nasdaq announced that it would withdraw from the system. n128 Several of the smaller exchanges also appeared to be considering alternatives to the ITS. n129

[B] The Regional Market System and the National Securities Trading System

In 1977, four regional stock exchanges commenced a pilot program, the Regional Market System ("RMS"), to transmit principal and agency orders electronically between market centers. n130 Brokers and dealers participating in the system could enter orders, which would be stored and displayed on the basis of time and price priority. The RMS began pilot operations with 36 issues.

Thereafter, the Cincinnati Stock Exchange, now known as the National Stock Exchange ("NSE"), obtained Commission approval to institute, on an experimental basis of nine months, the National Securities Trading System ("NSTS") as a pilot program utilizing RMS technology. n131 Originally called the Multiple Dealer Trading System, this system permitted NSE members, without the necessity of maintaining a presence on the floor of the NSE or any other exchange, to participate in an auction-type market.

In addition, the NSTS permitted a specialist on any national securities exchange, without being or becoming a member of the NSE, to enter bids in the NSTS as principal or agent in any security in which the specialist is registered on another exchange. The NSTS effectively linked the NSE exchange and "upstairs" market makers in geographically

dispersed locations, thereby permitting the full range of off-board trading contemplated by Congress. n132

The NSTS is an electronic communication system through which bids and offers of competing dealers, as well as public bids and offers, may be consolidated for review and execution by "Users." n133 Orders are accepted into the NSTS in certain securities ("designated issues") from persons who qualify as "Users." n134 All orders must be entered into the NSTS as limit orders; market orders, as such, are not executed by the system. n135

Orders in the NSTS are executed first by price and then, as to orders at the same price, by time of entry. "Public agency orders" n136 are granted priority over other orders at the same price. n137 A nonexecuted public agency order, once entered in the NSTS, may be removed only upon cancellation, in connection with a transfer of the order to another exchange, or to permit the approved dealer or member who entered the order to execute the order as principal pursuant to a prior guarantee to provide an execution should a trade take place in another market at the specified limit price (a "limit order guarantee"). n138 Trades executed on the NSTS are confirmed by a hard-copy confirmation of each transaction promptly to each User, or User's agent, who is a party to the transaction. n139

The NSTS was initially authorized by the Commission as a "pilot" experimental program. n140 The Commission twice extended the duration of that program. n141 In 1982, the Commission approved an application by the NSE to terminate the "pilot" phase of the NSTS and granted permanent status to the system. n142

The number of NSTS stocks has grown steadily since the system commenced operation in June 1978 with 38 issues. By 1980, this figure had increased to 49, and by the end of 1981 to 73. By August 1982, there were 88 NSTS stocks, of which 85 were NYSE-listed. n143

Merrill Lynch, Pierce, Fenner & Smith, the largest participant in the NSTS at the time, withdrew from the system in 1983, precipitating a large drop in the NSE's volume. The NSE's percentage of share volume dipped from 0.38 percent in 1982 to 0.15 percent in 1985. n144 In order to remedy this problem, the NSE began an affiliation with the Chicago Board Options Exchange ("CBOE"). After that time, trading volume increased, and in 2004 the NSE percentage of dollar volume on all national securities exchanges and Nasdaq was 10.5 percent, with over \$2.9 trillion in dollar volume. n145

Due to the limited number of NSTS issues and participants, NSTS trading volume has been modest compared to the NYSE, although trading increased steadily. n146

[C] The Computer Assisted Execution System

In the early 1970s the NASD determined to improve the efficiency of negotiating OTC transactions and developed an automated telecommunications system known as Nasdaq, now a registered national securities exchange known as the Nasdaq Stock Market. n147 Through a network of computer terminals, NASD members currently have virtually instantaneous interoffice communications.

Following the 1975 Amendments, the Commission urged the NASD to upgrade Nasdaq to permit intermarket linkage between the OTC market and securities exchanges. n148 The NASD responded by developing a Computer Assisted Execution System ("CAES") to route and automatically execute certain orders.

Utilizing Nasdaq, CAES participants could enter orders that are routed automatically to the participating market maker offering the best price. An order is executed automatically with the market maker who has entered the best price, if the order is within the market maker's displayed size. If the order exceeds his size, the balance is executed with the next market maker(s), according to time priority. n149

Every trade in CAES was reported within 90 seconds after execution. Large block trades are negotiated over the

telephone, but reported and displayed like any other trade through the Nasdaq system. All Nasdaq/National Market securities were traded through CAES. In March 2004, the Commission approved a Nasdaq proposal under which all securities traded through ITS were traded using SuperMontage, which resulted in the elimination of CAES because it was no longer necessary. n150

[iii] Interfacing of Market Linkage Systems

The second type of facility, in addition to an intermarket order routing system, n151 necessary to link qualified markets effectively is a universally available message switch. The message switch would permit any broker or dealer to route orders for the purchase or sale of qualified securities n152 from its offices "upstairs," or off the floor of an exchange, to any qualified market trading in that security. n153

A universally available "upstairs" message switch should operate in a neutral fashion, *i.e.*, permitting brokers and dealers to route orders to and among all such markets on a nondiscriminatory basis. n154

In its January 1978 statement concerning the development of a national market for securities, n155 the Commission expressed its belief that the self-regulatory organizations should combine their efforts and take joint action to make available to their members a single broker order routing system. n156 In June 1978 the Commission requested eight self-regulatory organizations to comment on issues relating, among other things, to whether the routing of orders by brokers on an order-by-order basis should be a characteristic of a national market system, and, if so, whether a single exclusive message switch is the means by which such routing should be achieved. n157

The development of a universally available, neutral, "upstairs" message switch was not imminent. n158

The formation and successful operation of the ITS, RMS, and NSTS proved, however, at least to the Commission, that the goals of Section 11A of the Exchange Act n159 were attainable. The ITS appeared to provide an effective basis for an intermarket order routing system for the purchase and sale of multiply-traded securities, n160 which was recognized by the Commission as early as 1978. n161

The NSTS also contained elements of a NMS, namely a composite quotation system, an order routing system, an intermarket communication system, and a central limit order book. n162 Moreover, the NASD's pending enhancements to Nasdaq offered further potential for NMS linkage.

In 1978 the Commission solicited comments on the feasibility and practicality of ordering some sort of interface between ITS, NSTS, and the NASD's systems. n163 The Commission also requested the NYSE and AMEX to make available to other SROs their jointly owned common message switch. n164

After extensive public comment, Commission analysis of the ITS and NSTS, and completion of the Nasdaq upgrading, the Commission announced in 1981 a proposed order that would mandate an automated interface between the ITS, NSTS, and Nasdaq. n165

Shortly thereafter, the NSE joined the ITS and the Commission approved a manual interface between the NSTS and the ITS. n166 Under the plan, an ITS terminal would be placed on NSE's trading floor and staffed by NSE personnel. n167 All commitments to or from the NSTS would be routed to the NSE trading floor and, thereafter, rerouted to the designated ITS market center.

While the Commission expressed concern that the manual interface might not be efficient, n168 the Commission viewed the linkage of ITS and NSTS to be "critical" to achieving the Commission's goals of "eliminating trade throughs and ensuring nationwide price protection of limit orders traded through ITS." n169

In April 1981, the Commission ordered the members of the ITS and the NASD to implement by March 1, 1982 an "automated interface" between the ITS and NASD's CAES, a part of the Nasdaq system. n170 The order set forth certain functional characteristics of the interface: n171

- (1) The integrated system should be able to send and receive commitments to trade and responses, preopening notifications and responses, and administrative messages.
- (2) Communications should be in standard ITS format.
- (3) The system should cover any security eligible for off-board trading under Rule 19c-3, n172 already included in ITS, and which had at least one OTC market member registered with the NASD.
- (4) No person other than a registered OTC market maker may have access to the automated interface to send or receive commitments to trade, preopening notifications, or administrative messages except through the facilities of an exchange participating in the ITS.
- (5) Registered OTC market makers may have access only with respect to securities in which they are acting as a CAES market maker.

Rejecting various arguments that the automated interface was premature, n173 the Commission asserted that the automated interface was essential to the development of an NMS. Accordingly, the Commission ordered the submission of an implementation timetable by June 15, 1981.

In March 1982, the Commission issued a "status report" on the ITS/CAES interface. n174 Simultaneously, the Commission announced proposed amendments to the ITS plan that would mandate integration of the NASD in ITS. Acknowledging that the ITS members and NASD had made "good faith efforts" toward achieving the interface, the Commission nevertheless concluded that progress had not been satisfactory. Declaring the interface "to be a critical event in the development of the national market system," the Commission lamented the "failure" of the ITS participants and the NASD to reach a final agreement. The Commission concluded that it could no longer refrain from interjecting its views in the negotiating process and, therefore, proposed amendments to the ITS plan which, in effect, would resolve or defer for future consideration the various issues raised by the ITS/NASD negotiators. n175

The Commission deferred implementation of the automatic interface until May 1, 1982 to obtain comments on its proposed order and to afford additional time to complete negotiations between ITS members and the NASD. In May 1982, the Commission adopted amendments to the ITS plan in substantially the same form as proposed but deferred the implementation date of the ITS/CAES interface to May 17, 1982. n176

On May 17, the ITS/CAES interface commenced "pilot" operations with trading limited to 30 exchange traded securities eligible for off-board trading. n177 After approximately six months of operation, the Commission termed the interface "a significant achievement," acknowledging however, that "there are a number of aspects of ITS which deserve further attention and improvement" n178

[iii] Trade-Through Rule

The trading of securities across multiple markets had long created a concern that transactions could be executed on one market while a better quotation is available on another market. In this situation, the market with the inferior quotation is said to "trade through" the superior quotation on the second market. Until Regulation NMS, the Commission did not directly address trade-throughs. As a result in the quirk in the development of securities markets, a trade-through rule applied only to exchange-listed, but not Nasdaq, securities. This situation came about because the only trade-through rule in existence prior to Regulation NMS was contained in the ITS Plan. n179 Nasdaq at the time was not a national

securities exchange and therefore not a participant in the ITS Plan, and no trade-through rule was adopted with respect to Nasdaq stocks. The ITS trade-through rule was thought by many to be ineffective and to inhibit competition, and many commentators argued for its abolition. n180 Ultimately, the Commission proposed not eliminating the rule but in fact expanding it, which touched off highly-charged debate reaching all the way to the halls of Congress. In the initial Regulation NMS proposing release, the Commission requested comment on a rule that would require markets trading national market system securities to adopt and enforce policies and procedures reasonably designed to prevent trade-throughs in their markets. n181 The proposed rule had two exceptions: the first was an "opt out" exception that would have allowed customers, as well as broker-dealers trading for their own account, to consent to having their orders executed on a market without regard to quotations in other markets, and the second would have allowed automated markets to trade through a non-automated market within certain price parameters. n182

As a result of the Regulation NMS Hearings and comments on the initial Regulation NMS proposing release, when it repropose Regulation NMS in December 2004, the Commission took a different approach to the proposed trade-through rule. One major difference is that under the repropose trade-through rule only automated quotations would be protected from trade-throughs. n183 In the December 2004 release the Commission also proposed two alternatives for the quotations covered by the trade-through rule, one labeled the "Market BBO Alternative" and the other designated as the "the Voluntary Depth Alternative." n184 The Market BBO Alternative would have protected only quotations that represented the best national bid or offer for a security. The Voluntary Depth Alternative would have protected any quotations that markets voluntarily disseminate in the consolidated quotations stream. n185 In addition, repropose trade-through rule had more exceptions than those in the rule as originally proposed, including one for failures or material delays in the market displaying the quotation that would otherwise be protected, for "intermarket sweep orders," i.e., limit orders that, when combined with other orders are designed to execute against the full displayed size of all protected quotations with a superior price. n186

The Commission received more than 2200 comments on the trade-through proposal, including over 34 from members of Congress. n187 Many of the comments were on the issue of whether extending trade-through protection was even appropriate. n188 The Commission exhaustively analyzed these comments, to the point of supplementing a study by the Commission's Office of Economic Analysis on the incidence of trade-throughs on the various markets when commenters questioned the accuracy of the original study. n189

As adopted, the Trade-Through Rule, Rule 611 of Regulation NMS, requires markets, subject to exceptions set forth in the rule, to "establish, maintain, and enforce written policies and procedures that are reasonably designed to prevent trade-throughs on that trading center of protected quotations in NMS stocks." n190 The term "protected quotations" is defined to include all automated quotations disseminated pursuant to an effective national market system plan. n191

The Trade-through Rule also requires trading center to conduct regular surveillance to determine the accuracy of its trade-through policies and procedures and to take prompt action to remedy deficiencies in the policies and procedures. n192

The Trade-Through Rule has exceptions for transactions:

- executed when the market displaying the traded-through quotation was experiencing a failure, material delay, n193 or malfunction of its systems or equipment;
- that are not settled "regular way," such as transactions with extended settlement terms;
- that are a single-priced opening, reopening, or closing transaction by the trading center; n194
- executed at a time when a protected bid was priced higher than a protected offer in the stock, i.e. when a market is "crossed";

- that are executions of intermarket sweep orders;
- effected by a market that simultaneously routed an intermarket sweep order to execute against the full displayed size of any protected quotation in the NMS stock in question. n195
- that represent executions of orders at a price not based, directly or indirectly, on the quoted price of the NMS stock at the time of execution and for which the material terms were not reasonably determinable at the time the commitment to execute was made;
- where the market displaying the protected quotation that was traded through had displayed, within one second prior to execution of the transaction that constituted the trade-through, a best bid or best offer, as applicable, for the NMS stock with a price that was equal or inferior to the price of the trade-through transaction;
- that represent executions by a market of an order for which, at the time of receipt of the order, the trading center had guaranteed an execution at no worse than a specified price, i.e., a "stopped order." n196

A market's trade-through procedures must include procedures designed to ensure compliance with the conditions for any exemption claimed. n197 The Commission may grant exceptions to the Trade-Through Rule, either unconditionally or on specified terms and conditions, to specific persons or for particular transactions, securities or classes of securities, quotations or orders. n198

[c] Composite Quotation System

Communications systems designed to provide automated dissemination of last sale and quotation information with respect to securities were cited in the Senate Committee Report to accompany Senate Bill 249 as forming "the heart of the national market system." n199 In Section 11A, added by the 1975 Amendments, Congress:

- (1) set forth one of the goals of a national market system as assuring to brokers, dealers, and investors the availability of information with respect to both quotations for and transactions in securities, n200 and then
- (2) granted the Commission rule-making powers relating to quotations and transactions. n201

The development of a composite quotation system was mentioned by the Commission as one of the initiatives that must be taken over the next year, in its January 1978 statement on the development of a national market system. n202 To facilitate the prompt development of a composite quotation system, the Commission adopted Rule 11Ac1-1 [now Rule 602] to improve the quality and reliability of quotation information made available by national securities exchanges and third market makers. n203

[i] Quote Rule--Rule 602 [former Rule 11Ac1-1]

In 1978, n204 the Commission adopted Rule 11Ac1-1, n205 "Dissemination of Quotations for Reported Securities," governing dissemination of quotation information with respect to equity securities n206 as to which last sale information is reported in the consolidated transaction reporting system. n207 After its adoption, Rule 11Ac1-1, the "Quote Rule," n208 was amended six times before being redesignated as Rule 602 with the adoption of Regulation NMS in 2005. n209

Rule 602 requires every exchange and association to establish and maintain procedures and mechanisms for:

- (1) collecting bids, offers, quotation sizes, and aggregate quotation sizes from responsible brokers or dealers n210 (who are members of such exchange or association);
- (2) processing such bids, offers, and sizes; and
- (3) making them available to vendors, n211 as follows:
 - (i) as to a national securities exchange, at all times the exchange is open for trading, the exchange must collect, process and make available to vendors the best bid, the best offer, and aggregate quotation sizes for each subject security n212 listed or admitted to unlisted trading privileges which is communicated on any national securities exchange by any securities responsible broker or dealer, n213 and
 - (ii) as to an association, at all times that last sale information with respect to reported securities is reported pursuant to an effective transaction reporting plan, the association must collect, process and make available to vendors the best bid, best offer, and quotation sizes communicated otherwise than on an exchange by each member of such association acting in the capacity of an OTC market maker n214 for each subject security and the identity of that member. n215

For each published bid or offer n216 of a member with respect to a subject security, every exchange is required to establish and maintain procedures for ascertaining and disclosing to exchange members, upon presentation of orders sought to be executed by exchange members in reliance upon Rule 602(b)(2) [former Rule 11Ac1-1(c)(2)], n217 the identity of each responsible broker or dealer who made the bid or offer n218 published, and the quotation size associated with the bid or offer.

If an exchange determines that, at any time while open for trading, the level of trading activity or the existence of unusual market conditions makes the exchange incapable of collecting, processing, and making available to quotation vendors the data for a reported security required by Rule 602(a)(1)(i) [former Rule 11Ac1-1(b)(1)] n219 in a manner accurately reflecting the current state of the market on the floor of that exchange, then the exchange must immediately notify all specified persons n220 of that determination. n221 Any such exchange determination must be pursuant to rules and regulations approved by the Commission under Section 19(b)(2). n222 Upon notification, both the responsible brokers or dealers who are members of that exchange and the exchange itself are relieved of their obligation under paragraphs (b)(2) and (c)(3), and (a)(1) and (2), respectively, of Rule 602 [Paragraphs (c)(2) and (d)(3) and (b)(1) and (2) of former Rule 11Ac1-1] with respect to that security. n223

An exchange or association may make available to quotation vendors

- (1) indications of interest, or
- (2) bids or offers with respect to a subject security at any time such exchange or association is not required by Rule 602(a)(1) [former Rule 11Ac1-1(b)(1)] to do so. n224

Any exchange may elect to collect, process and disseminate data on a covered security, except that notification must be given to all specified persons if the security is traded on only one exchange and not traded by any OTC market maker. n225

Similarly, an OTC market maker may elect to comply with the Quote Rule with respect to any covered security by communicating to his association bids, offers, and quotation sizes, except that notification of the election must be given to both the association and all specified persons if the covered security is traded on only one exchange and not traded by any other OTC market maker. n226

Any election by an exchange or OTC market maker to comply voluntarily with the Quote Rule will cease to be in effect if the exchange or market maker ceases to make available or communicate bids, offers, and quotation sizes. n227

Rule 602(b) [former Rule 11Ac1-1(c)] contains the obligations of responsible brokers and dealers under the Quote Rule. Responsible brokers and dealers must promptly communicate to their exchange or association, as the case may be, their bids, offers, and quotation sizes with respect to any subject security, pursuant to procedures established by that exchange or association. n228

Every responsible broker or dealer is obligated, subject to paragraph (b)(3) of Rule 602 [paragraph (c)(3) of former Rule 11Ac1-1], discussed below, to execute any order to buy or sell a subject security, other than an odd-lot order, presented to such broker or dealer by either

- (1) another broker or dealer, or
- (2) any other person belonging to a category of persons with whom such responsible broker or dealer customarily deals. n229

The order must be at a price at least as favorable as the bid price or offer price comprising the responsible broker's or dealer's published bid or published offer n230 in any amount up to the published quotation size. n231

The Quote Rule contains two exceptions to the firmness provisions discussed above. One exception is in the case of a "revised quotation size" and the other concerns a "revised bid or offer." n232

A responsible broker or dealer is not obligated by the firmness provisions in paragraph (b)(2) of Rule 602 [paragraph (c)(2) of former Rule 11Ac1-1] to purchase or sell a subject security in an amount greater than the broker's or dealer's revised quotation size, if

- (1) prior to the presentation of an order to buy or sell a subject security, a responsible broker or dealer has communicated to its exchange or association a revised quotation size, or
- (2) at the time an order to buy or sell a subject security is presented, a responsible broker or dealer is in the process of effecting a transaction in the subject security, and immediately after such transaction is completed, the broker or dealer communicates to its exchange or association a revised quotation size. n233

A responsible broker or dealer is obligated by the firmness provisions in paragraph (b)(2) of Rule 602 to execute a transaction in a subject security only at his revised bid or offer in any amount up to either his published or revised quotation size, as the case may be, if

- (1) before the order sought to be executed is presented, a responsible broker or dealer has communicated to its exchange or association a revised bid or offer, or
- (2) at the time the order sought to be executed is presented, the responsible broker or dealer is in the process of effecting a transaction in such subject security, and immediately after completion of such transaction, the broker or dealer communicates to its exchange or association a revised bid or offer. n234

Subject to the right of an exchange or OTC market maker to elect to comply voluntarily with the Quote Rule as to any reported security, n235 no exchange or OTC market maker may make available, disseminate, or otherwise communicate for display on a terminal or other display device any bid, offer, quotation size, or aggregate quotation size for any covered security not a subject security. n236

Similarly, no quotation vendor may disseminate or display on a terminal or related device any bid, offer, quotation size, or aggregate quotation size from any exchange or OTC market maker for any reported security which is not a covered security. n237

Finally, the Commission has broad exemptive powers under the Quote Rule, whenever the Commission determines that an exemption is consistent with the public interest, the protection of investors, and the removal of impediments to and perfection of the mechanism of a national market system. n238

[ii] Access to Quotations

One of the issues the Commission sought to address with Regulation NMS was ensuring full access to all markets participating in the national market system. In the Regulation NMS adopting release the Commission noted the difference between access to quotations for exchange-listed and Nasdaq stocks. As a result of provisions in the ITS requiring all participating markets to allow access to quotations without the imposition of fees, access to quotations in exchange-listed stocks was theoretically free and open. n239 However, as a practical matter access to quotations through the ITS was, in the words of the Commission, "often slow and limited." n240 For Nasdaq stocks, by contrast, there was no intermarket linkage system at all, leaving individual markets trading Nasdaq stocks free to establish their own access standards and fees. n241 While the system governing Nasdaq stocks had advantages in that it was more flexible and could adapt to technological advances, in some cases it inhibited access to a market's quotations. n242

The Commission believed that the fair access dilemma could be solved without the need for a collective intermarket linkage to which all markets belonged, if uniform rules were adopted for access to quotations. n243 Accordingly, with Rule 610 the Commission imposed several requirements designed to ensure fair access to all quotations. First, Rule 610(a) prohibits SROs from imposing "unfairly discriminatory terms that prevent or inhibit any person from obtaining efficient access" to quotations in NMS stocks through a member of the SRO. n244 Second, the Commission attempted to ensure that market participants have full access to the quotations of markets that are disseminated through the NASD's alternative display facility ("ADF"). n245 Rule 610(b)(1) requires any market displaying quotations in an NMS stock through the alternative display facility to "provide a level of cost and access to such quotations that is substantially equivalent to the level and cost of access to quotations displayed by SRO trading facilities in that stock." n246 Rule 610(b)(2) prohibits markets displaying quotations through the ADF from imposing "unfairly discriminatory terms" that serve to prevent access to quotations through the market's members or subscribers. n247 Finally, Rule 610(c) limits the fees that markets may charge for execution of orders at prices equaling the best bid or offer of a national securities exchange or Nasdaq to \$0.003 per share for stocks being quoted at a price of \$1.00 or more. n248 For quotations of less than \$1.00, the limitation on the fee is 0.3 percent of the quotation price per share. n249

In connection with its adoption of rules designed to ensure fair access to quotations, with Regulation NMS the Commission also addressed a related problem, that of "locked" and "crossed" markets. A "locked" market is one in which the bid price of one quoting market participant equals the ask price of another participant. n250 A "crossed" market is one in which the bid price of a quoting participant is more than the ask price of another participant. n251 Locked and crossed markets are thought to be a sign of inefficiencies in the markets. n252 They can occur within a market or across markets. In connection with Regulation NMS, the Commission was concerned with locked or crossed quotations that occur across markets, i.e., the bid quotation of a participant in one market being equal or higher than the ask quotation in another market. n253 Rule 610(d) of Regulation NMS requires each national securities exchange and national securities association to adopt rules requiring its members to reasonably avoid locking or crossing a quotation

in any NMS stock that is protected under the Trade-Through Rule, or displaying manual quotations that lock or cross any quotation in an NMS stock disseminated under an effective national market system plan. n254 National securities exchanges and associations must also adopt rules, under Rule 610(d), designed to ensure the reconciliation of locked or crossed quotations in NMS stocks and prohibiting members from "engaging in a pattern or practice of displaying quotations that lock or cross" or displaying manual quotations that lock or cross quotations disseminated under an effective national market system plan, except to the extent a valid exception exists under the SRO's rules. n255

[iii] Prohibition on Subpenny Pricing

Since April 2001 all quoting and trading in U.S. securities markets has been in decimals rather than in fractions. While "decimalization" is generally believed to have benefited investors by reducing spreads and eliminating the need to convert fractions to decimals, one unfortunate by-product of decimalization was that it made it easier for broker-dealers to "step ahead" of customer limit orders, a practice which reduces the quality of executions for customers. n256 When decimal trading first began there was no minimum uniform pricing increment, and some markets allowed quotations in increments of less than one cent, or "subpennies," which exacerbated the trading ahead problem. n257 The Commission ultimately concluded that the costs of subpenny quoting outweighed the benefits, and with Regulation NMS eliminated subpenny quoting. n258 Accordingly, the Commission, in what was the least controversial substantive aspect of Regulation NMS, adopted Rule 612, which prohibits markets and broker-dealers from disseminating a quotation for an NMS security that, if in the amount of \$1.00 or more per share, is in an increment smaller than \$0.01. n259 For quotations in an amount of less than \$1.00 per share, the minimum pricing increment is \$0.0001. n260 Rule 612 does not prevent trades from being executed in subpennies, which may occur, for example, when the execution price of a trade is based on the midpoint between the bid and offer or a volume weighted-average formula. n261

[iv] Consolidated Quotation (CQ) Plan

One of the four goals announced by the Commission in 1972 for the "central market system" was the development of a communications system in which "information on prices, volume and quotes for all securities in all markets [will be] available to all investors" n262 As the first step toward this goal, the Commission, also in 1972, proposed the adoption of Rule 17a-14 which, in substance, would require all registered securities exchanges and associations to make quotations available to vendors of market information on a current and continuing basis. n263

In 1974, the Commission revised proposed Rule 17a-14 to require that the securities industry adopt a joint plan for reporting quotations on a consolidated basis. n264 The plan would call for the collection, processing, and dissemination of quotations in all exchange and OTC traded securities on a real-time, current, and continuing basis.

The Commission refocused its proposal in late 1974 and, by letter, formally requested each national securities exchange to amend any rules or practices that restrict access to or use of quotation information to any quotation vendor. These changes were to be effected by May 1, 1975. n265 By facilitating access to quotation information, the Commission hoped to stimulate competition to provide market data to the securities industry.

Following the voluntary amendment of exchange rules and practices governing access to quotation information and the adoption of the Securities Acts Amendments of 1975, the Commission proposed the adoption of a firm quote rule--Rule 11Ac1-1[now Rule 602]. n266 Although Rule 11Ac1-1 as proposed did not specify the manner in which quotation information would be disseminated, the rule did contemplate communication of quotations by exchange specialists and OTC market makers. The final rule, adopted in January 1978, n267 required all SROs to collect and disseminate to vendors quotations and quotation size for all reported securities, *i.e.*, securities as to which last sale price is reported in the consolidated transaction reporting system. n268

In July 1978, the NYSE and AMEX filed with the Commission a plan for the development and operation of a consolidated quotation reporting system (the "CQ Plan"). n269

The Commission issued an order permitting implementation of the CQ Plan for a period of 180 days, n270 establishing requirements concerning the dissemination of quotation information for a particular reported security by a participating market center during a regulatory halt initiated by the "primary" market for that security. n271

The CQ Plan establishes joint procedures to govern the collection, processing, and dissemination of all quotation information required to be made available under Rule 602(a)(1) [former Rule 11Ac1-1(b)(1)] by the participating market centers. n272 The CQ Plan provides for selection and evaluation of an exclusive processor n273 to collect quotation information from participants and to make that information available to quotation vendors in a single data stream. n274 Finally, the CQ Plan establishes fees relating to the receipt of quotation information. n275

As a result of the ITS/CAES interface, n276 the CQ Plan participants in July 1982 submitted to the Commission certain amendments to the Plan. n277 Approved in December of that year, n278 the amendments, in substance, provided for the dissemination of an ITS/CAES best bid and offer display, *i.e.*, a display of the best bid and best offer price, together with the quotation size, for each ITS/CAES security based upon quotations submitted by exchange and OTC market makers which trade through the interface. n279

[v] Best Execution

One of the goals of a national market system is to assure "the practicability of brokers executing investors' orders in the best market." n280

At the time of the adoption of Rule 11Ac1-1 [now Rule 602], the Quote Rule, the Commission declined to adopt a "best execution" rule to require brokers under all circumstances to route their customers' orders to the market displaying the best quotation. n281 In its January 1978 statement on the development of a national market system, issued concurrently with the Commission's announcement of the adoption of Rule 11Ac1-1, the Commission expressed the belief that the availability of comprehensive quotation information would improve the knowledge of both brokers and public investors of current prices at which reported securities can be bought or sold throughout the country. n282 The availability of this information should then, among other things, lead to increased efforts by brokers to make informed order routing decisions from among the various competing market centers to choose that particular market affording, at that particular time, the most favorable execution opportunities to their customers. n283

While various members of the securities industry have urged the adoption of a "best execution" rule, n284 the Commission has declined to adopt such a rule based upon its belief that a "best execution" rule would be "unenforceable and unnecessarily burdensome given the present limitations on the firmness of quotations and the manner in which customer orders are currently handled." n285 Instead, the Commission has relied on the SROs to provide guidance to members concerning their duty to execute customer orders at the most favorable price obtainable. n286

In September 1996, the SEC again declined to adopt a proposed rule that would have required market makers to provide all market orders with an opportunity for price improvement. n287 Despite the absence of a formal rule adoption at this time, the SEC re-examined and effectively expanded a broker-dealer's duty of best execution.

Prior to September 1996, automatic execution of market orders in over-the-counter securities at the national best bid/best offer ("NBBO") was generally recognized as satisfying a market maker's duty of best execution. n288 The SEC noted that market evolution was changing the scope of a market maker's best execution obligations:

The duty of best execution requires a broker-dealer to seek the most favorable terms reasonably available under the circumstances for a customer's transaction. The scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions for customer orders, including opportunities to trade at more advantageous prices. As these changes occur, broker-dealers'

procedures for seeking to obtain best execution for customer orders also must be modified to consider price opportunities that become "reasonably available". n289

The SEC found that NBBO-based executions "would not necessarily satisfy a broker-dealer's duty of best execution." n290 Market makers were instructed to take into account all reasonably available price-improvement opportunities when executing customer orders, including undisplayed inside customer limit orders. This interpretation has resulted in substantial modifications to market makers' systems, which typically provided automatic executions at the NBBO. The SEC has continued to rely on SROs to provide further best execution guidance to their members. n291

[d] Consolidated Transaction Reporting System

A consolidated transaction reporting system ("CTRS") along with a composite quotation system, was considered by the Senate Committee on Banking, Housing and Urban Affairs to be part of the communications systems that would form "the heart of the national market system." In 1975 Congress granted the Commission rule-making power to facilitate the development of a CTRS, as well as a composite quotation system. n292 Prior to the Securities Acts Amendments of 1975, however, the Commission had already adopted Rule 17a-15 calling for the implementation of a consolidated tape to report transactions. n293 The advent of the 1975 Amendments resulted in the Commission amendment and redesignation of Rule 17a-15 as Rule 11Aa3-1. n294 With the adoption of Regulation NMS in 2005, Rule 11Aa3-1 was redesignated as Rule 601. n295

[i] Collection and Dissemination of Last Sale Information--Rule 601 [former Rule 11Aa3-1]

In 1972, the Commission adopted Rule 17a-15, "Reporting of Market Information on Transactions in Listed Securities." n296 The Rule required every registered national securities exchange and every national securities association to file a plan with the Commission on or before February 26, 1973. The plan was to provide for the dissemination of information, with respect to transactions executed through the facilities of the exchange, in the case of a registered national securities exchange, and with respect to over-the-counter transactions executed by association members, in the case of a national securities association, in securities registered or admitted to unlisted trading privileges on an exchange, through vendors of market transaction information. n297 After March 26, 1973, exchanges, associations, and members thereof were prohibited from releasing on a current and continuing basis last sale reports relating to transactions in listed securities executed through either the facilities of any exchange or in the over-the-counter market, except pursuant to an effective plan filed under Rule 17a-15 [now Rule 601]. n298

Every plan filed under Rule 17a-15 had to specify:

- (1) the manner of collecting, processing, sequencing, distributing, and displaying last sale reports;
- (2) the standards and methods to be utilized to ensure promptness of reporting, accuracy, completeness, and similar matters;
- (3) the rules or procedures to be adopted to prevent fraud and manipulation in reporting last sale information; and
- (4) the standards for denial of access to users of last sale reports and procedures for Commission review of such denials. n299

Furthermore, every plan had to require that every vendor receiving reports of transactions in listed securities must agree to make available to its subscribers, on a current and continuing basis, through a moving, real-time last sale reporting system (a "composite tape") or an interpretation system, last sale reports from all reporting markets in any listed security reported on by the vendor. n300 Last sale reports could not be excluded from any system for the display of such reports

based upon the market in which the transaction was executed. n301 The marketplace where each transaction displayed on either a tape or interrogation system was executed had to be identified on the tape or interrogation system itself. n302

In March 1973, five securities exchanges n303 and the NASD jointly filed with the Commission a plan for consolidated reporting of transactions. n304 Declared effective in May 1974, n305 the plan provides for a "tape" to be composed of two separate data networks, which are displayed. n306

While the consolidated transaction reporting system was generally considered to be a success, the Commission expressed concern in two major areas:

- (1) the anticompetitive consequences of a standard consolidated system symbol to recall data on a particular security, and n307
- (2) the then existing prohibition on retransmission n308 of the data stream of transaction reports. n309

In 1978, the Commission announced proposals to amend Rule 17a-15 that would restate the rule in revised format, n310 redesignate the Rule as Rule 11Aa3-1 n311 and relocate the provisions of Rule 17a-15 that currently govern the display of last sale reports in a new rule, proposed Rule 11Ac1-2. n312

Rule 11Aa3-1, "Dissemination of Transaction Reports and Last Sale Data With Respect to Transactions in Reported Securities," as amended in 1987 and 1997 n313 differed from Rule 17a-15 in two principal respects. n314 First, Rule 11Aa3-1, unlike Rule 17a-15, explicitly sets forth the manner in which any effective transaction reporting plan n315 may be amended. n316 Second, the Rule provided that no national securities exchange or association may prohibit retransmission n317 of the entire data stream of transaction reports contained in the consolidated transaction reporting system on a current and continuous basis for the purpose of creating a continuous moving ticker display. n318

In addition to the two principal differences between Rule 17a-15 and Rule 11Aa3-1, the Commission also made several technical amendments to Rule 17a-15, including the incorporation into Rule 11Ac1-2 n319 of the Rule 17a-15 provisions indirectly prescribing the manner in which market information vendors display transaction reports. n320

Rule 11Aa3-1 was amended six times before being redesignated as Rule 601 in Regulation NMS. n321 With the adoption of Rule 11Aa2-1 [now Rule 600(a)], n322 which established procedures to qualify securities for trading in the national market system, paragraph (b)(1) of Rule 11Aa3-1 was amended to make non-listed NMS securities subject to the transaction reporting requirements of the rule. n323

Similarly, when the Commission adopted Rule 11Aa3-2 to establish procedures for consideration of joint industry plans relating to the NMS, n324 Rule 11Aa3-1 was amended to delete the procedural requirements of this Rule relating to amendment of consolidated tape plans n325

Under existing regulation, every exchange must file with the Commission a "transaction reporting plan" regarding transactions in listed equity and Nasdaq securities executed through its facilities, and every association must file a "transaction reporting plan" regarding transactions in listed equity and Nasdaq securities executed by its members otherwise than on an exchange. n326 At a minimum, such plan must specify:

- (1) the listed equity and Nasdaq securities or classes of such securities for which transaction reports will be required by the plan;
- (2) reporting requirements with respect to transactions in listed equity securities and Nasdaq securities, for any broker or dealer subject to the plan;

1-2 Federal Securities Exchange Act of 1934 § 2.01

- (3) the manner of collecting, processing, sequencing, making available and disseminating transaction reports and last sale data reported pursuant to the plan;
- (4) the manner in which transaction reports will be consolidated with reports from the plans of other exchanges or associations;
- (5) the applicable standards and methods which will be utilized to ensure promptness, accuracy and completeness of transaction reports;
- (6) rules to prevent fraudulent or manipulative distribution of reports or last sale data;
- (7) specific terms of access to transaction reports; and
- (8) that transaction reports or last sale data made available to any vendor for display on an interrogation device identify the marketplace where each transaction was executed. n327

The NASD's "transaction reporting plan" could be amended by filing the text of the proposed amendment with the Commission with a statement of the purpose of the amendment. n328 Upon receipt of the NASD's "designated plan" or any amendment thereto, the Commission is to publish notice of the filing and solicit public comment prior to taking final regulatory action. n329 No "designation plan" or amendment may become effective without specific Commission approval. n330 Within 120 days after publication of notice, the Commission is to approve the plan or amendment, with such changes or subject to such changes or conditions as the Commission orders in the public interest, for the protection of investors, or "to remove impediments to and perfect the mechanism of a national market system," or in furtherance of the Exchange Act. n331

[ii] Display of Quotation and Transaction Data--Rule 603 [Replacing former Rule 11Ac1-2]

Rule 11Ac1-2 [now eliminated in favor of Rule 603] contained comprehensive requirements governing the manner in which vendors n332 display

- (1) transaction reports in securities with respect to which transaction reports are disseminated under Rule 11Aa3-1 [now Rule 601], and
- (2) quotation information with respect to certain equity securities. n333

The display requirements in Rule 11Ac1-2 were designed to assure that vendors provide consolidated market data in an easily accessible and useful format. n334

The rule governing the display of transactions reports n335 and quotation information requires the removal of market identifiers from a moving ticker n336 unless the moving ticker includes identifiers for all transaction reports for such security from all reporting market centers in that security. n337 Rule 11Ac1-2 also includes highly technical quotation display and retrieval requirements. n338

Rule 11Ac1-2 contained display requirements for quotation information n339 with respect to equity securities traded over-the-counter. n340 A consolidated display n341 of quotation information for any equity security traded over-the-counter must include, at a minimum, either

- (1) the best bid and best offer for such security together with identifiers indicating the market center and the quotation size, or

(2) a "quotation montage," *i.e.*, a display on an interrogation device that simultaneously disseminates quotations from all reporting market centers in such security. n342

Also, a representative bid or offer n343 can no longer be provided by a vendor on any interrogation device with respect to any subject security. n344

The rule governing the display of transaction reports and quotation information permits a vendor to combine the consolidated last sale display and the consolidated quotation display for a particular subject security. n345

Rule 11Ac1-2 did not apply to dissemination of market data made on the trading floor of a securities exchange, any system maintained by an SRO for surveillance or monitoring purposes, n346 or any system implementing market linkage n347 pursuant to a plan approved by the Commission under Section 11A(a)(3)(B) of the Exchange Act. n348 The Commission reserved the right to grant exceptions from the application of Rule 11Ac1-2 under certain circumstances. n349

Rule 11Ac1-2 became effective on April 5, 1980, except for the provisions of

(1) paragraph (c)(vi), which prohibited display of a representative bid or offer, and

(2) paragraphs (b)(2)(ii), (b)(2)(vi), (c)(2)(i), (ii), (iv) and (v), which establish certain technical requirements for the retrieval of data and the format for display of information.

Implementation of these paragraphs was repeatedly deferred to permit the industry to remedy certain technical problems. n350 The Rule became fully effective on October 1, 1981. n351 With the adoption of Regulation NMS in 2005, Rule 11Ac1-2 was eliminated in favor of Rule 603, which greatly simplified the consolidated display requirements. Rule 603 requires that any exclusive source of market information, whether an exclusive processor or a broker-dealer that is the exclusive source for specific information, distribute the market information "on terms that are fair and reasonable." n352 The rule similarly requires exchanges, associations or broker-dealers distributing information to "do so on terms that are not unreasonably discriminatory." n353 The only display obligations under Rule 603 are imposed on securities information processors and broker-dealers, and prohibit these parties from displaying quotation for a stock that can be used to implement trading or order-routing decisions without also providing last sale information. n354 These display requirements do not apply to the dissemination of information on the floor of an exchange or through "a market linkage implemented in accordance with an effective national market system plan." n355

[iii] Transaction Reporting Plans

There are four transaction reporting plans that have been filed with and approved by the SEC. n356 The first, known as the "Consolidated Tape," or "CTA Plan," was filed with the Commission pursuant to Rule 17a-15 [now Rule 601] n357 by six self-regulatory organizations n358 on March 23, 1973. n359 The second plan is the NASD's plan, which governs trading of Nasdaq NMS securities on Nasdaq. It was approved by the SEC on March 31, 1982. n360 As the NASD plan is not a joint industry plan like the CTA Plan, its provisions are simply set forth in the NASD's Rules. n361 The third plan is called the "Reporting Plan for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis," more commonly known as the "UTP Plan," and governs the collection and dissemination of last sale information for Nasdaq securities listed on an exchange or traded on an exchange through the granting of unlisted trading privileges. n362 The participants in the UTP Plan are the NSE, the NASD, Amex, the Boston Stock Exchange, the Chicago Stock Exchange, the Pacific Exchange [now NYSE Arca] and the Philadelphia Stock Exchange. n363 Nasdaq became eligible to become a participant in the plan when its exchange application was granted. n364 The fourth plan is the Plan for Reporting of Consolidated Options Last Sale Reports and Quotation Information, known more commonly as the "OPRA Plan." n365

The Commission declared the CTA Plan effective as of May 17, 1974. n366 After a pilot phase of the Joint Industry Plan began operations for a limited number of securities on October 18, 1974, the entire consolidated transaction reporting system became fully operational on April 30, 1976. n367

The Consolidated Tape Association, an unincorporated association, was created by the Joint Industry Plan to administer the system, and the Securities Industry Automation Corporation was employed as the initial processor of the consolidated transaction reporting system. n368

Under the Joint Industry Plan, the consolidated transaction reporting system consists of two discrete data streams: Network A, for transactions in NYSE-listed securities, and Network B, for transactions in securities listed or admitted to unlisted trading privileges on the AMEX and certain securities traded on participating regional exchanges. n369

At the time the participating exchanges requested the Commission to approve their plan for the creation of an Intermarket Trading System (ITS), n370 the exchanges requested the Commission to issue an exemptive order pursuant to Rule 17a-15(h) [now Rule 601(f)] n371 to permit the deletion of market identifiers from moving ticker displays for all transactions effected in any market participating in the ITS. n372 The Commission issued temporary, conditional exemptions to both the Consolidated Tape Association and the Securities Industry Automation Corporation from the market identifier requirements of Rule 17a-15 insofar as they apply to moving ticker displays. n373 This exemption, which was scheduled to expire on January 31, 1983, n374 was superseded by the adoption of Rule 11Ac1-2 [now eliminated in favor of Rule 602]. n375

[e] Securities Information Processors

[i] Registration of Securities Information Processors

The Senate Committee Report to accompany Senate Bill 249 stated that communications systems designed to provide automated dissemination of the prices at which transactions in particular securities are taking place (last sale reports) and the prices at which other traders have expressed their willingness to buy or sell (quotations) securities would form the heart of the national market system. n376 As the trading markets shifted from independent, self-contained units to a single integrated system, clear regulatory control over the communication links among markets became imperative. n377 The 1975 Amendments greatly expanded the Commission's regulatory authority over the processors and distributors of market information. n378 Section 11A was enacted with the intention of bringing under the Commission's direct jurisdiction all organizations engaged in the business of collecting, processing, or publishing information relating to quotations for, indications of interest to purchase and sell, and transactions in securities. n379

Section 11A(b)(1) makes it unlawful for any securities information processor, n380 directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce to perform the functions of a securities information processor unless registered in accordance with Section 11A(b). Unless the Commission, by rule or order, provides otherwise, n381 the only securities information processors that would be required to register are exclusive processors. n382 The Senate Committee Report to accompany Senate Bill 249 stated that all current proposals for a national market system appeared to assume the eventual existence of an exclusive processor or service bureau to which the exchanges and the NASD would transmit data and which, in turn, would make transactions and quotation information available to vendors of such information. n383 The Senate Committee Report stressed the key role an exclusive processor would play in determining how quotations and transaction information would reach the public. An exclusive information processor should be regarded as a public utility required to function in an absolutely neutral manner with respect to all market centers, market makers, and private firms. n384

[ii] Registration Statement

An application for registration must be in such form as the Commission prescribes by rule and must contain:

- (1) the address of the processor's principal office or offices;
- (2) names of securities and markets for which it is then acting and proposes to act as a securities information processor; and
- (3) such other information and documents as the Commission, by rule, may prescribe regarding:
 - (a) performance capability;
 - (b) standards and procedure for collecting, processing, distributing, and publishing information with respect to quotations for and transactions in securities;
 - (c) personnel qualifications and financial condition; and
 - (d) "such other matters as the Commission determines to be germane." n385

Rule 609 [former Rule 11Ab2-1] provides that an application for the registration of a securities information processor shall be filed on Form SIP n386 in accordance with the instructions contained therein. n387 An applicant or registrant seeking an exemption from responding to any item or exhibit of Form SIP should apply to the Commission for such exemption, which will be considered under Rule 609(c) [former Rule 11Ab2-1(c)]. n388

Every amendment filed pursuant to Rule 609 is a "report" within the meaning of: Sections 17(a), which requires the keeping of such records and the making and dissemination of such reports as the Commission prescribed by rule; 18(a), which imposes liability for false or misleading statements in any application, report, or document filed pursuant to the Exchange Act; and 32(a), which imposes criminal penalties for willful violation of the Exchange Act or for willfully and knowingly making a false or misleading statement in any application, report, or document filed pursuant to the Exchange Act. n389

[iii] Grant or Denial of Registration

After an application is filed with the Commission pursuant to Section 11A(b)(2), the Commission must publish notice of the filing and afford interested persons an opportunity to submit written data, views, and arguments concerning the application. n390 Within ninety days after the notice is published, the Commission must either grant such registration, by order, or institute proceedings to determine whether registration should be denied. n391 If proceedings with regard to denial of registration are instituted, the Commission must by order at the conclusion of the proceedings grant or deny application for registration of a securities information processor. n392

The Commission must grant the registration of a securities information processor if the Commission finds that the applicant is able to:

- (1) assure prompt, accurate, and reliable performance of its functions;
- (2) comply with the Exchange Act;
- (3) carry out its functions in a manner consistent with the purposes of Section 11A; and
- (4) insofar as it is acting as an exclusive processor, operate fairly and efficiently.

If any such finding is not made the application must be denied. n393

[iv] Withdrawal and Cancellation of Registration

A registered securities information processor may withdraw from registration, upon such terms and conditions as the Commission deems necessary or appropriate in the public interest or for the protection of investors, by filing a written notice of withdrawal with the Commission. n394

The Commission is directed in Section 11A(b)(4) to cancel, by order, the registration of any registered securities information processor that the Commission finds is:

- (1) no longer in existence, or
- (2) has ceased to do business in the capacity specified in its application for registration.

[v] Review of the Denial of Service by a Securities Information Processor

The Commission is empowered to review and set aside any exclusionary action by a registered securities information processor. n395 A registered processor is required to promptly file notice with the Commission of any prohibition or limitation of any person's access to services offered, directly or indirectly, by the processor. n396

Review of a prohibition or limitation may be upon the Commission's own motion or upon application by any person aggrieved thereby. n397 An application must be filed within thirty days after the processor's notice has been filed with the Commission and received by the aggrieved person, or such longer period as the Commission may determine. The filing of an application or the institution of a review does not operate as a stay of the prohibition or limitation. But the Commission may order a stay either summarily or after notice and opportunity for hearing. The Commission must establish an expedited procedure for appropriate cases on the question of a stay. n398

In a review proceeding, the Commission after notice and opportunity for hearing must set aside the prohibition or limitation unless the Commission finds such action consistent with the provisions of the Exchange Act, and the rules and regulations thereunder, and that the aggrieved person has not been discriminated against unfairly. If the Commission does not so find, or if the Commission does find that the prohibition or limitation does impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act, n399 then the Commission by order must set aside the prohibition or limitation and require the registered securities information processor to permit the aggrieved person access to its services. n400

[vi] Enforcement Power of the Commission

The Commission has the power to censure, place limitations upon the activities, functions, or operations of, suspend for a period of up to twelve months, or revoke the registration of any registered securities information processor. n401

Before the Commission may exercise its enforcement power, the Commission must find (on the record after notice and opportunity for hearing) n402 that:

- (1) the sanction is in the public interest, necessary or appropriate for the protection of investors, or to assure the prompt, accurate, or reliable performance by the securities information processor of its functions; and
- (2) the processor has violated or is unable to comply with any Exchange Act provisions, or the rules and regulations thereunder. n403

[f] Allocation of Market Data Revenues

The allocation of the revenues from the dissemination of securities data n404 by the United States securities markets has long been a source of controversy. n405 This controversy stems from the fact that the securities markets claim a proprietary interest in the information, while users of the information, such as brokerage firms, dispute this ownership claim and allege that the markets charge excessive fees for the information. n406 On December 9, 1999, the Commission issued a comprehensive concept release in which it solicited comment on these and other issues relating to market data fees. n407 In August 2000, the Commission formed a committee known as the SEC Advisory Committee on Market Information ("Advisory Committee"). On September 14, 2001, the Advisory Committee issued its report. n408 The Advisory Committee recommended, among other things, that no change be made to Rule 11Ac1-2 [now 603], the Display Rule, n409 under which markets are required to submit quotation and transaction information for consolidation and dissemination. However, the Advisory Committee recommended that markets be free to disseminate, and charge fees for, other market information, such as limit order data, as they see fit. n410 The Advisory Committee was split on the question of whether the current system, under which markets must disseminate market data to a single consolidator, should be retained. n411

In February 2004, in the Regulation NMS proposing release, the Commission proposed to dramatically revise the system for allocating market data revenue. Specifically, the Commission proposed to revise the formula to, among other things, reflect contributions to "price discovery," *i.e.*, volume of trades that have the effect of establishing a price for a stock, rather than simply trading volume. n412 The Commission also proposed to create advisory committees for the various market data plans, as a means of allowing additional parties to participate in their governance. n413 In addition, under the Commission's proposal, individual members of an SRO, such as specialists or market makers would still be required to report their trades to their SRO, but for the first time they would be able to also distribute their trade data independently. n414 The proposing release also included changes designed to ensure that trade data is consolidated from the various markets but also reduce the trade data required to be reported by requiring the inclusion of only the national best bid and offer and last sale information. n415 Finally, the proposing release requested comment on whether the system for consolidating and disseminating market data should be overhauled. n416

The Commission noted that if an overhaul was appropriate, alternative deconsolidation, competing consolidators and hybrid models would be considered. n417 Under a deconsolidation model, vendors and broker-dealers would no longer be required to provide consolidated data to their customers, and the national market system plans and networks would not be necessary. n418 Instead, each market would be required to disseminate its own information, to multiple vendors and brokers, and would set its own market data fees. n419 A competing consolidators model would retain the consolidated display requirement, but the plans and networks would not be necessary. n420 Under this model, each market could establish its own fees and its own arrangements for distributing market data, as well as its own distribution facility. n421 Under the hybrid model, originally proposed by Nasdaq, the existing system would have remained largely intact, but only the national best bid and offer would have been disseminated. n422 Commenters generally advocated some variation of the competing consolidator or hybrid model, but both were rejected by the Commission in the Regulation NMS adopting release. n423

In the Regulation NMS adopting release, the Commission discussed the level of market data fees, and specifically the questions raised by many panelists at the NMS Hearing regarding whether the costs were reasonably related to the cost of the data. n424 The Commission postponed any action on these fees, however, based on its belief that the level of the fees had to be considered in the context of a broader review of SRO funding. n425

On the issue of governance of national market system plans, with Regulation NMS the Commission adopted amendments to the plans that require the creation of non-voting advisory committees for each plan. n426 Many commenters thought that this did not go far enough to address perceived problems with the administration of the plans. n427 However, the Commission believed that a more extensive overhaul of the administration of the plans could interfere with their operations. n428

The amendments to the formula for allocation of market data fees was adopted with only minor modifications. n429 Under the new formula, revenues are allocated on an annual basis in two steps. n430 In the first step, the eligible revenues from a network will be allocated among the various securities in the network's data stream. n431 This allocation, known as the "security income allocation," is generally based on the square root of the dollar volume of trading revenue in each security. n432 In the second step, each participant in the plan will receive an annual payment equal to the sum of its "Trading Shares" and "Quoting Shares." n433 This formula is designed to measure the usefulness of that market's information. n434 An SRO's Trading Share for a security is the product of 50 percent of the security income allocation and its "trade rating" for the security. n435 The trade rating represents the SRO's proportion of the dollar volume and qualified trading in the security. n436 The Quoting Share for a security is the product of 50 percent of the security income allocation for the security and the SRO's "quote rating" for the security. n437 The quote rating is the SRO's proportion of best bids and best offers that equaled the price of the national best bid or offer, expressed in terms of "quote credits." n438

[g] Public Limit Order Protection

In its January 1978 statement concerning the development of a national market system, the Commission cited nationwide limit order protection as a necessary element of such a system. n439 The Commission proposed that nationwide limit order protection be achieved by a central limit order book for public agency orders to buy and sell qualified securities in specified amounts at specified prices ("public limit orders"). n440 Nationwide limit order protection is based upon the basic principle that the benefits of auction-type trading protections should be received by all agency orders in qualified securities, regardless of location. n441

The objectives of a central limit order book are:

- (1) to make available a mechanism in which public limit orders n442 can be entered and queued for execution according to the auction trading principles of price and time priority, and
- (2) to provide a means by which public limit orders can be assured of receiving an execution prior to the execution of any other order by a broker or dealer in any market at the same or inferior price. n443

The capacity to execute against public limit orders in the central limit order book may have to be limited to persons performing market making functions in a qualified market. n444 Brokers, however, would be able to enter, alter, or withdraw public limit orders in or from the CLOB. n445

The Commission requested the self-regulatory organizations to prepare and submit to the Commission a plan or plans by September 30, 1978, for the design, construction, and operation of a CLOB. n446 In calling for proposals concerning a CLOB, the Commission pointed out that its determination to proceed with the development of a CLOB should not be interpreted as "a decision to force all auction trading into an electronic system with automatic execution capabilities." n447

The Commission addressed the issues pertaining to nationwide limit order protection in its March 1979 status report entitled Development of a National Market System. n448 The Commission expressed as its first priority the achievement of nationwide price protection for all public limit orders based on the principle of price priority. n449 The Commission stated that nationwide price protection, whereby any appropriately displayed public limit order n450 for a qualified security is assured of receiving an execution prior to any execution by a broker or dealer at an inferior price, should be a basic characteristic of a national market system. n451

As an initial step towards the goal of nationwide price protection, the Commission determined to give the proponents of the Intermarket Trading System n452 an opportunity to develop that system as a means of providing intermarket price protection for public limit orders. n453 The Commission cited two types of initiatives as necessary to achieve

nationwide price protection through the use of the Intermarket Trading System (ITS).

First, the various practical and technical problems associated with:

- (1) disseminating and displaying public limit order information from each market center, n454 and
- (2) promptly enhancing the ITS to serve as a means by which price protection for public limit orders can be afforded on an intermarket basis, n455

must be resolved by collective action on the part of the self-regulatory organizations and the securities industry. n456

Second, the Commission would propose a rule (with an effective date "sufficiently distant to afford time for the industry to design and put in place procedures and facilities needed to assure price protection for all public limit orders in qualified securities") prohibiting any broker or dealer from executing any order to buy or sell a qualified security at a price inferior to the price of any displayed public limit order, a practice known as "trading ahead." The broker or dealer need not adhere to the price protection requirement of the proposed rule if, simultaneous with or immediately after execution, the broker or dealer assures that those limit orders displayed at the time of execution are satisfied at the limit price, or such better price as may be required by the principles of "gap print pricing." n457

The Commission, in a March 1979 status report, requested the views of the self-regulatory organizations, the securities industry, and the investing public on whether the Commission should bypass the interim step of providing price protection for public limit orders and proceed directly to price protection for all orders at the market. n458 The Commission emphasized that it was prepared to explore alternative mechanisms to provide nationwide price protection for public limit orders. n459

Shortly after the release of proposed Rule 11Ac1-3 [now Rule 607], the ITS announced the formation of a pilot Limit Order Information System ("LOIS"), which would provide on the floor of each Intermarket Trading System (ITS) participant a display of limit orders from all ITS members. n460 LOIS was intended to provide nationwide limit order protection for at least block transactions.

A significant event in the formation of a central limit order book occurred with the interface of ITS and the Computer Assisted Execution System (CAES). n461 While the Commission's order directing this interface did not expressly require development of a central limit order book, n462 the integrated CAES and ITS systems appeared to have the capacity to develop a CLOB.

The Commission's Market 2000 Report recommended that the SROs consider whether to encourage the display of all limit orders when the orders in listed stocks are priced better than the best intermarket quotes (unless the ultimate customer expressly requests that an order not be displayed). n463 The Market 2000 Report also recommended that the NASD consider whether to encourage the display of limit orders in Nasdaq stocks when the orders are at prices that are better than the best Nasdaq quotes, unless the ultimate customer expressly requests that an order not be displayed. n464 Recognizing that Nasdaq operates as an automated display of market maker quotes and not as an auction market, the report nonetheless states that increased transparency in Nasdaq could tighten spreads and enhance investors' ability to monitor the quality of execution received on trades. n465

Beginning in 1988, an NASD disciplinary action and subsequent rule changes dramatically increased limit order protection by limiting the practice of trading ahead. In 1988, in a disciplinary action against E.F. Hutton & Company, Inc. in 1988, the NASD interpreted its rules to prohibit trading ahead of customer limit orders. n466 In May 1989 the NASD proposed a new rule interpretation to clarify its position on the trading ahead issue. n467 This interpretation provided that an NASD member would not be deemed to have violated the NASD rules of fair practice if it provided a statement to customers describing the circumstances in which the firm accepted limit orders and the policies and

procedures followed in handling those orders. n468 This proposal, however, never became final.

In July 1993 the NASD decided that trading ahead of customer limit orders should not be allowed even if disclosed to customers. n469 The NASD therefore withdrew the proposed rule interpretation and filed a new proposed interpretation under which market makers would be prohibited from trading ahead of customer limit orders of their own customers. n470

The interpretation proposed by the NASD in July 1993 contained a "Terms and Conditions" exception under which a broker-dealer could negotiate the terms and conditions under which limit orders placed by institutional accounts for 10,000 shares or more and valued at least \$100,000 would be executed. n471 In a release known as "Manning I," the SEC approved the proposed interpretation in June 1994. n472 In the adopting release, however, the Commission stated that it believed that the ban on trading ahead of limit orders should apply not only to orders of a broker-dealer's own customers, but also to orders of customers of other firms that are sent to a broker-dealer for handling. n473

After "Manning I," the NASD appointed a task force to further study the practice of trading ahead of limit orders. n474 The task force recommended that the ban on trading ahead of limit orders of customers of other broker-dealers apply only if the trade occurred at a price better than the limit order price. n475 The NASD proposed for member comment an interpretation of its Rules of Fair Practice, under which a market maker would not be allowed to trade ahead of a customer limit order at a price equal to or better than the limit order price if the order was for 1,000 shares or less, and at a price better than the limit order if the order was for more than 1,000 shares. n476

The SEC expressed its displeasure with the NASD's intended resolution of the trading ahead issue by proposing a rule of its own which would prohibit broker-dealers from trading ahead of orders of customers of other firms regardless of the size of the order. n477 The NASD acceded to this SEC pressure, and the rule change actually filed by the NASD, in November 1994, proposed to limit the trading ahead of limit orders placed by customers of another broker-dealer, without differing obligations based on the size of the order. n478 It also proposed to amend the interpretation of the Rules of Fair Practice to limit the "Terms and Conditions" exception to limit orders from institutional accounts, whether from the broker-dealer's own customers or customers of another firm, regardless of order size, and limit orders from non-institutional accounts if the order is for 10,000 or more shares and has a value of at least \$100,000. n479 The Commission approved the proposed changes in May 1995, in a release known as "Manning II." n480 In approving the change, the SEC noted that market makers are not required to accept limit orders and are still permitted under NASD rules to charge commissions for handling limit orders, as long as the commission charges are fully disclosed to customers. n481 In February 2001, the SEC approved a Nasdaq rule change which extended limit order protection to some OTC Bulletin Board securities. n482 In December 2002 the SEC approved a Nasdaq rule change extending limit order protection to all OTC Bulletin Board Securities. n483 Protection was further expanded, to include exchange-listed securities, in August 2005. n484

[h] Order Handling Rules

On August 28, 1996, the SEC adopted Rule 11Ac1-4, [now Rule 604] the "Limit Order Display Rule," and amendments to Rule 11Ac1-1, [now Rule 601] the "ECN Rule". n485 These rules are collectively known as the "Order Handling Rules." The Order Handling Rules apply to the Nasdaq Stock Market and exchange specialists and were designed to enhance the quality of published quotations in Nasdaq securities, promote competition, improve price discovery, and increase market depth and liquidity. n486

The Limit Order Display Rule requires, subject to certain exceptions, the display of customer limit orders in market maker quotes if the limit order is priced better than the market maker's quote, or priced equal to the market maker's quote if the quote is at the national best bid or offer price and the limit order represents more than a de minimis change relative to the market maker's quote. n487

The ECN Rule requires market makers in exchange-listed stocks to reflect in their quotes certain orders that they place into an ECN. Market makers are not required to display the full size of the superior priced order in their Nasdaq quotes. Instead of updating its own quote, a market maker may comply with the ECN Rule through the ECN itself. In order to rely on the ECN for compliance, the ECN must ensure that the best-priced orders entered into its system are communicated to Nasdaq for public dissemination. The ECN must also provide access to non-subscribing broker-dealers to enable them to utilize the superior quotes.

The Order Handling Rules were phased in by particular securities beginning in January 1997. n488

[i] Order Routing and Execution Practices Disclosure Rules

In November 2000 the Commission adopted Rules 11Ac1-5 and 11Ac1-6 [now Rules 605 and 606 respectively], which are intended to improve order execution through enhanced disclosure. The Commission believes that the rules will provide brokers with more information to consider when choosing among market centers when determining where to route customer orders, and that investors will in turn be better able to evaluate the quality of their brokers' order executions. n489

Rule 605 [former 11Ac1-5] requires "market centers" n490 to make specified information available to the public each month in electronic form. The rule covers only NMS securities, n491 and "covered orders," which are orders received when a national "consolidated best bid and offer" is disseminated. n492 Rule 605 requires that the following information be included in market centers' reports for all covered orders for each NMS security:

- total number of covered orders;
- total number of shares for covered orders;
- total number of shares for covered orders cancelled before execution;
- total number of shares executed at the market center originally receiving the order;
- total number of shares executed at a market center other than that originally receiving the order;
- the number of shares for covered orders executed within five specified categories based on the time elapsed between receipt and execution, such as zero to nine seconds and ten to twenty-nine seconds; and
- the "average realized spread" for covered orders. n493

Rule 605 requires the following information for market orders and marketable limit orders only:

- the "average effective spread" for covered orders;
- the total number of shares for covered orders executed with price improvement;
- for shares executed with price improvement, the average price improvement, weighted by number of shares;
- the number of shares executed at the quote;
- for shares executed at the quote, the average time from order receipt to execution, weighted by number of shares;

- the number of shares executed outside the quote;
- for shares executed outside the quote, the average amount the prices were outside the quote, weighted by number of shares; and
- for shares executed outside the quote, the average time from order receipt to execution, weighted by number of shares. n494

Reports disseminated under Rule 605 [former Rule 11 Ac1-5], commonly known as "dash - 5 reports," have had an effect on order routing practices because market centers with better statistics have increased their market share. n495 However, some market participants believe that the reports do not accurately measure the quality of trade execution, primarily because they do not consider quotations beyond a market's best bid and offer, which could be important for larger orders. n496

Rule 606 [former Rule 11Ac1-6] requires broker-dealers to make disclosures to customers regarding the broker-dealers' order routing practices. While Rule 605 applies only to NMS stocks, Rule 606 applies to all NMS securities, including listed options. n497 Rule 606 requires broker-dealers to disseminate quarterly reports containing the following information: n498

- "non-directed orders," or customer orders which were not directed to a particular market center, as a percentage of total customer orders;
- the percentages of non-directed orders which were market orders, limit orders and "other" orders; and
- for each of the various market centers to which the broker-dealer sent non-directed orders, the percentage of non-directed orders sent to the market center, along with the percentage of non-directed market orders, non-directed limit orders, and non-directed "other" orders sent to the market center.

Rule 606 requires a broker-dealer to discuss the material aspects of its relationship with each of the market centers to which it has sent orders, including a description of any payment for order flow or profit-sharing arrangements. n499 Rule 606 also requires a discussion and analysis by the broker-dealer of its order routing practices, including the "objectives" affecting its order routing practices, the results obtained by them, a comparison of the execution quality of the market centers to which the broker-dealer routes orders to that of other market centers, and a statement as to whether the broker has made or intends to make significant changes in its order routing practices. n500 Broker-dealers are not required to send the reports required under Rule 606 to their customers, but must make the reports "publicly available," by posting them on a website, furnishing a written copy on request, and notifying customers at least once per year that the report will be furnished upon request. n501 In addition to making the quarterly reports available, broker-dealers must furnish, upon customer request, the name of the market center or centers to which the customer orders were routed in the six months preceding the request, whether the orders were directed or non-directed and, for any executed orders, the time of execution. n502 Broker-dealers also must notify customers at least annually that this additional detail is available upon request. n503

[3] Duties and Powers of the Commission

The Commission is directed in Section 11A(a)(2) to use its authority under the Exchange Act, having due regard for

- (1) the public interest,

- (2) the protection of investors, and
- (3) the maintenance of fair and orderly markets,

to facilitate the establishment of a national market system for securities in accordance with the findings and to carry out the objectives set forth in Section 11A(a)(1). n504 The national market system may include subsystems for particular types of securities with unique trading characteristics. n505

The Commission also has a duty to designate, by rule, the securities or classes of securities qualified for trading ("qualified securities") in the national market system from among securities other than exempted securities. n506

[a] Commission Implementation Authority

In furtherance of the Commission's efforts to facilitate the establishment of a national market system for securities, the Commission was authorized to:

- (1) create advisory committees pursuant to the Federal Advisory Committee Act n507 and to employ one or more outside experts; n508
- (2) permit or require self-regulatory organizations to act jointly in planning, developing, operating or regulating a national market system, or one or more facilities thereof; n509 and
- (3) study, and recommend to Congress from time to time, the possible need to modify the scheme of self-regulation under the Exchange Act to adapt such scheme to a national market system. n510

To provide a procedural framework for consideration of industry sponsored National Market System ("NMS") proposals, the Commission in 1981 adopted Rule 11Aa3-2 [now Rule 608]. n511 Under this rule, any two or more self-regulatory organizations jointly may submit or amend a national market system plan. n512

Every NMS plan shall be filed with the Commission accompanied by:

- (1) copies of all "governing or constituent documents," and
- (2) to the extent applicable
 - (a) a detailed plan of implementation;
 - (b) a list of the significant phases of development and implementation and estimated completion dates for each phase;
 - (c) an analysis of the effect of competition upon implementation of the plan;
 - (d) a description of any written agreements or undertakings between plan sponsors n513 or participants n514 with respect to interpretations of the plan or conditions for being a sponsor or participant; and
 - (e) in the case of an amendment to an existing plan, a statement that the amendment has been duly approved by the sponsors. n515

In addition, a detailed description of the method of operation is required. n516

After receipt of a proposed NMS Plan, the Commission will publish notice of the filing and solicit public comments. n517 No NMS plan may become effective unless approved by the Commission. n518

Within 120 days after publication, the Commission will approve the plan with such changes and subject to such conditions as the Commission deems appropriate. n519 An appeal from Commission action is permitted under certain circumstances. n520 To date, no NMS plan has been formally filed with the Commission, primarily because the SROs have elected to respond to Commission initiatives rather than create their own plan. n521

[b] Commission Rule-Making Powers

Section 11A(c) grants the Commission extensive rule-making powers with respect to information concerning quotations for and transactions in securities, trading in listed securities off an exchange, and exchange rules limiting the ability of exchange members to trade off the exchange. The purpose of this rulemaking power is to enable the Commission to develop and regulate both the national market system itself and the activities of persons involved in that system. n522

[i] Powers Relating to Quotations and Transactions

Self-regulatory organizations, members of such organizations, securities information processors, brokers, and dealers must comply with Commission rules adopted n523 for the following purposes:

(1) preventing the use, distribution, or publication of fraudulent, deceptive, or manipulative information concerning securities quotations or transactions. n524

(2) assuring:

(I) prompt and accurate collection, processing, distribution, and publication of information concerning securities quotations and transactions, and

(ii) the fairness and usefulness of the form and content of the information; n525

(3) assuring all securities information processors n526 access, for purposes of distribution and publication, to information concerning securities quotations and transactions from exclusive processors on fair and reasonable terms; n527

(4) assuring access by exchange members, brokers, dealers, securities information processors, and others to information concerning securities quotations and transactions published or distributed by a self-regulatory organization or a securities information processor on terms that are not unreasonably discriminatory; n528

(5) assuring that all exchange members, brokers, and dealers transmit and direct orders for the purchase or sale of qualified securities n529 in a manner consistent with the establishment and operation of a national market system; n530

(6) assuring equal regulation of all markets for qualified securities and all exchange members, brokers, and dealers effecting transactions in such securities. n531

The broad scope of the rule-making powers granted to the Commission in Section 11A(c)(1) is illustrated by the scope of activities covered by that Section. Persons subject to the Commission's rule-making powers consist of self-regulatory

organizations, members thereof, securities information processes, brokers and dealers. n532 The activities of such persons covered by the Commission's rule-making powers are:

- (1) collecting, processing, distributing, publishing, and preparing for distribution or publication information concerning quotations for or transactions in any nonexempt security. n533
- (2) effecting any transaction in any security (other than an exempted security), and
- (3) inducing or attempting to induce purchase or sales of any nonexempt security. n534

Commission rules pursuant to Section 11A(c)(1) have a greater scope than other provisions in the Exchange Act prior to the 1975 Amendments. In particular, a violation can be established by showing that a person subject to Section 11A(c)(1) violated a rule in an "attempt to induce the purchase or sale of" a nonexempt security, even though no purchase or sale was actually consummated. The general antifraud provision applicable to brokers and dealers, Section 15(c)(1), n535 was amended in 1975 to prohibit a broker or dealer from attempting to induce a purchase or sale by manipulation, deception, or other fraudulent devices. n536

[ii] Power to Require Reports of Transactions in Qualified Securities

The Commission has the power to require, by rule, as the Commission deems necessary or appropriate in the public interest or for the protection of investors,

- (1) persons purchasing or selling any qualified security n537 to report such purchase or sale to a registered securities information processor, national securities exchange, or registered securities association, and
- (2) such processor, exchange, or association to make appropriate distribution and publication of the information so reported. n538

[iii] Power to Prohibit Third Market Trading n539

Although the Congress refused to prohibit third market trading as part of the Securities Acts Amendments of 1975, n540 the Commission was given rulemaking power to prohibit brokers and dealers from trading in listed securities; n541 except on a national securities exchange. n542

Before the Commission may exercise its rule-making power under Section 11A(c)(3)(A), the Commission must find, on the record after notice and opportunity for hearing, that:

- (1) as a result of transactions in listed securities occurring over-the-counter, the fairness or orderliness of the markets for listed securities has been affected contrary to the public interest or the protection of investors;
- (2) no rule of any national securities exchange unreasonably impairs a dealer's ability to solicit or effect transactions in listed securities for his or her own account, n543 or unreasonably restricts competition:
 - (i) among dealers in such securities, or
 - (ii) between dealers acting in the capacity of market makers who are specialists in such securities and other such dealers who are not specialists in the listed securities; and

(3) the maintenance or restoration of fair and orderly markets in listed securities cannot be assured through other means under the Exchange Act. n544

The Commission also has the authority to conditionally or unconditionally exempt any security, transaction, class of securities, or class of transactions from any prohibition of third market trading by brokers and dealers. n545

General Effects of Regulation NMS

Overall, it appears that Regulation NMS has fostered increased competition among different markets to attract order flow and trade volume. For example, in April 2008, the NYSE Hybrid Market executed 34 percent of the volume in NYSE listed stocks and NASDAQ executed 42 percent of the volume in NASDAQ listed stocks. n546

With respect to the trade-through provisions (i.e., trade executions at prices inferior to the best-priced quotes displayed by automated trading centers) under Rule 611 of Regulation NMS, the Securities and Exchange Commission updated the responses to Frequently Asked Questions ("FAQs") Concerning Rule 611 and 610 of Regulation NMS on April 8, 2008. n547 These FAQs primarily address issues related to the increase in trading volumes and the manual trading of block transactions in volatile conditions under Rule 611.

Regarding Rule 612 of Regulation NMS, the sub-penny pricing rule, the SEC granted national securities exchanges a limited exemption, thereby permitting such exchanges to accept certain cross orders priced in sub-penny increments. n548 Rule 612 prohibits a national securities exchange, as well as other entities, from displaying, ranking, or accepting a bid or offer, an order, or indication of interest in any NMS stock that is priced in an increment of less than one penny per share, unless the price of the bid or offer, order, or indication of interest is priced less than \$1.00 per share. n549 The SEC also approved a number of self-regulatory organization rule changes that contemplate the acceptance of certain cross orders in sub-penny prices. n550 This exemption from the sub-penny pricing rule is limited to the acceptance of national securities exchanges of cross orders arranged by members that priced in sub-penny increments and are immediately executed against one another. n551 The SEC's rationale for exemption is that Rule 612 was designed to limit the ability of a market participant to gain execution priority over a competing limit order by an insignificant amount. The SEC subsequently observed that sub-trading does not give rise to the same concerns as sub-penny quoting. n552 Furthermore, sub-penny executions due to price improvement are generally beneficial to retail investors. As such, the SEC believes that permitting the exchanges to accept sub-penny cross orders for the limited purpose of immediately executing them, is similar to a sub-penny execution, and does not cause any problems with respect to sub-penny quoting. n553

Effects upon Exchanges

The major U.S. exchanges have modified or built new trading platforms to ensure compliance with Regulation NMS. The American Stock Exchange implemented a new hybrid structure known as "Auction & Electronic Market Integration" ("AEMI") to integrate automated and floor-based trading for equities and exchange traded funds. The American Stock Exchange designed AEMI to comply with Rules 610 and 611 of Regulation NMS in particular. n554

The Boston Stock Exchange, Inc. (the "BSE") launched a new electronic equities trading market, the BeX. n555 Although the BSE ceased operation of the BeX market on September 5, 2007, n556 the fact that the BSE created a new electronic trading market is reflective of the impact of Regulation NMS.

The Chicago Stock Exchange ("CHX") has proposed and implemented a new trading model that permits its participants to interact in a fully automated matching system. This trading system no longer utilizes a physical trading floor where on-floor specialists, brokers and market makers seek execution; n557 rather, the CHX now operates an automated system where market participants may participate from any location. Similarly, the National Stock Exchange, Inc. revamped its technology platform to comply with Regulation NMS. The NSX Blade System was built to meet the needs

of a post-Regulation NMS environment. n558

The NASDAQ has integrated the operations of the NASDAQ Market Center with its Brut ECN and the INET ECN facilities to create a single integrated system with a single pool liquidity. This integrated system is designed to enable NASDAQ to operate its execution system as a national securities exchange, as well as to comply with Regulation NMS. n559

The Philadelphia Stock Exchange, Inc. also ceased to operate its physical trading floor for equity securities, and developed a new equity trading system known as "XLE." n560 This system provides for entirely automated executions to occur within a central matching system.

Perhaps the most significant effect of Regulation NMS was that it compelled the NYSE to expand its electronic capacity. The NYSE Hybrid Market provides electronic execution along with traditional floor services. The SEC approved the NYSE Hybrid Market proposal on March 22, 2006. n561 The Order Protection Rule provides that market centers must satisfy better-priced quotes in other fast markets before filling orders in their own market. To qualify as a fast market, there must be sub-second automatic execution and immediate or cancel capabilities. Therefore, in order to comply with the Order Protection Rule, the NYSE established the NYSE Hybrid Market, which transformed the NYSE from an auction market to a fast market. n562

Thus, although Regulation NMS may not have brought about its intended results with respect to transparency, due to the increased use of dark pools (see below), it did cause an overall modernization of the major U.S. exchanges.

Dark Pools

Notwithstanding the stated purpose of Regulation NMS, it appears that dark pools of liquidity may be undermining some of those purposes. For example, large institutional traders have been utilizing alternative trading venues, such as dark pools, to perhaps avoid Regulation NMS.

The term "dark pools" of liquidity was defined broadly by Erik Sirri, Director of the SEC's Division of Trading and Markets, as "a service offered by any trading venue that offers the potential interact with liquidity beyond the venue's public quotes." n563 Dark pools reveal neither the identity of the parties nor the price until after the transaction is completed. Dark pools of liquidity are typically used by institutional investors to trade large blocks of stock without alerting market makers, as the order is broken up into by computer programs into smaller pieces that are matched and executed in different segments in separate transactions. n564 Dark pools are either independent, owned by exchanges, owned by broker-dealers, or owned by a consortium. Independent dark pools of liquidity include, for example, Instinet's "Instinet Crossing," Investment Technology Group's "POSIT," and Liquidnet's "Liquidnet." Exchange owned dark pools include, for example, ISE's "Midpoint Match," NASDAQ's "NASDAQ Crossing Network," and NYSE Euronext's "NYSE MatchPoint". The broker-dealer owned dark pools include, for example, Fidelity Capital Markets Services' "CrossStream," Goldman Sachs Execution and Clearing's "SIGMA X," Lehman Brother's "LCX," and Morgan Stanley's "MS POOL." The consortium owned dark pools include BIDS Trading, 'The BIDS ATS.' This is a wholly owned subsidiary of BIDS Holdings, a joint venture of Bank of Marica, Bear Stearns, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JP Morgan Chase & Co., Knight Capital Group, Lehman Brothers, Merrill Lynch, Morgan Stanley, and UBS. In May 2008, the Goldman Sachs Group, Morgan Stanley, and UBS AG entered into bilateral agreements that allow one another use each other's dark pools. n565 Although it has been estimated that trades in dark pools account for approximately 10 percent to 12 percent of all trades n566, and 20 percent of all trades in NYSE-listed stocks n567, others estimate that dark pool volume consists of approximately 5 percent to 9 percent of U.S. equity trades. n568

The use of dark pools of liquidity may give rise to a number of regulatory issues, although such issues have not, to date, been officially addressed by the regulators. Such issues include price transparency and trade-through related matters under Regulation NMS, best execution obligations, and fair access. In addition, concerns have been raised with respect

to dark pools causing volatility due to the lack of price visibility and lack of a central marketplace. When traders meet in a dark pool, however, they are not necessarily looking for the best price, but for efficient execution and anonymity. n569

The Trade Through Rule

One of the intentions underlying the adoption of Regulation NMS is price transparency, as per the establishment of Rule 611 of Regulation NMS (the "trade-through rule"). n570 The trade-through rule requires that markets "establish, maintain and enforce written policies and procedures that reasonably designed to prevent trade-through on that trading center of protected quotations in NMS stocks." n571 A trade-through occurs when an order placed in one trading center is executed despite immediately available better priced quotations in other trading centers. Therefore, if the best price is the displayed, it cannot be ignored or traded-through. This presents an issue with respect to large institutional transactions. Prior to Regulation NMS, block trades could go outside the National Best Bid and Offer. Post Regulation NMS, execution must now occur at the or within the National Best Bid and Offer. In the event that one wants to go outside the NBBO, then one must use an intermarket sweep order that will show the presence of the buyer or seller. As a result, institutional traders have sought out dark pools so as not to notify the market of their trading intentions. The use of a dark pool therefore avoids the identification of the parties involved. Although there is no mechanism for such trading venues to show large trading volumes, an argument could be made that dark pools have an incentive to show volume, as it would enhance liquidity.

Best Execution Obligations

When utilizing a dark pool, there is no guarantee that one will necessarily receive the best price or the lowest execution charge. Instead, institutional traders avail themselves of dark pools so as preserve anonymity. As a result, with respect to dark pools owned by broker-dealers or a consortium of broker-dealers, this may impact their best execution obligations under FINRA rules and guidance. n572

Fair Access

The use of dark pools may give rise to issues related to the fair access provisions under Regulation ATS and Regulation NMS. Rule 610 of Regulation NMS addresses access to markets and quotations and

prohibits trading centers from imposing unfairly discriminatory terms that would prevent or inhibit the efficient access of any person through members, subscribers, or customers of such trading center, and enable access to NMS quotations through private linkages, rather than mandating a collective intermarket linkage facility. n573

In connection with adopting Rule 610, the SEC amended Rule 301 of Regulation ATS, lowering the volume threshold that triggers the Regulation ATS fair access requirements from 20 percent to 5 percent of the average daily volume in a security. n574

Rule 301(b)(5), the "Fair Access Rule" of Regulation ATS provides, among other things, that if an ATS accounts for a certain percentage of the average daily trading volume over four of the preceding six months, then the ATS must establish written standards for granting access to trading on its system and must not unreasonably prohibit access to the system. n575 Rule 301(b)(5) of Regulation ATS provides that ATS's that display quotes to more than one person must make their quotes publicly available for each stock in which they exceed 5 percent.

Liquidnet Holdings Inc. ("Liquidnet"), a dark pool, received an exemption from the SEC allowing it to retain its 20 percent threshold test with respect to the Fair Access Rule. n576 Liquidnet's system interacts with a subscriber's order management system to determine the subscriber's open trading interest and identify potential contra-side interest. If

interest is located on both sides, the buyer and the seller can negotiate the transaction through Liquidnet's instant messaging system on an anonymous basis. Liquidnet argued that its system operates in a similar fashion to a traditional block trading desk, which would not be subject to Regulation ATS. n577 Liquidnet further argued that in the event that they cross the 5 percent threshold, it would be prohibited from denying a membership application based upon the potential strategies of the applicant, which is contrary to their business model which is premised on the ability to deny access to certain subscribers. n578

The Liquidnet subscribers expect that counterparties will negotiate in good faith, and will not use information gained on the system to trade ahead of such interest outside the Liquidnet system. The SEC granted Liquidnet limited relief from the Fair Access Rule, thereby preserving its ability to deny access to subscribers or potential subscribers whose trading strategies could cause institutional customers to discontinue use of Liquidnet's system, as Liquidnet does not disseminate trade quotations. The SEC provided in its order granting the exception, that "applying the new 5 percent fair access threshold to Liquidnet would not further the Commission's primary policy in lowering the threshold, namely facilitating indirect access to the quotes of ATSS that are displaying them in the public quote stream." n579 Therefore, if Liquidnet has 20 percent or more the average daily volume in at least four of the six preceding calendar months, it must cease applying its access standards in a manner that may be unfair or discriminatory and fully comply with Rule 301(b)(5) of Regulation ATS with respect to such security.

Sub-Penny Pricing

Rule 612 of Regulation NMS (the "Sub-Penny Rule") prohibits market participants from accepting, ranking, or displaying orders, quotations, or indications of interest in a pricing increment smaller than a penny, except for orders, quotations, or indications of interest that are priced at less than \$1.00 per share. n580 The SEC's purpose for adopting such rule is "to promote greater price transparency and consistency, and to prevent market participants from stepping ahead of other orders by an economically insignificant amount." n581

Liquidnet obtained an order granting a limited exemption to the Sub-Penny Rule. n582 Liquidnet explained to the SEC the methodology of its trading platform. Liquidnet's system scans the order management system of each subscriber to identify trading interest that may match that of another subscriber. When the system locates a potential match, it notifies the buyer and seller, who then negotiate the transaction amongst themselves. n583 During a negotiation, a subscriber enters certain information into the system, and instead of entering a specific price, a subscriber can elect to execute a trade at the midpoint by clicking 'mid.' n584 The midpoint is the current midpoint between the security's NBBO. In the event that the NBBO is an odd number at the given time, then the price of the order would result in a sub-penny increment. Prior to execution, the subscriber has the opportunity to submit the order, which would then transmit the firm-priced order to the potential counterparty, who could then accept, reject, or mark a counter-offer. n585 The Liquidnet system does not automatically execute a trade at the midpoint; instead there is an additional step in which the parties view the actual price at which the trade would occur if accepted. n586 Under the Sub Penny Rule, these midpoint quotes would be prohibited. As a result, Liquidnet requested and received an exemption from the Sub-Penny Rule, based upon the extra confirmatory step.

Regulatory Implications

Although it appears that dark pools are gaining in popularity since the implementation of Regulation NMS, the regulatory implications with respect to use of the dark pools is still unknown. Furthermore, it has been argued that institutional traders are fragmenting the market due to their use of dark pools. n587 Perhaps the most interesting aspect with respect to the adoption and implementation of the Regulation NMS is the manner in which dark pools such as Liquidnet are seeking and receiving exemptions from Regulation NMS based upon the mechanics of their trading systems. It is possible that the Liquidnet exemptions from Regulation NMS may serve as a foundation for other alternative trading venues to carve out exemptions from Regulation NMS based upon the structure of their trading platforms. As a result, the SEC's intention of creating a modern centralized electronic market system via the adoption of

Regulation NMS may be undermined by dark pools.

FOOTNOTES:

(n1)Footnote 1. Sec. Exch. Act Rel. No. 49325 (Feb. 26, 2004) (hereinafter cited as "Regulation NMS Proposing Release").

(n2)Footnote 2. A transcript of the hearing is available on the SEC's website at www.sec.gov/spotlight/regnms/nmstrans/042104.txt (last visited February 27, 2006).

(n3)Footnote 3. Sec. Exch. Act Rel. No. 49749 (May 20, 2004).

(n4)Footnote 4. Sec. Exch. Act Rel. No. 50870 (Dec. 16, 2004) (hereinafter cited as "Regulation NMS Reposing Release").

(n5)Footnote 5. Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Adoption of Regulation NMS, at 29 (June 9, 2005), *available at* <http://www.sec.gov/rules/final/34-51808-dissent.pdf> (last visited February 4, 2006).

(n6)Footnote 6. *See* Mark Hendrickson, *Senate Sets Reg NMS Hearings; Overturn Seems Unlikely*, Securities Week, Vol. 32, No. 20, August 22, 2005, at 1. Even Congressional opponents of Regulation NMS acknowledged, however, that Congress' overruling of Regulation NMS was probably not practicable. *Id.*

(n7)Footnote 7. 17 C.F.R. § 242.600 through 612.

(n8)Footnote 8. Sec. Exch. Act Rel. No. 51808, 2005 SEC LEXIS 1349 at *504 (June 9, 2005) (hereinafter cited as "Regulation NMS Adopting Release").

(n9)Footnote 9. Regulation NMS Adopting Release, *supra*, at *505.

(n10)Footnote 10. Regulation NMS Adopting Release, *supra*, at *504-505. The term "NMS security" includes all NMS stocks but also listed options. Rule 600(b)(46) and (47), 17 C.F.R. § 242.600(b)(46) and (47).

(n11)Footnote 11. P.L. 94-29, 89 Stat. 97 (June 4, 1975).

(n12)Footnote 12. *See* Section 11A(a) of the 1934 Act, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F.

(n13)Footnote 13. *See* S. Rep. No. 94-75, 94th Cong., 1st Sess., p. 7 (1975), reprinted in the Securities Primary Law Sourcebook, Vol. 2, Sec. I (hereinafter cited as "Senate Report"). For discussion of the development of the concept of a national market system, see Sec. Exch. Act Rel. No. 14416, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,502 (Jan. 26, 1978) (hereinafter cited as "National Market System Release"); Harman, *The Evolution of the National Market System--An Overview*, 33 *Bus. Law.* 2275 (1978). *See also* § 2.04[2] *infra*. For a discussion of the duties and powers of the Commission, see § 2.04[3] *infra*.

(n14)Footnote 14. The Committee on Banking, Housing and Urban Affairs of the United States Senate felt that the general concept of a "national market system" was "sufficiently clear from the words themselves" so that a definition of the term was not included in the Exchange Act. Senate Report, *supra*, at p. 7. The Senate Committee also rejected the approach of mandating certain minimum components of the national market system in favor of establishing "a statutory scheme clearly granting the Commission broad authority to oversee the implementation, operation, and regulation of the national market system and at the same time charging it with the clear responsibility to assure that the system develops and operates in accordance with Congressionally determined goals and objectives." Senate Report, *supra*, at 8-9.

(n15)Footnote 15. These segments include: all types of common and preferred stocks, bonds, debentures, warrants,

and options. Senate Report, *supra*, at 7.

(n16)Footnote 16. "The term "national market system" as used in the bill would encompass all segments of the corporate securities markets including all types of common and preferred stocks, bonds, debentures, warrants and options. This is desirable because many of the goals of the national market system, *e.g.*, availability of information with respect to price, volume, and quotations, coordination of self-regulatory systems, and strengthening of Commission oversight, are nearly universal in scope and might not be fully realized within separate market systems." This is not to say that it is the goal of the legislation to ignore or eliminate distinctions between exchange markets and over-the-counter markets or other inherent differences or variations in components of a national market system. Some present distinctions may tend to disappear in a national market system, but it is not the intention of the bill to force all markets for all securities into a single mold. Therefore, in implementing the bill's objectives, the SEC would have the power to classify markets, firms, and securities in any manner it deems necessary or appropriate in the public interest or for the protection of investors and to facilitate the development of subsystems within the national market system. Senate Report, *supra*.

(n17)Footnote 17. Senate Report, *supra*.

(n18)Footnote 18. H.R. Rep. No. 94-229, 94th Cong., 1st Sess. (1975), reprinted in the Securities Primary Law Sourcebook, Volume C, Part I.

(n19)Footnote 19. S. Rep. No. 94-75, 94th Cong., 1st Sess., 8 (1975).

(n20)Footnote 20. Response of the Securities and Exchange Commission to the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce, Questionnaire for Regulatory Commissions (July 25, 1975) (hereinafter cited as "SEC Response").

(n21)Footnote 21. SEC, Report of the Special Study of the Securities Markets, H. Doc. No. 95, 88th Cong., 1st Sess. (1964).

(n22)Footnote 22. The hearings commenced on July 1, 1968 and continued through July, 1971. The record encompassed 23 volumes of reported testimony and 15 volumes of written statements and exhibits.

(n23)Footnote 23. SEC, Institutional Investor Study Report, H. R. Doc. 92-64, 92d Cong., 1st Sess. (1971) (hereinafter "Institutional Investor Study Report").

(n24)Footnote 24. For a discussion of the Institutional Investors Study and the national market system, see Cohen, *The National Market System--A Modest Proposal*, 46 *Geo. Wash. L. Rev.* 743 (1978).

(n25)Footnote 25. Institutional Investor Study Report, *supra*, pt. 1 on XXIV-XXV.

(n26)Footnote 26. The July 2007 consolidation of certain aspects of the NYSE with the NASD is discussed in § 2.03[5][c][i].

(n27)Footnote 27. NYSE, *The Securities Markets: A Report with Recommendations* by William McC. Martin, Jr. (Aug. 5, 1971). (Hereinafter referred to as the "Martin Report.")

(n28)Footnote 28. To serve the interests of the public and the nation, as well as the interests of the securities industry itself, a national exchange system must be developed to provide a single, national auction market for each security qualified for listing. Such a system would integrate the New York Stock Exchange, the American Stock Exchange and the regional exchanges. Because of their geographical locations and their identification with local needs, the regional exchanges have a vital role to play in making a truly national system. To accomplish this, the structure of the market mechanism must be redesigned and modernized. The characteristics of this national auction market should

include the following:

1. A market which provides maximum opportunity for public buyers and sellers to effect trades directly through their agents, as opposed to a market in which the public trades with dealers trading for their own account;
2. A market in which the activities of broker-dealers, specialists and other professionals are uniformly defined and regulated and subordinated to the interests of the public;
3. A market which provides fair commission rates to all investors;
4. A market which permits equal access for a maximum number of broker-dealers and their customers, regardless of geographical location; and
5. A market which provides for equal access by all investors to material information about both the market itself and the securities traded in that market, including centralized reporting of price and volume of all trades.

The creation of such a national exchange system would provide one market for each listed security. There could be two or more divisions within this national exchange system. The present listing requirements of the New York and American Stock Exchanges might provide appropriate listing requirements for two such divisions. Whether all securities which meet the listing requirements for a particular division of the national exchange system should be required to be listed for trading in that division should be considered. Securities which are not listed on any division of the national exchange system would be traded in the over-the-counter market. Securities should be traded either in a single division of the national exchange system or in the over-the-counter market, not in both markets.

Suitable regulations will be required to coordinate the over-the-counter market, with the national exchange system and to protect the integrity of each. Martin Report, *supra*, at p. 4.

(n29)Footnote 29. SEC, Policy Statement on the Future Structure of the Securities Markets, pp. 10-11 (Feb. 2, 1972).

(n30)Footnote 30. Sec. Exch. Act Rel. Nos. 9529, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P78,599 (Mar. 8, 1972), and 9530, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P78,600, (Mar. 8, 1972).

(n31)Footnote 31. In July 1972, the Disclosure Committee tendered its initial report recommending, among other things, the formation of a central processor to receive and disseminate last sale data. The Disclosure Committee recommended that this processor be a neutral body "not under the control or domination of any particular market center" but functioning "under a set of rules approved by the Commission" In addition, the Committee urged that any moving display or interrogation system should include market identification because "the public is entitled to know ... under what regulatory conditions a transaction is taking place"

The Commission's republication of Rule 17a-15 and the consolidated tape plan filed pursuant to that rule substantially reflected the recommendations of the Disclosure Committee.

Shortly thereafter, the Central Market System (CMS) Committee in its interim report identified three problem areas that it believed required resolution concurrently with the implementation of the composite transaction recording and reporting system.

The reporting of unregulated short sales on a consolidated tape would create, in the view of the CMS Committee, a

serious problem since all sales displayed would have equal potential for attracting long sellers. In response to this concern, in March 1974, the Commission adopted Rule 10a-1 to regulate the display of short sales in the composite transaction reporting system. Sec. Exch. Act Rel. No. 11030, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P79,971 (Sept. 27, 1974).

With respect to the anti-manipulative rules, the CMS concluded that Sections 9, 10, and 15 of the Exchange Act were sufficiently broad to provide self-regulatory bodies adequate latitude to prevent deceptive trade practices provided that there was a basic rule prohibiting participation by brokers and dealers in securities transactions for the purpose of creating or inducing "a false, misleading or artificial appearance of activity" in a listed security or for the purpose of "unduly or improperly influencing the market price" for a listed security or for the purpose of "establishing a price which does not reflect the true state of the market" to a listed security.

The CMS Committee was also concerned that the securities exchanges and the NASD set up a review mechanism to determine whether a trading suspension by any self-regulatory body should be effective for all markets. This issue was addressed by the Commission when it adopted the consolidated tape plan in May 1974. In particular, Section X of that plan provides that, whenever the primary market halts or suspends trading in a security because of inadequate disclosure of information or other "regulatory problems which should be clarified before trading is permitted to continue," the primary market will notify each participant and the consolidated tape would not print any reports of last sale prices in that security, unless the Commission determines that the exclusion of reports is not necessary for the maintenance of fair and orderly markets.

Finally, in August 1982, the Advisory Committee on Block Transactions submitted its final report, which concentrated on the need to strengthen the ability of the market to absorb large blocks. The Committee specifically recommended amendments to certain exchange and SRO rules pertaining to block transactions. The more important of these recommendations focused on the activities of block positioners and exchange specialists, in such transactions, who would be permitted to register as "upstairs market makers" and to permit exchange specialists to accept "not held" orders and thereby aid in the accumulation or disposition of a position taken by a block trader. The Commission accepted many of these recommendations.

(n32)Footnote 32. SEC, Policy Statement of the Securities and Exchange Commission for the Structure of a Central Market System (Mar. 29, 1973) (hereinafter cited as "Policy Statement").

(n33)Footnote 33. Policy Statement, *supra*, at p. 64.

(n34)Footnote 34. Policy Statement, *supra*, at p. 65.

(n35)Footnote 35. An "upstairs market maker" is a broker-dealer who makes a market in a listed security from his office off the floor of the exchange.

(n36)Footnote 36. Policy Statement, *supra*, at pp. 65-68.

(n37)Footnote 37. See § 2.01 *supra*.

(n38)Footnote 38. SEC Response, *supra*.

(n39)Footnote 39. Senate Report, *supra*, at p. 8.

(n40)Footnote 40. Section 11A(a)(1)(A) of the Securities Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F.

(n41)Footnote 41. Section 11A(a)(1)(B).

(n42)Footnote 42. Section 11A(a)(1)(C).

(n43)Footnote 43. Section 11A(a)(1)(D). The Market 2000 Report states the Commission's view that it was "expected that in the NMS, competition would generate the best prices, comprehensive disclosure of market information would foster best execution of customer orders, and broker-dealers would place the interests of their customers first." Evaluating the progress towards these objectives, the report states that, "[s]ubsequent action by the Commission and the markets to advance the NMS have made the U.S. markets the most efficient and liquid in the world." "Market 2000: An Examination of Current Equity Market Developments," p. 1 (January 1994) (hereinafter cited as "Market 2000 Report").

(n44)Footnote 44. National Market System Release, *supra*.

(n45)Footnote 45. Senate Report, *supra*, at p. 16. Two benefits cited by the Committee as associated with trading in an ideal auction-type market for securities are:

(1) the limited price orders of public investors would have to be satisfied before any transaction could be effected at the same price, by a specialist or other market maker for his dealer account, or by the customer's broker for that broker's proprietary account, or by any participant in that market at a price less favorable to the other party to the trade than the limit order price, Sec. Exch. Act Rel. No. -14416, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P81,502 (Jan. 26, 1978), and

(2) the market orders of public investors could be executed against another public limit or market order at a better price than is currently being quoted by any dealer for his own account.

The investor benefits of auction trading would result from the placing of public orders ahead of dealers' orders in determining the sequence in which the orders entering the market are executed. Currently, for example, if a stock exchange member holds a customer's market or executable limited price order he may not initiate a transaction for his own account on the same side of the market until his customer's order has been executed. In other words, a member is required to yield priority to his customers' orders. Similarly, a member trading on the floor of an exchange is not entitled to parity with or precedence over orders originating off the floor of an exchange. The effect of this later requirement is to guarantee that public orders (or members' orders originated from off-the-floor), placed with a specialist are executed ahead of the specialist's own bid (or offer) at that price as well as ahead of the bid (or offer) of any other member trading on the floor.

The auction trading principle was the basis for the Commission's central limit order book proposals, *see* § 2.04[2][g] *infra*.

A fundamental goal of the national market system is the elimination of fragmented markets for securities suitable for auction trading, *see* Section 11A(a)(1)(D), so that all buying and selling interest in a given security can be centralized, to assure public investors the best execution available, thereby fully realizing the protections and benefits of the auction market. Senate Report, *supra*, at p. 17. The Senate Committee stated that the implementation of a consolidated transaction reporting system, discussed in § 2.04[2][d] *infra*, and a composite quotation system, discussed in § 2.04[2][c] *infra*, would do much to eliminate fragmented securities markets and Section 11A(c)(1), discussed in § 2.04[3][b][i] *infra*, would foster the development of the tape and quotation system:

However, a composite tape and composite quotation system will not by themselves provide appropriate protection for limit orders held in one market against transactions completed in other markets at prices somewhat above or below the prevailing market price. Nor will such facilities guarantee that orders of public investors receive priority over orders of specialists, floor traders, or market makers and other dealers regardless of the market in which they are entered. Therefore, the Committee believes that to eliminate market fragmentation and thus to achieve a true national market system, a set of trading rules and procedures must be adopted which will tie the individual market centers together.

Id.

Developments in the area of market linkage systems are discussed in § 2.04[2][b] *infra*.

Section 12(f) was amended in 1975 to extend auction-type protections to unlisted securities by permitting exchanges, subject to Commission approval, to commence trading in any unlisted security. Senate Report, *supra*, at p. 19. When an application is made to the Commission for the extension of unlisted trading privileges to a security not listed and registered on a national securities exchange, the Commission must consider, among other things, the desirability of removing impediments to and the progress that has been made toward the development of a national market system. Section 12(f)(2). This provision was included to prevent an extension of unlisted trading privileges, if such extension would have an effect similar to the disruption caused to the existing patterns of dealing in an over-the-counter stock admitted to trading on an exchange by the then existing restrictions against exchange member brokers effecting transactions off an exchange with nonmembers in listed securities traded on the exchange and because of the restrictions against member dealers who have made or would make competitive markets in such security effecting transactions off an exchange with members or nonmembers. See Senate Report, *supra*, at pp. 19-20.

The Committee views unlisted trading as appropriate to a national market system in which all market makers and brokers are permitted to deal freely with one another without unnecessary regulatory constraints, such as the NYSE's Rule 394(b). Until substantial progress has been made toward the development of such a national market system, the ability of an exchange to commence unlisted trading in an OTC security might well decrease rather than increase competition. This result would be directly contrary to the Committee's intention, and therefore Section 12(f)(2) directs the SEC to consider carefully the progress that has been made toward the development of a national market system.

Id. at 20.

Restrictions on off-board transactions by exchange members in listed securities are discussed in § 2.03[2][c] *supra*.

Unlisted trading privileges are discussed in § 2.01[1][c] *infra*.

(n46)Footnote 46. Qualified securities are discussed in § 2.04[2][a] *infra*.

(n47)Footnote 47. These characteristics are trading volume, price, and number of stockholders. S. Rep. No. 94-75, 94th Cong., 1st Sess., 16 (1975).

(n48)Footnote 48. National Market System Release, *supra*.

(n49)Footnote 49. Third market trading is discussed in § 2.03[2][c] *supra*.

(n50)Footnote 50. National Market System Release, *supra*; Section 11A(c)(3)(A), discussed in § 2.04[3][b][iii] *infra*. The New York Stock Exchange and "other industry groups" had urged that Senate Bill 249 require all trading in listed securities to take place on national securities exchanges after fixed commission rates have been eliminated. Senate Report, *supra*, at p. 20. Commission rates are discussed in § 2.03[2][d] *supra*.

(n51)Footnote 51. Section 11A(d)(1).

(n52)Footnote 52. The initial membership of the National Market Advisory Board was announced by the Commission in August of 1975, see Sec. Exch. Act Rel. No. 11623, [1975-1976 Transfer Binder] Fed. Sec. L. Rep.

(CCH) P80,288 (Aug. 28, 1975). The initial terms of the National Market Advisory Board members would have expired on September 30, 1977, but were extended by the Commission until December 31, 1977; 43 SEC Ann. Rep., p. 11 (1977).

(n53)Footnote 53. Section 11A(d)(1) of the Securities Exchange Act of 1934 reprinted in the Securities Primary Law Sourcebook, Volume B, Section F.

(n54)Footnote 54. Section 11A(d)(2).

(n55)Footnote 55. Section 11A(d)(3)(A). The National Market Advisory Board did, in fact, advise the Commission on several areas related to the development of a national market system: in September 1976 on in-house agency cross transactions; in January 1977 on the development of a composite limit order book; and in February and May of 1977 on off-board trading restrictions. 43 SEC Ann. Rep., pp. 5, 11-12 (1977); Report of the National Market Advisory Board on the Next Steps to Be Taken to Facilitate the Establishment of a National Market System, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P81,381 (Dec. 6, 1977). Off-board trading restrictions and in-house agency cross transactions are discussed in § 2.03[2][c] *supra*.

(n56)Footnote 56. Section 11A(d)(3)(B).

(n57)Footnote 57. Section 11A(d)(3)(B). Were the National Market Advisory Board to conclude that a National Market Regulatory Board (Regulatory Board) should be established, then the National Market Advisory Board should make recommendations as to:

- (1) the time when the Regulatory Board should be established;
- (2) its composition;
- (3) the scope of its authority;
- (4) the relationship of the Regulatory Board to both the Commission and existing self-regulatory organizations; and
- (5) the manner in which the Regulatory Board should be funded.

Id.

(n58)Footnote 58. Section 11A(d)(3)(B). The National Market Advisory Board issued a report to Congress pursuant to Section 11A(d)(3)(B) of the Exchange Act. National Market Advisory Board Report to the Congress, *The Possible Need for Modifications of the Scheme of Self-Regulation in the Securities Industry so as to Adapt it to a National Market System* (Dec. 31, 1976). The National Market Advisory Board saw no need for a new self-regulatory organization, the National Market Regulatory Board ("Regulatory Board") to administer the national market system:

Because at this time the exact form which the national market system may take is not clear, the [National Market Advisory] Board cannot now advise as to whether, at some later stage in the development of a national market system, it would be desirable for a Regulatory Board to be created. However, the Board believes that the establishment of a national market system can best be facilitated, and that at least certain national market system facilities best administered, by one or more coordinating entities in which the self-regulatory organizations and the public are represented, but in which no one or two existing self-regulatory organizations have a dominant position.

Id. at p. 9.

The National Market Advisory Board saw no need for new legislation to implement its recommendation with respect to the administration of a national market system because:

(1) the National Market Advisory Board made no recommendations of substantial modifications of the scheme of self-regulation provided for in Exchange Act, and

(2) the Exchange Act was recently amended to give the Commission power to require self-regulatory organizations "to act jointly with respect to matters as to which they share authority ... in planning, developing, operating, or regulating a national market system [Section 11A(a)(3)(B), see § 2.04[3][a] *infra*] ...

Id. at p. 10.

The Securities Acts Amendments of 1975 added a new Section 11A(e) directing the Commission to make a study, and report to Congress its findings on or before December 1, 1976, of the extent to which persons excluded from the definitions of "broker" and "dealer" maintain accounts on behalf of public customers for buying and selling securities registered under Section 12 and whether such exclusions are consistent with the protection of investors and with the other purposes of the Exchange Act.

Registration of securities pursuant to Section 12 is discussed in § 4.01 *infra*.

(n59)Footnote 59. Chairman Scanlon's letter said, in part:

"A variety of viewpoints are, by design, represented on the Board. Accordingly, rather than providing a single recommendation with respect to the next steps to be taken toward the establishment of a national market system, we provide a statement of major alternatives which we believe are open to the Commission." 432 B.N.A. Sec. Reg. L. Rep. I-1 (Dec. 14, 1977).

(n60)Footnote 60. The composite quotation system is discussed in § 2.04[2][c] *infra*.

(n61)Footnote 61. Intermarket linkage is discussed in § 2.04[2][b] *infra*.

(n62)Footnote 62. 432 B.N.A. Sec. Reg. L. Rep. I-1, I-2 (Dec. 14, 1977).

(n63)Footnote 63. On December 19, 1977, Senator Harrison A. Williams, Chairman of the Senate Banking and Securities Subcommittee, Rep. Bob Eckhardt, Chairman of the House Consumer Protection Subcommittee, and Rep. John E. Moss, Chairman of the House Oversight and Investigations Subcommittee, transmitted a joint letter to Harold Williams, the then Chairman of the Securities and Exchange Commission. The letter demanded that the Chairman establish by December 30, 1977, "the specific date by which the Commission will announce the exact next steps which it proposes to take to facilitate the establishment of a national market." See 433 B.N.A. Sec. Reg. L. Rep. A-12 (1978).

Thereafter, in early January 1978, Chairman Williams committed to issue a timetable and program for the development of a national market system. That program was announced in National Market System Release, *supra*.

(n64)Footnote 64. The composite quotation system is discussed in § 2.04[2][c] *infra*.

(n65)Footnote 65. National Market System Release, *supra*.

(n66)Footnote 66. Market linkage and order routing systems are discussed in § 2.04[2][b] *infra*.

(n67)Footnote 67. Public limit order protection is discussed in § 2.04[2][g] *infra*.

(n68)Footnote 68. Off-board trading restrictions are discussed in § 2.03[2][c] *supra*.

(n69)Footnote 69. The consolidated transaction reporting system is discussed in § 2.04[2][d] *infra*.

(n70)Footnote 70. The designation of securities eligible for trading in the NMS are discussed in § 2.04[2][a] *infra*.

(n71)Footnote 71. The five issues were:

- (1) whether to revise certain SRO rules prohibiting certain direct dealings between members and institutional customers;
- (2) the role, if any, standardized options should play in an NMS;
- (3) the extent to which there should be centralized governance of the NMS and nationwide surveillance of market professionals;
- (4) whether to revise the prohibition, then embodied in Section 11(a)(1), which prohibited an exchange member from effecting a transaction for its own account on such exchange; and
- (5) whether a national system for clearance and settlement is necessary for the operation of an NMS.

(n72)Footnote 72. P.L. 94-29, 89 Stat. 97 (June 4, 1975).

(n73)Footnote 73. See Section 11A(a)(1), discussed in § 2.04[1][b] *supra*.

(n74)Footnote 74. Melton, *Corporate Equities and the National Market System*, 3 Federal Reserve Bank of N.Y.Q. Rev. 25 (Winter 1978-79) (hereinafter cited as "Melton.")

(n75)Footnote 75. Melton stated in *Corporate Equities and the National Market System*:

The SEC has wisely refrained from attempting to design a system and to impose it on the industry, and has instead proceeded to implement the NMS [National Market System] by prodding the industry to develop trading systems that possess the essential features of the NMS as mandated by the Congress.

While the Congress clearly contemplated that the exchanges and the third market would continue to compete, the legislation [1975 Amendments] did not mandate any specific design for the NMS. In essence, the Congress expressed a preference for nationwide implementation of public auction trading principles, for competition in all aspects of the market, and for the development of an electronic communications system to facilitate attainment of these objectives.

Melton, *supra*, at 20.

(n76)Footnote 76. National Market System Release, *supra*. See also Sec. Exch. Act Rel. No. 15671 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,016 (Mar. 22, 1979) (hereinafter cited as "National Market System Progress Assessment"). The concept of "qualified securities" is discussed in § 2.04[2][a] *infra*.

(n77)Footnote 77. National Market System Release, *supra*. The Commission also discussed several policy areas to be considered with its program for development of a national market system. These areas included:

- (1) institutional trading prohibitions--consideration of the elimination of NYSE and AMEX prohibitions in NYSE Rule 113 and AMEX Rule 190 regarding direct dealing by specialists with institutional customers, and consideration of the extent to which all market makers should be limited in their ability to deal directly with companies for which they act as market makers, and with insiders of such companies;
- (2) options--the Commission must ultimately determine what role standardized put and call option contracts should play in a national market system;
- (3) government and surveillance--the need for changes in the functioning of self-regulatory organizations to provide (a) centralized governance of both national market facilities and participants and (b) comprehensive and nationwide surveillance of market professionals;
- (4) Section 11(a)--whether further Commission action with respect to Section 11(a) (Section 11(a)(1) prohibits, with certain exceptions, any member of a national securities exchange from effecting any transaction on such exchange for its own account, the account of an associated person, or an account with respect to which the member or any of its associated persons exercise investment discretion; Section 11(a)(3), as amended by P.L. 95-283, 92 Stat. 249 (Act of May 21, 1978), makes the provisions of Section 11(a)(1) effective on February 1, 1979 as those provisions pertain to transactions on a national securities exchange effected by a member thereof who was a member on February 1, 1978) is necessary or appropriate in the public interest and for the protection of investors (Section 11(a) is discussed in § 3.02 *infra*); and
- (5) clearance and settlement--the Commission must review the problems impeding the prompt development of an efficient, competitive national system for clearance and settlement of securities transactions.

Id.

Also cited by the Commission as two areas pertaining to the development of a national market system for securities are off-board trading restrictions, discussed in § 2.03[2][c] *supra*, and qualified securities, discussed in § 2.04[2][a] *infra*. *Id.*

The market structure program described in the January Statement [Sec. Exch. Act Rel. No. 14416 (1978)] consisted of six interrelated initiatives: the development and implementation of three new national market system facilities (a consolidated quotation system, a nationwide network of order routing facilities and a central public agency limit order file), the refinement of an existing national market system facility (the consolidated transaction reporting system), the commencement of rulemaking proceedings to consider designation of certain categories of securities as qualified for trading in the national market system, and the continued consideration of off-board trading rules in light of the progress made toward a national market system. The January Statement also indicated that the Commission anticipated consideration of certain corollary issues in conjunction with this program, including institutional trading prohibitions, options market structure, governance and surveillance, the provisions of Section 11(a) of the Act, and clearance and settlement.

National Market System Progress Assessment, *supra*.

The Commission's statement on the development of a national market system in National Market System Progress Assessment, *supra*, set forth an updated program attempting to be responsive to the progress made and the commentary received on the national market system during 1978 while remaining consistent with the objectives set forth in Section 11A(a), *see* § 2.04[1][b] *supra*. The Commission cited two major national market system facilities developments during 1978:

- (1) the implementation of the Commission's Quote Rule, Rule 11Ac1-1 [now Rule 602], discussed in § 2.04[2][c][i] *infra*, and
- (2) the two experimental programs (the ITS and the NSTS, *see* § 2.04[2][b] *infra*) intended to achieve comprehensive market linkage systems.

National Market System Progress Assessment, *supra*. The Commission announced that its priorities for 1979 in the development of a national market system for securities were: to achieve nationwide price protection for public limit orders against executions at inferior prices, *see* § 2.04[2][g] *infra*; to assure the general availability of neutral order routing facilities linking brokers' and dealers' offices to all market centers trading in reported securities, *see* § 2.04[2][b][ii] *infra*; and to initiate rule-making proceedings to consider whether to preclude the application of off-board trading restrictions to securities not previously subject to those restrictions. *Id.*

Proposals have been advanced to create a national market system having different assumptions and different characteristics than those contemplated by the Commission in achieving the objectives articulated by Congress in the 1975 Amendments. The Commission seeks to establish mechanisms for the linking of existing market centers (and any other market centers created in the future) in an increasingly close and effective manner to avoid market fragmentation and to coordinate the various market centers so that they will constitute, in combination, a national market system. National Market System Release, *supra*. Two proposed alternative concepts that the Commission has not sought to pursue are:

- (1) a national market system created by modifying the existing "primary" markets, particularly the NYSE, resulting in substantially all orders interacting either through the mechanisms of, or on the floor of, the "primary" market, with all qualified broker-dealers, possibly together with certain other organizations, having access to that market on a nondiscriminatory basis, and
- (2) an electronic market system in which all orders are entered into a computer-based system and executed on the basis of strict time and price priority.

(n78)Footnote 78. Section 11A(a)(2). It was never contemplated that all securities traded in the secondary securities markets would be eligible for trading in the national market system. In 1971, when the Commission first proposed the concept of a "central market system," the Commission envisioned a system limited to "securities of national importance." SEC, Institutional Investor Study Report, H. R. Doc. 92-64, 92d Cong., 1st Sess., pt. 1 at XXIV-XXV (1971). The House version of the 1975 amendments appeared to include all securities in the national market system, unless otherwise exempted from the system by order of the Commission. *See* Sec. 501 of H. R. 4111, 94th Cong., 1st Sess. (1975). This reflected a belief that the structure of the national market system should not be predetermined by Congress or the Commission, but, rather, should evolve "through the ingenuity and response of the marketplace" H. R. Rep. No. 94-123, 94th Cong., 1st Sess., 50-51 (1975).

In contrast to H. R. 4111, the Senate bill imposed upon the Commission the responsibility to define the classes of securities eligible for trading in the national market system. The Senate recognized:

"that many securities do not have the characteristics--*e.g.*, trading volume, price, and number of stockholders--which would justify auction-type trading. Within a national market system, securities should trade in the manner most appropriate to their characteristics, consistent with the public interest. However, with respect to securities which are suitable for auction trading, the Committee believes that every effort should be made to design the national market system in such a way that public investors in these securities receive the benefits and protections associated with auction-type trading."

Senate Report at 16. The Senate version was adopted by the conference committee. Conference Report at 92-93.

(n79)Footnote 79. Section 11A(a)(2). The term "exempted security" is defined in Section 3(a)(12). In summary, "exempted securities" include obligations of the U.S. government, securities issued or guaranteed by corporations in which the U.S. has a direct or indirect interest, municipal securities, bank sponsored trust funds, and certain insurance contracts. *See* historical comment, 3 Fed. Sec. L. Rep. (CCH), at P15586.001 (1994).

(n80)Footnote 80. Sec. Exch. Act. Rel. No. 12158, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P80,399 (Mar. 2, 1976) (hereinafter cited as "Composite Book Release").

(n81)Footnote 81. Composite Book Release, *supra*.

(n82)Footnote 82. Composite Book Release, *supra*.

(n83)Footnote 83. The Commission sought public comment on the standards that would distinguish Tier 1 securities from Tier 2 securities.

(n84)Footnote 84. Composite Book Release, *supra*.

(n85)Footnote 85. To effect this objective, the Commission announced proposed amendments to proposed Rule 11Aa3-1 [now Rule 601] that would require inclusion of all Tier 1 securities in consolidated transaction reporting and quotation systems within two months of the effective date of a trading program filed pursuant to Rule 11Aa2-1 [now replaced by Rule 600].

(n86)Footnote 86. Price protection mechanisms are discussed in § 2.04[2][g] *infra*.

(n87)Footnote 87. Nasdaq at the time was part of the OTC market. For a discussion of Nasdaq, *see* § 2.01[1][a][ii] *supra*.

(n88)Footnote 88. For a discussion of this linkage, *see* § 2.04[2][b][ii] *infra*.

(n89)Footnote 89. Off-board trading restrictions are discussed in § 2.03[2][c] *supra*.

(n90)Footnote 90. Nonmember access is discussed in § 2.03[2][b] *supra*.

(n91)Footnote 91. Sec. Exch. Act Rel. No. 17549, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,826 (Feb. 17, 1981) (hereinafter cited as "NMS Securities Release").

(n92)Footnote 92. The rule did not apply to exchange-listed securities because almost all of these securities were already part of the Consolidated Quotation Plan and Consolidated Tape Association, through which quote information and transaction information are combined, respectively, in a single data stream for multiple markets. *Id.* For a description of the Consolidated Quotation Plan and Consolidated Tape Association, *see* § 2.04[2][c][ii] and 2.04[2][d][iii], respectively.

(n93)Footnote 93. Sec. Exch. Act Rel. No. 18397, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,077

(Jan. 7, 1982); Sec. Exch. Act Rel. No. 21583, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,721 (Dec. 18, 1985); Sec. Exch. Act Rel. No. 22413, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,914 (Sept. 16, 1985); Sec. Exch. Act Rel. No. 24635, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P84,140 (June 23, 1987).

Implementation of Rule 11Aa2-1 [now replaced by Rule 600] was deferred twice to permit the NASD to phase in the approximately 1500 Tier 2 securities that would join the NMS from the OTC market. *See* Sec. Exch. Act Rel. Nos. 18514, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,101 (Feb. 25, 1982), and 19092, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,261, (Sept. 29, 1982).

(n94)Footnote 94. When the Commission proposed this change, it recognized that Congress had anticipated that the NMS designation criteria would relate to the trading characteristics of securities. It also noted, however, that Congress had provided the Commission with maximum flexibility in developing the NMS. Market 2000 Report, *supra*, at p. I-11 (footnote omitted).

(n95)Footnote 95. *See* Sec. Exch. Act Rel. No. 24635, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P84,140 (June 23, 1987).

(n96)Footnote 96. Former Rule 11Aa3-1a(4). The effect of this amendment was to allow the NASD to determine which securities were NMS securities by deciding which securities would be subject to the transaction reporting plan. However, there was little substantive change in the designation criteria because the NASD adopted standards for inclusion in the transaction reporting plan that incorporated the Tier 2 criteria and added corporate governance requirements. *Id.* Transaction reporting plans are discussed in § 2.04[2][d][iii].

The definition of "reported security" in former Rule 11Aa3-1(a)(4) was identical to that in former Rules 11Ac1-4(a)(10) and former Rule 11Ac1-2(a)(20), but differed from the definition in former Rule 11Ac1-1(a)(20). *See* Regulation NMS Adopting Release, *supra*, at *505. As a result of this inconsistency, and other changes to the NMS terminology, the term "reported security" was eliminated by Regulation NMS in favor of the terms "NMS Security" and "NMS Stock." *See id.*; Rule 600(b).

(n97)Footnote 97. Rule 600(a), 17 C.F.R. § 242.600(a).

(n98)Footnote 98. *See* Regulation NMS Adopting Release, *supra*, at *499-501.

(n99)Footnote 99. NASD rules 4400-4480 (1998).

(n100)Footnote 100. The Nasdaq National Market therefore was effectively created by Rule 11Aa2-1 [now replaced by Rule 600]. *See* NASD Manual, Rule 4400. The criteria for listing on the Nasdaq National Market are described in § 2.01[1][b] *supra*.

(n101)Footnote 101. *See* Sec. Exch. Act Rel. No. 45081, 2001 SEC LEXIS 2346 (Nov. 19, 2001). The UTP Plan is discussed in § 2.04[d][3] *infra*. Had the UTP Plan not been amended in 2001 to include all Nasdaq securities, all Nasdaq securities would have become NMS Securities in 2006, when Nasdaq became registered as a national securities exchange. *See* Sec. Exch. Act Rel. No. 53128 (Jan. 13, 2006). The distinction between Nasdaq National Market securities and the remaining Nasdaq securities, which used to be known as Nasdaq SmallCap Securities and now are known as Nasdaq Capital Market securities, remained after Nasdaq became a national securities exchange, when the Nasdaq National Market and Nasdaq Capital Market became separate listing tiers. *See id.*

(n102)Footnote 102. The Commission believes that communications and data processing facilities which link all qualified markets and permit orders in qualified securities to be transmitted promptly and efficiently from brokers or dealers to any qualified market, and from one such market to another, are necessary to increase the opportunities for brokers to secure best execution of their customers' orders, to ensure effective competition among qualified markets and to achieve the purposes of a national market system established by the Congress in Section 11A(a) of the Act. National

Market System Release, *supra*.

The linking of all markets for qualified securities through communication and data processing facilities is one of the goals of a national market system, *see* Section 11A(a)(1)(D), discussed in § 2.04[1][b] *supra*.

(n103)Footnote 103. National Market System Release, *supra*.

(n104)Footnote 104. The NSTS was originally referred to as the Multiple Dealer Trading System. *See* Sec. Exch. Act Rel No. 14674 (1978) (hereinafter cited as "NSTS Approval Order"). The Cincinnati Stock Exchange is now known as the National Stock Exchange.

(n105)Footnote 105. CAES is discussed in more detail in § 2.04[2][b][i][C] *supra*.

(n106)Footnote 106. The RMS was merged with the NSTS. *See* NSTS Approval Order, *supra*. The NSTS subsequently became part of the ITS. *See* Sec. Exch. Act Rel. Nos. 7516 n.22, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,818 (Feb. 5, 1981), and *Sec. Exch. Act Rel. No. 17532, 1981 SEC LEXIS 2094 (Feb. 10, 1981)* (hereinafter cited as "ITS CSE Amendment Release").

(n107)Footnote 107. While volume on the NSTS had increased to an average 8.1 million shares in 1982, approximately 2.8 million had originated or were confirmed through the ITS. For an analysis of the NSTS, *see* SEC, Report on the Operation of the Cincinnati Stock Exchange National Securities Trading System (1982).

(n108)Footnote 108. The original ITS members were the American, Boston, New York, Pacific, and Philadelphia Stock Exchanges. *See* Sec. Exch. Act Rel. No. 14661 (1978). The Midwest Stock Exchange joined ITS in 1979. *See* Sec. Exch. Act Rel. No. 15533 n.20, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 22,808B (Jan. 29, 1979). The Cincinnati Stock Exchange, now known as the National Stock Exchange, joined in 1981. *See* ITS CSE Amendment Release, *supra*.

(n109)Footnote 109. *See* Sec. Exch. Act Rel. No. 17744, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,866 (Apr. 21, 1981). The interface was desirable because ITS routed orders between markets but had no automatic execution capability, while CAES provided automatic executions but only within one market. For a more complete description of the ITS and CAES systems, *see* §§ 2.04[2][b][i][A] and [C] *infra*, respectively.

(n110)Footnote 110. National Market System Release, *supra*.

"Market fragmentation" refers to the existence of multiple, geographically separated forums in which trading in the same security occurs, and from the institutionalization of the markets. [The problems arising from market fragmentation] include, among others: (i) the need to perfect existing mechanisms for the disclosure of information concerning all completed transactions in multiply-traded securities; (ii) the absence of a comprehensive, composite quotation system displaying buying and selling interest in those securities from all markets (whether on an exchange or over-the-counter); (iii) the inadequacy of existing means available to brokers for routing orders to and among markets in pursuit of the most favorable execution opportunities; (iv) the lack of a mechanism to provide nationwide agency limit order protection, affording time and price priority to such orders regardless of geographical location; (v) impediments to effective market-maker competition for orders of relatively small size; and (vi) the need to integrate block transactions more effectively into the normal course of securities trading.

Id.

(n111)Footnote 111. Commission rates are discussed in § 2.03[2][d] *supra*.

(n112)Footnote 112. Off-board trading restrictions are discussed in § 2.03[2][c] *supra*.

(n113)Footnote 113. The exchanges were the American, Boston, New York, Pacific and Philadelphia Stock Exchanges. Sec. Exch. Act Rel. No. 14661 (1978).

(n114)Footnote 114. *Id.* The Commission initially authorized the system to operate for one year. In 1979, the Commission issued an order approving the continuation of the system until January 31, 1983. Sec. Exch. Act Rel. No. 16214 (1979). Thereafter, the Commission granted the system permanent status by extending its operating authority indefinitely. Sec. Exch. Act Rel. No. 19456 (1983) (hereinafter cited as "ITS Approval Order").

(n115)Footnote 115. According to the NYSE, for example:

The Intermarket Trading System is a simple, workable and inexpensive system. It provides the core of a communications and trading facility that can evolve and expand, to become, along with other elements, the National Market System called for by Congress.

NYSE, A Cornerstone of the National Market System: The ITS (1979).

(n116)Footnote 116. For a discussion of ITS, see ITS Approval Order, *supra*. See also Melton, *supra*. See also Sec. Exch. Act Rel. No. 15533, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P22,808B (Jan. 30, 1979):

The ITS provides facilities and procedures for (i) display on the floors of each of the participating exchanges (at the designated trading posts for ITS-traded securities) of composite quotation information disseminated pursuant to Rule 11Ac1-1 [now Rule 602] under the Act [Rule 602 is discussed in § 2.04[2][c][i] *infra*], thereby permitting members of each participating exchange to determine readily the best bid and offer available from any participant for a particular multiply traded security, (ii) routing of "commitments to trade" and administrative messages between and among the participants, and (iii) participation, under certain conditions, by members of all participating exchanges in opening transactions on those exchanges. (Footnotes omitted.)

Since the Composite Quotation System (CQS) used in conjunction with the Intermarket Trading System is an electronic system designed to display to broker-dealers on an exchange floor the best quotations--with size for listed stocks in different market centers--the Composite Quotation System contains no execution capability; Melton, *supra* at 22. Consequently, the ITS trading procedure, in conjunction with the CQS, is as follows:

Upon receipt of an order, a broker on the floor of a participating exchange checks the CQS display screen showing quotations on the various markets. If the quotation on his exchange is as good as or better than any other on the display screen, the broker would execute it on his exchange. If the display screen shows that a better quotation is posted on another exchange, the floor broker may decide to send the order there.

To do this, he enters a commitment for the bid or offer, stipulating the amount of shares and the price, in an ITS terminal located on the exchange floor and transmits it to the specialist on the other exchange. In principle, the price placed on a buy order must be the offering price quoted for the destination market on the CQS display, and a sell order must carry the bid price quoted for the destination market; the broker cannot enter a price between the quoted bid and offer. The specialist can either fill the order or cancel it. He might cancel it if there has been some sort of malfunction or if he was in process of changing his quotation. Any commitment not accepted within two minutes is automatically canceled by the system. While an order commitment is in ITS, the sender may not retrieve it to execute it on his own floor. Currently, the average time elapsed between submission of order commitments and

receipt of return messages is slightly less than one minute.

Melton, *supra* at 22.

Not only does the Composite System contain no execution capability, the CQS also displays only the best quotations in different market centers with specialists continuing to have exclusive knowledge of limit orders in their order books. Furthermore, a broker still must be physically present on the exchange floor to know of limit orders being held in the crowd. Such situation is inconsistent with nationwide protection of limit orders. Melton, *supra* at 22.

The Composite Quotation System is discussed in § 2.04[2][c] *infra*. Nationwide limit order protection is discussed in § 2.04[2][g] *infra*.

As to the "commitment to trade" that is part of the Intermarket Trading System trading procedure a question arose concerning whether a "commitment to trade" sent via the ITS would satisfy the requirements of Rule 11a2-2(T), or the "effect versus execute rule". The rule requires that orders for covered accounts ("covered accounts" are defined to include: (i) a member's own account (known as a "proprietary account"); (ii) the account of a person associated with a member; and (iii) an account over which the member or any person associated with the member exercises investment discretion (known as a "discretionary account"). Sec. Exch. Act Rel. No. 14563, 3 Fed. Sec. L. Rep. (CCH) at P22,808 (Mar. 14, 1978)) be transmitted from off the exchange floor. Sec. Act Rel. No. 14563, Fed. Sec. L. Rep. (CCH) P22,808 (Mar. 14, 1978). In a transaction through the ITS by a firm that was a member of both the exchange from which the order was sent and the exchange at which it was received, it was uncertain that this requirement would be satisfied. In a letter to the Pacific Stock Exchange, the Commission stated that ITS transactions of this nature would be deemed in accordance with the rule. *See Pacific Stock Exchange Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P81,967 (1979). Though termed a "temporary rule," Rule 11a2-2(T) has remained in existence since its adoption in 1978.

(n117)Footnote 117. Melton, *supra*, at 22.

(n118)Footnote 118. For statistical information on ITS, *see ITS Approval order, supra*.

(n119)Footnote 119. New York Stock Exchange, ITS Activity, NYSE Fact Book Online 2004 at www.nysedata.com/factbook/main.asp (last visited Feb. 18, 2006).

(n120)Footnote 120. New York Stock Exchange, ITS Activity, NYSE Fact Book Online, 2004 at www.nysedata.com/factbook/main.asp (last visited February 27, 2006).

(n121)Footnote 121. *See e.g.*, SEC, A Monitoring Report on the Operation of the Intermarket Trading System (1981), and SEC, A Report on the Operation of the Intermarket Trading System: 1978-1981 (1982).

(n122)Footnote 122. A "trade-through" occurs when an execution takes place in one ITS market center at a time when another ITS center is offering a better price. *See ITS Approval Order, supra*, at n.11.

Many market participants, however, question whether the trade-through rule does more harm than good. The Commission was considering whether to eliminate or modify the rule, but ultimately, with regulation NMS, extended the rule to all NMS Securities, though with some limitations. *See § 2.04[2][b][iii] infra*.

(n123)Footnote 123. Sec. Exch. Act Rel. No. 17704 (Apr. 9, 1981).

(n124)Footnote 124. Sec. Exch. Act Rel. No. 17704 (Apr. 9, 1981).

(n125)Footnote 125. *Id.* On September 30, 1999, the SEC approved rule changes by Nasdaq relating to a facility of the market known as the "Nasdaq Application of the Optimark System." Sec. Exch. Rel. No. 41967 (Sept. 30, 1999).

Nasdaq's facility, commonly known simply as "Optimark," is a screen-based trading service which allows users to anonymously enter indications of trading interest, known as "profiles," into the system; *see id.* The system executes orders, not continuously but at specified points in time at least five minutes apart, by matching a user's profile with the profile of other users. *Id.*

(n126)Footnote 126. *See* Isabelle Clary, *Sources: Days Numbered for ITS*, Securities Industry News, November 10, 2003.

(n127)Footnote 127. *See* Mark Hendrickson, *Intermarket Trading System is Doomed, but What Will Replace it?*, Securities Week, Vol. 32, No. 33, August 22, 2005, at 1.

(n128)Footnote 128. *See* Reuters, *A Nasdaq Trading Change*, New York Times, August 9, 2005, at C13.

(n129)Footnote 129. *See* Ivy Schmerken, *Are Regional Stock Exchanges Seeking an Alternative to ITS?*, Wall Street & Technology, September 1, 2005, at S14.

(n130)Footnote 130. The four participating exchanges were the Boston, Cincinnati [now National], Chicago and Pacific [now NYSE Arca] Stock Exchanges. *See* National Market System Release, *supra*.

(n131)Footnote 131. NSTS Approval Order, *supra*; *see also* Sec. Exch. Act Rel. Nos. 15413 and 16215 (1979).

(n132)Footnote 132. For a discussion of off-board trading, *see* § 2.03[2][c] *supra*.

(n133)Footnote 133. NSTS Approval Order, *supra*. The NSTS has been described as the only "hard CLOB" presently operating in the equities market. Melton, *supra*, at 23. A CLOB is a "central limit order book," *see* § 2.04[2][g] *infra*. A hard CLOB is a mandatory system which integrates electronic order execution capability with an electronic file of all outstanding limit orders, irrespective of the market center in which they were inserted. *Id.* A "soft CLOB" is a similar system but is voluntary. In the NSTS a "broker-dealer with access to the system can enter his own quotations and limit orders into the system, and he can "hit" bids and offers displayed on the system essentially instantaneously." *Id.*

(n134)Footnote 134. "Users" include members of the NSE and specialist and exchange market makers in designated issues registered as such on other exchanges who may (along with NSE members) become "approved dealers" on the exchange. *See* Article I, Section 1(a) of NSE By-laws; NSE Rules 11.9(a)(7), 11.9(a)(4) and 11.9(a). NSE members and approved dealers can enter both agency and principal orders, whereas access nonmembers of the NSE can enter only agency orders. NSE Rules 11.9(e) and 11.9(f).

(n135)Footnote 135. A market order, however, will be translated by a floor trader into a limit order and then the trading mechanism will match that order against a corresponding limit order on the other side of the market. Deloitte Haskins Sells; Evaluation of the Multiple Dealer Trading Facility (Cincinnati/NMS), p. 12 (Nov. 14, 1978) (hereinafter cited as "Evaluation"). The various types of orders that a customer may give his broker in connection with the purchase or sale of securities on an exchange are discussed in § 2.01[1] *supra*.

The NSTS is an auction market that has been observed to contain the following key elements of an auction market:

- (1) highest bid meeting lowest offer;
- (2) easy access to quote information;
- (3) firm quotes based only on executable orders; and
- (4) execution of orders at a price within a quoted spread.

Id.

(n136)Footnote 136. A "public agency order" is defined by NSE Rule 11.9(a)(9) as "any order for the account of a person other than a member, an Approved Dealer or a person who could become an Approved Dealer by complying with this Rule with respect to his use of the System, which order is represented, as agent, by a User."

(n137)Footnote 137. NSTS Approval Order, *supra*; Evaluation, *supra*, at p. 7.

(n138)Footnote 138. NSTS Approval Order, *supra*; Evaluation, *supra*, at pp. 6, 7.

(n139)Footnote 139. NSTS Approval Order, *supra*; Evaluation, *supra*, at pp. 7, 8.

(n140)Footnote 140. NSTS Approval Order, *supra*.

(n141)Footnote 141. Sec. Exch. Act Rel. Nos. 15413 and 16215 (1979).

(n142)Footnote 142. Sec. Exch. Act Rel. No. 18985 (1982).

(n143)Footnote 143. SEC, A Report on the Operation of the Cincinnati Stock Exchange National Securities Trading System 1978-1982, pp. 4, n.6 (1982). (Hereinafter referred to as "NSTS Report.")

(n144)Footnote 144. SEC Ann. Rep., Table 20 (1997).

(n145)Footnote 145. In September 2004, however, the CBOE announced that it was reducing its ownership stake in the NSE from 68 percent to approximately 10 percent. JB, *CBOE Selling Most of its Share of NSX*, Securities Week, Vol. 31, No. 38, September 20, 2004, at 10.

(n146)Footnote 146. One issue raised by the NSTS is the role of specialists in the system. While the NSTS enhances opportunities for market makers to compete because the order book is public and orders may be hit regardless of the geographical location of the market makers, a problem arises because exchange specialists derive a substantial amount of commission income by executing limit orders left with them:

In [the NSTS], execution of such orders is automatic and there are no commissions to be earned. Thus specialists may have less of an incentive to accept an affirmative obligation to preserve price continuity in the market unless some other means of compensating them is developed. Whether such compensation is necessary--and if so, how best to provide it--is an important policy issue, but there is no logical inconsistency between payments for specialist services and hard CLOB.

Melton, *supra*, at p. 24.

Another problem raised in connection with the NSTS is the entry of matching orders through the use of "internalization." A broker-dealer may "internalize" orders by entering one side within the existing spread and then executing against that order by immediately entering the other side. Evaluation, *supra*, at p. 26. This ability of NSE approved dealers to trade against their own retail order flow without exposing those orders to other buying or selling interest has been criticized by both the NYSE and the AMEX in comments to the Commission as possibly leading to market fragmentation and as being inconsistent with national market system objectives. See Sec. Exch. Act Rel. No. 15413 (1978).

The Commission announced in Sec. Exch. Act Rel. No. 15533, [1979 Transfer Binder] Fed. Sec. L. Rep. 9 (CCH) P22,808B (Jan. 29, 1979), that Section 11(a)(1) of the Exchange Act (discussed in § 3.02 *infra*,) may not have a

substantial impact on the operation of the NSTS because several of the exemptive provisions (such as the market maker exemption in Section 11(a)(1)(A) or, in the case of accounts as to which an NSE member exercises investment discretion, the effect versus execute exemption in Temporary Rule 11a2-2(T)) apply to trading in the NSTS.

(n147)Footnote 147. For a discussion of Nasdaq, see § 2.01[2][a][ii] *supra*.

(n148)Footnote 148. See, e.g., Sec. Exch. Act Rel. No. 16888, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,608 (June 11, 1980).

(n149)Footnote 149. NASD, Summary of Proceedings of the Tier 1 NASDAQ National Market System (1982). (Hereinafter referred to as "NASD Summary.")

(n150)Footnote 150. See Sec. Exch. Act Rel. No. 49349 (Mar. 8, 2004); Sec. Exch. Act. Rel. No. 48674 (Oct. 21, 2003).

(n151)Footnote 151. See § 2.04[2][b] *supra*.

(n152)Footnote 152. Qualified securities are discussed in § 2.04[2][a] *supra*.

(n153)Footnote 153. National Market System Release, *supra*.

(n154)Footnote 154. *Id.* Section 11A(c)(1)(E), discussed in § 2.04[3][b][i] *infra*, gives the Commission rulemaking power to assure that all exchange members, brokers, and dealers transmit orders for the purchase or sale of qualified securities in a manner consistent with the establishment and operation of a national market system.

(n155)Footnote 155. National Market System Release, *supra*.

(n156)Footnote 156. The Commission, while expressly refraining from endorsing one broker order routing system over another, did state that a new message switch facility for the routing of orders from brokers' and dealers' offices to any qualified market would not have to be developed if the existing order routing facility operated by the Securities Industry Automation Corporation (SIAC), and offered to members of the NYSE and the AMEX, were expanded to receive orders in qualified securities and if access to that facility were made generally available to all brokers and dealers. *Id.*

(n157)Footnote 157. Sec. Exch. Act Rel. No. 14885, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P81,625 (June 23, 1978).

The Commission had received two proposals concerning a universally available, neutral "upstairs" message switch:

(1) that of the NASD envisioning a national order routing system as the primary means for routing orders to the various market centers (and as the center of a communications network connecting all brokers, dealers, and market centers), and

(2) that of the NYSE, and concurred in by the AMEX, to use the existing order routing facility operated by SIAC.

The NYSE proposal contemplated the continued evidence of multiple, competing switches. *Id.*

The Commission received comments from several self-regulatory organizations, retail brokerage firms, the Securities Industry Association (now the Securities Industry and Financial Markets Association), and one individual in response to its June 1978 request for comment. National Market System Progress Assessment, *supra*. The commentators opposed

any Commission mandate to establish a single order routing facility that would eliminate broker discretion (to consider factors other than price, such as: order size, execution and clearing costs, perceptions as to the reliability of the displayed quotation, and the likelihood of obtaining execution at a price better than that indicated by the displayed quotation) by forcing automatic routing of all orders on the basis of machine-displayed quotations. *Id.*

(n158)Footnote 158. SEC Chairman Harold Williams stated in 1978:

While the Commission has not formally acted, I think it would be unlikely for the Commission to require order-by-order routing decisions by retail firms given the existing structure of the markets. Absent quotations which are firm under all conditions, given limitations on access and differences in clearing costs, and, most importantly, absent the means of accessing those quotations in a timely manner, such a requirement would not appear feasible at this time.

Whether order-by-order routing to the best market in size will eventually be a characteristic of a national market system should be left for future consideration in light of subsequent developments in the structure of the markets. However, improvements in order routing facilities can, and should, be achieved. We are aware that various brokerage service firms offer order routing facilities permitting brokers to route orders to any market center. However, as a practical matter, many of those brokers currently linked to the New York-AMEX switch, which provides access only to those exchanges, have no ready means of routing orders to other markets. Therefore, I urge the New York and the AMEX to promptly pursue the commitment they made in their responses to the January Statement [Sec. Exch. Act Rel. No. 14416 (1978)] to provide other market centers with access to their common switching facilities.

Address of Chairman Williams, *see* § 2.04[1][e] *supra*. *See also Work on a National Stock Trading System Lags Badly; Some Blame Brokers and SEC*, Wall Street Journal, p. 34 cols. 1-4 (Feb. 2, 1979).

In the Commission's status report on the progress made in 1978 in pursuing the initiatives described by the Commission in its January 1978 statement on the development of a national market system, *see* § 2.04[2] *supra*, the Commission reiterated its views on a broker order routing system:

The Commission continues to believe that a broker routing retail orders in a particular security to a single market (whether by automated or other means) must at least make periodic assessments of the quality of competing markets to assure that it is taking all reasonable steps under the circumstances to seek out best execution of customers' orders. For most brokers, the availability of a neutral order routing mechanism which would permit a firm easily to shift its order flow from one market center to another would facilitate compliance with this obligation. The need for development of neutral order routing facilities is not, however, premised solely on the contribution such facilities would make to the ability of a broker to achieve "best execution" of his customers' orders. Development of order routing facilities which facilitate the routing of orders to any market center also will contribute to establishment of an environment satisfying the statutory objective of assuring fair competition among brokers and dealers and among markets.

National Market System Progress Assessment. (Footnotes omitted)

The Commission announced that it was deferring consideration of whether order by order routing of retail orders to the best market in size should be required in a national market system for securities, in view of an offer in 1978 by both the NYSE and the AMEX to modify their message switch, *see* Address of Chairman Williams, *supra*, to permit all market centers desiring such linkage to send and receive messages through the system. In support of its decision to defer consideration of a broker order routing system, the Commission questioned whether individualized routing of all orders

on the basis of machine-displayed quotations should be required in the current trading environment (characterized by quotes that are not firm under all circumstances, practical limitations on access for execution purposes, and differences in clearing costs). *Id.* The need to develop a system capable of order by order routing from upstairs offices to all market centers may, in fact, diminish (at least from the standpoint of satisfying a broker's best execution responsibility, see § 2.04[2][c] *infra*) as market linkage systems are "enhanced," *i.e.*, the operating characteristics of the market linkage systems are substantially improved. *Id.*

(n159)Footnote 159. Section 11A of the Securities Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F, established certain goals for a national market system, which are discussed in § 2.04[1][b] *supra*.

(n160)Footnote 160. See Address by Chairman Williams, National Market System Release, *supra*. The intermarket order routing system was only one of the two types of facilities the Commission cited as mechanisms needed to link qualified markets effectively.

(n161)Footnote 161. National Market System Release, *supra*.

(n162)Footnote 162. Evaluation, *supra*, at p. 16. The central limit order book, or CLOB, is discussed in § 2.04[2][g] *infra*.

(n163)Footnote 163. Sec. Exch. Act Rel. No. 14885, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P81,625 (June 23, 1978).

(n164)Footnote 164. 45 SEC Ann. Rep., p. 3 (1980).

(n165)Footnote 165. Sec. Exch. Act Rel. No. 17516, [1980-1981 Transfer Binder] 1 Fed. Sec. L. Rep. (CCH) P82,818 (Feb. 5, 1981).

(n166)Footnote 166. ITS CSE Amendment Release, *supra*.

(n167)Footnote 167. For a description of the mechanics of this interface, see Sec. Exch. Act Rel. No. 17516 at n.22, [1980-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,818 (Feb. 5, 1981).

(n168)Footnote 168. According to the Commission, the manual interface between ITS and NSTS may "prove too slow and cumbersome to provide an efficient mechanism for routing orders among market centers." Sec. Exch. Act Rel. No. 17516 [1981-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,818 (Feb. 5, 1981); Amendment to ITS Release, *supra*.

(n169)Footnote 169. ITS CSE Amendment Release, *supra*.

(n170)Footnote 170. Sec. Exch. Act Rel. No. 17744, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,866 (Apr. 21, 1981) (hereinafter cited as "Release 17744").

(n171)Footnote 171. Release 17744, *supra*.

(n172)Footnote 172. Off-board trading is discussed in § 2.03[2][c] *supra*.

(n173)Footnote 173. The arguments that the ITS/ CAES interface was premature were numerous and varied. The Pacific Stock Exchange (now NYSE Arca) and the Chicago Stock Exchange urged the Commission to follow the NSTS/ITS route by ordering OTC market makers to install an ITS terminal in their trading rooms. Release 17744, *supra*, at n.22. The NYSE, while generally supporting some type of interface, argued that interfacing should be deferred until action was taken to abate the industry concern over internalization of off-board transactions. *Id.* at n.27. Specifically, the NYSE endorsed a two element "test" linkage of ITS and CAES: a pilot electronic linkage limited to the

30 most active Rule 19c-3 securities and a "preliminary" rule on internalization. The Commission rejected these arguments noting that it:

remains fully cognizant of the concerns raised by commentators relating to internalization by OTC market makers and its possible effects on the securities markets. However, the Commission carefully considered these concerns in the context of its Rule 19c-3 proceeding and determined that, on balance, any adverse effects resulting from the removal of off-board trading restrictions for a limited number of newly listed securities were off-set by the prospects of enhanced competitive and experimental benefits resulting from that action. The Commission concludes that it is neither necessary nor appropriate to reconsider that determination at this time. While the Commission views self-regulatory efforts to resolve industry concerns relating to OTC trading in listed securities as significant and positive, and remains prepared to take regulatory action itself if adverse consequences result from internalized trading and SRO efforts are unsuccessful, the Commission believes that the achievement of an efficient linkage between exchange and OTC markets is fundamental to the entire national market system program and must be implemented promptly independent of these collateral market structure concerns.

Id.

(n174)Footnote 174. Sec. Exch. Act Rel. No. 18536, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,107 (Mar. 4, 1982).

(n175)Footnote 175. The major impediments, according to the Commission, were the issue of internalization, market maker commitment requirements of OTC market makers participating in CAES, ITS order entry procedures, OTC trade reporting, identification by CAES of short sales, display of CAES bids and offers where the market is "locked" (*i.e.*, a displayed bid quotation is identical to an offer quotation) or "crossed" (*i.e.*, when a displayed bid is higher than a displayed offer), and certain technical matters. *Id.*

The Commission's lengthy plan covered such matters as administration of the ITS plan, monitoring the ITS/ CAES interface, receipt and submission of quotations, reporting of ITS trades, elements of a commitment to trade, acceptance of a commitment, validation of commitments, routing of commitments, pre-opening applications, implementation of the plan, order protection, OTC market obligations, clearance and settlement, operational matters, allocation of costs and expenses and withdrawal from the ITS plan. *Id.*

(n176)Footnote 176. Sec. Exch. Act Rel. Nos. 18712, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,213 (May 6, 1982), and 18713, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,214 (May 6, 1982).

(n177)Footnote 177. ITS Approval order, *supra* at n.7.

(n178)Footnote 178. ITS Approval Order, *supra*. The Commission made the following further comments on the interface:

The Commission recognizes that for CAES to be able to effectively prevent trade-throughs and for the system to operate at maximum efficiency, CAES' ITS order entry process must be enhanced so that CAES orders can be automatically entered into ITS without the manual intervention of a CAES market maker whenever an ITS exchange market is displaying a quotation superior to any interest in CAES. The NASD proposed to develop such a capability, which would enhance CAES to provide for automated routing to ITS if an exchange market is displaying a superior quotation and no CAES market maker matches or betters such a quotation within a specified time period. The Commission believes that use of the interface in this manner does not raise concerns with respect to CAES being employed as an order-routing mechanism by the users of CAES enabling those users to avoid brokerage and transaction

fees and the need for exchange membership. Accordingly, the Commission expects the participants to amend the ITS Plan by the end of the pilot phase of the linkage to provide for such an automated interface. *Id.* at n.20.

The Commission also notes that in order to achieve fully the Congressional goal that all markets for qualified securities be linked (Section 11A(a)(1)(D) of the Act), it will be necessary in the future for the ITS/CAES interface to be expanded to include all stocks traded in the third market. The Commission encourages the ITS participants to move promptly to achieve this goal once all Rule 19c-3 Securities are included in the interface.

(n179)Footnote 179. See Regulation NMS Adopting Release, *supra*, at *34-35.

(n180)Footnote 180. See Regulation NMS Adopting Release, *supra*, at *65-66.

(n181)Footnote 181. Regulation NMS Proposing Release, *supra*.

(n182)Footnote 182. Regulation NMS Proposing Release, *supra*, at *22-23.

(n183)Footnote 183. Regulation NMS, Reproposing Release, *supra*, at *21.

(n184)Footnote 184. Reg NMS Reproposing Release, *supra*, at *23-24.

(n185)Footnote 185. Reg NMS Reproposing Release, *supra*, at *24.

(n186)Footnote 186. Reg NMS Reproposing Release, *supra*, at *88-95.

(n187)Footnote 187. Regulation NMS Adopting Release, *supra*, at *60, *65 n.60.

(n188)Footnote 188. Regulation NMS Adopting Release, *supra*, at *61-66.

(n189)Footnote 189. See Regulation NMS Adopting Release, *supra*, at *74-94.

(n190)Footnote 190. Rule 611(a)(1), 17 C.F.R. § 242.611(a)(1).

(n191)Footnote 191. Rule 600(b)(57) and (58), 17 C.F.R. § 242.600(b)(57) and (58).

(n192)Footnote 192. Rule 611, 17 C.F.R. § 242.611.

(n193)Footnote 193. In the adopting release for Regulation NMS, the Commission stated that a market's "repeatedly failing to respond within one second after receipt of an order would constitute a material delay." Regulation NMS Adopting Release, *supra*, at *155 n.173.

(n194)Footnote 194. The exception for single-priced orders was created because of the practical difficulties in applying a trade-through rule to multiple orders executed at a single price, as occurs at opening, reopening and closing auctions. See Regulation NMS Proposing Release, *supra*, at * 106-07.

(n195)Footnote 195. The Trade-Through Rule requires that the market or broker-dealer responsible for the routing of an intermarket sweep order take reasonable steps to ensure that the order meets the definition of intermarket sweep order in Rule 600(b)(30). Rule 611(c), 17 C.F.R. § 242.611(c).

(n196)Footnote 196. The stopped order exception requires that the order be for the account of a customer, that the customer agree to the specified price on an order-by-order basis, and that the price at which the transaction is executed is superior to the national best bid or offer at the time of execution.

(n197)Footnote 197. Rule 611(a)(1), 17 C.F.R. § 242.611(a)(1).

(n198)Footnote 198. Rule 611(d), 17 C.F.R. § 242.611(d).

(n199)Footnote 199. In the securities markets it is critical for those who trade to have access to accurate, up-to-the second information as to the prices at which transactions in particular securities are taking place (*i.e.*, last sale reports) and the prices at which other traders have expressed their willingness to buy or sell (*i.e.*, quotations). For this reason, communications systems designed to provide automated dissemination of last sale and quotation information with respect to securities will form the heart of the national market system. Senate Report, § 2.01 *supra*, at p. 9.

(n200)Footnote 200. Section 11A(a)(C)(iii). The goals and objectives of a national market system are discussed in § 2.04[1][b] *supra*.

(n201)Footnote 201. Section 11A(c)(1), discussed in § 2.04[3][b][i] *infra*.

(n202)Footnote 202. National Market System Release, *supra*.

(n203)Footnote 203. Sec. Exch. Act Rel. No. 14415, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P81,501 (Jan. 26, 1978) (hereinafter cited as "Quote Rule Adopting Release"). The Commission views Rule 11Ac1-1 [now Rule 602] as an integral step in accomplishing the statutory goal, set forth in Section 11A(a)(1)(D), of linking all markets to:

- (1) foster efficiency,
- (2) enhance competition, and
- (3) contribute to best execution of customers' orders.

Id. Market linkage systems are discussed in § 2.04[2][b] *supra*. Best execution is discussed in § 2.04[2][c][v] *infra*.

(n204)Footnote 204. Quote Rule Adopting Release, *supra*.

(n205)Footnote 205. Rule 11Ac1-1 [now Rule 602] originally was to become effective on May 1, 1978. The Commission, however, postponed the effective date for three months to permit the self-regulatory organizations subject to the Quote Rule to plan for its joint implementation, *see* § 2.04 [2][c][ii] *infra*, by making available to vendors quotations in eligible securities from each participating self-regulatory organization through a single data stream. Sec. Exch. Act Rel. No. 14711, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P81,576 (Apr. 27, 1978).

(n206)Footnote 206. Rule 11Ac1-1 [now Rule 602] did not apply to quotations in listed options until 2000. *See* Sec. Exch. Act Rel. No. 43591 (Nov. 17, 2000).

(n207)Footnote 207. The consolidated transaction reporting system is discussed in § 2.04[2][d] *infra*.

(n208)Footnote 208. The rule is also frequently referred to as the "Firm Quote Rule" because one of its Primary Provisions requires broker-dealers to honor quotations in certain securities, *i.e.* disseminate "firm" quotations.

(n209)Footnote 209. Sec. Exch. Act Rel. Nos. 16589, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,455, (Feb. 19, 1980) (hereinafter cited as "Transaction Reporting Release"); 18482, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,098, (Feb. 11, 1982); 24635, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P84,140 (June 23, 1987); 37619A, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P85,837 (Sept. 6, 1996); 38110 [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P85,875 (Apr. 10, 1997); and 38139, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P85,876 (Jan. 20, 1997).

Rule 11Ac1-1[now Rule 602] evolved from Rule 17a-15, which required every exchange and association to file a plan with the Commission for the collection, processing, and transmission of quotation information on listed securities and securities admitted to unlisted trading privileges. Rule 17a-15 had been adopted in 1972. Sec. Exch. Act Rel. No. 9850, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P79,082 (Jan. 3, 1972).

In March 1973 various SROs filed a plan with the Commission to disseminate market information obtained pursuant to Rule 17a-15 in a consolidated system. *See § 2.04[2][d][i] infra*. The plan was approved in 1974. Sec. Exch. Rel. No. 440787, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) P79,782 (May 10, 1974).

By 1980, the securities industry had witnessed numerous legal, regulatory, and operational changes, which prompted the Commission to adopt a new rule, Rule 11Ac1-1, governing dissemination of quotations. The changes included:

- (1) The enactment of the Securities Acts Amendments of 1975, which mandated the formation of a national market system, subjected securities information processors to regulation (*See § 2.04[2][e] infra*), and gave the Commission express authority to order the development and implementation of an effective market communication system.
- (2) The speed, reliability, and performance capacity of computer and electronic equipment had improved.
- (3) Exchange off-board trading restrictions had been largely rescinded (*See § 2.03[2][c] supra*).
- (4) Nonmembers were allowed access to exchange trading facilities (*See § 2.03[2][b] supra*).
- (5) Various types of market linkage programs had been developed and were undergoing evolution (*See § 2.04[2][b][i] supra*).
- (6) Numerous service companies were competing to supply computerized programs and services to the securities industry.
- (7) The Commission and the securities industry had almost five years of experience in the operation and effect of a consolidated quotation system (*See § 2.04[2][c][iv] infra*).

The 1980 amendments to Rule 11Ac1-1 were accompanied by the amendment and re-designation of Rule 17a-15 as Rule 11Aa3-1 [now Rule 601]. Transaction Reporting Release, *supra*. The amendments to Rule 11Ac1-1 were largely technical in nature.

The 1982 amendments, however, permitted market centers, under some circumstances, to disseminate quotations on a voluntary, rather than mandatory, basis. Sec. Exch. Act Rel. No. 18482, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,098 (Feb. 11, 1982). The Commission concluded that Rule 11Ac1-1 "has not achieved its objective of fostering increased competition for order flow through [mandatory] dissemination of firm quotations by market makers." *Id.* This failure was attributable to:

- (1) continued reliance by regional exchanges on "other methods" to compete with the primary markets, such as reduced clearings and settlement charges,
- (2) routine routing of orders by retail firms to the primary market, and
- (3) a willingness and ability by specialists at the primary market to match superior quotations from

regional exchanges.

Id.

In addition, the Commission identified several problems in the operation of the Quote Rule in the three years since its adoption. These problems primarily arose from the practice of both regional exchange specialists and third market makers of disseminating "nominal, away-from-the-market quotations in many securities." The Commission identified the problems as:

- (1) Unreliable quotations published by secondary market makers, especially third market makers who are not linked to primary markets through the Intermarket Trading System (ITS). Because there is little incentive to maintain up-to-date quotations, some third market makers disseminate quotations with broad spreads or do not update quotes during the trading day. These quotes can "lock" or "cross" the market.
- (2) Some regional exchange specialists attempt to comply with the Quote Rule by releasing nominal away-from-the-market quotations, sometimes generated by computerized systems that are not accurate (*See* Sec. Exch. Act Rel. No. 18482 at n.16, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,098 (Feb. 11, 1982)).
- (3) The volume of quotations from secondary market makers places an unnecessary burden on vendors.

Accordingly, the Commission amended the Quote Rule in two significant respects:

- (1) Mandatory dissemination of quotations was required only where the information is necessary "to assure pricing efficiency or to enable investors to monitor the quality of executions." Sec. Exch. Act Rel. No. 18482, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,098 (Feb. 11, 1982). Therefore, mandatory dissemination was required only from
 - (a) the principal markets, and
 - (b) market makers in Rule 19c-3 securities (*i.e.*, securities eligible for trading off-board (*See* § 2.03[2][c] *supra.*)).

Secondary market makers, even participants in ITS, were no longer required to comply with the Quote Rule.

- (2) Market makers in NM "qualified securities" (*See* § 2.04[2][a] *supra.*) are not required to disseminate quotations pursuant to Rule 11Ac1-1, but may do so voluntarily.

As part of the changes effected by the Order Handling Rules adopted in 1996, an amendment to the Quote Rule expanded the quotation requirements of substantial OTC market makers and exchange specialists to require that they publicly disseminate continuous two sided quotations for any exchange-listed security for which they account for 1 percent or more of the trading volume. Prior to this amendment, mandatory quotations were only required from OTC market makers and exchange specialists who transacted more than 1 percent of the volume in a Rule 19c-3 security. The amended Quote Rule also included electronic communication systems' quotes within the definition of "bid" and "offer." *See* Sec. Exch. Act Rel. 37619A, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,837 (Sep. 6, 1996) (hereinafter cited as "Order Handling Release"). In 2000 the Quote Rule was amended to apply to listed options in addition to stocks. Sec. Exch. Act. Rel. No. 43591 (Nov. 17, 2000). Other technical amendments have also been made, primarily

relating to quotation dissemination standards for Rule 19c-3 securities.

(n210)Footnote 210. "Responsible broker or dealer" is defined in Rule 600(b)(65) [former Rule 11Ac1-1(a)(3)] to mean:

(i) When used with respect to bids or offers communicated on a national securities exchange, any member of such national securities exchange who communicates to another member on such national securities exchange, at the location (or locations) or through the facility or facilities designated by such national securities exchange for trading in an NMS security a bid or offer for such NMS security, as either principal or agent; provided, however, that, in the event two or more members of a national securities exchange have communicated on or through such national securities exchange bids or offers for an NMS security at the same price, each such member shall be considered a responsible broker or dealer for that bid or offer, subject to the rules of priority and precedence then in effect on that national securities exchange; and further provided, that for a bid or offer which is transmitted from one member of a national securities exchange to another member who undertakes to represent such bid or offer on such national securities exchange as agent, only the last member who undertakes to represent such bid or offer as agent shall be considered the responsible broker or dealer for that bid or offer; and

(ii) When used with respect to bids and offers communicated by a member of an association to a broker or dealer or a customer, the member communicating the bid or offer (regardless of whether such bid or offer is for its own account or on behalf of another person).

An "NMS security" is any security for which transactions are reported under a plan approved by the Commission. Rule 600(b)(46) [former Rule 11Ac1-1(a)(20)].

(n211)Footnote 211. The term "vendor" is defined in Rule 600(b)(83) [former Rule 11Ac1-1(a)(19)] to mean:

any securities information processor engaged in the business of disseminating transaction reports, last sale data, or quotations with respect to NMS securities to brokers, dealers, or investors on a real-time or other current and continuing basis, whether through an electronic communications network, moving ticker, or interrogation device.

Securities information processors are discussed in § 2.04[2][e] *supra*.

When the Commission announced the adoption of the Quote Rule, the Commission decided against imposing specific obligations on quotation vendors to display quotations from all market centers, believing that adequate dissemination of quotation information would be achieved without Commission action. Quote Rule Adopting Release, *supra*. However, the Commission expects quotations to "be displayed on a non-discriminatory basis (*i.e.*, from all market centers) and that access to composite quotations will be provided in a manner which will allow recall of these quotations as readily as quotations from a single market." The Commission's 1980 amendment to the Quote Rule, which excludes secondary market makers from the rule, was intended to reduce significantly the volume of multiple quotations on a single issue.

The Commission nevertheless expects vendors to indicate to users when the quotations are not firm due to an unusual market condition. *Id.*

The Commission reconsidered its decision not to impose specific obligations on vendors concerning the display of quotation information. See former Rule 11Ac1-2(c). However, specific display obligations were eliminated with the adoption of Regulation NMS. See Rule 603.

(n212)Footnote 212. "Subject security" is defined in Rule 600(b)(73) [former Rule 11Ac1-1(a)(25)] to mean:

(i) With respect to a national securities exchange: (A) Any exchange-traded security other than a security for which the executed volume of such exchange, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported pursuant to an effective transaction reporting plan or effective national market system plan; and (B) Any other NMS security for which such exchange has in effect an election, pursuant to [Rule 602(a)(5)(i)], to collect, process, and make available to a vendor bids, offers, quotation sizes, and aggregate quotation sizes communicated on such exchange; and

(ii) With respect to a member of a national securities association: (A) Any exchange-traded security for which such member acts in the capacity of an OTC market maker unless the executed volume of such member, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported pursuant to an effective transaction reporting plan or effective national market system plan; and (B) Any other NMS security for which such member acts in the capacity of an OTC market maker and has in effect an election, pursuant to [Rule 602(a)(5)(ii)], to communicate to its association bids, offers, and quotation sizes for the purpose of making such bids, offers, and quotation sizes available to a vendor.

(n213)Footnote 213. Rule 602(a)(1)(i) [former Rule 11Ac1-1(b)(1)(i)]. Exceptions are provided for: (1) Any bid or offer executed immediately after communication and any bid or offer communicated by a responsible broker or dealer other than an exchange market maker which is cancelled or withdrawn if not executed immediately after communication; and (2) Any bid or offer communicated during a period when trading in that security has been suspended or halted, or prior to the commencement of trading in that security on any trading day, on that exchange. *Id.*

(n214)Footnote 214. "OTC Market Maker" is defined in Rule 600(b)(52) [former Rule 11Ac1-1(b)(1)] to mean: "Any dealer that holds itself out as being willing to buy from and sell to its customers, or others, in the United States, an NMS Stock for its own account on a regular or continuous basis otherwise than on an exchange in amounts of less than block size."

(n215)Footnote 215. Rule 602(a)(1)(ii) [former Rule 11Ac1-1(b)(1)(ii)]. Any bid or offer executed immediately after communication is excluded from Rule 602(a)(1)(ii). An association is not required to make available any quotation information concerning a subject security during any period when over the counter trading in that security has been suspended. *Id.*

(n216)Footnote 216. The term "published bid" or "published offer" means "the bid or offer of a responsible broker or dealer for an NMS security communicated by it to its national securities exchange or association pursuant to [Rule 602] and displayed by a vendor on a terminal or other display device at the time an order is presented for execution to such responsible broker or dealer." Rule 600(b)(60) [former Rule 11Ac1-1(a)(16)].

(n217)Footnote 217. Rule 602(a)(1)(i) is discussed below.

(n218)Footnote 218. Rule 602(a)(2) [former Rule 11Ac1-1(b)(2)].

(n219)Footnote 219. Rule 602(a)(1)(i) is discussed below.

(n220)Footnote 220. The term "specified persons," when used in connection with the notification required to be provided pursuant to Rule 602(a)(3)(i) [former Rule 11Ac1-1(b)(3)(i)], shall mean:

(i) each vendor;

(ii) every plan processor; and

(iii) the processor for the Options Price Reporting Authority (in the case of a notification with respect to a subject security which is a class of securities underlying options admitted to trading on any national securities exchange).

Rule 600(b)(69) [former Rule 11Ac1-1(a)(24)].

To expedite the notification process, the Commission omitted any requirement that the Commission itself must be notified under Rule 602(a)(3)(i) [former Rule 11Ac1-1(b)(3)]. See Quote Rule Adopting Release, *supra*.

(n221)Footnote 221. Rule 602(a)(3)(i) [former Rule 11Ac1-1(b)(3)(i)].

(n222)Footnote 222. Rule 602(a)(3)(i). The requirement that exchange procedures utilized in making a determination that unusual market conditions exist be filed with the Commission under Section 19(b), which contains procedures for Commission approval of rule changes by self-regulatory organizations and is discussed in § 2.03[1][a] *supra*, is "to assure some uniformity between the various exchanges and to assure that the factors to be considered in reaching these determinations are consistent with the Commission's intention in providing the exception." Quote Rule Adopting Release, *supra*.

(n223)Footnote 223. Rule 602(a)(3)(i) [former Rule 11Ac1-1(b)(3)(i)]. The exchange must continue, to the maximum extent practicable, to collect, process, and make available to quotation vendors data for that security in accordance with Rule 602(a)(1) [former Rule 11Ac1-1(b)(1)]. *Id*.

During the period that the notification pursuant to paragraph (a)(3)(i) of Rule 602 [paragraph (b)(3)(i) of former Rule 11Ac1-1] is in effect, the exchange that gave such notification must monitor the activity or conditions forming the basis for the notification. Rule 602(a)(3)(i) [former Rule 11Ac1-1(b)(3)(ii)]. When the exchange is once again able to fulfill its obligations under paragraph (a)(1) of Rule 602 [paragraph (b)(1) of former Rule 11Ac1-1] with respect to the security that is the subject of the notification, the exchange must then immediately so renotify all specified persons. Such renotification reinstates the obligations imposed upon the exchange or responsible broker or dealer that had been suspended as a result of the prior notification. *Id*.

(n224)Footnote 224. Rule 602(a)(4) [former Rule 11Ac1-1(b)(4)].

(n225)Footnote 225. Rule 602(a)(5) [former Rule 11Ac1-1(b)(5)(i)]. This election was added in 1980. The notification is effective at the opening of trading on the business day following the notification. Rule 602(a)(5)(ii) [former Rule 11Ac1-1(b)(4)(ii)].

The election is no longer effective at such times as the market no longer transmits quotation information for a security. Rule 602(a)(5)(iii) [former Rule 11Ac1-1(b)(5)(iii)].

The Commission is aware that some persons required to provide quotations for dissemination pursuant to the Rule may be tempted to avoid the Rule's requirements by disseminating bid and asked prices which are a minimal increment "away" from, for example, the best published bid or offer, or from the published bid or published offer of the "primary" market, while quoting a more competitive market orally in response to inquiry. In this regard, it should be understood that the definitions of the terms "bid" and "offer" in the Rule require that the actual bid and asked prices at which a responsible broker or dealer is willing to effect transactions in reported securities from time to time be communicated to its exchange or association. The Commission believes that if a market maker continuously communicates quotations

which do not reflect its actual market, that activity would constitute a violation of Rule 11Ac1-1 [now Rule 602] and the issuance of fictitious quotations within the meaning of Section 15(c)(2) of the Act.

Quote Rule Adopting Release, *supra*.

Notwithstanding the Commission's concern, the occurrence of these practices prompted the Commission to amend Rule 11Ac1-1 in 1980.

(n226)Footnote 226. Rule 602(b)(2) [former Rule 11Ac1-1(c)(2)].

(n227)Footnote 227. The bid price or offer price is exclusive of any commission, commission equivalent, or differential customarily charged by such responsible broker or dealer in connection with execution of any such order pursuant to the broker's or dealer's obligation under Rule 602(b)(2) [former Rule 11Ac1-1(c)(2)]. Rule 602(b)(2).

(n228)Footnote 228. *Id.* The Commission declined to provide an exception from the firmness obligations of brokers and dealers under Rule 11Ac1-1(c)(2) [now Rule 602(b)(2)] for responsible brokers or dealers who communicate erroneous quotations:

"The Commission believes that responsible brokers and dealers should be held accountable for their own errors in order (i) to create incentive on the part of responsible brokers and dealers to accurately communicate their quotations and (ii) to avoid "backing away" by responsible brokers and dealers under the guise of erroneous quotations."

Quote Rule Adopting Release, *supra*.

The firmness provisions of Rule 11Ac1-1(c)(2) [now Rule 602(b)(2)], which require a responsible broker or dealer to deal directly with any person belonging to a category of persons with which such broker or dealer customarily deals, are not intended to supersede or contravene rules governing suitability and diligence as to customer accounts. *Id.* For example, see NYSE Rule 405, "Diligence as to Accounts," NYSE Guide (CCH) P 2405 (2003).

(n229)Footnote 229. Rule 11Ac1-1(c)(2) under the Securities Exchange Act of 1934 reprinted in the Securities Primary Law Sourcebook, Volume B, Section G. "[T]he Commission notes that the phrase "customarily deals" connotes, among other things, that a responsible broker or dealer should not engage in a transaction with a customer when the broker's fiduciary responsibility, including principles of suitability and other obligations imposed on such brokers by law, would otherwise prohibit such a transaction." Quote Rule Adopting Release, *supra*.

(n230)Footnote 230. Quote Rule Adopting Release, *supra*.

(n231)Footnote 231. Quote Rule Adopting Release, *supra*. The exception to the firmness provisions in Rule 11Ac1-1(c)(2) [now Rule 602(b)(2)] for revised quotations prevents a responsible broker or dealer from being required to execute more than one order on the basis of his published bid or published offer. Quote Rule Adopting Release, *supra*.

(n232)Footnote 232. See Rule 602(a)(4) [former Rule 11Ac1-1(b)(4)].

(n233)Footnote 233. Rule 602(b)(3)(i)(B) [former Rule 11Ac1-1(c)(3)(i)(B)].

(n234)Footnote 234. Rule 602(b)(3)(ii) [former 11Ac1-1(c)(3)(ii)]. The exception to the firmness provisions in Rule 602(b)(2) [former Rule 11Ac1-1(c)(2)] for revised quotations prevents a responsible broker or dealer from being required to execute more than one order on the basis of his published bid or published offer. Quote Rule Adopting

Release, *supra*.

(n235)Footnote 235. See Rule 602(a)(4) [former Rule 11Ac1-1(b)(4)].

(n236)Footnote 236. Rule 602(b)(4)(i) [former Rule 11Ac1-1(c)(4)(i)].

(n237)Footnote 237. Rule 602(b)(4)(ii) [former Rule 11Ac1-1(c)(4)(ii)].

(n238)Footnote 238. Rule 602(c) [former Rule 11Ac1-1(d)]. The exemptive provisions of the Quote Rule are designed to exempt market centers not accounting for any significant trading in a subject security or market centers that would suffer economic burdens not justified by the purposes of the Exchange Act, and to deal with other market structure developments (such as the Regional Market System (now the National Securities Trading System)), *see* § 2.04[2][b][i][B] *supra*, should such system eventually reflect all buying and selling interest in those securities traded in the system at all participating exchanges). Quote Rule Adopting Release, *supra*.

The Commission granted several exemptions from the requirements of the Quote Rule after consideration of the aggregate dollar and share trading volume in the reported securities and the cost burdens to the exchange in proportion to the benefits that would be obtained as a consequence of compliance with the Quote Rule. The Commission exempted the National Stock Exchange (only those reported securities traded on the National Stock Exchange other than through the Multiple Dealer Trading System (now the National Securities Trading System)), *See* Sec. Exch. Act Rel. No. 15010 (1978); the Spokane Stock Exchange, *See* Sec. Exch. Act Rel. No. 15011 (1978); the Intermountain Stock Exchange, *See* Sec. Exch. Act Rel. No. 15012 (1978); and the Philadelphia Stock Exchange (only from those provisions of the Quote Rule requiring that bids and offers made available to quotation vendors be accompanied by their associated size), *See* Sec. Exch. Act Rel. No. 15013 (1978).

(n239)Footnote 239. Regulation NMS Adopting Release, *supra*, at *283-84.

(n240)Footnote 240. Regulation NMS Adopting Release, *supra*, at *284.

(n241)Footnote 241. Regulation NMS Adopting Release, *supra*, at *284-85.

(n242)Footnote 242. Regulation NMS Adopting Release, *supra*, at *284-85.

(n243)Footnote 243. Regulation NMS Adopting Release, *supra*, at *285.

(n244)Footnote 244. Rule 610(a), 17 C.F.R. § 242.610(a).

(n245)Footnote 245. Rule 610(b)(1) refers to an "SRO display-only facility," but the only facility meeting this definition is the ADF. Rule 610(b)(1), 17 C.F.R. § 242.610(b)(1); Regulation NMS Adopting Release, *supra*, at *352.

(n246)Footnote 246. Rule 610(b)(1), 17 C.F.R. § 242.610(b)(1).

(n247)Footnote 247. Rule 610(b)(2), 17 C.F.R. § 242.610(b)(2).

(n248)Footnote 248. Rule 610(c), 17 C.F.R. § 242.610(c).

(n249)Footnote 249. Rule 610(c), 17 C.F.R. § 242.610(c).

(n250)Footnote 250. Regulation NMS Proposing Release, *supra*, at *110 n.88.

(n251)Footnote 251. Regulation NMS Proposing Release, *supra*, at *106 n.86.

(n252)Footnote 252. Regulation NMS Proposing Release, *supra*, at *219-220.

(n253)Footnote 253. See Regulation NMS Proposing Release, *supra*, at *220-21.

(n254)Footnote 254. Rule 610(d), 17 C.F.R. § 242.610(d).

(n255)Footnote 255. Rule 610(d), 17 C.F.R. § 242.610(d).

(n256)Footnote 256. See Nina Mehta, *The Problems of Decimal Pricing: The Minimum Tick Size is Spreading Pain*, Traders Magazine, August 1, 2003.

(n257)Footnote 257. Mehta, *supra*.

(n258)Footnote 258. See Regulation NMS Adopting Release, *supra*.

(n259)Footnote 259. Rule 612(a), 17 C.F.R. § 242.612(a).

(n260)Footnote 260. Rule 612(b), 17 C.F.R. § 242.612(b). The purpose of establishing a lower minimum pricing increment for quotations of less than \$ 1.00 per share is that one cent represents a larger percentage of the price of these securities. See Regulation NMS Adopting Release, *supra*, at *393-94.

(n261)Footnote 261. See Regulation NMS Adopting Release, *supra*, at *400-03.

(n262)Footnote 262. SEC, Policy Statement on the Future Structure of the Securities Markets (Feb. 2, 1972).

(n263)Footnote 263. Sec. Exch. Act Rel. No. 9529, [1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P78,599 (Mar. 8, 1972).

(n264)Footnote 264. Sec. Exch. Act Rel. No. 10969, [1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) P79,931 (Aug. 14, 1974). The Commission's proposal would provide the exchanges and NASD with the option to develop such a plan. Only if an exchange or the NASD did not file a plan could other persons submit quotation plans.

(n265)Footnote 265. Sec. Exch. Act Rel. No. 11288, [1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P80,129 (Mar. 5, 1975).

The Commission also stated that it [had] determined that quotation information, such as that currently provided by some exchanges to their members, is essential to broker-dealers, whether members or not, in discharging their duty of reasonable diligence in the execution of customers' orders. A broker-dealer that is prohibited from access to that information is severely disadvantaged thereby. In addition, quotation information is of significant value to the market place as a whole insofar as a quotation reflects the considered judgment of a market professional as to various factors affecting the market, including the current price levels and size of buying and selling interest. Thus, restrictions on dissemination of that information detract from the efficiency of the market place in reflecting all available fundamental and market information respecting an issuer's securities. Finally, quotation information is of considerable value to investors, both individual and institutional, in determining the best market for execution and in understanding the market forces at work at any given time.

Id.

(n266)Footnote 266. Sec. Exch. Act Rel. No. 12670, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P80,658 (July 29, 1976). The Quote Rule is discussed in § 2.04[2][c][i] *supra*.

(n267)Footnote 267. Quote Rule Adopting Release, *supra*.

(n268)Footnote 268. The consolidated transaction reporting system is discussed in § 2.04[2][d] *infra*.

(n269)Footnote 269. Sec. Exch. Act Rel. No. 15009 (July 28, 1978) (hereinafter cited as "CQ Plan Initial Approval Order"). The plan was entitled "Plan for the Purpose of Implementing Rule 11Ac1-1 under the Securities Exchange Act of 1934."

(n270)Footnote 270. See CQ Plan Initial Approval Order, *supra*. On January 24, 1979 the Commission announced the extension of authorization of the CQ Plan for a period of twelve months, subject to the participants' not implementing the regulatory halt provision. Sec. Exch. Act Rel. No. 15511 (Jan. 24, 1979) (hereinafter cited as "CQ Plan Extension Order").

(n271)Footnote 271. The CQ Plan contains a regulatory halt provision: all participants must cease communicating quotation information in a security to the CQ Plan processor during a regulatory halt in that security called by the "primary market" for that security. The practical effect of the halt provision would be to require every participant to halt trading during the pendency of any regulatory halt initiated by the "primary" market. CQ Plan Extension Order, *supra*.

In announcing the continuation of temporary authorization of the CQ Plan, the Commission requested the participants to eliminate the regulatory halt provisions from the CQ Plan. *Id*. The Commission believed that the regulatory halt provision may have anticompetitive effects on both the regional exchanges and the third market and that the provision would, in effect, delegate to the "primary" market for a particular security the power to halt all trading in that security in a manner possibly "contrary to the scheme of self-regulation created by the [Exchange] Act." *Id*.

(n272)Footnote 272. The original participants in the CQ Plan were the New York, American, Boston, Pacific, Philadelphia and Midwest Exchanges, and the National Association of Securities Dealers, Inc. CQ Plan Extension order, *supra*, at n.3. The current participants in the CQ Plan are the original participants plus the Chicago Board Options Exchange and the National Stock Exchange.

(n273)Footnote 273. The Securities Industry Automation Corporation ("SIAC") sequences and transmits the quotation information collected by the participants in the CQ Plan by means of a consolidated high speed data transmission line to vendors and subscribers.

(n274)Footnote 274. CQ Plan Extension Order, *supra*.

(n275)Footnote 275. CQ Plan Extension Order, *supra*. The fee schedule in the CQ Plan creates a permanent two-tier structure for quotation information: Network A reports transactions in NYSE-listed securities that occur on any participating exchange, in the "third market," or through the Institutional Networks Corporation; Network B reports transactions in AMEX and certain regional exchange listed securities.

Transaction and quotation information for Nasdaq securities traded on Nasdaq before Nasdaq's registration as a national securities exchange, was disseminated pursuant to a plan filed by the NASD. See § 2.04[2][d][iii] *infra*. See Sec. Exch. Act Rel. No. 43863 (Jan. 19, 2001). The Nasdaq securities covered by the CQ Plan are only those securities traded on Nasdaq. A separate plan governed the collection and dissemination of transaction and quotation information for Nasdaq securities listed on an exchange or traded on an exchange through the granting of unlisted trading privileges. See Sec. Exch. Rel. No. 44937 (Oct. 15, 2001). This plan is known as the "Reporting Plan for Nasdaq-Listed Securities Traded on Exchanges on an Unlisted Trading Privileges Basis." See Sec. Exch. Rel. No. 48882 (Dec. 4, 2003); § 2.04[2][d][iii] *infra*.

(n276)Footnote 276. This interface is discussed in § 2.04[2][b][ii] *supra*.

(n277)Footnote 277. Sec. Exch. Act Rel. No. 18982 (1982).

(n278)Footnote 278. Sec. Exch. Act Rel. No. 19363 (1982).

(n279)Footnote 279. *Id.* at n.4. For a discussion of the operation of the CQ Plan as it relates to the Intermarket Trading System, see § 2.04[2][b][i][A] *supra*.

(n280)Footnote 280. Section 11A(a)(1)(C)(iv). Furthermore, one of the purposes cited for the linking of all markets for qualified securities through communication and data processing facilities is to contribute to the best execution of investors' orders. Section 11A (a)(1)(D). The goals and objectives of a national market system are discussed in § 2.04[1][b] *supra*. See Harman, *The Evolution of The National Market System--An Overview*, 33 *Bus. Law.* 2275, 2296, 2297 (1978).

(n281)Footnote 281. "Because the Commission believes that a broker's existing fiduciary duty to his customer requires that he take cognizance of quotation information available through a composite quotation system in seeking best execution of his customer's order, it is not clear at this time that a more definitive Commission rule prescribing best execution standards is necessary to ensure adherence to appropriate principles of agency conduct by brokers." Quote Rule Adopting Release, *supra*.

(n282)Footnote 282. National Market System Release, *supra*.

(n283)Footnote 283. National Market System Release, *supra*.

(n284)Footnote 284. See, e.g., Sec. Exch. Act Rel. No. 16590, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,456 (Feb. 19, 1980) (hereinafter cited as "Display of Market Data Adopting Release").

(n285)Footnote 285. Display of Market Data Adopting Release, *supra*.

The Commission's determination to defer consideration of a 'best execution' rule, given the current posture of the evolution of a national market system, is not intended to be an indication that the quality of individual markets (as reflected by transaction and quotation information disseminated from each market) should not be regarded as an important factor in determining to which market an order should be sent. In the release announcing the adoption of Rule 11Ac1-1 [now Rule 602], the Commission indicated that it expected that the rule would improve the quality of quotation information available from all market centers and that brokers would utilize that information in making informed order routing decisions Furthermore, the Commission has also indicated that it expects that those broker-dealers that automatically route retail customer orders in a particular security to a predesignated market, at a minimum, make periodic assessments as to the quality of such market ... The Commission continues to believe that awareness of nationwide market information by brokers, dealers and investors is essential to improving the quality of order execution.

Furthermore, the Commission believes that broker-dealers who choose to automatically route their customer orders to a designated market should be alert for unusual market conditions in the designated market which would require brokers to take additional measures (such as disclosure of market conditions or special handling of customer orders). Examples of such unusual market conditions would include substantial price disparity between the designated market and other markets, extreme volatility of the market in the security and unusual trading patterns. In addition, the Commission notes that a broker's fiduciary responsibility to obtain the best execution of a customer's order under the circumstances may continue beyond the initial routing decision. In this regard, the Commission has proposed Rule 11Ac1-3 [now Rule 607] which would provide for nationwide protection of certain displayed public limit orders. See *Sec. Act Rel. No. 15770* (Apr. 26, 1979), 44 *FR* 26692 .

Id.

(n286)Footnote 286. See, e.g., American Stock Exchange 156(a), 2 Amex Guide (CCH) P9296, and New York

Stock Exchange Rule 123A.41, NYSE Guide (CCH) P2123A, which require members to exercise diligence to execute market orders at the best price available.

(n287)Footnote 287. Order Handling Release, *supra*.

(n288)Footnote 288. Order Handling Release, *supra* at 164.

(n289)Footnote 289. Order Handling Release, *supra* at 163.

(n290)Footnote 290. Order Handling Release, *supra* at 164. For a further discussion of a dealer's duty of best execution, see *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* (3rd Cir. 1998).

(n291)Footnote 291. See NASD Notice to Members 97-57 (September 1997).

(n292)Footnote 292. That rule-making power is contained in Section 11A(c)(1)(A) and (B). See Senate Report, *supra*, at pp. 103, 104.

(n293)Footnote 293. The adoption of Rule 17a-15 was announced in Sec. Exch. Act Rel. No. 9850, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P79,082 (Nov. 8, 1972).

(n294)Footnote 294. See Transaction Reporting Proposing Release, *supra*, and Sec. Exch. Act Rel. No. 16589 (Feb. 19, 1980).

The Commission also adopted a new Rule 11Ac1-2 [now eliminated in favor of Rule 603] to govern the display of last sale reports now covered by Rule 11Aa3-1 [now Rule 601], see Sec. Exch. Act Rel. No. 15250 [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P81,749 (Oct. 20, 1978) (hereinafter cited as "Transaction Reporting Proposing Release") and Transaction Reporting Release, *supra*. Sec. Exch. Act Rel. No. 15251, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,750, (Oct. 20, 1978) (hereinafter cited as "Display of Market Information Proposing Release") and Display of Information Release, *supra*. The rules are discussed in §§ 2.04[2][d][i] and 2.04[2][d][ii] *infra*.

Among other things, the 1975 Amendments

(1) consolidated and explicitly stated the Commission's power to regulate the dissemination and use of last sale (*i.e.*, the price and volume at which a completed transaction involving the purchase or sale of a security took place) and quotation information,

(2) granted the Commission plenary authority to regulate the manner in which vendors display transaction reports, and

(3) permitted the Commission to designate any security, not just securities registered or admitted to unlisted trading privileges on an exchange, as qualified for trading in the national market system.

Transaction Reporting Proposing Release, *supra*.

(n295)Footnote 295. See Regulation NMS Adopting Release, *supra*, at *491.

(n296)Footnote 296. See Sec. Exch. Act Rel. No. 9850 [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P79,082 (Nov. 8, 1972).

(n297)Footnote 297. Rule 17a-15 [now Rule 601]. Every broker or dealer not an exchange or association member who effects transactions in listed securities not reported pursuant to Rule 17a-15 by any exchange or association had to

file a plan meeting the requirements of Rule 17a-15(a). Former Rule 17a-15(e).

(n298)Footnote 298. Rule 17a-15 [now Rule 601]. Five national securities exchanges and the National Association of Securities Dealers, Inc. filed a Joint Industry Plan under Rule 17a-15, *see* § 2.04[2][d][iii] *infra*, to put into effect a consolidated tape system.

(n299)Footnote 299. Rule 17a-15 [now Rule 601].

(n300)Footnote 300. Rule 17a-15(b) [now Rule 601].

(n301)Footnote 301. Any public display of selected last sale reports, *i.e.*, reports of prices and volumes of all completed transactions, had to be clearly identified as only reporting selected transactions according to size, category of security, or other criteria. *Id.*

(n302)Footnote 302. Rule 17a-15 [now Rule 601].

(n303)Footnote 303. The five securities exchanges were the American, Midwest [now Chicago], New York, Philadelphia, and Pacific [now NYSE Arca] Stock Exchanges. *See* Sec. Exch. Act Rel. No. 10026, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P79,255 (Mar. 5, 1973).

(n304)Footnote 304. Sec. Exch. Act Rel. No. 10026 (1973), *supra*.

(n305)Footnote 305. Sec. Exch. Act Rel. No. 10787, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) P79,782 (May 10, 1974). The proposed plan was revised several times in response to Commission staff comments. *See* Sec. Exch. Act Rel. Nos. 10073, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P79,307 (Mar. 29, 1973), 10218, [1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) P79,397, (June 13, 1973), and 10671, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) P79,700 (Mar. 8, 1974).

(n306)Footnote 306. For a discussion of this plan, *see* § 2.04[2][d][iii] *infra*.

(n307)Footnote 307. *See* National Market System Release, *supra*.

Of particular concern to the Commission is the manner in which vendors currently provide for the recall of last sale data on information retrieval display devices. These vendors now permit information from the primary market by input of the letter (or combination of letters) used to identify the particular security involved in the consolidated system (the 'consolidated system symbol') followed by depression of an information request key. In most cases, entry of additional letters or symbols (plus depression of the information request key) is required in order to recall consolidated last sale information or last sale data from any particular market other than the primary market.

To date, this practice has been permitted under a Commission interpretation of Rule 17a-15 [now Rule 601] issued in March 1975. In that release the Commission stated:

Vendors may use the consolidated tape ticker symbol (the old NYSE symbol in the case of an NYSE listed security) to interrogate for last sale information from the NYSE and some other symbol to interrogate for consolidated data. However, any symbol which differs from the consolidated tape symbol which is used to interrogate for consolidated data must be simple and easy for brokers and dealers to use.

The Commission has reconsidered that interpretative statement in light of its experience with the consolidated system and no longer believes that vendors should be permitted to program their information retrieval devices for the recall of consolidated data by use of any combination of letters or symbols other than the consolidated system symbol. Current practice, with each vendor using a different

combination for the recall of consolidated data (generally a more complicated routine than that used for the retrieval of data from the primary market), discourages use of consolidated information, has anticompetitive consequences for markets as to which last sale data may be recalled only by relatively more difficult and time consuming interrogation routines, and impedes progress toward a national market system. Consequently, the Commission believes vendors should modify their systems promptly to confine use of consolidated system symbols in their interrogation and display devices to the recall of consolidated last sale data.

This problem was apparently remedied by the adoption of Rule 11Ac1-2 [now eliminated in favor of Rule 603], which prescribes the format for retrieval of last sale and quotation information. See § 2.04[2][d][ii] *infra*.

(n308)Footnote 308. "Retransmission" refers to the communications process by which the entire data stream of transaction reports disseminated through the consolidated [transaction reporting] system would be received by a vendor and retransmitted to its subscribers as a moving ticker display." Transaction Reporting Proposing Release, *supra*.

(n309)Footnote 309. National Market System Release, *supra*.

(n310)Footnote 310. Transaction Reporting Proposing Release, *supra*. Any plans previously filed and declared effective under Rule 17a-15 [now Rule 601], any amendments to such plans, and any Commission action concerning such plans or amendments thereto, would remain in effect without further action by the Commission under proposed Rule 11Aa3-1. Any provisions of any plan filed under Rule 17a-15, see § 2.04[2][d][iii] *infra*, that prohibit the retransmission of data for purposes of creating a moving ticker display, however, would be modified by paragraph (e) of proposed Rule 11Aa3-1. *Id.* at n.16.

(n311)Footnote 311. The Commission decided, in conjunction with its consideration of ways to improve the operation of the consolidated transaction reporting system, to propose its amendments to Rule 17a-15 under Section 11A and to renumber the Rule under Section 11A, because the 1975 Amendments now place explicit Commission authority to regulate the consolidated transaction reporting system in that Section of the Exchange Act. Transaction Reporting Proposing Release, *supra*.

(n312)Footnote 312. Transaction Reporting Proposing Release, *supra*.

(n313)Footnote 313. Transaction Reporting Proposing Release, *supra*; order Handling Release, *supra*.

(n314)Footnote 314. In addition, the Commission revised former Rule 17a-15 in the following respects:

- (1) to permit exchanges and associations to impose a "subscriber charge condition" that would permit the CTA to assure that CTA collects the charges it levies for dissemination of transaction information on moving tickers;
- (2) to delete the provisions of former Rule 17a-15(f) that permitted any exchange or association to require a vendor to make information it distributes available to all qualified subscribers throughout the continental United States at a uniform price;
- (3) to clarify under what conditions an amendment to the plan may be submitted to the Commission; and
- (4) to add additional definitions.

Id.

The Commission had considered, but did not adopt, an amendment that would permit an exchange or association to require that vendors ensure that all subscribers reserve transaction information at substantially the same display rate as subscribers to the ticker networks, the "synchronization condition." *Id.*

Similarly, the Commission determined not to impose accuracy and reliability standards on vendors. *Id.*

(n315)Footnote 315. "Transaction reporting plan" is defined in Rule 600(b)(82) [former Rule 11Aa3-1(a)(2)] to mean "any plan for collecting, processing, making available or disseminating transaction reports with respect to transactions in reported securities filed with the Commission pursuant to, and meeting the requirements of, this [Rule 601]."

(n316)Footnote 316. Under Rule 601(a)(2) [former Rule 11Aa3-1(b)(2)], all amendments to transaction reporting plans must be considered in accordance with the procedures outlined in Rule 608. Under Rule 608 [former 11Aa3-2], any two or more self-regulatory organizations, acting jointly, or the Commission can propose an amendment to a transaction reporting plan by filing the proposed amendment with the Commission, together with a statement of the purpose of the amendment and the proposed means of implementation and operation. The Commission then must publish a notice of the filing and afford interested parties the opportunity to offer written comments. Within 120 days of the publication of the notice of filing, or 180 days if the Commission finds that additional time for review is necessary, the Commission will approve the amendment if it finds the proposed changes are in the public interest, for the protection of investors, helpful in implementing a national market system, or in furtherance of the purposes of the Exchange Act. A proposed amendment may be declared temporarily effective for up to 120 days if doing so is deemed to be in the public interest. Certain minor amendments may be implemented upon filing the amendment with the Commission under Rule 11Aa3-2(c)(3).

(n317)Footnote 317. Rule 11Aa3-1(a)(11) defines the term "vendor" as any securities information processor engaged in the business of disseminating transaction reports or last sale data with respect to transactions in reported securities to brokers, dealers, or investors on a real-time or other current and continuing basis, whether through an electronic communications network, moving ticker or interrogation device. Securities information processors were brought under the direct jurisdiction of the Commission in 1975 with the enactment of Section 11A(b) of the Exchange Act, discussed in § 2.04[2][e] *infra*.

(n318)Footnote 318. Rule 17a-15 contained no provisions concerning retransmission. The CTA Plan (discussed in § 2.04[2][d][iii] *infra*) filed with the Commission pursuant to Rule 17a-15, however, does prohibit retransmission "except as may be incidental to the operation of approved interrogation devices or display devices." Transaction Reporting Proposing Release, *supra*. Rule 11Aa3-1(d) rendered the retransmission provisions of the Joint Industry Plan inoperative. *Id.* n. 75.

The Securities Acts Amendments of 1975, particularly the provisions of Section 11A(b)(5), *see* § 2.04[2][e][v] *infra*, and 11A(c)(1), *see* § 2.04[3][b][i] *infra*, expressly extended the Commission's authority to assure that market information is made available by exchanges, associations, and persons acting on their behalf, in the manner consistent with the development of a national market system. Transaction Reporting Proposing Release, *supra*. This extension of authority was an important factor in prompting the Commission to re-examine the retransmission prohibition. *Id.* While the statutory scheme in Section 11A contemplates that exclusive processors may exercise exclusive control over collecting and processing certain securities information, the Act further contemplates that exclusive processors would function as neutral suppliers of that information to competing vendors for distribution to subscribers, *see* Senate Report, § 2.01 *supra*, at pp. 11, 12. Therefore, the continued control by an exclusive processor (specifically the Consolidated Tape Association, *see* § 2.04[2][d][iii] *infra*) over its ticker network (specifically the ticker network of the Consolidated Tape Association, *see* § 2.04[2][d][iii] *infra*) may be inconsistent with the balance sought by the Exchange Act between the potential for efficiency derived from centralized data collection and the need for competition in the distribution of securities information. *Id.*

(n319)Footnote 319. Rule 11Ac1-2, entitled "Display of Transaction Reports, Last Sale Data and Quotation Information," was proposed simultaneously with Rule 11Aa3-1. Display of Market Information Proposing Release, *supra*. Rule 11Ac1-2 was also adopted simultaneously with Rule 11Aa3-1. Display of Market Information Adopting Release, *supra*.

(n320)Footnote 320. Display of Market Information Adopting Release, *supra*.

(n321)Footnote 321. Sec. Exch. Act Rel. Nos. 17549, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,826 (Feb. 17, 1981); 17580, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,836, (Feb. 26, 1981); 20409, [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,457, (Nov. 22, 1983); 22413, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,914, (Sept. 16, 1985); and 24635, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P84,140 (June 23, 1987); Order Handling Release, *supra*.

(n322)Footnote 322. NMS Securities Release, *supra*.

(n323)Footnote 323. NMS Securities Release, *supra*.

(n324)Footnote 324. NMS Securities Release, *supra*.

(n325)Footnote 325. NMS Securities Release, *supra*.

(n326)Footnote 326. Rule 601(a)(1) [former Rule 11Aa3-1(b)(1)].

(n327)Footnote 327. Rule 601(a)(2) [former Rule 11Aa3-1(b)(2)]. For more information on Rule 601(a)(2), see § 2.04[2][d][i] *infra*.

(n328)Footnote 328. Rule 608(b)(1) [former Rule 11Aa3-2(c)(1)].

(n329)Footnote 329. Rule 608(c)(1) [former Rule 11Aa3-2(d)(1)].

(n330)Footnote 330. Rule 608(c)(1) [former Rule 11Aa3-2(d)(1)].

(n331)Footnote 331. Rule 608(b)(2) [former Rule 11Aa3-2(c)(2)]. The 120-day period may be extended by the Commission to 180 days if the NASD consents to such extension or if the Commission "finds such longer period to be appropriate and publishes its reasons for so finding" *Id.*

Rule 608(b)(4) [former Rule 11Aa3-2(c)(4)] permits a proposed amendment to be placed into operation on a temporary basis, not to exceed 120 days, if the Commission finds such implementation to be in furtherance of the Exchange Act, for the protection of investors, or in furtherance of the national market system.

Where the NASD acts or fails to act in the designation of a NMS security or revokes or suspends any such designation, the Commission will entertain an appeal on its own motion or upon application by any aggrieved person. The application must be filed within 30 days of the event in question. Rule 608(d)(1) [former Rule 11Aa3-2(e)(1)]. Any appeal or request for review will not operate as a stay of the action in question. *Id.*

The Commission will dismiss the appeal if it finds, after appropriate notice and opportunity for hearing, that

(1) the action is in accordance with "applicable provisions" of a designated plan, and

(2) the "applicable provisions" were applied in a manner consistent with the public interest, protection of investors and the Exchange Act.

Rule 608(d)(3) [former Rule 11Aa3-2(e)(3)]. If the Commission does not make such a finding or if it finds that the action in question imposes a burden on competition not necessary and appropriate in furtherance of the Exchange Act, the Commission shall, by order, set aside the event in question. *Id.*

(n332)Footnote 332. The term "vendor" is defined in Rule 600(b)(83) [former Rule 11Ac1-2(a)(2)] to mean "any securities information processor [discussed in § 2.04[2][e] *supra*] engaged in the business of disseminating transaction reports, last sale data or quotation information with respect to subject securities to brokers, dealers or investors on a real-time or other current or continuing basis, whether through an electronic communications network, moving ticker or interrogation device."

(n333)Footnote 333. Until this time, the Commission has given vendors broad latitude regarding the manner in which they display market information, including transaction and quotation information. The results achieved in this unregulated environment have been mixed; although some progress has been made to assure that market information is made available to brokers, dealers, and investors in a nondiscriminatory manner, the Commission is also aware that some practices have continued or arisen which tend to impede the availability of important market information. Furthermore, the Commission's experience in attempting to rectify certain of these perceived difficulties through informal means has indicated an unwillingness on the part of certain vendors to alter voluntarily the manner in which they currently display market information unless the Commission were to establish mandatory, industry-wide minimum display criteria. For these reasons, the Commission is at this time proposing Rule 11Ac1-2 under the Act.

Display of Market Proposing Release, *supra*. (Footnote omitted.)

Currently, several vendors disseminate transaction and quotation information received through the consolidated transaction reporting and quotation systems without, for the most part, any Commission regulation. The Commission has preferred and still would prefer to let competition forces dictate the manner in which market information is displayed. However, the Commission has determined that it must take regulatory action to rectify deficiencies in the manner in which vendors operate their market information systems.

Display of Market Data Adopting Release, *supra*.

(n334)Footnote 334. Sec. Exch. Act Rel. No. 16990 (1980). On or after April 5, 1980, vendors who provide on an interrogation device transaction reports or quotation information with respect to a particular reported security from an individual market center would also have to provide on that same device consolidated transaction reports or last sale data that must include, at a minimum, the consolidated price and value or cumulative consolidated value for such security and an identifier indicating the reporting market center associated with the consolidated price and volume. Rule 11Ac1-2(b)(2)(i) [now eliminated in favor of Rule 603].

(n335)Footnote 335. "Transaction report" is defined in Rule 600(b)(80) [former Rule 11Aa3-1(a)(1)] as "a report containing the price and volume associated with a transaction involving the purchase or sale of one or more round lots of a security ("transaction")." This definition applied to Rule 11Ac1-2. Former Rule 11Ac1-2(a)(1). With Regulation NMS all definitions relating to NMS Securities have been consolidated.

(n336)Footnote 336. The term "moving ticker" means any "continuing real-time moving display of transaction reports or last sale data (other than a market minder) provided on an interrogation or other display device." Rule 600(b)(40)(i) [formerly in Rule 11Ac3-1(a)(9) and incorporated by reference into Rule 11Ac1-2(a)(1)].

(n337)Footnote 337. Rule 11Ac1-2(b)(2)(iv).

The Commission has consistently been of the belief that non-discriminatory market identifiers may

be an important tool to investors and in encouraging competition among market centers. For these reasons, the Commission included within Rule 17a-15 [now Rule 601] the requirement that transaction information be accompanied by market identifiers. However, the CTA Plan required that all moving tickers be supplied only from the low speed data streams which provide information to moving tickers at the rate of only 900 characters per minute. Because of the limitations of low speed data transmission, it became obvious that transaction information appearing on moving tickers could not include market identifiers on a non-discriminatory basis without unreasonably delaying the display of transaction information. As a result, the CTA instituted a manner of identifying markets of execution on moving ticker displays which differentiated between transactions executed in the primary markets and in other market centers. Primary market transactions which comprise the majority of reported transactions were not followed by any symbol, while transactions in other market centers were followed by an ampersand and a single alphabetic character identifying the market of execution. By utilizing this method of market identification excessive delays were avoided on moving tickers.

The regional exchanges and third market makers contended that this method of identification discriminated against their markets by differentiating the method of identifying transaction information emanating from their markets as compared to transaction information from primary markets. In the course of discussions among various market centers negotiating with respect to the creation of the ITS, those market centers jointly requested that the Commission permit the deletion of market identifiers from the tape with respect to ITS participants by amending Rule 17a-15 or by granting an exemption from that rule. In 1978, the Commission issued an exemptive order from Rule 17a-15 granting this request, conditioned on the prompt removal, as soon as technically possible, of all market identifiers. The Commission stated in its order that such differentiated transaction reporting was inconsistent with the underlying purpose of a consolidated system.

In adopting Rule 11Aa3-1 [now Rule 601] today, the Commission has created an opportunity to alter the environment in which transaction information is displayed. Specifically, Rule 11Aa3-1 permits the retransmission of transaction information supplied by the high speed data stream via moving tickers. Moving tickers so created might not be subject to excessive reporting delays engendered by non-discriminatory identification of markets. Accordingly, the Commission has adopted the market identifier provision in modified form to reflect this changed environment. Thus, Rule 11Ac1-2 [now eliminated in favor of Rule 603] precludes only the use of market identifiers for some, but not all, market centers and would permit the non-discriminatory use of market identifiers. Because the Commission believes that market identifiers provide useful information it urges vendors who are contemplating retransmitting transaction information to consider the feasibility of including market identifiers for all markets.

The Commission recognizes that market identifiers provide especially valuable information with respect to certain types of transactions, most particularly block trades and the opening transaction on each exchange. Accordingly, Rule 11Ac1-2, as adopted, would also permit the non-discriminatory use of market identifiers on a moving ticker for any definable sub-set of transactions. The Commission believes that tickers fed by either the low or high speed data systems could incorporate market identifiers for at least opening and block transactions without substantial delays and urges both the CTA and any other vendor who constructs a ticket network to provide market identifiers for such transactions.

Consolidated transaction information displayed on interrogation devices currently includes market identifiers on a nondiscriminatory basis (*i.e.*, all markets are identified by a symbol) without incurring delays in reporting because interrogation devices are supplied with transaction information via the high speed data stream. Because market identification may be included on consolidated displays without delay and in a non-discriminatory fashion and on the basis of the unanimous comment that market identifiers remain relevant to investors, the Rule will continue to require inclusion of market identifiers on the

consolidated display.

Display of Market Data Adopting Release, *supra*.

(n338)Footnote 338. If a vendor distributes, publishes, or otherwise provides quotation information to brokers or dealers on a real-time or other current and continuing basis, whether by an interrogation device, electronic communications network, moving ticker, or otherwise, the following conditions apply:

(1) If the information is furnished on an interrogation device, the vendor must also provide a consolidated display of quotation information for each security that, at a minimum, includes either:

(a) the best bid and best offer for the security, and for a reported security, (i) identifiers indicating the reporting market center, and (ii) the quotation size or aggregate quotation size, or

(b) a display on the interrogation device that disseminates simultaneously quotations in that security from all reporting market centers, *i.e.*, a quotation montage.

(2) The method of access must occur through retrieval instructions "involving a number of key strokes which is fewer than the number of strokes required to access any individual market center quotation display," provided that an equal number of key strokes is permissible if the information request or transmit key for the consolidated quotation display is the "most prominent."

(3) Subject to the provisions of paragraph (1) above, a vendor may provide data on an individual market center through an interrogation device or a quotation montage.

(4) A consolidated quotation display or separate quotation montage may not exclude any quotation information because the market center is making such information available, but data from third market makers can be consolidated to derive a best bid and offer for all such market centers if the interrogation device is capable of displaying, either separately or as part of a quotation montage

(a) identifiers indicating the market centers with the best bid and best offer, and

(b) quotation sizes for each quote.

(5) Vendors may not display a representative bid or offer.

Former Rule 11Ac1-2(c)(2)(i) through (vi).

The terms "best bid" and "best offer" were defined in former Rule 11Ac1-2(a)(15) to mean:

(i) with respect to quotations for a reported security, the highest bid or lowest offer for that security made available by any reporting market center pursuant to § 240.11Ac1-1 (Rule 11Ac1-1 under the Act) (excluding any bid or offer made available by an exchange during any period such exchange is relieved of its obligations under paragraphs (b)(1) and (2) of § 240.11Ac1-1 by virtue of subparagraph (b)(3)(i) thereof: provided, however, that in the event two or more reporting market centers make available identical bids or offers for a reported security, the bid or best offer (as the case may be) shall be computed by ranking all such identical bids or offers (as the case may be) first by size (giving the highest

1-2 Federal Securities Exchange Act of 1934 § 2.01

ranking to the bid or offer associated with the largest size), then by time (giving the highest ranking to the bid or offer received first in time); and

(ii) with respect to quotations for a subject security other than a reported security, the highest bid or lowest offer (as the case may be) for such security disseminated by an over-the-counter market maker in Level 2 or 3 of NASDAQ.

This definition has since been modified and moved to Rule 600(b)(8). The term "representative bid or offer" was defined in Rule 11Ac1-2(a)(17) to mean:

any number representing a bid price or an offer price (as the case may be) for a particular subject security which is (i) the mean, median, mode or weighted average of two or more bids or offers of reporting market centers in such security, (ii) calculated with reference to or derived from any such mean, median, mode or weighted average, or (iii) calculated by adding to or subtracting from the bid or offer of any reporting market center in such security any number representing a commission, commission equivalent, mark-up or differential.

(n339)Footnote 339. The Commission discussed in the Display of Market Data Proposing Release, *supra*, why minimum display requirements with respect to quotations were being proposed:

Discussion between the Commission's staff and each of the major vendors of market information have indicated that most vendors are in the process of further enhancing their quotation display facilities. However, these discussions have also indicated a hesitancy on the part of at least certain vendors to expend the capital necessary to develop composite quotation displays without some indication from the Commission as to the nature of an acceptable display. These discussions have convinced the Commission that further development in the display of quotation information may, in fact, be impeded because the Commission has not specified minimum display requirements with respect to quotations. Therefore, the Commission is at this time proposing that Rule 11Ac1-2 include minimum quotation display requirements.

(n340)Footnote 340. The traditional over-the-counter market and Nasdaq, formerly the most active and developed segment of the over-the-counter market but now a national securities exchange, are discussed in § 2.01[2] and 2.01[a][1][ii] *supra*, respectively.

(n341)Footnote 341. Former Rule 11Ac1-2(a)(8) provided that the term "consolidated display" shall mean, with respect to a particular reported security,

(i) any display (other than a moving ticker or market minder) of transaction reports for such security from all reporting market centers;

(ii) any display (other than a moving ticker or market minder) of last sale data for such security, or information derived therefrom, based on transaction reports from all reporting market centers; or

(iii) any display of quotation information for that security based on quotations from all reporting market centers.

Former Rule 11Ac1-2(a)(8).

(n342)Footnote 342. Former Rule 11Ac1-2(c)(2)(i).

(n343)Footnote 343. Prior to 1980, Nasdaq Level 1 terminals displayed a "representative bid and ask" quotation. With the adoption of Rule 11Ac1-2, Nasdaq was enhanced to display current quotations. *See § 2.01[2][b] supra.*

(n344)Footnote 344. Former Rule 11Ac1-2(c)(2)(vi); Sec. Exch. Act Rel. Nos. 15250 n.55, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P81,750 (Oct. 20, 1978); and 16590, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,456 (Feb. 19, 1980).

(n345)Footnote 345. Former Rule 11Ac1-2(d). Were a vendor to provide both the most recent transaction report and quotation for a security from a particular market center on a single interrogation device display, then that vendor was required by Rule 11Ac1-2(d) to comply with Rule 11Ac1-2(b)(2)(ii) and (c)(2)(ii). These subsections required, in summary, that the consolidated quotation display and last sale display be accessed by retrieval instructions involving certain specified number of key strokes.

(n346)Footnote 346. SRO surveillance programs are discussed in § 2.03[3][a] *supra*.

(n347)Footnote 347. Market linkage programs are discussed in § 2.04[2][b] *supra*.

(n348)Footnote 348. Former Rule 11Ac1-2(f).

(n349)Footnote 349. Former Rule 11Ac1-2(g). To grant an exemption, the Commission must determine that the exception "is consistent with the public interest, the protection of investors and the removal of impediments to, and perfection of the mechanisms of, a national market system." *Id.*

(n350)Footnote 350. Sec. Exch. Act Rel. Nos. 16924, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,617 (June 24, 1980), and 17368, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,703, (Dec. 11, 1980) and 18066, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P83,022 (Aug. 26, 1981).

(n351)Footnote 351. Former Rule 11Ac1-2(h).

(n352)Footnote 352. Rule 603(a)(1).

(n353)Footnote 353. Rule 603(a)(2).

(n354)Footnote 354. *See* Rule 603(c)(1); Rule 600(b)(13).

(n355)Footnote 355. Rule 603(c)(2).

(n356)Footnote 356. Pursuant to Rule 11Aa3-2(b)(8), NMS Plan participants were required to post up-to-date versions of plans and proposed amendments on their website. Although this rule has been rescinded, the plans are still available online. The CTA Plan is available at <http://www.nysedata.com/cta>. The UTP Plan is available at <http://www.utpdata.com>. The OPRA Plan is available at <http://www.opradata.com>.

(n357)Footnote 357. Rule 17a-15 was amended and redesignated as Rule 11Aa3-1, which was itself redesignated as Rule 601. *See § 2.04[2][d][i] supra.*

(n358)Footnote 358. The plan was filed by the New York, American, Midwest, Pacific, and PBW (predecessor to the Philadelphia Stock Exchange) exchanges, and the National Association of Securities Dealers, Inc. Transaction Reporting Proposing Release, *supra*. The NASD was a participant in the plan because of the trading of listed securities by Nasdaq market makers in the so-called "third market." Third market trading is discussed in § 2.03[2][c] *supra*.

(n359)Footnote 359. Transaction Reporting Proposing Release, *supra*.

(n360)Footnote 360. Sec. Exch. Act Rel. No. 18590 (Mar. 31, 1982). The NASD was required to file this plan by virtue of an amendment to Rule 11Aa3-1 approved in 1981 in connection with the designation of NMS Securities. See NMS Securities Release, *supra*.

(n361)Footnote 361. See NASD Manual, Rule 4400, 4600 Series.

(n362)Footnote 362. Prior to November 2001, Nasdaq SmallCap Securities were not included in this plan. See Sec. Exch. Act Rel. 45081 (Nov. 19, 2001). Accordingly, Nasdaq SmallCap Securities were not considered "reported securities" for the purpose of Commission rules such as Rule 11Ac1-1 [now Rule 602]. See § 2.04[2][c][i] *supra*. In November 2001, the plan was amended to include Nasdaq SmallCap Securities, and all Nasdaq Securities became "reported securities." See Exch. Act. Rel. No. 45081 (Nov. 19, 2001).

(n363)Footnote 363. See Sec. Exch. Act Rel. No. 48882, 2003 SEC LEXIS 2907 (Dec. 4, 2003) .

(n364)Footnote 364. See Sec. Exch. Act Rel. No. 48882, 2003 SEC LEXIS 2907, at *4 (Dec. 4, 2003) . Even before its exchange registration, however, beginning in 1996, Nasdaq functioned like a participant in the UTP Plan because the NASD delegated to Nasdaq the authority to administer the NASD's participation in the plan, including the right to vote. See Sec. Exch. Act Rel. No. 48761, 2003 SEC LEXIS 2675 (Nov. 7, 2003) . However, the existence of the Alternative Display facility made this delegation problematic, as the ADF, which is a facility of the NASD, had no representation in connection with the plan because of the delegation. See *id.* at *3-4. Accordingly, at the SEC's prompting, the NASD has proposed to retract the delegation. See *id.* This proposed change was never adopted, and became unnecessary with the registration of Nasdaq as a national securities exchange in January 2006, because as a registered exchange Nasdaq was eligible to directly participate in the plans. See Sec. Exch. Act. Rel. No. 53128 (Jan. 13, 2006).

(n365)Footnote 365. See Sec. Exch. Act Rel. No. 42208 (Dec. 9, 1999).

(n366)Footnote 366. Sec. Exch. Act Rel. No. 10787, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) P79,782 (May 10, 1974).

(n367)Footnote 367. Transaction Reporting Proposing Release, *supra*.

(n368)Footnote 368. Transaction Reporting Proposing Release, *supra*. Both the Consolidated Tape Association and the Securities Industry Automation Corporation are exclusive processors (as defined in Section 3(a)(22)(B)) and are registered with the Commission as such. *Id.*, n. 50. The Securities Industry Automation Corporation is also the processor for the CQ Plan, § 2.04[2][c][iv] *supra* .

(n369)Footnote 369. Transaction Reporting Proposing Release, *supra*. The CQ Plan contains a similar two-tier structure for quotation information with Networks A and B, see § 2.04[2][c][iv] *supra*.

(n370)Footnote 370. The Intermarket Trading System is one of the two competing designs for a market linkage system and is discussed in § 2.04[2][b][i][A] *supra*.

(n371)Footnote 371. Rule 17a-15 was amended and redesignated as Rule 11Aa3-1, which itself has been redesignated as Rule 601. See § 2.04[2][d][i] *supra*. Former Rule 17a-15(h) [now Rule 601(f)] permitted the Commission to exempt from the provisions of the Rule any exchange, association, broker, dealer, vendor, or specified type of security, if the Commission found that it was not necessary in the public interest or for the protection of investors that such party or security be subject to the provisions of Rule 17a-15.

(n372)Footnote 372. Sec. Exch. Act Rel. No. 15059 (1978).

(n373)Footnote 373. Sec. Exch. Act Rel. No. 14662 (1978). This temporary exemption was extended for twelve months on August 11, 1978, see Sec. Exch. Act Rel. No. 15059 (1978), the same date that the Commission extended its

temporary approval of the Intermarket Trading System for twelve months, see Sec. Exch. Act Rel. No. 15058 (1978).

(n374)Footnote 374. Sec. Exch. Act Rel. No. 16216 (1979).

(n375)Footnote 375. See § 2.04[2][d][ii] *supra*.

(n376)Footnote 376. Senate Report, *supra*, at p. 9.

(n377)Footnote 377. Senate Report, *supra*, at p. 9.

(n378)Footnote 378. "The goals of this pervasive regulatory authority would be to insure the availability of prompt and accurate trading information, to assure that these communications networks are not controlled or dominated by any particular market center, to guarantee fair access to such systems by all brokers, dealers and investors, and to prevent any competitive restriction on their operation not justified by purposes of the Exchange Act." Senate Report, *supra*.

(n379)Footnote 379. Senate Report, *supra*.

(n380)Footnote 380. The term "securities information processor" is defined in Section 3(a)(22)(A) to mean:

... any person engaged in the business of (i) collecting, processing, or preparing for distribution or publication, or assisting, participating in, or coordinating the distribution or publication of, information with respect to transactions in or quotations for any security (other than an exempted security) or (ii) distributing or publishing (whether by means of a ticker tape, a communications network, a terminal display device, or otherwise) on a current and continuing basis, information with respect to such transactions or quotations.

Excluded from the definition are bona fide newspaper, news magazine, or business and financial publications of general and regular circulation, and any self-regulatory organization. Banks, brokers, dealers, building and loan, savings and loan, and homestead associations are exempted to the extent that they would come within the definition of "securities information processor" solely by reason of functions performed as part of their customary activities. Section 3(a)(22)(A).

A common carrier subject to the jurisdiction of the FCC or a state commission is exempt unless the Commission determines the carrier is engaged in the business of collecting, processing, or preparing for distribution or publication, information with respect to transactions in or quotations for any security. Senate Report, *supra*.

(n381)Footnote 381. Section 11A(b)(1) empowers the Commission to conditionally or unconditionally exempt any securities information processor, class of securities information processors, security, or class of securities from any provisions of Section 11A, or the rules or regulations thereunder. Before such exemption may be granted, however, the Commission must find the exemption consistent with the public interest, the protection of investors, and the purposes of Section 11A, including:

- (1) the maintenance of fair and orderly markets in securities, and
- (2) the removal of impediments to and perfection of the mechanism of a national market system.

(n382)Footnote 382. An "exclusive processor" is defined in Section 3(a)(22)(B) as:

... any securities information processor or self-regulatory organization which, directly or indirectly, engages on an exclusive basis on behalf of any national securities exchange or registered securities

association or any national securities exchange or registered securities association which engages on an exclusive basis on its own behalf in collecting, processing, or preparing for distribution or publication any information with respect to (i) transactions or quotations on or effected or made by means of any facility of such exchange or (ii) quotations distributed or published by means of any electronic system operated or controlled by such association.

A self-regulatory organization, although an exclusive processor of securities information, is nonetheless excluded from designation as a securities information processor (*see* Section 3(a)(22)(A)) and is thus exempt from registration under Section 11A(b)(1). Sec. Exch. Act Rel. No. 11673, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P80,302 (Sept. 23, 1975) (hereinafter cited as "SIP Release"). Subsidiaries and affiliates of national securities exchanges and registered securities associations that engage in the business of securities information processing, however, are not exempt from registration under Section 11A(b)(1). Senate Report, § 2.01 *supra*, at p. 10.

Moreover, to the extent a national securities exchange or registered securities association engages in the business of securities information processing other than through a subsidiary or other instrumentality registered as a securities information processor, the Commission's broad authority under the bill [Senate Bill 249] includes all powers necessary to ensure the regulation of the securities information processing activities of such exchanges and associations in the same manner and to the same extent as the Commission may regulate securities information processors registered and regulated under new Section 11A(b).

Id.

(n383)Footnote 383. Senate Report, *supra* at 11.

(n384)Footnote 384. The Committee believes that if economics and sound regulation dictate the establishment of an exclusive central processor for the composite tape or any other element of the national market system, provision must be made to insure that this central processor is not under the control or domination of any particular market center. Any exclusive processor is, in effect, a public utility, and thus it must function in a manner which is absolutely neutral with respect to all market centers, all market makers, and all private firms. Although the existence of a monopolistic processing facility does not necessarily raise antitrust problems, serious antitrust questions would be posed if access to this facility and its services were not available on reasonable and nondiscriminatory terms to all in the trade or if its charges were not reasonable. Therefore, in order to foster efficient market development and operation and to provide a first line of defense against anti-competitive practices, Sections 11A(b) and (c)(1) would grant the SEC broad powers over any exclusive processor and impose on that agency a responsibility to assure the processor's neutrality and the reasonableness of its charges in practice as well as in concept.

Senate Report, *supra* at 11-12.

In the SIP Release, *supra*, the Commission cited the following six "persons" whose activities at that time appeared to the SEC to be within the Section 3(a)(22) definition of securities information processor, and who also appeared to be performing the functions of an exclusive securities information processor:

(1) the Consolidated Tape Association, created for the purpose of coordinating and administering a plan for the dissemination on a current and continuing basis of last sale prices relating to completed transactions in eligible securities traded on a national securities exchange, *see* § 2.04[2][d][iii] *supra*.

(2) the Options Price Reporting Authority, which administers a plan for the reporting of options last sale price information;

(3) the Securities Industry Automation Corporation (SIAC), a wholly-owned subsidiary of the New York and American Stock Exchanges (on November 1, 2006, NYSE purchased AMEX's stake in SIAC), which collects, processes, and prepares for distribution the information disseminated by the consolidated tape, consolidated options tape, and with respect to transactions and quotations on the NYSE and AMEX;

(4) Bunker Ramo Corporation, a publicly-owned corporation that was the exclusive securities information processor for the NASD and builder of Nasdaq, discussed in § 2.01[2][b] *supra*.

(5) Pacific Stock Exchange Service Corp. (now NYSE Arca), wholly-owned subsidiary of, and exclusive securities information processor for, the Pacific Stock Exchange, Inc.; and

(6) Quotron Systems, Inc., a publicly-owned company that is the exclusive securities information processor on behalf of both the Midwest and Boston Stock Exchanges. (Quotron was subsequently acquired by Citicorp and later Automatic Data Processing).

As of June 30, 1976, the SEC had granted registration as a securities information processor to the Consolidated Tape Association, Options Price Reporting Authority, and the Securities Industry Automation Corporation. A temporary exemption was granted to NASDAQ, Inc., pending review of its application for registration. The Commission also exempted from registration as a securities information processor, subject to certain conditions, the Bunker Ramo Corporation, Quotron Systems, Inc., and P.C. Service Corporation. 42 SEC Ann. Rep., p. 23 (1976).

In fiscal year 1977, the Commission granted the registration of NASDAQ, Inc. as a securities information processor and exempted from registration the Bradford National Clearing Corporation, which took over the securities information processing services performed for the Pacific Stock Exchange, Inc. by the P.C. Service Corporation. 43 SEC Ann. Rep., p. 19 (1977). Nasdaq is the exclusive SIP for both OTC securities and for the UTP Plan. *See* Supermontage Approving Release, *supra*, at *230-31. In connection with its approval of the Supermontage system, the SEC stated that as a condition of extending the effectiveness of the UTP Plan, it would require that Nasdaq and the other participants in the UTP Plan engage in good faith discussions regarding the establishment of a different entity as the SIP for Nasdaq securities, either on an exclusive or non-exclusive basis. *See id.* at *238-40.

Control Data Corporation applied to the Commission on March 23, 1979, for a determination that it is not an exclusive processor as defined in Section 3(a)(22)(B), or, in the alternative, for an exemption from registration as a securities information processor. Sec. Exch. Act Rel. No. 15759, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P82,060 (Apr. 24, 1979). Control Data Corporation, through its Service Bureau Company division, purchased the hardware and software owned by Weeden Holding Corporation and used to operate the National Securities Trading System of the National Stock Exchange (discussed in § 2.04[2][b][i][B] *supra*). *Id.*

(n385)Footnote 385. Section 11A(b)(2) of the Securities Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F.

(n386)Footnote 386. Form SIP contains thirty-one items under the following headings: general information, business organization, signatures, exhibits--business organization, exhibits--financial information, exhibits--operational capability, and exhibits--access to services. The information provided by Form SIP is required to enable the Commission to make the finding required by Section 11A(b)(3) before granting an applicant's registration; or, if it appears such findings cannot be made, to institute proceedings to determine whether registration of a securities information processor should be denied. SIP Release, *supra*.

(n387)Footnote 387. Rule 609(a) [former Rule 11Ab2-1(a)]. Rule 609(b) [former Rule 11Ab2-1(b)] provides that a

securities information processor must promptly file an amendment on Form SIP correcting any information reported in Items 1-13 or Item 21 of Form SIP, or in any amendment thereto, that has become inaccurate for any reason. If Form SIP is being filed as an amendment (other than an annual amendment), only the facing page, signature page (Item 11), and any pages on which an answer is being amended (together with such exhibits as are being amended) need be filed. Paragraph 8, General Instructions for Preparing and Filing Form SIP, Form SIP. Furthermore, the submission of an amendment constitutes a representation that all unamended items and exhibits are "true, current and complete as previously filed." *Id.*

(n388)Footnote 388. SIP Release, *supra*.

(n389)Footnote 389. Rule 609(d) [former Rule 11Ab2-1(d)]. To keep the information about each registered securities information processor current so that the Commission would be able to ascertain that the processor continues to be able to perform its functions as such, the Commission proposed in the SIP Release, *supra*, Rule 11Ab2-2, which would require each registered securities information processor to file on or before June 30 of each year, an annual amendment to Form SIP. The Commission also proposed Rule 11Ab2-3 in the SIP Release, *supra*, which would allow a successor to a registered securities information processor to be registered for an initial period of thirty days following the date of succession, provided that the successor files a statement with the Commission adopting the Form SIP, and all amendments thereto, of its predecessor as its own. Neither Rule 11Ab2-2 nor Rule 11Ab2-3 were ever adopted. See Sec. Exch. Act Rel. No. 42208 (Dec. 9, 1999).

(n390)Footnote 390. Section 11A(b)(3).

(n391)Footnote 391. Section 11A(b)(3). Proceedings to determine whether registration of a securities information processor should be denied must include notice of the grounds for denial under consideration and opportunity for hearing and must be concluded within 180 days of the date the notice of the filing of the application for registration was published. Section 11A(b)(3).

(n392)Footnote 392. Section 11A(b)(3).

(n393)Footnote 393. Section 11A(b)(3).

(n394)Footnote 394. Section 11A(b)(4).

(n395)Footnote 395. Section 11A(b)(5)(A).

(n396)Footnote 396. *Id.* Section 11A(b)(5)(A) grants the Commission rule-making power over the form and content of the information that the notice of prohibition or limitation of access must contain. In the SIP Release, *supra*, the Commission announced a proposed Rule 11Ab5-1 that would require the notice to be filed within fifteen days of the prohibition or limitation of access to any of the services offered by the registered securities information processor and a copy of such notice to be sent to the aggrieved person. The notice would have included, among other things, the reason for the prohibition or limitation and would have to have been in narrative form. Proposed Rule 11Ab5-1. The Commission never adopted this proposed rule.

(n397)Footnote 397. The Commission did, in fact, receive a request in fiscal year 1977 under Section 11A(b)(5) to review a limitation of access to the services of a registered securities information processor. See 43 SEC Ann. Rep., pp. 19-20 (1977).

(n398)Footnote 398. Section 11A(b)(5)(A).

(n399)Footnote 399. For discussion of the provisions of the Exchange Act added in 1975 directing the Commission to review burdens on competition see § 2.02[2][c][ii] *supra*.

(n400)Footnote 400. Section 11A(b)(5)(B).

(n401)Footnote 401. Section 11A(b)(6).

(n402)Footnote 402. Before exercising its enforcement power under Section 11A(b)(6), the Commission must conduct a proceeding in accordance with 5 U.S.C. § 554 (the "adjudications" provisions of the Administrative Procedure Act) and make the findings required by Section 11A(b)(6). Senate Report, § 2.01 *supra*, at p. 103.

(n403)Footnote 403. Section 11A(b)(6).

For discussion of the Commission's interpretation of what constitutes "reasonable justification or excuse" in the context of Section 19(g)(1) (enforcement of compliance provisions pertaining to self-regulatory organizations), see § 2.03[3][a] *supra*.

(n404)Footnote 404. The systems through which market data--including quotation and transaction information--are collected and disseminated, are discussed in §§ 2.04[2][c] and [d] *supra*.

(n405)Footnote 405. See Sec. Exch. Rel. No. 42208 (December 9, 1999) (hereinafter cited as "Market Data Release").

(n406)Footnote 406. See Market Data Release, *supra*. David Ignatius, *Putting a Meter on the Flow of Information*, Op. Ed., Wash. Post, June 30, 1999, at A31.

(n407)Footnote 407. Market Data Release, *supra*.

(n408)Footnote 408. Report of the Advisory Committee on Market Information: *A Blueprint for Responsible Change* (September 14, 2001), available at www.sec.gov/divisions/marketreg/marketinfo/finalreport.htm (hereinafter cited as "Advisory Committee Report").

(n409)Footnote 409. Rule 603 [former Rule 11Ac1-1] is discussed in § 2.04[2][d][2] *supra*.

(n410)Footnote 410. The NYSE's OpenBook system is an example of a market's dissemination of this type of information. OpenBook is discussed in § 2.01 *supra*.

(n411)Footnote 411. A majority of the committee members concluded that the current system should be replaced by a system under which markets are allowed to sell their data to competing consolidators, provided the attendant technological and economic issues can be resolved. Advisory Committee Report, *supra*. A minority of the committee members believed that the competing consolidator model was not viable due to the technological and economic risks involved with the implementation of this type of system.

(n412)Footnote 412. See Regulation NMS Proposing Release, *supra*, at Section VI.C.

(n413)Footnote 413. Regulation NMS Proposing Release, *supra*, at Section VI.D.

(n414)Footnote 414. Regulation NMS Proposing Release, *supra*, at Section VI.E.1.

(n415)Footnote 415. Regulation NMS Proposing Release, *supra*, at Section VI.E.2 and E.3.

(n416)Footnote 416. Regulation NMS Proposing Release,

(n417)Footnote 417. Regulation NMS Proposing Release, *supra*, at *Part II, *15-17.

(n418)Footnote 418. Regulation NMS Proposing Release, *supra*, at Part II, * 17-20.

(n419)Footnote 419. Regulation NMS Proposing Release, *supra* , at Part II, * 17-20.

(n420)Footnote 420. Regulation NMS Proposing Release, *supra* , at Part II, *20.

(n421)Footnote 421. Regulation NMS Proposing Release, *supra* , at Part II, *20.

(n422)Footnote 422. Regulation NMS Proposing Release, *supra* , at Part II, *24.

(n423)Footnote 423. Regulation NMS Adopting Release, *supra*, at *418-423.

(n424)Footnote 424. Regulation NMS Adopting Release, *supra*, at *424-31.

(n425)Footnote 425. Regulation NMS Adopting Release, *supra*, at *424-31.

(n426)Footnote 426. Regulation NMS Adopting Release, *supra*, at *431-35.

(n427)Footnote 427. Regulation NMS Adopting Release, *supra*, at *431-35.

(n428)Footnote 428. Regulation NMS Adopting Release, *supra*, at *431-35. Two commenters thought that the governance amendment went *too far*, and proposed instead that any advisory committees, like the advisory committee for the UTP Plan, meet separately from the plan operating committee and have the right to submit written questions or comments to the operating committee. Regulation NMS Adopting Release, *supra*, at *432 n.591.

(n429)Footnote 429. Regulation NMS Adopting Release, *supra*, at *436-40.

(n430)Footnote 430. Regulation NMS Adopting Release, *supra*, at *474.

(n431)Footnote 431. Regulation NMS Adopting Release, *supra*, at *474.0

(n432)Footnote 432. Regulation NMS Adopting Release, *supra*, at *475-76. The Commission believed that the use of the square root function avoided allocation of a large percentage of market data revenues to the trading of a relatively small number of heavily-traded stocks. Regulation NMS Adopting Release, *supra*, at *475-76. Conversely, however, the use of the square root function can result in a disproportionately large allocation for most inactive stocks, so the amendment to the plans also includes a cap of \$4 per trade report. Regulation NMS Adopting Release, *supra*, at *475-77.

(n433)Footnote 433. Regulation NMS Adopting Release, *supra*, at *477-80.

(n434)Footnote 434. Regulation NMS Adopting Release, *supra*, at *474.

(n435)Footnote 435. Regulation NMS Adopting Release, *supra*, at *477. The trade rating is the average of the SRO's percentage of dollar volume in the security and its percentage of the trade reports for the security. Regulation NMS Adopting Release, *supra*, at *477-78. Applying 50 percent of the security income allocation to each of the Trading Share and the Quoting Share is based on the Commission's belief that trades and quotations are generally of equal importance to the price discovery process. Regulation NMS Adopting Release, *supra*, at *478.

(n436)Footnote 436. Regulation NMS Adopting Release, *supra*, at *477-78.

(n437)Footnote 437. Regulation NMS Adopting Release, *supra*, at *478-79.

(n438)Footnote 438. Regulation NMS Adopting Release, *supra*, at *478-79. An SRO will receive one quote credit for each second and dollar value of a quotation that matches the national best bid or offer. Regulation NMS Adopting Release, *supra*, at *479. To contribute to an SRO's Quote Rating, a quotation must be displayed for one full second. Regulation NMS Adopting Release, *supra*, at *479. Manual quotation are not eligible for quote credits. Regulation

NMS Adopting Release, *supra*, at *480.

(n439)Footnote 439. National Market System Release, *supra*.

Each exchange specialist today maintains a book of public limit orders placed with him by other brokers for execution at specified prices. Any transactions in that security at a price inferior to the customer's limit order price will trigger a transaction for that customer. In other words, his order is "protected" in that market against any transaction taking place at a more favorable price or, under some circumstances, at the same price. Although the customer's limit order is protected in the market in which he places that order, transactions may take place in other markets at the same price or a more favorable price without triggering the customer's limit order. The Commission has indicated that it is in the public interest to develop a means of providing nationwide comprehensive limit order protection.

Harman, The Evolution of the National Market System--An Overview, 33 *Bus. Law.* 2275, 2286 (1978).

The Commission had initially raised the issue of public limit order protection in its release adopting Rule 19c-1, governing off-board trading by exchange numbers. Sec. Exch. Act Rel. No. 11942 (1976). Off-board trading is discussed in § 2.03[2][c] *supra*. In 1976, the Commission and the National Market Advisory Board, see § 2.04[1][d] *supra*, solicited public comments on this issue, including, in particular, whether the then computer technology could provide the protection sought by the Commission. Composite Book Release, *supra*.

(n440)Footnote 440. National Market System Release, *supra*.

The Commission called for comment, on or before May 1, 1976, on specific questions concerning the development and implementation of a CLOB as a means of providing nationwide limit order protection. Composite Book Release, *supra*. The Commission received the views of the National Market Advisory Board on the establishment of a CLOB. In a letter to the Commission dated January 28, 1977, the National Market Advisory Board expressed its belief that an important objective of a national market system for securities is the development of facilities providing limit order protection "to the maximum extent practicable" and that the securities industry itself, rather than the Commission, should be allowed the primary role in any effort to achieve limit order protection.

The types of orders a customer may give his broker, including limit orders, are discussed in § 2.01[1][a] *supra*.

The Commission altered its views as to nationwide limit order protection, in favor of nationwide price protection, and as to the necessity of a CLOB, in favor of use of the ITS with modifications, or "enhancements" (the CLOB being only one alternative should the ITS prove inadequate), in its March 1979 status report on the development of a national market system, discussed *infra*.

(n441)Footnote 441. National Market System Release, *supra*.

(n442)Footnote 442. The Commission defined "public limit order," for the purposes of a CLOB, as "any limit order not for the proprietary account of a broker or dealer." National Market System Release, *supra*, at n.52. The Commission pointed out that not all public limit orders, regardless of size, may be appropriate for inclusion in the CLOB. *Id.*

(n443)Footnote 443. Price is to be determined by reference to the price that must be reported in the consolidated transaction reporting system pursuant to Rule 11Ac1-2, [now eliminated in favor of Rule 603] see § 2.04[2][d][ii] *supra*, in the event of a completed transaction. See National Market System Release, *supra*. On the subject of price and time priority, see Senate Report, *supra*, at pp. 17-18.

In its Policy Statement on the Structure of a Central Market System [March 29, 1973], the SEC proposed that all trading in the national market system for listed securities be subject to two basic rules. First, public limit orders, wherever entered or held in the system, must be satisfied before any transaction in the same security is effected anywhere at a less favorable price to the other party. Thus, any public order in the system would be "protected" against a transaction being effected at an inferior price without prior satisfaction of that order. Second, public orders would have price priority over the bids or offers of specialists and other market makers. This would mean that a dealer operating in the system could not trade for his own account unless he is willing to buy at a higher price or sell at a lower price than any available public bid or offer.

According to the Commission:

adoption of these [two] rules would take the best features of the auction-agency market that exchanges now provide and expand them into principles to govern the functioning of the entire central market system [for securities with suitable trading characteristics].

The Committee is satisfied that S.249 [that became, as modified by the Conference Committee, the Securities Acts Amendments of 1975] grants the Commission complete and effective authority to implement a system for the satisfaction of public limit orders. The bill would give the SEC broad authority to prescribe rules requiring all broker-dealers trading for their own account in such securities to yield in the execution of their transactions to public orders. Sections 11(a)(2) and 11(b) [discussed in § 3.02 *infra*] would provide the SEC with this authority over members of exchanges. Section 15(c)(5) would provide the SEC with this authority with respect to other dealers. The SEC would also be given similar regulatory control over transactions effected by persons with access to exchange markets on terms comparable to those enjoyed by members. (Section 6(f).)

In order to assure priority for public orders, a mechanism must be established by which specialists and other market members can be made aware of all such orders within the national market system. The bill would not mandate the form of such a mechanism nor would it prescribe the precise terms of any rules with respect to auction-type protections. The Commission would be free to provide appropriate exemptions or to adopt an entirely different approach to the achievement of auction-type protections than the approach outlined in the Commission's Policy Statement. The bill would, however, remove all questions concerning the SEC's authority over trading practices and market integration and establish a clear Congressional policy supporting the preservation and extension of the protections associated with auction-type trading for appropriate securities under appropriate circumstances.

Section 11(a), discussed in § 3.02 *infra*, prohibits exchange members from trading on the exchange for their own account, with certain exceptions. One exception permits a member to effect a transaction for its own account if the member satisfies:

- (1) the "business mix" test (gross income of member derived principally from certain types of business), and
- (2) the transaction is both consistent with the maintenance of fair and orderly markets and yields priority, parity, and precedence in execution to orders for the account of persons who are neither members nor associated with members of the exchange.

The proprietary trading rule, Rule 11a1-1(T), "Transactions Yielding Priority, Parity, and Precedence," was adopted to

implement the exemptions under Section 11(a)(1)(G) for members' proprietary transactions. Sec. Exch. Act Rel. No. 15533, 3 Fed. Sec. L. Rep. (CCH) P22,808B (Jan. 29, 1979). Compliance with the terms of Rule 11a1-1(T) is deemed to be compliance with Section 11(a)(1)(G)(ii). Sec. Exch. Act Rel. No. 14563, 3 Fed. Sec. L. Rep. (CCH) P22,808 (Mar. 14, 1978). To satisfy the requirements of Section 11(a)(1)(G)(ii), a transaction effected on a national securities exchange for the account of a member must meet each of the following requirements:

(1) disclosure that the bid or offer is for the account of a member must be made--

(a) by the member to any other exchange member with whom the bid or offer is placed or to whom it is communicated, and

(b) by any member through whom such bid or offer is communicated to others participating in effecting the order;

(2) disclosure by a member (other than the specialist in the security) to the specialist and to other members also present for trading in that security that the member is presenting an order for the account of a member, immediately before executing the order; and

(3) priority must be granted (notwithstanding rules of priority, parity, and precedence otherwise applicable) by any member, presenting for execution a bid or offer for either its own account or for the account of another member, to any bid or offer at the same price, for the account of a person who is neither a member, nor associated with a member, regardless of the size of the bid or offer or the time when entered.

Temporary Rule 11a1-1(T)(a)(1), (2), (3).

(n444)Footnote 444. In 1978, it appeared that such a limit might be necessary "for technological among other reasons." National Market System Release, *supra*. Due largely to increased technological advancements, this may no longer be true. National Market System Release, *supra*.

(n445)Footnote 445. *Id.* In its January 1978 statement, the Commission also addressed the question whether information as to all public limit orders in the CLOB should be made publicly available on a current and continuous basis and concluded that such information should be available, at least in summarized form. *Id.*

(n446)Footnote 446. In response to the Commission's proposal for a CLOB, several alternative approaches to providing nationwide limit order protection were suggested. Both the New York and Midwest [now Chicago] Stock Exchanges suggested, in place of a single CLOB, that each exchange maintain its own separate electronic file of limit orders, that orders in each of these files would have the same priority in that market as manually entered limit orders presently have, and that the Intermarket Trading System (discussed in § 2.04[2][b][i][A] *supra*), enhanced to provide more rapid execution, be employed to provide limit order protection among markets. The NYSE suggested intermarket limit order protection on a voluntary basis, whereas the Midwest Stock Exchange proposed that the Commission adopt a rule requiring brokers or dealers to satisfy limit orders at a better price in other markets prior to executing a trade in their own market. Address of Chairman Harold M. Williams to the Securities Industry Association 1978 Annual Convention, The Securities Industry and the National Market System: A Current Perspective (Nov. 30, 1978).

The NYSE announced plans to begin operating a preliminary version of an electronic limit order file, known as a "market center limit order file" or MCLOF, that would handle "good-til-cancelled" limit orders (discussed in § 2.01[1] *supra*), on December 4, 1978. 480 B.N.A. Sec. Reg. L. Rep. A-5, A-6 (Nov. 29, 1978). The MCLOF would give all interested parties current knowledge of limit orders held by specialists and market makers on the floor of the NYSE. *Id.* at A-6. Prior to the operation of the MCLOF, NYSE floor specialists handled limit orders by writing down all orders in

their "book" and manually matching and executing limit orders. *Id.*

(n447)Footnote 447. National Market System Release, *supra*.

An electronic file of all outstanding limit orders, regardless of market center, integrated with electronic order execution capability is known as a "hard CLOB." Melton, *supra*, at 23.

One of the objections to the creation of a "hard CLOB" as a component of a national market system for securities is that it would result in the gradual elimination of the exchange specialist system, because the "hard CLOB" would permit upstairs (off the floor of the exchange) firms to enter orders directly into the system, or would permit orders to meet without the intervention of a dealer. Harman, *supra*, at 2295.

(n448)Footnote 448. National Market System Progress Assessment, *supra*. The purpose of the status report was two-fold:

(1) to assess the progress made in 1978 in pursuing the initiatives described in the January 1978 Statement (Sec. Exch. Act Rel. No. 14416), and

(2) to indicate the Commission's views concerning what the next issues are to be resolved and steps taken to continue progress towards a national market system.

Id.

(n449)Footnote 449. National Market System Progress Assessment, *supra*.

(n450)Footnote 450. The Commission defined "public limit order" for the purpose of its discussion of nationwide price protection as:

... any limit order to purchase or sell a qualified security not for the proprietary account of a broker or dealer or any person associated with a broker or dealer which is entered into a market center's limit order repository (whether that be a specialist's book or some other similar mechanism) and displayed in other market centers.

National Market System Progress Assessment, *supra* at n. 24.

Compare the definition of "public limit order" as used in the National Market System Release, *supra*.

(n451)Footnote 451. National Market System Progress Assessment, *supra*.

(n452)Footnote 452. The Intermarket Trading System is discussed in § 2.04[2][b][i][A] *supra*.

(n453)Footnote 453. National Market System Progress Assessment, *supra*.

(n454)Footnote 454. Each self-regulatory organization was required to develop a means of storing public limit order information (not necessarily by creating facilities permitting the electronic storage of limit orders, although the Commission did encourage the NYSE to continue the implementation of its own electronic repository for limit orders routed to the NYSE and disseminating that information for electronic display in all other market centers. *Id.*

(n455)Footnote 455. Certain operating characteristics of the ITS were required to be substantially improved; for example, the length of time required to enter commitments to trade, and receive execution or rejection reports had to be

reduced to "significantly less than one minute." *Id.*

(n456)Footnote 456. In furtherance of the necessary collective action called for by the Commission, each self-regulatory organization was required to:

- (1) inform the Commission in writing, by May 1, 1979, of its commitment to work actively with other self-regulatory organizations in concert, and
- (2) submit to the Commission by September 1, 1979 a joint plan for implementing the mechanisms to provide price protection for all public limit orders, at least on a pilot basis, not later than the end of calendar year 1980.

National Market System Progress Assessment, *supra*. A joint plan, however, was never submitted.

(n457)Footnote 457. *Id.* "Gap print pricing" is the execution of limit orders at the "cleanup" price of a block transaction, *see, e.g.*, NYSE Rule 127, "Block Positioning," NYSE Guide (CCH) P2127 (2003). In the Commission's view, gap print pricing for displayed public limit orders away from the market should be a characteristic of price protection in the national market system. National Market System Progress Assessment, *supra*.

The creation of an explicit obligation on the part of a broker to execute an order according to the proposed price protection rule "would in no way limit a broker's existing duty to seek to obtain best execution of his customers' orders." *Id.* n. 30. Best execution is discussed in § 2.04 [2][c][iii] *supra*.

(n458)Footnote 458. "[I]f nation-wide price protection is to be accomplished in a fair manner consistent with the purposes of the [Exchange] Act, it ultimately should encompass protection for all buying and selling interest displayed by a particular market center as part of its current bid or offer--regardless of whether or not that interest is comprised of public limit orders--as well as all displayed public limit orders away from the market at prices superior to the price of a proposed trade. In this context, nation-wide price protection for public limit orders should be viewed as an interim step toward, and experiment in, the achievement of price protection for all displayed orders. The techniques developed to implement this interim goal should provide valuable experience in assessing the practicability of requiring price protection for all displayed orders in the future." National Market System Progress Assessment, *supra*.

(n459)Footnote 459. Two examples of possible alternatives are:

- (1) an electronic trading facility modeled after the National Stock Exchange NSTS, *see* § 2.04[2][b][i][B] *supra*, as repository for limit orders from varying locations, with market makers in any market center executing directly against those orders, and
- (2) a CLOB, modified to remove priority for orders stored in the CLOB over other orders at the same price in the various market centers.

National Market System Progress Assessment, *supra*.

(n460)Footnote 460. 46 SEC Ann. Rep., p. 2 (1981).

(n461)Footnote 461. *See* § 2.04[2][b][i][C] *supra*.

(n462)Footnote 462. *See* Release 17744, *supra*.

(n463)Footnote 463. Market 2000 Report, *supra*, at p. 17 (1994).

(n464)Footnote 464. On June 29, 1994, the Commission approved a proposed rule change by the NASD issuing an interpretation to its Rules of Fair Practice that would prohibit member firms from trading ahead of customer limit orders in their market making capacity, but would continue to allow members to continue trading ahead of limit orders of non-customers sent to them for execution by other firms. *See* Sec. Exch. Act Rel. No. 34270 (June 29, 1994).

(n465)Footnote 465. Sec. Exch. Act Rel. No. 34270 (June 29, 1994).

(n466)Footnote 466. *See* Sec. Exch. Rel. No. 25887 (July 6, 1988) (hereinafter cited as "E.F. Hutton Release"). The action arose out of a limit order placed by William Manning, a customer of E.F. Hutton, in January 1984. *Id.* Manning placed a limit order to sell 5,000 shares of Genex Corporation at 17 1/2 at a time when the inside quotation for Genex was 17 bid, 17 1/8 offer. *Id.* E.F. Hutton sold 4,755 shares of Genex from its own inventory at 1/4 and 1/2 and, because the price of Genex subsequently declined, never filled Manning's order. *Id.* Manning instituted a disciplinary hearing against Hutton. At the time of the Manning case the NASD's rules allowed a customer of a NASD firm to bring a disciplinary action against the firm. *See id.* at *1 n.1. The rules were later amended to eliminate this procedure. Sec. Exch. Rel. No. 40690 (Nov. 19, 1998).

After a hearing, the NASD found that E.F.Hutton violated Article III, Section 1 of the NASD's Rules of Fair Practice, which required NASD members to "observe high standards of commercial honor and just and equitable principles of trade." E.F. Hutton Release, *supra*. Article III, Section 1 of the Rules of Fair Practice has since been redesignated as Rule 2110 of the NASD's Conduct Rules. *See* NASD Manual, Rule 2110, at 4111. The only sanction imposed against E.F. Hutton by the NASD was a letter of caution. E.F. Hutton Release, *supra*.

E.F. Hutton appealed the NASD's decision to the SEC, arguing that it had no obligation to execute Manning's limit order. *Id.* The Commission found, however, that E.F. Hutton assumed a fiduciary obligation to Manning by agreeing to act as his agent with regard to the limit order, and therefore had an obligation not to give its own trade priority over Manning's order. *Id.* The Commission also found that E.F. Hutton could have avoided this obligation by disclosing to Manning that it intended to give its own proprietary position priority over his orders. *Id.* However, no such disclosure had been made. *Id.* E.F. Hutton argued that the NASD was adopting a new interpretation of its rules, which could only be accomplished by rulemaking. *Id.* at *4. The Commission, in sustaining the NASD decision, rejected this argument on the grounds that the interpretation at issue was supported by "long-standing principles and prior decisions of the courts" and the Commission. *Id.*

(n467)Footnote 467. Sec. Exch. Rel. No. 26824 (May 15, 1989).

(n468)Footnote 468. Sec. Exch. Rel. No. 26824 (May 15, 1989).

(n469)Footnote 469. Sec. Exch. Rel. No. 34279 (June 29, 1994) (hereinafter cited as "Handling of Customer Limit Orders").

(n470)Footnote 470. Handling of Customer Limit Orders, *supra* n.369.

(n471)Footnote 471. Handling of Customer Limit Orders, *supra*. *See also* Sec. Exch. Rel. No. 35391, (Feb. 16, 1995), NASD Manual, 4120. "Institutional Accounts" are defined in Rule 3110(c)(4) of the NASD's Rules of Conduct, which was formerly designated as Article III, Section 21(c)(4) of its Rules of Practice, to include banks, savings and loans, insurance companies, registered investment companies, registered investment advisers, and any person or institution with total assets of \$50 million. *Id.* at 4891-92.

(n472)Footnote 472. Handling of Customer Limit Orders, *supra*.

(n473)Footnote 473. Handling of Customer Limit Orders, *supra*, at *4.

(n474)Footnote 474. Sec. Exch. Act Rel. No. 35751, (May 22, 1995) (hereinafter cited as "Manning II Release").

(n475)Footnote 475. Manning II Release, *supra*.

(n476)Footnote 476. Manning II Release, *supra*.

(n477)Footnote 477. Manning II Release, *supra*.

(n478)Footnote 478. Manning II Release, *supra*.

(n479)Footnote 479. Manning II Release, *supra*.

(n480)Footnote 480. Manning II Release, *supra*.

(n481)Footnote 481. Manning II Release, *supra*. In April 2001 the Commission approved Nasdaq's establishment, on a pilot basis, of standards for determining what constituted price improvement in a decimal environment. *See* Sec. Exch. Act Rel. No. 45286 (Jan. 15, 2002). Under these standards, a market maker trading ahead of customers, without executing those orders, would have to provide a minimum of \$.01 in price improvement for orders placed at or inside the best market displayed in Nasdaq. *Id.* For orders outside the best market, the market maker would be required to provide price improvement in an amount equal to Nasdaq's minimum quotation increment, which is currently \$.01. *Id.* The pilot price improvement standard was implemented on a permanent basis on February 26, 2007. *See* Sec. Exch. Act Rel. No. 34-55351 (Feb. 26, 2007).

(n482)Footnote 482. Sec. Exch. Rel. No. 43944 (Feb. 8, 2001).

(n483)Footnote 483. Sec. Exch. Act Rel. No. 47008 (Dec. 16, 2002).

(n484)Footnote 484. Sec. Exch. Act Rel. No. 52210 (Aug. 4, 2005). The NASD also separately extended equivalent protection to market orders with the adoption of Rule 2111 in August 2005. Sec. Exch. Act Rel. No. 52226 (Aug. 9, 2005).

(n485)Footnote 485. Order Handling Release, *supra*.

(n486)Footnote 486. Order Handling Release, *supra*.

(n487)Footnote 487. Order Handling Release, *supra*. Rule 604 [former Rule 11Ac1-4] provides in part:

(1) Each member of an exchange that is registered by that exchange as a specialist, or is authorized by that exchange to perform functions substantially similar to that of a specialist, shall publish immediately a bid or offer that reflects:

(i) The price and the full size of each customer limit order held by the specialist that is at a price that would improve the bid or offer of such specialist in such security; and

(ii) The full size of each customer limit order held by the specialist that:

(A) Is priced equal to the bid or offer of such specialist for such security;

(B) Is priced equal to the national best bid or offer; and

(C) Represents more than a de minimis change in relation to the size associated with the specialist's bid or offer.

(2) Each registered broker or dealer that acts as an OTC market maker shall publish immediately a bid or

offer that reflects:

- (i) The price and the full size of each customer limit order held by the OTC market maker that is at a price that would improve the bid or offer of such OTC market maker in such security; and
- (ii) The full size of each customer limit order held by the OTC market maker that:
 - (A) Is priced equal to the bid or offer of such OTC market maker for such security;
 - (B) Is priced equal to the national best bid or offer; and
 - (C) Represents more than a de minimis change in relation to the size associated with the OTC market maker's bid or offer.

Exceptions. The requirements in [preceding paragraphs (1) and (2)] shall not apply to any customer limit order:

- (1) That is executed upon receipt of the order.
- (2) That is placed by a customer who expressly requests, either at the time that the order is placed or prior thereto pursuant to an individually negotiated agreement with respect to such customer's orders, that the order not be displayed.
- (3) That is an odd lot order.
- (4) That is a block size order, unless a customer placing such order requests that the order be displayed.
- (5) That is delivered immediately upon receipt to an exchange or association sponsored system, or an electronic communications network that complies with the requirements of Sec. 240.11Ac1 1(c)(5)(ii) [now Rule 602(b)(5)(ii)] with respect to that order.
- (6) That is delivered immediately upon receipt to another exchange member or OTC market maker that complies with the requirements of this section with respect to that order.
- (7) That is an "all or none" order.

Exemptions. The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any responsible broker or dealer, electronic communications network, exchange, or association if the Commission determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system.

(n488)Footnote 488. Order Handling Release, *supra*. While greatly improving market transparency, the Order Handling Rules had an unfortunate side effect, which was that it allowed unscrupulous customers to engage in a practice known as "spoofing." Spoofing occurs when a customer places orders, typically through an ECN, at a price superior to the best price currently displayed in the market, for the purpose of artificially affecting the price of the stock in question in order to execute a trade on the other side of the market. A party engaged in spoofing can profit by placing larger orders on the other side of the market or by cancelling the original order before it is executed against. *See* Sec. Exch. Rel. No. 45018 (Nov. 5, 2001).

(n489)Footnote 489. See Sec. Exch. Rel. No. 43590 (Nov. 17, 2000) (hereinafter cited as "Disclosure Release").

(n490)Footnote 490. "Market centers" generally include exchange specialists, market makers in OTC securities, and alternative trading systems, including ECNs. Disclosure Release, *supra*.

(n491)Footnote 491. NMS Securities are discussed in § 2.04[2][a] *supra*.

(n492)Footnote 492. *Id.* As a consolidated best bid and offer is not disseminated at the market opening, market opening orders are not covered orders. Rule 605 [former Rule 11Ac1-5] also does not apply to orders such as short sales for which special handling was requested.

(n493)Footnote 493. Rule 605. The "realized spread" for an order is defined as double the difference between the execution price of an order and the midpoint of the consolidated best bid and offer thirty minutes after the execution time. See Rule 600(b)(6).

(n494)Footnote 494. Rule 605. The effective spread for an order is defined as double the difference between the execution price and the midpoint of the consolidated best bid and offer at the time the order is received. See Rule 600(b)(6). The average effective spread for marketable limit orders and market orders is a measure of the price improvement, or lack thereof, associated with these orders. Disclosure Release, *supra*. In other words, it measures the "liquidity premium" associated with placing orders that are immediately marketable. *Id.*

The average realized spread has different significance for non-marketable and marketable orders. *Id.* For non-marketable limit orders, the average realized spread measures "adverse selection" costs, or the extent to which limit orders tend to "be executed when the market is moving significantly against them." *Id.* The Commission believes that the practice of "stepping ahead" of limit orders by local traders on exchange floors and OTC market makers increases adverse selection costs. *Id.* For market orders and marketable limit orders, the average realized spread measures the routing of "informed" and "uninformed" orders. *Id.* Informed orders are orders placed by parties with better information than generally available in the marketplace. *Id.* Market centers are believed to have an incentive to attract uninformed orders, which are considered to have less risk. *Id.* A positive average realized spread for a market center would presumably mean that the market center attracted informed orders, while a market center with a negative average realized spread would be presumed to have attracted uninformed orders. *Id.*

(n495)Footnote 495. Peter Chapman, *Dash - 5 Stats Headed for Extinction?*, Traders Magazine, November 1, 2005.

(n496)Footnote 496. Peter Chapman, *Dash - 5 Stats Headed for Extinction?*, Traders Magazine, November 1, 2005.

(n497)Footnote 497. Rule 11Ac1-6. The rule applies only to "customer orders," which are defined as orders not for the account of the broker-dealer that have a market value of less than \$50,000, in the case of options, or \$200,000, in the case of other securities. *Id.* Broker-dealers are not required to provide order routing disclosures with regard to orders that a customer directs to a specific market center. *Id.*

(n498)Footnote 498. Rule 606.

(n499)Footnote 499. Rule 606 [former Rule 11Ac1-6] expands on the disclosures required by Rule 10b-10 and Rule 607 [former 11Ac1-3]. Rule 10b-10 requires a broker-dealer to disclose on its trade confirmations only that payment for order flow was received and to furnish details upon written request, and Rule 607 requires broker-dealers to disclose to new customers and annually to existing customers its "policies" on payment for order flow and order routing.

(n500)Footnote 500. Rule 606.

(n501)Footnote 501. Rule 606.

(n502)Footnote 502. Rule 606.

(n503)Footnote 503. Rule 606. The Commission's Division of Market Regulation has issued a staff legal bulletin which answers frequently asked questions of broker-dealers regarding the form and content of the reports required under Rule 606. *See* Division of Market Regulation: Staff Legal Bulletin No. 13A, available at 2001 SEC No-Act. LEXIS 759.

(n504)Footnote 504. The findings and objectives set forth in Section 11A(a)(1) are discussed in § 2.04[1][b] *supra*.

(n505)Footnote 505. Section 11A(a)(2) of the Securities Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F. On the subject of subsystems within the national market system, the conference committee on Senate Bill 249 stated: The Senate Bill specifically referred to the possibility of subsystems within the national market system. The conferees determined that such reference is desirable. Although the studies and hearings on which the bills are based were concerned almost exclusively with common stocks, it is the intention of both Houses that all securities, other than exempted securities, be eligible to be qualified for trading in the national market system. The unique characteristics of other securities however, may require treatment different from that for listed common stocks. For example, it has not been determined whether a transactional reporting system is appropriate for debt securities. Accordingly, the Commission should have the flexibility of establishing subsystems within the national market system, which are tailored to the characteristics of the particular type of securities, which are to be traded in each subsystem. H.R. Rep. No. 94-229, 94th Cong., 1st Sess., 92-93 (1975).

(n506)Footnote 506. Section 11A(a)(2). Exempted securities are defined in Section 3(a)12, see § 4.01 *infra*. It was the intention of Congress that all securities, other than exempted securities, be eligible to become qualified securities 90 Stat. 1247 (Sept. 13, 1976); *see also* 5 U.S.C.A. App. 1 § 1. *See* § 2.04[2][a] *supra* for further discussion of qualified securities.

Any advisory committee created pursuant to the Federal Advisory Committee Act is in addition to the National Market Advisory Board established under Section 11A(d), *see* § 2.04[1][d] *supra*. Section 11A(a)(3)(A).

(n507)Footnote 507. P.L. 92-463, 86 Stat. 770 (Oct. 6, 1972), as amended P.L. 94-405, § 5(c).

(n508)Footnote 508. P.L. 92-463, 86 Stat. 770 (Oct. 6, 1972), as amended P.L. 94-405, § 5(c).

(n509)Footnote 509. Section 11A(a)(3)(B).

(n510)Footnote 510. Section 11A(a)(3)(C).

(n511)Footnote 511. Sec. Exch. Act. Rel. No. 17580, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) 82.836 (Feb. 26, 1981). Prior to the adoption of Rule 11Aa3-2, SROs would approach the Commission on an ad hoc basis seeking Commission approval of proposed undertakings. *See, e.g.*, Sec. Exch. Act Rel. Nos. 11255 (1975) (approving an industry sponsored consolidated transaction reporting system) and 14661 (1978) (approving on an experimental basis the formation of the Intermarket Trading System, which is discussed in § 2.04[2][b][i][A] *supra*).

Rule 608 [former 11Aa3-2] provides a procedure for the Commission to carry out the express statutory authority embodied in Section 11A(a)(3)(B), *i.e.*, to approve joint industry plans with respect to the establishment of a NMS.

(n512)Footnote 512. Rule 608(b)(2) [former 11Aa3-2(b)]. The term "national market system plan" means any SRO plan in connection with:

1-2 Federal Securities Exchange Act of 1934 § 2.01

(i) The planning, development, operation or regulation of a national market system (or a subsystem thereof) or one or more facilities thereof, or

(ii) The development and implementation of procedures and/or facilities designed to achieve compliance by self-regulatory organizations, their members or nonmember brokers and dealers with any section of this subpart promulgated pursuant to Section 11A of the Act. Rule 608(b)(43) [former Rule 11Aa3-2(a)(1)].

(n513)Footnote 513. The term "sponsor" means any SRO that is a signatory to the plan and has agreed to act in accordance with the plan. Rule 600(b)(70) [former 11Aa3-2(a)(5)].

(n514)Footnote 514. The term "participant" means any SRO or nonmember broker or dealer that has agreed to act in accordance with the plan but is not a signatory to the plan. Rule 600(b)(53) [former Rule 11Aa3-2(a)(6)].

(n515)Footnote 515. Rule 608(a)(4) [former Rule 11Aa3-2(b)(4)].

(n516)Footnote 516. The operation statement must include:

- (a) the terms and conditions under which broker, dealers, and SROs will be granted or denied access;
- (b) the calculation of any fees or charges to be imposed and the distribution of such proceeds;
- (c) the method and frequency of evaluating the performance of the plan processor; and
- (d) the method for resolving disputes arising out of operation of the plan.

Rule 608(a)(5)(i)-(iv) [former Rule 11Aa3-2(b)(5)(i)-(iv)].

(n517)Footnote 517. Rule 608(b)(2) [former Rule 11Aa3-2(c)(1)].

(n518)Footnote 518. Rule 608(b) [former Rule 11Aa3-2(c)(1)].

(n519)Footnote 519. Rule 608(b)(2) [former Rule 11Aa3-2(c)(2)]. The processing period may be extended for up to 180 days if the Commission determines that additional time is appropriate and publishes its reasons for so concluding. *Id.* The Commission may revise a proposed NMS plan if it finds that such plan or amendment is necessary or appropriate in the public interest, for the protection of investors and the maintenance of fair and orderly markets, to remove impediments to, and perfect the mechanism of, a national market system, or otherwise in furtherance of the purposes of the Act. *Id.* A proposed plan may become effective upon filing if the sponsors designated it as

- (1) establishing or changing a fee or other charge,
- (2) concerned solely with the administration of the plan or involving the governing or constituent documents, or
- (3) involving solely technical or ministerial matters.

Rule 608(b)(3) [former Rule 11Aa3-2(c)(3)].

(n520)Footnote 520. Rule 608(d) [former Rule 11Aa3-2(e)]. In summary a petition for review must be filed within

30 days after entry of the Commission's order. The Commission may move to review its prior action *sua sponte*. During the period of review, there is no automatic stay of the action under evaluation. Upon review, the Commission will dismiss the proceeding if it determines that the action or failure to act is in accordance with the applicable provisions of such plan and the applicable provisions are, and were, applied in a manner consistent with the public interest, the protection of investors, the maintenance of fair and orderly markets and the removal of impediments to, and perfection of the mechanisms of, a national market system. Rule 608(d)(3) [former Rule 11Aa3-2(e)(3)]. If it cannot so find, or if the Commission concludes that the action under review would impose an unnecessary burden on completion, the Commission will set aside or amend the action as the Commission deems necessary or appropriate in the public interest, for the protection of investors, and the maintenance of fair and orderly markets, or to remove impediments to, and perfect the mechanisms of, a national market system. *Id.*

(n521)Footnote 521. *See, e.g.,* the discussion of the designation of "qualified securities" for the NMS in § 2.04[2][a] *supra* .

(n522)Footnote 522. Senate Report, *supra*, at p. 103.

(n523)Footnote 523. Commission rules adopted pursuant to Section 11A(c)(1) must be necessary or appropriate in the public interest, for the protection of investors, or in furtherance of the purposes of the Exchange Act. Section 11A(c)(1).

(n524)Footnote 524. Section 11A(c)(1)(A). Section 15(c)(2) generally prohibits a broker, dealer, or municipal securities dealer from using any means or instrumentality of interstate commerce to purchase or sell, or induce or attempt to induce the purchase of or sale of, any security in connection with, among other things, any fictitious quotation made by such person.

(n525)Footnote 525. Section 11A(c)(1)(B). The Commission, for example, has the authority under Section 11A(C)(1)(A) and (B) to prescribe the hours of operation of any ticker tape or quotation system, the method and format of reporting various types of transactions on a tape, and the identification, if any, of market centers. Senate Report, § 2.01 *supra* , at p. 104.

(n526)Footnote 526. Securities information processors are discussed in § 2.04[2][e] *supra*.

(n527)Footnote 527. Section 11A(c)(1)(C).

(n528)Footnote 528. Section 11A(c)(1)(D). The Commission is directed by Section 11A(c)(1)(C) and (D) "to remove present and prevent future anti-competitive restrictions on access to basic market information, e.g., by eliminating rules giving members of an exchange an exclusive right to particular information." Senate Report, § 2.01 *n.42 supra* , at p.104.

(n529)Footnote 529. Qualified securities are discussed in § 2.04[2][a] *supra*.

(n530)Footnote 530. Section 11A(c)(1)(E).

[T]he Commission would be required to assure that any order transmission or "switching" system utilized by a brokerage firm or an exchange operates in a manner consistent with the development and operation of a national market system. Large brokerage firms rely heavily on high-speed systems for the direction of orders to a designated facility for execution. The Committee has been informed that many of these systems are currently geared to route orders for any particular security to only one market center, e.g., the NYSE. The functioning of such systems in this manner is inconsistent with the development and operation of a national market system. It may also be inconsistent with a broker's obligation to obtain "best execution" for his customers. The subsection [Section 11 A(c)(1)(E)] would accordingly give the SEC the responsibility to require brokers to utilize order "switching" services which are "neutral" as to market centers, giving preference to one execution facility over another only to insure best execution. Senate Report, *supra*, at

p. 104-105.

The "best execution" of customers' orders, *i.e.*, the execution by brokers of investors' orders in the best market, is one of the goals of a national market system, see Section 11A(a)(1)(C)(iv). "Best execution" is discussed in conjunction with a composite quotation system, *see* § 2.04[2][c][v] *supra*.

A switching or broker order routing system is discussed in § 2.04[2][b][ii] *supra*.

(n531)Footnote 531. Section 11A(c)(1)(F), The term "equal regulation" is defined in Section 3(a)(36):

A class of person or markets is subject to "equal regulation" if no member of the class has a competitive advantage over any other member thereof resulting from a disparity in their regulation under this title [the Exchange Act] which the Commission determines is unfair and not necessary or appropriate in furtherance of the purposes of this title.

In the Committee's view equal regulation is appropriate only if the phrase is understood to mean that persons enjoying similar privileges, performing similar functions, and having the potential for similar market impact are treated equally. For example, the purpose of integrating all market makers into a single system is not to make them all do business in the same way, but rather to enable public investors to take full advantage of the distinctive contributions that each group can make. The slogan "equal regulation," therefore, is not a meaningful guide to regulatory action unless persons similarly situated in terms of the purpose of the regulation are first identified; S. Rep. No. 94-75, 94th Cong., 1st Sess., 16 (1975).

The definition of "equal regulation" in Section 3(a)(36), when combined with the Commission's power to classify in Section 23(a)(1), *see* § 9.01 n.16 *infra*, is intended to ensure that the Commission "regulate comparably those market matters and specialists enjoying the same opportunities, having the same market power, and subject to the same conflicts of interest." *Id.*

If it should appear to the Commission that any disparity in regulation which permits an unfair competitive advantage is not justified by any of the purposes of the Act the Commission, in the exercise of its discretion, is authorized to modify such regulation. It should be noted, however, that this section is not intended to create a new standard for any right of action by any person to challenge the Commission's determination to exercise, or not to exercise, its authority under this provision; rather, it is intended to provide a guide for Commission action. *Id.*

Commission regulation of market makers, including specialists and other dealers, pursuant to Sections 11(b) and 15(c)(5) (discussed in § 3.02 *infra*) must be carried out with a view to Sections 11A(a)(1)(C)(ii) (establishing fair competition among brokers and dealers as a goal of the Exchange Act) and 11A(c)(1)(F) (empowering the Commission to assure "equal regulation" of all dealers effecting transactions in qualified securities); S. Rep. No. 94-75, 94th Cong., 1st Sess., 15 (1975).

The concept of "equal regulation" is used in other contexts in addition to the Commission's rule-making powers with respect to a national market system for securities. Section 6(f), discussed in § 2.03[3][b] *supra*, empowers the Commission to subject certain nonmembers of a national securities exchange to the rules of such exchange in order, among other things, to assure "equal regulation." Section 11 (a)(2), discussed in § 3.02 *infra*, grants the Commission rule-making power to regulate or prohibit certain transactions by exchange members, brokers, or dealers, if the Commission deems such rule-making necessary or appropriate, among other things, to assure "equal regulation" of both exchange markets and markets occurring otherwise than on an exchange.

(n532)Footnote 532. Section 11A(c)(1).

(n533)Footnote 533. "Exempted securities" are listed in Section 3(a)(12), *see* § 4.01 *infra*.

(n534)Footnote 534. The activities covered by the rulemaking power granted in Section 11A(c) are discussed in Senate Report, § 2.01 *supra* .

It would be unlawful for any self-regulatory organization, member thereof, broker, dealer or securities information processor to perform the functions of a securities information processor with respect to any security (other than an exempt security) or to purchase or sell any such security in contravention of rules prescribed by the Commission as necessary or appropriate for the development of a national market system or for the regulation of the use and operation of communications and data processing facilities and services related to that system. Under this grant of authority, the SEC would have regulatory control over all organizations engaged in the business of collecting, processing or publishing information relating to transactions in and quotations for securities.

The Commission's rule-making authority would extend to facilitating the development of a composite tape and composite quotation system, determining the occasion for suspension of the operation of a tape or quotation system with respect to particular securities, establishing performance standards for securities information processors, prescribing the terms and conditions for retransmission of information collected by any exclusive processor, preventing the use or publication of fraudulent, deceptive, or manipulative market information, and integrating information services and market facilities. The Commission's direct regulatory authority under this subsection is intended to assure that it will play an effective leadership role in the establishment and regulation of a national market system.

(n535)Footnote 535. Section 15(c)(1) is discussed in § 6.01 *infra*.

(n536)Footnote 536. See Senate Report, *supra*, at p. 197. Prior to 1975, Section 15(c)(1) was limited to actual--as opposed to attempted--purchases of sales. Section 10(b), the statutory basis of *Rule 10b-5*, however, was not amended in 1975 and continues to prohibit activities "in connection with the purchase or sale of any security." Section 10(b) and *Rule 10b-5* are discussed in § 5.04 *infra*.

(n537)Footnote 537. Qualified securities are discussed in § 2.04[2][a] *supra*.

(n538)Footnote 538. Section 11A(c)(2).

(n539)Footnote 539. Third market trading is discussed in § 2.03[2][c] *supra*.

(n540)Footnote 540. P.L.94-29, 89 Stat. 97 (June 4, 1975).

(n541)Footnote 541. Listed securities are discussed in § 4.01[1] *infra*.

(n542)Footnote 542. Section 11A(c)(3)(A).

[T]he Committee [on Banking, Housing and Urban Affairs of the United States Senate] believes that the SEC should be vested with flexible and effective power to deal with any serious disruptions in the operation of the markets for listed securities caused by trading in the third market. Section 11A(c)(3) embodies this proposition. Senate Report, § 2.01 *supra* , at p. 21. In fact, one of the principles cited as a basic underlying principle of a national market system for securities was the refusal by Congress to abolish over-the counter trading in exchange-listed securities, see § 2.04[1][c] *supra*.

It was the response to concerns that the advent of competitive commission rates would cause serious disruptions in the operation of the exchange markets for listed securities that resulted in the enactment of Section 11A(c)(3). See Senate Report, *supra*, at p. 20-21.

(n543)Footnote 543. Any rule of an exchange

(1) fairly and reasonably prescribing the sequence of order execution, or

(2) adopted to effect compliance with a Commission rule adopted pursuant to the provisions of the Exchange Act shall not be deemed to unreasonably impair the ability of a dealer to solicit or effect transactions in securities for his own account. Section 11A(c)(3)(B).

(n544)Footnote 544. Section 11A(c)(3)(A); The Conference Committee Report to accompany Senate Bill 249 refers to the provision for prohibition of trading of an exchange in listed securities as " ... failsafe powers," reflecting the expectation that they are provisions which may only be used as regulatory powers of last resort." H.R. Rep. No. 94-229, 94th Cong. 1st Sess., 95 (1975). This expectation is codified in the Section 11A(c)(3)(A)(iii) requirement that the Commission find that the maintenance or restoration of fair and orderly markets in securities registered pursuant to Section 12(b), discussed in § 4.01[1] *infra*, may not be assured through other lawful means under the Exchange Act.

(n545)Footnote 545. Any such exemption must be consistent with the public interest, the protection of investors, and the maintenance of fair and orderly markets. Section 11A(c)(3)(A).

Section 11A(c) contains two other provisions, one of which has expired and the other not pertaining to Commission rule-making powers to facilitate the development and regulation of the national market system. Section 11A(c)(4) directs the Commission to review all exchange rules that limit or condition the ability of an exchange member to trade off the exchange (off-board trading restrictions are discussed in § 2.03[2][c] *supra*.) and report to Congress the results of its review within ninety days of the date of enactment of the Securities Acts Amendments of 1975.

Section 11A(c)(5) prohibits a national securities exchange or a registered securities association from limiting or conditioning the participation of any member in any registered clearing agency.

(n546)Footnote 546.

(n547)Footnote 547. Available at www.sec.gov/divisions/marketreg/nmsfaq610-11.htm.

(n548)Footnote 548. See Securities Exchange Act Release No. 54714 (November 6, 2006).

(n549)Footnote 549. See Rule 612(a), 17 C.F.R. 242.612(a).

(n550)Footnote 550. *Id.*, referencing Securities Exchange Release No. 54450 (September 29, 2006) (approving, among other things, Chicago Stock Exchange rules permitting cross transactions in increments as small as \$0.000001); Securities Exchange Release No. 54538 (September 28, 2006) (approving Philadelphia Stock Exchange rules, providing that benchmark orders could be priced in increments as small as \$0.0001).

(n551)Footnote 551. See Securities Exchange Act Release No. 54714 (November 6, 2006).

(n552)Footnote 552. *Id.*

(n553)Footnote 553. *Id.*

(n554)Footnote 554. See Securities Exchange Act Release No. 54552 (September 29, 2006).

(n555)Footnote 555. See Securities Exchange Act Release No. 54365 (August 25, 2006).

(n556)Footnote 556. See <http://www.bostonexchange.com/news/bexdiscontinuationpr950783007final9407.pdf>

(n557)Footnote 557. See Securities Exchange Act Release No. 54301 (August 10, 2006).

(n558)Footnote 558. See Securities Exchange Act Release No. 54391 (August 31, 2006). See also

http://www.nsx.com/about_history.html

(n559)Footnote 559. See Securities Exchange Act Release No. 54155 (July 14, 2006).

(n560)Footnote 560. See Securities Exchange Act Release No. 54329 (August 17, 2006).

(n561)Footnote 561. See Securities Exchange Act Release No. 53539 (March 22, 2006).

(n562)Footnote 562. See http://www.nyse.com/pdfs/nyse_regnms_updates_final.pdf.

(n563)Footnote 563. See Erik Sirri, Director, S.E.C. Division of Trading and Markets, Keynote Speech at the SIFMA 2008 Dark Pools Symposium (February 1, 2008), *available at* www.sec.gov/news/speech/2008/spch020108ers.htm.

(n564)Footnote 564. See Liz Peek, 'Dark Pools' Threaten Wall Street, The New York Sun, October 16, 2007, *available at* www.nysun.com/business/dark-pools-threaten-wall-street/64598.

(n565)Footnote 565. See Phil Wahba, Goldman, UBS and Morgan Stanley Agree On Dark Pools, Reuters, May 20, 2008, *available at* www.reuters.com.

(n566)Footnote 566. See Emily Chasin, Dark Pools May Obscure Market Prices, Reuters, April 21, 2008, *available at* www.reuters.com.

(n567)Footnote 567. See Liz Peek, 'Dark Pools' Threaten Wall Street, The New York Sun, October 16, 2007, *available at* www.nysun.com/business/dark-pools-threaten-wall-street/64598.

(n568)Footnote 568. See Darla Mercado, Dark Pool Volume Greatly Exaggerated, Says Morgan Stanley Exec, Financial Week, May 8, 2008, *available at* www.financialweek.com/apps/pbcs.dll/article?AID=/20080506/REG/519964453.

(n569)Footnote 569. See Emily Chasin, Dark Pools May Obscure Market Prices, Reuters, April 21, 2008, *available at* www.reuters.com.

(n570)Footnote 570. See Securities Exchange Act Release No. 51808 (June 9, 2005)

(n571)Footnote 571. Rule 611(a)(1), 17 C.F.R. § 242.611(a)(1).

(n572)Footnote 572. See NASD Rule 2320 and Notice to Members 01-22 for information relating to broker-dealers' best execution obligations.

(n573)Footnote 573. See Securities Exchange Act Release No. 51808 (June 9, 2005).

(n574)Footnote 574. *Id.*

(n575)Footnote 575. See Rule 301(b)(5) of Regulation ATS, 17 C.F.R. § 242.301(b)(5).

(n576)Footnote 576. See Securities Exchange Act Release No. 52514 (September 27, 2005).

(n577)Footnote 577. *Id.*

(n578)Footnote 578. *Id.*, *referencing* Securities Exchange Act Release No. 40760.

(n579)Footnote 579. *Id.*

(n580)Footnote 580. *See* Securities Exchange Act Release No. 51808 (June 9, 2005).

(n581)Footnote 581. *Id.*

(n582)Footnote 582. *See* Securities Exchange Act Release No. 53193 (January 30, 2006).

(n583)Footnote 583. *Id.*

(n584)Footnote 584. *Id.*

(n585)Footnote 585. *Id.*

(n586)Footnote 586. *Id.*

(n587)Footnote 587. *See* Marshall E. Blume, Competition and Fragmentation in the Equity Markets: The Effect of Regulation NMS, The Rodney L. White Center for Financial Research, The Wharton School, University of Pennsylvania (February 2007).

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Federal Securities Exchange Act of 1934

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CHAPTER 2 Regulation of Securities Markets *

1-2 Federal Securities Exchange Act of 1934 § 2.02

§ 2.02 Securities Markets: An Overview

Secondary securities markets n1 serve two general purposes: to facilitate capital formation for businesses and the government and to provide a means of profitable asset utilization for investors. n2 The most efficient markets achieve these goals through effective price discovery n3 and low-cost liquidity. n4 Secondary markets also serve as important leading indicators of economic trends.

Conceptually, there are two primary types of securities markets: centralized "auction" markets and "negotiation" or "dealer" markets. Historically, the United States securities markets could be easily divided into two segments national securities exchanges, which were floor-based auction markets, and the over-the-counter, or "OTC" market, which was a dealer market. In the late 20th and early 21st century, there were many more securities markets, and the distinction between national securities exchanges and the OTC market, while still technically accurate, became less useful. Currently, as a result of markets' consolidating, the clear division between the exchange and OTC markets is returning. This is particularly true in light of the registration of Nasdaq, which as discussed below had historically been part of the OTC market, as a national securities exchange. There are currently ten national securities exchanges. Six of these exchanges operate floor-based auction markets--the American, Boston, Chicago, New York, and Philadelphia Stock Exchanges and the Chicago Board Options Exchange. n5 Three national securities exchanges, the National Stock Exchange, the International Securities Exchange and Nasdaq, are purely electronic markets, with no trading floor. n6 NYSE Arca (formerly the Pacific Exchange) operates two trading floors for options, but all equity trading on the exchange occurs through a purely electronic facility. n7

The over-the-counter, or "OTC," market encompasses all non-exchange traded securities, including stocks, corporate and government bonds, debentures, and mutual funds. n8 The over-the-counter market was long dominated, at least in terms of public perception, by the Nasdaq Stock Market ("Nasdaq"), which grew out of a simple inter-dealer quotation system operated by the NASD. n9 Once Nasdaq became registered as a national securities exchange, this left the Over-the-Counter Bulletin Board, n10 which is operated by, but not part of, Nasdaq, and stocks quoted on a less formal quotation system known as the "pink sheets" as the primary components of the over-the-counter market. n11 Alternative trading systems, which are securities markets operating with some characteristics of exchanges and some of the OTC market, rose in prominence in the late 20th and early 21st century years. Alternative trading systems are technically part of the OTC market, but the Commission has created a separate regulatory scheme for these systems. n12 In 2006, the market value of equity and option transactions on registered exchanges total \$42.3 million. n13

1-2 Federal Securities Exchange Act of 1934 § 2.02

Certain securities tend to trade in certain kinds of markets. n14 Exchange traded or "listed" securities generally must be registered with the Commission and meet exchange-determined listing criteria. n15 Similar requirements existed with regard to securities included in Nasdaq before it became registered as a national securities exchange. n16

Some trading of exchange registered or "listed" securities occurs on the OTC markets. n17 Conversely, in addition to listed securities, certain OTC securities that have been admitted to unlisted trading privileges trade on exchanges. n18 Although they have similar regulatory responsibilities, n19 the exchange and OTC markets have historically operated very differently with respect to the execution of transactions. n20

The federal securities laws regulating national securities exchanges were passed in reaction to the "speculative boom of the Roaring Twenties and the ensuing Great Depression." n21 In drafting legislation, Congress specifically considered whether the securities industry should continue to govern the conduct of and establish professional standards for securities professionals or whether that responsibility should shift to the federal government. n22 Finding that direct government regulation of securities markets would be "ineffective," n23 Congress approved a unique pattern of regulation under which the securities exchanges were to be directly responsible for enforcement of the Exchange Act as well as the applicable standards of professional conduct. n24 The newly created Securities and Exchange Commission ("SEC" or "Commission") was given oversight responsibilities with respect to exchanges to assure that the system of self-regulation was effective. n25

Accordingly, Section 6 of the Exchange Act n26 requires national securities exchanges to register with the Commission. n27 The Exchange Act establishes registration criteria that the exchanges must satisfy, including that exchanges have a mechanism for disciplining their members, and persons associated with their members, for violations of the federal securities laws, including the Exchange Act and the rules and regulations thereunder, as well as for violations of exchange rules. n28 The Exchange Act also prescribes the grounds upon which exchanges may or must deny persons membership or bar persons from becoming associated with members. n29

As enacted originally, the Exchange Act did not regulate the OTC market. n30 Recognizing the increasingly important role of the OTC markets, in 1938 Congress amended the Exchange Act to add Section 15A, n31 which permits associations of brokers and dealers to register with the Commission as national securities associations or affiliated national securities associations, with responsibilities substantially similar to the national securities exchanges.

In 1971, the Commission embarked upon an attempt to "influence the evolutionary forces which shape the market place in order to stimulate the exploitation of technological advancements and to insure a fair field of vigorous competition." n32 The Commission called for the creation of a "central market system" to assure the continued viability of securities markets, to minimize "market fragmentation," and to foster competition among securities professionals. n33 After four years of regulatory initiatives by the Commission n34 and numerous studies, hearings, and congressional inquiries, n35 Congress through the Securities Acts Amendments of 1975 (the "1975 Amendments") directed the Commission to "facilitate" implementation of a "national market system." n36 The national market system is discussed in more detail in § 2.04 *infra*. This system would embrace "the principles of competition in which all buying and selling interests are able to participate and be represented" n37 in order "to enhance competition and to allow economic forces, interacting within a fair regulatory field, to arrive at appropriate variations in practices and services." n38

In the debate leading to the enactment of the 1975 Amendments, Congress reconsidered the regulatory framework of the Exchange Act n39 and again concluded that direct regulation of the securities markets by the government would be "ineffective." n40 Congress reaffirmed that the securities industry should continue to be regulated directly by those registered marketplaces through which secondary trading occurs. To eliminate any doubt as to the responsibilities of these registered markets, Congress designated all registered national securities exchanges and securities associations to be self-regulatory organizations n41 responsible for enforcing "at their own initiative compliance by members of the industry with both the legal requirements laid down in the Exchange Act and ethical standards which go beyond those requirements." n42 Moreover, Congress expanded the power of the Commission to oversee the operations of

self-regulatory organizations n43 and reconfirmed that the self-regulatory organizations' regulatory authority emanates solely from the Commission. n44

Since 1975, the Commission, the SROs, and other participants in the secondary securities markets have spent inestimable time and money in response to the 1975 Congressional mandate and have instituted numerous regulatory and operational changes in an attempt to develop a functional national market system. n45 These changes have dramatically altered the organization, operation, and future of the secondary securities markets. n46

Since April 2001, securities on all markets have been traded in decimals. n47 The purpose of the conversion to decimal pricing was to reduce bid-ask spreads and eliminate the need to convert fractions to decimals. n48 The conversion has, however, also allowed professional traders to trade in a manner which can be detrimental to investors. n49

In June 2005 the SEC attempted a major reform of the national market system with its adoption of Regulation NMS. n50 Regulation NMS itself is in large part a reorganization of existing rules governing the securities markets into a single regulation. In adopting Regulation NMS, however, the SEC also significantly revised existing regulations by:

- extending a prohibition on "trade-throughs," or execution of orders on one exchange while a better price exists on another exchange, to Nasdaq, in addition to exchange-listed, stocks, though limiting "protected" quotes to those against which automatic executions are immediately available; n51
- limiting fees that markets can charge for access to their quotations, in an effort to improve access to quotations in NMS stocks. n52
- prohibiting pricing in increments of less than one cent, or "subpenny pricing," for all stocks priced at \$1.00 or more. n53
- amending the rules governing market data, in an effort to improve the availability of market data and allocate market data revenues in a manner designed to reward markets that produce the most valuable data. n54

[1] Trading on Exchanges

The three primary stock exchanges, the New York Stock Exchange ("NYSE"), the Nasdaq Stock Market and the American Stock Exchange ("Amex"), list most of the stocks traded on exchanges. The five other national stock exchanges, n55 the Boston, Philadelphia, National, Chicago, and NYSE Arca (formerly the Pacific) Stock Exchanges, generally trade securities that also are listed on the primary markets. n56

Since 1990 the Chicago Board Options Exchange ("CBOE") has been authorized to trade stocks, n57 but as of 2003 trades primarily standardized n58 options. n59 In 2006, the market value of CBOE transactions was approximately \$531 billion. n60 The International Securities Exchange exclusively trades options. The exchange began trading in 2000, and by 2004 had dollar trading volume of approximately \$221 billion. n61

Both stock and options trade on the Amex, NYSE Arca and Philadelphia Stock Exchanges. n62 The largest exchange in terms of market value of stock traded is the NYSE, but Nasdaq typically has higher total share volume. n63 In 2006, transactions on the NYSE accounted for 37.1 percent of the total market value of all stock transactions on exchanges and Nasdaq; Nasdaq's percentage of the total market value of these transactions was 54 percent. n64

[a] Operation of Markets

[i] Traditional Exchanges

The primary exchanges operate as modified auction markets. In such an auction all order flow for a stock is directed to a central location, the trading post for the specialist in the stock, and orders interact to the maximum extent possible without specialist intervention. n65 A specialist acts as a market maker by trading for its own account to ameliorate temporary disparities in supply and demand for the stock and also acts as agent for orders left with it by parties seeking execution. n66

Transactions effected on a national securities exchange traditionally have been made through a member of that exchange who is customarily an individual, often a general partner or holder of voting stock in one of the brokerage concerns that is known as a "member firm" or "member corporation" by virtue of the exchange membership of a partner or stockholder. n67 At the end of 2002, the NYSE had 337 member firms. n68 In 2006, the New York Stock Exchange, Inc. ("NYSE") demutualized, resulting in the termination of NYSE seat ownership. Presently, shares of NYSE Euronext trade on the New York Stock Exchange. n69 On June 17, 2008, NYSE Euronext and the American Stock Exchange announced that The American Membership Corporation ("AMC") approved a merger agreement between AMC and NYSE Euronext and certain of their subsidiaries. Rule changes related to the merger are subject to the approval of the U.S. Securities and Exchange Commission (the "SEC"). n70

As a result of the 1975 Amendments, the exchanges were directed to permit non-members to access their trading facilities under certain circumstances. n71 The NYSE, for example, permits members to lease their seats to non-members n72 and provides non-members with electronic access to the exchange trading floor. n73 In 1982, the NYSE introduced a special category of membership, Physical Access Membership, effective for a one-year period and carrying no equity rights, but otherwise permitting full participation in exchange trading operations. n74

Each exchange has specific rules addressing categories of market professionals who are eligible to participate in the trading process and imposing duties and responsibilities upon these participants commensurate with their level of participation in the marketplace. n75 Because the definition of trading participants and allocation of responsibilities is a matter of exchange rule rather than statute, no mandated or uniform exchange practices exist. n76 However, the exchanges generally have adopted rules governing member conduct and activity which embody similar principles. Section 6(b)(5) of the Exchange Act states that the rules of an exchange must be designed to, among other things, "prevent fraudulent and manipulative acts and practices," "promote just and equitable principles of trade," "remove impediments to and perfect the mechanism of a free and open market and a national market system," and "protect investors and the public interest." n77 Further, the rules of an exchange may not "impose any burden on competition not necessary or appropriate in furtherance of the purposes of" the Exchange Act." n78 The categories of market professionals most commonly defined and regulated by the exchanges are the following:

Specialists, who act as dealers to the extent necessary to maintain fair and orderly markets. The specialist is responsible for purchasing and selling securities in a manner that contributes to the maintenance of fair and orderly markets in the particular security to which he or she is assigned. n79

Dealers, who trade for their own accounts on the floor of the exchange.

Commission brokers, who are employed by member firms to represent customer orders on the trading floor.

Floor brokers, who act as independent commission brokers to execute customer orders and buy and sell stock on the floor of the exchange. n80

Registered Competitive Market Makers ("RCMM"), who, when called upon by an exchange official, trade for their own accounts to narrow the existing quote spread or improve the depth of an existing quote. An RCMM may also be asked to assist a commission broker or floor broker in executing a customer's otherwise unexecutable order.

Historically, the procedures for effecting a trade on the floor of a securities exchange were nearly identical at all exchanges. The most common method of trading is known as a "continuous two-sided auction market" in which investors or brokers representing them trade directly with each other, as opposed to a dealer market where most trades are made through a dealer at the dealer's bid or ask price. n81 In this market, each security that is traded on an exchange is traded at one designated place on the "floor" of the exchange called a "post." At each post there are one or more exchange members who are registered with that exchange as specialists in one or more securities. At the larger exchanges, each equity security is generally allocated to a single specialist. These specialists are awarded, in effect, a monopoly right to make a market in that security on the floor, in return for which the specialist undertakes certain responsibilities. n82

In a typical transaction on a floor-based exchange, a public customer would contact his broker with an order to either buy or sell a certain security. The broker then communicates with his firm's order booth at the exchange, and the order soon reaches the floor of the exchange. There a commission or floor broker receives the order and proceeds to the trading post for that particular security. At the post, the broker ascertains the current market either by inquiry to the specialist or by visually checking a video display screen which discloses current market data for each security traded at that post. The broker then announces his bid or requests a quote from the other traders at the post. When a sale is made, the broker notifies his central office, which, in turn, notifies the customer. n83

In the case of an order to buy or sell less than 100 shares, known as an "odd lot" order, the price is based upon the best price quoted at the time the order is received. n84

In addition to an "at the market" order (*i.e.*, an order to buy or sell a security at the best market price), there are several special instructions a customer may give his broker in connection with a purchase or sale of securities on an exchange:

- A *limit order* specifies a maximum price at which the stock may be purchased or a minimum price at which the stock may be sold.
- A *stop order* requires that a security be bought or sold once a certain price level has been reached. Once the market reaches that price, the stop order effectively becomes a market order. n85
- A *good-till cancelled order* is carried by a broker until either he is able to execute the order or the customer cancels it.

As a result of technological advances and competition from electronic markets, among other factors, traditional exchanges have modified their execution systems. For example, in December 2000 the Commission approved the NYSE's proposal to establish NYSEDirect+, under which member firms could submit customer orders of 1099 shares or less for automatic execution. n86 Though originally approved as a one-year pilot program, the NYSEDirect+ pilot was extended on numerous occasions n87, and appears to have been implemented on a permanent basis n88.

As an electronic platform, NYSEDirect+ seeks to provide faster order execution than the traditional NYSE auction market. In August 2004, the NYSE filed a proposal to create the "NYSE Hybrid Market," which would expand the types of orders that could be entered through Direct+ allowing investors to choose either the NYSE's traditional auction model or its electronic trading platform to execute orders. n89 This was approved in March 2006. As noted above, NYSEDirect+ currently only allows automatic execution of limit orders of 1,099 shares or less. In addition, NYSEDirect+ has a number of other limitations, including, a 30-second restriction for orders of the same beneficial owner, and a lack of functionality for immediate or cancel ("IOC") orders. n90 As a way of increasing investor interaction with NYSEDirect+, the Hybrid proposal aims to improve upon NYSEDirect+ by, among other things:

- eliminating the current order restriction from automatic execution to allow the full extent of an order

size to be automatically executed;

- eliminating the 30-second limitation for consecutive automatically executed orders for accounts in which the same person is directly or indirectly interested;
- introducing IOC functionality;
- permitting market orders to be automatically executed, if so designated;
- creating new order types; and
- fostering greater floor broker and specialist interaction with Direct+. n91

The Hybrid Proposal's enhancements to NYSEDirect+ allows marketable limit orders and market orders designated for automatic execution, regardless of size, to be eligible for immediate execution against the trading interest reflected in the NYSE's published quotations. Any unfilled portion of an order would "sweep" the NYSE Display Book, n92 a file reflecting broker agency interest and a file reflecting specialist interest until the order is executed, or until other conditions are satisfied. n93 In addition, Hybrid Market orders would automatically be routed to other "fast markets" when those market centers quote a better price than the NYSE. n94 If the order is designated as "Do Not Ship," however, the order would remain at the NYSE. n95 In the Hybrid Market, customer orders may be directly submitted electronically, or through floor brokers. n96

As a way to enhance floor broker and specialist interaction with Direct+, the Hybrid proposal provides new tools for floor brokers and specialists to continue to meet their best execution and market making obligations on the NYSE. Floor brokers would represent customer interest on the NYSE Display Book through NYSE e-Quote, also referred to as "NYSE Floor Broker Agency Interest Files." n97 Specialists would have the ability to provide electronic representations of their trading interest through NYSE s-Quote, also referred to as "NYSE Specialist Interest Files." n98 In each instance, the NYSE noted that its intent is to provide customer orders greater choice in execution, while giving floor brokers greater flexibility in their representation of customer orders, and enhancing the specialists' ability to add liquidity and stabilize prices. n99

When an order is executed, notice of the transaction is disseminated by the exchange through various types of electronic reporting systems. On the NYSE, for instance, trade reporting is done directly through the specialist's electronic display book or by floor reporters on wireless, hand-held computer terminals. The data then travels to the NYSE's Market Data System for validation and dissemination. n100 In 1974, the Commission approved a plan n101 filed jointly by the American, Chicago, Pacific, Philadelphia, and New York Stock Exchanges and the NASD for the formation of a Consolidated Tape Association which would compile and report price and volume information for completed transactions with respect to securities "listed" on exchanges, irrespective of whether the trade occurred on the floor of an exchange, through the Nasdaq system, or in the "third market." n102

Most national securities exchanges maintain a specific trading floor. However, Nasdaq, n103 the National Stock Exchange and the International Securities Exchange ("ISE") are "electronic markets" or "black box systems," through which buyers and sellers effect trades through computer terminals. n104 The Pacific Exchange has two trading floors for options, but its equity trading occurs exclusively through an electronic facility n105 known as the Archipelago Exchange (now NYSE Arca). n106 All of the others have computerized systems to expedite the execution of certain categories of orders. n107 The exchanges have also developed an Intermarket Trading System ("ITS") which electronically links geographically separate markets, provides timely and accurate price and quotation information to participants and allows orders to be routed to the market providing the best price at a given point in time. n108

Each exchange is required to maintain a market surveillance system to detect improper or illegal trading practices. n109

Over the years, the SEC has maintained continued discussions with the exchanges regarding continued improvements in market surveillance. n110 The exchanges' response to Commission demands for improved market surveillance has been varied and negotiations continue with the Commission. n111

In October, 1980, Congress authorized appropriations for the Commission to design and purchase a computerized Market Oversight and Surveillance System ("MOSS"). n112 This federally owned and operated system would have permitted the Commission to oversee various aspects of market activity through direct access to exchanges' computerized files. n113 Though the MOSS System was never implemented on a permanent basis, the potential of direct Commission surveillance of the exchanges' markets prompted increased self-regulation by the exchanges. n114

[iii] Nasdaq

Nasdaq rose from humble beginnings as a simple electronic quotation service to a major stock market and ultimately a registered national securities exchange. n115 Originally, Nasdaq simply created greater exposure for unlisted securities and diminished a statistical information gap that existed prior to its creation. This increased quotation exposure enabled brokers to obtain real-time prices and better order execution.

In 2004, the Nasdaq Stock Market surpassed the trading volume of the NYSE by a wide margin. n116 The share volume of Nasdaq securities in 2004 was 455.6 billion shares, as compared to an aggregate share volume of 367 billion on the NYSE. n117

Nasdaq market participants access quotes and orders using the Nasdaq WorkstationSM, which in 2005 replaced Workstation II. n118 WorkstationSM has three levels of service--Query Only, Order Entry and Market Maker. n119 Query Only Service allows a participant to view quotes and orders, but not to enter orders or make trades. n120 Participants who subscribe to Order Entry Service can view quotations and orders and also enter orders into the Nasdaq system. n121 Market Maker Service allows registered market makers to view all other quotations and orders, and to enter both quotations and orders into the system for execution. n122

In the late 1990s and early 21st century, Nasdaq introduced trading systems which fundamentally changed the nature of the market. The first was the "Nasdaq National Market System," or "SuperSOES," approved by the SEC in January 2000. n123 The SuperSOES system provided for automatic execution of orders for Nasdaq National Market securities of up to 999,999 shares. n124 The SuperSOES System introduced a "reserve size functionality" which allows market makers to display only a portion of a customer's order and hold the remainder in reserve.

The second major system introduced by Nasdaq, the "SuperMontage" system, was approved by the Commission on January 10, 2001, and began operations in October 2002. n125 SuperMontage expanded the SuperSOES order display. In addition, unlike SuperSOES, it applied to all Nasdaq securities, including National Market and SmallCap [now Capital Market] securities. The Nasdaq Workstation II [since replaced by WorkstationSM] contained a "quotation montage" displaying the quotes and orders of market participants. The advanced system took its name from one of its primary features, the Nasdaq Order Display Facility, or "SuperMontage," which supplemented an amended quotation montage. Nasdaq began revising or adding new features to SuperMontage even before its launch, and frequently made changes after the launch as well. n126

In 2004 Nasdaq eliminated the "SuperMontage" terminology and called its system simply the "Nasdaq Market Center," though the operation of the system was unchanged. n127 Through the Nasdaq Market Center, quotes and orders for all Nasdaq securities are displayed and can be executed. The Nasdaq Market Center displays orders four levels away from the so-called "top of the market," or best bid and ask quotes. n128 The Nasdaq Market Center displays trading interest of market makers and ECNs, as well as exchanges on which Nasdaq stocks have UTPs. n129 The Nasdaq Market Center allows Nasdaq market makers and ECNs, collectively known as "Nasdaq Quoting Market Participants," to display their trading interest anonymously, on both a pre and post-trade basis. n130 The Nasdaq Market Center, like the SuperSOES

system, allows Nasdaq Quoting Participants to use "reserve size," which is not displayed in the quotation montage or Order Display Facility, but against which orders can be executed. n131 The SuperMontage proposal, which established what is now known as the Nasdaq Market Center, introduced an Order Collector Facility, which is a central facility through which all orders are channeled for execution.

The SuperMontage system, now known as the Nasdaq Market Center, continued the trend, starting with the original SOES system, toward automatic executions of orders for Nasdaq securities. In fact, Nasdaq market makers are required to provide automatic executions. n132 However, ECNs and UTP exchanges are not required to provide automatic executions. n133

There are numerous variations on the types of orders that market participants can enter into the Nasdaq Market Center. As in other markets, orders may be market or limit orders. In addition, participants can enter "non-directed," "preferenced" or "directed orders." Non-directed orders, the most common type, are entered into the system for execution against the quotes or orders of quoting market participants. Preferenced orders are entered into the system and intended for a specific participant, but are only executed if that participant is at the inside market when the order is next in line for execution. Directed orders are intended for a particular participant and entered into the normal order display and execution system. n134 There are numerous other variations as well. For example, in November 2003, Nasdaq introduced a "pegged order," which is a non-directed limit order that is automatically adjusted to correspond to the inside market, and in January 2004 the Commission approved Nasdaq's establishment of an "Auto-Ex" order, which executes only against the quotes or orders of market participants who do not charge a separate quote-access fee. n135

In 2004, when Nasdaq dropped the SuperMontage terminology, it also introduced a single trading platform that combined the functionality of not only SuperMontage and CAES and other systems, but allowed trading of securities listed on other markets. n136

Nasdaq securities are divided into two separate subgroups. First, some Nasdaq securities are designated as National Market System securities ("Nasdaq/National Market Securities"). n137 Nasdaq/National Market Securities are securities that are listed on Nasdaq and that must satisfy criteria relating to trading volume and issuer financial strength which are more stringent than criteria for other Nasdaq securities. n138 As a general matter, Nasdaq/National Market Securities represent the most highly capitalized, most actively traded Nasdaq securities. n139 The second group of Nasdaq securities--Nasdaq Capital Market [formerly SmallCap] n140 Securities--are securities which are listed on Nasdaq, but are either ineligible for designation as Nasdaq/National Market Securities or have elected not to be so designated. n141 These securities, while sometimes actively traded, generally are less highly capitalized than Nasdaq/National Market Securities and less actively traded. n142

One important consequence of the Nasdaq System was an increase in OTC surveillance. n143 The Market Surveillance Section of the NASD monitors activity in all Nasdaq issues and relies heavily upon the daily computer analysis of all quotation changes and trading volume entered into the Nasdaq System. n144

[b] Listing Standards

As of December 31, 2003, there were 5,471 issues of stock and bonds listed on national securities exchanges. n145 Each exchange has its own initial listing and maintenance criteria. n146 The NYSE's requirements, the most stringent of all exchanges, specify, among other things, that the applicant must have:

- Either 2,000 holders of 100 shares or more; 2,200 total stockholders together with average monthly trading volume for the last six months of 100,000 shares; or 500 total shareholders together with average monthly trading volume of one million shares for the last twelve months. n147
- A minimum of 1,100,000 publicly-held shares with a market value of \$60 million for companies that

list at the time of their initial public offerings, and \$100 million for all other companies. n148

- Total pre-tax earnings of \$10 million in the aggregate for the last three fiscal years, together with a minimum of \$2 million in each of the two most recent fiscal years, and positive amounts in all three years; for companies with at least \$500 million in market capitalization and \$100 million in revenues during the last year, a total of \$25 million in operating cash flow for the past three years, if cash flow was positive in each year; or, for companies with at least \$750 million in market capitalization, revenues of \$75 million during the most recent fiscal year. n149

The NYSE has long had extensive corporate governance and similar requirements which issuers must follow in order for their securities to become and remain eligible for listing. n150 For example, issuers must follow rules regarding the dissemination of material information, the voting rights of shareholders, proxy solicitations, and similar matters. n151 However, in 2003 the exchange's corporate governance requirements were dramatically revised and expanded, primarily as the result of several high-profile corporate scandals. n152 In 2002, as the result of these scandals, the SEC's Chairman requested that the exchanges and Nasdaq review their listing standards with a focus on corporate governance. n153 Before the NYSE had filed the first proposal to revise its listing standards, Congress adopted the Sarbanes-Oxley Act of 2002, a sweeping corporate reform measure which, among other things, prescribed, in general terms, corporate governance listing standards to be adopted by the exchanges and Nasdaq. n154 The drafters of the Sarbanes-Oxley Act chose to direct the Commission to adopt more specific rules governing the listing standards as one means of reforming corporate governance practices. n155 As a result, the Commission adopted Rule 10A-3 in April 2003. n156 Rule 10A-3 specifies requirements that listing standards of the exchanges must include, at a minimum, and these bodies are expected to adopt requirements which are even more specific and perhaps more strict. n157

The NYSE's significant revision of its listing standards was approved by the SEC in November 2003. n158 The revised standards require, among other things, that:

- a majority of the members of issuers' boards of directors be independent;
- directors, to be considered independent, satisfy a more stringent definition of "independence" designed to exclude directors who, among other things, have been employed with the issuer or its outside auditor in the past three years or have received material compensation other than directors' fees, or whose family members have had specified relationships with the issuer;
- independent board members meet in "executive sessions" without management;
- each issuer have a nominating/corporate governance committee composed entirely of independent directors;
- each issuer have a compensation committee composed entirely of independent directors;
- the compensation of each issuer's CEO be established by either the compensation committee or all independent directors of the board and be based on the CEO's performance;
- the responsibilities of each issuer's audit, corporate governance/nominating and compensation committees be specified in a written charter;

1-2 Federal Securities Exchange Act of 1934 § 2.02

- each issuer have an internal audit function;
- each issuer adopt corporate governance guidelines and make them publicly available;
- each issuer adopt a code of business conduct for directors, officers and employees; and
- the CEO of each issuer annually certify that he or she is not aware of any violation by the issuer of the exchange's corporate governance listing standards. n159

Prior to Nasdaq's registration as a national securities exchange in January 2006, it had established criteria that all securities were required to satisfy in order to be included on the market, as well as financial and trading criteria which differ depending on whether the issuer was seeking inclusion in the Nasdaq National Market or the SmallCap Market. Once Nasdaq became registered as a national securities exchange, these criteria became listing standards.

To be listed on Nasdaq, an issuer's securities must be registered under Section 12(b) of the Exchange Act. n160 The following are the financial and trading criteria for listing in the Nasdaq SmallCap Market: n161

	Initial	Continued
Market Makers:	3	2
Stockholders' Equity/Market Capitalization/Income	(1) Stockholders' Equity of \$5 million; (2) Market capitalization of \$50 million; or (3) net income from continuing operations of \$750,000 in most recently completed fiscal year or two of three most recently completed fiscal years.	(1) Stockholders' Equity of \$2.5 million; (2) Market Capitalization of \$35 million; or (3) net income from continuing operations of \$500,000 in most recently completed fiscal year or two of three most recently completed fiscal years.
Operating History:	At least two years or market capitalization of \$50 million	--
Minimum Bid Price per Share n162	\$4	\$1
Round Lot Shareholders n163	300 for common stock, 100 for preferred stock and secondary classes of common stock	
Shares (Public Float) n164	1,000,000 for common stock, 200,000 for preferred stock and secondary classes of common stock	500,000 for common stock, 100,000 for preferred stock and secondary classes of common stock
Market Value of Public Float	\$5 million for common stock, \$2 million for preferred stock and secondary classes of common stock	\$ 1 million for common stock, \$500,000 for preferred stock and secondary classes of common stock

An issuer's securities are eligible for initial inclusion in the Nasdaq National Market if the issuer satisfies one of three alternative entry standards, which are summarized below: n165

1-2 Federal Securities Exchange Act of 1934 § 2.02

	ENTRY STANDARD 1	ENTRY STANDARD 2	ENTRY STANDARD 3
Market Makers:	3	3	4
Pre-tax income	\$1,00,000 in most recently completed fiscal year or two of three most recently completed fiscal years	--	--
Stockholders' Equity	\$15 million	\$30 million	--
Market Value of Listed Securities/Assets and Revenue	--	--	Market Value of Listed Securities of \$75 million or total assets and total revenue of \$75 million each for most recently completed fiscal year or two of last three most recently completed fiscal years
Minimum Bid per Share	\$5	\$5	\$5
Round Lot Shareholders	400	400	400
Shares (Public Float)	1,100,000	1,100,000	1,100,000
Market Value of Public Float	\$8 million	\$18 million	\$20 million
Operating History	--	2 Years	--

To maintain its inclusion in the Nasdaq National Market, an issuer must satisfy one of two alternative maintenance standards, which are summarized below n166

	MAINTENANCE STANDARD 1	MAINTENANCE STANDARD 2
Market Makers:	2	4
Stockholders' Equity	\$10 million	--
Market Value of Listed Securities/Assets and Revenue	--	Market value of listed securities of \$50 million or total assets of \$50 million for most recently completed fiscal year or two of last three most recently com-

1-2 Federal Securities Exchange Act of 1934 § 2.02

		pleted fiscal years
Minimum Bid Price per Shares	\$1	\$1
Round Lot Shareholders	400	400
Shares (Public Float)	750,000	1,100,000
Market Value of Public Float	\$5 million	\$15 million

For its securities to be eligible for listing in either segment of Nasdaq, an issuer must satisfy corporate governance and similar requirements. n167 Like the corporate governance standards of the NYSE, Nasdaq's standards were revised extensively in 2003, primarily as the result of a corporate reform movement prompted by several high-profile corporate failures. Nasdaq's revised standards require, among other things, that:

- a majority of the members of issuers' boards of directors be independent;
- directors, to be considered independent, satisfy a more stringent definition of "independence" designed to exclude directors who, among other things, have been employed with the issuer in the past three years or have received material compensation other than directors fees, who have been employed by the issuer's outside auditor in the last three years, or whose family members have had specified relationships with the issuer;
- independent board members meet in "executive sessions" without management;
- the compensation of each issuer's CEO be established by either the compensation committee or all independent directors of the board;
- nominees for director positions be made by either a nominating committee composed of independent directors or a majority of independent directors;
- each issuer have a written charter addressing the process for nominating directors;
- each issuer's audit committee have a formal written charter;
- each issuer have a code of conduct applicable to all directors, officers and employees;
- issuers publicly disclose if they have received an audit opinion containing a going concern qualification; and
- each issuer review related party transactions for conflicts of interest on an ongoing basis, and that related party transactions be approved by the issuer's audit committee or a majority of its independent directors. n168

A security is subject to removal from Nasdaq if it does not satisfy the criteria summarized above. In addition, a security may be subject to removal from the market if:

- it is the subject of a suspension by the SEC from trading;
- it fails to disclose promptly to the public material information; or

- it fails to disclose promptly material information to any state or federal agency requiring the disclosure.

Exchanges list and trade a large number of derivative products, typically with returns tied to the return of a specified index. These products may be in the form of options, warrants, index funds shares or equity-linked notes. n169 The listing and trading of these products pose special problems because each product with a different structure has historically been considered a new type of security, requiring the exchange listing and trading the product to adopt listing standards for the particular type of product. Adopting new listing standards, in contrast to the listing of a new security covered by existing listing standards, is considered a rule change subject to Commission approval. The requirement that a new rule filing be made for each new product became a major obstacle to the trading of derivative products when their trading began to accelerate in the mid 1990s. Accordingly, in 1998 the Commission amended Rule 19b-4 to make it easier for exchanges to trade and list new derivative products. n170 Rule 19b-4(e), which was added by the 1998 amendments, allows exchanges to adopt "generic" listing standards for a particular product class, so that future products falling within that class do not require rule filings. n171

Exchange rules governing derivatives products typically combine listing and trading standards, and the listing standards are therefore generally not located with the listing standards for more conventional securities. n172 Within the rules governing derivatives products are the "generic" listing standards that a new product must satisfy to avoid a rule filing under Rule 19b-4, typically focused on the criteria that the index underlying the derivatives products. n173 The generic listing criteria must be approved by the Commission. n174 If the underlying index for a new product does not satisfy the generic listing criteria, the exchange seeking to list and trade the product must make a filing under Rule 19b-4. n175

[c] Unlisted Trading Privileges

A security may not be traded on a national securities exchange unless it is registered with, or "listed," on the exchange, or if it has been extended unlisted trading privileges ("UTP") by that exchange. n176 Few OTC securities were granted unlisted trading privileges before 1975, either because the SEC did not have the power to approve the extension of such privileges or because its power was not exercised. The SEC was originally given the authority to approve extensions of UTP in OTC stocks with the 1936 amendments to the Exchange Act, but this authority was limited to stocks subject to disclosure requirements that were "substantially equivalent" to those for listed companies. n177 However, OTC stocks were not subject to periodic reporting requirements until 1964, and from 1936 to 1964 the Commission rarely granted UTP for OTC stocks. n178 When the Exchange Act was amended in 1964 to extend the periodic reporting requirements to OTC stocks, Congress removed the Commission's power to grant UTP for OTC stocks. n179 This authority was reinstated with the 1975 amendments to the Exchange Act. n180

The 1975 amendments to the Exchange Act permitted exchanges to extend UTP to OTC securities provided that certain standards were satisfied. n181 From 1975 to 1985, the SEC, awaiting progress on the development of the national market system, generally refrained from granting exchanges UTP in OTC stocks. n182 In 1985, the SEC announced a new policy, allowing each exchange to trade OTC securities pursuant to UTP, subject to an application, notice, and approval process. n183 In each of the following ten years, the SEC processed hundreds of exchange applications for UTP, but only in extremely rare situations did it receive any comments on an application. n184 The Unlisted Trading Privileges Act of 1994 amended the Exchange Act to remove this application and notice process requirement for exchange-listed securities, in effect allowing exchanges to trade via UTP any security listed on another exchange without further SEC approval. n185 However the Exchange Act still prohibited the extension of UTP in OTC securities except pursuant to a rule, regulation, or order of the SEC. n186 This requirement was, and continues to be, fulfilled by periodic SEC approval orders granting temporary extensions to the Nasdaq UTP Plan, which governs the collection, consolidation and dissemination of quotation and transaction information in Nasdaq securities listed on an exchange or traded on an exchange pursuant to a grant of UTP, subject to the conditions of that program as they are updated from time to time. n187 Accordingly, there is currently no need for exchanges to apply to the SEC on a case-by-case basis to

approve the extension of UTP to a security, and there is no requirement that a security granted UTP by an exchange must fulfill that exchange's listing standards to be traded pursuant to UTP, so long as the stock is listed on another national security exchange or is an eligible security under the Nasdaq UTP Plan. n188

[2] Trading in and Regulation of the OTC Market

The trading which takes place away from exchanges is known as the "over-the-counter," or "OTC," market. n189 From 1971 through 2005, the OTC market was divisible into two rather distinct segments: the traditional OTC market and the Nasdaq Stock Market. However, in January 2006, Nasdaq became registered as a national securities exchange, leaving only the traditional OTC market. n190

The traditional OTC market encompasses off-exchange trading of securities including corporate stocks, corporate and government bonds, debentures, and mutual funds. The OTC market is a way of doing business by negotiation. n191 Traditionally, in the OTC market, dealers, acting as principals, buy from and sell to investors or other dealers at an undisclosed profit. n192 More the OTC market has become predominantly an agency market. n193

In a dealer market, historically there was little or no interaction between customer orders: each order was executed against a market-maker's inventory. n194 Market-makers n195 in a dealer market post prices at which they are willing to buy or sell a security. Interested investors or their brokers then contact the market maker to execute a trade for that security at the market maker's posted price. The price is determined through competition among market makers for incoming orders, not through the meeting of buy and sell interest as in an auction market. Since there is no central "book" of orders, there is no way a public order to buy a security at a price can meet directly with a public order to sell the same security at the same price.

There are no "seats" in the OTC market. n196 The buying, selling, and trading taking place in the OTC market is conducted by brokers and dealers, n197 most of whom are members of the NASD. n198 Under Section 15(b)(8) of the Exchange Act, every registered broker or dealer who engages in transactions in securities, other than commercial paper, bankers' acceptances or commercial bills, must become a member of a registered securities association unless the broker or dealer effects transactions in securities solely on a national securities exchange of which it is a member. Thus, every broker-dealer must be a member of, and therefore subject to the regulation and oversight of, a self-regulatory organization, either a securities association or an exchange. n199 FINRA (formerly the NASD) is registered with the Commission pursuant to Section 15A of the Exchange Act as a national securities association and is the only association so registered. n200

NASD members are classified as either wholesale dealers or retail firms. The wholesale dealer, often referred to as a "market maker," buys securities from and sells securities to professionals who act for themselves or on behalf of customers. n201 The retail firm is engaged in selling securities to its customers and buying or finding buyers when its customers wish to sell. n202 A broker or dealer doing business in the OTC market may also be a stock exchange member. Furthermore, most stock exchange member firms maintain OTC departments.

Issuers of OTC securities that are not traded on an exchange must be registered under Section 12(g) n203 and are subject to the same reporting, n204 proxy, n205 and insider trading n206 provisions as issuers whose securities are traded on a national exchange.

Historically, obtaining quotations in the OTC market was difficult. n207 Using a combination of telephone calls, teletype, and statistical charts published daily by the National Quotation Bureau *i.e.*, pink sheets, n208 the broker determined the price of a security. However, the pink sheets did not provide real-time quotation information, and telephone calls were a cumbersome and inefficient method of obtaining such information. n209

Today, real-time quotations are available on the OTC Bulletin Board, which is a computerized communications systems

operated by, but not part of, Nasdaq, linking all dealer members. Even "pink sheet" quotations are now available in real time. n210

The SEC conditioned approval of Nasdaq's SuperMontage system n211 on, among other things, the NASD's providing an alternative quotation medium for market participants who did not wish to use Supermontage. n212 Accordingly, the NASD established the Alternative Display Facility for these participants. n213 The Alternative Display Facility was originally established for a pilot period of nine months, beginning July 24, 2002. n214 On April 10, 2003, the SEC approved an extension of the pilot through January 26, 2004, and on January 27, 2004 another extension through October 26, 2004. n215 The Alternative Display Facility is a means only of displaying quotes and reporting transactions; it does not include an order execution facility. n216 Participants using the facility are responsible for establishing their own order linkages. n217 The system is similar to the Nasdaq system before Nasdaq began implementing automatic order execution features, except that ECNs are recognized, along with market makers, as a type of participant. Market participants must allow other participants to access their quotes and orders electronically, but may charge access fees. n218 The NASD has established numerous other rules for the Alternative Display Facility governing matters such as minimum times for accepting or declining an order, trade reporting and withdrawal of quotations. n219 Use of the ADF, which was never widespread, declined to the point where by October 2005 it was used in connection with only 15,000 trades per day. n220 On January 26, 2007, the SEC granted approval of a proposed rule change to operate ADR on a permanent basis. Securities Exchange Act. Release No. 34-55181 (Jan. 26, 2007). n221

The Federal Reserve Board establishes guidelines for the margin eligibility of OTC securities. To be eligible for margin, OTC securities must meet the following minimum requirements: n222

- be registered pursuant to Exchange Act Section 12(g);
- have four market makers;
- have either 1,200 public holders of record or an average daily trading volume of 500 shares;
- be of an issuer that has been in existence for three years;
- have been publicly traded for six months;
- have daily quotes for bid and asked prices that are continuously available to the public;
- be of an issuer that has 400,000 publicly held shares;
- have an average bid price per share of \$5, and
- be of an issuer that has \$4 million of capital, surplus, and undivided profits. n223

[3] Alternative Trading Systems

Alternative trading systems ("ATSs") are systems which bring securities buyers and sellers together, like exchanges, but typically require less participation of a party acting as a principal such as a specialist or market maker. Regulation of participants by ATSs is limited to trading conduct, and ATSs in turn are less heavily regulated by the SEC than are exchanges. n224 An electronic communications network ("ECN") is a type of electronic ATS that collects buy and sell orders for securities and allows the orders to be executed against each other. n225 ECNs do not generally "make markets" in the sense of acting as a principal on trades; instead, they act purely as agents by bringing buyers and sellers together. ECNs place limitations on the parties who may subscribe to their system, and typically charge an access fee. ECNs display subscriber orders, typically to subscribers but in some cases to the general public. n226

ECNs have existed since 1969. n227 They did not begin to flourish, however, until the mid to late 1990s, aided by the development of the Internet and other communications technologies and the SEC's adoption of its Order Handling Rules in September 1996. n228 The Order Handling Rules were adopted partially to address perceived problems created by the rise of ECNs, but actually facilitated the growth of ECNs by sanctioning the role of ECNs in order executions, subject only to the condition that they open their book of orders to investors beyond their subscribers.

In June 2000, there were nine independent ECNs operating in the United States--Instinet, Island, Bloomberg Tradebook, Archipelago, REDIBook, Brut, Attain, NexTrade, Market XT and GFI Securities. n229 One by one, however, almost all either merged with one another or were acquired by Nasdaq or the NYSE. Instinet and Island, two of the larger ECNs, merged in September 2002. n230 This merger created the INET ECN. n231 Archipelago purchased REDIBook in 2002. n232 MarketXT filed for bankruptcy in June 2005. n233 In October 2005, Knight Capital Group acquired Attain and renamed it Direct Edge. n234 In December 2005, Nasdaq purchased Instinet Group Incorporated, the owner of the INET ECN. n235 As of June 2006, the following entities operated as ECNs n236: Bloomberg, Tradebook, Direct Edge, Track, NexTrade, BATS ECN n237, and OnTrade ECN n238. In contrast to the Archipelago and Inet ECNs, which had each garnered approximately 25 percent of the volume of trading in Nasdaq stocks by 2004, none of the remaining ECNs had a significant market share in Nasdaq stocks. n239

[4] National Market System

During 1963 through 1971, the Commission conducted three major studies of the securities industry. n240 These provided an analytical basis upon which the Commission could determine whether the secondary securities markets were operating effectively, efficiently, and equitably. n241 Following these studies, in 1971 the Commission conducted hearings into the structure of the securities markets. n242 Following these hearings, the Commission called for a revolutionary integration of the securities markets into a "central market system" to achieve various policy objectives:

1. "To make the relationships in the securities markets and their operatives as simple, as direct, and as open as [the SEC] can."
2. "To adapt the securities markets to growing institutionalization, with its increased tempo and magnitude of transactions, while maintaining the confidence and the participation of the individual investor."
3. To make "the professional service available to investors as efficient and economic as possible without diluting standards of service and responsibilities." n243

By 1975, the Commission had received final reports from three special advisory committees, n244 held extensive public hearings on the proposed "central market system," n245 and adopted or proposed the adoption of several significant new rules affecting directly the organization and operation of the secondary securities markets. n246

The Commission's enthusiasm and vigor was mirrored in both Houses of Congress as members sponsored proposed legislation and Congressional subcommittees held extensive hearings into the securities industry. n247 These efforts culminated with the 1975 Amendments which mandated, among other things, that the Commission "facilitate" the establishment of a "national market system" for securities. n248 The objectives of the national market system are enumerated in Section 11A of the Exchange Act which provides in relevant part:

It is in the public interest and appropriate for the protection of investors and the maintenance of fair and orderly markets to assure

- (i) economically efficient execution of securities transactions;

(ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;

(iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;

(iv) the practicability of brokers executing investors' orders in the best market; and

(v) an opportunity consistent with the provisions of clauses (i) and (iv) of this subparagraph, for investors' orders to be executed without the participation of a dealer." n249

Congress determined that these objectives could be best achieved by the integration of all secondary securities markets, thereby permitting access to these markets by all qualified broker-dealers and eliminating artificial impediments to dealing in the best available markets. n250

Since the 1975 Amendments, the Commission has worked to eliminate market fragmentation and to integrate the various securities markets to create a national market system. n251 The exchanges and the NASD have combined efforts to develop intermarket communications systems to facilitate market linkage and order routing. n252 The Commission has required the creation of a composite quotation system to improve the quality and reliability of quotation information disseminated by securities information vendors. n253 The Commission also has mandated the development of SRO requirements to ensure that public limit orders n254 obtain priority nationwide over the execution of any order by a broker or dealer at the same or an inferior price. n255

All exchange off-board trading restrictions have been eliminated, through a combination of Commission rulemaking and pressure. n256 Members of an exchange are now permitted to effect OTC agency transactions in securities listed or admitted to unlisted trading privileges on an exchange with any other person not also represented as agent by that member. n257 The Commission has stated that the elimination of these restrictions has furthered the purposes of the Exchange Act by enhancing the practicability of brokers executing investors' orders in the best market and improving customers' ability to achieve the most economically efficient execution of their securities transaction. n258

[5] The Role of the Securities and Exchange Commission

As self-regulatory organizations, the national securities exchanges and FINRA are granted special rulemaking and enforcement responsibilities under the Exchange Act to assist the SEC in regulating the securities industry. n259 Self-regulatory organizations are responsible for establishing, reviewing and enforcing standards of conduct for their members and, if they provide trading facilities, for fair and orderly operation of those facilities. n260 In practical terms, this means the self-regulatory organizations must make rules governing sales practices, trading and business practices, member financial responsibility and enforcement of those rules and the securities laws and regulations. n261

The Commission's mandate is to oversee the self-regulators and, when necessary, to compel remedial industry action. Among other things, the Commission has the authority to

1. Establish industry-wide standards governing commission rates; n262
2. Allocate duties and responsibilities among self-regulators to avoid duplication of expenses and to promote industry cooperation; n263
3. Review disciplinary proceedings; n264
4. Approve, disapprove or modify exchange and NASD rules; n265

5. Adopt rules and promulgate regulations as well as amend, delete, or abrogate rules and regulations of an SRO to protect investors and assure a fair, orderly market; n266 and

6. Commence administrative and civil proceedings to discipline SROs for failure to fulfill their statutory duties and responsibilities. n267

The Commission functions as an independent regulatory agency accountable to Congress and the President. n268 Accordingly, while many of its orders and final agency actions are reviewable by a federal court, n269 the Commission largely exercises its independent judgment in the performance of its statutory mandate. n270

FOOTNOTES:

(n1)Footnote 1. The term "secondary trading of securities" refers to purchases and resales of securities after the initial or primary distribution. For a discussion of primary securities distributions, *see* SEC Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, House Document No. 95, Pt. I, p. 495 (1963) (hereinafter cited as "Special Study").

(n2)Footnote 2. International Institute for Securities Market Development, Markets and Regulation, Overview, Securities and Exchange Commission, p. 2 (1993) (hereinafter cited as "International Institute").

(n3)Footnote 3. "Price discovery" is the process by which the interaction of the buyer's demand and the seller's supply establishes a price for the security. *Id.*

(n4)Footnote 4. "Liquidity" is the state of a market in which an immediate transaction of a reasonable size does not cause more than a reasonable variation in price. *Id.*

(n5)Footnote 5. The scope of traditional exchange trading and a summary of exchange trading procedures are discussed in § 2.01[1][a] *infra*.

(n6)Footnote 6. The National Securities Exchange was formerly known as the Cincinnati Stock Exchange. *See* Isabelle Clary, SEC Set to Tackle Long-Overdue Filings, Securities Industry News, December 8, 2003. For a description of the operation of electronic markets, *see* § 2.01[1][a] *infra*.

(n7)Footnote 7. *See* Sec. Exch. Act Rel. No. 44983 (Oct. 25, 2001), *available at* 2001 SEC LEXIS 2266. The Archipelago Exchange is essentially an ECN which achieved exchange status. In April 2005, however, Archipelago agreed to be acquired by the NYSE, and once the acquisition is complete, Archipelago will be part of the NYSE. For a more detailed description of the evolution and operation of the Archipelago Exchange, *see* § 2.01[1] *infra*.

(n8)Footnote 8. The over-the-counter market is discussed in § 2.01[2] *infra*.

(n9)Footnote 9. Since January 2006 Nasdaq has been registered as a national securities exchange. Nasdaq is discussed in § 2.01[1][a][ii] *infra*.

(n10)Footnote 10. On March 31, 1997, the SEC gave final approval to the operation of the OTC Bulletin Board Service. This service had operated on a temporary basis since 1990. Sec. Exch. Act Rel. No. 38456 (Mar. 31, 1997).

(n11)Footnote 11. This traditional OTC market is discussed in § 2.01[2][a] *infra*.

(n12)Footnote 12. The operation of alternative trading systems is discussed in § 2.01[3] *infra*. Regulation ATS, which provides the regulatory framework under which alternative trading systems operate, is discussed in § 2.02[4] *infra*.

(n13)Footnote 13. Select SEC and market data, fiscal 2007, at Table 12. p. 30 available at

<http://www.sec.gov/about.shtml>.

(n14)Footnote 14. In January 1994, the Commission's Division of Market Regulation issued a report entitled "Market 2000: An Examination of Current Equity Market Developments" (hereinafter cited as "Market 2000 Report") announcing the results of a year and a half study of the overall structure of the U.S. equity markets. See Sec. Exch. Act Rel. No. 30920 (July 14, 1992), 57 FR 32589 (hereinafter cited as "Concept Release"). Citing dramatic changes in the markets since 1975 in response to advances in technology, new product developments, and global economic expansion, the Division determined that it was appropriate to raise questions regarding whether the existing regulatory framework had kept pace with market developments. During the review, the Division gathered data on equity trading and analyzed comment letters submitted in response to the Concept Release. Concurrently with the study, Congress held hearings on many of the issues addressed in the study: Oversight Hearing on the Future of the Stock Market focusing on the National Market System Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 103d Cong., 1st Sess. (Apr. 14 1993); Oversight Hearing on the Future of the Stock Market focusing on Inducements for Order Flow Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 103d Cong., 1st Sess. (May 13, 1993); Oversight Hearing on the Future of the Stock Market focusing on Proprietary Trading Systems Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 103d Cong., 1st Sess. (May 26, 1993); Oversight Hearing on the Future of the Stock Market focusing on Soft Dollar Practices Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 103d Cong., 1st Sess. (July 13, 1993)). In addition, the U.S. General Accounting Office ("GAO") released a report on market structure (GAO, SEC Actions Needed to Address Market Fragmentation Issues (1993)): Oversight Hearing on the Future of the Stock Market focusing on the Results of a GAO Study on Market Fragmentation Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 103d Cong., 1st Sess. (June 29, 1993).

In the Market 2000 report, the Division stated:

The Division's basic finding is that today's equity markets are operating efficiently within the existing regulatory structure. Record amounts of trading activity are processed smoothly and efficiently. The equity markets continue to perform effectively their primary function of raising capital for public corporations. Investors have a wide range of alternative trading mechanisms from which to select. Although trading of major U.S. equities has become dispersed among the various markets and participants, this development has not impaired market quality. Accordingly, the Division does not believe that a major revision of equity market regulation is needed. The Commission should, however, concentrate on the improvements that are needed to make the markets work better for investors and to make competition work better for the markets. The Division believes that improvements are possible in four areas.

The first area involves the *fair treatment of investors*. The broadest possible investor participation, both retail and institutional, is vital to the health of the market. If the market structure works to the disadvantage of customers, they ultimately will lose confidence in the integrity and fairness of the market. To protect customers, professionals should seek to secure the best prices for their customers and should disclose relationships that could interfere with the customers' interests. Market practices such as payment for order flow, soft dollar arrangements, and certain order handling procedures raise concerns as to whether investors are being treated fairly.

Second, *market information* should be disclosed in a timely and comprehensive manner. Information on quotations, trading volume, and trading prices is essential to the effective operations of the markets. Selective or partial disclosure of information impairs the secondary market pricing mechanism, weakens the ability of markets to compete, and prevents customers from monitoring the quality of their executions

...

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Third, *fair competition* among markets and market participants should be promoted ... To promote fair competition as well as investor protection, the Commission must ensure that the regulatory responsibilities of the various market centers are rationally allocated without stifling the ability of alternative markets and services to emerge. In some instances, this goal will require more vigorous oversight of new trading systems. In other instances, this goal will justify different regulatory guidelines for the organized markets.

Fourth, *open market access* needs to be expanded. Restrictions on where the users of the markets can transact business limits the ability of competition to provide ... better markets and services. Several exchange rules and proposals act to restrict market access. These restrictions need to be examined to determine if they serve valid regulatory purposes.

The Division recommends specific action in each of these areas. The most significant recommendations involve Commission rulemakings on payment for order flow and soft dollar practices; proposals to narrow spreads and expand transaction reporting; and increased oversight of automated trading systems and third market makers.

(n15)Footnote 15. Section 12(a) of the Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F provides that it is unlawful for "any member, broker, or dealer to effect any transaction in any security on a national securities exchange unless a registration is effective as to such security." Section 12(b) specifies the procedures for registration of securities on a national stock exchange. In addition, each exchange has its own rules for registration of securities. The registration requirements of the NYSE are summarized in § 2.01[1][b] *infra*, and are discussed in more detail in § 4.01 *infra*. A security that has been registered for trading is said to be "listed" on the exchange for which the registration is effective.

(n16)Footnote 16. The Exchange Act does not directly require securities to be registered unless listed on a national securities exchange. If an issuer's securities are not listed on an exchange, they must still be registered with the Commission if the issuer has over 500 shareholders and \$10 million in total assets. See Section 12(g)(1); Rule 12g-1. While it is conceivable that an issuer could have not been subject to this registration requirement and still have met the financial criteria for inclusion on Nasdaq, before its exchange registration Nasdaq required, with limited exceptions, securities to be registered with the Commission to be considered for inclusion in the market. NASD Manual, Rule 4310(a)(1).

(n17)Footnote 17. The trading of listed securities away from exchanges is known as the "third market." Third market trading is discussed in § 2.03[2][c] *infra*.

(n18)Footnote 18. Unlisted trading privileges are summarized in § 2.01[1][c] *infra*, and are discussed in more detail in § 4.01[5] *infra*.

(n19)Footnote 19. Section 3(a)(26) defines a "self-regulatory organization" to include every national securities exchange and securities association which is registered with the Securities and Exchange Commission. Accordingly, registered exchanges and associations have statutory responsibilities to enforce both the federal securities laws as well as their own rules and regulations. For a more detailed discussion of the regulatory responsibilities of self-regulatory organizations, see § 2.03 *infra*.

(n20)Footnote 20. The trading procedures of stock exchanges are discussed in § 2.01[1][a] *infra*, and the trading procedures of the OTC market are discussed in § 2.01[2] *infra*.

(n21)Footnote 21. Report by the Subcommittee on Oversight and Investigations of the Committee on Interstate and Foreign Commerce, House of Representatives, H.R. 95-134, 94th Congress, 2d Sess., 18,-21 reprinted in the Securities Primary Law Sourcebook, Volume C, Section I of the 1934 Act. See also Special Study Part I, *supra*, at pp. 2-5.

(n22)Footnote 22. House Report No. 94-123, 94th Congress, 1st Sess., 48 (1975) (hereinafter cited as "House Report"), reprinted in the Securities Primary Law Sourcebook, Vol. C, Section I.

(n23)Footnote 23. House Report; *See also* § 2.03 *infra*.

(n24)Footnote 24. Section 6 provides, in part, that an exchange "shall not be registered as a national securities exchange unless the Commission determines that-(1) such exchange is so organized and it has the capacity to be able to enforce compliance by its members and persons associated as members, with the provisions of this title, the rules and regulations thereunder, and the rules of the exchange." A more detailed discussion of the specific responsibilities of national securities exchanges can be found in §§ 2.03[3] and [4] *infra*. While it is unlikely that the self-regulatory system will be eliminated in the foreseeable future, in the 1990s and early 21st century questions arose as to the efficacy of the system, in light of the failures of markets, particularly Nasdaq and the NYSE, to police themselves. Accordingly, there have been calls for a modification of the system, such as a requirement that the regulatory function for each market be separated from the operation of the market itself. *See* § 2.05 *infra*.

(n25)Footnote 25. As restated by Congress in 1975, the pattern of self-regulation mandated by the Exchange Act "calls upon industry organizations to exercise delegated governmental powers in order to enforce at their own initiative compliance by members of the industry with both legal requirements laid down in the Securities Exchange Act and ethical standards which go beyond those requirements. The SEC is charged with supervising the exercise of this regulatory power in order to assure that it is used effectively to fulfill the responsibilities assigned to regulatory organizations, and that it is not used in a manner inimical to the public interest or unfair to private interest." House Report, *supra*, at 48.

(n26)Footnote 26. **15 U.S.C. § 78f.**

(n27)Footnote 27. Exchange registration under Section 6 is discussed in § 2.02 *infra*.

(n28)Footnote 28. Section 6(b)(6). For a discussion of exchange disciplinary action, *see* § 2.03[4] *infra*.

(n29)Footnote 29. Section 6(b)(7) and (d). Membership on a national securities exchange is discussed in § 2.03[2] *infra*.

(n30)Footnote 30. "When the [Exchange] Act was adopted in 1934, it contained a very brief section dealing with the national securities exchanges, and did not treat at all the subject of the over-the-counter market." House Report, *supra*, at 59. Transactions effected in the OTC market were subject, however, to various provisions of the Exchange Act, including the antifraud provisions. *See* § 2.02 n.1 *infra*.

(n31)Footnote 31. **15 U.S.C. § 78-3.** The criteria that an association of brokers and dealers must satisfy to register as a securities association or affiliated securities association with the SEC are discussed in § 2.02[2] *infra*.

(n32)Footnote 32. Response of the Securities and Exchange Commission to the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce, Questionnaire for Regulatory Commissions (July 25, 1975) (hereinafter cited as "SEC Response").

(n33)Footnote 33. *See* Transmittal Letter accompanying SEC Report on Institutional Investors (1971). *See also* SEC, Statement on the Future Structure of the Securities Markets (Feb. 2, 1972). The "central market system" is discussed further in § 2.04[1][a] *infra*.

(n34)Footnote 34. *See* SEC Response, *supra*, for a summary of its regulatory initiatives.

(n35)Footnote 35. Hearings on the Administration of the Laws Pertaining to the Regulation of the Securities Markets by the Administrative Agency and by the Self-Regulatory Agencies Involved Before the Subcommittee on

Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 91st Cong., 1st Sess., ser. 91-9 (1969) [Securities Market Agencies].

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(n36)Footnote 36. The 1975 Amendments, discussed in § 1.01[d] *supra*, added a new Section 11A to the Exchange Act. Section 11A provides, in part, that the Commission is directed "having due regard for the public interest, the protection of investors and the maintenance of fair and orderly markets, to use its authority under this title to facilitate the establishment of the national market system for securities."

To carry out the mandate of Section 11A, the Commission was authorized "to create one or more advisory committees pursuant to the Federal Advisory Committee Act" and "by rule or order, to authorize or require self-regulatory organizations to act jointly with respect to matters as to which they share authority under this title in planning, developing, operating, or regulating a national market system (or a subsystem thereof) or one or more facilities thereof."

For a discussion of the legislative intent underlying Section 11A, see Conference Report to the Securities Act Amendments of 1975, H. Rep. No. 94-229, Cong., 1st Sess., 91 (1975) (hereinafter cited as "Conference Report"), reprinted in Securities Primary Law Sourcebook, Vol. C, Section I and House Report, *supra*, at 49-57.

(n37)Footnote 37. House Report, *supra*, at 51.

(n38)Footnote 38. House Report, *supra*, at 51.

(n39)Footnote 39. The 1975 Amendments were preceded by "the most searching reexamination of the competitive, statutory and economic issues facing the securities markets, the securities industry, and, of course, the public investors, since the 1930's." Conference Report, *supra*, at p. 91. In recommending adoption of this legislation, the Conference Committee further concluded that the:

securities markets of the United States are indispensable to the growth and health of this country's

and the world's economy. In order to raise the enormous sums of investment capital that will be needed in the years ahead and to ensure that capital is properly allocated among the competing uses, these markets must continue to operate fairly and efficiently. The increasing tempo and magnitude of the changes that are occurring in our domestic and national economy make it clear that the securities markets are due to be tested as never before. Unless these markets adapt and respond to the demands placed upon them, there is a danger that America will lose ground as an international financial center and that the economic, financial and commercial interests of the nation will suffer.

The basic goals of the Exchange Act remain salutary and unchallenged: To provide fair and honest mechanisms for the pricing of securities, to assure that dealing in securities is fair and without undue preference or advantages among investors, to ensure that securities can be purchased and sold at economically efficient transaction costs, and to provide, to the maximum degree practicable, markets that are open and orderly.

Conference Report, *supra*, at 91-92. For a summary of the four-year battle to enact the 1975 Amendments, see House Report, *supra*, at pp. 45-47.

(n40)Footnote 40. House Report, *supra*, at 48.

(n41)Footnote 41. The term "self-regulatory organization" had not been used before the 1975 Amendments, as exchanges and securities associations were subject to separate regulatory schemes. The 1975 Amendments in large measure combined these two schemes into one. See S. Rep. No. 94-75, 94[th] Cong., 1[st] Sess., 2 (1975), reprinted in the Securities Primary Law Sourcebook, Vol. C, Section I (hereinafter cited as "Senate Report").

Section 19 grants to the Commission the authority to regulate self-regulatory organizations. The Commission's oversight function is to assure that the self-regulatory organizations are enforcing applicable legal and ethical standards, to assure fair dealings in securities, to protect investors, and to establish over-riding standards of trading that will promote fair orderly markets. Act of June 4, 1975, P.L. 94-29, 89 Stat. 97. The 1975 Amendments are Senate Bill 249, as modified by the Conference Committee in lieu of House Bill, H.R. 4111.

S. 249 would significantly amend the provisions of the Exchange Act dealing with the powers of the self-regulatory organizations and the oversight authority of the SEC with respect to these organizations. The Committee [Senate Committee on Banking, Housing, and Urban Affairs] believes that self-regulation should be preserved in the securities industry, but it also believes that the self-regulatory organizations must display a greater responsiveness to their statutory obligations and to the need to coordinate their functions and activities. In the new regulatory environment created by this bill, self-regulation would be continued, but the SEC would be expected to play a much larger role than it has in the past to ensure that there is no gap between self-regulatory performance and regulatory need and, when appropriate, to provide leadership for the development of a more coherent and rational regulatory structure to correspond to and to police effectively the new national market system.

Senate Report, *supra*.

(n42)Footnote 42. House Report, *supra*, at 48.

(n43)Footnote 43. The 1975 Amendments provide the Commission with "certain oversight powers with respect to exchanges which are absent from the present statute but which have been a part of the regulatory pattern with respect to registered securities associations such as the NASD. Thus, the Commission will for the first time be in a position to disapprove changes in an exchange's body of rules. And the Commission may, upon its own motion, review disciplinary

action taken by the exchange against one of its members as a means of assuring an observance of fair procedures and a coherent, and more uniform, imposition of sanctions for prohibitive conduct." House Report, *supra*, at 49.

(n44)Footnote 44. "The securities industry regulatory organizations, it should be emphasized, are intended to be subject to the SEC's control and have no governmentally derived authority to act independently of SEC oversight." House Report, *supra*, at 48.

(n45)Footnote 45. The years since the enactment of the 1975 Amendments have seen the securities industry, prodded by the Commission, move toward the Congressional goal of a national market system. Notably, the development of the Intermarket Trading System (ITS) has helped further the Congressional objective of "the linking of all markets for qualified securities through communication and other data processing facilities." Section 11A(a)(1)(D). The ITS is discussed in more detail in § 2.04[2][b][i][A], *infra*.

The Commission has also, by rule, mandated the development of a composite quotation system to improve the dissemination of price information to brokers and public investors throughout the country. Sec. Exch. Act Rel. No. 14416, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,502 (Jan. 26, 1978). This composite system, by providing more information, allows brokers to choose among the competing market centers for the most favorable execution of their customers' orders. The composite quotation system is discussed in more detail in § 2.04[2][c], *infra*. The Commission, in an effort to facilitate the nationwide disclosure of market information in a fair and useful form, has also adopted several rules under Section 11. These rules govern the collection and dissemination of transaction information, the manner in which transactions, quotations, and market information are displayed by vendors of securities information.

Sec. Exch. Act Rels. No. 16589 (Feb. 19, 1980) and No. 16590 (Feb. 19, 1980). Collection, dissemination, and display of transaction reports, last sale data, and quotation information is discussed in § 2.04[2][d] *infra*.

The Commission in 1980 adopted Rule 19-3, which precludes the application of offboard trading restrictions to certain securities that became exchange listed after April 26, 1979. The rules also allow broker-dealers who are members of exchanges to deal as principals in an over-the-counter market in securities which became listed on exchanges after April 26, 1979. Offboard trading restrictions are discussed in more detail in § 2.03[2][c] *infra*.

In 1981 the Commission established criteria for the designation of certain OTC securities as national market system securities with the adoption of Rule 11Aa2-1. Sec. Exch. Act Rel. No. 17549 [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,826 (Feb. 17, 1981). Those OTC securities that met the criteria for designation as national market system securities were deemed to be qualified for trading in a national market system. Once designated as national market system securities, these OTC securities were subject to the rules regarding the dissemination of transaction and quotation information.

In 1987 the Commission amended Rule 11Aa2-1 [now replaced by Rule 600] to designate as national market system securities all OTC or exchange listed securities for which transactions are reported pursuant to an effective transaction reporting plan approved by the Commission. National market system securities and the criteria for designation as such are discussed in more detail in § 2.04[2][a] *infra*. In 1996 the SEC implemented Order Handling Rules which govern the display of customer limit orders and the use of Electronic Communications Networks. See Sec. Exch. Act Rel. No. 37619A (Sept. 6, 1996). The Order Handling Rules are discussed in § 2.04[2][h] *infra*.

The developments discussed above represent a movement by the Commission and the securities industry toward a national market system. Congress, in enacting the 1975 Amendments, believed that the establishment of a national market system was essential to insure that our nation's capital markets continue to be the best in existence. Conference Report, *supra*, at 92-93. The 1975 Amendments charged the Commission with the clear responsibility to assure that the national market system developed and operated in accordance with congressional objectives. House Report, *supra*, at

50-51 n.180. A more detailed discussion of the 1975 Amendments' goals and objectives is found in § 2.04[1][b] *infra*.

(n46)Footnote 46. The status of the national market system is discussed in § 2.04 *infra*.

(n47)Footnote 47. See Sec. Exch. Rel. No. 43232 (Aug. 30, 2000).

(n48)Footnote 48. See *id*; Sec. Exch. Rel. No. 42360 (Jan. 28, 2000).

(n49)Footnote 49. See § 2.04[2][c][iii] *infra*.

(n50)Footnote 50. Sec. Exch. Act Rel. No. 51808, 2005 SEC LEXIS 1349 (June 9, 2005) (hereinafter cited as "Regulation NMS Adopting Release").

(n51)Footnote 51. The extension of trade-through protection to Nasdaq stocks is discussed in § 2.04[2][b][iii] *infra*. While at the time Regulation NMS was adopted the distinction between Nasdaq and exchange-listed stocks was important, it later became irrelevant when Nasdaq became registered as a national securities exchange. See Sec. Exch. Act. Rel. No. 53128 (Jan. 13, 2006).

(n52)Footnote 52. Access fees are discussed in § 2.04[2][c][ii] *infra*.

(n53)Footnote 53. Subpenny pricing is discussed in § 2.04[2][c][iii] *infra*.

(n54)Footnote 54. Allocation of market data revenues is discussed in § 2.04[2][f] *infra*.

(n55)Footnote 55. Under the terminology of the Exchange Act, any exchange which is registered with the SEC is a "national securities exchange." See Section 6(a). The Boston, Philadelphia, National, Chicago and Pacific (now NYSE Arca) exchanges are sometimes referred to as "regional exchanges." However, this terminology can be confusing, because of the conflict with the terminology used in the Exchange Act, and will not be used here.

(n56)Footnote 56. In the late 1990s and early 21st century there were numerous mergers, failed mergers and other activities which dramatically altered the ownership and capital structure of the United States securities markets. In 1998 Amex merged with, and became a subsidiary of, the NASD. See Nasdaq Completes Its Merger with Amex, N.Y. Times, November 3, 1998, C10. Also in 1998, the Pacific Exchange and the Chicago Board Options Exchange entered into a merger agreement. See Greg Burns, CBOE, Pacific Exchange Dot Merger I's, Chicago Tribune, November 12, 1998. However, the Chicago Board Options Exchange canceled the merger in January 1999. See Sam Zuckerman, Arthur M. Louis, Peter Sinton, Merger Partner Abruptly Jilts Pacific Exchange, San Francisco Chronicle, January 8, 1999, A1. In July, 2000, the Pacific Exchange entered into a transaction with Archipelago, LLC, one of the larger ECNs, which ultimately led to Archipelago's becoming a trading facility of the Pacific Exchange. See Sam Zuckerman, Pacific Exchange Nearing Launch Into Cyberspace, San Francisco Chronicle, July 14, 2000, B1. The operation of the Archipelago facility is discussed in § 2.01[3] *infra*. Nasdaq announced its plans to become a for-profit market in the Summer of 1999, and sold 40 percent of its stock to investors in a private placement in June 2000. See Press Release, Nasdaq Completes the First Phase of its Private Placement, 40 Percent of Nasdaq sold to Over 2,800 Investors, Over \$330 million raised (June 28, 2000). For a more detailed discussion of Nasdaq's transition to for-profit status, see § 2.05.

Instinet and Island, two of the larger ECNs, merged in September 2002. Reuters, Instinet Completes Island Merger, San-Diego Union Tribune, September 21, 2002, at C-2. This merger created the INET ECN. JB, As SEC Ponders Access Fee Changes, SuperMontage Fee Cap Begins, Securities Week, Vol. 31, No. 9, March 1, 2004, at 9. In November 2003, after a failed attempt to sell Amex to a buyout firm, the NASD decided to sell the exchange to its members, which would essentially reverse the 1998 merger. See Donna Block, NASD Cuts Amex Loose, Daily Deal, November 5, 2003. This sale was completed in January 2005. Exchanges Changing Hands; Stock Exchanges,, Securities Industry News, January 10, 2005. In September 2005, Archipelago Holdings, Inc., the owner and operator of the Archipelago Exchange, acquired PCX Holdings, Inc., the parent company of the Pacific Exchange and PCX

Equities, Inc. Archipelago Holdings, Inc., Form 8-K (September 27, 2005). In December 2005, Nasdaq purchased Instinet Group Incorporated, the owner of the INET ECN. Nasdaq Press Release, NASDAQ Completes Acquisition of INET, December 8, 2005, *available at* www.nasdaq.com/newsroom/news/pr2002/ne_sections_118.stm. The NYSE's members in December 2005 approved a transaction under which the NYSE would acquire Archipelago and both the exchange and Archipelago would become part of a new for-profit publicly-traded entity known as NYSE Group, Inc. Donna Block, Members Approve NYSE Merger, *The Daily Deal*, December 8, 2005, M&A Section; see Final Prospectus pursuant to Rule 424(b)(3) filed by NYSE Group, Inc., SEC File No. 333-126780 (Nov. 4, 2005).

(n57)Footnote 57. See Sec. Exch. Act Rel. No. 28556 (Oct. 19, 1990).

(n58)Footnote 58. In 1976, the Commission authorized the Chicago, then known as the Midwest, Stock Exchange to commence trading in standardized options. After approximately three years of trading both stock and options, the exchange concluded that it was not economically feasible to continue options trading and, accordingly, merged its options program with that of the CBOE. See Sec. Exch. Act Rel. No. 15762 (1979). The NYSE began trading options in 1983, but never gained a significant market share in options trading, and agreed to sell its options business to the CBOE in 1997. Laurie Morse, *NYSE in Options Deal with CBOE*, *Financial Times*, March 6, 1997, at International Capital Markets Section, p.40.

(n59)Footnote 59. Prior to 1972 there were no established markets for the purchase and sale of options. While an informal group of OTC broker-dealers wrote options, the contract terms and price were negotiated on a transaction-by-transaction basis and no secondary market for resale existed. In 1973 the Commission authorized the CBOE to commence trading standardized options on a "pilot" basis. See Sec. Exch. Act Rel. No. 9985 [1972-1973 Transfer binder] Fed. Sec. L. Rep. (CCH) P 79,212 (Feb. 1, 1973). The options traded by the CBOE differed from the OTC options previously available in that the CBOE option was standardized, having a uniform set of terms and conditions which made them readily transferable in a secondary market. See SEC Report of the Special Study of the Options Markets, 96th Cong., 1st Sess., pp. 73-74 (1978) (hereinafter cited as "Options Study").

(n60)Footnote 60. *Supra* n. 13, at Table 12, p. 30.

(n61)Footnote 61. 2004 SEC Annual Report, *supra*, at Table 12.

(n62)Footnote 62. 2004 SEC Annual Report, *supra*, at Table 12.

(n63)Footnote 63. See 2004 SEC Annual Report, *supra*, at Table 12; 2004 New York Stock Exchange Annual Report at 11; 2004 Nasdaq Annual Report at 6.

(n64)Footnote 64. See *supra* n. 13, at Table 12, p. 30.

(n65)Footnote 65. Market 2000 Report, *supra*, at II-7.

(n66)Footnote 66. Division of Market Regulation, SEC, October 1987 Market Break Report at 4-1 to 4-4 (1988) (hereinafter cited as "Market Break Study").

(n67)Footnote 67. See, e.g., NYSE Rules 311 to 324, NYSE Guide, *supra*, at PP 2311-2344. NYSE member firms in 1981 constituted only 18.3 percent of the classified securities firms, but accounted for 88.5 percent of total broker-dealer revenues and employed approximately 80 percent of the employees working for broker-dealers. SEC Staff Report on the Securities Industry in 1981, p. 35 and Exhibit III-10. The definitions of "member," "membership," "member firm," "allied member," "non-member," and "member corporation" are found in Sec. 3, Article I, New York Stock Exchange, Inc. Constitution. See New York Stock Exchange Constitution, Sec. 3, NYSE Guide (CCH) P 1003 (2003). In 2005 the NYSE amended its constitution and rules to allow limited liability companies, in addition to individuals, to become members of the exchange. Sec. Exch. Act Rel. No. 52891 (Dec. 5, 2005). For discussion of the requirements of the Exchange Act concerning membership on a national securities exchange, see § 2.03[2][a] *infra*.

(n68)Footnote 68. New York Stock Exchange Facts & Figures, Member Organization By Type (1972-2002), at www.nyxdata.com/nysedata/default.aspx?tabid=115 (last visited on May 4, 2008), (hereinafter cited as "NYSE Facts & Figures"). There were over 8,000 brokers and dealers registered with the Commission in 2002. SEC Annual Report, at p. 32 (2002).

(n69)Footnote 69. See Securities Exchange Act Release 34-53382 (Feb. 27, 2006).

(n70)Footnote 70. See Amex Members Approve Acquisition of Amex by NYSE Euronext, Joint News Release, available at <http://www.nyse.com/press/1213699341224.html>). In April 2002, the International Stock Exchange was restructured from a limited liability company to a corporation. (See Exchange Act Release No. 34-45803 (Apr. 23, 2002)). In 2004, the SEC granted an order approving the demutualization of the Pacific Stock Exchange, Inc., converting the ownership of the Pacific Stock Exchange from a non-stock, not-for-profit corporation into a for-profit stock corporation. In 2005, Archipelago Holdings, Inc. purchased PCX Holdings Inc., the parent of the Pacific Stock Exchange, who, in turn, was acquired by the New York Stock Exchange in 2006. As a result of the acquisition by the New York Stock Exchange, the names of the Pacific Exchange, Inc. and the Archipelago Exchange, LLC were changed to NYSE Arca, Inc. and NYSE Arca, LLC, respectively. (See Securities Exchange Release No. 34-49718 (May 17, 2004) (granting approval of the demutualization of the Pacific Stock Exchange); Securities Exchange Act Release No. 34-53615 (Apr. 7, 2006) (filing and approval of proposed rule change and amendments thereto to change the names of the Pacific Exchange, Inc., PCX Equities, Inc., PCX Holdings, Inc., and the Archipelago Exchange, L.L.C.). In 2000, the NASD commenced action to restructure its relationship with the Nasdaq through a series of private placements. As a result of such restructuring, Nasdaq became a separate entity from the NASD. In 2005, Nasdaq completed a public offering, and in 2006, Nasdaq received SEC approval to become its own national securities exchange. (See Securities and Exchange Act Release No. 34-52049 (July 15, 2005) (filing of proposed rule change relating to Nasdaq's separation from the NASD, pending approval of Nasdaq's anticipated registration as a national securities exchange); Securities Exchange Act Release No. 34-53128 (Jan. 23, 2006) (granting approval of the Nasdaq's registration as a national securities exchange). In 2006, the National Stock Exchange received SEC approval to reorganize as a for-profit stock corporation. (See Securities Exchange Act Release No. 34-53963 (June 8, 2006) (order granting approval of proposed rule change and amendments relating to the demutualization of the National Stock Exchange). In May 2008, the Boston Stock Exchange, Inc. ("BSE") filed with the SEC certain proposed rule changes relating to the acquisition of BSE by the Nasdaq OMX Group, Inc. (formerly Nasdaq Stock Market, Inc.). As a result of the proposed merger, Nasdaq OMX Group, Inc. would acquire all of the outstanding interests in BSE; BSE member would not retain ownership interests in BSE or its affiliates. (See Securities Act Release No. 34-57757 (May 1, 2008)). In 2004, the Chicago Stock Exchange, Inc. became a for-profit stock corporation as a result of demutualization. (See Securities Exchange Act Release No. 34-51149 (Feb. 9, 2005)). In 2004, the Philadelphia Stock Exchange became the first "floor based" stock exchange to demutualize. (See Securities Exchange Act Release No. 34-49098 (Jan. 16, 2004; see also SEC Approves Philadelphia Stock Exchange Demutualization--PHLX Becomes The First Floor-Based US Stock Exchange To Demutualize, Press Release, available at <http://www.exchange-handbook.co.uk/index.cfm?section=news&action=detail&id=45694>). In 2007, the Chicago Board Options Exchange ("CBOE") announced an anticipated plan to demutualize. As result of the proposed demutualization, CBOE would become a wholly-owned subsidiary of CBOE Holdings, Inc. Furthermore, CBOE would become a for-profit stock corporation whose memberships would be converted to shares of CBOE Holdings, Inc. The proposed restructuring is subject to SEC approval. (See CBOE Board Unanimously Approves Filing to Demutualize; CBOE Reports Earnings for First Six Months of 2006, Press Release, available at <http://www.cboe.com/AboutCBOE/ShowDocument.aspx? DIR=ACNews&FILE=20060727b.doc>).

(n71)Footnote 71. For a discussion of non-member access to exchange facilities, see § 2.03[2][b] *infra*.

(n72)Footnote 72. See Sec. Exch. Act Rel. No. 14256 (Dec. 12, 1977).

(n73)Footnote 73. Sec. Exch. Act Rel. No. 14256 (Dec. 12, 1977).

(n74)Footnote 74. See Sec. Exch. Act Rel. No. 19520 (Feb. 22, 1983). Other exchanges have adopted similar

limited memberships. *See, e.g.*, Article IV, Section 1 of the Constitution of the American Stock Exchange (associate members permitted to maintain electronic access to certain automated systems of the exchange); Pacific Stock Exchange Rule 1.14; (permitting access to exchange data systems and conferring other limited membership rights and responsibilities).

(n75)Footnote 75. *See, e.g.*, American Stock Exchange General and Floor Rules; Chicago Board Options Exchange Rules ch. VI; PCX Equities, Inc. Rule 2.

(n76)Footnote 76. *See generally* Options Study, pp. 129-32; Special Study, *supra*, Pt. 2 at 40-47.

(n77)Footnote 77. Section 15A(b)(6) of the Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F, contains similar provisions with respect to registered securities associations.

(n78)Footnote 78. Section 6(b)(8) of the Exchange Act. Section 15A(b)(9) of the Exchange Act imposes similar requirements on registered securities associations.

(n79)Footnote 79. *See* Market Break Study, *supra*, at 4-2. The NYSE describes the specialist's role as follows:

Market professionals called specialists are the contact point between brokers with buy and sell orders in the NYSE's agency auction market. Each stock is allocated to a specialist, who acts as an auctioneer in specific stocks at a designated location. All buying and selling of a stock occurs at that location, called a trading post. The number of stocks traded by an individual specialist varies according to the total activity of the stocks. High-definition post display units above the trading posts contain a variety of information about each stock that is traded at that location.

Although 95 percent of orders are delivered directly to the trading post by electronic means, they represent 65 percent of the share volume. The remaining 5 percent of orders, which represents 35 percent of share volume, are represented by the floor brokers who meet openly at the trading post to find the best price for a security by interacting with a specialist.

The people who gather around the specialist's post are referred to as the trading crowd. Bids to buy and offers to sell are spoken aloud so that anyone present has an opportunity to participate in the buying and selling. This enhances the competitive determination of prices. When the highest bid meets the lowest offer, a trade is executed.

The specialist is responsible for maintaining the market's fairness, competitiveness, and efficiency. Specifically, the specialist performs four vital functions:

- Auctioneer: At the start of each trading day, specialists establish a fair market price for each of their stocks. They base that price on the supply and demand for the stock. Then, during the day, specialists quote the current bids and offers in their stocks to other brokers, acting as auctioneers.

- Agent: A specialist is the agent for all orders routed electronically through the SuperDOT(r) System, and for orders with special instructions on them left with the specialists by floor brokers to be executed at the best price available.

- Catalyst: Specialists are called upon to maintain "orderly markets" in their assigned stocks. That is, they ensure that trading in their stocks moves smoothly during the day with minimal fluctuation in price so that the public is protected.

- Dealer: If there are temporarily more buy orders than sell orders in a specialist's assigned stocks--or if there are more sell orders than buy orders--then the specialist is required to step in and sell

or buy stock using his own firm's money or reserves of that stock. This is done by buying or selling against the trend of the market, until a price is reached at which public supply and demand are once again in balance. In this role, the specialist acts as principal or dealer.

New York Stock Exchange, A Guide to the World's Leading Securities Market, *available at* www.nyse.com/about/education/1098034584990.html (last visited May 4, 2008), at 10-11.

(n80)Footnote 80. Floor brokers are often referred to as "two dollar brokers," because at one time they charged two dollars for every 100 share execution. Floor brokers are discussed in Special Study, *supra*.

(n81)Footnote 81. See Market Break Study, *supra*, at 4-1.

(n82)Footnote 82. Market Break Study, *supra*, at 4-1. In its 1963 Special Study of the Securities Markets, the SEC described the operation of exchange markets as follows:

The fundamental distinction between exchange and over-the-counter markets is that the exchange provides a centralized marketplace or "floor." All buying and selling interests are funneled to one place, where buyers have an opportunity to find the cheapest sellers, and sellers the most eager buyers.

The method of trading on the two major New York exchanges is known as the continuous auction system. This system, although somewhat resembling the conventional auction procedure, differs from it in that it is a two-way process with competition among sellers as well as among buyers, and that parties usually can achieve an execution, at least for 100 shares, at any time during the trading session. The prevailing "market" or the "quote" for each security is the highest bid and the lowest offer, e.g., 50 (bid), 50 1/4 (offer). An investor desiring to buy or sell with as little delay as possible will usually do so "at the market." If the investor does not wish to execute at the market price, he may enter his own bid or offer to buy or sell at a particular price. This is known as a "limit" order. He may also enter a "discretionary" order, empowering his broker to decide the time and price at which to execute the transaction. Trading in each security takes place at a specified place on the Exchange floor known as a "post." There are 22 posts on the floor of the NYSE, each with an average of about 100 stocks traded at it. A broker who is at a post to trade in a particular security is in "the crowd," which is merely a way of saying he is participating in the auction.

When two or more parties have placed bids (offers) in a security at the same price, technical rules determine who is entitled to the transaction. These are known as "priority," "precedence," and "parity." "Priority" holds that the bid or offer which is first in time is entitled to the first execution. If all orders were placed simultaneously, or if the party entitled to priority has effected his transaction, the principle of "precedence" becomes determinative, holding that bids (or offers) are to be executed in order of size. All bids for amounts as large or larger than the amount of stock offered are considered of equal size, or on a "parity." These bidders then "match" (flip a coin) to determine who is entitled to the execution. If none of the bids is as large as the amount offered (or no offer as large as the bid), they are executed in order of size, with parties having bids (or offers) of equal size "matching" to determine the order of execution.

The continuous auction method of trading, in which orders from the public to buy and to sell are often joined at a central location, operates best when there are many participants in the auction.

Special Study, *supra*, Pt. 2 at pp. 40, 41 (1963).

The Special Study's description of exchange operations is still useful because, although some modern exchanges do

not have trading floors, all employ basis auction principles. However, there are many variations in the procedures employed by the various exchanges, which limit the description's utility in describing the precise nature of trading at the exchanges. Even the NYSE, which is aptly described as a continuous auction market, does not fit this mold perfectly; at times the NYSE functions as a "call auction" market, in which all open orders are executed at a fixed point in time. *See* Market Structure Report of the New York Stock Exchange Special Committee on Market Structure, Governance and Ownership 20 (2001).

(n83)Footnote 83. The NYSE uses the following example to illustrate the process through which orders are executed:

1. Roger Smith of Des Moines, Iowa, decides to invest in the stock market.
 - 1A. Diane Whitford of Hartford, Connecticut, decides to sell 100 shares of Gap Stores stock (GPS) to help pay for a new car.
2. Roger consults a broker who is a member of the New York Stock Exchange. They discuss a number of possible long-term investments. Roger asks his broker for a quote--the highest bid (to buy) and the lowest offer (to sell) for a stock at any given time--on Gap Stores stock (GPS).
 - 2A. Diane calls her broker, a member of the New York Stock Exchange, and asks for a quote on Gap Stores (GPS).
3. The brokers access an electronic market data system to obtain quotes on (GPS) Gap Stores stock from the NYSE floor. A number of information vendors offer this service to brokerage houses. The information vendors get quotes from the NYSE systems via direct high-speed lines.
4. Taking into account what he already knows about GPS--and after a discussion with his broker--Roger instructs his broker to purchase 100 shares of GPS at the current market price. Or Roger goes to his online computer at his home or office and enters the order through his online account which links to SuperDot.
 - 4A. Diane instructs her broker to sell 100 shares of GPS at the current market price. Or Diane goes to her online computer at her home or office and enters the order through her online brokerage account which links to SuperDot.
5. The two brokers send their orders to the floor of the NYSE. Orders can be sent to the floor in two ways: electronically to a booth around the perimeter of the floor and displayed via touch screen in an order management system called Broker Booth Support System (BBSS). Floor brokers are given these orders in printed form or by wireless voice or data terminals, and represent these orders in the trading crowds. If the SuperDot system is used, the order is sent directly to the workstation.
6. At the post, the specialist who handles GPS makes sure the transactions are executed fairly and in an orderly manner.
7. The two floor brokers compete with other brokers on the Trading Floor to get the best price for their customers. The brokers representing Roger and Diane agree on a price.
8. After the transaction is executed, the specialist's workstation sends notice to the firms originating the orders and to the consolidated tape so that a written record is made of every transaction.
9. The transaction is reported by computer and appears within seconds on the consolidated tape displays across the country and around the world.

10. The transaction is processed electronically, crediting Roger's brokerage firm and debiting the account of Diane's brokerage firm. Both Roger and Diane receive a trade confirmation from their respective firms within a few days describing the trade, its terms and conditions, and the exact amount to be tendered or credited.

11. Roger settles his account within three business days after the transaction by submitting payment to his brokerage firm for the 100 shares of GPS, plus any applicable commissions.

11A. Diane's trade is also settled in three business days. Her account will be credited with the proceeds of the sale of stock, minus any applicable commissions.

New York Stock Exchange, *How a Stock is Bought and Sold*, available at <http://www.nyse.com/about/education/1098034584990.html> (last visited February 17, 2006).

Historically, specialists have had exclusive access to valuable information on customer limit orders. See *Smart Gamble*, U.S. BANKER, Vol. 110, No. 9, Sept. 2000, at 12, available at 2000 WL 17705070; *The Battle for Efficient Markets*, ECON., June 17, 2000. The NYSE, however, introduced a service known as "OpenBook," which allows investors, for a fee, to view buy and sell orders on the specialist's limit order book. See *The Exchange*, Volume 9, No. 1, available at www.nyse.com/pdfs/xnlv9n01pc.pdf (January 2002); Sec. Exch. Act Rel. No. 44138 (Dec. 7, 2001); see also www.nyxdata.com/nysedata/tabid/214/default.aspx.

(n84)Footnote 84. In the example used by the NYSE, *supra*, if Helen wanted to only purchase 25 shares, this "odd-lot" would typically be processed by a NYSE firm specializing in odd-lot executions at the best national offer price, whether on the NYSE or another exchange. See NYSE Rule 124, NYSE Guide (CCH) PP 2124, 2124.6 (2003) (hereinafter cited as "NYSE Guide").

(n85)Footnote 85. Market Break Study, *supra*, at 4-1 n.3. The NYSE has described the Purpose of Stop Orders as follows:

STOP ORDERS may be used in an effort to protect a paper profit or to try to limit a possible loss to a certain amount. To illustrate: if you bought stock at \$35 a share, you could enter an order to sell at "30 stop." In the event the stock declines to \$30 or below, your order automatically becomes a market order and is then executed at the best price available to your broker on the floor--which could be at \$30, or below or above \$30, depending upon the market in the stock at that time.

Or, if stock bought at \$35 a share should rise to \$55, the customer could enter a stop order to sell at \$50. Should the stock decline to \$50 or below the stop order would automatically become a market order and the stock would be sold at the best price then available to him on the floor. Stop orders may also be used when buying stock.

NYSE Pamphlet, pp. 32, 34 (1976).

(n86)Footnote 86. Sec. Exch. Act. Rel. No. 43767 (Dec. 22, 2000).

(n87)Footnote 87. See Sec. Exch. Act. Rel. No. 53014 (Dec. 22, 2005).

(n88)Footnote 88. See Sec. Exch. Act. Rel. No. 53539 (Mar. 22, 2006).

(n89)Footnote 89. See Sec. Exch. Act. Rel. No. 50173 (Aug. 10, 2004) (hereinafter cited as "NYSE Hybrid

Proposal"). In response to market participant concerns over the Hybrid Market's operation and its impact on the securities market as a whole, the NYSE filed a number of amendments to the Hybrid Proposal seeking to either clarify or make additional changes to the Hybrid Market. *See* Sec. Exch. Act Rel. No. 50667 (Nov. 15, 2004) (hereinafter cited as "Hybrid Amendment Nos. 2 and 3"); Sec. Exch. Act. Rel. No. 51906 (June 22, 2005) (hereinafter cited as "Hybrid Amendment No. 5"). In order to test the effectiveness of certain components of the Hybrid Market, the NYSE filed a proposal to implement a pilot program, which was approved by the SEC on December 14, 2005. Sec. Exch. Act Rel. No. 52954 (Dec. 14, 2005). SEC Exch. Act Rel. No. 2954 (Dec. 14, 2005). For this pilot program, the NYSE selected approximately 200 securities out of the 3,600 listed on the NYSE and identified them as pilot securities. *Id.* The pilot commenced on December 12, 2005 and is scheduled to terminate in 90 calendar days from that date or until the SEC approves the Hybrid proposal, whichever comes first. *See id.* *See also* Sec. Exch. Act. Rel. No. 53539 (mar. 22, 2006).

(n90)Footnote 90. These are market or limit orders that execute immediately and automatically cancel any unfilled portion of the order.

(n91)Footnote 91. *See* NYSE Hybrid Proposal, Hybrid Amendment Nos. 2 and 3, Hybrid Amendment No 5, *supra*.

(n92)Footnote 92. NYSE Display Book is an order-management and execution facility used by specialists on the floor of the NYSE. The NYSE Display Book receives and displays orders to the specialist and provides a mechanism to execute and report transactions on the NYSE. *See* Sec. Exch. Act. Rel. No. 51906, n.12 (June 22, 2005).

(n93)Footnote 93. *See* NYSE Hybrid Proposal, *supra*..

(n94)Footnote 94. NYSE Hybrid Proposal, *supra*.

(n95)Footnote 95. NYSE Hybrid Proposal, *supra*.

(n96)Footnote 96. NYSE Hybrid Proposal, *supra*.

(n97)Footnote 97. NYSE e-Quote is a new electronic tool that would be used by floor brokers to electronically place bids and offers at various prices via their hand-held devices. Sec. Exch. Act. Rel. No. 52954 (Dec. 14, 2005)

(n98)Footnote 98. The specialists' trading interest could be entered manually into the NYSE Display Book, or entered algorithmically through the NYSE Specialist Application Programming Interface, a new tool that would operate as an electronic conduit allowing specialists to interact with customer orders. NYSE Hybrid Proposal, *supra*.

(n99)Footnote 99. *See* Hybrid Amendment No. 5, *supra*.

(n100)Footnote 100. Trade and Quote Reporting 2002, NYSE Facts and Figures, *supra*.

(n101)Footnote 101. Sec. Exch. Act Rel. No. 10787, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,782 (May 10, 1974).

(n102)Footnote 102. The term "third market" refers to OTC transactions in exchange-traded securities effected between or among brokers or dealers that do not take place on the floor of an exchange. The generic term "third market" should be distinguished from "Nasdaq's Third Market," which is a specific system operated by Nasdaq for third market trading. For a discussion of the consolidated transaction reporting system contemplated by the national market system, see § 2.04[2][d] *infra*.

(n103)Footnote 103. Nasdaq is discussed in detail in § 2.01[1][a][ii] *infra*.

(n104)Footnote 104. The ISE, on which only options are traded, is an electronic auction market. *See* Sec. Exch. Act. Rel. No. 42455 (Feb. 24, 2000), *available at* 2000 SEC LEXIS 325, at *48. Liquidity is provided by three classes of members--"primary" and "competitive" market makers, and "electronic access members." *Id.* at *10, 48. Primary

market makers have the highest level of responsibility, but also have superior access information concerning pending orders and quotations. *Id.* at *48. The auction market function of the National Stock Exchange is performed by the National Securities Trading System, which is described in § 2.04[2][b][i][B] *infra*.

(n105)Footnote 105. Section 3(a)(9) defines "facility" of an exchange broadly to include, among other things, the exchange's physical location, any tangible or intangible property of the exchange, and the right to use the exchange's property "for the purpose of effecting or reporting a transaction" on the exchange. This definition is broad enough to include both the floor of an exchange, the phone or computer systems used on or near the floor, and trading systems located completely away from the floor. The use of the term "facility" in the Exchange Act and the rules thereunder ensures that the reach of these provisions extends to systems or property other than the floor of an exchange, and transactions occurring using these systems or properties.

(n106)Footnote 106. Sec. Exch. Act Rel. No. 44983 (Oct. 25, 2001). The Archipelago Exchange is essentially an ECN which has been transformed into a facility of an exchange. In 2000, Archipelago, LLC, which operated the ECN, entered into an alliance with the Pacific Exchange under which the Pacific Exchange received a 10 percent interest in Archipelago LLC's parent company and Archipelago LLC and the Pacific Exchange agreed to develop a purely electronic equities exchange. The Pacific Exchange then made an application to the SEC for approval of the creation of the Archipelago Exchange as a facility of the Pacific Exchange. *See id.* As a facility of the Pacific Exchange, Archipelago is subject to the self-regulatory function of the Pacific Exchange, though it continues to be operated by Archipelago, LLC. *See id.*

The Archipelago Exchange functions like an electronic auction market in which there is no specialist to facilitate orderly trading but market makers enter orders for their own accounts to provide liquidity. The Archipelago Exchange allows users, which are typically broker-dealers but may be other persons who are "sponsored" by a broker-dealer authorized to trade on the exchange, to enter orders of various types which interact on the exchange with orders placed by other users. *Id.* Users have substantial flexibility in the types of orders they may enter. For example, a user may enter a market order, a limit order, an order directed to a particular market maker, and order in which only a portion of the shares the user is willing to buy or sell are displayed, and other types of orders. *Id.* Market makers are required to maintain continuous limit orders on both the buy and sell sides of the market in securities for which they are registered as market makers. *Id.*

However, there is no requirement that there be market makers for all securities. *Id.*

(n107)Footnote 107. In 1976, for example, the NYSE introduced its Designated Order Turnaround, or "DOT," System. The system, which is now called "SuperDOT" because of enhancements made to it, permits a member firm or non-member access firm to transmit market and limit orders for up to 3,000,000 shares electronically to the proper trading post, thereby bypassing the commission and floor brokers. *See* www.nyse.equities/nyseequities/10952052040263.html.

See Sec. Exch. Act Rel. No. 44399 (June 7, 2001). During 2002, there were 339 subscribers to the SuperDot system. *Order Transmission and the SuperDot System*, NYSE Facts and Figures, *supra*. The advantages of SuperDOT are that electronic order-routing and execution reporting directly to and from the specialist post reduces transaction costs and the probability of human error. While the original DOT system had been criticized for significant operational problems during the market crash of 1987, *See* Market Break Study at 7-16 to 7-24, improvements to the SuperDOT system have greatly increased system-wide speed and efficiency.

In 2002, SuperDot processed an average of 5,427,980 orders per day. *Id.*

The Commission has outlined the operation of the regional exchanges' automated systems as follows:

The Boston, Midwest [now Chicago], Pacific ("PSE") [now NYSE Arca], and Philadelphia (Phlx) Stock Exchanges have developed systems called BEACON, MAX, SCOREX, and PACE, respectively, that automatically route and execute small orders (generally up to 1,099 shares). These four systems basically operate in the same manner. After an order is routed to the system, it is priced based on the best bid or offer displayed on the Intermarket Trading System ("ITS") at the time the order was received by the system, and then routed to the applicable specialist post. The order is then displayed on a video terminal at the post for 15 seconds to permit the specialist and/or trading crowd to improve upon the price. If no floor trader intervenes within the 15 seconds, the order is automatically executed against the specialist at the predetermined price. Under the PACE system, however, orders are executed once priced and are not displayed for price improvement. The four systems also transmit transaction reports to members and market data vendors.

Sec. Exch. Act Rel. No. 27445, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,505, at n.7 (Nov. 16, 1989).

(n108)Footnote 108. For a discussion of the Intermarket Trading System, see § 2.04[2][b][i][A], *infra*.

(n109)Footnote 109. Section 6(b)(1), reprinted in the Securities Primary Law Sourcebook, Volume B, Section F of the 1934 Act

(n110)Footnote 110. For a discussion of the New York Stock Exchange surveillance system and the dialogue between the Commission and the exchange on continued improvement, see Options Study, pp. 223-30. *See also* Sec. Exch. Act Rel. No. 15575, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,962 (Feb. 22, 1979), in which the Commission announced that further expansion of exchange trading of standardized options was dependent upon significant improvements in, among other things, the exchanges' market surveillance systems.

The Commission generally inspects the market surveillance programs of the SROs annually. During the 1980s the Commission criticized the SROs' ability to adapt their surveillance programs to an increasingly complex market, *see, e.g.*, 47 SEC Ann. Rep., at 10 (1983), and in response the SROs enhanced their capabilities. A Commission review of the NASD Market Surveillance Department in November 1992 found that the NASD had "significantly improved its automation and enhanced its surveillance procedures." A similar inspection of NYSE procedures found "significant improvement in the NYSE's surveillance and investigatory operations for program trading," and that generally the NYSE maintained "effective surveillance programs." 59 SEC Ann. Rep., at p. 35 (1994). However, the Commission in recent years has continued to find what it believes to be significant deficiencies in the SROs' fulfillment of their market surveillance responsibilities. In 2000 a report by the Commission's Office of Compliance Inspections and Examinations and Office of Economic Analysis found "significant weaknesses" in the SROs' market surveillance programs as they relate to compliance with limit order display requirements. *See* Securities and Exchange Commission, *Special Study: Report Concerning Display of Customer Limit Orders* (May 4, 2000), available at www.sec.gov/news/studies/limitorder.htm (last visited May 4, 2008).

(n111)Footnote 111. *See, e.g.*, Options Study, pp. 19-33.

(n112)Footnote 112. Section 401, Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2291 (1980). For a general discussion of MOSS, see SEC, Fourth Six-Month Report to the Senate Committee on

Banking, Housing and Urban Affairs and the House Committee on Energy and Commerce Regarding Implementation of the Market Oversight and Surveillance System, Attachment A at pp. 2-3 (Oct. 1, 1982) (hereinafter cited as "MOSS Report").

(n113)Footnote 113. In authorizing the Commission to proceed with the development of the MOSS Project through fiscal 1983, the Senate Committee instructed the Commission to begin discussions with the SROs, in fiscal year 1981, regarding the receipt by the Commission for use in MOSS of certain additional information maintained by the SROs. This information included: (1) NASD broker-dealer quotes; (2) NASD end of day broker-dealer volume; (3) NASD broker-dealer quote drops; (4) broker-dealer symbol cross-references; (5) broker-dealer securities relationships; (6) unmatched option trades; and (7) inquiry/investigations. In fiscal years 1982 and 1983, the Commission was to initiate discussions with the SROs regarding the specifics of interfacing with the MOSS System on matters regarding: (1) inspections of brokers and dealers; (2) extensions of credit pursuant to Regulation T; (3) investor complaints; (4) sales personnel; (5) securities' violations and pending actions; and (6) Broker-Dealer Focus Reports. MOSS Report, *supra*, at p. 8.

See also Report of the Senate Committee on Banking, Housing and Urban Affairs to Accompany S. 2465, S. Rep. No. 96-752, 96 Cong., 2d Sess. (1980) at pp. 4-5 and Report to the House Committee of Interstate and Foreign Commerce to Accompany H.R. 6830, H. Rep. No. 96-961, 96th Cong., 2d Sess. (1980).

(n114)Footnote 114. The Commission in the MOSS Report noted that the "development of MOSS was a precipitating factor encouraging SRO efforts to develop an effective intermarket surveillance program and the New York Stock Exchange's efforts to develop and implement a complete transaction audit trail for its listed equity securities. The Commission's MOSS pilot enabled the staff to provide the SROs with theoretical and technical input concerning an effective multimarket surveillance program. It also demonstrated to the SROs the Commission's commitment to realize an effective intermarket surveillance program, whether administered by the Commission or by the SROs, that would be responsive to the Commission's mandate to oversee the integrity of the nation's financial marketplaces as well as the Commission's commitment to improve its oversight capabilities of SRO surveillance programs." MOSS Report, *supra*, at pp. 9-10.

Moreover, in February, 1981, the Intermarket Surveillance Group ("ISG") was formed to design and implement improved intermarket surveillance procedures among the self-regulatory organizations. The self-regulatory organizations participating in the ISG are: The American Stock Exchange, Boston Stock Exchange, Chicago Board of Options Exchange, Cincinnati Stock Exchange, Chicago Stock Exchange, National Association of Securities Dealers, New York Stock Exchange, Pacific Stock Exchange, and Philadelphia Stock Exchange. Members of the ISG are committed to work jointly to assure that there is appropriate coordination of intermarket surveillance matters as a national market system develops. In addition to the ISG surveillance efforts, each individual SRO continues to maintain and develop its own surveillance facilities. *Id.*, Attachment A at pp. 2-3.

(n115)Footnote 115. In 1982, the NASD summarized the growth of Nasdaq as follows:

In a single decade, NASDAQ has brought order to what had been a largely unrecognized and sometimes chaotic market and, in the process, completely transformed the nature of over-the-counter trading. Before NASDAQ came on the scene, up-to-the-minute quotations for OTC securities were elusive. Messengers scrambled to deliver multi-colored sheets with quotations that were hours, even days, old. For a more recent quote, a broker had to contact a market maker by telephone or telegraph. Shopping for the best quotation among various market makers was practical only for large orders. Small wonder, then, that promising companies fled the OTC market for the relative calm and organization of

the exchanges.

The climate began to change when NASDAQ began operations as a trailblazer of the electronics age a decade ago. The NASDAQ's electronic flow of up-to-the-second price quotations throughout the trading day created a vital communications link between the market makers, brokers and investors. It also brought the market its first real public visibility. The system started with quotation information only but was soon expanded to include other trading information that in the past had been largely unavailable. Volume information was added in the system's first year, as a running index of NASDAQ's stock performance. Other innovations such as the best bid and asked prices (known as "inside quotations") were added later.

Until NASDAQ, many investors had considered the over-the-counter market to be a moribund backwater of the securities industry. The initial statistics gathered by the NASDAQ's computers were surprising to the skeptics. During 1972, NASDAQ's first full year, 2.2 billion shares were traded. By 1981, NASDAQ volume had surged to a record 7.8 billion shares, up 17 percent over the previous year and more than twice the level of 1979. The NASDAQ Securities Fact Book, at pp. 1-2 (1982).

In January 2006, Nasdaq became registered as a national securities exchange. Sec. Exch. Act. Rel. No. 53128 (Jan. 13, 2006).

(n116)Footnote 116. See 2004 Nasdaq Annual Report, at 6; 2004 New York Stock Exchange Annual Report, at 11.

(n117)Footnote 117. See 2004 Nasdaq Annual Report, at 6; 2004 New York Stock Exchange Annual Report, at 11.

(n118)Footnote 118. See National Association of Securities Dealers, Inc., "Transaction Services/How to Become a Market Participant," at www.nasdaqtrader.com/trader/tradingservices (last visited February 2, 2004); Sec. Exch. Act. Rel. No. 51583 (Apr. 20, 2005).

(n119)Footnote 119. Nasdaq formerly used three different types of terminals corresponding to three different levels of service. Level 1 served individual investors and registered representatives. 1994 NASD Fact Book, *supra*, at p. 30. Level 1 terminals, located primarily in retail branches, provided quotation information, last sale reports, and market summary data. *Id.* Level 2 terminals were used by institutions and brokerage firms. *Id.* The Level 2 terminals showed specific quotations by market makers in Nasdaq securities but did not permit the entry of information into the Nasdaq system. Level 3 terminals were used by market makers in Nasdaq securities to enter, change, or update their quotations and view the quotations of other market makers. *Id.* at p.43.

Prior to 1980, Level 1 terminals did not display the actual quotations of specified market makers. Rather, they displayed for each security quoted in the Nasdaq system, a single "Representative Bid and Ask" ("RBA") consisting of the median bid and the median offer price of all registered market makers who had entered quotations for that security into the Nasdaq system. For a discussion of the representative bid and ask system, see Sec. Exch. Act Rel. No. 15250 nn. 45 and 46, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,749 (Oct. 20, 1978).

In 1980 the Commission adopted Rule 11 Ac1-2 [now Rule 603]. Sec. Exch. Act Rel. No. 16590, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,456 (Feb. 19, 1980). This rule prohibited the display of representative bid and ask price information on Level 1 terminals. Instead, Level 1 terminals were required to display at a minimum the highest bid and lowest offer price for a given security. The Commission believed that the display of this information on Level 1 terminals would make broker-dealers more diligent in executing customer orders at the best price. Sec. Exch. Act Rel. No. 15250, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,749 (Oct. 20, 1978). The Commission felt that the only feasible way for a customer to police a broker's efforts to obtain the best execution was to

receive information as to the best bid and offer available at the time the order is placed to buy or sell a Nasdaq security. The Commission felt that a retail customer who only had RBA information could not properly evaluate the quality of execution of price and services rendered by the broker-dealer handling the order. *Id.*

(n120)Footnote 120. See National Association of Securities Dealers, Inc., Transaction Services/How to Become a Market Participant, *available at* www.nasdaqtrader.com/trader/tradingservices (last visited February 2, 2004).

(n121)Footnote 121. National Association of Securities Dealers, Inc., Transaction Services/How to Become a Market Participant, *supra*.

(n122)Footnote 122. See National Association of Securities Dealers, Inc., Transaction Services/How to Become a Market Participant, *supra*.

(n123)Footnote 123. Sec. Exch. Act. Rel. No. 42344 (Jan. 14, 2000) (hereinafter cited as "SuperSOES Adopting Release"). The SuperSOES system grew out of Nasdaq's Small Order Execution System ("SOES"), which provided for automatic execution of small orders, and which was designed to allow small investors to obtain rapid executions. For a description of the SOES system, see Sec. Exch. Act Rel. No. 26361 (Dec. 15, 1988). As originally instituted, participation in the SOES system was voluntary, and under the SOES system orders for up to 500 shares were automatically executed at the inside bid or offer of participating market makers. *Id.* The rules governing the SOES system were later amended on several occasions. Among other changes, the system became mandatory for Nasdaq market makers with respect to National Market securities, and the maximum order sizes for National Market securities were introduced which vary to based on the characteristics of securities. *Id.*

(n124)Footnote 124. SuperSOES Adopting Release, *supra*.

(n125)Footnote 125. See Sec. Exch. Act Rel. No. 43863 (Jan. 19, 2001), *available at* 2001 SEC LEXIS 112, at *12 (S.E.C.) (hereinafter cited as "SuperMontage Adopting Release"); John Sandman, ADF Still Lagging in FIX Connectivity, Securities Industry News, October 21, 2002. Once SuperMontage was phased in for all Nasdaq securities, it replaced SuperSOES. See Sec. Exch. Act. Rel. No. 45906 (May 10, 2002).

(n126)Footnote 126. See, e.g., Sec. Exch. Act Rel. No. 45790 (Apr. 19, 2002); Sec. Exch. Act Rel. No. 46141 (June 28, 2002); Sec. Exch. Act. Rel. No. 48798 (Nov. 17, 2003).

(n127)Footnote 127. See Sec. Exch. Act. Rel. No. 50074 (July 23, 2004).

(n128)Footnote 128. As originally proposed, the system would have displayed trading interest at the top of the market and two levels away. See SuperMontage Adopting Release, *supra*. In April 2002, the SEC approved a change under which the top of the market and four additional levels are displayed. Sec. Exch. Act Rel. No. 45790 (Apr. 19, 2002).

(n129)Footnote 129. SuperMontage Adopting Release, *supra*.

(n130)Footnote 130. *Id.* Post-trade anonymity was not a feature of the original system, but was added as the result of a rule change approved by the SEC in September 2003. See Sec. Exch. Act Rel. No. 48527 (Sept. 23, 2003). In addition to Nasdaq Quoting Market Participants, SuperMontage allows for the participation of "order entry firms," which can execute against the quotes and orders of other firms. See SuperMontage Adopting Release, *supra*. Order entry firms may not enter quotes into the system, and any orders entered into the system are for immediate execution only, and are to be canceled if not immediately executed. See *id.*

(n131)Footnote 131. SuperMontage Adopting Release, *supra*. In addition, in May 2003, the SEC approved a pilot

program under which order entry firms may also use reserve size. Sec. Exch. Act Rel. No. 47830 (May 12, 2003).

(n132)Footnote 132. See SuperMontage Adopting Release, *supra*, at * 18 n.27.

(n133)Footnote 133. SuperMontage Adopting Release, *supra*, at * 18 n.27.

(n134)Footnote 134. See The Nasdaq Stock Market Inc., NASDAQ SuperMontage, *available at* www.nasdaqtrader.com/trader/hottopics/smfactshe08063.pdf (last visited January 31, 2004). Directed orders, because they are not entered into the system like other orders, may be at any price and quantity and also may be executed outside normal trading hours. *Id.*

(n135)Footnote 135. Sec. Exch. Act Rel. No. 48798 (Nov. 17, 2003). Market participants can also enter "reverse pegged orders," which are pegged to the opposite side of the market but deviate from that price by \$.01. *Id.* For example, if the inside market for a stock is \$30.00--\$30.05, a reverse pegged buy order would peg at a price of \$30.04. A reverse pegged order cannot be pegged to the exact price on the opposite side of the market, because this would result in a "locked" market, *i.e.*, a market in which a bid quote and ask quote are the same. See *id.* For a discussion of "Auto-Ex orders, see Sec. Exch. Act. Rel. No. 49020 (Jan. 5, 2004).

(n136)Footnote 136. Nasdaq Unveils Single Platform, Cross, Securities Industry News, March 22, 2004.

(n137)Footnote 137. See Rule 11Aa2-1 [now Rule 600(a)] under the Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section G. Rule 11Aa2-1 was amended in 1987 to designate as NMS securities all OTC or exchange-listed securities for which transactions are reported pursuant to an effective transaction reporting plan approved by the Commission pursuant to Rule 11Aa3-1 under the Exchange Act. This included in the NMS designation all securities listed on the NYSE and Amex and sole regional exchange listings that substantially meet Amex or NYSE listing criteria, as well as OTC securities that meet NMS eligibility criteria in the NASD's Transaction Reporting Plan. See Sec. Exch. Act Rel. Nos. 24633 and 24635 (June 23, 1987). See § 2.04 *infra*.

(n138)Footnote 138. See Rule 602 [former Rule 11 Ac1-1].

(n139)Footnote 139. Market Break Study, *supra*, at 9-2-9-3.

(n140)Footnote 140. In September 2005, Nasdaq renamed the Nasdaq SmallCap Market the "Nasdaq Capital Market." Sec. Exch. Act. Rel. No. (Sept. 21, 2005).

(n141)Footnote 141. Nasdaq SmallCap [now Capital Market] securities were not originally subject to Nasdaq's transaction reporting plan, which covered only National Market securities, although transactions in SmallCap securities were reported on a real-time basis. Beginning in November 2001, SmallCap securities became subject to Nasdaq's reporting plan. See Sec. Exch. Rel. No. 45081 (Nov. 19, 2001).

(n142)Footnote 142. Market Break Report at 9-3.

(n143)Footnote 143. In 1981 the NASD described the increased OTC surveillance as follows:

The NASDAQ Computer System allowed the NASD to greatly expand its market surveillance. In July of 1981, the NASD's Market Information Data Access System (MIDAS) became operational. MIDAS represented a major enhancement of the NASD's market surveillance capabilities. The system provided the 17 NASD professionals who are assigned exclusively to market surveillance with instantaneous, on-line access to up to 60 days of price information about every NASDAQ security. MIDAS can recapture quotation data on a second-by-second basis and reconstruct trading patterns as they occurred. This gives the NASD the ability to create a complete audit trail of quotation activity for all market makers. NASD 1981 Ann. Rep. pp. 14-15.

Better supervision of listed stocks once was claimed as a desirable reason for exchange listing since there was no comparable way of monitoring the OTC market's activity or performance. NASDAQ has reduced this advantage by making possible for the first time a computerized "Stock Watch" program for OTC companies. Created by the NASD, this program monitors trading patterns of Nasdaq securities and irregular market activity. The program is supervised by trained analysts who constantly check such things as unusual price fluctuation, irregular volume swings, new highs and lows of stocks, and uncommon variances between bid and asked prices. Market surveillance data ranges from all Nasdaq markets made by each market maker to Nasdaq issuer press releases and earnings reports, recent financial filings, and histories of price and volume trends.

NASDAQ and the Listing Dilemma--How the NASDAQ System is Influencing the Corporate Question on Stock Exchange Listing, p. 16 (NASD Pamphlet 1973).

(n144)Footnote 144. In 1997 the NASD described the surveillance of Nasdaq as follows:

The NASD continues to update and improve its monitoring of Nasdaq. The NASD currently employs a number of sophisticated computer systems to monitor trading. The Nasdaq Equity Audit Trail ("NEAT") provides a fully integrated data base of second by second quotation, transaction, and clearance and settlement information for all Nasdaq securities on a firm by firm basis. NEAT is used in a broad range of NASDR surveillance systems and provides an efficient and effective means of overseeing trading activity in the Nasdaq market. In addition to NEAT, the NASD monitors trading through an automated system known as the StockWatch Automatic Tracking ("SWAT") system. SWAT analyzes trading activity on a monthly, weekly, and daily basis for any unusual price or volume movements in any Nasdaq security.

SWAT, along with NEAT, enables analysts to reconstruct unusual trading patterns and create a complete audit trail of quotation changes by all market makers in an issue. These capabilities facilitate the efforts of analysts to investigate insider trading cases and document other instances of questionable activity.

The Research and Data Analysis Repository, RADAR, further facilitates the analysis of trading activity. RADAR provides immediate access to market data and other related information, allowing large quantities of data to be analyzed quickly. Whenever Nasdaq's SWAT system detects unusual price or volume movements in a stock's trading, RADAR assists market surveillance analysts by rapidly pinpointing the identity of the securities firms responsible for the trading, the precise time at which trades took place, how much was bought or sold, and for whose account.

NASD Manual, Administrative Profile at p. 152-153, 157-158 (1997).

In addition to its existing systems, in 1998 NASDR began implementation of the Order Audit Trail System ("OATS"). OATS is designed to provide an accurate, time-sequenced record of orders and transactions beginning with the order and documenting the life of the order through routing and execution. This information enables NASDR to construct a comprehensive audit trail of order and transaction data. Sec. Exch. Act Rel. No. 39729 (Mar. 6, 1998).

(n145)Footnote 145. 2004 SEC Annual Report, *supra*, at Table 13.

(n146)Footnote 146. *See, e.g.*, New York Stock Exchange Listed Company Manual, § 102 (2008); American Stock Exchange Company Guide, § 101.

(n147)Footnote 147. New York Stock Exchange Listed Company Manual, § 102 (2008).

(n148)Footnote 148. New York Stock Exchange Listed Company Manual, § 102 (2008). The \$60 million requirement also applies to companies listing as a result of spin-offs or under standards applicable to companies that have an affiliate that is already listed on the exchange.

(n149)Footnote 149. New York Stock Exchange Listed Company Manual, § 102 (2008). An affiliated company that has at least \$500 million in global market capitalization, at least twelve months' operating history and is controlled by or under common control with a NYSE-listed company is exempt from the earnings listing standard.

(n150)Footnote 150. See New York Stock Exchange Listed Company Manual, §§ 303, 303A.

(n151)Footnote 151. See New York Stock Exchange Listed Company Manual, §§ 202.01, 202.05, 202.06, 313, 402 (2008).

(n152)Footnote 152. See Sec. Exch. Rel. No. 48745 (Nov. 4, 2003), *available at* 2003 SEC LEXIS 2654, at *13 (hereinafter cited as "Listing Standards Release"). At this time the exchange's listing standards relating to issuer's audit committees had already been revised as the result of a report by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees commissioned by the NASD and the NYSE. *Id.*

(n153)Footnote 153. Listing Standards Release, *supra*.

(n154)Footnote 154. See Listing Standards Release, *supra*, at *14--15; Mike Allen, Bush Signs Corporate Reforms into Law, Washington Post, July 31, 2002, at A4.

(n155)Footnote 155. See Listing Standards Release, *supra*, at *14.

(n156)Footnote 156. Listing Standards Release, *supra*, at * 14-15.

(n157)Footnote 157. See Rule 10A-3 under the Exchange Act of 1934.

(n158)Footnote 158. See Listing Standards Release, *supra*.

(n159)Footnote 159. Listing Standards Release, *supra*, at *16-35.

(n160)Footnote 160. Prior to Nasdaq's registration as a national securities exchange, securities included in Nasdaq were required to be registered under Section 12(g), rather than Section 12(b), of the Exchange Act. Registration of securities pursuant to Sections 12(b) and 12(g) of the Exchange Act is discussed in § 4.01[2] *infra*.

(n161)Footnote 161. After the NASD to FINRA transition, the small-cap market compliance rules are listed in the NASDAQ Manual. NASDAQ Manual, Rule 4310.

(n162)Footnote 162. A deficiency in the maintenance criteria for market value of public float and bid price will be determined if the issuer fails any of these requirements for 30 consecutive days. If failure of any of the 10-day tests occurs, the issuer will be notified promptly and will be given 90 calendar days to comply with the bid price or market value of public float requirements. A failure to meet the required number of market makers shall exist only if the deficiency continues for a period of 10 consecutive business days. Upon such failure, the issuer shall be notified promptly and shall have a period of 30 calendar days to comply with the standard. NASDAQ Manual, Rule 4310(c)(8)(C).

(n163)Footnote 163. A round lot holder is a holder of 100 shares or more.

(n164)Footnote 164. The public float consists of shares held by members of the public who are not insiders of the

company. NASDAQ Manual, Rule 4310(c)(7)(B). It excludes shares held by officers or directors of the issuer or persons who beneficially own more than 10 percent of the issuer's total outstanding shares. *Id.*

(n165)Footnote 165. NASDAQ Manual, Rule 4420.

(n166)Footnote 166. NASDAQ Manual, Rule 4450.

(n167)Footnote 167. These requirements relate to, among other things, shareholder communications, the number of independent directors, the issuer's audit committee, solicitation of proxies and voting rights. *See* NASDAQ Manual, Rule 4350.

(n168)Footnote 168. *See* Listing Standards Release, *supra*, at *45-74.

(n169)Footnote 169. *See* Sec. Exch. Act Rel. No. 40761, 1998 SEC LEXIS 2665, at *8 (Dec. 8, 1998).

(n170)Footnote 170. *See* Sec. Exch. Act Rel. No. 40761, 1998 SEC LEXIS 2665, at *8 (Dec. 8, 1998). The amendment to Rule 19b-4 relating to new derivatives products are discussed in more detail in § 2.03[1][a][i] *infra*.

(n171)Footnote 171. Rule 19b-4(e); *see* Sec. Exch. Act Rel. No. 40761, 1998 SEC LEXIS 2665, at *15 (Dec. 8, 1998).

(n172)Footnote 172. *See, e.g.*, NYSE Rules 1200 through 1202, governing listing and trading of Trust Issued Receipts. NYSE Guide, *supra*, PP 3201-3203.

(n173)Footnote 173. *See, e.g.*, NYSE Rule 1202.10 (establishing generic listing standards for Trust Issued Receipts). NYSE Guide, *supra*, P 3203.

(n174)Footnote 174. Rule 19b-4(e)(1).

(n175)Footnote 175. *See, e.g.*, Sec. Exch. Act Rel. No. 50799 (Dec. 6, 2004) (filing made for exchange-traded fund based on FTSE/ Xinhua China 25, which did not satisfy generic listing criteria).

(n176)Footnote 176. Sections 12(a) and (f).

(n177)Footnote 177. Sec. Exch. Act Rel. No. 21498 (Nov. 16, 1984) (hereinafter cited as "Over-the-Counter UTP Release").

(n178)Footnote 178. Over-the-Counter UTP Release, *supra*.

(n179)Footnote 179. Over-the-Counter UTP Release, *supra*.

(n180)Footnote 180. Over-the-Counter UTP Release, *supra*.

(n181)Footnote 181. The 1975 Amendments amended Section 12(f) to permit the extension of unlisted trading privileges; the extension of such privileges is to be guided by "the public trading activity in the security, the impact of the extension on the existing markets for the security and on competition, and the progress that has been made toward the development of a national market system." The Committee concluded that "unlisted trading privileges may not be granted if the effect would be to restrict rather than to increase competition." Conference Report, *supra*, at 5.

(n182)Footnote 182. Sec. Exch. Act Rel. No. 22412 (Sept. 16, 1985).

(n183)Footnote 183. Sec. Exch. Act Rel. No. 22412 (Sept. 16, 1985).

(n184)Footnote 184. Sec. Exch. Act Rel. No. 35323 (Feb. 2, 1995).

(n185)Footnote 185. Sec. Exch. Act Rel. No. 35323 (Feb. 2, 1995).

(n186)Footnote 186. Section 12(f)(1)(E); Sec. Exch. Act Rel. No. 35637 (Apr. 21, 1995).

(n187)Footnote 187. *See, e.g.*, Sec. Exch. Act Rel. No. 51292 (Mar. 2, 2005); Sec. Exch. Act Rel. No. 44937, n. 3 (Oct. 15, 2001); Sec. Exch. Act Rel. No. 36481, n.2 (Nov. 13, 1995). The Nasdaq UTP Plan is discussed in § 2.04[2][d][iii], *infra*.

(n188)Footnote 188. In fact, to trade such a security pursuant to UTP, all that is required is that the exchange has in effect trading rules providing for transactions in that class or type of security. *See* Rule 12f-5; Sec. Exch. Act Rel. No. 51691, n. 8 (May 12, 2005). Language in certain SEC releases dealing with derivative products suggests a further requirement--that in order to trade a particular class or type of security pursuant to UTP, an exchange must have in place listing standards "comparable" to those of the listing exchange. *See, e.g.*, Sec. Exch. Act Rel. No. 46834, n.21 (Nov. 14, 2002); Sec. Exch. Act Rel. No. 37589 (Aug. 21, 1996). However this language only surfaces, and is only relevant, with respect to derivative products. This language has emerged because listing standards and trading rules are often combined with respect to these products. The listing of derivative products is discussed in more detail in § 2.01[1][b], *supra*. The granting of Nasdaq's exchange application in January 2006 made even the requirement that securities be eligible under the UTP Plan irrelevant, because all Nasdaq securities are now listed securities. *See* Sec. Exch. Act Rel. No. 53128 (Jan. 13, 2006).

(n189)Footnote 189. "Under the Securities Exchange Act of 1934, the over-the-counter markets are deemed to include all transactions in securities which take place other than upon a national securities exchange." S. Rep. No. 1455, 75 Cong. 3d Sess. (1938), of the 1934 Act, Section I and H.R. Rep. No. 2307, 75th Cong., 3d Sess., (1938). Both reports are reprinted in the Securities Primary Law Sourcebook, Volume C, Part I.

(n190)Footnote 190. *See* Sec. Exch. Act Rel. No. 53128 (Jan. 13, 2006).

(n191)Footnote 191. A Look at Nasdaq, 1994 Nasdaq Fact Book and Company Directory, p.1 (hereinafter cited as "1994 NASD Fact Book").

(n192)Footnote 192. The SEC's 1963 Special Study of the Securities Markets aptly describes the traditional OTC market:

Exchange markets and over-the-counter trading markets are fundamentally similar in purpose and functions but substantially dissimilar in mechanics and practices. A brief introductory enumeration of certain of their respective characteristics may help to show their basic similarities and differences and, as to the latter, may help to differentiate between those that are fundamental, inherent or substructural, and those that are merely historical, superficial or incidental.

In general, although exchange markets differ widely among themselves, each exchange market is relatively concentrated, homogeneous and organized. By comparison, over-the-counter markets are diffuse, heterogeneous and more loosely organized.

Over-the-counter markets exist, as organized markets, only as and to the extent that dealers elect to "make" them, by standing ready to buy and sell for their own accounts. As many as 20 or 30 dealers, or as few as 1 or 2, or none, may be trading a particular security at any time. There is no place of congregation of buyers and sellers, and therefore the transaction of business depends on telephone and wire connections through which firms may communicate and negotiate. There are organized systems for interdealer circulation of quotations, and an intricate communications network which permits broker-dealers to keep in touch with one another, directly or indirectly, and to be generally aware of changes in quotations and in buying and selling pressures. The only vestige of a "counter" over which business may be done is at the retail level.

On the exchanges there is a clear-cut definition of who may participate in the auction on the exchange floor, through the concept of exchange membership, or "seats." Furthermore, there is on most exchanges a recognized division of labor among members; the members act within a framework of regulations prescribed by their exchange and the Commission, which governs how particular functions are to be performed and who may perform them.

In the over-the-counter markets there is no institutional limit on who may engage in any particular function with respect to any or all securities, except in the broad sense that all broker-dealers in interstate commerce must register with the Commission, and most over-the-counter broker-dealers are under economic compulsion to join the National Association of Securities Dealers. The latter, which is the over-the-counter markets' only officially recognized central institution, is essentially regulatory rather than operational in function.

For the exchanges there is also a clear-cut definition of what securities may be traded on each exchange, through the concepts of "listing" and controlled "unlisted trading privileges."

In the over-the-counter markets there are no similar concepts or controls, except insofar as the Securities Act of 1933 may limit initial entry into a public market.

Like other major institutions, securities markets in the United States are dynamic rather than static. Historically they have shown a considerable capacity to change, grow, and adapt to the needs of their times, even if not always voluntarily, not always immediately, and not always perfectly--also like other major institutions. In their present forms, each market reflects the results of shifting needs and responses. The process of change and adaptation has not ended. For example, the volume of over-the-counter trading in exchange-listed securities has grown considerably in recent years and apparently is still growing. To mention only one more development, recent improvements in communications and data processing have had notable effects on the mechanics of doing business and the allocation of business, and there are strong indications that the full potential of these developments has not yet been realized.

Special Study, *supra*, Pt. 2, at pp. 7-9, 12.

(n193)Footnote 193. See SEC Staff Report on The Securities Industry in 1981, Exhibit III-1 (1982).

(n194)Footnote 194. International Institute, *supra*, at page 4.

(n195)Footnote 195. A market maker in a dealer market is obligated to make a two-sided continuous market in those securities in which it is registered, to execute orders for a limited number of shares at its displayed prices at all times the market is open and to keep its prices competitive. International Institute, *supra*, at page 4.

(n196)Footnote 196. Loss, Securities Regulation 2578 (3rd Ed. 1990 Supp. 1998).

(n197)Footnote 197. The term "broker" means "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." Section 3(a)(4).

The term "dealer" means "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business." Section 3(a)(5).

Section 15 provides, in part, that it is unlawful "for any broker or dealer to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security unless such broker or dealer is registered in accordance with subsection (b) of this Section." Special

Study, *supra*, Pt. 2 at pp. 546-50:

Just as there is an unlimited right of entry of securities into the over-the-counter markets, there is also virtually free access of persons into the over-the-counter securities business. In February 1962, there were about 5,000 active broker-dealers registered with the Commission. Of these, 3,303 participated in over-the-counter transactions in equity issues in 1961. By comparison, approximately 1,200 member firms participated in trading on the Nation's securities exchanges.

Broker-dealer participants in the over-the-counter markets exhibited vast differences in size, experience, and type of activity. Firms range in size from the large retail firm with a network of branch offices to the sole proprietor principally engaged in distributing mutual fund shares or merchandising a single underwritten issue. The reported over-the-counter sales of stocks by any one broker-dealer during 1961 ranged from less than \$50,000 to \$2 billion.

There is a high concentration of over-the-counter business within a few large firms. Fifty-six broker-dealers, or less than 2 percent of the total number, accounted for half the dollar volume of over-the-counter sales reported by broker-dealers for their own accounts or the accounts of others in 1961. NYSE member firms were responsible for 47 percent of the number of shares sold and 55 percent of the dollar volume of over-the-counter sales during 1961. Of 67 broker-dealers with over-the-counter sales of \$100 million or more in 1961, 43 were NYSE members.

Firms engaging in over-the-counter business show wide differences in professional experience and capital commitment. Some older firms have years of experience in over-the-counter trading while many of the newer firms are managed by persons totally unacquainted with the intricacies of the over-the-counter markets.

As described below, professional activity in the over-the-counter markets breaks down into two general categories--wholesale and retail. The wholesale dealer "makes markets" by standing ready to buy or sell securities for his own account from or to professionals who act for themselves or for the public. The retail firm, on the other hand, is engaged in selling securities to public customers and buying or finding buyers when its customers wish to sell. Some of the most important firms--called "integrated firms"--combine wholesale and retail activities in varying degrees.

In early 1962, there were about 1,100 broker-dealer firms who "made markets" in over-the-counter securities. These firms ranged from sole proprietorships making markets in only 1 or 2 stocks to a few large firms making markets in 200 or more. Almost 40 percent of the dealer firms made markets in five or fewer stocks. Some firms making markets were primarily wholesale dealers who sold principally to other broker-dealers and institutional investors, while others were integrated firms who made markets in order to service their customers. By way of contrast there were 110 specialist units on the NYSE, each registered in an average of 12 common stocks.

(n198)Footnote 198. Since December 6, 1983 all broker-dealers have been required to be registered with a national securities association, *i.e.*, the NASD. Section 15(b)(8), amended by Section 3, P.L. 98-38 (Act of June 6, 1983). As the Commission noted in its 1963 Special Study of the Securities Markets, even before this date brokers had a financial incentive to become members of the NASD: the "bulk of the over-the-counter broker-dealers are members of the NASD. In trading with nonmember broker-dealers, NASD members must charge the same price as they charge the general public, whereas member broker-dealers may be given a "wholesale" price. Thus, there is an important economic pressure on all broker-dealers doing business in the over-the-counter markets, including member firms of the exchanges, to join the NASD." Special Study, *supra*, Part I at 13. The National Association of Securities Dealers, Inc. is discussed in § 3.05 *infra*.

(n199)Footnote 199. Many member firms of the NASD are also members of national securities exchanges and, accordingly, these dual-member firms and their sales staff are subject to the jurisdiction of multiple self-regulatory organizations. *See* SEC Special Studies of the Options Markets, p. 517 (1979).

(n200)Footnote 200. Section 15A of the Exchange Act is discussed in § 2.02[2][c] *infra*.

(n201)Footnote 201. The OTC market makers, ready to buy and sell as individual and institutional orders appear, are vital links in merchandising securities through the OTC distribution network. *NASDAQ and The Listing Dilemma--How the NASDAQ System is Influencing the Corporation Question on Stock Exchange Listing*, 7 (NASD Pamphlet 1973).

A market maker's role is similar in many ways to that of a stock exchange specialist. One important difference, however, is that there is only one specialist making a market in most exchange stocks, while a half-dozen or more market makers may compete in a particular NASDAQ-OTC security, thus adding to market depth and liquidity." *Id.*

(n202)Footnote 202. *See* Special Study, *supra*, Pt. 2 at pp. 550, 553-57, 610.

(n203)Footnote 203. Registration under Section 12(g) of the Securities Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F, is discussed in § 4.01 *infra*.

(n204)Footnote 204. Periodic reporting requirements are discussed in § 4.02 *infra*.

(n205)Footnote 205. Proxy regulation is discussed in ch. 7 *infra*.

(n206)Footnote 206. Insider transactions are discussed in ch. 8 *infra*.

(n207)Footnote 207. For a discussion of the pre-1971 problems affecting the NASD, see *An Introduction to the NASD*, p. 10 (1982):

Until February 8, 1971, over-the-counter quotes were disseminated by telephones, private wires and printed quotation sheets. Published quotations were generally stale by the time they were disseminated. Locating the best market was, at a minimum, cumbersome and expensive. Important data such as volume and price indices were unavailable.

(n208)Footnote 208. Actually, the "pink sheets" were the stock sheets of the Eastern edition of the quotations published by the National Quotation Bureau, Inc. There were two other editions of the National Daily Quotation Service--the Western edition from Chicago and the Pacific Coast edition from San Francisco. 5 Loss, Securities Regulation 3320 (2d ed. 1961 Supp. 1969). For discussion of the National Daily Quotation Service, see Loss 3317-27.

(n209)Footnote 209. *See* *NASDAQ and the Listing Dilemma--How the NASDAQ System is Influencing the Corporate Question on Stock Exchange Listing*, pp. 5-6. (NASD Pamphlet 1973).

(n210)Footnote 210. The National Quotation Bureau later changed its name to Pink Sheets, LLC, and now offers real-time quotations on some securities. *See* Pink Sheets, at www.pinksheets.com.

Though the OTC market now no longer includes Nasdaq, there still remains an active group of brokers and dealers who participate in the OTC market. Because the volume of trades effected by such individuals is very small, probably less than one percent of the aggregate volume of all securities transactions, there is little attention given to them. Nevertheless, they remain a part of the secondary securities markets and can be important to holders of securities not

eligible for trading on a national securities exchange, such as holders of new issues recently offered by companies that have "gone public."

(n211)Footnote 211. Nasdaq and SuperMontage are discussed in § 2.01[1][a][ii] *supra*.

(n212)Footnote 212. See Sec. Exch. Act Rel. No. 46429 (Aug. 29, 2002).

(n213)Footnote 213. See Sec. Exch. Act Rel. No. 46249 (July 24, 2002) (hereinafter cited as. "ADF Release").

(n214)Footnote 214. ADF Release, *supra*.

(n215)Footnote 215. Sec. Exch. Act Rel. No. 47663 (Apr. 10, 2003); Sec. Exch. Act Rel. No. 49131 (Jan. 27, 2004).

(n216)Footnote 216. ADF Release, *supra*.

(n217)Footnote 217. ADF Release, *supra*.

(n218)Footnote 218. ADF Release, *supra*.

(n219)Footnote 219. ADF Release, *supra*.

(n220)Footnote 220. See Gregory Bresiger, NASD Seeks ADF Extension, Traders Magazine, October 1, 2005. As of January 2006, only three firms used the ADF.

(n221)Footnote 221. Sec. Exch. Act Rel. No. 55181 (Jan. 26, 2007).

(n222)Footnote 222. For discussion of margin requirements, *i.e.*, the amount of credit that may be extended on any security, and the role of the Federal Reserve Board, see § 3A.02[1] *infra*.

(n223)Footnote 223. For continued eligibility, OTC securities must satisfy the following minimum requirements:

- be registered under Section 12(g) of the Securities Exchange Act of 1934;
- have three market makers;
- have 800 public holders of record or average daily trading volume of 300 shares;
- have daily quotations for bid and asked prices continuously available to the public;
- have 300,000 publicly held shares;
- have a minimum average bid price of \$2 per share; and
- be of an issuer that has at least \$1 million of capital, surplus, and undivided profits.

12 C.F.R. 220.11(b). Prior to January 2006, when the Nasdaq Stock Market became registered as an exchange, most OTC stocks satisfying the margin criteria were included in the Nasdaq Stock Market. See Sec. Exch. Act Rel. No. 53128 (Jan. 13, 2006). Since January 2006, Nasdaq stocks have been considered exchange-traded, rather than part of the OTC market, and few OTC stocks will be eligible for margin.

(n224)Footnote 224. The term "alternative trading system" is defined in Rule 300(a) of Regulation ATS as:

any organization, association, person, group or persons, or system:

(1) That constitutes, maintains, or provides a market place of facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of [Rule 3b-16]; and

(2) That does not:

(i) Set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system; or

(ii) Discipline subscribers other than by exclusion from trading.

For a discussion of Regulation ATS, see § 2.02[4] below.

(n225)Footnote 225. Rule 11Ac1-1 defines the term ECN to include as "any electronic system that widely disseminates to third parties orders entered therein by an exchange market maker or OTC market maker, and permits such orders to be executed against in whole or in part." Under Rule 11Ac1-1, the definition of ECN does not include systems that cross multiple orders at specified times only at a price determined by the system and a system operated by or on behalf of a market maker that executes orders primarily against the account of the market maker as a principal, other than a riskless principal. In a "riskless principal" transaction a broker-dealer technically acts as a principal but has arranged for another party to buy or sell from it, which eliminates the risk normally associated with a principal transaction. Sec. Exch. Act Rel. No. 33743 (Mar. 9, 1994).

(n226)Footnote 226. The Island ECN makes its order display available to the public through its "BookViewer." See Island BookViewer, *available at* www.island.com/BookViewer/index.htm (last visited Mar. 19, 2001).

(n227)Footnote 227. Instinet was the first ECN. It was founded in 1969 to allow institutional money managers to trade directly with each other.

(n228)Footnote 228. Sec. Exch. Act. Rel. No. 37619A (Sept. 6, 1996). The Order Handling rules are discussed in § 2.04[2][h] *infra*.

(n229)Footnote 229. SEC Division of Market Regulation, Special Study: Electronic Communications Networks and After-Hours Trading (June 2000), at Part II, Section I.B ("ECN Special Study"). Strike combined with the Brass Utility Network, commonly known as "Brut," to form the Brut ECN near the time of the ECN Special Study. See John Labate, *Mergers Speed Consolidation*, Financial Times, February 11, 2000, at Companies and Finance Section, p.29. The Special Study lists Strike rather than Brut as an operating ECN, but the Brut ECN was viewed as the survivor of the combination.

(n230)Footnote 230. Reuters, *Instinet Completes Island Merger*, San-Diego Union Tribune, September 21, 2002, at C-2.

(n231)Footnote 231. See Jenny Anderson, Owner of Big Electronic Stock Trading System is Said to be for Sale, New York Times, November 18, 2004, at C1.

(n232)Footnote 232. Form 10-K of Archipelago Holdings, Inc. for the year ending December 31, 2004 (filed March 23, 2005).

(n233)Footnote 233. Greg Johnson, MarketXT Files for Ch. 11, Daily Deal, June 17, 2005.

(n234)Footnote 234. PR Newswire, Direct Edge Opens for Trading Nasdaq NMS and Small-Cap Equities; Launch Follows Close of Knight Capital Group's Acquisition of the ATTAIN ECN from Domestic Securities, October 24, 2005.

(n235)Footnote 235. Nasdaq Press Release, NASDAQ Completes Acquisition of INET, December 8, 2005.

(n236)Footnote 236. *See generally* Peter Chapman, Tradebot Readies ECN Launch: Are These Guys Batty?, Traders Magazine, December 1, 2005.

(n237)Footnote 237. BATS Trading, Inc. SEC No-Action Letter (May 8, 2006).

(n238)Footnote 238. OnTrade ECN, SEC No-Action letter (June 28, 2006).

(n239)Footnote 239. *See* Annual Report on Form 10-K of Archipelago Holdings, Inc. for the year ending December 31, 2004 (filed Mar. 23, 2005); Annual Report on Form 10-K of Instinet Group Incorporated for the year ending December 31, 2004 (filed Mar. 11, 2005); Securities Industry News, Two Independents Left Now that Knight Obtains Attain ECN, May 16, 2005.

(n240)Footnote 240. In mid-1992 through 1994, the Commission in the Market 2000 Report undertook a review of the structure of the U.S. equity markets. Although the Market 2000 study was narrower in scope than the Commission's prior review, it recommended various reforms.

(n241)Footnote 241. *See* Special Study, *supra*; SEC Special Study of Commission Rates and Institutional Membership (1968); SEC Special Study of Institutional Investors (1971).

(n242)Footnote 242. In the Matter of the Structure, Operation and Regulation of the Securities Markets (Commission File No. 4-147). The Commission received testimony from 87 witnesses over a three-month period. The transcript covered 3,907 pages.

(n243)Footnote 243. SEC Statement on the Future Structure of the Securities Markets (Feb. 2, 1972).

(n244)Footnote 244. In March, 1972, the Commission formed three industry advisory committees: the Advisory Committee on Market Disclosure, the Advisory Committee on a Central Market System, and the Advisory Committee on Block Transactions. These committees prepared a total of five reports, which are discussed in more detail in § 2.04[1][a] *infra*.

(n245)Footnote 245. *See* § 2.01 *supra*.

(n246)Footnote 246. For a discussion of the Commission's regulatory efforts toward the formation of a "central market system," *See* § 2.04[1] *infra*.

(n247)Footnote 247. *See* § 2.01 *supra*.

(n248)Footnote 248. Section 11A(a)(2) of the 1934 Act, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F.

(n249)Footnote 249. Section 11A(a)(1)(C).

(n250)Footnote 250. House Report, n.23 *supra*, at 48.

(n251)Footnote 251. *See generally* Harman, The Evolution of the National Market System--An Overview, 33 Bus.

Law. 2275, 2285 (1978).

(n252)Footnote 252. The efforts of the Commission and the investment community toward the goal of a national market system are discussed in detail in § 2.04[1] *infra*.

(n253)Footnote 253. The composite quotation system is discussed in § 2.04[2][c] *infra*.

(n254)Footnote 254. The composite limit order book is discussed in § 2.04[2][g] *infra*.

(n255)Footnote 255. Limit order protection is discussed in § 2.04[2][g] *infra*.

(n256)Footnote 256. Off-board trading restrictions are discussed in § 2.03[2][c] *infra*.

(n257)Footnote 257. Rule 19c-3.

(n258)Footnote 258. Sec. Exch. Act Rel. No. 14416, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,502 (Jan. 26, 1978).

(n259)Footnote 259. International Institute, *supra*, at p. 8.

(n260)Footnote 260. International Institute, *supra*, at p. 8.

(n261)Footnote 261. See § 2.03 *supra* for a discussion of the Commission's oversight of self-regulation in the securities industry.

(n262)Footnote 262. Section 6(e) provides in part: "the Commission, in accordance with the provisions of Section 19(b) of this title as modified by the provisions of paragraph (4) of this section, may-

(A) permit a national securities exchange, by rule, to impose a reasonable schedule to fix reasonable rates of commissions, allowances, discounts, or other fees to be charged by its members for effecting transactions on such exchange prior to November 1, 1976, if the Commission finds that such schedule or fixed rates of commission, allowances, discounts, or other fees are in the public interest; and

(B) permit a national securities exchange, by rule, to impose a schedule or fix rates of commission, allowances, discounts or other fees to be charged by its members for affecting transactions of such exchange after November 1, 1976, if the Commission finds that such schedule or fixed rates of commission, allowances, discounts, or other fees (i) are reasonable in relation to the cost of providing the service for which such fees are charged (and the Commission publishes the standards employed in adjudging reasonableness) and (ii) do not impose a new burden on competition not necessary or appropriate in furtherance of the purposes of this title, taking into consideration the competitive effects of permitting such schedule or fixed rates weighed against the competitive effects of other lawful actions which the Commission is authorized to take under this title.

(2) Notwithstanding the provisions of Section 19(c) of this title, the Commission, by rule, may abrogate any exchange rule which imposes a schedule or fixes rates of commissions, allowances, discounts, or other fees, if the Commission determines that such schedule or fixed rates are no longer reasonable, in the public interest, or necessary to accomplish the purposes of this title."

Exchange commission rates are discussed in § 2.03[2][d] *infra*.

(n263)Footnote 263. Section 17(d)(1) of the 1934 Act, reprinted in the Securities Primary Law Sourcebook,

Volume B, Section F.

(n264)Footnote 264. Section 19(e)(1).

(n265)Footnote 265. Section 19(b).

(n266)Footnote 266. Sections 19(c) and 23.

(n267)Footnote 267. Section 21.

(n268)Footnote 268. Section 4(a) of the Securities Exchange Act of 1934 authorized the creation of the Commission with five Commissioners and further provided that:

not more than three of such Commissioners shall be members of the same political party, and in making appointments members of different political parties shall be appointed alternately as nearly as may be practicable.

Thus Congress established a bipartisan independent regulatory commission rather than an Executive Branch bureau which would bear the traditional and direct relation to the President and his Executive Office.

Federal Regulatory and Regulatory Reform Report by the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce, H. Doc. 95-134, 95th Cong., 1st Sess. at p. 42 (1976).

(n269)Footnote 269. See Section 25 of the Exchange Act.

(n270)Footnote 270. The SEC, like other administrative agencies, is afforded great deference by the courts while carrying out its legislative mandate. The court's role is to decide only whether, under the applicable statutes and the facts as found, the agency has made "an allowable judgment in its choice of the remedy." *Jacob Siegel Co. v. FTC*, 327 U.S. 608, 612, 66 S. Ct. 758, 760, 90 L. Ed. 888 (1946), quoted in *Butz v. Glover Livestock Commission Co.*, 411 U.S. 182, 189, 93 S. Ct. 1455, 1459, 36 L. Ed. 2d 142 (1973).

The Fifth Circuit Court of Appeals, quoting the above language, said in *Steadman v. SEC*, 603 F.2d 1126 (1979):

'The fashioning of an appropriate and reasonable remedy is for the Commission, not this court, and the Commission's choice of sanction may be overturned only if it found 'unwarranted in law or without justification in fact.'

(*Citing American Power and Light Co. v. SEC*, 329 U.S. 90, 112-13, 67 S. Ct. 133, 146, 91 L. Ed. 103 (1946), quoted in *Butz vs. Glover Livestock Commission Co.*, 411 U.S. at 185-86, 93 S. Ct. at 1458.)

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Federal Securities Exchange Act of 1934

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CHAPTER 2 Regulation of Securities Markets *

1-2 Federal Securities Exchange Act of 1934 § 2.03

§ 2.03 Regulation of Exchanges, Securities Associations and Alternative Trading Systems

When the Exchange Act was adopted, its primary focus, as evidenced by the title, was organized securities markets, *i.e.*, the stock exchanges, although it covers generally all security transactions including over-the-counter and private transactions. n1 Accordingly, the exchanges are the first subject of the Exchange Act, after Section 2's statement of purpose, the definitions of Section 3, and the establishment of the SEC in Section 4.

Section 5 prohibits any broker-dealer from effecting a transaction in a security on an exchange unless the exchange is either registered as a national securities exchange under Section 6 or is exempt from such registration. n2 The procedures that an exchange must follow, and the standards that it must satisfy to obtain registration with the Commission, are enumerated in Section 6. n3

In 1938, Congress adopted the Maloney Act which amended the Exchange Act by adding new Section 15A n4 to add the concept of a national securities association as a means of recognizing a self-regulatory organization that could oversee the OTC markets. Section an association of brokers and dealers to become registered with the Commission. The NASD (now FINRA), which became registered in 1939, is still the only registered securities association.

Under Section 15A, an association of brokers and dealers may be registered under the terms and conditions contained therein and in accordance with the provisions of Section 19(a) either

- as a national securities association pursuant to Section 15A(b); or
- as an affiliated securities association pursuant to Section 15A(d).

Registration is accomplished by filing an application with the Commission. n5 Once registered, an entity becomes fully subject to the provisions of Section 15A and 19.

The end of the long-standing prohibition on the trading of futures on a single stock, as opposed to a stock market index, complicated the regulatory scheme for national securities exchanges and registered securities associations. Single-stock futures were prohibited for over 20 years as the result of what was, by all accounts, a "turf battle" between the SEC and the CFTC. n6 Congress' adoption of the Commodity Futures Modernization Act of 2000 ("CFMA") legalized single

stock futures, n7 although whether it improved relations between the two regulators is unclear. n8

Under the CFMA, the SEC and CFTC jointly regulate single stock futures. n9 From the securities perspective, the legislation was designed to allow the SEC to exercise limited jurisdiction over commodities exchanges and market participants who otherwise do not engage in securities activities, and whose primary regulator is the CFTC. Commodities markets on which single stock futures are traded therefore must undertake a process known as "notice registration," which is far less burdensome than the traditional registration process. n10 Similarly, a futures association registered with the CFTC under the Commodity Exchange Act must register with the SEC as a "limited purpose national securities association" for the purpose of regulating members of the association who are registered as broker-dealers by virtue of their trading of single stock futures. n11

[1] Prior to the Securities Acts Amendments of 1975

A comparison of Section 6 as it stood prior to the 1975 Amendments n12 and today n13 demonstrates significant differences in the congressional approach to the regulation of securities exchanges. Notwithstanding vigorous criticism of the securities exchanges in the 1930s, n14 Section 6 as adopted originally evidenced a fair amount of deference on several significant matters, *e.g.*, rates and fees that exchange members may charge investors, disciplinary proceedings against exchange members and associated persons, the qualifications and number of exchange members, and access to exchange services by nonmembers. n15 Section 6(c) in particular appeared to embody a Congressional intent to preserve a limited autonomy of the exchanges. n16

Similarly, original Section 19, n17 concerning the powers of the Commission with respect to exchanges, granted a limited, if somewhat ambiguous, mandate. Under this section, the Commission: (1) possessed only cumbersome, ambiguous powers with respect to the rules of self-regulatory organizations such as the exchanges, (2) was unable to enforce a self-regulatory organization's rules directly and (3) lacked authority to review and alter securities exchange disciplinary actions n18. Such deference may have been necessary during the controversial early days of the New Deal. n19 After several decades, however, the situation was quite different. The 1975 Amendments imposed more explicit requirements and limitations on the exchanges and greatly increased the Commission's oversight functions.

In contrast to the ambiguity surrounding its oversight authority of exchanges, the Commission, after Section 15A of the Exchange Act was adopted in 1938, possessed clear and expansive oversight authority over registered securities associations. n20 One of the purposes of the 1975 Amendments was to clarify the Commission's oversight function with respect to exchanges by extending the pattern of regulation applicable to registered securities associations under Section 15A to the exchanges. n21

[2] Under the Securities Acts Amendments of 1975

The 1975 Amendments effected significant changes in the provisions of the Exchange Act governing self-regulatory organizations, n22 such as the securities exchanges and the NASD (now FINRA). n23 The two main purposes of the 1975 Amendments with respect to self-regulatory organizations were:

- (1) to clarify the scope of the responsibilities of such organizations, and the manner in which SROs exercise those responsibilities, and
- (2) to clarify and strengthen the Commission's oversight role.

The Senate Committee on Banking, Housing and Urban Affairs (the "Committee") emphasized its disagreement with the "common and serious misunderstanding" that the "securities industry regulates itself" through the securities exchanges and the NASD, without being subject to government regulation. It also rejected forcefully any suggestion

that the self-regulatory organizations and the Commission are on equal footing. If there is a "partnership" between the self-regulatory organizations and the Commission, the Committee left little doubt as to the senior partner. It stated: "the self-regulatory organizations exercise authority subject to SEC oversight. They have no authority to regulate independently of the SEC's control." n24

Illustrative of the approach taken in the 1975 Amendments are:

- (1) the provisions granting the Commission unequivocal powers over the rules of a self-regulatory organization; n25
- (2) the provisions prescribing the subjects of an organization's rules in terms that impose both affirmative and negative requirements on an organization, *i.e.*, what it *must* do and what it *may not* do; n26 and
- (3) the *repeal* of former Section 6(c) thereby terminating "the seemingly open-ended authority" of exchanges to adopt rules and regulations without prior Commission approval. n27

[a] Application for Registration as a National Securities Exchange and Special and Periodic Reporting Requirements

Section 6(a) of the Exchange Act provides for the registration of a national securities exchange with the Commission n28 under the terms and conditions provided in Section 6 n29 and in accordance with the provisions of Section 19(a) of the Exchange Act. An exchange is required to file an application for registration in such form as the Commission may determine by rule. n30

Rule 6a-1(a) under the Exchange Act provides that an application for registration as a national securities exchange, or for exemption from such registration, is to be made in duplicate on Form 1. n31 Rule 6a-1(b) requires any amendment to Form 1 to be filed in duplicate, dated, and numbered in order of filing, on Form 1-A. An exchange must file an amendment correcting any inaccuracy in the Form 1 or any exhibit or amendment thereto promptly after discovery of the inaccuracy. n32

Within ten days after an exchange, registered as a national securities exchange or exempted from such registration, takes any action rendering inaccurate certain information in its Form 1 or Form 1-A, the exchange must file with the Commission written notice of the action and the effective date thereof. n33 Rule 6a-2 contains an annual filing requirement, but was amended in 1994 to ease the filing burden on exchanges, in light of the increased availability of the required information in other publications. n34 The rule currently requires exchanges to file an amendment to Form 1 by June 30 of each year to update the following: financial statements for the exchange and subsidiaries and affiliates; in the case of an exchange that is not member-owned, information on its owners; the list of its members; and the list of securities listed on or otherwise traded on the exchange. n35 Complete exhibits containing corporate governance documents, rulings and interpretations and information on subsidiaries, affiliates, service providers for trading systems and officers, governors and committee members must be filed every three years. n36 However, an exchange may satisfy the above filing requirements for all of the information, except financial information, through one of three alternative methods: identifying a publication in which the information is contained, and certifying to its accuracy as of the publication date; certifying that the information is kept up to date and available to the Commission and the public upon request; or indicating the location of a website on which the information is available and certifying to the accuracy of the information on the site. n37

Three copies of any material issued or made generally available to members of the exchange must be filed by the exchange with the Commission within ten days of issuance. n38 This information, however, can be provided by indicating its location on a website and certifying to the accuracy of the information on the site. n39 An exchange must file a report with the Commission within fifteen days after the end of each calendar month concerning stock, bonds,

rights, and warrants traded on the exchange during the month. n40

New registrations of national securities exchanges are rare. From 1975 to 2006 there were only two--the registration of the International Securities Exchange, which was approved on February 24, 2000, n41 and Nasdaq's registration, which was approved on January 13, 2006. n42

[b] Application for Registration as a National or Affiliated Securities Association and Special and Periodic Reporting Requirements

An application for registration as either a national securities association or as an affiliated securities association must be made on Form X-15AA-1. n43 Registration statements and applications for registration must be kept current by the filing of amendments n44 and current supplements n45 on Form X-15Aj-1. n46 In addition, an annual consolidated supplement must be filed with the Commission on Form X-15Aj-2 n47 "promptly" after March 1 of each year, and a supplement, setting forth the balance sheet at the close of the fiscal year and the income and expense statement for the fiscal year must be filed "promptly" after the close of each fiscal year of the association. n48

[c] Requirements for Registration as a National Securities Exchange or Securities Association

As discussed above, the registration of an exchange with the Commission as a national securities exchange and the registration of an association of brokers and dealers as a national securities association must be in accordance with the provisions of Section 19(a) of the Exchange Act. n49 Section 19(a)(1) prescribes the procedures to be followed by the Commission after a securities exchange or securities association has filed an application for registration. n50 The Commission must publish notice of the filing and afford interested persons the opportunity to submit written data, views, and arguments. Within ninety days after publication of the notice, or later, if the applicant consents, the Commission must either grant the registration or institute proceedings to determine whether registration should be denied. Such proceedings must include notice of the grounds for denial under consideration and an opportunity to be heard. A proceeding must be concluded within one hundred eighty days of the publication of notice of filing of the application. The time for conclusion of the proceeding may be extended up to ninety days for good cause by the Commission or for a longer period if the applicant consents. Registration must be granted or denied at the conclusion of the proceeding. n51

[i] Organization and Regulatory Capacity

Section 6(b) of the Exchange Act enumerates explicit requirements for registration with the Commission as a national securities exchange, n52 which are substantially identical to the registration requirements under Section 15A for national securities associations.

For an exchange or association of brokers and dealers to be registered, the applicant must be organized so as to have the capacity to:

(1) be able to carry out the purposes of the Exchange Act and the rules thereunder, and

(2) comply, and enforce compliance by its "members" and "persons associated with members," with the Exchange Act, the rules thereunder, and its own rules. n53 If the applicant is a proposed national securities association, Section 15A also requires that the applicant have the capacity to enforce compliance by its "members" and "persons associated with members" with the rules of the Municipal Securities Rulemaking Board ("MSRB"). n54 Moreover, a Section 15A applicant must show that, by the number and geographic distribution of its members and the scope of their transactions, the proposed association is able to carry out the purposes of the Exchange Act. n55

The rules of every applicant under Section 6 or 15A must cover specified purposes and standards, including:

- (1) admission to membership or becoming associated with a member; n56
- (2) fair representation of members in the selection of directors of the applicant and in the administration of its affairs, with issuers and investors being represented by at least one director each; n57
- (3) equitable allocation of dues, fees, and other charges; n58
- (4) prevention of fraud and manipulation and the promotion of just and equitable principles of trade; n59
- (5) fostering cooperation and coordination with persons engaged in regulating, clearing, and settling securities transactions, as well as those processing information with respect to transactions; n60
- (6) promotion of a free and open market and a national market system; n61
- (7) protection of investors and the public interest, without permitting unfair discrimination between customers, issuers, brokers, or dealers and without permitting regulation of matters not related to the purposes of the Act or the administration of the applicant; n62
- (8) appropriate disciplining of members and persons associated with members for violations of the Exchange Act, the rules thereunder or the rules of the applicant and, for Section 15A applicants, the rules of the MSRB; n63
- (9) provision of a fair procedure for disciplining members and persons associated with members in accordance with the due process requirements set forth, as applicable, in either Section 6(d) or Section 15A(h); n64
- (10) provision of a fair procedure for the denial of membership to an applicant, the barring of any person from becoming associated with a member, and the prohibition or limitation of access to services offered by the applicant or a member; n65
- (11) avoidance of the imposition of any burden on competition not necessary or appropriate in furtherance of the Act; n66 and
- (12) no rule may fix minimum profits, impose any schedule, or fix any rates of commission, allowances, discounts or other fees to be charged to members. n67

In addition, the rules of an applicant under Section 15A:

- (1) must satisfy the requirements of Section 15A(c) relating to an affiliated securities association, if applicable; n68 and
- (2) provide for the form, content, and distribution of securities quotations distributed or published by any member or person associated with any member, relating to OTC securities not sold on a national securities exchange and the persons to whom such quotations may be supplied. n69

The former requirement that an exchange agree to comply, and to enforce compliance, with the provisions of the Exchange Act has been deleted, presumably as being unnecessary. n70 However, the rules of an exchange, like those of a securities association, must provide for the expulsion, suspension, or discipline of a member or persons associated

with a member for conduct that violates any provision of the Exchange Act, the rules or regulations thereunder, or the rules of the applicant, including rules mandating adherence to just and equitable principles of trade. n71

[ii] Elimination of Unnecessary Regulatory Restrictions

Neither an exchange nor a securities association can be registered unless the Commission determines that the applicant's rules do not impose any burden on competition that is unnecessary or inappropriate in furthering the purposes of the Exchange Act. n72 This is only one of several provisions added by the 1975 Amendments directing the Commission to review burdens on competition. n73 Under Sections 15A(b)(9) (rules of securities associations), 19(b) (proposed rule changes of self-regulatory organizations) n74 and 19(c) (Commission amendment of rules of self-regulatory organizations), n75 as well as under Section 6(b)(8), the Commission must review the existing, and proposed, rules of the organization and set aside or amend any rule having the effect of a competitive restraint not necessary or appropriate in furtherance of the purposes of the Exchange Act.

Under Sections 19(e) and (f), n76 in reviewing any final disciplinary sanction or exclusionary action of a self-regulatory organization, the Commission or other appropriate regulatory agency must set aside any action imposing an unnecessary or inappropriate burden on competition.

Section 23(a)(2) requires the Commission to consider the effect of its own proposed rules on competition and prohibits the Commission from adopting any rule that would impose an unnecessary or inappropriate burden on competition.

Under Section 12(f)(2) of the Exchange Act, the Commission has been directed to deny applications for unlisted trading privileges by national securities exchange if any rule of the national securities exchange would unreasonably impair competition in the markets for the security. n77

Under Section 6(e), n78 the Commission cannot permit a national securities exchange, by rule, to impose a schedule or fixed rate of commissions, allowances, discounts, or other fees to be charged after November 1, 1976, unless the Commission finds that such schedule or fixed rates further the purposes of the Exchange Act without imposing any unnecessary or inappropriate burden on competition. n79 Similarly, Section 15A(b) provides that the rules of a registered securities association may not establish minimum profits or fix commissions, allowances, discounts, or other fees. n80

As to the anticompetitive effects of exchange rules restricting members from effecting transactions off the exchange, Section 11A(c)(4) originally directed the Commission to:

- (1) review national securities exchange rules that limit or condition the ability of members to effect transactions in securities off the exchange;
- (2) report the results of its review to Congress within ninety days following the enactment of the Securities Acts Amendments of 1975; and
- (3) commence a proceeding under Section 19(c) to amend any rule imposing an unnecessary or inappropriate burden on competition. n81

[iii] Additional Considerations Regarding Applications Under Section 15A

[A] Affiliated Securities Associations

The Commission has the authority to permit or require the rules of an applicant for registration as a national securities association to provide for the admission of an association, registered as an affiliated securities association pursuant to

Section 15A(d), to participation in the applicant securities association as an affiliate of the association:

- (1) under terms permitting such powers and responsibilities to the affiliated securities association; and
- (2) under such other appropriate terms and conditions, as may be provided by the rules of the applicant securities association. n82

The rules of the applicant securities association, governing the admission of an affiliated securities association thereto, must appear to the Commission to be appropriate in the public interest or for the protection of investors, and to carry out the purposes of Section 15A. n83 Furthermore, any affiliation between a national securities association and an affiliated securities association does not in any way limit the duties and powers of the Commission regarding either association. n84

For a securities association to be registered as an affiliated securities association, the Commission must be satisfied that:

- (1) the applicant, whether or not it satisfied the requirements of Section 15A(b)(1), "forthwith upon the registration thereof" will be admitted to affiliation with an association previously registered as a national securities association, according to the rules of such national securities association as provided in Section 15A(c); n85 and
- (2) the applicant and its rules must satisfy the requirements of Section 15A(b)(2) through (10) and (12); n86 however, any restrictions of the type authorized by Section 15A(b)(3) n87 cannot be less stringent than those of the national securities association with which the applicant is to be affiliated. n88

[B] Dealings by Members With Nonmember Professionals

The rules of a registered securities association may provide that no member may deal with a "nonmember professional" except at the "same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public." n89

A "nonmember professional" is a registered broker or dealer, including a municipal securities broker or dealer, that is not a member of a registered securities association. n90 An exception is made for banks that are municipal securities dealers: such banks are not regarded as "nonmember professionals." n91

The rules of an association may not, however, prevent an association member or a municipal securities dealer that is a bank, or division or department of a bank, from granting to any other member of any registered securities association or any municipal securities dealer that is a bank, any dealer's discount, allowance, commission, or special terms in connection with the purchase or sale of securities, including, in the case of municipal securities dealers, municipal securities. n92 However, any dealer's discount, allowance, commission, or special terms granted in connection with the purchase or sale of municipal securities is subject to the rules of the MSRB adopted pursuant to Section 15B(b)(2)(K). n93

[d] Withdrawal From Registration as a National Securities Exchange or Securities Association

A self-regulatory organization n94 may withdraw from registration:

- (1) upon such terms and conditions as the Commission, by rule, deems necessary or appropriate in the public interest or for the protection of investors; and
- (2) by filing a written notice of withdrawal with the Commission. n95

The Commission may cancel the registration of a self-regulatory organization if it no longer exists or has ceased doing business in the capacity specified in its application. n96

[3] Under the Commodity Futures Modernization Act of 2000

Under the CFMA, because single stock futures are considered both securities and futures, an exchange that trades these products must be registered as a national securities exchange. n97 However, under Section 6(g) of the Exchange Act, which was added by the CFMA, a commodities market may register as a national securities exchange for the limited purpose of trading single stock futures, through a process known as "notice registration," if it is subject to the regulation of the CFTC, either as a "contract market" or a "derivative transaction execution facility," is in good standing with the CFTC, and does not serve as a securities market other than with respect to single-stock futures or futures on broad-based indices. n98 A notice registration filed by a commodities market is effective upon filing with the Commission, unless its CFTC registration is subject to revocation by that agency. n99 Similarly, a self-regulatory organization in the commodities industry may become registered as a "limited purpose national securities association" under Section 15A(k) of the Exchange Act. n100

The Commission adopted Rule 6a-4 to implement the registration provisions of the CFMA. Rule 6a-4 is modeled after Rules 6a-1, 6a-2 and 6a-3, which govern the initial registration, filing of amendments to registration statements and filing of supplemental information for traditional national securities exchanges, but its requirements are less onerous. n101 Rule 6a-4 provides that a commodities market that satisfies the requirements described above may register as a national securities exchange solely for the purpose of trading single stock futures by filing Form 1-N, which was adopted specifically in connection with the notice registration process. Rule 6a-4 also provides that the information in Exhibit F of Form 1-N, which requires information on the owners of an exchange which is not wholly owned by members, must be updated within 30 days after it becomes incorrect or incomplete, and that the information on the execution page of the form must be updated within ten days. n102 Most of the remaining information must be kept up to date merely by making the updated information available to the public and the SEC upon request, filing an updated exhibit once every three years, or some combination of these two methods. n103

Under Rule 6a-4(c), a commodities exchange must file with the SEC any materials relating to the trading of single stock futures, such as notices or periodicals, within ten days after making the information publicly available. n104 This information may also be provided by reference to the exchange's website. n105 Commodities exchanges trading single stock futures must file a report within 15 days of the end of each month with information on the number of contracts and the number of shares underlying the contracts for each single stock future traded on the exchange. n106

[4] Regulation ATS

The Commission's adoption of Regulation ATS in 1998 was designed to address numerous issues raised by the emergence of alternative trading systems, primarily ECNs. By the time Regulation ATS was adopted more than twenty percent of orders for Nasdaq securities and almost four percent of orders for exchange-listed securities occurred on alternative trading systems. n107 In conjunction with the adoption of Regulation ATS, the Commission adopted Rule 3b-16 to clarify the definition of an "exchange." The adoption of Rule 3b-16 clarified the applicability of the definition of an "exchange" to electronic trading systems but also granted the Commission authority to exempt systems from the definition. n108 Under Rule 3b-16, an entity will generally be considered an exchange if it brings together buyers and sellers and establishes fixed rules for executing their orders. n109

Regulation ATS is designed to impose new regulations on electronic trading systems without requiring them to register as an exchange. Rule 3a1-1, accordingly, exempts systems from the definition of exchange if they comply with Regulation ATS and do not exercise self-regulatory responsibilities. n110 Rule 3a-1, accordingly, exempts systems from the definition of an exchange if they are operated by a national securities association, comply with Regulation

ATS, or are exempt from Regulation ATS. A trading system will lose its exemption from the definition of an exchange if the system exceeds certain volume levels and the Commission determines, after giving the system notice and an opportunity to respond, that an exemption is not appropriate. n111

Regulation ATS n112 is designed to allow developing systems with low volume to operate with minimal regulatory burdens. Systems with larger volume must comply with more extensive regulation of their quotation dissemination and access standards, depending on the significance of their market presence. n113 "Alternative trading system" is generally defined to include any organization or system that meets the definition of an exchange but does not set rules governing subscribers' conduct, other than trading conduct, and does not discipline subscribers other than by prohibiting them from trading on the system. n114 Some entities that are subject to a separate regulatory scheme, either under the Exchange Act or banking laws, or which have been granted an exemption from registration as an exchange based on limited trading volume, are exempt from Regulation ATS under Rule 301. n115 The Commission also may exempt a trading system from some or all of the requirements of Regulation ATS. n116

Trading systems subject to Regulation ATS must register as broker-dealers. n117 Systems subject to Regulation ATS must also file an initial operation report, on Form ATS, at least twenty days before beginning operations as a trading system. n118 Amendments to Form ATS are required if a system proposes a material change to its operations, learns that the form was inaccurate when filed, or if the form was accurate when filed but later becomes inaccurate. n119 A trading system must file a "cessation of operations" report if it ceases to operate as an alternative trading system. n120 Filings under Regulation ATS are confidential, but are treated like other reports filed under the Exchange Act for purposes of liability for false or misleading statements. n121

Regulation ATS has provisions governing public display and execution of orders. However, these provisions apply only to "NMS stocks," which are generally exchange-listed securities. n122 Whether a system is subject to these provisions depends upon the volume in a particular covered security, not the total volume of the system. As a result, a trading system could be subject to the requirements of Regulation ATS for some securities but not others. If a trading system displays orders for a particular security, either to subscribers or third parties, and had trading volume during four of the previous six months of at least five percent of the total average daily volume of the security, it must supply the best prices to a national securities exchange for public dissemination. n123 Rule 301(b)(3) also requires that a system provide registered broker-dealers with an ability to execute against orders placed in the system for these securities. n124

Alternative trading systems such as ECNs charge access fees to their subscribers. n125 However, because alternative trading systems are in many cases required under Regulation ATS to make their orders available to broker-dealers that do not subscribe to the system, Regulation ATS also addresses the ability of ECNs to charge fees to these non-subscribers. Under Rule 301(b)(4) alternative trading systems are prohibited from charging fees that are "inconsistent with [the] equivalent access to the system" required by Rule 301(b)(3). n126

Trading systems subject to Regulation ATS must establish written standards for granting access to its system and may not apply the standards in a discriminatory or unfair manner. If a trading system is subject to Regulation ATS it also is required to keep records and make reports of access grants and denials for any security in which it has twenty percent or more of the average daily volume. n127 The fair access provisions, like the public display and order execution provisions, are applied on a security-by-security basis. A trading system can therefore arbitrarily exclude access to trades in some securities but not others. n128 Systems which match customer orders, without displaying them, at a price on or derived from an automated quotation system or transaction reporting plan are exempt from the fair access requirements. n129

Regulation ATS has system capacity, integrity, and security requirements for alternative trading systems that meet certain volume thresholds. n130 Like the fair access, public display and order execution standards, the system capacity, integrity and security requirements are applied on a security-by-security basis. n131 Systems that match orders are exempt from the system capacity, integrity, and security provisions. n132

Regulation ATS has extensive record keeping requirements. n133 Trading systems subject to the regulation must preserve certain records for at least three years, the first two years in an "easily accessible place." n134 In addition, some records that are not required must nonetheless be retained for three years if created. n135

A trading system must retain, for the entire period of its existence, copies of its organizational documents, such as articles of incorporation and copies of reports filed with the Commission. n136 Records required under Regulation ATS can be kept electronically, and trading systems may be maintained by a third party if certain procedures are followed. n137 Records kept under Regulation ATS are subject to examination by the Commission. n138

Systems subject to Regulation ATS are required to file quarterly reports on Form ATS-R. n139 The form must include the volume of trading in each class of security traded on the system, such as exchange-listed stocks, and listed options, by share or other unit of trading and by dollars, and information on denials of access to the system. n140 Regulation ATS also requires systems to establish procedures to protect confidential trading information. n141 Trading systems may not use the word "exchange" or a similar term, such as "stock market," in their names. n142

FOOTNOTES:

(n1)Footnote 1. There is some doubt that Congress had in mind the private transaction when adopting the Exchange Act. The statement of purposes in Section 2 refers only to transactions on the exchanges and in the OTC market. However, the courts have consistently ignored this fact and have applied the Act to private transactions not involving any broker-dealer or the mechanics of either security market. *See, e.g., Robinson v. Difford*, 92 F. Supp. 145, 147-49 (E.D. Pa. 1950):

Defendants' first argument for the dismissal of the complaint is that the Securities Exchange Act does not apply where, as in the present case, the securities in question were neither registered on a national exchange nor traded in the over-the-counter market. Clearly this argument is without foundation.

The Act applies both to securities registered on a national securities exchange and to 'any security not so registered.' Rule X-10B-5 [now Rule 10b-5] clearly makes the acts set forth in the complaint unlawful. Consequently, the Act applies to the present case even though the securities involved were not registered on a securities exchange and were never traded in the over-the-counter market. This is so clear from the language of section 10(b) itself that no other proper interpretation is possible. However, defendants vigorously contend that the limited purpose of the Act was to regulate only transactions in securities registered on a national exchange or traded in the over-the-counter market, and not to regulate private transactions. In support of this contention they point to the preamble statement (section 2, **15 U.S.C.A. 78b**) of the general purpose of the Act and to statements made by members of Congress when the Act was under consideration therein. Without deciding that these statements do show such a limited purpose as is contended by defendants, this court must reject defendants' contention, because section 10(b) itself, under which the present action was brought, is unambiguous. Reliance on the preamble statement of section 2 in order to alter the plain and unambiguous provisions of section 10(b) would violate a basic canon of statutory construction that statements in a preamble may be referred to only for the purpose of clarifying an ambiguity in a statutory provision. Likewise, the legislative history of an act may not properly be considered in construing an unambiguous statutory provision such as section 10(b). There are no other sections of the Act which indicate that Congress intended to limit the application of the Act to transactions involving either registered securities or unregistered securities traded in the over-the-counter market. (Footnotes omitted.)

Indeed, the first case holding that Rule 10b-5 under Section 10(b) would support a private civil action involved a

controversy growing out of a private transaction between the four shareholders of a closed corporation. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946), 73 F. Supp. 798 (E.D. Pa. 1947), 83 F. Supp. 613 (E.D. Pa. 1947). *See, generally*, § 5.01 *infra*.

See also *Fratt v. Robinson*, 203 F.2d 627, 630-631 (9th Cir. 1953):

We think the whole tenor of the Act indicates that its operative procedure is by regulation of security-transfer businesses and persons who function in or through them. That 'stock exchange' and 'over-the-counter markets' mean, in the Act, any security-transfer business wherein the businesses of marketing securities is conducted. We think the authors of the Act realized that the remedy of the abuses sought to be applied by the Act would be more or less completely effective in the proportion of security-trading done on or through the established businesses. To this end § 10 was enacted in order that those who desire to promote crooked deals would see little advantage in using devious methods to bypass the security-dealing business houses under regulation. And, further, that prospective crooked deals would be under a powerful deterrent by reason of the fact that perpetrators of fraud in security exchanges would be in violation of federal laws and, as we shall see in our discussion under the next point to be considered herein, would be answerable in damages in federal courts to those they have injured.

We are in substantial agreement with Judge Clark's dissenting opinion in the case of *Baird v. Franklin*, 2 Cir., 1944, 141 F.2d 238, 244, *cert. denied*, 323 U.S. 737, 65 S. Ct. 38, 89 L. Ed. 591, as to which we shall have more to say presently, wherein he construed § 6(b) of the same Act upon the point under consideration as we construe § 10 and, as we see it, such construction conforms to the intent of Congress as expressed in the Act's preamble, that is, to make the control of security transactions 'reasonably complete and effective.' Without going into the details of the legislative history, and we have made some examination thereof, we believe our construction is in harmony therewith.

The decisions on the point, save the one in the case we are now reviewing, are in accord with our conclusion, but the reasoning of the several courts varies. Some of the courts take the straight road, that no matter about the rest of the Act, the wording of the section is too plain to admit of extraneous matter in explanation of its meaning. Some say, as does the Commission, that over-the-counter security transfers include all security transactions not made through 'stock exchanges' and therefore all transfers covered by § 10 are included in the preamble and sections of the Act following it. The terms 'stop-gap,' 'plugging a loop-hole' and 'catch-all' have been applied to § 10. Each expression has been used in argument to support the theory that the questioned section was placed in the Act to more perfectly effectuate the primary purposes of the Act. There appears to be a logic in all these roads to the common destination. There is one phase common to the reasoning of all the cases: § 10 is in aid of the end sought by the Act, to-wit, the lessening of fraudulent and sharp practices in the securities market. We hold that the district court erred in holding that the facts as alleged in the complaint are outside the purview of the Act, and that it was error to dismiss the action. (Footnotes omitted.)

Accord, *Errion v. Connell*, 236 F.2d 447 (9th Cir. 1956); *Miller v. Bargain City, U.S.A., Inc.*, [1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,360 (D. Pa. 1964).

See also *Schine v. Schine*, 250 F. Supp. 822, 823 (S.D.N.Y. 1966), *appeal dismissed*, 367 F.2d 685 (2d Cir. 1966):

First, the defendants move to dismiss the complaint for lack of subject matter jurisdiction pursuant to Rule 12(b)(1) of the Federal Rules of Civil Procedure. The defendants here advance a contention repeatedly urged upon the courts from the inception of the 1934 Act, to wit, that section 10(b) does not apply to transactions in the instance of closely held or family-owned corporations, but was intended by Congress to reach deceptive and manipulative practices only in instances of the purchase and sale of

1-2 Federal Securities Exchange Act of 1934 § 2.03

securities registered on a national exchange or publicly traded and distributed. This court recently rejected such a contention in analogous circumstances, holding that as long as the jurisdictional requirements as to the use of commerce are satisfied, it matters not that the securities transaction was private. Other courts which have considered the question uniformly have ruled adversely to the defendants' contention. (Footnotes omitted.)

See also Collins v. Rukin, 342 F. Supp. 1282 (D. Mass. 1972); Bush v. Masiello, 55 F.R.D. 72 (S.D.N.Y. 1972); 3 Loss, Securities Regulation 1466-67 (2d ed. 1961 Supp. 1969).

(n2)Footnote 2. *See* Federal Home Loan Mortgage Corporation, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,677 (Dec. 14, 1973); USF Mortgage Exchange, [1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,636 (Oct. 18, 1971).

As of December 31, 2004, there were nine registered national securities exchanges. *See* 2004 SEC Annual Report, *supra*, at Table 12. This does not include two exchanges registered solely for the purpose of trading single stock futures, and Nasdaq, which at the time was not registered as a national securities exchange. In addition, the Arizona Stock Exchange operates pursuant to an exemption from registration granted by the SEC. Sec. Exch. Act. Rel. No. 37271 (June 3, 1996).

There were originally a far greater number of exchanges, but the ranks were thinned by mergers and dissolutions. Thirty exchanges filed applications for registration, practically all of them in 1934. At one time, as many as twenty-five exchanges were registered. 2 Loss, Securities Regulation 1170 (2d Ed. 1961 Supp. 1969). In addition, not all exchanges trade the same category of securities, *See* § 2.01[1] *supra*. *See also* Board of Trade of the City of Chicago v. SEC, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,555 (7th Cir. 1989) (SEC order registering system covering trading in options and government securities remanded to the Commission for determination of essential preliminary question whether the system constituted an "exchange" under Section 3(a)(1) of the Exchange Act.

(n3)Footnote 3. *See* § 2.02[2][a] and [c] *infra*.

(n4)Footnote 4. **15 U.S.C. § 780-3.**

(n5)Footnote 5. The registration process for Section 15A applicants is discussed in § 2.02[2][c] *infra*.

(n6)Footnote 6. *See* Esau, Joint Regulation of Single Stock Futures: Cause or Result of Regulatory Arbitrage and Interagency Turf Wars?, 51 Cath. U.L.Rev. 917 (2002). The prohibition actually extended to futures on "narrow" stock indices, such as those for a particular industry, as opposed to futures on a "broad-based indices" such as the Standard & Poor's Index of 500 stocks. The term "single-stock future" will be used here to refer to futures on both single stocks and narrow stock indices.

(n7)Footnote 7. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (Dec. 21, 2000) (codified in scattered sections of 7 U.S.C., 11 U.S.C., 12 U.S.C., and 15 U.S.C.).

(n8)Footnote 8. *See* Esau, *supra*, at 917-18.

(n9)Footnote 9. *See* CFMA §§ 202, 257 (2005).

(n10)Footnote 10. *See* Section 6(g) of the Exchange Act. This process is described in more detail in § 2.02[3] *supra*.

(n11)Footnote 11. Section 15A(k) of the Exchange Act. The National Futures Association serves a function very similar to that of the NASD for the futures industry and is the only registered futures association.

(n12)Footnote 12. Act of June 4, 1975, P.L. 94-29, **89 Stat. 97**.

Section 6 formerly required that a securities exchange enter into an agreement with the Commission as a condition to registration as a national securities exchange. The agreement, in substance, required the exchange "to comply, and to enforce so far as is within its powers compliance by its members, with the provisions of [the Exchange Act], and any amendment thereto and any rule or regulation made or to be made [t]hereunder." As the 9th Circuit observed in *Hughes v. Dempsey-Tegeler and Co., Inc.*, 534 F.2d 156 (9th Cir.), *cert. denied*, 429 U.S. 896 (1976):

Private suits have been allowed against exchanges for violation of Section 6 on two legal theories. The first, established by the leading case of *Baird v. Franklin*, 141 F.2d 238, *cert. denied*, 323 U.S. 737, 65 S. Ct. 38, 89 L. Ed. 591 (1944), is essentially a tort theory in which the duty element is supplied by § 6(b) of the Act. The second theory, suggested in the *Baird* case, *supra*, and subsequently adopted in *Weinberger v. New York Stock Exchange*, 335 F. Supp. 139 (S.D.N.Y. 1971), is that the private plaintiff can sue as a third party beneficiary of the agreement required by § 6 (a) of the Act between the registered exchange and the Commission. In our view, the content of that duty is the same under either of the two theories.

The Supreme Court has, of course, recently handed down several decisions bearing on the question of whether a private right of action is to be implied under a statute which does not expressly provide for such a right of action. *See Cort v. Ash*, 422 U.S. 66, 95 S. Ct. 2080, 45 L. Ed. 2d 26 (1975); *Securities Investor & Protection Corp. v. Barbour*, 421 U.S. 412 95 S. Ct. 1733, 44 L. Ed. 2d 263, 4 C.B.C. 274 (1975). The parties have not argued and we find no reason to conclude that the factors enunciated in those decisions mandate a reversal of the longstanding rule that a private right of action is available under Section 6. *Id.*, at 166 n.5.

The Second Circuit has limited the application of *Hughes* to private actions brought by public investors. In *Lank v. New York Stock Exchange*, 548 F.2d 61 (2d Cir. 1977), the court concluded that:

The beneficiary of the 1934 legislation was intended to be the public investor. One finds in the Act and its legislative history no indication of intention to benefit members of the ex-changes at the expense of the exchange itself. 548 F.2d at 65.

It was the intention of Congress to draw a clear line of demarcation between public investors, on the one hand, who may assert claims against a stock exchange for damages arising out of violations of Section 6, and, on the other hand, members of those exchanges, who may not. Congress did not enact Section 6 for the purpose of affording protection to those very members of the stock exchanges whose conduct was being regulated at the expense of those exchanges. We, therefore, hold that a securities exchange is not liable to a member organization for failure to force the member to comply with the exchange's rules. *Id.* at 66.

Moreover, with respect to the right of third party beneficiaries to commence civil actions against an exchange for violation of Section 6, the court in *Lank* also concluded that such beneficiaries:

... [stand] in the shoes of the corporation and can assert only those claims which the corporation could have asserted.

... Since the member corporation may not sue the exchange, neither may its receiver nor its creditor, for the latter cannot bring themselves within the protective class. To the extent that a receiver's recovery in a Section 6 suit would benefit public investors those investors already have a cause of action in their own right under *Baird v. Franklin* and the receiver's suit would add nothing to those rights. To allow the

receiver to sue as a representative of the corporation's creditors would be to allow the corporation itself to sue, for ultimately the recovery is the same. Finally, to allow the receiver but not the corporation to sue would create the anomalous situation of allowing recovery only where the corporation becomes insolvent and enters receivership while denying recovery by a going concern which suffered the same sort of injury.

548 F.2d at 67.

See also Carr v. New York Stock Exchange, 414 F. Supp. 1292 (N.D. Cal. 1976).

Where there is judicial recognition of a right of an investor to sue as a third party beneficiary, the plaintiff may take advantage of the longer statute of limitations applicable to suit based on contract, as opposed to the shorter period provided for suit on a liability created by statute. *Arneil v. Ramsey*, 414 F. Supp. 334 (S.D.N.Y. 1976), *aff'd*, 550 F.2d 774 (2d Cir. 1977); *Fischer v. New York Stock Exchange, Inc.*, 408 F. Supp. 745 (S.D.N.Y. 1976); *Lank v. New York Stock Exchange, Inc.*, 405 F. Supp. 1031 (S.D.N.Y. 1975), *rev'd on other grounds*, 548 F.2d 61 (2d Cir. 1977).

In *Lank, supra*, the District Court applied the contract period of limitations even though the plaintiff had alleged only a breach of statutory duty, since a dismissal based on expiration of that period of limitations could be avoided by an amendment of the complaint to allege breach of the agreement. The District Court noted that the Securities Acts Amendments of 1975 deleted the statutory requirements of an agreement from Section 6. *See S. Rep. No. 94-75*, 94th Cong., 1st Sess., 33-34 (1975):

At present, an exchange's responsibility for its members' compliance with the Exchange Act and regulations thereunder takes the form of an agreement filed by the exchange with the Commission 'to comply, and to enforce, so far as is within its powers compliance by its members, with the provisions of this title.' This formulation is replaced by a provision in Section 6(b)(1) to the effect that, when the Commission permits registration of an exchange, it must appear that the exchange is so organized and has the capacity to comply with and enforce compliance by its members and persons associated with its members with the Exchange Act, the rules and regulations thereunder, and the rules of the exchange. In making this change the Committee has omitted the phrase 'so far as is within its powers' as superfluous. Section 19(g) would obligate a self-regulatory organization 'absent any reasonable justification or excuse' to enforce compliance by its members or participants with applicable provisions of the Exchange Act and its own rules. In Section 19(h)(1), the SEC or other appropriate regulatory agency would be authorized to sanction any self-regulatory organization which fails to enforce compliance by its members 'without reasonable justification or excuse.' The Committee believes the standard in these Sections appropriately defines the responsibility of the self-regulatory organizations. Such organizations should never be placed in the position of being insurers of their members' compliance. They do, however, have an obligation to enforce applicable provisions of the Exchange Act and their own rules which they should not be permitted to avoid except for a good cause.

The Amendments did not affect the plaintiff in *Lank* because they took effect after the time period involved in that action.

The Second Circuit has recognized, however, a cause of action against a securities exchange based on the failure of the exchange to use reasonable diligence in supervising and disciplining a member firm. *Rich v. New York Stock Exchange*, 522 F.2d 153 (2d Cir. 1975). The majority opinion in *Rich* characterized the plaintiff's cause of action as being based on a negligence standard. *Id.* at 155 n.4. *But see Hochfelder v. Midwest Stock Exchange, infra.*

See also *Bosco v. Serhant*, 836 F.2d 271, 278 (7th Cir. 1987) (The appeals court asserted that a cause of action against a securities or mercantile exchange would be valid "if [the] exchange's regulation imposes a duty that the exchange should know is being flouted." The exchange would then be acting "wrongfully" and bad faith would be established using a negligence standard).

See also *Brawer v. Options Clearing Corp.* 807 F.2d 297 (2d Cir. 1986).

In general, investors also lack an implied private right of action for violations by member firms of exchange rules. *See* *Sacks v. Reynolds Secur., Inc.*, 434 F. Supp. 37 (D.D.C. 1977); *Zagari v. Dean Witter and Co., Inc.*, [1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,777 (N.D. Cal. 1976); *Colonial Realty Corporation v. Bache & Co.*, 358 F.2d 178 (2d Cir. 1966).

(n13)Footnote 13. *See* § 2.02[2] *infra*.

(n14)Footnote 14. The Act was adopted after the hearings of the "Pecora Investigation," *see* "Stock Exchange Practices," S. Rep. No. 1455, 73d Cong., 2d Sess. (1934), *reprinted in* the Securities Primary Law Sourcebook, Volume C, Section I of the 1934 Act. Securities Exchange Bill of 1934, H. R. Rep. No. 1383, 73d Cong., 2d Sess. (1934), confirmed the existence of unsavory practices in the securities markets in the period following World War I and continuing into 1934. Those conditions included dishonesty in securities transactions in the banking and securities industries, abuse of "inside information" by directors, officers, and principal stockholders of publicly-held companies, refusal of corporate managements to render fair and adequate reports to security holders, and ultimately disastrous speculation in securities by means of margin accounts collateralized by securities valued at unrealistically high prices, *i.e.*, at prices supported only by the speculative hysteria in the markets preceding the Depression, "discounting the hereafter."

As a consequence, the Exchange Act was originally intended to have its greatest effect on the stock exchange markets and issuers whose securities were listed on the exchanges, although the Commission (by Section 4 of the Act) was also given certain powers as to the over-the-counter markets.

With respect to issuers, the effects of the Exchange Act were originally confined to issuers whose securities were listed on a national stock exchange. They were required to file periodic and annual reports with the Commission and the exchanges on which their securities were listed. They were also required to supply information concerning matters to be voted on at annual and special meetings to security holders if their proxies were solicited. Additionally, the directors, officers, and principal stockholders of listed companies were required to report their holdings of equity securities of their companies and to disgorge profits realized in "short-swing" trading in such securities, *i.e.*, any purchase and sale, or sale and purchase, within a period of less than six months.

In 1964, the provisions of the Exchange Act previously applicable only to issuers of listed securities were imposed on the much larger number of corporations whose equity securities are traded over-the-counter. An issuer with total assets of three [now effectively ten for most issuers] million dollars and a class of equity security held of record by five hundred or more persons must register the security under the Exchange Act as amended. *See* § 4.01[2] *infra*). Such an issuer then becomes subject to the reporting and proxy requirements of the Act and its directors, officers, and principal stockholders become subject to the equity security reporting requirement and to liability for "short-swing" profits. In 1968 the Williams Act amendments to the Exchange Act imposed disclosure requirements on persons acquiring substantial holdings of equity securities that are registered under the Exchange Act, as well as securities of investment and insurance companies, and on persons making "tender offers" for such securities. The Williams Act amendments also empowered the Commission to prescribe rules regarding repurchase of equity securities by their issuers. The Williams Act amendments to the Exchange Act are discussed in ch. 7A *infra*.

(n15)Footnote 15. In addition to the agreement between an exchange and the Commission discussed above,

Section 6(a) of the Exchange Act required an exchange, as part of a registration statement filed with the Commission, to agree to furnish the Commission "copies of any amendments to the rules of the exchange forthwith upon their adoption." Section 6(a)(4). The registration statement of an exchange as a national securities exchange had to contain the data that the SEC required as necessary or appropriate in the public interest or for the protection of investors concerning the organization, rules of procedure, and membership of the exchange. Section 6(a)(2) of the Securities and Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F. Furthermore, the exchange had to provide the SEC with copies of its constitution, articles of incorporation, and rules. Section 6(a)(3).

Under Section 6(b), an exchange could not be registered as a national securities exchange unless the rules of the exchange provided for expulsion, suspension, or disciplining of a member "for conduct or proceeding inconsistent with just and equitable principles of trade" and the rules of the exchange provided that the willful violation of the Exchange Act or any rule or regulation thereunder would be considered "conduct or proceeding inconsistent with just and equitable principles of trade."

The Commission was required by Section 6(d) to register an exchange as a national securities exchange if (1) the exchange was so organized to be able to comply with the Exchange Act and the rules and regulations thereunder, and (2) the rules of the exchange were just and adequate to insure fair dealing and to protect investors.

Section 6(e) concerned the procedure the Commission had to follow in granting or denying registration as a national securities exchange.

Section 6(f) provided for withdrawal of a registration by an exchange.

(n16)Footnote 16. Section 6(c), prior to the 1975 Amendments, stated:

Nothing in this title shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with this title and the rules and regulations thereunder and the applicable laws of the State in which it is located.

(n17)Footnote 17. Section 19 was proposed originally in 1934 as Section 18, "Powers With Respect to Exchanges and Securities," in H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934).

(n18)Footnote 18. The powers of the Commission with respect to exchanges in original Section 19 are discussed in H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934) reprinted in the Securities Primary Law Sourcebook, Volume C, Section I of the 1934 Act.:

Subsection (a) authorizes the Commission when it deems such action necessary-(1) to suspend or withdraw registration of an exchange which the Commission finds has violated the act or the rules and regulations thereunder or has failed to take adequate steps to enforce compliance therewith by its members, (2) to deny, postpone, suspend, or withdraw the registration of the security in case of violation by the issuer, (3) to suspend or expel a member or officer of an exchange who is guilty of a violation or of aiding a violation by acting as broker for a person whom he has reason to believe is engaged in a violation, and (4) summarily to suspend trade in any registered security for a period not exceeding 10 days or with the approval of the President of the United States summarily to suspend all trade on a registered exchange for not more than 90 days. Orders issued pursuant to (1), (2), and (3), must be preceded by appropriate notice and opportunity for hearing; action under (4) is of an emergency nature and therefore limited in time.

Subsection (b) authorizes the Commission to amend the rules of an exchange in certain particulars by rules and regulations, after the exchange has failed to comply with the Commission's written request

for such amendment of the rules of the exchange as the Commission deems necessary or appropriate for the protection of investors or to insure fair dealing or administration of the exchange.

See *San Francisco Mining Exchange v. SEC*, 378 F.2d 162 (9th Cir. 1967), affirming an order of the SEC, entered pursuant to Section 19(a)(1) of the Exchange Act, withdrawing the registration of the San Francisco Mining Exchange. Oversight by the SEC of the self-regulatory activities of an exchange is discussed in § 2.03[5] *infra*

(n19)Footnote 19. See Schlesinger, *The Coming of the New Deal*.

(n20)Footnote 20. As Congress observed in debating the enactment of the Securities Acts Amendments of 1975:

When the [Exchange] Act was adopted in 1934 it contained a very brief section dealing with the national securities exchanges, and did not treat at all the subject of the over-the-counter market. In 1938 this was rectified by the passage of the Maloney Act, which added Section 15A to the Securities Exchange Act. That section provided for the establishment of national securities associations, which would regulate professional participants in the over-the-counter market. In comparison to the very brief section dealing with national securities exchanges, the Maloney Act addition contained a quite lengthy and detailed section governing the authorities and responsibilities of national securities associations. H.R. Rep. No. 1383, *supra*, at 59-60.

The Commission in its Special Study of the Securities Markets discussed the development of regulation of the over-the-counter markets:

Regulation of the over-the-counter markets has developed in several stages. While comparatively little was known about these markets in 1934 when the Exchange Act became law, it was early recognized that their regulation was necessary, since 'to leave the over-the-counter markets out of a regulatory system would be to destroy the effects of regulating the organized exchanges.' Because of the potential scope and complexity of over-the-counter regulation, the statute entrusted to the Commission broad rulemaking powers over the over-the-counter markets rather than creating a detailed system of regulation as in the case of the exchanges.

SEC, Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, House Document No. 95, Pt. 4, p. 604 (1963). With respect to the scope of OTC regulation by a securities association, the Special Study observed:

As an inducement to joining, the act permits a registered association to prohibit its members from dealing with non-members 'except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public.' To become registered, an association must meet certain standards. It must be appropriately organized by reason of the number and geographical distribution of its members and the scope of their transactions to be able to comply with and carry out the purposes of the act; it must admit to membership all qualified broker-dealers and continue in membership those who remain qualified; it must insure a certain degree of internal democracy in the administration of its affairs; its rules must meet certain broad objectives; and, of primary importance, it must discipline those who violate its rules.

The writings and public statements of the period indicate that the self-regulatory objectives of the act were twofold: first, to bring about self-discipline in conformity to law--'voluntary law obedience so complete that there is nothing [sic] left for government representatives to do'-and, secondly, to encourage 'obedience to ethical standards beyond those any law can establish.' The end product of such a system

would be to put the over-the-counter markets on a 'highly professional plane' and at the same time 'afford to the investor a service characterized by efficiency commensurate with its economic importance' It was thought that this kind of self-regulation was far preferable to detailed and pervasive regulation by the Government which might be overly burdensome to business and Government alike. Senator Maloney, shortly after enactment of the legislation, described the allocation of regulatory responsibilities between the NASD and the Commission in this way:

... Congress has undertaken to provide a mechanism whereby the securities business of the country may deal with all problems of technical regulation, leaving to the Securities and Exchange Commission what it is hoped will be the residual position of policing the submarginal fringe which recognizes no sanctions save those of the criminal law and of dealing with those problems of regulation with which the industry, as organized under the act, finds itself unsuitable or unable to deal.

The existing allocation of regulatory responsibility between the exchanges and the Commission was envisioned as the basic pattern to be followed, but 'with 1938 improvements.'

Id., Pt. 4 at pp. 605-06.

(n21)Footnote 21. The Senate Committee on Banking, Housing and Urban Affairs in its Summary of the Principal Provisions of the Securities Acts Amendments of 1975 stated:

The Exchange Act does not clearly specify the substantive reach of an exchange's authority over its members. Apart from specific provisions confirming an exchange's authority in particular areas, there is nothing in the Exchange Act which limits or defines an exchange's rule-making authority. Indeed, present section 6(c) states:

Nothing in this title shall be construed to prevent any exchange from adopting and enforcing any rule not inconsistent with this title and the rules and regulations thereunder and the applicable laws of the State in which it is located.

The authority of registered securities associations is dealt with substantially differently. The scope of an association's rule-making authority is defined by present section 15A(b) in terms of affirmative and negative requirements. The bill would extend the pattern now applicable to registered securities associations to exchanges. Thus, the bill would eliminate present section 19(b) of the Act insofar as it provides an enumeration of subject matters of exchange rulemaking. And it would also eliminate the open-ended authority in present section 6(c). Although these provisions have been read as expressing, at least in part, both the scope and the limits of an exchange's rule-making authority, they have proved to be unclear and unsatisfactory in both respects. Under the bill the scope of the rule-making authority and responsibility of all self-regulatory organizations would be defined in terms of purposes and standards rather than subject matters. The purposes to be served by self-regulatory rules would be expressed affirmatively and negatively (what the rules must be, and what they may not be designed to accomplish). New sections 6(b)(5) and 15A(b)(6) would require the rules of any self-regulatory organization to be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, to foster cooperation and coordination with other self-regulatory organizations, to remove impediments to and perfect the mechanism of a national market system, and, in general, to protect investors and the public interest. Similarly, by reason of the same sections a self-regulatory organization's rules must not be designed to permit unfair discrimination between customers, issuers, brokers, or dealers or to regulate matters not related to the purposes of the Exchange Act or the administration of the exchange or association. Under procedures established by the bill

whereby self-regulatory rule changes would have to be justified to and reviewed by the Commission after opportunity for public comments, the Commission's action in approving any such change would constitute a determination by the Commission that the rule is within the permitted purposes and is in conformity with the specified standards of the Exchange Act (Sec. 19(b)). Summary of Principal Provisions of Securities Acts Amendments of 1975, S. 249, Committee on Banking, Housing and Urban Affairs, United States Senate (1975).

(n22)Footnote 22. The term "self-regulatory organization" is defined by Section 3(a)(26) of the Securities Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F to mean any national securities exchange, registered securities association, or registered clearing agency. The term "self-regulatory organization" also includes the Municipal Securities Rulemaking Board (the "Board"), *see* § 3.06[6] *infra*, but only for purposes of:

- (1) the Board's proposed changes of its rules;
- (2) Commission amendment of Board rules; and
- (3) Commission reports to Congress.

At present, the only registered securities association is FINRA (formerly the NASD).

The Commission is the "appropriate regulatory agency" for national securities exchanges, registered securities associations, the Municipal Securities Rulemaking Board, and for any clearing agency that is not a bank.

(n23)Footnote 23. The NASD is discussed in § 3.05 *infra*.

(n24)Footnote 24. Senate Report, *supra*.

(n25)Footnote 25. Section 19(b) and (c). *See* § 2.03[1] *infra*.

The 1975 Amendments added two new subsections to Section 3(a) defining the rules of self-regulatory organizations. Section (a)(27) defines "rules of an exchange," "rules of an association" or "rules of a clearing agency" to mean:

The constitution, articles of incorporation, bylaws, and rules, or instruments corresponding to the foregoing, of an exchange, association of brokers and dealers, or clearing agency, respectively, and such of the stated policies, practices, and interpretations of such exchange, association, or clearing agency as the Commission, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules of such exchange, association or clearing agency.

The term "rules of a self-regulatory organization" is defined by Section 3(a)(28) to mean the rules of a national securities exchange, a registered securities association, a registered clearing agency, or the Municipal Securities Rulemaking Board.

(n26)Footnote 26. *See* Sections 6(b), 15A(b).

As the Senate Committee concluded:

Under the bill the scope of the rule-making authority and responsibility of all self-regulatory organizations would be defined in terms of purposes and standards, rather than subject matters. The

purposes to be served by self-regulatory rules would be expressed affirmatively and negatively (what the rules must be, and what they may not be, designed to accomplish).

Summary of Principal Provisions of Securities Acts Amendments of 1975, Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 1st Sess. 6 (1975), *supra*.

Section 15A(b), pertaining to the requirements for registration as a national securities association, is discussed in § 2.02[2][c] *infra*.

(n27)Footnote 27. S. Rep. No. 94-75, 94th Cong., 1st Sess., p. 27 (1975), reprinted in the Securities Primary Law Sourcebook, Vol. 2, Section I (hereinafter cited as "Senate Report"). The 1975 Amendments also repealed former Section 6(a).

(n28)Footnote 28. Section 6(a) "would provide for the registration of a national securities exchange with the Commission. The SEC would have the authority to require an exchange to file such documents and information as it deems necessary or appropriate in the public interest or for the protection of investors and to prescribe the form and substance of an exchange's application for registration." Senate Report, *supra*, at p. 95.

(n29)Footnote 29. Section 6(b), discussed in § 2.02[2][c][i] *infra*, contains the "explicit statutory requirements that must be satisfied before an exchange may be registered as a national securities exchange." *Id*.

(n30)Footnote 30. Section 6(a) explicitly requires the application for registration as a national securities exchange to contain the rules of the exchange.

(n31)Footnote 31. Form 1, under the Securities Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section H. "Application For Registration or Exemption From Registration As A National Securities Exchange," requires information about the organization, membership, and conduct of business of the exchange.

Under Section 19(b), as amended in 1975, an exchange must generally file all proposed rule changes with the Commission and receive Commission approval prior to the exchange rule taking effect. Some routine rule changes may be effective on filing with the Commission, subject to the right of the Commission, within 60 days of the filing, to abrogate the rule filing and to require its re-consideration under the usual procedures. See Section 19(b)(3); § 2.03[1][a] *infra*.

Form 1 also requires the filing of certain exhibits, including copies of the constitution, articles of incorporation, by-laws, rules, and written rulings of the exchange; exchange forms; financial statements for the exchange, and its affiliates and subsidiaries; a list of the officers of the exchange and of its affiliates and subsidiaries; a list of member firms of the exchange; a schedule of securities listed on the exchange; and a schedule of securities admitted to unlisted trading privileges on the exchange. If any exhibit required by Form 1 is inapplicable, then a statement to that effect must be filed in place of the exhibit. Note 2, Form 1.

(n32)Footnote 32. Rule 6a-1(c) under the Securities Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section G. An exchange may, either at its own election or at the request of the Commission, file as an amendment a complete new Form 1 "whenever the number of changes to be reported in an amendment, or the number of amendments filed, are so great that the purpose of clarity will be promoted by the filing of a new complete statement and exhibits." Rule 6a-1(d). With its Governance and Transparency Release in November 2004, the Commission proposed a major revision of the exchange registration process, including revising Form 1 and providing that it would be used for both initial registrations and amendments. Sec. Exch. Act. Rel. No. 50699, 2004 SEC LEXIS 2683, at *202 (Nov. 18, 2004) (hereinafter cited as "Governance and Transparency Release").

(n33)Footnote 33. Rule 6a-2(a). The information to be updated within ten days is that on the execution page, which contains the most basic information on the exchange, and that contained in the following exhibits: C (pertaining to subsidiaries and service providers for trading systems); F (membership applications); G (member financial responsibility); H (listing applications); J (officers, governors, and members of committees); K (ownership information for exchanges not owned by members); and M (list of members, subscribers and other users). *Id.*; Form 1.

(n34)Footnote 34. *See* Sec. Exch. Act Rel. No. 35123 (Dec. 20, 1994).

(n35)Footnote 35. Rule 6a-2(b); *see* Form 1. The financial information must be current as of the end of the latest fiscal year of the exchange, and the remaining information must be current as of the latest practicable date within three months of filing. *Id.*

(n36)Footnote 36. Rule 6a-2(c); *see* Form 1.

(n37)Footnote 37. Rule 6a-2(d).

(n38)Footnote 38. Rule 6a-3(a)(1). The material covered by this requirement includes "notices, circulars, bulletins, lists, and periodicals." *Id.*

(n39)Footnote 39. Rule 6a-3(a)(2).

(n40)Footnote 40. The report must set forth the aggregate dollar amount and number of shares of stock, aggregate dollar amount and principal amount of bonds and aggregate dollar amount and number of units sold of rights and warrants. Rule 6a-3(b).

In November 2004 the Commission proposed a new Rule 17a-26 that would require national securities exchanges to file quarterly and annual reports containing detailed information about their regulatory programs. Governance and Transparency Release, *supra*, at *312-313.

(n41)Footnote 41. *See* Sec. Exch. Act. Rel. No. 42455 (Feb. 24, 2000).

(n42)Footnote 42. *See* Sec. Exch. Act. Rel. No. 53128 (Jan. 13, 2006).

(n43)Footnote 43. Rule 15Aa-1. Form X-15AA-1 contains thirty items under the following headings: organization, membership, representation of membership, dues and expenses, business conduct and protection of members, disciplining of members, affiliated associations, miscellaneous, and additional information to be supplied if application is made for registration as an affiliated securities association. Exhibits to Form X-15AA-1 include:

- (1) copies of the association's constitution, charter, articles of incorporation or association (with all amendments thereto), by-laws, and any rules or instruments corresponding to the foregoing (Exhibit A);
- (2) a balance sheet as of a date within thirty days of the filing of the Form X-15AA-1, along with an income and expense statement for the year preceding the date of the balance sheet (or from the date the association was organized to the date of the balance sheet, if the association was organized during the year preceding the balance sheet date) (Exhibit B); and
- (3) an alphabetical list of the name and principal place of business of each member of the association (Exhibit C).

In November 2004 the Commission proposed a major revision of the process for registration as a national securities association, including replacing Form X-15AA with a new Form 2 and providing that the new form would be used for

both initial filings and amendments. Governance and Transparency Release, *supra*, at *202.

(n44)Footnote 44. Amendments must be filed with the Commission "promptly after the discovery of any inaccuracy in the registration statement or in any amendment or supplement thereto" correcting such inaccuracy. Rule 15-Aj-1(a).

(n45)Footnote 45. Current Supplements must be filed "promptly" after any change rendering any information in the registration statement, or in any amendment or supplement thereto, no longer accurate. Rule 15Aj-1(b). However, changes in the information called for by Exhibit B (financial statements) do not require the filing of a current supplement; changes in the information called for in Exhibit C (list of association members) do not require the filing of a current supplement until ten days after the calendar month in which the changes occur. *Id.* In fact, if changes in the information called for in Exhibit C are published by the association at least once a month and promptly filed in triplicate with the SEC, no current supplement need be filed with respect to these changes. Rule 15Aj-1(b)(3).

(n46)Footnote 46. Rule 15Aj-1.

(n47)Footnote 47. Form X-15Aj-2, "Annual Consolidated Supplement," contains items similar to those found on Form X-15AA-1. In addition, the three exhibits to be furnished with Form X-15AJ-2 are identical with those required for Form X-15AA-1, discussed above, except that the financial statements to be furnished as Exhibit B to the annual consolidated supplement must cover the last fiscal year of the securities association.

(n48)Footnote 48. Rule 15Aj-1(c)(1),(2). Three copies of any notices, reports, circulars, loose-leaf insertions, riders, new additions, lists, or other records of changes covered by amendments or supplements, if available to members of the association, must be sent to the Commission, in addition to the formal filing of amendments and supplements required by Rule 15Aj-1. Rule 15Aj-1(d).

It is important to keep in mind that Rule 15Aj-1 was enacted well before the Securities Acts Amendments of 1975. Section 19(b), as amended in 1975, contains new procedures for Commission approval of proposed rule changes by self-regulatory organizations, including securities associations, requiring the filing of proposed rule changes with the Commission. Section 19(b) is discussed in § 2.03[1][a] *infra*. Thus, many of the changes necessitating the filing of a current supplement pursuant to Rule 15Aj-1 will already be on file with the Commission, thereby resulting in a filing pursuant to Rule 15Aj-1 for informational purposes only, the rule change already having been approved by the Commission under Section 19(b).

(n49)Footnote 49. Sections 6(a) and 15A(a). As part of its Governance and Transparency Release, in November 2004 the Commission proposed a new Rule 17a-26 that would require national securities associations to file quarterly and annual reports containing detailed information about their regulatory programs. Governance and Transparency Release, *supra*, at *312-313.

(n50)Footnote 50. The purpose of Section 19(a)(1) is to "establish a uniform pattern for the registration with the Commission of national securities exchanges, registered securities associations and registered clearing agencies." Senate Report, at p. 128.

(n51)Footnote 51. In the case of clearing agencies for which the Commission is not the appropriate regulatory agency, *e.g.*, banks, Section 19(a)(2) prescribes different procedures that involve review by the other regulatory agency prior to final Commission action.

(n52)Footnote 52. The full text of Section 6(b) is as follows:

(b) An exchange shall not be registered as a national securities exchange unless the Commission determines that-

1-2 Federal Securities Exchange Act of 1934 § 2.03

- (1) Such exchange is so organized and has the capacity to be able to carry out the purposes of this title and to comply, and (subject to any rule or order of the Commission pursuant to Section 17(d) or 19(g)(2) of this title) to enforce compliance by its members and persons associated with its members, with the provisions of this title, the rules and regulations thereunder, and the rules of the exchange.
- (2) Subject to the provisions of subsection (c) of this section, the rules of the exchange provide that any registered broker or dealer or natural person associated with a registered broker or dealer may become a member of such exchange and any person may become associated with a member thereof.
- (3) The rules of the exchange assure a fair representation of its members in the selection of its directors and administration of its affairs and provide that one or more directors shall be representative of issuers and investors and not be associated with a member of the exchange, broker, or dealer.
- (4) The rules of the exchange provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities.
- (5) The rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the exchange.
- (6) The rules of the exchange provide that (subject to any rule or order of the Commission pursuant to section 17(d) or 19(g)(2) of this title) its members and persons associated with its members shall be appropriately disciplined for violation of the provisions of this title, the rules or regulations thereunder, or the rules of the exchange, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.
- (7) The rules of the exchange are in accordance with the provisions of subsection (d) of this section, and, in general, provide a fair procedure for the disciplining of members and persons associated with members, the denial of membership to any person seeking membership therein, the barring of any person from becoming associated with a member thereof, and the prohibition or limitation by the exchange of any person with respect to access to services offered by the exchange or a member thereof.
- (8) The rules of the exchange do not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title.
- (9) The rules of the exchange prohibit the listing of any security issued in a limited partnership roll-up transaction (as such term is defined in paragraphs (4) and (5) of section 14(h)), unless such transaction was conducted in accordance with procedures designed to protect the rights of limited partners, including-

(A) the right of dissenting limited partners to one of the following:

(i) an appraisal and compensation;

(ii) retention of a security under substantially the same terms and conditions as the original issue;

(iii) approval of the limited partnership roll-up transaction by not less than 75 percent of the outstanding securities of each of the participating limited partnerships;

(iv) the use of a committee of limited partners that is independent, as determined in accordance with rules prescribed by the exchange, of the general partner or sponsor, that has been approved by a majority of the outstanding units of each of the participating limited partnerships, and that has such authority as is necessary to protect the interest of limited partners, including the authority to hire independent advisors, to negotiate with the general partner or sponsor on behalf the limited partners, and to make a recommendation to the limited partners with respect to the proposed transaction; or

(v) other comparable rights that are prescribed by rule by the exchange and that are designed to protect dissenting limited partners;

(B) the right not to have their voting power unfairly reduced or abridged;

(C) the right not to bear an unfair portion of the costs of a proposed limited partnership roll-up transaction that is rejected; and

(D) restrictions on the conversion of contingent interests or fees into non-contingent interests or fees and restrictions on the receipt of a non-contingent equity interest in exchange for fees for services which have not yet been provided.

As used in this paragraph, the term "dissenting limited partner" means a person who, on the date on which soliciting material is mailed to investors, is a holder of a beneficial interest in a limited partnership that is the subject of a limited partnership roll-up transaction, and who casts a vote against the transaction and complies with procedures established by the exchange, except that for purposes of an exchange or tender offer, such person shall file an objection in writing under the rules of the exchange during the period during which the offer is outstanding.

Section 6(b)(9) was added in 1993 as part of the Limited Partnership Roll-up Reform Act of 1993, in response to perceived abuses in connection with limited partnership roll-ups. See Federal Securities Law Reports (CCH) (2001), P 21,360.001.

(n53)Footnote 53. Sections 6(b)(1), 15A(b)(2).

Section 3(a)(3)(A), as amended, sets forth a new definition of "member" with respect to an exchange to mean:

(1) a natural person permitted to effect transactions on the floor of the exchange without using another person as a broker;

(2) a registered broker or dealer with which such a natural person is associated;

(3) a registered broker or dealer permitted to designate such a natural person as a representative; and

(4) any other registered broker or dealer that agrees to be regulated by the exchange and with respect to which the exchange undertakes to enforce compliance with the Act, the Rules thereunder and the exchange's rules.

The term "member" also includes persons required by the Commission to comply with exchange rules pursuant to Section 6(f), *see* § 2.03[3][b] *infra*, for certain purposes, including compliance with the Act and rules thereunder, allocation of fees and charges, disciplinary proceedings by the exchange and investigations and enforcement proceedings by the Commission.

Section 3(a)(3)(B) defines the term "member" when used with respect to a national securities association to mean "any broker or dealer who agrees to be regulated by such association and with respect to the association undertakes to enforce compliance with the provisions of [the Exchange Act], the rules and regulations thereunder, and its own rules."

The term "person associated with a member" or "associated person of a member" is defined in amended Section 3(a)(21) to mean:

- (1) any partner, officer, director, or branch manager of a member (or a person occupying a similar status or performing similar functions);
- (2) any person directly or indirectly controlling, controlled by, or under common control with a member; or
- (3) any employee of a member.

(n54)Footnote 54. Section 15A(b)(2).

(n55)Footnote 55. Section 15A(b)(1).

(n56)Footnote 56. Sections 6(b)(2), 15A(b)(3). The rules of an exchange concerning membership on the exchange are subject to the provisions of Section 6(c) of the Exchange Act. *Id.* Section 6(c) sets forth the grounds on which an exchange may deny a person membership or bar a person from becoming associated with a member.

Section 6(b)(2), which is designed to prevent unfair discrimination in the membership approval process, essentially provides that Section 6(c)'s grounds for denial are the only permissible grounds for excluding members.

Similarly, the rules of a securities association are subject to the provisions of Section 15A(g), which also provides grounds upon which an association may deny membership or bar a person from becoming associated with a member.

Sections 6(c) and 15A(g) are discussed in § 2.03[2][a], *infra*.

(n57)Footnote 57. Sections 6(b)(3), 15A(b)(4).

(n58)Footnote 58. Sections 6(b)(4), 15A(b)(5).

(n59)Footnote 59. Sections 6(b)(5), 15A(b)(6).

(n60)Footnote 60. Sections 6(b)(5), 15A(b)(6).

(n61)Footnote 61. *Id.* This requirement in Sections 6(b)(5) and 15A(b)(6) is one of several provisions of the 1975

Amendments addressing the anticompetitive effects of exchange rules restricting members from effecting transactions off the exchange. *See* § 2.02[2][c][ii] *infra*.

(n62)Footnote 62. Sections 6(b)(5), 15A(b)(6).

The rules of a securities association are not permitted "to fix minimum profits, to impose any schedules or fix rates of commissions, allowances, discounts, or other fees to be charged by its members." Section 15A(b)(6). A similar prohibition is placed upon exchanges by Section 6(e)(1).

The regulation of commission rates is discussed in § 2.03[2][d] *infra*.

(n63)Footnote 63. Sections 6(b)(6), 15A(b)(7).

The rules of an exchange or securities association providing for appropriate disciplinary action are subject to any rule or order of the Commission pursuant to Section 17(d) or Section 19(g)(2) of the Exchange Act. Sections 6(b)(6), 15A(b)(7).

Section 17(d) of the Exchange Act authorizes the Commission "to relieve self-regulatory organizations of regulatory responsibilities for persons who are members of or participants in more than one self-regulatory organization and to allocate among self-regulatory organizations the authority to exercise regulatory authority." Senate Report, *supra*, at p. 121. One purpose of the Commission's power to allocate regulatory responsibilities is to "remove impediments to the development of a national market system and national system for the clearance and settlement of securities transactions." *Id.* The national market system is discussed in § 2.04 *infra*.

Section 19(g)(2) of the Exchange Act, authorizing the Commission to relieve any self-regulatory organization from enforcing compliance with the Exchange Act, the rules thereunder, and the rules of the self-regulatory organization, is discussed in § 2.03[3][a] *infra*.

(n64)Footnote 64. Sections 6(b)(7), 15A(b)(8). Disciplinary procedures are discussed in § 2.03[4][a] *infra*.

(n65)Footnote 65. Sections 6(b)(7), 15A(b)(8).

(n66)Footnote 66. Sections 6(b)(8), 15A(b)(9). For discussion of the Commission's review of the burdens on competition, *see* § 2.02[2][c][ii] *infra*.

(n67)Footnote 67. Section 15A(b)(6) of the Securities Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F. Similarly, under Section 6(e), the Commission cannot permit a national securities exchange, by rule, to impose a schedule or fixed rate of commissions, allowances, discounts, or other fees to be charged after November 1, 1976, unless the Commission finds that such schedule or fixed rates further the purposes of the Exchange Act without imposing any unnecessary or inappropriate burden on competition.

(n68)Footnote 68. Section 15A(b)(10). Pursuant to Section 15A(c), the Commission may require that the rules of a registered securities association provide for the admission of a registered affiliated securities association under Section 15A(d) under such terms and with such responsibilities as the Commission deems necessary and appropriate.

(n69)Footnote 69. Section 15A(b)(11). These rules are required to "be designed to produce fair and informative quotations, and to promote orderly procedures for collecting, distributing and publishing quotations." *Id.*

(n70)Footnote 70. *See* Section 6(a)(1) (prior to the 1975 Amendments), discussed above.

(n71)Footnote 71. Sections 6(b)(6), 15A(b)(7). *See* *Hochfelder v. Midwest Stock Exchange*, 350 F. Supp. 1122 (N.D. Ill. 1972), *aff'd*, 503 F.2d 364 (7th Cir.), *cert. denied*, 419 U.S. 875 (1974) (defendant stock exchange not required

to investigate and supervise member's activities to the extent plaintiffs alleged):

[P]laintiffs also allege that this defendant violated Section 6(a)(1) of the Securities Exchange Act (15 U.S.C. § 78f). This section, in part, requires a national securities exchange to file an agreement with the S.E.C. 'to enforce so far as is within its powers compliance by its members, with the provisions of this chapter, and any amendment thereto and any rule or regulation made or to be made thereunder.' Presumably such an agreement was filed by Midwest.

The remainder of plaintiffs' allegations against this defendant involve its alleged failure to investigate and supervise Nay's activities sufficiently to discover his fraud. No case has been cited where this type of omission or practice gives rise to an action against an exchange under Rule 10b-5. The only cited case resulted in summary judgment for the exchange. *Butterman v. Walston & Co., Inc., et al.*, 387 F.2d 822 (7th Cir. 1967). As a matter of fact it is doubtful that the language of Section 6(a)(1) supports an action by a third party except possibly as a contract beneficiary.

The other cited cases involve representations or omissions made with respect to the issuance or sale of specific securities. There is no indication that Rule 10b-5 was intended to make a national security exchange responsible for all of the personal transactions and financial stability of its members. *Cf. Buttrey v. Merrill Lynch et al.*, 410 F.2d 135 (7th Cir. 1969) for a typical case involving violations of a stock exchange rule by a broker.

Assuming, however, that Midwest could be liable for ineffectively policing its members' dealings in unlisted securities, the defendant's affidavits demonstrate that it adequately performed its agreement under Section 6(a)(1) of the Act. Although plaintiffs have shown instances where this defendant arguably was put on notice of Nay's untrustworthiness, these do not raise an issue of fact concerning the adequacy of the defendant's supervision, but merely tend to show that it was not fluoroscopic. Neither the law nor common sense requires perfection but only an agreement 'to enforce so far as is within its powers compliance by its members' (15 U.S.C. § 78f). Defendant affidavits establish this without contradiction.

The court finds and concludes as a matter of law that Midwest performed its obligations under Section 6(a)(1) and that no triable issue of fact remains therein.

350 F. Supp. at 1123-25.

(n72)Footnote 72. Sections 6(b)(8), 15A(b)(9).

(n73)Footnote 73. The purpose behind a Commission review of burdens on competition to eliminate all present and future restraints on competition that are incompatible with the purposes of the Exchange Act was to facilitate the development of a national market system. Senate Report, *supra*, at pp. 12-13.

(n74)Footnote 74. Section 19(b) is discussed in § 2.03[1][a] *infra*.

(n75)Footnote 75. Section 19(c) is discussed in § 2.03[1][b] *infra*.

(n76)Footnote 76. Sections 19(e) and (f) are discussed in § 2.03[4][c] *infra*.

(n77)Footnote 77. Unlisted trading privileges are discussed in § 4.01[5] *infra*.

(n78)Footnote 78. Section 6(e) is discussed in § 2.03[2][d] *infra*.

(n79)Footnote 79. Section 6(e)(1)(B)(ii).

(n80)Footnote 80. Section 15A(b)(6).

(n81)Footnote 81. The Commission reported the results of its initial review pursuant to Section 11A(c)(4) to the Congress on September 2, 1975. SEC, Report of the Securities and Exchange Commission on Rules of National Securities Exchanges Which Limit or Condition the Ability of Members to Effect Transactions Otherwise Than on Such Exchanges, Sec. Exch. Act Rel. No. 11628 (1975). In view of its conclusion that certain existing off-board trading restrictions were apparently unnecessary, the Commission instituted a proceeding pursuant to Section 19(c) to determine whether to modify or rescind the restrictions. After public hearings in October 1975, the Commission announced on December 19, 1975 in Sec. Exch. Act Rel. No. 11942 the adoption of Rule 19c-1, effective March 31, 1976, preventing the rules, policy, or practice of a national securities exchange from prohibiting, conditioning, or limiting the ability of any member acting as agent, *i.e.* broker, to effect transactions otherwise than on such exchange in listed equity securities, or securities to which unlisted trading privileges have been extended on that exchange.

On December 4, 1987, Section 11A(c)(4) was amended to delete reference to the reporting requirement of 11A(c)(4)(2) and the Section 19(c) proceeding requirement of 11A(c)(4)(3). SEC Authorization Act of 1987, Sec. 313, Pub. Law 100-181, 101 Stat. 1249.

Section 11A(c)(4) now reads: "The Commission is directed to review any and all rules of national securities exchanges which limit or condition the ability of members to effect transactions in securities otherwise than on such exchanges."

For a discussion of off-board trading developments, see § 2.03[2][c] *infra*.

The applicability of the antitrust statutes to the securities industry is discussed in § 2.03[6] *infra*.

(n82)Footnote 82. Section 15A(c).

(n83)Footnote 83. Section 15A(c).

(n84)Footnote 84. Section 15A(c).

(n85)Footnote 85. Section 15A(d)(1).

(n86)Footnote 86. Sections 15A(b)(2) through (10) contain requirements that an association of brokers and dealers must meet to be registered with the Commission as a national securities association, *See* § 2.02[2][c][i] *supra*.

Section 15A(b)(12), governing the form and content of securities quotations, became (with some alteration) Section 15A(b)(11) as a result of the Securities Acts Amendments of 1975. *See* Senate Report, *supra*, at p. 204.

(n87)Footnote 87. Section 15A(b)(3) requires, as a condition for registration as a national securities association, that the rules of an association (defined in Section 3(a)(27)) provide that any registered broker or dealer may become a member of such association and any person may become associated with a member, subject to the provisions of Section 15A(g), discussed in § 2.03[2][a] *infra*.

(n88)Footnote 88. Section 15A(d)(2).

(n89)Footnote 89. Section 15A(e)(1). *See* 42 SEC Ann. Rep., p. 83 (1976) at 83:

In adopting legislation to permit the formation and registration of national securities associations, Congress provided an incentive to membership by permitting such associations to adopt rules precluding any member from dealing with a nonmember broker or dealer except on the same terms and conditions and at the same prices as the member deals with the general public. The NASD has adopted such rules.

As a practical matter, therefore, membership is necessary for profitable participation in many underwritings since members properly may grant only to other members price concessions, discounts and similar allowances not granted to the general public.

(n90)Footnote 90. Section 15A(e)(2). *See* Senate Report, *supra*, at p. 112.

The bill would also further amend subsection 15A(e) of the Act to change the definition of the term non-member for purposes of the authority granted to registered securities [associations] to prohibit members, by rule, from dealing with non-members except at the same prices and on the same terms and conditions as are accorded to the general public. Since the self-regulatory organization created for the municipal securities industry by the bill, the Municipal Securities Rulemaking Board, would not be a membership organization, the revision to this important provision of the Act would effectively require all nonbank municipal securities dealers which participate in underwriting syndicates to join the NASD. In this connection, syndicate and underwriting practices and the granting of any discounts, allowances or concessions would be the subject of direct rulemaking by the Municipal Securities Rulemaking Board.

Broker-dealer registration requirements under the Exchange Act are discussed in § 3.03 *infra*.

(n91)Footnote 91. Section 15A(e)(2).

(n92)Footnote 92. Section 15A(e)(3).

(n93)Footnote 93. *Id.* Section 15B(b)(2)(K) requires the Municipal Securities Rulemaking Board, *see* § 3.06[6] *infra*, to propose and adopt rules that, at a minimum, would "establish the terms and conditions under which any municipal securities dealer may sell, or prohibit any municipal securities dealer from selling, any part of a new issue of municipal securities to a municipal securities investment portfolio during the underwriting period."

(n94)Footnote 94. For the definition of "self-regulatory organization," *see* § 2.02[2] *supra*.

(n95)Footnote 95. Section 19(a)(3).

(n96)Footnote 96. Section 19(a)(3).

(n97)Footnote 97. *See* Sec. Exch. Act Rel. No. 44692, *available at* 2001 SEC LEXIS 1641 (Aug. 13, 2001) (hereinafter "Single-Stock Futures Release"), at *7.

(n98)Footnote 98. *See* Section 6(g).

(n99)Footnote 99. *See* Section 6(g)(2)(B).

(n100)Footnote 100. Section 15A(k).

(n101)Footnote 101. The initial registration and subsequent filing requirements applicable to traditional exchanges are discussed in § 2.02[2] *supra*.

(n102)Footnote 102. Rule 6a-4(b). The information on the cover page of Form 1-N consists of basic data such as the name, address and form of organization of the exchange, and therefore is unlikely to change frequently. *See* Form 1-N.

(n103)Footnote 103. *See* Rule 6a-4(b).

(n104)Footnote 104. Rule 6a-4(c)(1)(i).

(n105)Footnote 105. Rule 6a-4(c)(1)(ii).

(n106)Footnote 106. Rule 6a-4(c)(2).

(n107)Footnote 107. Sec. Exch. Act Rel. No. 40760 (Dec. 8, 1998) (hereinafter cited as "Reg. ATS Adopting Release").

(n108)Footnote 108. Reg. ATS Adopting Release, *supra*.

(n109)Footnote 109. Rule 3b-16 provides that an entity is an exchange if it:

- (1) Brings together the orders for securities of multiple buyers and sellers; and
- (2) Uses established, non-discretionary methods (whether by providing a trading facility or by setting rules) under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade.

"Non-discretionary methods" are fixed procedures or rules which govern order execution. *See* Reg. ATS Adopting Release, *supra*. For example, exchange rules that establish a priority for the execution of orders in terms of price, time, or some other criteria are non-discretionary methods. The "non-discretionary" element of the definition of exchange excludes routine functions of broker-dealers from the definition. For example, a broker-dealer's block trading desk, at which employees of the broker-dealer execute large customer orders but retain discretion in determining how to fill the orders, would not be considered an exchange. *See id.*

(n110)Footnote 110. *See* Reg. ATS Adopting Release, *supra*; *see also* Rule 3a1-1(a).

(n111)Footnote 111. The volume levels are as follows:

1. Fifty percent of the average daily trading volume in any single security and five percent of the average daily trading volume for any class of security, such as equity securities, listed options, or investment-grade debt; or
2. Forty percent of the average daily trading volume for any class of security. If a system exceeds these levels for three out of four calendar quarters, the Commission may seek to revoke the exemption, but is not required to do so.

See Rule 3a1-1(b)(1)(i), (ii).

(n112)Footnote 112. Regulation ATS consists of Rules 300 through 303.

(n113)Footnote 113. Reg. ATS Adopting Release, *supra*.

(n114)Footnote 114. The term "alternative trading system" is defined in Rule 300(a) of Regulation ATS as:

any organization, association, person, group or persons, or system:

- (1) That constitutes, maintains, or provides a market place of facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of [Rule 3b-16]; and

(2) That does not:

(i) Set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system; or

(ii) Discipline subscribers other than by exclusion from trading.

A system cannot be considered an "alternative trading system" within the meaning of the rule if it performs self-regulatory functions; the Commission believes that any system exercising any significant self-regulatory authority should be registered as an SRO. Reg. ATS Adopting Release, *supra*.

(n115)Footnote 115. Under Rule 301 a system does not have to comply with Regulation ATS if it:

1. is registered as a national securities exchange;
2. is exempted by the Commission from registration as an exchange based on limited trading volume;
3. is operated by a national securities association; or
4. is registered as a broker-dealer, or is a bank, and limits the securities it deals in to specified government securities and commercial paper.

(n116)Footnote 116. Rule 301(a)(5).

(n117)Footnote 117. Rule 301(b)(1).

(n118)Footnote 118. Rule 301(b)(2). The initial operation report is simply a notice filing; no Commission approval is required.

(n119)Footnote 119. Rule 301(b)(2)(ii), (iii), (iv).

(n120)Footnote 120. Rule 301(b)(2)(v).

(n121)Footnote 121. See Sections 17, (a), 18(a), 32(a) of the Exchange Act; Rule 301(b)(2)(vi), (vii).

(n122)Footnote 122. See Rule 301(b)(3); Reg. ATS Adopting Release, *supra*; Rules 600(b)(46), 600(b)(47).

(n123)Footnote 123. Rule 301(b)(3).

(n124)Footnote 124. Rule 301(b)(3).

(n125)Footnote 125. See § 2.01[3] *supra*.

(n126)Footnote 126. Rule 301(b)(4). In the Regulation ATS adopting release, the Commission stated that any fees charged by these systems should be similar to communications or access fees charged by other markets. Reg ATS Adopting Release, *supra*.

(n127)Footnote 127. Rule 301(b)(5).

(n128)Footnote 128. Reg. ATS Adopting Release, *supra*.

(n129)Footnote 129. Rule 301(b)(5)(iii)(A)-(C).

(n130)Footnote 130. Rule 301(b)(6)

(n131)Footnote 131. The volume threshold under Rule 301(b)(6) is five percent of the average daily volume for a security in four of the preceding six months. 17 C.F.R. § 242.301(b)(6). The threshold was originally 20 percent, but was lowered to 5 percent by Regulation NMS in 2005. *See* Sec. Exch. Act Rel. No. 51808 (June 9, 2005). Once the threshold is satisfied, for systems that support order entry, order routing, order execution, transaction reporting and trade comparison, the system must:

- establish reasonable capacity estimates;
- conduct capacity stress tests of critical systems;
- institute procedures to review its system development and testing methodology;
- review the vulnerability of its systems to hackers, physical hazards and natural disasters;
- establish adequate contingency and disaster recovery plans;
- have an independent review performed of the system's controls, and have senior management of the system review the report; and
- notify the SEC promptly of significant system outages and changes.

Rule 301(b)(6)(ii). The Commission recognized that, as a practical matter, if the requirements apply to one security the entire trading system would have to satisfy the requirements. *See* Reg ATS Adopting Release, *supra*.

(n132)Footnote 132. Rule 301(b)(6)(iii).

(n133)Footnote 133. Rule 302 of Regulation ATS requires that the following records be kept:

1. A record of subscribers to the system;
2. Daily summaries of trading which include:
 - a. securities traded;
 - b. transaction volume for securities including number of trades, number of shares traded, and dollar volume;
 - c. transaction volume for debt securities including number of trades and dollar value;
3. Time-sequenced records of order information which include:
 - a. the date and time, to the second, that orders are received;
 - b. the identity of the security;
 - c. the number of shares or the principal amount of bonds;
 - d. a special identification if the order relates to a program trade or an index arbitrage

trade;

- e. designation of the order as a buy or a sell;
- f. designation of the order as a short-sale, if applicable;
- g. designation of the type of order, such as market, limit, or stop loss;
- h. a limit or stop price, if applicable;
- i. the date at which the order expires or, for a day order, the time;
- j. the time during which the order is in force;
- k. any instructions to modify or cancel the order;
- l. the type of account, such as retail, wholesale, employee, etc.;
- m. the date and time, to the second, that the order was executed;
- n. the price at which the order was executed;
- o. the size of the executed portion of the order, in number of shares or, for bonds, principal amounts;
- p. the identity of the parties to the transaction.

(n134)Footnote 134. Rule 303(a)(1).

(n135)Footnote 135. The following records must be retained if they are created:

- notices to subscribers;
- if the system is subject to the fair access standards, a copy of its access standards and all documents relating to its grants or denials of access;
- all documents related to its compliance with the capacity, integrity and system requirements.

Rule 303(a)(1).

(n136)Footnote 136. Rule 303(a)(2).

(n137)Footnote 137. Rules 17d-4(f), 303(d).

(n138)Footnote 138. Rule 303(e).

(n139)Footnote 139. Rule 301(b)(9).

(n140)Footnote 140. Form ATS-R, Federal Securities Laws (CCH) P 33,015.

(n141)Footnote 141. Rule 301(b)(10).

(n142)Footnote 142. Rule 301(b)(11).

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Federal Securities Exchange Act of 1934

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CHAPTER 2 Regulation of Securities Markets *

1-2 Federal Securities Exchange Act of 1934 § 2.04

§ 2.04 Self-Regulation and Commission Oversight

Congress, at the urging of the securities industry, took the position in the Exchange Act that primary responsibility for the discipline of exchange members should rest with the exchange itself. Then Commission Chairman Douglas described it as letting the exchange take the leadership with Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with hope it would never have to be used. n1

Accordingly, Section 6 of the Exchange Act required an exchange to agree to enforce the provisions of the Exchange Act and rules and regulations thereunder. n2 Moreover, Section 6 further stated that no registration "shall be granted or remain in force" unless the rules of the exchange provided for the discipline of the member for conduct that was "inconsistent with just and equitable principles of trade," including the provisions of the Exchange Act and the rules thereunder. n3 Similarly, Section 6(c) as enacted provided seemingly open-ended authority for rule making by an exchange without Commission approval. n4 Prior to the 1975 Amendments, Section 19 provided the Commission with limited and ambiguous oversight power over the exchanges. n5 For example, the SEC had no jurisdiction to review administratively a disciplinary action by an exchange against a member of that exchange, the member's only remedy being a lawsuit against the exchange for reinstatement or damages. n6

In contrast to the exchanges, the OTC market had no member organizations upon which government regulation could focus. Accordingly, the Maloney Act subjected any national securities association to more stringent statutory obligations and Commission oversight. n7 While there was recognition that "to leave the over-the-counter markets out of a regulatory system would destroy the effects of regulating the organized exchanges," n8 the Commission was concerned that direct government regulation without a self-regulatory organization "is a little like trying to build a structure out of dry sand. There is no cohesive force to hold it together, no organization with which we can build." n9

The adoption of Section 15A reflected concern over the effectiveness of new securities associations and differed in several significant respects from the original 1934 pattern. For example, registered national securities associations were from the beginning required to file with the Commission all proposed rule changes, n10 and the Commission could enter a single order of disapproval preventing effectiveness. n11 Moreover, the Commission had from the beginning the authority to "abrogate" an association's rule if necessary to assure fair dealing, fair representation or otherwise to protect investors. n12 The Commission also had the authority to proceed against an officer or director of an association for willful failure to enforce an association's rules, but, as in the case of exchanges, the Commission had no direct authority

to take disciplinary action for violation of association rules.

In marked contrast to its authority with respect to exchanges, the Commission had the express power to review association disciplinary action taken against a member and could reduce, but not increase, any penalty. n13

The 1975 Amendments effected significant changes in the statutory responsibilities imposed upon national securities exchanges and the Commission's oversight powers over these exchanges. n14 In summary, Congress subjected the exchanges to the statutory scheme embodied originally in Section 15A for registered securities associations. n15 The 1975 amendments:

- (1) imposed more explicit requirements with respect to exchange rules;
- (2) gave the Commission power to impose more flexible sanctions on an exchange and its officers;
- (3) imposed due process requirements to be observed in any exchange disciplinary or exclusionary proceeding; and
- (4) subjected such proceedings to review by the Commission.

The 1975 Amendments clearly evidence Congressional concern over the anti-competitive effects of regulation in the securities industry, including the effects of exchange rules and disciplinary and exclusionary proceedings. n16 Thus, exchange rules may not be designed to allow the exchange or its members to unfairly discriminate between customers, issuers, brokers, or dealers. n17 Nor may an exchange's rules regulate, by virtue of any authority contained in the Exchange Act, matters not related to the purposes of the Exchange Act or the administration of the exchange. n18 Nor may the rules of an exchange impose a burden on competition that is not necessary or appropriate to further the Exchange Act. n19 Moreover, Congress designated both registered securities exchanges and associations to be self-regulatory organizations, n20 with virtually identical substantive duties and responsibilities under the Exchange Act.

The Commission has also taken steps to ensure the fairness of the self-regulatory regime. Commission inquiries into the operation of the NASD and NYSE spurred a significant restructuring of the organizations in 1996 and 2003, respectively, to ensure equitable treatment and enforcement among its diverse member constituencies. n21 As SROs increasingly come into competition with their members, Commission oversight of the potential for conflicts of interest will likely increase. Failures of the self-regulatory system as employed by both the NYSE and NASD (now FINRA--the NASD as well as certain functions of the NYSE) have increased the likelihood that the self-regulatory regime will be re-examined and perhaps modified. n22

[1] Adoption of Rules and Regulations by Self-Regulatory Organizations (SROs)

[a] Commission Review of Proposed Rules n23

[i] National Securities Exchanges and Registered Securities Associations

The 1975 Amendments establish a procedure for Commission review of a proposed change in any self-regulatory organizations' rules n24 and impose upon the Commission "the responsibility to determine with respect to such change that the requirements of the Exchange Act are satisfied." n25

The procedure for Commission approval of rule changes of self-regulatory organizations, including national securities exchanges and registered securities associations, is contained in Section 19(b) of the Exchange Act. Section 19(b)(1) provides that a proposed rule of an SRO or any proposed change in, addition to, or deletion from the rules of an SRO,

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n26 must be filed with the Commission n27 together with a concise general statement of the basis and purpose of the proposed rule or change. n28 The Commission requires a statement which, at a minimum, describes the reasons for adopting the proposed rule and the problems to be addressed by the rule. n29 In addition, the form filed as to the proposed rule or rule change must be accompanied by a "detailed and specific" statement adequate to permit the Commission to find that the proposed rule is consistent with the provisions of the Exchange Act and the rules and regulations thereunder. n30 The Commission must then publish notice of the filing and the substance of the proposed rule or change, or a description of the subjects and issues involved. Interested persons must be given an opportunity to submit written data, views, and arguments. n31 No proposed rule change can take effect unless approved by the Commission or otherwise permitted in accordance with Section 19(b). n32

Within thirty-five days of publication of the notice of filing, the Commission must either:

- (1) approve the proposed rule or change, or
- (2) institute proceedings to determine whether the proposed rule or change should be disapproved, giving notice of the grounds for disapproval under consideration and an opportunity for hearing.

The proposed rule or change must be approved if it is found to be consistent with the requirements of the Exchange Act and the rules thereunder applicable to the organization. n33 The thirty-five day period for the Commission to approve or institute proceedings may be extended up to ninety days by the Commission or upon consent of the organization. If the Commission orders a proceeding, it must be concluded within one hundred eighty days from the date of publication of the notice of filing; that period may be extended for up to sixty days by the Commission or for a longer period if the organization consents. n34 A proposed rule or change may not be approved prior to the thirtieth day after publication of the notice of filing unless the Commission finds good cause for doing so, and publishes its reasons. n35

The Commission must promptly publish notice of orders approving or disapproving a proposed rule change together with a written statement of the reasons for the Commission action. n36

In 1998, the Commission adopted an amendment to Rule 19b-4 designed to make it easier for SROs to trade and list new derivative products. n37 Accordingly, Rule 19b-4 now provides that proposals to list and trade new securities derivatives products will not be considered proposed rule changes, so long as the SRO has rules and standards applicable to the product and a surveillance program for the class of product to which the new issue belongs. n38 SROs are required to notify the SEC of the creation of a new derivative product, on a newly-created form, Form 19b-4(e). n39

Under Section 19(b)(3)(A) of the Exchange Act, a proposed rule or change may take effect upon filing if:

- (1) it is designated by the self-regulatory organization as
 - (i) constituting a stated policy, practice, or interpretation of an existing rule of the organization;
 - (ii) establishing or changing dues, fees, or other charges; or
 - (iii) dealing solely with the administration of the organization, or n40
- (2) it is a matter that has been excluded from Section 19(b)(2) by a rule of the Commission. n41

In December 1994, the SEC adopted a significant amendment to Rule 19b-4 designed to streamline the process under which SRO rules are adopted or amended. n42 The amendment added two categories of rule filings to those that may take effect upon filing--routine amendments to existing order-entry and trading systems, and so-called

"non-controversial filings." n43 Specifically, Rule 19b-4 now provides that a rule change may take effect upon filing if:

- it changes an existing order-entry or trading system of an SRO in a manner that does not limit access to or the availability of the system; or
- it does not become effective for 30 days after filing, and the SRO has given the Commission five business days notice of the filing. n44

In either case the filing must not "significantly affect the protection of investors or the public interest" or impose significant burdens on competition. n45

A rule or change put into effect summarily may be abrogated within sixty days by the Commission and it must then be refiled in accordance with Section 19(b)(1) and reviewed in accordance with Section 19(b)(2). n46

A rule or change may also be put into effect summarily by the Commission if it finds such action necessary for the protection of investors, maintenance of fair and orderly markets, or the safe-guarding of securities or funds, but the rule or change must then be filed promptly under Section 19(b)(1). n47

When the Commission approves a self-regulatory rule change, the notice of final disposition of the matter and the entry of an order approving such change must be accompanied by a written statement of the reasons for the Commission's approval of the change. n48

In early 2001, the Commission proposed to improve the efficiency of the process for approving SRO rule changes by, among other things, requiring the Commission to issue a release relating to a proposed rule change within ten business days of filing and allowing more rule changes to become immediately effective upon filing. n49 However, this proposed rule change was never approved.

In October 2004 the Commission amended Rule 19b-4 to require SROs to file rule changes and amendments to rule changes electronically, to post proposed rule changes on their web sites within two business days of filing, and to maintain a complete, up-to-date version of their rules on their website. n50

[iii] Security Futures Product Exchanges and Limited Purpose National Securities Associations

As a result of the CFMA, the SEC and CFTC jointly regulate single stock futures and commodities exchanges that trade single stock futures as well as commodities. n51 From the securities perspective, the legislation was designed to allow the SEC to exercise limited jurisdiction over commodities exchanges and market participants who otherwise do not engage in securities activities and whose primary regulator is the CFTC. Commodities markets on which single stock futures are traded therefore must undertake a process known as "notice registration." n52 Similarly, futures associations may register as "limited purpose national securities associations" under the CFMA. n53

In connection with single stock futures, the drafters of the CFMA had to consider the desirability of Commission review of rule filings relating to securities but also the need to minimize the administrative burden imposed on exchanges and associations subject to joint regulation in connection with these new products. The act attempts to balance these competing concerns by requiring rule filings with the Commission only on certain topics and allowing most rule filings to become effective immediately. Specifically, under Sections 6(a) and 15A(k) of the Exchange Act, which were added by the CFMA, a commodities SRO must file a proposed rule change with the Commission under the normal procedures mandated by Sections 19(b)(1) and 19(b)(2) of the Exchange Act if the rule change relates to margin, unless it imposes a higher margin level. n54 Rule changes that relate to "higher margin levels, fraud or manipulation, recordkeeping, reporting, listing standards, or decimal pricing," sales practices, or "effectuating" the SRO's "obligation to enforce the securities laws" must be filed with the Commission under Section 19(b)(7) of the Exchange Act, which was added by

the CFMA. n55 These rule changes are effective immediately upon filing, as long as a certification is filed with the CFTC to the effect that the filing is in compliance with the Commodity Exchange Act, the CFTC determines that review of the rule filing is not necessary, or the CFTC approves the rule change. n56 The SEC may abrogate rule filings made pursuant to Section 19(b)(7), after consulting with the CFTC, if it appears to the Commission that the rule change "unduly burdens competition or efficiency, conflicts with the securities laws, or is inconsistent with the public interest and the protection of investors." n57 The SEC implemented Section 19(b)(7) by adopting Rule 19b-7, which mandates the use of a newly-adopted form, Form 19b-7, for these filings, and requires the SROs to maintain and make available to the public, at their principal place of business, a copy of all rule filings and related comment letters. n58

[b] Commission-Initiated Changes in SRO Rules

Section 19(c) of the Exchange Act permits the Commission to "abrogate, add to, and delete from" the rules of a self-regulatory organization, other than a registered clearing agency, to insure fair administration of the organization or as it deems necessary or appropriate in furtherance of the purposes of the Exchange Act. n59 The Commission must notify the organization and publish a notice of the proposed rulemaking in the Federal Register that includes the text of the proposed amendment and a statement of the Commission's reasons for the proposed rulemaking. n60 Interested persons must be given an opportunity for oral presentation of data, views, and arguments, in addition to written submissions. A transcript must be kept of oral presentations. n61

A Commission-initiated rule under Section 19(c) must incorporate:

- (1) the text of the amendment to the organization's rules,
- (2) a statement of the Commission's basis and purpose for the amendment,
- (3) an identification of any facts on which the Commission considers its determination to be based, and
- (4) the reasons for the Commission's conclusions as to any facts disputed in the rulemaking. n62

In addition to the procedures specified in paragraphs (1) through (3) of Section 19(c), Commission-initiated rulemaking must be in accordance with the procedures specified in **Section 553 of Title 5 of the U.S. Code** (the "Administrative Procedure Act") for rulemaking not on the record. An amendment to an organization's rules pursuant to Section 19(c) is considered to be a rule of the organization and not a rule of the Commission. n63

[2] Regulation of Members and Associated Persons

[a] Admission to Membership

Section 6(b)(2) of the Exchange Act requires the rules of every exchange to provide that any registered broker or dealer or natural person associated with a registered broker or dealer may become a member of that exchange if certain conditions are satisfied. n64 This requirement subjects the exchanges to the same open membership requirement that Section 15A establishes for national securities associations. n65 Section 6(c) enumerates the grounds upon which an exchange may or must deny a person membership or bar a person from becoming associated with a member. Section 15A(g) establishes substantially the same criteria governing membership in a national securities association.

Membership in an SRO must be denied to any person who is not a registered broker or dealer. n66 Membership or association with a member may be denied by a self-regulatory organization, and must be denied if directed by the Commission, if the applicant for membership on a national securities exchange is subject to a "statutory disqualification." n67 The statutory disqualification scheme of the Exchange Act is the source of some confusion. In particular, it is not immediately obvious how this scheme meshes with the provisions of the Exchange Act under which

the Commission can revoke or suspend a firm's registration with the Commission or membership in an exchange or securities association or bar or suspend an individual with association with a member. n68 For example, if the Commission has permanently barred an individual from association with a broker or dealer, the statutory disqualification provisions, which prevent the individual from being associated with a member of an exchange or securities association, are superfluous. However, if an individual is barred with the right to reapply in a number of years, the statutory disqualification scheme ensures that when the individual seeks to become associated with a member of an SRO the SRO will have to notify the Commission if it intends to allow the association. n69 In addition, there are numerous regulatory actions, in addition to SEC orders, which create a statutory disqualification. For example, any type of felony conviction would form the basis for a statutory disqualification, which places the burden on the individual to demonstrate suitability for association with a member of an SRO. n70

A self-regulatory organization may deny membership to, or condition the membership of, a broker or dealer who:

- (1) does not meet financial responsibility or operational capability standards;
- (2) does not meet training, experience, or competence standards prescribed by the rules of the self-regulatory organization; or
- (3) has engaged and is reasonably likely to again engage in acts or practices inconsistent with just and equitable principles of trade. n71

A self-regulatory organization may, in accordance with the procedures established by its rules, examine and verify the qualifications of;

- (1) both an applicant to become a member and the natural persons associated with such applicant, n72 and
- (2) an applicant to become a person associated with a member. n73

A person may be barred from becoming a member or associated with a member on ground (2) or (3) above. n74

An SRO may bar a person from becoming associated with a member if the person does not agree to:

- (1) supply such information concerning his relationship and dealings with the member as may be specified in the rules of the SRO or
- (2) permit examination of his books and records to verify the accuracy of information supplied by that person. n75

A national securities exchange may limit the number of:

- (1) members and
- (2) members and designated representatives of members permitted to effect transactions on the exchange floor;

but it may not decrease either number below that in effect on May 1, 1975 or the date of registration of the exchange under the Act, whichever is later. n76

The Commission may increase (but not decrease), or remove any limitation on, the number of:

(1) members of an exchange, or

(2) members and designated representatives permitted to effect transactions on the exchange floor. n77

Finally, a registered securities association may deny membership to a registered broker or dealer on the ground that it is not engaged in a type of business in which the rules of the association require members to be engaged. n78 However, membership may not be denied by reason of either the amount of such type of business done, or other types of business in which the registered broker or dealer is engaged. n79

[b] Non-Member Access

Although the Exchange Act provides that certain categories of individuals are not eligible for membership to a national securities exchange, n80 it nevertheless permits an exchange to establish its own rules governing admission to membership. Accordingly, prior to the 1975 Amendments, some exchanges denied membership to persons or companies who were otherwise statutorily eligible to be a member of an exchange and who, in fact, might be members of other exchanges. n81 A broker wishing to execute a transaction through the facilities of an exchange of which he was not a member was obligated, therefore, to utilize the services of a member, for which a discounted commission was charged, n82 to gain access to the exchange trading facilities.

In early 1968, the Commission initiated a lengthy analysis of the effect of increased institutional participation in the securities markets. n83 This analysis ultimately led to the Commission's issuance in 1972 of a "white paper" n84 advocating the formation of a "central market system" n85 which would establish, among other things, "terms and conditions upon which any qualified broker-dealer can attain access to all exchanges." n86 A subsequent Congressional report also issued in 1972 took this concept one step further by concluding:

One must start with the assumption that all broker-dealers unless for some reason disqualified by lack of experience or inadequate financial resources should have equal access to a central market system.
n87

As a result of Congressional support for the view that exchanges are public institutions and, therefore, should be accessible by all qualified broker-dealers, n88 the Commission requested each national securities exchange to adopt by July 31, 1972, the substance of a proposed rule regarding utilization of exchange memberships. n89 By August, 1972, it became apparent that the exchanges would not comply voluntarily with the Commission's request. Consequently, the Commission proposed Rule 19b-2, n90 which was adopted in January, 1973 n91 and rescinded three years later in January, 1976. n92

To increase access to exchange trading facilities, Rule 19b-2:

(1) eliminated the practice of some exchanges of restricting membership to firms whose primary business was that of a broker or dealer, and

(2) prevented institutions and others from joining exchanges for the sole purpose of trading for their own accounts. n93

Thus, Rule 19b-2 removed the anticompetitive effect of certain exchange membership criteria that prevented some broker-dealers from becoming members if, for example, they were subsidiaries of financial institutions. The rule also assured that exchange members were principally engaged in a public securities business. n94

To minimize the potential adverse effect of Rule 19b-2, the Commission provided for a three year phase-in period for

exchange members not then conducting a predominantly public business.

In March, 1973, the Commission issued a second "white paper" n95 which re-emphasized, among other things, that the "central market system" had two essential elements:

- (1) the "elimination of artificial impediments, created by exchange rules or otherwise, to dealing in the best available market," and
- (2) the "establishment of terms and conditions upon which any qualified broker-dealer can attain access to all exchanges." n96

Asserting that a system "of negotiable access by all broker-dealers" is both "logical and efficient," n97 the Commission determined to proceed "with caution" to avoid an adverse effect upon the self-regulatory system. n98 Additionally, the Commission observed that the then imminent demise of fixed commission rates n99 might foster increased access to exchange trading facilities. n100 Nevertheless, the Commission called upon exchanges to modify their rules "to increase the maximum level up to which non-member access can be negotiated," n101 which may require "some sort of basic redefinition of the membership status of a recipient of such access." n102

The Commission's authority to promulgate a rule regulating exchange membership and the rulemaking procedures followed by the Commission in adopting Rule 19b-2 were criticized strongly by various facets of the securities industry. n103 Within a month after the adoption of Rule 19b-2, the PBW Stock Exchange petitioned the United States Court of Appeals for the Third Circuit for judicial review of the Commission's rulemaking action. n104

The court, after a lengthy analysis of the Exchange Act and Supreme Court precedents, concluded that the Commission's rulemaking action did not constitute an "order" within the parameters of the Exchange Act and, therefore, the court lacked jurisdiction to review Rule 19b-2. n105 The Supreme Court declined to issue a writ of certiorari.

During the three year phase-in period of Rule 19b-2, it became increasingly clear that Congress intended to address the issue of exchange membership. The subsequent enactment of the 1975 Amendments did so in three significant respects:

- (1) the concept of membership was clearly defined; n106
- (2) Section 6 was amended to provide, in substance, that any registered broker or dealer which satisfied exchange established standards of financial responsibility and competence should be granted membership; n107
- (3) the Commission was given express authority to amend any rule of a national securities exchange, including rules pertaining to membership. n108

Additionally, Section 31(b) of the 1975 Amendments authorized the Commission to conduct a special review of the rules of every national securities exchange and association to verify that such rules complied with the Exchange Act, as amended. Pursuant to this section, the Commission announced on March 2, 1976 the commencement of a general inquiry into exchange rules governing membership and association with members. n109 Thereafter, the Commission disapproved two proposed NYSE rules that would have (1) denied membership to any broker-dealer whose parent was not a United States person, unless the NYSE determined that broker-dealers domiciled in the U.S. could obtain reciprocal access to securities exchanges in the domicile of the applicant's parent, and (2) prohibited a member from being controlled by or being under common control with a commercial banking operation within the United States. n110 The Commission reasoned that the 1975 Amendments made exchange membership available to any registered broker or dealer irrespective of the nature, origin, or character of its "parent." n111

Given the pervasive sweep of the 1975 Amendments, the Commission rescinded Rule 19b-2 n112 and the securities exchanges, notably the NYSE, began to propose various plans to enhance nonmember access, including direct electronic access, n113 leasing of memberships, n114 and purchase of floor access privileges for short term periods. n115 Additionally, the implementation of an intermarket electronic trading system greatly expanded the accessibility of exchange markets to nonmembers. n116

In April 1998, in a proposed rule release that would overhaul the regulatory framework governing alternative trading systems, the SEC addressed the issue of institutional membership in national securities exchanges. Although recognizing the increasingly important role that institutions play in today's marketplace, the SEC concluded that non-broker-dealers should not be permitted to be exchange members. n117

[c] Off-Board Trading

Under Section 11 of the Exchange Act, as enacted originally, the Commission was authorized "to prevent such excessive trading on the exchange but off the floor by members as the Commission may deem detrimental to the maintenance of a fair and orderly market." n118 The Commission never exercised that authority.

Each national securities exchange, however, adopted rules that prohibited exchange members from effecting securities transactions otherwise than through such exchange (off-board trading rules). n119 Off-board trading rules required exchange members to route trades in listed securities through the exchange, thereby assuring the exchange of its transaction fee, as well as restricting the ability of third-market makers to compete for agency orders handled by exchange members. n120

From 1961 through 1975, off-board trading rules underwent extensive scrutiny by both Congress and the Commission. n121 The 1975 Amendments addressed specifically these rules by directing the Commission "to review any and all rules of national securities exchanges which limit or condition the ability of members to effect transactions in securities otherwise than on such exchanges." n122 Moreover, the Commission was further directed, within 90 days of the enactment of this legislation, to report to Congress "the results of its review, including the effects on competition of such rules," and to commence a proceeding pursuant to Section 19(c) to "amend any such rule imposing a burden on competition which does not appear to the Commission to be necessary or appropriate in furtherance of" the purpose of the Exchange Act. n123

Following the solicitation of comments on the off-board trading rules, n124 the Commission reported to Congress that "off-board trading rules of exchanges impose burdens on competition, and the Commission is not prepared to conclude that these burdens are necessary or appropriate in furtherance of the purposes of the [Exchange] Act." n125

Accordingly, the Commission commenced a proceeding to determine the extent of such burdens, whether there are countervailing considerations justifying the retention, and, if not, whether modifications are appropriate. Simultaneously, the Commission released three alternative proposed rules which, in effect, would permit off-board trading under certain circumstances. n126

Following extensive public hearings, n127 the Commission adopted Rule 19c-1 which required amendments to exchange off-board trading rules as of January 2, 1977, to eliminate prohibitions that prevented exchange members from effecting OTC agency transactions in listed securities with third market makers and non-member block positioners. n128 The Commission determined simultaneously that other exchange rules which also affected off-board trading had anticompetitive effects, but declined to mandate modifications of those rules pending further study n129 and receipt of comments from the recently established National Market Advisory Board ("Board"). n130

In May 1977, the Board submitted its final conclusions regarding off-board trading rules to the Commission. n131 In summary, the Board determined that "the purposes of the Exchange Act do not justify exchanges promoting such

restrictions generally and indefinitely." n132 To minimize the potential adverse effect of immediate rescission, the Board recommended that "an effective composite quotation system should be in place prior to removal." n133 Moreover, the Board urged the Commission to make "appropriate changes to Commission rules (and permit comparable rescissions of exchange rules) so that those who make markets in listed securities on exchange floors and those who do so off such floors may be subject to 'equal regulation' as defined in the Exchange Act." n134 Thereafter, the Commission proposed Rule 19c-1 to expand the scope of off-board trading and also proposed Rule 19c-2 to permit an exchange member to effect an "in-house" agency cross as both principal and agent. n135

Following extensive public hearings, n136 the Commission amended Rule 19c-1 to permit OTC agency transactions in listed securities and securities admitted to unlisted trading privileges between two broker-dealers. n137 Trades which a broker-dealer acted as agent on both sides of the trade, i.e., "in-house" agency crosses, were still prohibited. n138

Consideration of Rule 19c-2 was deferred pending further study and analysis. n139

On April 26, 1979, the Commission once again initiated proceedings to consider rulemaking to amend the exchanges' off-board trading rules. n140 The Commission simultaneously proposed for comment Rule 19c-3, which would rescind off-board trading rules with respect to OTC transactions in any exchange traded security which became listed on an exchange after April 26, 1979, or which was traded on an exchange as of April 26, 1979, but which ceased to be exchange traded for any period of time thereafter. n141 According to the Commission, proposed Rule 19c-3 would increase competition between the OTC and exchange markets for a narrow class of securities, which would provide incentives for markets to compete aggressively in the types and costs of services offered to brokers and investors. n142

After considering the various arguments raised by the commentators, n143 on June 11, 1980, the Commission adopted Rule 19c-3, and withdrew from consideration Rule 19c-2. n144 The Commission later released a report on the first year of operation of Rule 19c-3. n145 The report contained an overview of trading in Rule 19c-3 securities, including a discussion of trends in the number of such securities, volume of trading, market maker participation, continuous market making and characteristics of order flow. The report also contained an assessment of the effect of Rule 19c-3 on market quality and execution quality as well as an evaluation of the NASD surveillance of Rule 19c-3 trading. The report concluded that too few transactions had been effected pursuant to Rule 19c-3 to support any conclusions concerning the rule's effect on the securities market. The report stated that the perceived experimental nature of Rule 19c-3 trading had deterred broker-dealers from making the financial commitments necessary to trade extensively in 19c-3 securities. More time would be needed, the report concluded, before the Commission could make a valid assessment of Rule 19c-3.

To improve the trading of 19c-3 securities, the Commission then took several steps. Recognizing that effective competition for order flow would be impaired without an efficient linkage between exchange and off-board trading markets, the Commission on April 21, 1981, ordered an automated interface between the Computer Assisted Execution System ("CAES") operated by the NASD and the Intermarket Trading System ("ITS") operated by seven national securities exchanges. n146 This interface became operational on May 17, 1982.

In addressing NYSE Rule 390, the NYSE's off-board trading rule which prohibited NYSE members from effecting certain transactions off an exchange in NYSE-listed stocks, n147 the Market 2000 Report concluded that the practical effect of the rule, together with Rule 19c-3, is to prevent exchange member firms from directly internalizing order flow during exchange hours in stocks listed before April 26, 1979 and encourage such members to effect transactions overseas in these stocks after the close of the exchange (after-hours trading). The Market 2000 Report concluded further that it cannot identify a continuing justification for maintaining off-board trading rules as applied to after-hours trading. They force NYSE member firms desiring to act as principal to trade with U.S. customers overseas, losing the protection offered by the Commission's oversight of the markets. Moreover, the anti-competitive effect of the after-hours restriction within the United States is absolute. NYSE member firms simply have no choice: they must trade overseas or be forced to use the NYSE's crossing sessions, which are limited in time and scope. As a result, NYSE members send orders after hours via fax or telephone to their overseas trading desks. The Division recommends that the NYSE submit

a proposed rule change to lift the off-board trading restrictions as they apply to after-hours trading. If the NYSE were to develop a viable after-hours trading session that operated after the NYSE crossing sessions, the Division would be willing to reconsider whether off-board trading restrictions could apply during the session's operation.

With respect to off-board trading rules during regular trading hours, the report reached a different conclusion:

The actual effect on NYSE members of off-board trading restrictions during regular trading hours is somewhat less constraining than it appears. Numerous regional specialists have become affiliated with large NYSE member firms, which generally route small order flow to their regional affiliates. In practice, these alternatives allow a NYSE member firm to, in effect, execute its order flow as principal without running afoul of off-board trading restrictions. Furthermore, the anti-competitive effect of Rule 390 has been somewhat reduced to the extent that NYSE members can act as agents and route orders to third market makers for executions. n148

The report concluded that:

Although the circumstances just described do not remove the anti-competitive nature of off-board trading restrictions, in the Division's view, they reduce the urgency with which off-board trading restrictions have to be addressed. n149

As a result of SEC pressure to completely eliminate off-board trading restrictions, the exchanges rescinded the rules imposing these restrictions, beginning with the NYSE's Rule 390 on May 5, 2000. n150 On June 1, 2000, all remaining off-board trading restrictions were rescinded. n151

[d] Commission Rates

One of the principal amendments to the Exchange Act effectuated by the 1975 Amendments concerned schedules and fixed rates of commissions, allowances, discounts, and other fees of national securities exchanges. n152 Section 6(e)(1), as amended in 1975, prohibits a national securities exchange from unilaterally imposing schedules or fixed rates of commissions, allowances, discounts, or other fees to be charged by the exchange's members. n153

The Commission, however, may permit a national securities exchange to impose schedules or fixed rates in accordance with specified procedures. For schedules or fixed charges on transactions made after November 1, 1976, the Commission must find that such schedules or fees:

- (1) are reasonable in relation to the costs of providing the service (and publish the standards employed in determining reasonableness); and
- (2) further the purposes of the Exchange Act without imposing any unnecessary or inappropriate burden on competition.

In making the second finding the Commission must weigh the adverse competitive effects of the schedule or fixed rates against the competitive effects of alternative actions the Commission could take under the Exchange Act. n154

Commission proceedings concerning proposed schedules or fixed charges must follow the general procedures for proposed rule changes by self-regulatory organizations, n155 as modified by the special provisions for proceedings concerning schedules or rates contained in Section 6(e)(3). The latter affords interested persons an opportunity for oral presentation of data, views, arguments and, with respect to proposed schedules or rates for transactions after November 1, 1976, rebuttal submissions and cross-examination. n156

Section 6(e)(2) empowers the Commission to abrogate any exchange rule imposing a schedule or fixed rate if the Commission determines that the schedule or fixed rate is no longer reasonable, in the public interest, or necessary to accomplish the purposes of the Exchange Act.

To assure that the Commission has flexible authority to deal effectively with any "untoward consequences of a fully competitive rate environment," the 1975 Amendments granted the SEC certain powers, in addition to broad general powers related to the protection of investors and the maintenance of fair and orderly markets: n157

(1) to require any nonmember broker or dealer regularly effecting transactions on an exchange to comply with "such rules of such exchange as the Commission may specify," n158 and

(2) to take all appropriate action to deal with any serious disruption in the market operations for listed securities caused by trading in the third market after the advent of fully competitive rates. n159

With the elimination of fixed commission rates, Congress adopted Section 28(e) which protects fiduciaries under state and federal law, except state or federal legislation enacted to the contrary after June 4, 1975, from being charged with a breach of duty solely because the fiduciary failed to obtain the least expensive commission for an account as to which he or she exercises investment discretion. Section 28(e) permits a fiduciary to pay an exchange member, a broker, or a dealer an amount of commission greater than that charged by others (i.e., "soft dollars") if the fiduciary determines in good faith that the amount of the commission paid is reasonable. The fiduciary's decision as to reasonableness may take into consideration the value of the brokerage and research services provided by the member, broker, or dealer with respect to a specific transaction or with respect to all of the fiduciary's accounts. n160

"Payment for order flow" generally refers to the payment of cash by dealers and specialists to brokers to induce them to send aggregated small orders to purchase or sell securities to the dealers for execution. n161 This practice has generated much controversy. On the one hand, it is argued that it causes the broker to violate its fiduciary duty to the individual customer and, by influencing the broker's order-routing decision, diminishes the likelihood that best execution will be obtained for that order. Conversely, order handling practices derive from business relationships between firms, and the connection between order flow practices and overall business interests is not always direct. n162 The Commission has taken the position that customers need more information to monitor execution quality more closely where payment or inducements are provided and thus adopted Rule 11Ac1-3 in 1994 to increase disclosure of payment for order flow. n163

[3] SRO Enforcement

[a] Statutory Framework and SRO Programs

Every SRO must comply with the provisions of the Exchange Act and the rules thereunder, and the rules of the self-regulatory organization itself. In addition, in the absence of reasonable justification or excuse, n164 an SRO must enforce compliance with such provisions by its members and by persons associated with its members. n165 The Commission, by rule, may relieve a self-regulatory organization of any responsibility to enforce compliance with any provision of the Exchange Act or the rules thereunder by any member or person associated with a member. n166 The Commission adopted Rule 19g2-1 pursuant to its exemptive authority under Section 19(g)(2). n167 Under this rule, a national securities exchange or national securities association is not required to take certain actions n168 to enforce compliance by members and persons associated with members: n169

(1) with Sections 12 n170(other than Sections 12(j) (suspension or revocation of the registration of a security) and 12(k) (summary suspension of trading in a security)), 13, n17114 n172(other than Section 14(b) (solicitation by exchange members, brokers, or dealers)), 15(d), n173 and 16, n174 and the rules and regulations thereunder, except to the extent of any action normally taken with respect to any person

not an exchange member or person associated with an exchange member, n175

(2) regarding persons associated with a member, other than securities persons or persons who control a member, n176 and

(3) with respect to persons associated with a member, other than securities persons n177 whose functions are not solely clerical or ministerial, by (a) conducting examinations as to the qualifications of such persons, (b) requiring the filing of periodic reports by such persons, or (c) conducting regular inspections, including examinations of books and records, of such persons. n178

There are three categories of SRO surveillance and detection programs that enable SROs to uncover questionable activities and, when appropriate, to initiate remedial action.

Market Surveillance programs focus on trading activities and seek to detect suspect transactions. n179 Several SROs have developed computerized systems for identifying suspect trades, while others rely primarily on trained personnel to identify particular transactions for subsequent analysis. Once a trade is singled out for review, a detailed trading analysis is generally conducted. n180

Member firm compliance programs focus on the organization and operation of member firms. n181 In one program, potential salespeople are screened by one or more SROs to verify that there is no statutory bar to employment and to determine whether special supervision or other action is required. n182 In addition, complaints from customers are investigated to determine whether SRO or Exchange Act rules may have been violated. Proposed advertising also is reviewed to assure compliance with SRO rules prohibiting deceptive and questionable solicitations. Finally, member firm offices are inspected to ascertain, among other things, whether records have been properly maintained and to analyze selected customer accounts for potential improper practices. n183

Financial responsibility programs are designed to: require a broker-dealer to maintain sufficient liquid assets such that it could be liquidated in an orderly manner without the need for a formal proceeding; provide safeguards with respect to customer funds and securities held at registered broker-dealers; ensure accountability of those funds and securities; ensure that extensions of credit comply with applicable standards; and require the maintenance of accurate books and records. n184 An important financial responsibility requirement for broker-dealers is Rule 15c3-1 under the Exchange Act, the Net Capital Rule, which prescribes minimum liquidity standards for broker-dealers. n185 Another important financial responsibility requirement for broker-dealers is Rule 15c3-3 under the Exchange Act (the "Customer Protection Rule"), the purpose of which is to prevent a broker-dealer from using customer monies to finance its business. n186 A SRO is free to impose additional requirements in order to protect the interests of the customers of its members. n187

Not every SRO maintains each of these programs. To conserve resources and minimize expenses, the SROs frequently allocate responsibility for maintaining certain surveillance programs among themselves and this is one of the purposes for the creation of FINRA. n188 The Commission evaluates periodically the adequacy and effectiveness of SRO surveillance programs. n189

[b] Extension of Exchange Regulatory Control to Non-Members

Section 6(f) of the Exchange Act, as amended in 1975, authorizes the Commission to require persons who are not members or designated representatives of members to comply with the rules of an exchange:

(1) if they deal on the exchange without the services of another person as broker or, (2) if they are nonmember brokers or dealers and trade on the exchange on a regular basis. n190

The Commission may exercise its power to extend exchange regulatory control to non-members of the exchange, by rule or order, as the Commission deems necessary or appropriate in the public interest and for the protection of investors (a) to maintain fair and orderly markets or (b) to assure equal regulation. n191

[4] SRO Disciplinary Action

[a] Fair Disciplinary Procedures

For an exchange or securities association to be registered under the Exchange Act, the rules of the applicant must provide fair procedures for disciplining members and persons associated with members, denying membership, barring persons from becoming associated with members, and limiting or prohibiting access to services offered by the applicant or any member thereof. n192 These procedures must reflect fundamental standards of due process. n193 Section 6(d) describes the minimum due process that an exchange must follow in disciplinary and other proceedings. n194 Section 15A(h) establishes substantially the same due process standards for national securities associations.

Sections 6(d) and 15A(h) of the Exchange Act set forth identical procedures to be followed by an exchange or securities association in determining whether to:

- (1) discipline a member or person associated with a member; or
- (2) deny a person membership, bar a person from becoming associated with a member, or prohibit or limit a person with respect to access to services offered by the exchange or association or a member of an SRO.

In the case of disciplining a member, or person associated with a member, or denying membership, or prohibiting a person from becoming associated with a member, or limiting access to services, the person who is the subject of the proceeding must be given notice of the grounds for the proposed sanction or other action and an opportunity to be heard. A record of the proceedings must be kept. The imposition of a disciplinary sanction must be supported by a statement setting forth:

- (1) the act or practice engaged in or omitted,
- (2) the specific provision of the Act, the Commission rule, or SRO rule, that the person is deemed to have violated, and
- (3) the sanction imposed and the reason for imposing the sanction. n195

If the disciplinary sanction involves the denial of membership, association with an SRO member, or access to services offered by the exchange or its members, must be supported by a statement setting forth the specific grounds on which the denial or limitation is based. n196

Sections 6(d)(3) and 15A(h)(3) provide for summary proceedings on specific grounds. Such proceedings may be brought:

- (1) against members and persons associated with members who have been expelled or suspended by a SRO or who have been barred from being associated with a member of the organization, or
- (2) against members on the basis of financial or operating difficulty.

Proceedings also may be brought to limit or prohibit any person access to services of an SRO if either of the grounds

specified in (1) or (2) above is applicable to such person, or if not a member, the person does not meet the requirements for access and cannot be permitted access with safety to investors, creditors, members, or the SRO. Persons aggrieved by a summary action must be afforded a prompt hearing in accordance with Sections 6(d)(1) and (2) and 15A(h)(2) and (3), described above. The Commission may stay a summary action on its own motion or application by an aggrieved person if the Commission determines summarily, or, after notice and opportunity for hearing, that such stay is consistent with the public interest and the protection of investors. n197

[b] Review by the Commission

If an SRO imposes any final disciplinary sanction on any member thereof, participant therein, or any person associated with a member; denies an application for membership or participation; bars any person from becoming associated with a member; or prohibits or limits access to services offered by the SRO or a member thereof, then the SRO taking such action must give notice to:

(1) the regulatory agency for the SRO, and

(2) the appropriate regulatory agency, if different from that for the SRO, for the person against whom the action was taken. n198

The form and content of the notice of action by the SRO are governed by rule of the appropriate regulatory agency. n199

The action by an SRO of the type specified in Section 19(d)(1) is subject to review by the regulatory agency for the person against whom the action was taken on its own motion or upon application by any person aggrieved, filed within thirty days, or longer period if the agency so determines. An application for review does not stay the organization's action, but the regulatory agency may order a stay, either summarily or after notice and opportunity for hearing. Each regulatory agency is directed to establish an expedited procedure for consideration and determination of the question of a stay. n200

In a proceeding to review a final disciplinary action by an SRO against a member or a person associated with a member, the Commission must affirm or modify the sanction, or remand to the exchange for further proceeding, if it finds:

(1) the person engaged in the acts or omissions specified in the SRO's findings;

(2) the acts or omissions violated the Act, the rules or regulations thereunder, or the SRO's rules; and

(3) the provisions the person was found to violate are consistent with, and are applied in a manner consistent with, the Act. n201

The Commission must set aside the sanction and, if appropriate, remand for further proceedings if it does not make any of the foregoing findings. n202 If the sanction is found to impose an unnecessary or inappropriate burden on competition, or is excessive or oppressive, the Commission may cancel, reduce, or require the remission of the sanction. n203

In a proceeding to review an exclusionary action, n204 the Commission must dismiss the proceeding if it finds that the ground on which the action was based exists in fact, that the action is in accordance with the exchange's rules, and that the rules are and were applied in a manner consistent with the purposes of the Act. If the Commission does not make all the foregoing findings, or if it finds that the SRO's action imposes a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, it must set aside the action and require the SRO to take affirmative action on the request. n205

[c] Judicial Review**[i] Financial Industry Regulatory Authority (Formerly the National Association of Securities Dealers)**

Final Commission orders under Sections 19(e) and (f) are reviewable at the instance of the person aggrieved in the appropriate Court of Appeals by the filing of a written petition within sixty days after the entry of the order. n206

[5] Commission Oversight of SROs

As stated above, the Exchange Act delegates to the Commission the responsibility to ensure that SROs require their members to comply with the federal securities law and the rules of the SROs. n207 In the performance of its oversight responsibilities, the Commission is in continual contact with the SROs. In addition the Commission, on its own initiative, may obtain access to SRO records n208 and employees in order to verify that each SRO is fulfilling its statutory mandate. n209

[a] Inspection and Monitoring Programs

The Commission maintains various programs to inspect and monitor SROs. Each year, the Commission conducts routine inspections of programs administered by the SROs, including SRO market surveillance programs, clearing operations, and regulatory and arbitration programs. n210

In addition, the Commission requires SROs and their members to file an annual report and, sometimes, to report to the Commission on the effect of new Commission rules or unusual trading activity. n211

On the basis of this activity, the Commission may engage in rulemaking activity, request SROs to initiate new regulatory programs, n212 institute an administrative proceeding to sanction an SRO, n213 or seek legislative action from Congress.

[b] Allocation of SRO Responsibilities

Section 17(d) authorizes the Commission to allocate certain regulatory responsibilities among SROs "to foster cooperation and coordination among self-regulatory organizations or to remove impediments to and foster the development of a national market system." n214 In particular, the Commission has the authority:

1. to relieve an SRO of the responsibility to receive regulatory reports, to examine for compliance with the provision of its rules, and to carry out other regulatory functions with respect to any person who is a member of or participates in more than one SRO, n215 and
2. to allocate among SROs the authority to adopt rules on matters as to which they share authority. n216

In exercising this authority, the Commission is required to take into consideration the regulatory capabilities of the SROs, including "availability of staff, convenience of location, unnecessary regulatory duplication" and other relevant factors. n217

In 1976, the Commission adopted Rule 17d-2 which provides, in substance, that any two or more SROs may file a plan with the Commission for allocation of regulatory responsibilities. n218 Thereafter, the Commission will solicit public comment prior to ruling on the application. Through fiscal 1982, more than 25 plans were filed, many of which related to allocation of oversight responsibilities of member firms. n219

[c] SRO Governance

[i] Financial Industry Regulatory Authority

Effective July 30, 2007, the NASD and NYSE Regulation, Inc. ("NYSE Regulation"), a subsidiary of the New York Stock Exchange LLC ("NYSE"), merged to form a new SRO, the Financial Industry Regulatory Authority, Inc. ("FINRA"). As a result of the consolidation, FINRA became responsible for the supervision and regulation of broker-dealers that engage in securities transactions with the public. FINRA consists of both the former NASD and NYSE Regulation employees and conducts business from Washington, D.C. and New York, in addition to 15 district offices located in various states. The U.S. Securities and Exchange Commission ("SEC") is responsible for the supervision and oversight of FINRA.

A. History

Prior to the formation of FINRA, the regulation of securities firms was administered by the various SROs, including both NYSE Regulation and the NASD. The NYSE created NYSE Regulation to facilitate the oversight of the NYSE and its member firms. The creation of NYSE Regulation served as a means of protecting investors by ensuring compliance through the enforcement of NYSE rules and federal securities laws. NYSE Regulation was divided into four different divisions: Market Surveillance, Member Regulation, Enforcement, and Listed Company Compliance. Market Surveillance reviewed trading activities on the NYSE trading floor, including surveillance for abusive trading practices, while the Enforcement Division was responsible for the enforcement of NYSE rules and securities laws through the use of investigations and disciplinary actions against securities firms.

In 1939, the NASD was created as result of the 1938 Maloney Amendments to the Exchange Act, which allowed for the self-regulation of the over-the-counter markets. The NASD was formerly the largest private securities regulator responsible for overseeing approximately 5100 securities firms, 116,000 branch offices and 650,000 registered securities representatives. In connection with its regulatory functions, the NASD's responsibilities included registering entities and individuals who intended to effect securities transactions with the public, providing for the examination of securities firms, and enforcing both NASD rules and federal securities laws. In addition, the NASD provided investors with an alternative dispute resolution forum in which to resolve securities related controversies and claims.

In November 2006, the NASD and NYSE Group, Inc. announced that the two entities had signed a letter of intent to merge the regulatory arms of the NASD and NYSE Regulation into a single SRO. The consolidation was intended to facilitate the regulation of the financial services industry and to increase consistency in connection with the administration and oversight of securities laws and rules, by providing for the establishment of a single set of rules and subjecting members firms to regulatory examinations by one examining authority. In addition, as approximately 200 of the NASD's 5100 members were also NYSE members, the consolidation was aimed at reducing regulatory costs by millions of dollars per year.

In seeking SEC approval of the merger, the NASD specifically stated that its objectives were to establish a new organization to be

the single SRO for all securities firms doing business with the public in the U.S.; build and sustain the confidence critical to the operation of vibrant capital markets; increase efficient, effective and consistent regulation of securities firms; provide cost savings to securities firms of all sizes; and strengthen investor protection and market integrity.

The plans for consolidation received praise from the SEC. In response to the announcement of the merger, the Chairman of the SEC, Christopher Cox, stated that the merger was "a significant step forward for America's investors and for our nation's capital markets. Protecting investors from fraud in today's complex, integrated markets requires that regulators look across markets to prevent wrongdoers from exploiting the seams in regulatory jurisdiction. Eliminating overlapping regulation, establishing a uniform set of rules, and placing oversight responsibility in a single organization

will therefore enhance investor protection while increasing competitiveness in our markets."

In connection with the merger, the NASD filed with the SEC a proposed rule change to amend its By-laws. The amendments to the NASD By-laws were aimed predominantly at implementing changes with respect to governing the new SRO. On July 26, 2007, the SEC granted approval of the amendments to the NASD By-laws. Although the merger became effective on July 30, 2007, FINRA is undergoing a three year transitional period during which the Chief Compliance Officers of the former NASD and NYSE Regulation will serve as governors of the new SRO, and dual member firms of the former NASD and NYSE Regulation must continue to comply with NASD and NYSE Regulation rules until FINRA establishes a consolidated rulebook.

B. FINRA's Mission

FINRA's objective is to protect investors and to maintain market integrity through "effective and efficient regulation and complementary compliance and technology-based services." In connection with its regulatory function, FINRA is responsible for monitoring and administering the regulatory oversight of all securities firms that transact business with the public. Included among its responsibilities, FINRA oversees the licensing of broker-dealers and representatives, provides professional training, and administers arbitration and mediation functions for the securities industry. In addition, FINRA is responsible for administering member firm examinations, advertising review, enforcement, and market surveillance, which addresses abuses within the securities industry, such as illegal trading. Furthermore, FINRA regulates, via contract, The NASDAQ Stock Market, Inc., the American Stock Exchange LLC, and the International Securities Exchange, LLC, in addition to industry utilities (i.e, Trade Reporting Facilities and over-the-counter operations).

In connection with FINRA's mission to protect investors, FINRA places a strong emphasis on investor education. To achieve this goal, FINRA provides investors with internet, media and public forums to educate investors and enhance investor understanding of the markets and investing.

C. Consolidated Rulebook

Immediately prior to the merger of the NASD and NYSE regulation, each regulatory entity had its own rulebook by which its members firms had to comply. As a result of the consolidation between the NASD and NYSE Regulation, the rulebooks of each respective entity will be combined into one consolidated rulebook. Although the merger between the NASD and NYSE Regulation became effective in July 2007, the harmonization of each former SRO's rules into a single rulebook is still pending, as a result of the significant number of rules that require reconciliation. Until a new rulebook is created, the NASD and NYSE Regulation rulebooks will be preserved, and NASD and NYSE member firms must continue to comply with each entities' respective rulebook. During this "transitional period," FINRA will continue to harmonize duplicative rules, so as to create a more efficient and effective rulebook to aid in the regulation of securities firms.

On March 12, 2008, FINRA issued an Information Notice (the "FINRA Information Notice"), discussing the methods to be used by FINRA in connection with the development of a consolidated FINRA rulebook. Pursuant to the FINRA Information Notice, FINRA has established a four-pronged approach to aid in the development of a consolidated FINRA rulebook. The approach is as follows:

1. FINRA will use "analytical touchstones" to review NASD rules and NYSE rules for obsolescence, or that may otherwise be duplicative in nature. All obsolete and duplicative NASD rules and NYSE rules will be omitted from the consolidated FINRA rulebook.
2. FINRA will identify differences in the NASD rules and the NYSE rules relating to member conduct, member application and registration, and financial and operation requirements and will determine how

the NASD rules and NYSE rules will influence the consolidated FINRA rules.

3. FINRA will explore possible approaches, including "principle-based and tiered" approaches, to apply in connection with the consolidated FINRA rules governing member conduct, member application and registration, and financial and operation requirements. 4. FINRA will review NASD rules and NYSE rules that may not be conducive to the analytical approaches, as discussed above, and that may be incorporated into the consolidated FINRA rulebook without undergoing substantive alterations.

All consolidated FINRA rules are subject to the approval of the SEC. In order to obtain the necessary SEC approval, FINRA intends on making several rule filings with the SEC. Upon receiving SEC approval and upon the effective date of the consolidated FINRA rule, FINRA members must comply with the consolidated FINRA rule. In addition, upon SEC approval, the NASD rule and NYSE rule will be eliminated and subsequently replaced with the consolidated FINRA rule.

[iii] National Association of Securities Dealers (Now FINRA)

As historic background relating to the NASD-side of FINRA, in 1994, the SEC initiated an investigation into the trading practices of the Nasdaq market and the operation of the NASD as a self-regulatory organization. The investigation culminated in a wide-ranging settlement in 1996. n220 As part of its investigation, the SEC determined that the NASD did not comply with certain of its rules or satisfy its obligations under the Exchange Act to enforce its rules and the federal securities laws. The NASD was censured and agreed to spend \$100 million over five years to improve its market surveillance capabilities and to increase staffing for examinations, surveillance, enforcement and internal audit. n221 The NASD also agreed to implement the following:

- To provide for at least 50 percent public and non-industry membership on the NASD, Nasdaq Stock Market and NASD Regulation boards and on several influential committees; n222
- To ensure that its subsidiary, NASD Regulation, has primary responsibility for the regulation, surveillance, examination and disciplining of member firms and registered persons;
- To mandate that professional hearing officers who are trained attorneys preside over disciplinary hearings;
- To ensure that the regulatory staff of the NASD be independent and autonomous with sole discretion as to investigations, membership approval, rule proposals and other policy matters and generally insulated from the commercial interests of the Nasdaq market;
- To promulgate and apply consistently uniform standards for regulatory and other access issues and to institute safeguards to insure fair and evenhanded access to NASD services and facilities;
- To ensure a substantial, independent internal audit staff;
- To design and implement an audit trail to document the life cycle of orders; n223
- To improve substantially the surveillance and examination of order handling;
- To improve substantially the reliability of trade reporting;
- To upgrade substantially the NASD's capability to enforce the Quote Rule; n224

- To propose a rule expressly making unlawful coordination among market makers of quotes, trades and trade reports;
- To enhance market maker competitiveness by eliminating anticompetitive or unlawfully enforced pricing conventions, coordination of quotes, trades and trade reports and concerted discrimination and refusals to deal by market makers;
- To redefine or repeal the excess spread rule; and
- To retain an independent consultant to monitor and report on the implementation of the above actions. n225

Concurrently with the SEC investigation, the NASD chartered a committee to respond to criticism that it was not meeting its regulatory obligations relating to supervising the OTC market. The committee examined four main issues during its review. These included basic NASD structure, the effectiveness of Nasdaq policies and processes, the fairness of NASD governing entities and the fairness and effectiveness of NASD disciplinary procedures.

In 1995, the committee released a report summarizing its findings, known as the "Rudman Report." n226 The Rudman Report concluded that, overall, the NASD had discharged its self-regulatory functions professionally and reasonably.

However, the Rudman Report recognized several areas that required improvements in response to rapid changes and growth in the Nasdaq market.

The most fundamental change recommended by the Rudman Report was the proposal that the NASD create two new, independent entities, the Nasdaq Stock Market, Inc. and NASD Regulation, Inc. The Nasdaq Stock Market would be responsible for the operation and oversight of Nasdaq. NASD Regulation would be responsible for the regulation of NASD members and associated persons. The NASD would remain the parent organization of these two new entities and would maintain ultimate policy making and oversight authority. n227

The Rudman Report also called for: increased public representation on the boards of the NASD and its subsidiaries; increased diversity in the types and sizes of member firm representation on District Committees; procedural improvements and increased funding for disciplinary proceedings; and the establishment of an Office of Internal Review. n228

As part of its settlement with the NASD, the SEC recognized the NASD' to implement the changes recommended by the Rudman Report. The NASD has complied with virtually all of these undertakings.

[iii] New York Stock Exchange

Before the creation of FINRA and prior to the end of 2003, the corporate governance structure of the NYSE permitted the exchange's Chief Executive Officer to exercise a great deal of control and autonomy. n229 Specifically, the exchange had a large Board of Directors consisting of 24 outside directors and as many as three members of management. n230 Of the 24 outside directors, 12 were to represent the securities industry and 12 the public. n231 In February 2003, the NYSE appointed a special committee to review its corporate governance practices. n232 The committee was formed as a reaction to the furor over perceived deficiencies in corporate governance practices at listed companies that culminated in the passage of the Sarbanes-Oxley Act in 2002. The formation of the committee was designed to address, among other things, the incongruity of the exchange's demanding corporate governance practices of listed issuers that were stricter than those of the exchange itself. The major event prompting a change in the NYSE's governance practices, however, was the disclosure in late 2003 of a \$139.5 million retirement-pay package to the exchange's Chief Executive Officer. n233 After disclosure of the proposed pay package, the SEC specifically

questioned the wisdom of the fact that the exchange's Chief Executive Officer's compensation was established by persons regulated by the exchange, and the exchange's corporate governance practices in general. n234

The NYSE quickly proposed a series of dramatic changes to its constitution to address governance issues raised by the compensation controversy, and the changes were approved by the SEC on December 17, 2003. n235 One major change related to the size and composition of the Board of Directors. As amended, the constitution provides that the Board of Directors will be comprised of six to twelve outside directors, plus the Chairman of the Board and, if the Chief Executive Officer is not also the Chairman, the Chief Executive Officer. n236 All directors, other than the Chief Executive Officer, must be independent. n237 The amended provisions of the NYSE constitution approved in 2003 included some basic independence standards, n238 and a more detailed independence policy, designed to establish standards similar to those applicable to NYSE-listed issuers, was approved in 2005. n239 The revised policy requires the Board of Directors to make a determination that each director, other than the CEO, does not have any material relationship with the NYSE. n240 The policy also lists certain relationships between directors or their family members and the exchange that would be deemed to impair independence. n241

The NYSE's amended constitution calls for a Board of Executives responsible for advising the CEO in connection with the managing the exchange. The Board of Executives is to consist of the Chairman of the Board, the CEO if different from the Chairman, and at least 20 but no more than 25 other members. n242 The Board of Executives must include: at least six individuals who are the principal executive officer of a broker-dealer with direct contact with customers; at least two representatives of NYSE specialist firms; at least two floor representatives who are not specialists; at least two lessors of seats on the exchange who are not affiliated with a broker-dealer; at least four persons who are the principal executive officer of an institutional investor, one of whom is a fiduciary for a public pension fund; and at least four individuals who are the principal executive officer of a listed company. n243

The amendment to the NYSE's constitution that reduces the size of the Board of Directors could create concerns regarding compliance with the "fair representation requirement" of Section 6(b)(3) of the Exchange Act. Section 6(b)(3) requires that the rules of any registered exchange provide for fair representation of its members in the selection of its directors and administration of its affairs, and that issuers and investors be represented by at least one director each. n244 To address this concern, the exchange included a provision in the constitution that the members of the Board of Executives representing the securities industry recommend candidates for election to the board comprising at least 20 percent of the directors to be elected, but in any event no fewer than two directors. n245 The constitution provides that the industry members must propose directors who, in their opinion, "are committed to serving the interests of the public and strengthening the [NYSE] as a public market, and will allow the [NYSE] to meet the fair representation requirements" of Section 6(b)(3). n246 Similar requirements apply to the committee responsible for nominating candidates for director, and to the members themselves in electing directors. n247

Under the NYSE constitution, as amended, at least forty members can propose a candidate for an elected position, and at least 100 members can propose an entire ticket. n248 In either case the proposed candidates will appear on the ballot if the Board of Directors determines they are eligible for election. n249

The amendments to the NYSE's constitution approved in December 2003 also mandated the formation of committees with specified responsibilities. n250 Most significantly, the constitution provides for the creation of Nominating and Governance, Human Resources and Compensation, Audit and Regulatory Oversight & Regulatory Budget Committees consisting exclusively of directors other than the CEO. n251 The constitution further provides for a Regulation, Enforcement and Listing Standards ("RELS") Committee that includes members of the Board of Directors and of the Board of Executives, including at least one member representing the securities industry. n252 This committee reports to the Regulatory Oversight & Regulatory Budget Committee, and a majority of the members of the committee voting on a particular matter must be members of the Board of Directors. n253 Other committees may have members of the Board of Directors and Board of Executives, but report to the board and must have at least one independent director as a member. n254

In addition to the above changes, the amendments to the constitution approved in December 2003: provide for the creation of special committees, advisory committees and other bodies; define the officers of the exchange and the responsibilities of its Chairman, who may or may not be the same person as the CEO; allow delegation of functions by the Board of Directors, within prescribed limits; and allow the Board of Directors, in limited circumstances, to amend the constitution without member approval. n255

Among other changes, the 2005 supplemental governance amendments prohibit the exchange's CEO from participating in reviews by the Board of Directors of decisions by staff, officers or committees of the exchange; requiring reviews of disciplinary decisions or participating in Board reviews of disciplinary decisions. n256 Under the constitution as amended in 2005 members of the Board of Executives are prohibited from serving on the NYSE's Hearing Board. n257

In light of the fact that all members of the RELS Committee were to be members of the Board of Directors or Board of Executives, and the annual election of directors and annual appointment of members of the Board of Executives, a concern arose that significant turnover on the RELS Committee could impair its effectiveness. n258 Continuity of RELS Committee members is desirable in light of the committee's function of hearing appeals. n259 Accordingly, in 2004 the NYSE constitution was amended to allow prior members of the RELS Committee or its predecessor, the Committee for Review, to serve on the RELS Committee. A majority of the members of the Committee voting on a matter, however, must be members of the Board of Directors. n260

In December 2005, the NYSE members voted to approve an historic merger with Archipelago Holdings, Inc., the operator of the Archipelago Exchange. n261 The NYSE-Archipelago merger resulted in a major restructuring of the NYSE, including its regulatory division. After the merger, NYSE Group, Inc. ("NYSE Group"), a public company, wholly owned New York Stock Exchange, LLC, which was the entity registered as a national securities exchange. n262 New York Stock Exchange, LLC was the sole equity member of NYSE Regulation, Inc. ("NYSE Regulation"), a not-for-profit corporation performing the functions then performed by the NYSE's regulatory division. n263 The consolidation with the NASD has now superseded this structure.

[d] Commission Enforcement Powers

The Commission exercises its enforcement powers over the securities markets both directly, by disciplining participants in the securities markets who violate the relevant provisions of the Exchange Act or Commission rules, and indirectly, through oversight of SROs, which are charged with enforcing both the above provisions and their own rules governing trading.

[i] Direct Regulation

The Commission may, by order, suspend for a period not exceeding twelve months or expel any member of an SRO or participant therein, if the member or participant is subject to a Commission order pursuant to Section 15(b)(4). n264 The Commission may suspend or bar any person from becoming associated with a member of a SRO, if the person is subject to a Commission order pursuant to Section 15(b)(6). n265 If the Commission finds on the record, after notice and opportunity for hearing, that a member, participant, or person associated with a member has willfully violated, or has effected any transaction for any other person that the member, participant, or person associated with a member had reason to believe was violating, with respect to such transaction, any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Exchange Act, or the rules or regulations under any of such statutes, then the Commission has the power to suspend or expel a member or participant in an SRO and to suspend or bar any person from being associated with a member of such SRO. n266

[ii] Oversight Powers

The oversight powers of the Commission, and other "appropriate regulatory agencies" in the case of banks, have been increased significantly by various legislative initiatives, including the 1975 Amendments. Under the 1975 Amendments, the Commission was given the authority to censure SROs, n267 or impose limits upon their activities, functions, and operations, if, after notice and opportunity for hearing, the agency finds, on the record, that the self-regulatory organization has:

- (1) violated or is unable to comply with any provisions of the Exchange Act, the rules or regulations thereunder, or its own rules, or
- (2) without reasonable justification or excuse n268 failed to enforce compliance with any such provision, by a member thereof or by a person associated with a member thereof. n269

Prior to the 1975 Amendments, Commission oversight of the activities of registered securities exchanges and associations was governed by Sections 15A and 19. n270 The 1975 Amendments consolidated all oversight provisions in Section 19, n271 and made those provisions applicable to all "self-regulatory organizations," n272 not just to registered securities associations. n273 The provisions of the Exchange Act governing Commission oversight of SROs are:

- (1) Section 19(a)(1) concerning Commission action after an application for registration is filed with the SEC; n274
- (2) Section 19(a)(3) concerning withdrawal from registration; n275
- (3) Section 19(b) concerning Commission review of proposed self-regulatory rules; n276
- (4) Section 19(c) concerning Commission-initiated changes in the rules of self-regulatory organizations; n277
- (5) Section 19(d) concerning Commission review of final disciplinary action by self-regulatory organizations; n278
- (6) Section 19(e) concerning the standard for review by the Commission of final disciplinary sanctions imposed by self-regulatory organizations; n279
- (7) Section 19(f) concerning the standard for review by the Commission of denial of membership or participation in a self-regulatory organization, barring association with a member thereof, or prohibiting or limiting access to services offered by such organization or any member thereof;
- (8) Section 19(g) concerning enforcement and compliance responsibilities of self-regulatory organizations; n280 and
- (9) Section 19(h) concerning the Commission's power to sanction a self-regulatory organization. n281

The grounds for the sanctions of removal from office or censure of any director or officer of a self-regulatory organization include willful violations of the Exchange Act, the rules and regulations thereunder, or the rules of the self-regulatory organization, willful abuse of authority, and failure to enforce compliance, without reasonable justification or excuse, n282 with the provisions that the organization is required to enforce by any member or person associated with a member. n283

The Commission adopted Rule 19h-1 in 1977 n284 to prescribe the form and content of:

(1) notices by self-regulatory organizations of proposed admission to, or continuances in, membership, participation, or association with a member, of any person subject to a statutory disqualification, n285 and

(2) applications to the Commission for relief from a statutory disqualification. n286

Historically, the Commission has infrequently exercised its authority to discipline SRO's for failure to carry out their regulatory responsibilities. However, in the 1990s, the Commission instituted two major enforcement actions against SROs. The first was filed in 1996 against the NASD, and resulted from an SEC investigation into the conduct of Nasdaq market makers and Nasdaq's oversight thereof. Among the violations uncovered as a result of the investigation were: a "pricing convention" under which market makers in Nasdaq securities quoted stocks only in even-eighth prices; market makers' colluding with other market makers to display quotations at prices at which they did not intend to trade; and market makers' failing to honor their price quotations and consistently reporting their trades late to Nasdaq. n287 The SEC found that the NASD ignored substantial evidence of wrongdoing on the Nasdaq market and therefore failed to properly carry out its supervisory responsibilities. n288 On the same date as the enforcement action, the Commission issued a "Section 21(a)" report detailing the problems both with the Nasdaq market and with the NASD's supervision of the market. n289 The enforcement action took the form of a settled administrative proceeding against the NASD, in which the SEC did not impose any fine but required the NASD to comply with certain "actions" relating to its composition and surveillance and enforcement functions. n290

The Commission instituted an administrative proceeding against the NYSE in June 1999 based on alleged supervisory failures in connection with independent floor brokers' trading for their own accounts, or sharing in others' trading profits, which is considered the equivalent of trading for their own account. n291 The Commission found that the NYSE failed to diligently carry out its self-regulatory responsibilities in connection with the floor brokers' alleged violations. Specifically, the Commission found that the NYSE violated failed to properly investigate the receipt of performance-based compensation by independent floor brokers, a violation of Commission and NYSE rules. n292 In addition, the Commission found that the NYSE, without reasonable justification, suspended its surveillance of floor brokers for extended periods of time. n293 The Commission's enforcement action against the NYSE, like the NASD action, did not impose a fine, but required the NYSE to comply with various undertakings relating to its market surveillance and its education of members and their representatives. n294

In September 2003, in a settled proceeding, the SEC brought a disciplinary action against the Chicago Stock Exchange based on what the Commission found to be the exchange's failure to adequately enforce the Quote rule, prohibitions on trading ahead and the Limit Order Display rule. n295 Specifically, the Commission found, among other things, that the exchange's surveillance systems were inadequate, that it lacked adequate standards for its surveillance staff, that its disciplinary actions were untimely and inadequate and that it focused on individual violations rather than on patterns of violations. n296 The Commission found that the exchange therefore violated Section 19(g)(1) of the Exchange Act, and imposed a censure and cease-and-desist order against it. n297 The exchange also, as part of the settlement, agreed to actions designed to improve its regulatory processes. n298 Among these were the creation of a Regulatory Oversight Committee and the engagement of a consultant to analyze the efficacy of the exchange's surveillance and enforcement procedures and compliance with the recommendations of the consultant to the extent practicable. n299

The Commission's 1999 enforcement action against the NYSE was followed less than six years later with another action, this one involving specialists. In April 2005, the Commission instituted a settled administrative proceeding against the NYSE based on what was alleged to be a "widespread and pervasive" pattern of illegal proprietary trading by several specialist firms. n300 The Commission found that from 1999 through 2003, individuals associated with seven specialist firms engaged in two types of unlawful trading--"interpositioning" and "trading ahead." n301 Both practices are considered a major violation of specialists' duty to place the interests of the public above their own interests. n302 The Commission found that the NYSE failed to "properly detect, investigate and discipline" these

practices by its specialist firms, and that the NYSE therefore violated Section 19(g) of the Exchange Act. n303 Specifically, the Commission found that the NYSE established parameters in its automated surveillance system designed to detect trading ahead by specialists that were unreasonably broad, and also reviewed trading for unreasonably narrow periods. n304 Where alerts were generated, the Commission found, the NYSE's surveillance department, as a result of deficient referral procedures, referred only a small number of the alerts for further investigation. n305 The Commission further found that when the surveillance department made referrals, it was almost always with respect to violations of Rule 104.10, which could be resolved informally, rather than Rule 92, which required a refer for a formal enforcement action. n306

In the 2005 disciplinary action against the NYSE, the Commission found that the exchange's trading investigations department failed to fulfill its responsibilities by failing to: conduct thorough investigations of potential violations referred to it; attempt to determine whether trading ahead activity was intentional; or expand its reviews to cover time periods beyond those specified in the referral. n307 Finally, the Commission found that the disciplinary actions recommended by the trading investigations department were inappropriately lenient. n308

In determining the sanctions to impose against the NYSE, the Commission considered significant changes the NYSE had made to its corporate governance structure. n309 The Commission also considered the NYSE's voluntary undertaking to cooperate in several respects in connection related actions, undoubtedly in connection with SEC actions against the specialist firms and individuals. n310 The sanctions against the NYSE consisted of:

- a censure;
- a cease-and-desist order against future violations of Section 19(g);
- an undertaking to retain a third-party regulatory auditor to comprehensively audit the exchange's surveillance, examination, investigation and disciplinary functions relating to specialists;
- an action to improve the NYSE's regulation of floor members by increasing authority of various supervisory personnel to make enforcement referrals and mandatory training for staff involved in surveillance, examination, investigation and discipline of floor members;
- an undertaking to implement a pilot audio and video surveillance system to monitor activity at exchange trading posts;
- an undertaking to enhance its trading systems with a view to preventing specialists from trading ahead and interpositioning; and
- an undertaking to create a staff position with specific responsibilities relating to regulation of floor members. n311

On the same date that the NYSE resolved the charges relating to specialist practices, the Commission instituted administrative and cease-and-desist proceedings against twenty former specialists. n312 In these proceedings, the Commission alleged that these individuals, between 1999 and mid-2003, violated numerous provisions of the Exchange Act, Commission regulations and the NYSE rules by engaging in interpositioning and trading ahead. n313 The Commission had previously, in March and July 2004, instituted settled administrative proceedings against several specialist firms based on the activity of the individual specialists. n314

In May 2005, in a proceeding similar to that against the NYSE the previous month, the National Stock Exchange settled Commission charges by agreeing to a censure and cease-and-desist order. n315 The exchange's President and Chief Executive Officer was also named as a respondent in the proceedings. n316 The Commission found that, among other

violations, the National Stock Exchange failed to enforce its customer priority rule, which is designed to prevent trading ahead of customer orders. n317 The exchange's alleged failures to enforce the rule took the form of a failure to conduct surveillance, for a period of several years, for violations of the priority rule. n318 The Commission found that the exchange's failure to enforce its priority rule violated Section 19(g) of the Exchange Act. n319 In addition to a censure and cease-and-desist order, the exchange agreed to numerous actions designed to strengthen its enforcement of its rules, including the creation of a regulatory oversight committee, the appointment of a chief regulatory officer who reports to the exchange's board of directors and regulatory oversight committee, and the implementation of daily automated surveillance for violations of its priority rule. n320

The Commission is empowered by Section 21 to apply to a federal district court to enjoin violations of, or enforce compliance with, the Exchange Act, the rules and regulations thereunder, or the rules of a self-regulatory organization. It may also compel an SRO to enforce compliance with such provisions. n321 However, with respect to the rules of an SRO, the Commission cannot take action against any person pursuant to Section 21(e) unless it appears to the Commission that:

- (1) the self-regulatory organization is unable or unwilling to take appropriate action against such person, or
- (2) such action is otherwise necessary or appropriate in the public interest or for the protection of investors. n322

For Congress to monitor the Commission's exercise of its oversight responsibilities, the Commission must report annually to Congress on its work during the preceding year. n323

[6] Effect of Antitrust Laws

[a] On Securities Exchanges

An exchange, being a voluntary association, is privileged to establish its own requirements for membership, and to adopt rules governing the conduct of its members. In fact, it is required by Section 6 to do so. n324 The question arises whether the collective action of the members in adopting or implementing these rules is subject to the antitrust laws if it injures a nonmember.

The Exchange Act does not provide for antitrust immunity; however, securities exchanges do enjoy an implied and limited exemption from the antitrust laws. n325 The propriety of self-regulation by an exchange was not subject to an antitrust challenge until 1963. Then, in *Silver v. New York Stock Exchange* n326 the Supreme Court held that:

- (1) the Exchange Act was not a pervasive regulatory scheme that ousted the courts of antitrust jurisdiction;
- (2) self-regulatory exchange activities not subject to SEC review are subject to judicial review under the antitrust laws; n327 and
- (3) the appropriate antitrust test was a rule of reason approach that could immunize activities
 - (a) if the activities were essential to a policy of the Exchange Act, and
 - (b) only to the minimum extent necessary to make that policy work. n328

Since the founding of the New York Stock Exchange, one of its basic features was the minimum commission

provisions, that were established from time to time by the member firms. Serious questions were raised, especially at the insistence of the Attorney General, whether this provision of the Exchange charter was in violation of the antitrust laws.

An early challenge to the minimum commission provisions was *Kaplan v. Lehman Brothers*,ⁿ³²⁹ a class action suit brought on behalf of investors generally. The plaintiffs claimed that the minimum commission fee regulations of the New York Stock Exchange violated the Sherman Act since the regulations precluded competition among brokers and resulted in higher commission rates charged to investors. Referring to the Supreme Court's holding in *Silver*, the Court of Appeals held that the questioned regulations were immune from antitrust attack since Section 19(b)(9) of the Securities Exchange Act of 1934ⁿ³³⁰ authorized the Commission to alter rules regarding the fixing of reasonable commission rates. The Exchange commission rules, the Court of Appeals found, therefore served as a necessary part of the statutory legislation.

In *Gordon v. New York Stock Exchange, Inc.*, the Supreme Court was again presented with an antitrust challenge involving fixed commission rates.ⁿ³³¹ The Supreme Court held the challenged activity was necessary to make the regulatory scheme work and was, therefore, impliedly immune from the antitrust laws.ⁿ³³²

Following the Supreme Court's decision in *Silver*, the Commission in 1965 tendered to the Senate Committee on Banking and Currency its views on the application of the antitrust laws to the regulatory system embodied in the Exchange Act.ⁿ³³³ The Commission acknowledged that its lack of authority to review exchange rulemaking action was a significant factor in the Supreme Court's determination that exchange activities not subject to Commission review are subject to judicial review under the antitrust laws. The Commission contrasted its authority over exchange rule-making activities with its powers over the NASD. The Commission concluded that "a different case would arise concerning exemption" from the antitrust laws if the Exchange Act were to be amended or require exchanges to adhere to the same substantive rulemaking procedures as are applicable to registered securities associations. Noting that "marked differences between the provisions defining the Commission's powers with respect to exchanges and those applicable in respect to the NASD affect the Commission's authority to intervene in secondary securities markets, the Commission concluded that the *Silver* case "pointed out the need to assure, throughout said review, that what is done in the name of self-regulation is genuinely such and not inimical to other aspects of the public interest."ⁿ³³⁴

The Commission concluded that effective self-regulation "requires that the self-regulatory bodies take concerted action to enforce the standards of conduct which they establish. Such enforcement by concerted action involves conduct which, absent the statutory mandate of the Exchange Act, would frequently constitute a violation of the antitrust laws."ⁿ³³⁵

The Commission proceeded to identify areas of exchange operation which, in the Commission's view, raised problems under the antitrust laws. These activities included the rules which fixed minimum commission rates and provided lower commissions for transactions between members than are charged to nonmembers; restrictions on the ability of members to deal in listed securities off the floor of the exchange; and the application of Section 19(b) to exchange activities which operate as "an unreasonable and unjustified restraint upon interstate commerce." The Commission concluded that "ad hoc determinations in the antitrust courts of complex matters" such as off-board trading and commission rates could have "an undesirable impact on the quality of the markets and the interests of the investing public."ⁿ³³⁶ Accordingly, the Commission asserted that "specific gaps in the rule-making, enforcement and disciplinary areas of exchange activity should be filled by some form of review power and, to that end, [the Commission has] initiated discussions with the principal exchanges looking toward legislation to be submitted" to Congress.ⁿ³³⁷ Finally, the Commission contended that the review process would be subject to judicial review under Section 25 of the Exchange Act and any failure on the part of the Commission "to give proper weight to the antitrust considerations to be corrected in that way."ⁿ³³⁸ Accordingly, the Commission urged that "it might, therefore, be advisable to provide antitrust immunity in areas subject to this review."ⁿ³³⁹

The 1975 Amendments have had a major impact in some of the areas addressed in 1965 by the Commission. In particular, the Exchange Act now prohibits exchange rules that establish minimum commission rates. n340 Section 6(e)(1), as amended in 1975, prohibits a national securities exchange from unilaterally imposing schedules or fixed rates of commissions, allowances, discounts, or other fees. However, the Commission does have the authority to permit the exchanges to reestablish fixed rates at any time, provided the Commission makes certain findings. n341 In view of the 1975 Amendments, it is doubtful that antitrust challenges to collective action by exchange members in adopting or implementing the rules of an exchange will continue to be focused upon commission rates. n342

On the subject of membership on a national securities exchange, a district court has held that a securities broker-dealer denied full membership on the Midwest Stock Exchange, after being accorded procedural due process, n343 was still entitled to a trial on the issue of whether the Exchange rules that the plaintiff was alleged to have violated were essential enough to the operation of the Exchange Act so as to preclude operation of the antitrust laws. n344 Another district court found both the New York and American Stock Exchanges immune from antitrust liability for temporarily suspending a broker-dealer from membership thereon for failure to comply with the net capital rule of the Exchanges. n345

Concerning the delisting of stock, the actions of the American Stock Exchange in suspending trading in stock listed on the Exchange and applying to the SEC to strike the suspended stock from listing on the Exchange n346 were held immune from antitrust liability in *Harding v. American Stock Exchange, Inc.* n347

The Seventh Circuit addressed the scope of antitrust immunity that the modern regulatory framework provides to securities exchanges in *American Agriculture Movement v. Chicago Board of Trade* ("AAM"), n348 in which a farmer's organization alleged that the CBOT created an unreasonable restraint of trade, in violation of the Sherman Act, when requiring certain owners of soybean futures contracts to reduce their holdings. The CBOT claimed immunity from the Sherman Act under the Commodities Exchange Act of 1974 (CEA). The court's reasoning in AAM proceeded along lines that, if adopted by other courts, could provide useful guidelines for the analysis of antitrust claims against securities exchanges. The court first considered whether the CEA was written in a manner that bestowed "pervasive" implied immunity on the markets it regulated. Finding that the Act's legislative history did not support this conclusion, n349 the court ruled that "we may imply immunity in either one of two circumstances: first, where the challenged action was compelled by a statute, regulation, or agency, and, second, where the action was 'scrutinized] and approv[ed] by the appropriate agency'." n350 Since the CBOT's action was not mandated by any law or by the supervising regulatory agency, in this case the Commodities Futures Trading Commission ("CFTC"), the court turned to the level of scrutiny given to the CBOT action by the CFTC. While finding that the CFTC had the ability to scrutinize the CBOT action, the court ruled that the agency failed to do so to an extent that conferred implied antitrust immunity. Summarizing its findings, the court concluded:

Silver and Gordon teach that outside the context of a pervasive regulatory scheme, such immunity is proper when the relevant agency's scrutiny and approval of the challenged practice is active, intrusive and appropriately deliberative. Put another way, an antitrust court, before relinquishing jurisdiction over allegedly anticompetitive activities, must be convinced that the agency has exercised its independent judgment in reflecting upon and approving the activity at issue. n351

In the wake of AAM, a challenge to the action of a securities exchange on antitrust grounds may not succeed if the overseeing regulatory agency conducts a thorough examination of the exchange decision.

In addition to the effect of the antitrust laws upon the collective action of exchange members, there is an entirely separate question of the effect of the antitrust laws upon concentration in the securities industry itself. There has been a consolidation trend among securities firms, especially since competitive commission rates went into effect on May 1, 1975. n352 Mergers by securities firms have not yet been challenged by the Justice Department, n353 and there are no provisions of the Exchange Act that directly pertain to securities firm mergers. n354 An approach to the area of

securities firm mergers has been suggested whereby the proposed merger would first be reviewed by the SEC for a determination of its reasonableness in the context of the national market system n355 and then subject to an antitrust proceeding under the Clayton Act. n356

[b] On National Securities Associations

Antitrust issues have also been raised with respect to the NASD (now FINRA), as a registered national securities association. In 1945, for example, the Commission vacated an NASD disciplinary proceeding against members who participated in an underwriting of a bond issue for selling bonds below the price schedules contained in the syndicate agreements. n357 The NASD found that such conduct violated a rule of the association requiring members to observe high standards of commercial honor and just and equitable principles of trade. The Commission concluded that "whatever may be the general meaning of the term 'just and equitable principles of trade,' it is clear that as used in the NASD rules the term cannot be interpreted or applied so as to add 'impediments to a free and open market,' to 'fix minimum profits,' or to impose 'any schedule of prices' or 'any schedule of commissions, allowances, discounts or other charges.'" n358

Although the Department of Justice asserted that the price maintenance provisions of the syndicate agreements violated the Sherman Act, the Commission refused to address that issue since it concluded that the NASD's interpretation of its rules was inconsistent with the Exchange Act. Nevertheless, the Commission proffered that it was "inclined to the view that the price maintenance agreements now" before it was "not illegal under the Sherman Act." n359 Cautioning that its views should not be taken to mean "that the Sherman Act is inapplicable to the underwriting business," the Commission concluded that "the mere making of agreements containing provisions for a fixed price offering, price maintenance and stabilization is not per se unlawful. But, like many other contracts, these may be entered into and performed under circumstances that amount to an unlawful suppression of competition." n360

In 1950 the Department of Justice addressed again the issue of the application of the antitrust laws to national securities associations registered pursuant to Section 15A of the Exchange Act. Observing that "the Maloney Act grants to associations formed thereunder no express exemption from the antitrust laws," the Department of Justice concluded that the Maloney Act must be construed to provide "no exemption for acts or activities that would constitute a violation of the antitrust laws, except to the extent that such acts or activities are expressly authorized by" the Maloney act, and that the provisions of the Maloney Act are to be construed, insofar as possible, "in a manner consistent with the principles of the antitrust laws." n361

From this prospective, the Department concluded that the only provision of the Maloney Act "that in any way could be construed as limiting the application of the antitrust laws is subsection (i)(1)," which states that the rules of a registered securities association may provide that a member must deal with a nonmember "at the same prices, for the same commissions or fees, and on the same terms and conditions as or by such member accorded to the general public." n362

In view of that conclusion, the Department of Justice posed four issues:

1. Whether the NASD has conformed to the principles of the antitrust laws "in the conduct of its affairs and activities and in the promulgation of rules for its members." n363
2. Whether subsection (i)(1) of the Maloney Act "is a desirable provision or one that should be stricken from the law." n364
3. Whether 'self-regulatory' organizations of the NASD type have any proper place "in our economic structure. Assuming arguendo that they do, [the Department] seriously question[s] the propriety of authorizing by statutes organizations with such power that they can practically compel all those in the trade to become members." n365

4. Whether "this type of regulatory statute is fundamentally undesirable and inconsistent with our traditional free enterprise system." n366

In conclusion, the Department of Justice commented upon the NASD disciplinary procedures and concluded:

That the trial system of the NASD appears to be a rather distinctive departure from our usual conception of democratic procedure. The NASD acts as investigator, complainant, judge and jury in connection with the hearings before its committees. Moreover, it may well be difficult to obtain an impartial decision from a committee of the association when those who are actively engaged in the securities business sit in judgment on their competitors. n367

Notwithstanding the views of the Department of Justice, the Maloney Act has not been amended. Prior to 1996, the major involvement of the Department of Justice was with regulatory proposals by the Commission dealing with fixed commissions, n368 the structure, operation and regulation of the securities markets including, n369 in particular, the formation of a central market system, and market structure issues concerning standardized options trading. n370 In 1996, the Justice Department's Antitrust Division instituted a major enforcement initiative resulting from alleged anti-competitive practices in the OTC market which led to settlements with numerous broker-dealers. n371

FOOTNOTES:

(n1)Footnote 1. Douglas, *Democracy and Finance* 82 (1936). *See also* SEC, Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, House Document No. 95, Pt. 3, pp. 501-02 (1963) (hereinafter cited as "Special Study").

The Commission's relationship to the business it regulates is fundamentally different from that of other Federal independent administrative agencies; it is not only regulator, but also supervisor of 'self'-regulators. There are, no doubt, many other instances in which the policy of entrusting a degree of social control to 'private' groups has been adopted, but securities regulation is unique in featuring self-regulation, as an essential and officially sanctioned part of the regulatory pattern.

Self-regulation was originally advanced and adopted as a feature of Federal control on the ground of practicality. Initially, attention was focused on the exchanges--the over-the-counter market was too uncharted in 1934 to be capable of detailed regulation--and it was thought that the extent of the control necessary, either actually or potentially, made direct governmental intervention ineffective, if not infeasible. As John Dickinson, Assistant Secretary of Commerce and Chairman of the so-called "Roper Committee," put it in his testimony before the House of Representatives:

In framing a regulatory measure, the practical problem of administration has always to be faced and when regulation gets beyond a certain point the sheer ineffectiveness of attempting to exercise it directly through government on a wide scale counterbalances the fact that possibly the exchanges might not be as diligent as we would wish them to be about regulating themselves or as diligent as the Government would be if the task were compact enough to fall within the limits of effective governmental performance.

As indicated in the latter part of the quotation, an important limitation of self-regulation was recognized from the outset, that self-regulatory agencies might approach their regulatory duties with something less than enthusiasm. To quote Dickinson again (this time emphasizing the limitation but reverting to the theme of practicality):

Now, it may be said, of course, cynically--and I think that there is a good deal in it, and of course we have to recognize the weakness of human nature--it may be said that the idea of self-regulation is just a

device to avoid regulation and so in some instances it no doubt is; but self-regulation in the first instance, with the Government holding its power in reserve to see that self-regulation is exercised, is after all a necessary recourse in view of the mere physical limitations in time and in personnel, which operate on the direct exercise of the powers of government as the task of regulation becomes more and more extensive over a wider and wider field.

The safeguard was inherent in the original conception: it was to be the power of government held in reserve. Congressman Wolverton put the matter somewhat colorfully, in a nutshell:

I understand that the fundamental principle ... is this--that the exchanges should be permitted or required to regulate themselves; but there should be Federal authority holding the power which in a previous administration would have been referred to as 'a big stick.'

Thus there was to be, not merely self-regulation, but self-regulation supervised by the Government.

The need for public supervision is at least threefold. The aspect emphasized by Dickinson, providing assurance that self-regulatory agencies actually assume responsibility for and effectively discharge those functions assigned to them instead of to the Government, hardly needs elaboration. One of the important rationales of self-regulation is that the Government's undertaking those functions would be inefficient and self-defeating. If the Government does not undertake them and self-regulatory bodies do not perform them faithfully and effectively, the result will be an appearance, a mere facade, of protection for the public that will be more dangerous than no protection at all.

Secondly, self-regulation by a member organization involves some degree of impairment of competition and public control is necessary not only to insure that such impairment is compensated for by effective regulation, but also to insure that the kinds and extent of impairment are only such and no greater than required by the exigencies of regulation. Inherent in self-regulation is the 'private' formulation of restrictive standards of business conduct and their enforcement by, at the very least, exclusionary practices. It is essential that the standards and their application not be left to the unfettered discretion, or perhaps even lack of bona fide regulatory purpose, of the private regulators. The accommodation of various public policies inherent in the formulation of appropriate standards and their proper application cannot be abdicated by public authority.

Finally, in some of their aspects self-regulatory agencies, at present especially the exchanges, operate as quasi-public utility institutions in relation to the general public and in this capacity require public oversight for much the same reason that railroads, power companies, or telephone companies do. Thus, for example, exchanges actually operate a marketplace for public participants and fix minimum commission rates to be paid by such participants; operation of that marketplace and enforcement of the rates involve, perhaps consist largely of, conducting what is essentially a business affected with the public interest and therefore requiring public supervision and control. (Footnotes omitted).

(n2)Footnote 2. Former Section 6(a)(1) of the 1934 Act, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F.

(n3)Footnote 3. Former Section 6(b), which is discussed in § 2.02 *supra*.

The statute by no means places the entire burden of policing the exchange market upon the Commission. Recognizing that in a highly complex field like the securities business there is a large area for the operation of exchange rules on the level of business ethics rather than law, Congress relied in some measure upon the exchanges themselves to assure high standards of trade and to discipline members who violate those standards. 2 Loss, Securities Regulation 1175-76 (2d Ed. 1961 Supp. 1969).

(Footnote omitted.)

The provisions of Section 6, prior to the Securities Acts Amendments of 1975, are discussed in § 2.02 *supra*.

(n4)Footnote 4. The text of former Section 6(c) appears in § 2.02 *supra*.

(n5)Footnote 5. The powers of the Commission with respect to exchanges in original Section 19 are discussed in § 2.02 *supra*.

The statutory procedure under old Section 19(b), authorizing the Commission to amend the rules of an exchange, has been described as "on the circuitous side, and not too well articulated:"

Traditionally, the Commission discharged its functions under the section by means of informal procedures, which were not significantly changed until 1958. At least in the commission rate area, the New York Stock Exchange would notify it of a proposed rule change well in advance and wait for an indication of lack of objection. 2 Special Study, *supra*, at 344.

Rates aside, a letter from the President of the New York Stock Exchange to the Director of the Division of Trading and Markets formalized the previous practice whereby the Exchange as a "courtesy" undertook, except in "unusual circumstances," to give the staff notice of any "material change in Exchange rules or stated policy at least 2 weeks before such change is publicly announced." *Id.* at 711. And from some time in 1962 the Exchange followed a policy of discussing all rule changes informally with the staff shortly before submission to the Board [of Governors of the NYSE], instead of doing so only on occasion as it had previously. *Id.* at 711-12.

The American Stock Exchange, in the absence of any written agreement with the Commission or its staff regarding proposed rule changes, adopted the practice of discussing them in advance with the staff when the new administration of the Exchange took office in 1962. And the regional exchanges generally did not discuss rule changes in advance, but merely filed them pursuant to § 19(b) after adoption. *Id.* at 712.

In early 1964 the Commission adopted Rule 17a-8 [superseded by Rule D-4, and therefore rescinded in Sec. Exch. Act Rel. No. 11604 (1975)], under the recordkeeping provision of the statute in order to require every exchange to file a report of any proposed change in its rules not less than three weeks before any action is taken by the membership or any governing body of the exchange. If any substantive change is made in a proposal after a report is filed, the notice process must be repeated unless the change is made to comply with a suggestion by the Commission. In an emergency the exchange need give only as much notice as the circumstances permit, together with a written statement of reasons why the filing of a report as required was impracticable. *See* Sec. Exch. Act Rels. 7218 (1964) (proposed), 7253 (1964) (adopted). Authority under the rule to approve requests of exchanges to file reports of proposed changes or additions less than three weeks prior to their adoption has been delegated to the Director of the Division of Trading and Markets.

Counsel to the New York Stock Exchange thought that the Commission's power to require a report under § 17 did not give it authority to delay an exchange from exercising its rule-making powers under § 6(c) or to require the filing of rule changes otherwise than "forthwith upon their adoption" as specified in § 6(a)(4). *See* 2 Investor Protection, Hearings before Subcom. of House Com. on Int. & For. Commerce on H. R. 6789, H. R. 6793, S. 1642, 88th Cong., 1st Sess. (1963-64) 1137-38 (hereinafter cited as "Investor Protection"). And the Chairman of the House committee, though critical of the Exchange, nevertheless reminded the Commission that its own Special Study report had said that "the Exchange Act

does not require exchanges to file rule changes prior to adoption" (4 Special Study, *supra*, at 725). See Cary, Politics and the Regulatory Agencies (1967) 52. But the Commission decided that its authority to require reports was adequately broad and clear (See 2 Investor Protection, *supra*, at 1068-71), and so it went ahead, ultimately receiving a letter from the Chairman of the House committee to the effect that he was "not unaware of the fact that on March 3 the Commission adopted Rule 17a-8." Cary, Politics and the Regulatory Agencies, *supra*, at 52. The Exchange, for its part, had decided not to oppose adoption of the rule, while reserving its right to test its position at some future time. 2 Investor Protection, *supra*, at 1137-238. In any event, the Commission's rule is specific that an exchange's failure to file a required report "shall not affect the validity, force or effect of any rule of the exchange or of any exchange action or omission to act thereunder." Former Rule 17a-8(d). This proviso is altogether appropriate in view of the fact that § 19(b) does not contemplate the SEC's giving "affirmative sanction" to exchange rules. *Silver v. New York Stock Exchange*, 196 F. Supp. 209, 221 (S.D.N.Y. 1961), *rev'd on other grounds*, 320 F.2d 714 (2d Cir. 1962), *rev'd on other grounds*, 373 U.S. 341, 83 S. Ct. 1246, 10 L. Ed. 2d 389 (1963), *supra* p. 3127.

2 Loss, *supra*, 1969 Supp. at 3150-3153.

(n6)Footnote 6. In contrast with the Exchange Act's lack of any requirements with regard to an exchange's disciplinary and other proceedings, Section 15A required that disciplinary actions and similar proceedings of the NASD meet certain criteria and provide for review by the Commission. Section 15A, concerning registered securities associations, is discussed in § 2.02 *supra*.

(n7)Footnote 7. This may reflect that the NASD is "a creature of statute" which "did not exist as an organization prior to the adoption of the Exchange Act." 4 Special Study, *supra*, at 603. Congress also may have been influenced by the comparative intangible nature of the OTC market. While trading on an exchange "is concentrated in a central marketplace where it can be observed and supervised, trading on the over-the-counter markets takes place throughout the country over a telephone-and-wire network connecting members bilaterally and privately with one another. The lack of "tape" or other means of reporting and publicizing transactions results in an absence of continuing information about market activities." *Id.*

(n8)Footnote 8. "Stock Market Control," Twentieth Century Fund, p. 668 (1934).

(n9)Footnote 9. Testimony of Commissioner George Matthews, Hearing on S. 3255, 75th Cong., 3d Sess., p. 7 (1938).

(n10)Footnote 10. Former Section 15A(j).

(n11)Footnote 11. Former Section 15A(j).

(n12)Footnote 12. Former Section 15A(k)(1).

(n13)Footnote 13. Former Sections 15A(g) and (h).

(n14)Footnote 14. See S. Rep. No. 94-75, 94th Cong., 1st Sess., p. 27 (1975), reprinted in the Securities Primary Law Sourcebook, Vol 2, Sec. I (hereinafter cited as "Senate Report").

... S. 249 [the Securities Acts Amendments of 1975] would significantly amend the provisions of the Exchange Act dealing with the powers of self-regulatory organizations and the oversight authority of the SEC with respect to these organizations. The Committee believes that self-regulation should be preserved in the securities industry, but it also believes that the self-regulatory organizations must display a greater responsiveness to their statutory obligations and to the need to coordinate their

functions and activities. In the new regulatory environment created by this bill, self-regulation would be continued, but the SEC would expect to play a much larger role than it has in the past to ensure that there is no gap between self-regulatory performance and regulatory need and, when appropriate, to provide leadership for the development of a more coherent and rational regulatory structure to correspond to and to police effectively the new national market system.

Id. at 2.

The self-regulatory roles of the exchanges and the NASD have been major elements of the regulatory scheme of the Exchange Act since 1934 and 1938, respectively. Although self-regulation has not always performed up to expectations, on the whole it has worked well, and the Committee believes it should be preserved and strengthened. S. 249 [the Securities Acts Amendments of 1975] is designed to accomplish this, not only by clarifying regulatory responsibility at all levels but also by assuring that the self-regulatory organizations follow effective and fair procedures, that their activities are not anticompetitive and that the Commission's oversight powers are ample and its responsibility to correct self-regulatory lapses is unmistakable. The intent of the bill is not to diminish the role of self-regulation but to strengthen the total regulatory fabric.

Id. at 23.

(n15)Footnote 15. According to the Senate Committee, "the statutory pattern governing the scope of the NASD's authority is basically sound. The bill would extend the pattern now applicable to the registered securities associations to exchanges." *Id.* at 27.

(n16)Footnote 16. For discussion of the provisions contained in the 1975 Amendments directing the Commission to review burdens on competition and to eliminate all present and future restraints on competition that are incompatible with the purposes of the Exchange Act, *see* § 2.02[2][c][ii] *supra*.

(n17)Footnote 17. Section 6(b)(5). For discussion of what criteria rules of an exchange must meet under Section 6(b) so that it may be registered as a national securities exchange, *see* § 2.02[2][c][i] *supra*.

(n18)Footnote 18. Section 6(b)(5).

(n19)Footnote 19. Section 6(b)(8).

(n20)Footnote 20. *See* § 2.01[5] *supra*.

(n21)Footnote 21. *See* §§ 2.03[5][c][i] and [ii] *infra*.

(n22)Footnote 22. *See* § 2.05 *infra*.

(n23)Footnote 23. Section 3(a)(27) of the Securities Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F defines the term "rules of an exchange" and "rules of an association" to mean "the constitution, articles of incorporation, bylaws, and rules, or instruments corresponding to the foregoing, of an exchange [or] association of brokers and dealers ... and such of the stated policies, practices, and interpretations of such exchange [or] association ... as the Commission, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules of such exchange [or] association"

Rule 19b-4(b) under the Securities Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section G, defines the phrase "stated policy, practice, or interpretation" to mean "(1) any material aspect of

the operation of the facilities of the self-regulatory organization or (2) any statement made generally available to the membership of, to all participants in, or to persons having or seeking access ... to facilities of, the self-regulatory organization ('specified persons') or to a group or category of specified persons that establishes or changes any standard, limit, or guideline with respect to (i) the rights, obligations, or privileges of specified persons, or, in the case of national securities exchanges or registered securities associations, persons associated with specified persons, or (ii) the meaning, administration, or enforcement of an existing rule."

Rule 19b-4(c) further provides that a stated policy, practice or interpretation is deemed to be a proposed rule change "unless (1) it is reasonably and fairly implied by an existing rule of the self-regulatory organization or (2) it is concerned solely with the administration of the self-regulatory organization and is not a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization."

Finally, pursuant to Rule 19b-4(d), an interpretation of an existing rule is itself a proposed rule change if "(1) it is approved or ratified by the governing body of the self-regulatory organization and (2) it is not reasonably and fairly implied by that rule."

(n24)Footnote 24. The term "self-regulatory organization" is defined in Section 3(a)(26), *see also* § 2.02[2] *supra*.

(n25)Footnote 25. Senate Report, *supra*, at p. 129.

On the subject of rule-making by self-regulatory organizations, the Report of the Senate Committee on Banking, Housing and Urban Affairs ("the Committee") to accompany Senate Bill 249 (that became, as modified by the Conference Committee, the Securities Acts Amendments of 1975) states:

The Exchange Act says very little about the internal decision-making processes of the self-regulatory organizations. These bodies do not act just like Government agencies, whose procedures and functions are derived from, and often prescribed by statutes rather than from the decisions of those who choose to become members, and the Committee believes the distinction is essential to the concept of self-regulation. This does not mean that the decision-making processes of the self-regulatory bodies cannot be improved. Quite to the contrary, but in the Committee's view it would be self-defeating to saddle the self-regulatory organizations with the whole panoply of Governmental administrative procedure.

One of the advantages of self-regulation is the flexibility and informality of its decision-making procedures. Further, self-regulatory organizations differ as to their membership, regulatory responsibilities, and economic power. It would be difficult to prescribe a single "proper" decision-making procedure appropriate to the circumstances of every self-regulatory organization, and it is doubtful that any such formal procedure would better serve the goal of effective securities regulation than the present practice of encouraging each organization to develop procedures which best serve its needs and those of the public investors.

The increased use of public governors, providing an opportunity for public comment on proposed rule changes, and the delegation of increased authority to professional staffs are only some of the positive steps that are being taken by the self-regulatory organizations in the area of policy formation. The Committee encourages the self-regulatory organizations to continue their healthy experimentation and innovation with regard to decision-making processes, keeping in mind at all times that they are quasi-public organizations, not private clubs, and that one of their principal goals is the prevention of inequitable and unfair practices and the advancement of the public interest.

Id. at 28-29.

(n26)Footnote 26. The terms "rules of an exchange" and "rules of an association" are defined in Section 3(a)(27). The term "rules of a self-regulatory organization" is defined in Section 3(a)(28), *see* § 2.02[2] *supra*.

(n27)Footnote 27. The filing with the Commission must be in accordance with "such rules as the Commission may prescribe." Section 19(b)(1).

The Commission initially adopted Rule 19b-4 and related forms 19b-4A and 19b-4B to establish procedures for the notification and review process mandated by Section 19(b) of the Exchange Act. As initially adopted, Rule 19b-4 contained a definition of the term "proposed rule change" and further defined the circumstances under which a stated policy, practice, or interpretation of a self-regulatory organization would be deemed not to be a rule of such organization. *See* Sec. Exch. Act Rel. No. 11604, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,267 (Aug. 19, 1975).

In 1979, the SEC proposed a definition of the term "rule" that was meant to resolve "problems with the existing standards for determining whether a particular self-regulatory action is a 'proposed rule change.'" SEC Release No. 34-15838 (May 18, 1979). The proposed Rule 3b-7 would have defined "rule" as:

the whole or part of any statement or of any stated policy, practice, or interpretation (including any form, report, or questionnaire) (a) that is of general or particular applicability and future effect, (b) that is designed to implement, interpret, describe, or prescribe a requirement, procedure, definition, standard, guideline, policy, or any part of a corporate or financial structure or organization, and (c) that directly or indirectly affects the rights or obligations of any person or the conduct of business by any person; [p]rovided, however, [t]hat the term "rule" shall not include any stated policy, practice, or interpretation with respect to an existing rule that is reasonably and fairly implied by that rule and that is not required under the rules of the self-regulatory organization to be approved by the governing body of the self regulatory organization.

Release No. 34-15838. Ultimately, many commentators objected to the proposed definition. Some expressed concerns relating to the breadth of the definition, others thought that the terms meaning was "already sufficiently clear," and still others thought the definition was "difficult to read and understand." SEC Release No. 34-17258 (Oct. 30, 1980). Ultimately, this proposal was withdrawn. *Id.*

Effective January 1, 1981, the Commission amended Rule 19b-4, *See* Sec. Exch. Act Rel. No. 17258, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,681 (Oct 30, 1980). The amendments clarify which actions of a self-regulatory organization will be deemed to constitute proposed rule changes and, thereby, come within the parameters of Section 19(b). In particular, Rule 19b-4, as amended, provides, in pertinent part, that a stated policy, practice, or interpretation of a self-regulatory organization shall be deemed to be a proposed rule change:

unless (1) it is reasonably and fairly implied by an existing rule of the self-regulatory organization or (2) it is concerned solely with the administration of the self-regulatory organization and is not a stated policy practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the self-regulatory organization.

Rule 19b-4(c). The "reasonably and fairly implied" standard has generated the most review by the Commission. While there is no clear standard for determining whether a proposal is "reasonably implied" by an existing rule, most administrative decisions have held that when an SRO's interpretive statements establish a new standard of conduct for its membership, these statements are not "fairly and reasonably implied" by existing SRO rules, and therefore do not fall within the exception of 19b-4(c). Another relevant consideration is whether the SRO may bring an enforcement action for purported violations of the standard. *See, e.g., Matter of the National Stock Exchange and David Colker*, SEC

Release No. 34-51714, 2005 SEC Lexis 1178 (May 19, 2005) (holding that the National Stock Exchange's failure to file a proposed rule change concerning the enforcement of its market order exposure rule violated Section 19(b)); *Matter of the Application of Bloomberg L.P.*, SEC Release No. 34-49076, 2004 SEC Lexis 79 (January 14, 2004) (finding that the NYSE's certain attempts to impose contractual restrictions on vendors' use of market quotation data disseminated by the NYSE via Bloomberg could not be "fairly implied"); *Lehl v. SEC*, 90 F. 3d 1483, 1487-88 (10th Cir. 1996) (holding that the NASD's markup policy did not set forth a new standard of conduct, and, therefore it was not a rule change requiring formal approval by the Commission).

The 1980 amendments to Rule 19b-4 also provided that a proposed rule change may take effect upon filing with the Commission if the proposal has been designated by the self-regulatory organization as:

(1) constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule, (2) establishing or changing a due, fee, or other change, [or] (3) concerned solely with the administration of the self-regulatory organization

Rule 19b-4(f).

Finally, through the 1980 amendments the Commission rescinded Form 19b-4B and modified and redesignated Form 19b-4A as Form 19b-4. Accordingly, all filings with respect to proposed rule changes by self-regulatory organizations must now be made on Form 19b-4. Rule 19b-4(a).

Form 19b-4 requires disclosure of:

(1) The text of the proposed rule change and, if the self-regulatory organization "reasonably expects" that the proposed rule "will have any direct effect, or significant indirect effect, on the application of any other rule of the self-regulatory organization," the designation or title of such rule and a description of the anticipated effect of the proposed rule on the application of such other rule. Item 1, Form 19b-4.

(2) A description of the action taken by the members or board of directors or other governing body with respect to the proposed rule, together with the names and telephone numbers of the persons on the staff of the self-regulatory organization who are prepared to respond to questions and comments on the proposed rule change. Item 2, Form 19b-4.

(3) A detailed and specific statement of the purpose of the proposed rule change and its basis under the Exchange Act and the rules and regulations thereunder applicable to the self-regulatory organization together with a response specifically addressing all significant arguments that the proposed rule change is inconsistent with those requirements. Item 3, Form 19b-4. At a minimum, the statement is required to describe the reasons for adopting the proposed rule change, any problems that the proposed rule change is intended to address, the manner in which the proposed rule change will resolve those problems, any significant issues known to the self-regulatory organization that persons affected are likely to have in compliance with the proposed rule change, together with an explanation as to why the proposed rule change is consistent with the Exchange Act requirements and the rules and regulations thereunder. *Id.*

(4) A statement whether the proposed rule change will have an effect on competition and, if so, the nature of that effect and the particular categories of persons and kinds of business upon which any burden will be imposed. Item 4, Form 19b-4.

(5) A summary of the written comments, if any, that were received by the self-regulatory organization pertaining to the proposed rule change. Item 5, Form 19b-4.

(6) A statement whether the self-regulatory organization consents to an extension of time within which the Commission may consider the proposed rule. Item 6, Form 19b-4.

(7) A statement of the basis for summary effectiveness or accelerated effectiveness if requested by the self-regulatory organization. Item 7, Form 19b-4.

(8) A statement whether the proposed rule change is based upon the rules of another self-regulatory organization or of the Commission and, if so, an explanation of any differences between the proposed rule and the rule upon which it is based. Item 8, Form 19b-4.

In addition, the application is required to be accompanied by certain exhibits including

- (1) a completed notice of proposed rule change for publication in the Federal Register;
- (2) copies of notices issued by the self-regulatory organization soliciting comments on the proposed rule change and copies of all written comments received, including comments received after the original filing date of the rule change;
- (3) any transcript of comments on the proposed rule change made at any public meeting, and if the transcript is not available, a summary of such comments; and
- (4) copies of any form, report, or questionnaire to be utilized by the self-regulatory organization in the operation or implementation of the proposed rule. Item 9, Form 19b-4.

SROs were formerly required to file twelve copies of Form 19b-4 and a specified number of copies of the exhibits, but these requirements were removed in 2004 when the Commission mandated electronic filings of all Forms 19b-4. See Sec. Exch. Act. Rel. No. 50486 (Oct. 4, 2004); General Instruction F to Form 19b-4.

(n28)Footnote 28. Section 19(b)(1). Prior to the Securities Acts Amendments of 1975, self-regulatory organizations were not required to file any explanation or justification for any proposed rule changes filed with the Commission. The requirement of a justification for the proposed change was added to facilitate expeditious Commission review and evaluation of such proposals and to assure informed public comment on the proposals. Senate Report, *supra*, at p. 29. Also, in its report the Senate Committee on Banking, Housing and Urban Affairs stated that it was its "intention in adopting this standard to hold the self-regulatory organizations to the same standards of policy justification that the Administrative Procedure Act imposes on the SEC." *Id.*

(n29)Footnote 29. Item 3, Form 19b-4.

(n30)Footnote 30. Item 3, Form 19b-4. Section 19(b)(2) provides, in part, that the "Commission shall approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of this title [the Exchange Act] and the rules and regulations thereunder applicable to such organization. The Commission shall disapprove a proposed rule change of a self-regulatory organization if it does not make such finding."

(n31)Footnote 31. "[T]he Committee believes interested persons should have a meaningful opportunity to obtain accurate information about proposed changes in self-regulatory rules and to comment on the need or justification for these changes. Section 19(b)(1) would require the SEC to give notice and provide an opportunity for interested persons to participate in the process of reviewing a proposed change in a self-regulatory organization's rules. In addition, this

section would require that all comments and all correspondence between the SEC and the self-regulatory agency concerning the proposal be available for public inspection." Senate Report, *supra*, at pp. 29-30.

Rule 19b-4(g) states the Commission's policy of allowing both the self-regulatory organization and interested persons the opportunity to submit additional written data, views, and arguments, after the Commission has instituted proceedings to determine whether a proposed rule change should be disapproved.

Rule 19b-4(i) requires all self-regulatory organizations to retain a file, at their principal place of business, for public inspection and copying, of all filings and correspondence received with respect to any filing made pursuant to Rule 19b-4.

(n32)Footnote 32. Section 19(b)(2). Under Section 19(b)(3)(A) and Rule 19b-4(f), a proposed rule change may take effect upon filing with the Commission if certain requirements are satisfied.

(n33)Footnote 33. Section 19(b)(2).

(n34)Footnote 34. Section 19(b)(2). These matters, however, are usually dealt with informally; the Commission almost never uses the outlined formal procedures.

For example, the Commission's approval of Nasdaq's SuperMontage proposal took over fifteen months. Sec. Exch. Act. Rel. No. 43863 (Jan. 19, 2001), *available at* 2001 SEC LEXIS 112, at *1. As is almost always the case with controversial rule changes, Nasdaq chose to work informally with the SEC staff rather than forcing the Commission to institute proceedings to determine whether the rule change should be approved. The proposal was amended nine times, primarily in response to staff comments. *Id.* at *1-2.

Proposed rule changes may be filed by a self-regulatory organization, such as a national securities exchange, prior to completion of all action required to be taken under the constitution, articles of incorporation, by-laws, rules, or instruments corresponding thereto if the organization consents to an extension of the time period specified in Exchange Act Section 19(b)(2) until at least thirty-five days after appropriate amendments have been filed with the Commission setting forth the completion of all such action. Paragraph E, General Instructions, Form 19b-4.

On the subject of the Commission's procedure after a proposed rule change is filed by a self-regulatory organization, the Senate Committee on Banking, Housing, and Urban Affairs, *supra*, stated:

Section 19(b)(2) would give the SEC sufficient flexibility to fashion a proceeding appropriate to the particular self-regulatory proposal being considered. In many, perhaps most, situations, notice and an opportunity for written comment would be sufficient and there would undoubtedly be few, if any, comments. In cases in which fundamental policy issues are involved, however, oral hearings or publicly announced conferences might be most appropriate.

[T]he Exchange Act at present creates the anomalous situation whereby an exchange, which may not lawfully do business until its rules have undergone official scrutiny in relation to statutory standards, is free to change those rules at any time thereafter without similar advance scrutiny or approval. Section 19(b)(2) would fill this regulatory gap by providing that, subject to certain exceptions specified in Section 19(b)(3), no change in the rules of any self-regulatory organization may become effective until the SEC finds it to be consistent with the registration requirements for the organization and the purposes of the Exchange Act. The Committee believes the Commission has a responsibility to see that self-regulatory rules are fully responsive to regulatory needs. By explicitly providing that the Commission's oversight authority encompasses major self-regulatory [sic] policies, the bill would make this responsibility clear and substantially decrease the possibility of slippage between regulatory need and self-regulatory performance.

Senate Report, *supra*, at p. 30.

(n35)Footnote 35. Section 19(b)(2). The Commission frequently grants accelerated approval to amendments to proposed rule changes, and when it does so, typically solicits comments on the amendments. *See, e.g.*, Sec. Exch. Act Rel. No. 43863 (Jan. 19, 2001); Sec. Exch. Act Rel. No. 47351 (Feb. 11, 2003).

(n36)Footnote 36. Rule 19b-4(g), reprinted in the Securities Primary Law Sourcebook, Volume B, Section G.

(n37)Footnote 37. Sec. Exch. Act Rel. No. 40761 (Dec. 8, 1998).

(n38)Footnote 38. Rule 19b-4(e).

(n39)Footnote 39. *Id.* The 1998 amendments also re-designated Rules 19b-4(e), (f), (g) and (h) as 19b-4(f), (g), (h) and (i), respectively. Sec. Exch. Act Rel. No. 45761 (Dec. 8, 1998).

(n40)Footnote 40. Rule 19b-4(f)(1)-(3).

(n41)Footnote 41. Section 19(b)(3)(A).

(n42)Footnote 42. Sec. Exch. Act Rel. No. 35123, 1994 SEC LEXIS 4053 (Dec. 20, 1994). This amendment was in part in response to SRO concerns that the process of modifying rules was too lengthy and hampered their efforts to provide prompt, flexible and innovative order-entry and trading services to their members and to the investing public. *See* "Market 2000: An Examination of Current Equity Market Developments" (January 1994) (hereinafter cited as "Market 2000 Report") (recommending that the self-regulatory rule review process be expedited for routine procedural and administrative modifications to existing order entry and trading systems).

(n43)Footnote 43. Sec. Exch. Act Rel. No. 35123, 1994 SEC LEXIS 4053 (Dec. 20, 1994).

(n44)Footnote 44. Rule 19b-4(f)(5) and (6).

(n45)Footnote 45. Rule 19b-4(f)(5) and (6).

(n46)Footnote 46. Section 19(b)(3)(C).

(n47)Footnote 47. Section 19(b)(3)(B). Special provisions are contained in Section 19(b)(4) for proposed rules or rule changes of registered clearing agencies for which the Commission is not the "appropriate regulatory agency," *i.e.*, banks. These provisions permit review by the other agency before Commission action and permit the appropriate regulatory agency to compel disapproval of the proposed rule or rule change if it determines that it is inconsistent with the safeguarding of securities or funds in the custody or control of the clearing agency for which it is responsible.

(n48)Footnote 48. Section 23(c).

(n49)Footnote 49. Sec. Exch. Act Rel. No. 43860 (Jan. 19, 2001). The Commission proposed adopting a new rule, Rule 19b-6, to replace Rule 19b-4. The primary effect of Rule 19b-6 would be to:

- require the SEC to issue a release relating to a proposed SRO rule change within ten business days of filing, unless the SRO consents to a longer time period;
- eliminate the pre-filing and thirty-day waiting period before effectiveness for "non-controversial" rule changes;
- include changes to trading rules, other than those which make fundamental structural changes to a

market, in the categories of rule changes which can become immediately effective;

- clarify that if a rule change becomes immediately effective under Section 19(b)(3)A, this does not create an inference that the change is in the public interest; and
- permit SROs to file rule changes electronically.

Id.

(n50)Footnote 50. Sec. Exch. Act. Rel. No. 50486 (Oct. 4, 2004).

(n51)Footnote 51. *See* § 2.02[3] *supra*.

(n52)Footnote 52. *See* Section 6(g).

(n53)Footnote 53. Section 15A(k).

(n54)Footnote 54. Sections 6(g)(4)(B)(ii), 15A(k)(3)(B).

(n55)Footnote 55. Section 19(b)(7); *see* Sec. Exch. Act Rel. No. 44692, 2001 SEC LEXIS 1641, at *42-43 (Aug. 13, 2001) (hereinafter cited as "Single-Stock Futures Release").

(n56)Footnote 56. Section 19(b)(7)(B). This process conforms to the rule approval process used in the futures industry. *See* Single Stock Futures Release, *supra*, at *51-53.

(n57)Footnote 57. Section 19(b)(7)(c).

(n58)Footnote 58. Rule 19b-7.

(n59)Footnote 59. Section 19(c) was amended in 1975 to address several problems with the SEC's then existing indirect regulatory powers, *i.e.*, through requiring self-regulatory organizations such as exchanges to take specified actions. The Senate Report explained:

First, the SEC has divergent authority with respect to a registered securities association's rules on the one hand and an exchange's rules on the other. Under the bill, the SEC would have uniform authority to "abrogate, add to, or delete from" any self-regulatory organization's rules. (Section 19(c)). Moreover, where the Commission has exercised its rulemaking authority under Section 19(c) of the Exchange Act to abrogate, add to, or delete from the rules of any self-regulatory organization, any rule of a self-regulatory organization inconsistent with such Commission rule adopted pursuant to Section 19(c) shall be null and void.

Second, there has been a continuing controversy as to the precise scope of the SEC's power to amend the rules of a self-regulatory organization. The bill would give the SEC clear authority to amend any self-regulatory organization's rules in any respect consistent with the objectives of the Exchange Act (Section 19(c)).

Third, there is also a controversy over the procedures that the SEC must follow in order to force a change in the rules of a self-regulatory organization. In recognition of the quasi-legislative, policy-making nature of an SEC determination to require such a change, Section 19(c) would provide that the Commission's action shall be by "rule". Accordingly, the basic procedures the Commission would be required to follow are specified in the Administrative Procedure Act (5 U.S.C. § 553) for rulemaking not on the record. The bill would, however, also require the Commission to (1) provide all

interested persons an opportunity to present their views in person as well as in writing; (2) keep a transcript of all oral presentations; and (3) publish a statement of its reasons for taking the action it did, including an identification of the facts, if any, it has relied upon in reaching its conclusion. (Section 19(c)).

In order to avoid any doubt as to the SEC's authority in areas where its direct authority overlaps its indirect authority, Section 19(c)(4) would make clear that where the Commission has direct authority, it would not be required to proceed under Section 19(c) or to follow the procedures specified in that section. In such cases, the SEC could rely on its direct authority and follow the usual Administrative Procedure Act requirements for notice and comment rule-making.

Senate Report, *supra*, at pp. 31-32.

Although section 19(c) would give the SEC plenary power over self-regulatory rules, the section in no way limits the SEC's ability to use its other powers or modifies the standard requirements that it must comply with in doing so. Where the SEC has direct authority with respect to a specific subject matter and a self-regulatory organization also exercises authority in the area, the SEC may change regulatory policy in any one of three ways: (1) by promulgating its own substantive rule preempting self-regulatory rules on the subject, *e.g.*, Rule 10a-1 concerning short sales; (2) by promulgating a rule under its grant of substantive authority which imposes conditions on the exercise of self-regulatory jurisdiction in the area or the utilization of self-regulatory facilities, *e.g.*, Rule 9b-1 concerning options trading and Rule 11b-1 concerning specialist trading; or (3) by utilizing section 19(c) to force the self-regulatory organization to change its rules. The bill would not alter the SEC's ability to proceed in these ways.

Id.

(n60)Footnote 60. Section 19(c)(1) of the Securities Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F.

(n61)Footnote 61. Section 19(c)(2).

(n62)Footnote 62. Section 19(c)(3).

(n63)Footnote 63. Section 19(c)(4).

(n64)Footnote 64. Section 6(b)(2).

(n65)Footnote 65. Former Section 15A(b)(3) provided, in part, that the rules of every national securities association must provide that "any broker or dealer who makes use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security otherwise than on a national securities exchange," is eligible to become a member of such association, unless ineligible for membership pursuant to Section 15A(b)(4), which specifies various categories of misconduct, or 15A(b)(5), which permits associations to establish training, experience, and education criteria for members.

(n66)Footnote 66. Sections 6(c)(1); 15A(g)(1). In the case of an exchange, a person "associated with" a registered broker-dealer is eligible for membership. Section 6(c)(1). The 1975 Amendments added to the Exchange Act a definition of the term "person associated with a broker or dealer" or "associated person of a broker of dealer" in Section 3(a)(18) to mean:

any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a

similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of section 15(b) of this title (other than paragraph (6) [sanctions] thereof).

Broker-dealer registration requirements under Section 15 of the Exchange Act are discussed in § 3.03 *infra*.

(n67)Footnote 67. Sections 6(c)(2); 15A(g)(2). A national securities exchange or association cannot admit a person to membership or permit a person to become associated with a member if that person is under a statutory disqualification, without prior notice to the Commission. The notice must be not less than thirty days prior to admission or permission to become associated with a member, and the form and content of the notice are governed by Commission rule. Section 6(c)(2); Section 15A(g)(2). Neither a registered securities association nor a registered clearing agency may admit a person under a statutory disqualification to membership or permit a person to become associated with a member without prior notice to the Commission. Section 15A(g)(2); Section 17A(b)(4)(A).

Section 3(a)(39) provides that a person is subject to a "statutory disqualification" if such person:

(A) has been and is expelled or suspended from membership or participation in, or barred or suspended from being associated with a member of, any self regulatory organization, foreign equivalent of a self regulatory organization, foreign or international securities exchange, contract market designated pursuant to section 5 of the Commodity Exchange Act (7 U.S.C. 7), or any substantially equivalent foreign statute or regulation, or futures association registered under section 17 of such Act (7 U.S.C. 21), or any substantially equivalent foreign statute or regulation, or has been and is denied trading privileges on any such contract market or foreign equivalent;

(B) is subject to:

(i) an order to the Commission, other appropriate regulatory agency, or foreign financial regulatory authority:

(I) denying, suspending for a period not exceeding 12 months, or revoking his registration as a broker, dealer, municipal securities dealer, government securities broker, or government securities dealer or limiting his activities as a foreign person performing a function substantially equivalent to any of the above; or

(II) barring or suspending for a period not exceeding 12 months his being associated with a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, or foreign person performing a function substantially equivalent to any of the above;

(ii) an order of the Commodity Futures Trading Commission denying, suspending, or revoking his registration under the Commodity Exchange Act (7 U.S.C. 1 *et seq.*); or

(iii) an order by a foreign financial regulatory authority denying, suspending, or revoking the person's authority to engage in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof;

(C) by his conduct while associated with a broker, dealer, municipal securities dealer, government securities broker, or government securities dealer, or while associated with an entity or person required to be registered under the Commodity Exchange Act, has been found to be a cause of any effective suspension, expulsion, or order of the character described in subparagraph (A) or (B) of this paragraph, and in entering such a suspension, expulsion, or order, the Commission, an appropriate regulatory agency, or any such self regulatory organization shall have jurisdiction to find whether or not any person was a cause thereof;

(D) by his conduct while associated with any broker, dealer, municipal securities dealer, government securities broker, government securities dealer, or any other entity engaged in transactions in securities, or while associated with an entity engaged in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof, has been found to be a cause of any effective suspension, expulsion, or order by a foreign or international securities exchange or foreign financial regulatory authority empowered by a foreign government to administer or enforce its laws relating to financial transactions as described in subparagraph (A) or (B) of this paragraph;

(E) has associated with him any person who is known, or in the exercise of reasonable care should be known, to him to be a person described by subparagraph (A), (B), (C), or (D) of this paragraph; or

(F) has committed or omitted any act enumerated in subparagraph (D), (E), or (G) of paragraph (4) of section 15(b) of this title, has been convicted of any offense specified in subparagraph (B) of such paragraph (4) or any other felony within ten years of the date of the filing of an application for membership or participation in, or to become associated with a member of, such self regulatory organization, is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4), has willfully made or caused to be made in any application for membership or participation in, or to become associated with a member of, a self regulatory organization, report required to be filed with a self regulatory organization, or proceeding before a self regulatory organization, any statement which was at the time, and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, or has omitted to state in any such application, report, or proceeding any material fact which is required to be stated therein.

Section 15(b)(4), referred to in subsection (F) of Section 3(a)(39), contains the grounds upon which the Commission may impose a sanction upon a broker or dealer.

(n68)Footnote 68. Sections 15(b)(4) and 15(b)(6), which provide the Commission with the authority to suspend or revoke a firm's registration or suspend or bar an individual from association with a broker-dealer, and Sections 19(h)(2) and (3), under which the Commission may suspend or bar a firm from membership in an association or an individual from membership in the association, are discussed in § 2.03[5][d] *infra*.

(n69)Footnote 69. Conversely, the Commission would not seem to need to bring an administrative proceeding barring someone from the securities industry if they have been subject to an injunction in an SEC action, because Section 3(a)(39)(F) makes this type of injunction the basis for a statutory disqualification. However, the Commission always brings these types of "follow-up" administrative proceedings, which provide guidance to the self-regulatory organizations regarding when, if ever, readmittance may be appropriate.

(n70)Footnote 70. The procedures which must be followed to overcome a statutory disqualification are summarized in § 2.03[5][d] *infra*.

(n71)Footnote 71. Sections 6(c)(3)(A); 15A(g)(3)(A).

(n72)Footnote 72. Sections 6(c)(3)(B); 15A(g)(3)(B).

(n73)Footnote 73. An SRO may also require a person associated with a member, or any class of such persons, to be

registered with the SRO in accordance with procedures established by its rules. Sections 6(c)(3)(B); 15A(g)(3)(B).

(n74)Footnote 74. Sections 6(c)(3)(B), and 15A(g)(3)(B). The phrase "natural person" appears in Section 6(c)(3)(B) but is omitted from Section 15A(g)(3)(B), which refers only to a "broker or dealer." This discrepancy does not appear to have any substantive significance because the criteria for barring an applicant from membership are identical in both Section 6(c)(3)(B) and Section 15A(g)(3)(B).

Sections 6(c)(3) and 15A(g)(3) authorize a national securities exchange and association to establish, by rule, procedures enabling the SRO to examine and verify the qualifications of an applicant to become a member, or a person associated with a member. Furthermore, an SRO may require either a person associated with a member or a class of such persons to be registered with the SRO according to procedures established by the SRO. *Id.*

(n75)Footnote 75. Sections 6(c)(3)(C); 15A(g)(3)(C). Commission review of action by an SRO that results in denial of membership or barring of a person from becoming associated with a member is governed by Section 19(e) and (f), *see* § 2.03[4][c] *infra*.

(n76)Footnote 76. Section 6(c)(4).

(n77)Footnote 77. Section 6(c)(4).

(n78)Footnote 78. Section 15A(g)(5).

(n79)Footnote 79. Section 15A(g)(5). Under the conference substitute, a registered securities association would be permitted to deny membership to registered brokers and dealers who are not engaged in particular types of business specified in the association's rules. An association would be prohibited, however, from denying membership to a registered broker and dealer by reason of his being engaged in other lines of business not specified in the rules of the association or because of any mixture of specified and nonspecified business. Thus, the substitute has the advantage of permitting specialized associations of broker and dealers to be formed and registered with the SEC, but assures that eligibility for membership will not be determined in an arbitrary or discriminatory manner. If such a specialized association is formed, the conferees believe the SEC has ample authority under amended section 17(d) and 19(g)(2) and elsewhere to tailor the association's statutory responsibilities to its specialized objectives.

H.R. Rep. No. 94-229, 94th Cong., 1st Sess., 99 (1975).

Section 17(d) empowers the Commission to relieve a self-regulatory organization of certain responsibilities, and Section 19(g)(2) empowers the Commission to relieve a self-regulatory organization from enforcement of compliance responsibilities.

(n80)Footnote 80. *See* § 2.03[2][a] *supra*.

(n81)Footnote 81. For example, some exchanges, *e.g.*, the New York and American Stock Exchanges, denied membership to any person or entity whose "parent" was not also engaged in a securities business. This effectively barred from membership broker-dealer firms which were subsidiaries of financial institutions. In contrast, most regional exchanges, *e.g.*, the Philadelphia, Pacific [now NYSE Arca], Boston and Midwest [now Chicago] Stock Exchanges, permitted some form of institutional membership. For a general discussion of the then existing exchange membership criteria, *see* Sec. Exch. Act Rel. No. 9950, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,178 (Jan. 16, 1973).

(n82)Footnote 82. As of 1973, the executing member normally charged a standard commission, less a professional discount of about 40 percent. *See* SEC, Policy Statement of the Securities and Exchange Commission for the Structure of Central Market System, pp. 48-49 (Mar. 29, 1973) (hereinafter cited as "Policy Statement").

(n83)Footnote 83. For a history of the Commission's analysis, see Sec. Exch. Act Rel. No. 9950, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,178 (Jan. 16, 1973).

(n84)Footnote 84. SEC, Statement on the Future Structure of the Securities Markets (Feb. 2, 1972). (hereinafter referred to as "Future Structure Statement"). The Statement had been preceded by extensive hearings in 1971 which included 83 witnesses and covered 3,907 pages of transcript. In the Matter of the Structure, Operation and Regulation of the Securities Markets (Commission File No. 4-147). The Commission first endorsed the concept of a "central market system" in the letter of transmittal to its 1971 Institutional Investor Study Report, H.R. Doc. No. 92-64, 92d Cong., 1st Sess., pt. 1 (1971).

(n85)Footnote 85. For a discussion of the "central market system" and its successor, the "national market system," see § 2.04 *infra*.

(n86)Footnote 86. Future Structure Statement, *supra*, at p. 10.

(n87)Footnote 87. Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 92d Cong., 2d Sess., Securities Industry Study at 122 (Comm. Print 1972). ("House Study"). The report acknowledged that:

it will be physically impossible to accommodate on one single trading floor all members of a central market system who might wish to trade thereon. Accordingly, some members of the system, must be given priority in the use of the exchanges' physical facilities In this sense, but only in this sense, should the concept of "seats" on a particular exchange have continuing validity. To put the matter differently, a seat on an exchange should not represent a monopoly on its use or economic advantages to exchange members which are disproportionate to the value of the functions they perform for others.

Id. at 122-23.

(n88)Footnote 88. See House Report No. 94-123, 94th Cong., 1st Sess., 48 (1975) (hereinafter cited as "House Report"); See also Hearings on S. 1164 and S. 3347 before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 92d Cong., 2d Sess. (1972).

(n89)Footnote 89. Letter, dated May 26, 1972, from William J. Casey, Chairman, Securities and Exchange Commission, to the President of each national securities exchange, Sec. Exch. Act Rel. No. 9623 (1972).

(n90)Footnote 90. Sec. Exch. Act Rel. No. 9616 (1972).

(n91)Footnote 91. Sec. Exch. Act Rel. No. 9950, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,178 (Jan. 16, 1973).

(n92)Footnote 92. Sec. Exch. Act Rel. No. 12055, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,367 (Jan. 27, 1976).

(n93)Footnote 93. See Response of the Securities and Exchange Commission to the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce, Questionnaire for Regulatory Commissions (July 25, 1975) (hereinafter cited as "SEC Response").

(n94)Footnote 94. A member would be deemed to have the requisite "public purpose" if at least 80 percent of the value of exchange securities transactions within the preceding six months was effected.

(a) for or with persons who are not affiliated with the broker, or

(b) in one of eight categories of specified transactions. Rule 19b-2(a).

(n95)Footnote 95. Policy Statement, *supra*.

(n96)Footnote 96. Policy Statement, *supra*, at p. 49.

(n97)Footnote 97. Policy Statement, *supra*, at p. 52.

(n98)Footnote 98. Policy Statement, *supra*, at p. 52.

(n99)Footnote 99. As of 1973, most exchanges had a rule mandating the commission rates to be charged by members. The Commission had announced its opinion, however, that such rules were not consistent with the just and equitable principles of trade mandated by the Exchange Act and, therefore, would be the subject of remedial rulemaking. For a discussion of the deregulation of exchange mandated commission rates, see § 2.03[2][d] *infra*.

(n100)Footnote 100. Policy Statement, *supra*, at pp. 53-54.

(n101)Footnote 101. Policy Statement, *supra*, at p. 55.

(n102)Footnote 102. Policy Statement, *supra*, at p. 58. The Commission acknowledged, but did not address, the issue of exchange access by foreign financial institutions. *Id.* at pp. 60-61.

(n103)Footnote 103. The Commission's release adopting Rule 19b-4 attempted to respond to many of these criticisms. Sec. Exch. Act Rel. No. 11604, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,267 (Aug. 19, 1975). In summary, opponents of Rule 19b-2 asserted that

- (a) the regulatory objectives of the Exchange Act did not encourage exchange membership,
- (b) the Commission lacked statutory authority to mandate changes to exchange membership rules, and
- (c) adoption of any rule directly affecting exchange membership should be preceded by an evidentiary, adversary hearing.

The Department of Justice supported the Commission's assertion of authority:

[T]here is an open-ended phrasing of Section 19(b) granting the Commission power over exchange rules concerning matters that are "similar" to those enumerated in the statute. Because of this open-ended phrasing and inherent relationship between many of the categories enumerated in 19(b) and membership, it would seem that the Commission does have sufficient power to deal with this problem.

Hearings Before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce, 92d Cong., 2d Sess., pt. 8, p. 4119 (1972).

For a discussion of the effects of the antitrust laws on the Exchange Act and the views of the Department of Justice, see § 2.03[6] *infra*.

(n104)Footnote 104. PBW Stock Exchange, Inc. v. Securities and Exchange Commission, 485 F.2d 718, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,162 (3d Cir. 1973), *cert. denied*, 416 U.S. 969, 94 S. Ct. 1992, 40 L. Ed.

2d 558 (1973). The PBW Stock Exchange (currently the Philadelphia Stock Exchange) was joined by three other petitioners: two broker-dealers and the Treasurer of the State of Connecticut.

(n105)Footnote 105. Section 25(a) of the Act provides, in part, that any "person aggrieved by a final order of the Commission" may obtain review of that order in the United States Court of Appeals in the district in which the aggrieved person resides or has his principal place of business or for the District of Columbia. Judicial review of Commission orders is discussed in § 2.03[4][c] *infra*.

The court in PBW concluded that the Commission had elected to engage in rulemaking under Section 19(b) rather than by order. Accordingly, the court had "no jurisdiction under § 25(a) to review on direct appeal rules and regulations promulgated by the Commission." 485 F.2d at 731.

(n106)Footnote 106. Section 3(a)(3)(A) defines the term "member" when used with respect to a securities exchange to mean

(i) any natural person permitted to effect transactions on the floor of the exchange without the services of another person acting as broker, (ii) any registered broker or dealer with which such a natural person is associated, (iii) any registered broker or dealer permitted to designate as a representative such a natural person, and (iv) any other registered broker or dealer which agrees to be regulated by such exchange and with respect to which the exchange undertakes to enforce compliance with the provisions of [the Exchange Act], the rules and regulations thereunder, and its own rules.

Section 3(a)(3)(B) defines the term "member" with respect to a registered securities association to be "any broker or dealer who agrees to be regulated by such association and with respect to which the association undertakes to enforce compliance with the provisions of [the Exchange Act], the rules and regulations thereunder, and its own rules.

(n107)Footnote 107. Section 6(c)(3). Congress recognized, however, that floor space may be inadequate and, therefore, permitted exchanges to limit the number of memberships available, provided that the number of memberships could not be less than the number in effect on May 1, 1975. Section 6(c)(4).

(n108)Footnote 108. Sections 6(c)(3) and 6(c)(4).

(n109)Footnote 109. Sec. Exch. Act Rel. No. 12157 (1976). After the 1975 Amendments, but before the commencement of the Commission's inquiry, the issue of access by foreign persons and entities arose through correspondence between James J. Needham, then Chairman of the NYSE, and Roderick M. Hills, then Chairman of the Commission. *Id.*

(n110)Footnote 110. Sec. Exch. Act Rel. No. 12737, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,691 (Aug. 25, 1976).

(n111)Footnote 111. Sec. Exch. Act Rel. No. 12737 (1976), *supra*.

(n112)Footnote 112. See Sec. Exch. Act Rel. No. 12055, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,367 (Jan. 27, 1976).

(n113)Footnote 113. See Sec. Exch. Act Rel. No. 14535 (1978), in which the Commission tentatively approved a NYSE proposal that would create two categories of membership: physical floor access and electronic access members. See § 2.01[1] *supra*.

(n114)Footnote 114. See Sec. Exch. Act Rel. No. 14256 (1977).

(n115)Footnote 115. See Sec. Exch. Act Rel. No. 19520 (1983), in which the Commission approved an NYSE proposal to create a class of access rights under the title "Physical Access Membership." See § 2.01[1][a] *supra*.

(n116)Footnote 116. The intermarket trading system is discussed in § 2.04[2][b][i][A] *infra*.

(n117)Footnote 117. Sec. Exch. Act Rel. 39884, at p. 66-68. (Apr. 17, 1998).

(n118)Footnote 118. This provision reflected Congressional concern over the potential adverse market effect of "pool" operations who initiated transactions away from the floor of the exchange and, thus, were unsupervised. See Special Study, *supra*, Pt. 2 at pp. 242-246.

(n119)Footnote 119. See, e.g., former NYSE Rule 394, Amex Rule 5, CBOE Rule 6.49(a), and PSE Rule XIII. For a summary of these rules, see Sec. Exch. Act Rel. No. 11628 (1975). The Commission's Rule 19c-3, discussed *infra*, limited the applicability of these rules to securities listed on or before April 26, 1979. As the result of Commission pressure, all off-board trading rules were completely rescinded by June 1, 2000. See Sec. Exch. Act Rel. No. 16888, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,608 (June 11, 1980).

(n120)Footnote 120. For a discussion of the anticompetitive effect of the off-board trading rules, see Sec. Exch. Act Rel. No. 11628 (1975) and Regulatory Reform Report by the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce, 95th Cong., 1st Sess., 24-29 (1976) (hereinafter cited as the "Regulatory Reform Report").

(n121)Footnote 121. The Commission's 1963 Special Study of the Securities Markets found, for example, that off-board trading "accounts for approximately 5 percent of total exchange purchases and sales, but on occasion accounts for more than 50 percent of all purchases or sales in a given stock over a given day or week." Special Study, *supra*, Pt. 2 at p. 246. Nevertheless, the Study concluded that further information was necessary before "conclusions as to the significance of such trading may be reached." *Id.*, Pt. 5 at pp. 98-99.

Thereafter, in 1965, the Commission's staff completed a special study of NYSE Rule 394, which prohibited off-board trading by NYSE members. SEC, Report: Rule 394 (Sept. 1965) (hereinafter cited as "Rule 394 Report") While the staff acknowledged the prophylactic effect of regulatory supervision of floor trades and public reporting of transactions, the report concluded:

Whatever are the advantages which these aspects offer the public, they must be balanced against the disadvantages as well as considered from the point of view of whether the same advantages could be preserved with certain adjustments in the Rule. On balance, the disadvantages seem to outweigh the advantages, and neither the Rule nor the current interpretations seem to be a *sine qua non* for a healthy market operating in the public interest. It simply goes too far and encompasses too much.

Rule 394 Report at pp. 206-07.

Also in 1965, the Commission represented to Congress that it had the authority to regulate off-board trading rules and that further legislation in this area was not necessary. See letter dated July 30, 1965, from Manuel F. Cohen, Chairman, Securities and Exchange Commission to Hon. A Willis Robertson, Chairman, Senate Committee on Banking and Currency. Nevertheless, the Commission did not initiate any regulatory action until 1973 when, as part of its policy statement on a "central market system," the Commission called for the formation of a new nationwide trading system that would embrace all listed securities and all market centers. This system would render off-board trading rules, such as NYSE Rule 394, obsolete. See Policy Statement, *supra*, at pp. 61-64.

By 1973, both Houses of Congress had determined that off-board trading rules were unnecessary. See H.R. Rep. No.

92-1519, 92d Cong., 2d Sess., XIII (1972); Securities Industry Study Report, S. Doc. No. 93-13, 93d Cong., 1st Sess., 104-05 (1973).

For a discussion of other Congressional statements regarding off-board trading rules, *see* Regulatory Reform Report, *supra*, at pp. 25-27.

(n122)Footnote 122. Section 11A(c)(4)(A).

(n123)Footnote 123. Although Congress did not prohibit off-board trading rules, there was little doubt of Congressional sentiment. A House Subcommittee concluded in 1972 that:

New York Exchange Rule 394 is not necessary to make the Exchange Act work. Accordingly, the New York Stock Exchange should immediately rescind the rule. If this is not done, the Subcommittee will introduce legislation which will have the effect of abrogating the rule.

H.R. Rep. No. 92-1519, 92d Cong., 2d Sess., XIII (1972).

The New York Stock Exchange did not heed this request. Accordingly, H. R. 4111 (the House version of the 1975 amendments) provided that from and after September 1, 1975 no national securities exchange may "by rule or otherwise, limit or condition a member's ability to transact business on any other exchange or otherwise than on an exchange" unless such rule has been previously approved by the Commission. H. R. 4111, Title V. Sec. 501. The accompanying report concluded that "the third market has proved to be a valuable competitive force in the market place, and, accordingly, [the subcommittee] reject[s] proposals that all trading in listed securities be confined to exchange markets." House Report at 91.

Similarly, the Senate, while endorsing the concept of a Commission study of off board trading rules in lieu of an absolute prohibition of such rules, concluded that the Commission should "break down all barriers to competition that do not serve a valid regulatory purpose." Senate Report, § 2.01 *supra*, at p. 8. Thus, the Commission is called upon "to balance, against other regulatory criteria and considerations, the competitive implications" of self-regulatory rules. *Id.* at 13. With respect to off-board trading rules,

The Committee has carefully evaluated all arguments that have been presented in support of abolishing the third market and found them unpersuasive. The advent of competitive commission rates will unquestionably result in altered economic and regulatory conditions in the securities industry. It appears to the Committee, however, that on balance the changes will be beneficial and will contribute to a stronger industry and more efficient markets. Furthermore, the Committee found that the dealers operating in the third market provide valuable competition to the specialists operating on the exchanges and that this competition enhances the total market capacity for listed securities.

Id. at 20-21.

Finally, the Conference Committee, in accepting the Senate proposal for a study of off-board trading rules, emphasized the underlying goal of the 1975 amendments, *i.e.*, to eliminate "restrictive rules and practices which prohibit brokers from searching out the best price for their customers or which limit or impede market making activities as inconsistent with the development of a national market system." Conference Report to the Securities Act Amendments of 1975, H. Rep. No. 94-229, Cong., 1st Sess., 94 (1975) (hereinafter cited as "Conference Report").

(n124)Footnote 124. Sec. Exch. Act Rel. No. 11521 (1975).

(n125)Footnote 125. Sec. Exch. Act Rel. No. 11628 (1975).

(n126)Footnote 126. *Id.* Proposed Rule 19c-1[A] would have, effectively, rescinded all off-board trading rules.

Proposed Rule 19c-1[B] would permit off-board transactions at a price equal to or better than the current bid/offer on the floor. If the proposed off-board transaction was to occur at a price worse than the current bid/offer, the member would be required (a) to verify whether public limit orders on the specialist's book could satisfy the proposed transaction, (b) to believe that a better price may be obtained off floor, and (c) to assure that public limit orders on the specialist's book and disclosed to the member are satisfied at the same prices obtained by the member.

Proposed Rule 19c-1 under the Securities Exchange Act of 1934, reprinted in the Securities Primary Law sourcebook, Volume B, Section G was substantially similar to Proposed Rule 19c-1[B], but would restrict off-board trades to transactions "at a price between the highest bid and the lowest offer on the exchange."

(n127)Footnote 127. In the Matter of Rules of National Securities Exchanges Which Limit or Condition the Ability of Members to Effect Transactions Otherwise than on Such Exchanges, Commission File No. 4-180 (1975). Hearings were held for eight days and encompassed more than 1,400 pages of testimony.

(n128)Footnote 128. *See* Sec. Exch. Act Rel. No. 11942 (1975). Block positioners facilitate the purchase or sale of large blocks by acting as principals in these transactions. *See* New York Stock Exchange Rule 97, NYSE Guide (CCH) P 2097.10 (2003).

(n129)Footnote 129. New York Stock Exchange Rule 97, NYSE Guide (CCH) P 2097.10 (2003). In summary, the Commission also focused on off-board trading restrictions that precluded members from executing OTC transactions as principal or as agent through "in-house" agency crosses and other agency transactions. In deferring further regulatory action, the Commission stated its need for "additional time to develop and propose such new rules (and to eliminate such existing rules) as may be necessary or appropriate in the context of an environment permitting off-board market making by retail firms." *Id.*

Finally, the Commission emphasized its belief that

... the self-regulatory organizations and the securities industry in general should be afforded additional time to take steps to ensure the prompt development of a composite quotation system, a composite book and facilities for the routing and execution of orders and to consider whether changes should be made in existing self-regulatory organization rules coincident with establishment of a more competitive environmental for market making.

Id.

The composite quotation system is discussed in § 2.04[2][c] *infra*.

(n130)Footnote 130. The 1975 Amendments ordered the Commission to "establish a National Market Advisory Board ... to formulate and furnish to the Commission its views on significant regulatory proposals ... concerning the establishment, operation, and regulation of the markets for securities in the United States ... [to] study and make appropriate recommendations to the Commission as to the steps it finds appropriate to facilitate the establishment of a national market system ... [to] study the possible need for modifications of the scheme of self-regulation provided for in this title so as to adapt it to a national market system" and to report to Congress "the results of such study and recommendations."

Sections 11A(d)(1), (3)(A) and (3)(C).

The Board was established on September 30, 1975, and tendered its report to Congress on December 31, 1976. Report of the National Market Advisory Board published in Hearings before the Subcommittee on Oversight and Investigation and the Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce, 95th Cong., 1st Sess., 3-55 (1977) (hereinafter cited as "NMAB Report"). The Board's conclusions and recommendations are discussed in § 2.04[1][d] *infra*.

(n131)Footnote 131. The Board had furnished its preliminary views by correspondence to the Commission in September 1976 and February 1977.

(n132)Footnote 132. See Sec. Exch. Act. Rel. No. 13662, Fed. Sec. L. Rep. (CCH) No. 700 Extra Edition (June 23, 1977) (hereinafter cited as "Off-Board Trading Release").

(n133)Footnote 133. Off-Board Trading Release, *supra*. The composite quotation system is discussed in § 2.04[2][c] *infra*.

(n134)Footnote 134. Off-Board Trading Release, *supra*.

(n135)Footnote 135. Off-Board Trading Release, *supra*.

(n136)Footnote 136. The hearings were conducted in August 1977. Off-Board Trading Release, *supra*.

(n137)Footnote 137. See Sec. Exch. Act Rel. No. 14325, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,397 (Dec. 30, 1977).

(n138)Footnote 138. Sec. Exch. Act Rel. No. 14325 (1977), *supra*.

(n139)Footnote 139. See Exch. Act Rel. No. 14416, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,502 (Jan. 26, 1978). The Commission's announcement was part of a larger statement entitled "Development of a National Market System." This statement summarized the progress to date in the implementation of the Congressionally mandated national market system. In summary, the Commission deferred further consideration of Rule 19c-2 pending receipt of industry responses to the NMAB Report and related Commission statements. *Id*.

(n140)Footnote 140. Sec. Exch. Act Rel. No. 15769, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,061 (Apr. 26, 1979).

(n141)Footnote 141. Sec. Exch. Act Rel. No. 15769 (1979), *supra*.

(n142)Footnote 142. Sec. Exch. Act Rel. No. 15769 (1979), *supra*.

(n143)Footnote 143. The Commission received numerous comments opposing the adoption of proposed Rule 19c-3. The commentators who opposed the rule were concerned primarily with the possibility that broker-dealers with substantial retail order flow or extensive correspondent networks ("integrated firms") would internalize buy and sell orders for 19c-3 securities, *i.e.*, execute these orders completely "in-house" without exposing them to buying and selling interest in other market centers, the sale and purchase of 19c-3 securities. Sec. Exch. Act Rel. No. 16888, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,608 (June 11, 1980). This internalization, the commentators argued, would be more anticompetitive than the off-board trading restrictions which Rule 19c-3 was designed to eliminate. *Id*.

Several commentators suggested that it would be in the best interest of the large integrated firms to execute their retail order flow "in-house," thereby eliminating the opportunity for specialists and third market makers to compete for this order flow. *Id*. Internalization by integrated firms would also place small broker-dealers at a competitive disadvantage because they would no longer be able to provide executions equivalent to those provided by the integrated firms.

Integration of market making and retail business by the larger firms enable them to provide lower cost executions than could be provided by smaller firms. *Id.*

Further, the commentators felt that internalization would result in market fragmentation which would adversely affect market efficiency and liquidity. *Id.* The commentators were afraid that the adoption of Rule 19c-3 would cause the order flow in 19c-3 securities to be directed away from the AMEX and NYSE and "primary" markets. *Id.* Movement away from these primary markets, the commentators feared, would, in the absence of a comprehensive intermarket linkage system, result in a dispersion of order flow that would make the markets in 19c-3 securities less efficient. *Id.*

Other commentators, however, argued that internalization was appropriate if the execution of customer orders was required to be made at a price equal to the best price displayed in the consolidated quotation system. Those commentators suggested that internalization did not raise competitive concerns as long as there was no overreaching, and the customer received an execution price equal to or better than the best price available in any other market. *Id.*

(n144)Footnote 144. Sec. Exch. Act Rel. No. 16888, (1977), *supra*. In its Regulatory Reform Report, the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce stated:

The Commission has been strongly criticized for its protracted response to the Congressional mandate of 1975 to evaluate off-board trading rules and initiate remedial rulemaking action within 90 days of enactment of the Securities Acts Amendments of 1975. According to the House Subcommittee on Oversight and Investigations, the regulatory action taken by the Commission shows a failure by the Commission to carry out the terms of the statute as written by the Congress. It has moved more slowly than the Congress intended. It seems most reluctant to disturb the status quo. It seems to have substituted its own judgment for the basic legislative conclusion. Finding that all criteria for abrogation were met, it nevertheless concluded that it was not wise to take the action required by statute. The Commission may certainly come to Congress and request amendment to the statute. It may not disregard the law.

Regulatory Reform Report, *supra*, at p. 29.

(n145)Footnote 145. Sec. Exch. Act Rel. No. 18062, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,024 (Aug. 25, 1981).

(n146)Footnote 146. See Exch. Act Rel. No. 17744, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,866 (Apr. 21, 1981). This interface is discussed in more detail in § 2.04[2][b][ii] *infra*.

(n147)Footnote 147. The NYSE replaced Rule 394 with Rule 390 to comply with Rule 19c-1 as originally adopted. See Off-Board Trading Release, *supra*. Rule 390 was amended in 1978 in accordance with the amendment of Rule 19c-1. See Sec. Exch. Act. Rel. No. 14599 (Mar. 24, 1978).

(n148)Footnote 148. See Market 2000 Report, *supra*, n.25 at 29-30.

(n149)Footnote 149. Market 2000 Report, *supra*, at 29-30.

(n150)Footnote 150. Sec. Exch. Act Rel. No. 42758 (May 5, 2000).

(n151)Footnote 151. See Sec. Exch. Act Rel. No. 42450; Sec. Exch. Act Rel. No. 42888 (June 1, 2000).

(n152)Footnote 152. For discussion of developments in the area of exchange commission rates in the 1960s, see 2 Loss, *supra*, p. 3173-3186. For a summary of the evolution of exchange commission rates and discussion of the SEC's consideration of such rates prior to the 1975 Amendments, see Sec. Exch. Act. Rel. No. 11203 (Jan. 23, 1975).

(n153)Footnote 153. An exception was provided for schedules or fixed rates on transactions by members acting as floor brokers or odd-lot dealers, until May 1, 1976. An order for less than the number of shares making up the normal unit of trading is an "odd-lot" order. Odd-lot dealers trade with parties placing odd-lot orders to facilitate the execution of these orders.

(n154)Footnote 154. Section 6(e)(1)(B) of the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section F. To assure a proper data base for any ratemaking proceeding, the Commission has explicit authority under Section 17(e) over the accounting practices of brokers and dealers. Senate Report, *supra*, at 72.

Section 6(e)(1)(A) pertains to schedules or fixed charges imposed on transactions occurring prior to November 1, 1976, and required that such commissions only be "reasonable" and "in the public interest."

Prior to the Securities Acts Amendments of 1975, the Commission adopted Rule 19b-3, which prohibited a national securities exchange from requiring, by rule, any member or person associated with a member to charge any person any fixed rate of commission for transactions effected on, or effected by the use of the facilities of, such exchange. Rule 19b-3(a); Sec. Exch. Act. Rel. No. 11203 (Jan. 23, 1975). Furthermore, each exchange was required to provide in its rules that nothing in those rules, or in the practices of the exchange, shall be construed to require or authorize any member, or person associated with a member, to charge any fixed rate of commission for exchange transactions. Rule 19b-3(b). Both the New York and American Stock Exchanges adopted identical rules, effective May 1, 1975, embodying the provisions of Rule 19b-3(b), *See* New York Stock Exchange Rule 388, NYSE Guide (CCH) P 2388 (2003); AMEX Rule 401, AMEX Constitution and Rules (CCH) P 9429B (1978). Rule 19b-3 became effective on May 1, 1975, except as to floor brokerage commissions (the effective date being May 1, 1976). Rule 19b-3(e).

The House of Representatives proposed to adopt the provisions of Rule 19b-3 as part of a new Section 6(p) of the Exchange Act concerning commission rates. *See* H.R. Rep. No. 94-123, 94th Cong. 1st Sess. p. 67 (1975). However, the Conference Committee that acted upon what were to become the Securities Acts Amendments of 1975 did not adopt the House of Representatives' proposal concerning commission rates, but rather adopted a conference substitute that is the present Section 6(e) of the Exchange Act. *See* H.R. Rep. No. 94-229, 94th Cong. 1st Sess. pp. 107-08 (1975). Rule 19b-3, as it was no longer necessary, was rescinded in Sec. Exch. Act. Rel. No. 26180, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,338 (Oct. 14, 1988).

(n155)Footnote 155. The general procedures for proposed rule changes by self-regulatory organizations, contained in Section 19(b), are discussed in § 2.03[1][a] *supra*. For the definition of the term "self-regulatory organization," *see* § 2.01 *supra*.

(n156)Footnote 156. Section 6(e)(3)(A). The Commission has the authority to limit by rule and rulings the oral presentation permitted by subparagraph (A) and to require any cross-examination, also permitted by subparagraph (A), to be conducted by the Commission on behalf of the person entitled to cross-examine. Section 6(e)(3)(B).

In case any class of persons, the members of which are entitled to cross-examination under this section, cannot agree upon a single representative for the purposes of cross-examination, the Commission can, by rule and rulings, determine how such interests will be represented and the cross-examination conducted. Section 6(e)(3)(C)(i). However, a member of a class, upon satisfaction of the Commission that the member has made a reasonable and good faith effort to reach agreement with the class members as to a representative of the class and that there are substantial and relevant issues that would not be presented adequately by the class representative determined by the Commission pursuant to Section 6(e)(3)(C)(i), cannot be denied the opportunity to cross-examine as to the issues affecting that member's particular interests. Sections 6(e)(3)(C)(ii).

The Commission must keep a transcript of any oral presentation and cross-examination. Section 6(e)(3)(D).

If the Commission issues an order pursuant to Section 19(b), *see* § 2.03[1][a] *supra*, approving an exchange rule imposing a schedule or fixed rates of commissions, allowances, discounts, or other fees, a court, reviewing such order, may set the order aside if the court finds either that

(1) a Commission determination that an interested person is not entitled to conduct cross-examination or make rebuttal submissions, or

(2) a Commission rule or ruling limiting the petitioner's cross-examination or rebuttal submissions has precluded full disclosure and proper resolution of disputed issues of material fact necessary for fair determination by the SEC.

Section 6(e)(3)(E).

These bases for setting aside a Commission order are in addition to those specified in Section 25, *see* § 9.02[2][c] *infra. Id.*

(n157)Footnote 157. Senate Report, *supra*, at 72.

(n158)Footnote 158. Furthermore, a broker or dealer, required by the Commission to comply with the rules of the exchange, would be deemed a "member" of the exchange with respect to transactions on the exchange for purposes of various procedural and regulatory provisions of the Exchange Act. *See* Section 3(a)(3), containing the new definition of "member" with respect to an exchange; Section 6(d)(3)(C) with respect to summary action by an exchange involving a nonmember of the exchange. The exchange itself would be entitled to enforce compliance with its rules by any nonmember broker or dealer required to comply with such rules by the SEC under Section 6(f). Senate Report, *supra*, at p. 73.

(n159)Footnote 159. Section 11A(c)(3). The Commission could even prohibit all trading of listed securities in the third market upon carefully prescribed factual findings and subject to judicial review. *Id.* Section 25(b), discussed in § 9.02[2][c] *infra*; Senate Report, *supra*, at p. 73.

(n160)Footnote 160. The Commission has the authority to prescribe, by rule, the disclosure that a person, subject to regulation by the Commission, exercising investment discretion with respect to an account, must make of that person's policies and practices with respect to commissions to be paid for effecting securities transactions. Section 28(e)(2).

The Conference Report of the House Committee on Interstate and Foreign Commerce on what was to become the Securities Acts Amendments of 1975 indicates that the conferees considered the possibility that Section 28(e) could be used to reintroduce the "give-ups" and reciprocal practices of the late 1960's. The conferees concluded that the language of Section 28(e) would not permit such a result. The new Section, they stated, provides only that "a money manager may pay a broker or dealer an amount of commission, for that broker or dealer's executing a transaction, if the money manager determines that the services it receives from that broker or dealer justify the payment. The provisions have no application whatsoever to a situation in which payment is made by a money manager to one broker or dealer for services rendered by another broker or dealer. The give-up was a regrettable chapter in the history of the securities industry and the limited definition of fiduciary responsibility added to the law by this bill will in no way permit its return. H.R. Rep. No. 94-229, 94th Cong. 1st Sess. p. 108 (1975).

(n161)Footnote 161. Market 2000 Report, *supra*, at p.22.

(n162)Footnote 162. Market 2000 Report, *supra*, at p.22.

(n163)Footnote 163. Sec. Exch. Act Rel. No. 34902 (Oct. 27, 1994). Rule 11Ac1-3 provides in part:

(a) No broker or dealer acting as agent for a customer may effect any transaction in, induce or attempt to induce the purchase or sale of, or direct orders for the purchase or sale of, any security unless such broker or dealer informs the customer, in writing, upon opening a new account and on an annual basis thereafter, of the following:

(1) The broker's or dealer's policies regarding receipt of payment for order flow from any broker or dealer, national securities exchange, registered securities association, or exchange member to which it routes customers' orders for execution, including a statement as to whether any payment for order flow is received for routing customer orders and a detailed description of the nature of the compensation received; and (2) The broker's or dealer's policies for determining where to route customer orders that are the subject of payment for order flow absent specific instructions from customers, including a description of the extent to which orders can be executed at prices superior to the best bid or best offer.

Rule 11Ac1-3 also provides the Commission with the authority to issue exemptions to this rule if such exemptions are consistent with the public interest and the protection of investors.

(n164)Footnote 164. What constitutes "reasonable justification or excuse" for relieving a self-regulatory organization of its duty to enforce compliance under Section 19(g)(1) was explained by the Commission in Sec. Exch. Act Rel. No. 12994 (Nov. 18, 1976) (hereinafter cited as "Enforcement Obligations Release"):

[S]ection 19(g)(1) qualifies the obligation to enforce compliance with the phrase 'absent reasonable justification or excuse.' Generally an exchange or association will have 'reasonable justification or excuse' for failing to prevent a particular violation of the Act or the rules thereunder as to which it is required to enforce compliance, unless, at a time when action reasonably within its capacity would have prevented the violation, it knew, or, in view of all the facts and circumstances, should have known, that a member or person associated with a member proposed to commit acts constituting the violation. Similarly, an exchange or association should normally have 'reasonable justification or excuse' with respect to any failure to stop a course of conduct which violates any provision of the Act or the rules and regulations thereunder and as to which it is required to enforce compliance unless it knew, or, in view of all the facts and circumstances, should have known, that its system of reports, examinations and inspections was in material respects inadequate, in relation to resources reasonably available to it for the purpose of detecting such a course of conduct. Also, in appropriate circumstances, an exchange or association will have 'reasonable justification or excuse' if its failure to enforce compliance resulted from its reliance in good faith upon reports prepared by qualified independent third parties, such as independent accountants, unless the exchange or association possessed or should otherwise have discovered information suggesting the need for further inquiry. (Footnotes omitted.)

(n165)Footnote 165. Section 19(g)(1). The enforcement of compliance requirements of Section 19(g)(1) are subject to: (1) the provisions of Section 17(d) (granting the SEC the power to allocate regulatory responsibilities among self-regulatory organizations) discussed in § 2.03[5][b] *infra*; (2) Section 19(g)(2) (granting the SEC authority to relieve a self-regulatory organization from the duty to enforce compliance); and (3) Rule 19g2-1, discussed below. Section 19(g)(1).

Requiring self-regulatory organizations to comply, and to enforce compliance by its members or participants, with these provisions [the Exchange Act, the rules and regulations thereunder, and the rules

of the self-regulatory organization itself], is an essential prerequisite to vigilant and effective self-regulation.

Senate Report, *supra*, at p. 133.

As a requirement for registration as a national securities exchange or national securities association, the Commission must determine that the Applicant is so organized and has the capacity, subject to Section 17(d) (*See* § 2.03[5][b]) or 19(g)(2), to enforce compliance by its members and persons associated with its members, with the provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the applicant. Sections 6(b)(1) and 15A(b)(2) are discussed in § 2.02[2][c][i] *supra*.

(n166)Footnote 166. Section 19(g)(2).

The Committee recognizes, however, that the affirmative duty to enforce compliance imposed by this subsection [19(g)] may not be appropriate in some circumstances. Therefore, although the obligation of a self-regulatory organization would be expressed as an affirmative duty, the Commission would be given the authority to relieve any self-regulatory organization of the responsibility to enforce compliance with specified provisions of the Exchange Act, the rules thereunder, or its own rules, by any member or participant or person associated with a member. It is expected that the Commission will use this authority, for example, to limit in a manner consistent with the purposes of the Exchange Act, a self-regulatory organization's responsibilities with respect to corporate parents of members or participants.

Senate Report, *supra*, at p. 133.

For an exchange or securities association to be registered, the Commission must determine that the rules of the applicant provide for appropriate disciplinary action against members or persons associated with members for violation of the Exchange Act, the rules thereunder, or the rules of the applicant, subject to any rule or order of the Commission pursuant to Section 17(d) (*See* § 2.03[5][b] *infra*) or 19(g)(2). Sections 6(b)(6) and 15A(b)(7), discussed in § 2.02[2][c][i] *supra*.

(n167)Footnote 167. Enforcement Obligations Release, *supra*.

(n168)Footnote 168. Such actions include: adopting rules, conducting inspections, reviewing reports, making inquiries as to particular acts or practices, monitoring trading activity, determining qualifications, denying membership, instituting disciplinary proceedings, and imposing disciplinary sanctions for particular violations. *Id.*

[A] self-regulatory organization is not expected to employ at all times the full range of enforcement techniques with a view to preventing or discovering violations by every possible person associated with a member within the meaning of the Act.

Id.

(n169)Footnote 169. Rule 19g2-1(a) of the 1934 Act, reprinted in the Securities Primary Law Sourcebook, Volume B, Section G. Rule 19g2-1 establishes three classes of associated persons:

(1) a "securities person," defined in Rule 19g2-1(b)(1) as a general partner or officer (or person occupying a similar status or performing similar functions) or employee of an exchange member, and includes the general partners, officers, and employees of a registered broker or dealer that (a) controls, is

controlled by, or is under common control with an exchange member and (b) effects, directly or indirectly, transactions in securities through the exchange member by use of facilities maintained or supervised by such exchange;

(2) a person who controls a member, control being defined by Rule 19g2-1(b)(2) as the power to direct or cause the direction of the management or policies of a company through stock ownership, by contract, or otherwise, provided that the following three classes of persons are presumed to control a member: (A) any person with the right to vote 25 percent or more of the voting securities, (B) any person entitled to receive 25 percent or more of the net profits, or (c) a director of the company (or a person occupying a similar status or performing similar functions); and

(3) all others.

Enforcement Obligations Release, *supra*.

Rule 19g2-1 relieves a national securities exchange (and a registered securities association) of the obligation to take specific types of action, to enforce the Exchange Act and the rules thereunder, depending upon the classification of an associated person. *Id*.

(n170)Footnote 170. Section 12 contains the registration requirements for securities and is discussed in ch. 4 *infra*.

(n171)Footnote 171. Section 13 contains the reporting requirements under the Exchange Act and is discussed in ch. 4 *infra*.

(n172)Footnote 172. Section 14 contains the provisions governing proxies, discussed in ch. 7 *infra*, and tender offers, discussed in ch. 7A *infra*.

(n173)Footnote 173. Section 15(d) governs the reporting requirements under the Exchange Act for issuers with a registration statement that has become effective under the Securities Act of 1933 and is discussed in ch. 4 *infra*.

(n174)Footnote 174. Section 16 governs insider transactions and is discussed in ch. 8 *infra*.

(n175)Footnote 175. Rule 19g2-1(a)(1). An exchange or association does not have any greater obligation to assure compliance with the sections of the Exchange Act specified in Rule 19g2-1(a)(1) by an issuer of securities who is a member of the exchange or association than by any other issuer of securities listed or traded on or through the facilities of the exchange or association. However, Rule 19g2-1 does not "contemplate discontinuance of steps taken by an exchange or association, consistent with the Act, to facilitate the distribution of information provided by any issuer." Enforcement Obligations Release, *supra*.

(n176)Footnote 176. A "securities person" and a person who controls a member are defined above. Rule 19g2-1(a)(2) does not impose any limitation on investigatory techniques when violations are suspected or when appropriate disciplinary proceedings are brought:

The rule simply makes clear that an exchange or association need not employ routine techniques such as reporting requirements or routine inspections with respect to associated persons who are not engaged in the securities business.

Enforcement Obligations Release, *supra*.

(n177)Footnote 177. "Securities person" is defined above.

(n178)Footnote 178. Rule 19g2-1(a)(3). Paragraph (a)(3), when read in connection with paragraph (a)(2), essentially relieves an exchange or association of any obligation to take the specified types of surveillance action (such as administration of examinations or regular inspection programs) with respect to persons who control a member but are not securities persons." Enforcement Obligations Release, *supra*.

(n179)Footnote 179. For a discussion of SRO market surveillance programs, see SEC Report of the Special Study of the Options Markets, 96th Cong., 1st Sess. 197-206 (1978) (hereinafter cited as "Options Study").

(n180)Footnote 180. See Options Study, *supra*, at 243-54.

(n181)Footnote 181. For a general discussion of member firm compliance programs, see Options Study, *supra*, at 487-501.

(n182)Footnote 182. The SROs are required to prevent their members from employing, without appropriate authorization, individuals who have been prohibited from selling securities because they have been found to have violated the federal securities laws or certain other statutes or rules as specified in the Exchange Act, or who are subject to a "statutory disqualification" as defined in the Exchange Act. In addition, each SRO has specified qualification standards for registered representatives which include the passing of certain qualification examinations. As an initial step in the qualifying process, an applicant must apply for registration with the SROs to which his prospective employer belongs. The standard application form used by the SROs requires the applicant to respond to questions about his background and employment history, and to state whether he is currently the subject of any investigation by an SRO, the Commission, or other securities regulatory bodies. Through this registration process, SROs should be able to identify those individuals who may require special supervision by the employing firm, or who should be excluded from the securities business.

When a salesperson leaves a firm, the firm is required to notify each SRO of which it is a member so that the salesperson's registration with the SRO may be cancelled. SROs require these termination notices to specify the circumstances of termination, including whether the salesperson was terminated because he violated a provision of the securities laws or an SRO rule, is or has been the subject of a customer complaint, or has been named as a defendant in a civil action for alleged violations of the securities laws. The SRO compliance staffs believe that termination notices aid significantly in detecting potential problems.

Options Study, *supra*, at 493-94 (footnotes omitted).

(n183)Footnote 183. NASD staff examiners conduct on-site inspections in the offices of broker/dealers who were trading the securities during the periods under investigation. The examiners look at the broker/dealers' books and records, to see precisely what transactions they made, and may request written statements from traders and others, concerning their activities in the securities. Further, the examiners may obtain additional information from investors for whom the transactions were made. This NASD broker/dealer surveillance activity is an important reinforcement of the work of Market Surveillance.

Broker/dealers trading Nasdaq securities are subject not only to the NASD's Market Surveillance regulatory programs, but also the qualification standards, financial reporting requirements, routine examinations and disciplinary proceedings of the Association. In its overall surveillance of broker/dealers, the Association checks for and enforces compliance with the NASD By-Laws and Rules of Fair Practice and with Federal and state regulations.

The NASD through its disciplinary proceedings in 2005, expelled 15 firms, barred 383 individuals and suspended 3 firms and 357 individuals. NASD Regulation Statistics, NASDR Web Site, *available at* www.nasdr.com/web/idcplg?IdcService=ss_get_page&nodeId+749 (updated 2/7/06).

(n184)Footnote 184. Financial regulation of broker-dealers and related SRO programs are discussed in the Options Study, *supra*, pp. 615-92.

(n185)Footnote 185. The purpose of the Net Capital Rule is to ensure that broker-dealers maintain sufficient liquid assets to satisfy promptly the claims of customers in the event the broker-dealer fails, plus a cushion of liquid assets in excess of liabilities to cover potential market and credit risks.

Rule 15c3-1 describes how to compute "net capital." In determining net capital, a broker-dealer first computes its net worth in accordance with generally accepted accounting principles and then adds to that amount subordinated liabilities (as defined in the rule). From that figure, the broker-dealer subtracts assets not readily convertible into cash such as fixed assets, exchange seats, and most unsecured receivables. The broker-dealer then subtracts prescribed percentages of the market value, known as "haircuts," of securities owned by the broker-dealer to discount for market movement. The resulting figure is the broker-dealer's net capital, a figure which reflects the current liquidity status of the broker-dealer, *i.e.*, its ability to pay promptly all liabilities. Under the rule, a broker-dealer may elect one or two specified methods for calculating net capital.

In 1992, the Commission amended the net capital rule to raise the absolute minimum net capital required of certain registered broker-dealers. *See* Sec. Exch. Act Rel. No. 31511, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 5,064 (Nov. 24, 1992).

(n186)Footnote 186. Rule 15c3-3 protects customer funds and securities held by the broker-dealer. The first part of this two part rule requires the broker-dealer to have possession or control of all fully paid and excess margin securities of customers. The broker-dealer must make a daily determination to ensure that its complying with this aspect of the rule. The second part covers customer funds, and requires the broker-dealer to make a periodic computation to determine how much money it is holding which is either customer money or money obtained from use of customer securities (credits). From that figure the broker-dealer subtracts the amount of money which it is owed by customers or by other broker-dealers relating to customer transactions (debits). If the credits exceed the debits, the broker-dealer must deposit the excess in a Special Reserve Bank Account for the Exclusive Benefit of Customers (Special Reserve Bank Account). If the debits exceed the credits, no deposit is necessary. The broker-dealer must therefore provide the capital to finance its firm activities such as the purchase of furniture, fixtures, and equipment and trading, and may not rely upon customers' monies left with the firm for such purposes.

(n187)Footnote 187. *See* Warren & Brown Associates, Inc., Sec. Exch. Act Rel. No. 25963, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,331 (Aug. 4, 1988).

(n188)Footnote 188. The Commission has in the past been critical of uncoordinated, duplicatory SRO surveillance programs. Options Study, *supra*, at pp. 516-518 (footnotes omitted). Subsequently, SROs have attempted to eliminate duplicative efforts, *see* § 2.03[5][b], *infra*; NYSE 1993 Ann. Rep. p. 19.

(n189)Footnote 189. The Commission's annual reports to Congress discuss such evaluations. *See, e.g.*, 59 SEC Ann. Rep., pp. 34-35 (1994). While during the 1980s the Commission was critical of the SROs' ability to adapt their surveillance programs to an increasingly complex market, *see* 47 SEC Ann. Rep., at 10 (1983), it later found that the SROs had made improvements in this area. A Commission review of the NASD Market Surveillance Department in November 1992 found that the NASD had "significantly improved its automation and enhanced its surveillance procedures." A similar inspection of NYSE procedures found "significant improvement in the NYSE's surveillance and investigatory operations for program trading," and that the NYSE maintained "effective programs." 59 SEC Ann. Rep., at 35. The Commission continues to recommend to the SROs that their programs be updated, as it did when reporting that the Boston Stock Exchange's compliance and financial surveillance programs were "adequate but in need of improvement". *Id.*

The Commission's inspection and monitoring programs are discussed in § 2.03[5][a] *infra*.

(n190)Footnote 190. Such nonmember broker-dealers and other persons, designated in Section 6(f)(1), are deemed to be members of the exchange for certain purposes, including compliance with the Exchange Act and the rules thereunder, allocation of fees and charges, disciplinary proceedings by the exchange, and investigations and enforcement proceedings by the Commission. *See* Section 3(a)(3)(A), discussed *supra*.

(n191)Footnote 191. Section 6(f). The Senate Committee on Banking, Housing, and Urban Affairs commented on what was to become Section 6(f) of the Exchange Act:

[T]he Committee is strongly committed to the principle that all persons enjoying preferential or privileged access to execution facilities, *e.g.*, as members now do to exchange markets, should be subject to SEC regulation to insure that their trading is not inconsistent with the maintenance of fair and orderly markets or with equal regulation. This subsection would give the SEC the power to effect such regulation as well as the authority to define the scope and extent of an exchange's responsibility and authority with respect to trading on the exchange by non-members.

Senate Report, *supra*, at p. 99.

(n192)Footnote 192. Sections 6(b)(7) and 15A(b)(8). The requirements for registration as a national securities exchange or national securities association are discussed in § 2.02[2][c] *supra*.

(n193)Footnote 193. The self-regulatory organizations exercise government power, and they do so in basically three ways which may adversely affect the interests of particular persons: (1) by imposing a disciplinary sanction, broadly defined, on a member or person affiliated with a member, (2) by denying membership to an applicant, and (3) by requiring members to cease doing business entirely or in specified ways with a particular non-member or with respect to a particular security.

The self-regulatory organizations must exercise governmental-type powers if they are to carry out their responsibilities under the Exchange Act. When a member violates the Act or a self-regulatory organization's rules, the organization must be in a position to impose appropriate penalties or to revoke relevant privileges. Similarly, a self-regulatory organization must be able to prevent an unqualified person from obtaining access to facilities and business opportunities by denying membership. And members' transactions and relationships with non-members must be regulated, as the Supreme Court pointed out in the *Silver* case, in order that "... contact with an unreliable non-member (does not) injure the member or the member's customer on whose behalf the contract is made and [thus] ultimately imperil the future status of the [self-regulatory organization] by sapping public confidence."

Recognizing that the self-regulatory organizations utilize governmental-type powers in carrying out their responsibilities under the Exchange Act highlights the fact that these organizations must be required to conform their activities to fundamental standards of due process.

Senate Report, *supra*, at pp. 24-25.

(n194)Footnote 194. As previously mentioned, the Exchange Act contained no requirements prior to the 1975 Amendments concerning both the disciplinary proceedings of an exchange and Commission review of enforcement actions of an exchange. However, the Exchange Act contained requirements concerning disciplinary actions by the NASD, *see* § 3.05 *infra*. The 1975 Amendments amended Sections 6(b)(7), 15A(b)(8) (rules of a national securities association must provide a fair procedure for disciplinary and other proceedings), and 19(d) and (e) (notice requirement and review of final disciplinary sanction by SROs) to eliminate the situation prior to the 1975 Amendments whereby the Exchange Act contained standards governing disciplinary actions by the NASD but not by a national securities exchange and to "establish uniform standards to which both exchange and NASD rules would be required to conform

and in accordance with which SEC review would be available." Senate Report, § 2.01 *supra*, at p. 25. Furthermore, the 1975 Amendments established the same procedural requirements and review rights for exchange and NASD actions concerning (1) membership applications and (2) a nonmember of the self-regulatory organization (for the definition of the term "self-regulatory organization" see § 2.01 *supra*.) *Id.*

Since the adoption of the 1975 Amendments, the adequacy of the disciplinary procedures of the NYSE have survived several constitutional challenges. See 6 Loss, Securities Litigation, at p. 2736 fn. 199 (3d. ed. 1990). For example, in 1992 the SEC restated the long-held opinion that, for the purposes of its disciplinary proceedings, the NYSE possessed immunity from liability for alleged violations of constitutional rights, for its authority to discipline, does not make the NYSE a governmental agency for the purposes of the Fifth Amendment.

In re Daniel Turov, Sec. Exch. Act Rel. No. 31649, 53 SEC Dock. 198, 200 (Dec. 23, 1992).

In 2001, in a case arising out of investigations by the SEC and the United State's Attorney's Office involving NYSE floor brokers' improperly sharing in profits on customers' trades, in violation of Section 11(a) and Rule 11a-1, the United States Court of Appeals for the Second Circuit found that the NYSE enjoys immunity from lawsuits when it acts in its capacity as an SRO and its conduct is consistent with the quasi-governmental powers delegated to it under the Exchange Act and SEC regulations. *D'Allessio v. New York Stock Exchange et al.*, 258 F.3d 93 (2d Cir. 2001). The investigation of the floor brokers' activity resulted in numerous disciplinary actions, including an action by the SEC against the NYSE for failure to properly exercise its supervisory responsibility. The SEC's action against the NYSE is discussed in § 2.03[5][d] *infra*. One of the NYSE enforcement actions resulting from this investigation, against John D'Allessio and D'Allessio Securities, Inc., was appealed to the Commission, and sustained in April 2003. Sec. Exch. Act Rel. No. 47627, 2003 LEXIS 806 (Apr. 3, 2003). In sustaining the decision, the Commission rejected several procedural and due process challenges to the NYSE's action, including claims that the respondents were induced to commit the violations at issue by the NYSE's failure to enforce the relevant provisions of the securities laws, and that the action was brought in retaliation for the respondents' lawsuit against the exchange. *Id.* Section 11(a) is discussed in § 3.02 *infra*.

(n195)Footnote 195. Sections 6(d)(1) of the 1934 Act, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F. 15A(h)(2).

(n196)Footnote 196. Sections 6(d)(2), 15A(h)(2).

(n197)Footnote 197. Sections 6(d)(3) and 15A(h)(3).

(n198)Footnote 198. Section 19(d)(1).

(n199)Footnote 199. *Id.* The Commission adopted Rule 19d-1 to prescribe the form and content of notices that self-regulatory organizations for which the SEC is the appropriate regulatory agency must file with the Commission. Sec. Exch. Act Rel. No. 13726,[1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,225 (July 8, 1977) (hereinafter cited as "Disciplinary Sanctions Release"). Rule 19d-1 provides for the content of notices relating to four general types of self-regulatory actions:

- (1) final disciplinary actions (Rule 19d-1(c) and (d)),
- (2) final denial, bar, prohibition, or limitation of membership, participation, or association with a member, or of access to services offered by a self-regulatory organization or a member thereof, based on qualification or administrative rules (Rule 19d-1(e) and (f)),
- (3) based on prior adjudicated statutory disqualifications (Rule 19d-1(g) and (h)), and
- (4) summary suspension of a member, participant, or person associated with a member or summary

limitation or prohibition of any person with respect to access to or services offered by the organization or a member thereof pursuant to Section 6(d)(3), see § 2.03[4][a] *supra* (summary action by a national securities exchange), 15A(h)(3) (summary proceedings by a registered securities association), see § 2.03[4][a] *supra*, or 17A(b)(5)(C) (summary suspension by a registered clearing agency) (Rule 19d-1(i)). *Id.*

Rule 19d-1(a) excludes from the scope of the Rule notice of an action taken by a self-regulatory agency to condition or limit membership, participation or association with a member, or access to services based upon a statutory disqualification as defined in Section 3(a)(39) of the Exchange Act, where the self-regulatory organization and the parties involved have; agreed on the conditions or limitations. In such a case, notice is filed pursuant to Rule 19h-1, see § 2.03[5][d] *infra*, since the SEC will review all such actions on the merits and not merely where an appeal is taken or where the SEC calls up the matter. Disciplinary Sanctions Release, *supra*.

(n200)Footnote 200. Section 19(d)(2). The Commission adopted Rules 19d-2 and 19d-3 to set forth certain Commission review procedures. Disciplinary Sanctions Release, *supra*. The two rules are not reporting rules as such and do not apply to actions over which the Commission has no review jurisdiction. *Id.* Persons desiring to stay actions by a self-regulatory organization must apply to the Commission pursuant to Rule 19d-2. *Id.* Filing may be by telegram or otherwise, and the request for a stay must be in writing and include a statement why the stay of the self-regulatory action should be granted. Rule 19d-2. Prior to the 1975 Amendments, NASD disciplinary actions were subject to the automatic stay provisions of Section 15A(g) of the Exchange Act. Disciplinary Sanctions Release, *supra*. Now, sanctions may become effective upon the date set by the self-regulatory organization, unless the Commission orders a stay. *Id.*

Rule 19d-3 provides procedures for review of all final disciplinary sanctions, membership denials, and similar actions of self-regulatory organizations (SROs):

The Secretary of the Commission will serve a copy of the application for review on the SRO which, within 10 days, must certify and file with the Commission one copy of the record and seven copies of an index of the record. The Secretary will then serve on the parties copies of the index and any papers subsequently filed. The applicant may file a brief within 20 days after receipt of the copy of the index and, within 20 days thereafter, the SRO shall file its brief. Oral argument may be requested by the applicant or the SRO which request may be granted or denied at the discretion of the Commission. These procedures are essentially the same as those found in present Rule 15Ag-1 (as to the NASD), which is rescinded.

Disciplinary Sanctions Release, *supra*.

(n201)Footnote 201. Section 19(e)(1)(A). In a proceeding to review a final disciplinary action by an SRO, after notice of the proceeding has been given, there must be an opportunity for a hearing prior to the affirmance, modification, or remand, as the case may be. Such hearing may consist solely of consideration of the record before the Commission and opportunity for presentation of supporting reasons for the Commission action desired by the party making the presentation. Section 19(e)(1).

(n202)Footnote 202. Section 19(e)(1)(B).

(n203)Footnote 203. Section 19(e)(2). For discussion of the provisions added by the 1975 Amendments directing the Commission to review burdens on competition, see § 2.02[2][c][ii] *supra*.

(n204)Footnote 204. An exclusionary action is an action of the type described in Section 6(d)(2) or Section

15A(h)(2) governing SRO procedures for denial of membership. *See* § 2.03[2][a] *supra*.

(n205)Footnote 205. Section 19(f).

(n206)Footnote 206. The written petition must request that the final order of the Commission be modified or set aside in whole or in part. Section 25(a)(1). For discussion of appeals from Commission orders, *see* § 9.02 *infra*.

(n207)Footnote 207. *See* § 2.03[3][a] *supra*.

(n208)Footnote 208. Section 17(a) authorizes the Commission, by rule, to proscribe recordkeeping requirements applicable to SROs and the circumstances under which copies of such records shall be furnished to the Commission. Rule 17a-1(c) provides, in pertinent part, that every SRO "shall, upon request by any representative of the Commission, promptly furnish to the possession of such representative copies of any documents required to be kept and preserved" pursuant to Rule 17a-1(a) or (b).

(n209)Footnote 209. For a discussion of the statutory duties of SROs, *see* § 2.03[3][a], *supra*.

(n210)Footnote 210. International Institute for Securities Market Development, Markets and Regulation Overview, Securities and Exchange Commission, p. 11 (1993) (hereinafter cited as "International Institute"). SRO surveillance programs are discussed in § 2.03[3][a], *supra*. The results of the Commission's inspections are summarized in the Commission's annual report to Congress.

(n211)Footnote 211. When the Commission authorized the commencement of trading in standardized options, for example, the Commission labeled the endeavor a "pilot" project and instituted a monitoring program. *See* Sec. Exch. Act Rel. No. 9985, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,212 (Feb. 1, 1973). After the adoption of Rule 19c-3 permitting off-board trading in certain exchange listed securities, *see* § 2.03[2][c] *supra*, the Commission instituted a monitoring program to determine the extent of off-board trading and its impact on the market. Sec. Exch. Act Rel. No. 18062, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,024 (Aug. 25, 1981). Similarly, the Commission watched closely the activities of the Cincinnati Stock Exchange, now known as the National Stock Exchange, when it commenced trading operations in 1978 and requested periodic data upon which a special report was based. SEC, Report on the Operation of the Cincinnati Stock Exchange (1982). Special reports also have been issued by the Commission on the effect of Section 6(c)(3), which prohibited exchange rules that fixed commission rates, and on the operation of the Intermarket Trading System (*see* § 2.04[2][b][i][A], *infra*).

(n212)Footnote 212. In 1978, for example, the Commission's staff observed, during an inspection of a regional securities exchange, that trading continued on the floor of the exchange in standardized options after the close of the NYSE market. Upon inquiry to other exchanges, the staff verified that the several exchanges which traded standardized options did not have a common rule regulating the cessation of trading at the close of a trading day. The Commission requested the exchanges to adopt such a rule. The exchanges responded with a uniform rule that would permit trading in standardized options to extend through 4:10 p.m. (E.S.T.). *See* Sec. Exch. Act Rel. No. 15241 (Oct. 18, 1978).

(n213)Footnote 213. *See* § 2.03[5][d] *infra*.

(n214)Footnote 214. Section 17(d)(1). This provision was added through the Securities Acts Amendments of 1975 in order to remedy two "significant" defects:

1. The activities and records of many firms are subject to inspection and surveillance by more than one self-regulatory agency. This may lead, on the one hand, to duplication of effort and increased expense to the firms, and, on the other hand, to the danger of violations that are missed because they fall somewhere between the responsibilities of different agencies. The Commission and the self-regulatory agencies have over the years arrived at general understandings governing the allocation of regulatory responsibilities, but these understandings are informal and tend to be somewhat inexact in practical application. The

Commission found large gaps in the coverage and coordination of the regulatory pattern.

2. The standards of the different self-regulatory agencies differ both in substance and in enforcement. As a result public investors cannot always rely on uniform rules being applied to the different brokers with whom they may deal.

Senate Report at 32.

(n215)Footnote 215. Section 17(d)(1)(A).

(n216)Footnote 216. Section 17(d)(1)(B).

(n217)Footnote 217. Section 17(d)(1).

(n218)Footnote 218. Sec. Exch. Act Rel. No. 12935 (Oct. 28, 1976).

(n219)Footnote 219. See 43 SEC, Ann. Rep., p. 18 (1978); 44 SEC, Ann. Rep., p. 19 (1979); 46 SEC Ann. Rep., p. 12 (1981); 47 SEC, Ann. Rep., p. 14 (1982). Within nine months after the adoption of Rule 17d-2, SROs filed 21 plans with the Commission. Of these, 15 embodied agreements between two exchanges with respect to dual members. In general these plans pertained to allocation of financial responsibility monitoring activity. In addition, plans were submitted to permit the NASD to assume responsibility for inspecting the retail firm activities of regional exchange members who were also NASD members. Also, the then five exchanges that traded standardized options submitted a plan to eliminate duplicative investigations of questionable options transactions. See 43 SEC Ann. Rep., at p. 18 for a more detailed discussion of these plans.

(n220)Footnote 220. See Sec. Exch. Act Rel. No. 37542, 1996 SEC LEXIS 2121 (Aug. 8, 1996) (hereinafter cited as "NASD Report") and Sec. Exch. Act Rel. No. 37538, 1996 SEC LEXIS 2146 (Aug. 8, 1996) (hereinafter cited as "NASD Disciplinary Order"). For a more detailed description of the Nasdaq settlement, see § 2.03[5][d] *infra*.

(n221)Footnote 221. NASD Disciplinary order, *supra*.

(n222)Footnote 222. In November 2004 the Commission proposed to adopt a new Rule 15Aa-3 that would require, among other things, that a national securities association's board of directors have a majority of independent directors. Governance and Transparency Release, *supra*, at *57. The rule would also require that each national securities association have, at a minimum, Nominating, Governance, Compensation, Audit and Regulatory Oversight Committees. *Id.* at *87.

(n223)Footnote 223. See Sec. Exch. Act Rel. No. 39729 (Mar. 6, 1998) (SEC approval of the Order Audit Trail System, OATS).

(n224)Footnote 224. The Quote Rule is discussed in § 2.04[2][c][i], *infra*.

(n225)Footnote 225. NASD Disciplinary order, *supra*.

(n226)Footnote 226. Report of NASD Select Committee on Structure and Governance to NASD Board of Governors (September 15, 1995).

(n227)Footnote 227. *Id.* This restructuring of the NASD was originally approved by the SEC on a temporary accelerated basis in 1996. See Exch. Act Rel. No. 37107 (Apr. 11, 1996). Subsequent temporary approvals were granted in Exch. Act Rel. No. 37425 (July 11, 1996); Exch. Act Rel. No. 37957 (Nov. 15, 1996); Exch. Act Rel. No. 38645 (May 15, 1997); and Exch. Act Rel. No. 38909 (Aug. 7, 1997). The NASD later reduced its ownership in Nasdaq in connection with Nasdaq's transition to for-profit status, and intends to ultimately divest itself of its remaining ownership

interest in Nasdaq. See § 2.05 *supra*. In its Governance and Transparency Release issued in November 2004, the Commission proposed to require national securities associations to ensure that their regulatory program be either functionally or structurally separate from its market operations or other commercial enterprises. Governance and Transparency Release, *supra*, at *110-111. It also proposed, as a means of allowing the Commission to monitor the degree of control exercised by a single member, a new Rule 17a-27 that would require any member of an association to disclose to the Commission its beneficial ownership of 5 percent of more of any class of securities of the association or a facility of the association. *Id.* at *367-69.

(n228)Footnote 228. Report of NASD Select Committee on Structure and Governance to NASD Board of Governors (Sept. 15, 1995).

(n229)Footnote 229. See Laurie P. Cohen and Deborah Solomon, *NYSE Feels Heat from Inside and Outside*, Wall St. Journal, September 16, 2003, at C1; Sec. Exch. Rel. No. 48946, 2003 SEC LEXIS 3009 (Dec. 17, 2003) (hereinafter cited as "NYSE Governance Release").

(n230)Footnote 230. NYSE Governance Release, *supra*; Cohen and Solomon, *supra*.

(n231)Footnote 231. Cohen and Solomon, *supra*.

(n232)Footnote 232. Cohen and Solomon, *supra*.

(n233)Footnote 233. See Cohen and Solomon, *supra*.

(n234)Footnote 234. Cohen and Solomon, *supra*.

(n235)Footnote 235. NYSE Governance Release, *supra*.

(n236)Footnote 236. NYSE Governance Release, *supra*, at *4-5.

In November 2004 the Commission proposed to adopt a new Rule 6a-5 that would require, among other things that the majority of the members' of an exchange's board of directors be independent. Governance and Transparency Release, *supra*, at *57. The rule would also require that each exchange have, at a minimum, Nominating, Governance, Compensation, Audit and Regulatory Oversight Committees. *Id.* at *87. In addition, as a means of allowing the Commission to monitor the degree of control exercised by a single member, a new Rule 17a-27 would require any member of an exchange to disclose to the Commission its beneficial ownership of 5 percent of more of any class of securities of the exchange or a facility of the exchange. *Id.* at *367-69.

(n237)Footnote 237. NYSE Governance Release, *supra*, at *5.

(n238)Footnote 238. NYSE Governance Release, *supra*, at *4-5.

(n239)Footnote 239. Sec. Exch. Act Rel. No. 51217 (Feb. 16, 2005) (hereinafter cited as "NYSE Independence Release").

(n240)Footnote 240. NYSE Independence Release, *supra*.

(n241)Footnote 241. NYSE Independence Release, *supra*. These specific independence criteria are modeled on the criteria applicable to directors of NYSE-listed issuers. See Sec. Exch. Act Rel. No. 51217 (Feb. 16, 2005).

(n242)Footnote 242. NYSE Governance Release, *supra*, at *9.

(n243)Footnote 243. NYSE Governance Release, *supra*, at *9-10.

(n244)Footnote 244. Section 6(b)(3). The fair representation and other relevant requirements applicable to exchange rules are discussed in § 2.02[2] *supra*.

(n245)Footnote 245. See NYSE Governance Release, *supra*, at *11.

(n246)Footnote 246. NYSE Governance Release, *supra*, at *11-12.

(n247)Footnote 247. NYSE Governance Release, *supra*, at *12-13.

(n248)Footnote 248. NYSE Governance Release, *supra*, at *13-14.

(n249)Footnote 249. NYSE Governance Release, *supra*, at *14.

(n250)Footnote 250. NYSE Governance Release, *supra*, at *14-23.

(n251)Footnote 251. NYSE Governance Release, *supra*, at *15-16.

(n252)Footnote 252. NYSE Governance Release, *supra*, at *21.

(n253)Footnote 253. NYSE Governance Release, *supra*, at *21.

(n254)Footnote 254. NYSE Governance Release, *supra*, at *22.

(n255)Footnote 255. NYSE Governance Release, *supra*, at *23-31.

(n256)Footnote 256. NYSE Independence Release, *supra*; NYSE Guide, *supra*, at PP 1164, 1406.

(n257)Footnote 257. NYSE Independence Release, *supra*; NYSE Guide, *supra*, at P 1403. This change was deemed necessary because decisions of exchange hearing panels are subject to review by the exchange's Regulation, Enforcement and Listing Standards Committee, which includes members of the Board of Executives. Sec. Exch. Act Rel. No. 51217 (Feb. 16, 2005).

(n258)Footnote 258. Sec. Exch. Act Rel. No. 50133, 2004 SEC LEXIS 1700, at *5-6 (Aug. 2, 2004) (hereinafter cited as "NYSE RELS Amendment").

(n259)Footnote 259. NYSE RELS Amendment, *supra*, at *5-6.

(n260)Footnote 260. NYSE RELS Amendment, *supra*, at *7 n.6.

(n261)Footnote 261. Dean Starkman and Ben White, NYSE Approves Archipelago Acquisition, Electronic Stock Exchange Joins Big Board, Washington Post, December 7, 2005, at D1; Final Prospectus pursuant to Rule 424(b)(3) filed by NYSE Group, Inc., SEC File No. 333-126780 (Nov. 4, 2005) (hereinafter cited as "NYSE Merger Prospectus").

(n262)Footnote 262. NYSE Merger Prospectus at 125-26.

(n263)Footnote 263. NYSE Merger Prospectus at 126. NYSE Regulation is anticipated to provide services to New York Stock Exchange LLC and Archipelago pursuant to a services agreement. *Id.* at 264. A rule proposed by the Commission in its Governance and Transparency Release in November 2004 would require exchanges to provide for a functional or structural separation of their regulatory program from their market operations or other commercial enterprises. Governance and Transparency Release, *supra*, at *110-111.

(n264)Footnote 264. Section 15(b)(4) governs Commission orders of censure, limitation on activities, functions, or operations of, suspension, or deregistration of brokers and dealers. Control over brokers and dealers is discussed in ch. 3 *infra*.

1-2 Federal Securities Exchange Act of 1934 § 2.04

(n265)Footnote 265. Section 15(b)(6) governs the censure, limitation on the activities or functions, suspension for a period not exceeding twelve months, or bar of any person associated with or seeking to become associated with a broker or dealer, by order of the Commission.

(n266)Footnote 266. The Commission may sanction a member, participant, or person associated with a member pursuant to Section 19(h)(2) or (3) without the necessity for prior action by an SRO.

(n267)Footnote 267. For the definition of the terms "self-regulatory organization" and "appropriate regulatory agency" *see* § 2.02[2] *supra*.

(n268)Footnote 268. For discussion of the Commission's interpretation of what constitutes "reasonable justification or excuse" in the context of Section 19(g)(1), *see* § 2.03[3][a] *supra*.

(n269)Footnote 269. Section 19(h)(1). Registered securities associations are also charged with the responsibility of enforcing the rules of the Municipal Securities Rulemaking Board and therefore may be subject to a disciplinary action if they fail to adequately enforce these rules. *Id.*

(n270)Footnote 270. Specifically, Section 15A(e), (f), (g), (h), (j), (k), and (l) and Section 19(a) and (b).

(n271)Footnote 271. *See* H. Rep. No. 94-75, 94th Cong., 1st Sess., 111-12 (1975).

(n272)Footnote 272. The term "self-regulatory organization" is defined by Section 3(a)(26) to mean any national securities exchange, registered securities association, or registered clearing agency. The term "self-regulatory organization" also includes the Municipal Securities Rulemaking Board (the "Board") but only for purposes of: (1) the Board's proposed changes of its rules, (2) Commission amendment of Board rules, and (3) Commission reports to Congress.

Furthermore, as a result of the 1975 Amendments, the SEC is the "appropriate regulatory agency" for national securities exchanges, registered securities exchanges, registered securities associations, the Municipal Securities Rulemaking Board and any nonbank clearing agency. Section 3(a)(34).

(n273)Footnote 273. *See* the introductory Subsection of § 2.03 *supra*.

(n274)Footnote 274. Section 19(a)(1) is discussed in connection with national securities exchanges in § 2.02[2][c] *supra*.

(n275)Footnote 275. Section 19(a)(3) is discussed in § 2.02[2][d] *supra*.

(n276)Footnote 276. Section 19(b) is discussed in § 2.03[1][a] *supra*. Rule 19b-4, pertaining to filings with respect to proposed rule changes by a self-regulatory organization, is also discussed in § 2.03[1][a] *supra*.

(n277)Footnote 277. Section 19(c) is discussed in § 2.03[1][b] *supra*.

(n278)Footnote 278. Notice to the Commission of final disciplinary action, or denial, bar, or limitation respecting membership, by a self-regulatory organization is governed by Rule 19d-1.

Rule 19d-2, pertaining to applications to the Commission for stays of final disciplinary sanctions or summary suspensions by a self-regulatory organization, is discussed above.

Rule 19d-3, pertaining to applications and procedure for, Commission review of final disciplinary sanction, denial or conditioning of membership, association, or participation, or prohibition or limitation with respect to access to services by either a self-regulatory organization or a member thereof, is discussed above.

SROs are required under Section 19(d)(1) of the Exchange Act and Rule 19d-1 to file reports with the SEC of all final disciplinary actions. In fiscal 2002, the SROs filed a total of 2,507 reports with the SEC, as follows: 30 by Amex, 112 by CBOE, 414 by the Chicago Stock Exchange, 1,317 by the NASD, 528 by the NYSE, 25 by the Philadelphia Stock Exchange and 68 by the Pacific Exchange. No reports were filed by the Boston or National Stock Exchanges. SEC Ann. Rep. (2002), at pp. 75-76.

(n279)Footnote 279. Section 19(e) is discussed in § 2.03[4][b] *supra*. In the case of a registered securities association, violation of the rules of the Municipal Securities Rulemaking Board is one of the grounds for a final disciplinary sanction to be imposed by a registered securities association upon a member thereof, participant therein, or person associated with a member; and, a sanction based thereon is subject to Commission review under Section 19(e)(1)(A).

Judicial review of a final order of the Commission is provided for in Section 25(a)(1).

(n280)Footnote 280. A registered securities association is required, absent reasonable justification or excuse, to enforce compliance with the provisions of the rules of the Municipal Securities Rulemaking Board by its members and persons associated with its members, Section 19(g)(1)(B), unless relieved from responsibility to enforce compliance by Commission rule, Section 19(g)(2).

Rule 19g2-1 sets forth the matters for which a registered securities association, and a national securities exchange, are not required under Section 19(g) to enforce compliance.

(n281)Footnote 281. A registered securities association may be sanctioned for failure to enforce compliance by a member or person associated with a member with any provision of the rules of the Municipal Securities Rulemaking Board. Section 19(h)(1)(B). Any member of, or participant in, a registered securities association may be suspended for up to twelve months or expelled from the association, if such member or participant willfully violates, or effects any transaction for any other person whom the member or participant had reason to believe was violating with respect to such transaction, the rules of the Municipal Securities Rulemaking Board. Section 19(h)(2)(B). Any person may be suspended for up to twelve months or barred from being associated with a member of a registered securities association, if such person willfully violates, or effects any transaction for any other person whom the person associated with a member had reason to believe was violating with respect to such transaction, the rules of the Municipal Securities Rulemaking Board. Section 19(h)(3)(B). Finally, any officer or director of a registered securities association may be removed from office or censured by the Commission, if such officer or director, without reasonable justification or excuse, has failed to enforce compliance with any provision of the rules of the Municipal Securities Rulemaking Board by any member of a registered securities association. Section 19(h)(4)(B).

Rule 15A12-1 provides that Rule 15b7-1, governing proceedings under Sections 15(b), 15A(1)(2) and 19(a)(3) of the Exchange Act, governs a proceeding under Section 15A(1)(2), transferred in amended form to Section 19(h)(2), to the extent that such proceeding involves the conduct of any person other than a member of a national securities association.

(n282)Footnote 282. For discussion of the Commission's interpretation of what constitutes "reasonable justification or excuse" in the context of Section 19(g)(1), see § 2.03[3][a] *supra*.

(n283)Footnote 283. Section 19(h)(4). Section 19(h)(4) combines the powers of the Commission over exchange officials in old Section 19(a)(3) and its powers over NASD officials in old Section 15A(l)(3). See Senate Report, *supra*, at p. 134.

(n284)Footnote 284. Disciplinary Sanctions Release, *supra*.

(n285)Footnote 285. The term "statutory disqualification" is defined in Section 3(a)(39) of the Exchange Act, See

§ 2.03[2][a] *supra*. Rule 19h-1(a) requires the filing of the notice and supporting record of the proposed admission or continuance in membership, participation, or association with a member of any person subject to a statutory disqualification. If such person has not consented to the proposed admission or continuance, then notice must be filed pursuant to Rule 19d-1. § 2.03[4][b] *supra*.

In the case of a national securities exchange, or registered securities association, notice need be filed with the Commission pursuant to Rule 19h-1 with respect to a person associated with a member only if such person: (1) controls (as defined in Rule 19h-1(f)(2), such definition being identical to that in Rule 19g2-1(b)(2), *see* § 2.03[3][a] *supra*, except Rule 19g2-1 uses a 25 percent stockholding or net profit entitlement standard, whereas Rule 19h-1(f) uses a 10 percent standard for stockholding or net profit entitlement) the member or is a general partner, officer, or employee of such member, or (2) is an unregistered broker or dealer, controls an unregistered broker or dealer, or is a general partner of such broker or dealer. Rule 19h-1(a). One purpose behind this provision is to avoid the burden upon all parties concerned of requiring a self-regulatory organization to notify the SEC in the case of a disqualified person not in a control position in relation to the member firm and employed in a non-securities affiliate of a large, diversified corporation. Disciplinary Sanctions Release, *supra*. Another purpose is to require the filing of a notice in the case of a nonmember affiliate in the securities business:

[N]onmember affiliates which are in the securities business are of significant regulatory concern in the context of the purposes of the reporting requirements of the Rule. However, those affiliates will, unless not registered with the Commission, generally fall under the immediate jurisdiction of another SRO [self-regulatory organization] ... which would be responsible for compliance with the Rule as to both the affiliate and its personnel.

Id.

Rule 19h-1(a) also provides that notice need not be filed with the Commission pursuant to Rule 19h-1 if:

(1) the person subject to the statutory disqualification is then a participant in, member of, or a person associated with a member of another self-regulatory organization and the proposed admission or continuance is on essentially the same terms and conditions as the person's prior admission or continuance, or

(2) the sole disqualification consists of a willful violation of the Securities Acts, Investment Advisers Act, Investment Company Act, or a rule or regulation under one or more of such Acts and the sanction for such violation is no longer in effect.

Under Rule 19h-1(b), a second notice representing the same proposed employment need not be filed by a second self-regulatory organization, after the first filing of such notice by a different self-regulatory organization, if the second organization agrees with the terms and conditions of the notice filed by the first organization. Such concurrence would be noted in the application for admission or continuance filed pursuant to Rule 19h-1(a). Rule 19h-1(c)(6). *See* Disciplinary Sanctions Release, *supra*.

(n286)Footnote 286. Rule 19h-1(d), (e), (g), and (h). At the time of filing a notice pursuant to Rule 19h-1(a), an application may be made to the Commission for an order stating that the Commission will not proceed under Section 15(b) (empowering the Commission to sanction a broker or dealer, *see* § 3.03[7] *infra*) or 19(h), notwithstanding the statutory disqualification. Rule 19h-1(d). Rule 19h-1(a) requires the filing of notice not only in the case of a disqualified person initially seeking entry or reentry, but also when a disqualified person is to be continued in membership or association. In both cases:

... the Commission, depending upon the nature of the disqualification, may have independent authority under section 15(b) or 19(h) effectively to prevent the admission or continuance and will need to have the information called for in the notice [required by Rule 19h-1(a)] to determine if it wishes to exercise that power.

Disciplinary Sanctions Release, *supra*. Accordingly, an application pursuant to Rule 19h-1(d) is needed.

Under Section 6(c)(2) of the Exchange Act, a national securities exchange cannot admit a person to membership or permit a person to become associated with a member if that person is under a statutory disqualification, without prior notice to the Commission. *See* § 2.03[2][a] *supra*. Rule 19h-1 implements, in part, the provisions of Section 6(c)(2) (and also of Sections 15A(g)(2), *see* § 2.03[2][a] *infra*, and 17A(b)(4)(A), *see* § 2.03[2][a] *supra*) by requiring notice to the Commission by the self-regulatory organization respecting proposed admissions of disqualified persons. Disciplinary Sanctions Release, *supra*. The notice filed pursuant to Rule 19h-1(a) may be accompanied by an application to the Commission for an order declaring that the Commission will not direct otherwise, *i.e.*, will not direct that membership be denied, as provided in Section 6(c)(2), 15A(g)(2), or 17A(b)(4)(A). Rule 19h-1(d)(2).

Rule 19h-1(e) describes the contents of an application filed pursuant to Rule 19h-1(d). The Commission may grant or deny an application filed pursuant to Rule 19h-1(d) on the basis of the papers filed by the parties, without an oral hearing, unless a request for oral hearing or argument is submitted with the application. Rule 19h-1(g). The SEC Rules of Practice (17 C.F.R. Part 201, *see* § 9.02[2][a] *infra*) apply to proceedings under Rule 19h-1 to the extent that they are not inconsistent with Rule 19h-1. Rule 19h-1(h).

(n287)Footnote 287. NASD Report, *supra*.

(n288)Footnote 288. NASD Report, *supra*.

(n289)Footnote 289. NASD Report, *supra*. A "Section 21(a) report" is issued under Section 21(a) of the Exchange Act, which grants the Commission the authority to issue a report detailing findings of violations of the securities laws, generally in lieu of an enforcement action. In the NASD's case, however, the Section 21(a) report supplemented an enforcement action.

(n290)Footnote 290. NASD Release, *supra*. The NASD's undertakings are described in § 2.03[5][c][i] *supra*.

(n291)Footnote 291. Sec. Exch. Act. Rel. No. 41574, 1999 SEC LEXIS 1290 (June 29, 1999) (hereinafter cited as "NYSE Release").

(n292)Footnote 292. NYSE Release, *supra*.

(n293)Footnote 293. NYSE Release, *supra*. For example, the NYSE suspended this surveillance from approximately August 1995 through December 1997. *Id*.

(n294)Footnote 294. The undertakings included, among others, the NYSE's agreeing to:

- improve its regulation of independent floor brokers, specialists, and other exchange members by, among other things, engaging in continuous surveillance of all members on the floor of the exchange, ensuring that members of the exchange's regulatory staff are present on the floor at all times during trading hours, and increasing its enforcement staff;
- form an independent committee of the exchange's board of directors to draft comprehensive procedures manuals detailing the objectives of the NYSE's surveillance program governing members on the floor of the exchange;

- design and implement a mandatory education program for members on the floor of the exchange; and

- continue the development of an electronic audit trail system.

NYSE Release, *supra*.

(n295)Footnote 295. Sec. Exch. Act Rel. No. 48566, 2003 SEC LEXIS 2309 (Sept. 30, 2003) (hereinafter cited as "Chicago Stock Exchange Release"). The Quote Rule, trading ahead and Limit Order Display Rule are discussed in §§ 2.04[2][c][1], 2.04[2][f] and 2.04[2][g] *infra*, respectively.

(n296)Footnote 296. Chicago Stock Exchange Release, *supra*,

(n297)Footnote 297. Chicago Stock Exchange Release, *supra, supra*, at *26.

(n298)Footnote 298. Chicago Stock Exchange Release, *supra*, at *28-41.

(n299)Footnote 299. Chicago Stock Exchange Release, *supra*.

(n300)Footnote 300. Sec. Exch. Act Rel. No. 51524, 2005 SEC LEXIS 814 (Apr. 12, 2005) (hereinafter cited as "2005 NYSE Disciplinary Order").

(n301)Footnote 301. 2005 NYSE Disciplinary Order, *supra*, at *11-12.

(n302)Footnote 302. *See* 2005 NYSE Disciplinary Order, *supra*, at *6-9. Specialists have an affirmative obligation to trade for their own account where necessary to maintain an orderly market, but also a negative obligation to refrain from trading for their own account when it is not necessary, i.e., when customer orders can be matched with each other. *See id.* at 6-7. *See also* § 2.01[1][a][i] *supra*, describing the function of a specialist. Interpositioning and trading ahead violate Section 11(b) of the Exchange Act and Rule 11b-1 thereunder and NYSE Rules 92 and 104.10. 2005 NYSE Disciplinary Order, *supra*, at *8-9.

(n303)Footnote 303. 2005 NYSE Disciplinary Order, *supra*, at *36.

(n304)Footnote 304. 2005 NYSE Disciplinary Order, *supra*, at *14.

(n305)Footnote 305. 2005 NYSE Disciplinary Order, *supra*, at *19-20.

(n306)Footnote 306. 2005 NYSE Disciplinary Order, *supra*, at *21.

(n307)Footnote 307. 2005 NYSE Disciplinary Order, *supra*, at *22-23.

(n308)Footnote 308. *Id.* at *27-29.

(n309)Footnote 309. These changes are discussed in § 2.03[5][c][ii] *supra*.

(n310)Footnote 310. *Id.* at *33-34.

(n311)Footnote 311. 2005 NYSE Disciplinary Order, *supra*, at *37-50.

(n312)Footnote 312. Sec. Exch. Act Rel. No. 51525, 2005 SEC LEXIS 813 (Apr. 12, 2005).

(n313)Footnote 313. *Id.* at *3. Specifically, the former specialists were alleged to have violated Section 17(a) of

the Securities Act, Sections 10(b) and 11(b) of the Exchange Act, and Rules 10b-5 and 11b-1 thereunder, and NYSE Rules 92, 104, 123B and 401. *Id.* at *3-4. The Commission's order alleged that it had evidence of the specialists' intent to disadvantage public customers placing orders through the NYSE's DOT system in the form of statements such as "f--k the DOTs" and "screw the DOTs." *Id.* at *3. Several individual specialists were criminally indicted based on the conduct at issue in the SEC proceeding. *See* Floyd Norris, Trading Scandal may Strengthen Stock Exchange, New York Times, April 14, 2005, at C1.

(n314)Footnote 314. *See* Sec. Exch. Act Rel. Nos. 49498, 49499, 49500, 49501 and 49502 (Mar. 30, 2004), and Sec. Exch. Act Rel. Nos. 50075 and 50076 (July 26, 2004).

(n315)Footnote 315. *See* Sec. Exch. Act. Rel. No. 51714 (May 19, 2005) (hereinafter cited as "NSX Disciplinary Action").

(n316)Footnote 316. NSX Disciplinary Action, *supra*.

(n317)Footnote 317. NSX Disciplinary Action, *supra*. The order was also based on the exchange's alleged failure to enforce a rule requiring dealers on the exchange to provide customer market orders with the opportunity for price improvement in certain circumstances. *Id.* In addition, the exchange was alleged to have failed to preserve certain e-mail correspondence as required. *Id.*

(n318)Footnote 318. NSX Disciplinary Action, *supra*.

(n319)Footnote 319. NSX Disciplinary Action, *supra*.

(n320)Footnote 320. NSX Disciplinary Action, *supra*.

(n321)Footnote 321. Section 21(e) of the Securities Exchange Act of 1934 reprinted in the Securities Primary Law Sourcebook, Volume B, Section F.

(n322)Footnote 322. Section 21(f).

(n323)Footnote 323. Section 23(b).

(n324)Footnote 324. Section 6(b)(2) requires the rules of an exchange to provide that any registered broker or dealer, or any natural person associated therewith, may become a member of the exchange and that any person may become associated with a member, as a condition for registration as a national securities exchange.

Section 6(c) sets forth the grounds on which an exchange may deny a person membership or bar a person from becoming associated with a member, see § 2.03[2][a] *supra*.

Section 6(d) contains the minimum due process requirements that an exchange must follow in disciplinary and other proceedings, see § 2.03[4] *infra*.

(n325)Footnote 325. The federal laws do not contain an express exemption for organized securities or commodities exchanges, such as the various stock exchanges, the Chicago Board of Trade, and the Sugar and Cotton Exchanges. However, an implied exemption has long been assumed to exist because of the very nature of the functions of such exchanges and because of the extensive statutory regulation of securities and commodities exchanges, as well as of administrative and government sanctioned self regulation. This exemption has been assumed to apply to the formation of uniform standards for quality, terms, trading hours, and fees, some degree of discipline for members and traders, and a con-comitant right to ostracize non-members so as to make membership advantageous.

Securities and Commodity Exchanges, 33 A.B.A. Antitrust L.J. 88 (1966). (Footnote omitted.)

See *Silver v. New York Stock Exchange*, 373 U.S. 341, 83 S. Ct. 1246, 10 L. Ed. 2d 389, *reh'g denied*, 375 U.S. 870 (1963):

The Securities Exchange Act contains no express exemption from the antitrust laws or, for that matter, from any other statute. This means that any repealer of the antitrust laws must be discerned as a matter of implication, and '[i]t is a cardinal principle of construction that repeals by implication are not favored.' *United States v. Borden Co.*, 308 U.S. 188, 198, 60 S. Ct. 182, 188, 84 L. Ed. 181; see *Georgia v. Pennsylvania R. Co.*, 324 U.S. 439, 456-457, 65 S. Ct. 716, 725-726, 89 L. Ed. 1051; *California v. Federal Power Comm.*, 369 U.S. 482, 485, 82 S. Ct. 901, 903, 8 L. Ed. 2d 54. Repeal is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary. This is the guiding principle to reconciliation of the two statutory schemes.

373 U.S. at 357, 83 S. Ct. at 1257, 10 L. Ed. 2d at 400.

The question of the applicability of the antitrust statutes to the securities industry and the corollary question of the primary jurisdiction for the SEC was studied in 1972 by the House Subcommittee on Commerce and Finance:

The Subcommittee concludes, therefore, that it would not be in the public interest to grant the blanket immunity from the antitrust laws being sought here. Rather, we concur with the following language from the Supreme Court's opinion in *Silver*, 373 U.S. at 359-60:

Since the antitrust laws serve, among other things, to protect competitive freedom, *i.e.*, the freedom of individual business units to compete unhindered by the group action of others, it follows that the antitrust laws are peculiarly appropriate as a check upon anticompetitive acts of exchanges which conflict with their duty to keep their operations and those of their members honest and viable. Applicability of the antitrust laws, therefore, rests on the need for vindication of their positive aim of insuring competitive freedom. Denial of their applicability would defeat the congressional policy reflected in the antitrust laws without serving the policy of the Securities Exchange Act.

The Subcommittee agrees with its colleagues on the Judiciary Committee and in the Senate, however, that any challenge to an exchange rule on antitrust grounds should be made to the Federal courts and not to the agency.

H.R. Rep. No. 92-1519, 92d Cong., 2d Sess. (1972).

On the subject of the primary jurisdiction of the SEC, see *Nielsen v. Dean Witter & Co.*, 1975-1 Trade Cases P 60,264 (N.D. Cal. 1975), in which a district court held that it should stay a treble damage suit by a terminated securities representative, whose registration as a representative was revoked by the NASD Board of Governors, against his former employer pending SEC review of the disciplinary action by the NASD. The court also held that it would not only be appropriate but also extremely helpful to refer the matter back to the SEC for review to determine if the revocation of the plaintiff's registration was in accordance with the Commission's rules. Also, "where certain facets of the dispute are within the jurisdiction of the SEC," SEC review of the facts would be of material aid to the court. Finally, the SEC could even consider the antitrust implications of the dispute; however, "a federal court may be the final adjudicator of antitrust claims."

See also *Ricci v. Chicago Mercantile Exchange*, 409 U.S. 289, 93 S. Ct. 573, 34 L. Ed. 2d 525, *reh'g denied*, 410 U.S. 960 (1973) (district court antitrust case should be stayed pending administrative review where the Commodity

Exchange had administrative authority over the dispute); *United States v. National Association of Securities Dealers, Inc.*, 422 U.S. 694, 95 S. Ct. 2427, 45 L. Ed. 2d 486, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,214 (June 26, 1975) (certain vertical restrictions on secondary market transactions in mutual fund shares immune from antitrust laws because Section 22(f) of the Investment Company Act of 1940 grants the SEC the final authority in the matter).

(n326)Footnote 326. In *Silver*, the complainant, a broker-dealer in the over-the-counter market, was deprived of his private wire service to members of the New York Stock Exchange by the Exchange itself. No notice was given to the complainant, nor was any reason given nor an opportunity to be heard. The Supreme Court found that the statutory duty to regulate conduct of exchange members, including their relations with nonmembers, did not exempt an exchange from liability under the antitrust laws, where it had ordered members to terminate wire services with a nonmember over-the-counter dealer without giving him an explanation of the reasons for the termination. Having ruled that the procedurally arbitrary decision of the New York Stock Exchange violated Section 1 of the Sherman Act, the Supreme Court refused to discuss the substantive issue of whether the act of depriving an over-the-counter dealer access to wire service with member houses violated the antitrust laws.

Silver is discussed in 5 Loss, Securities Regulation 3157-63 (2d Ed. 1961, 1969 Supp.).

See also *Robert W. Stark, Jr., Inc. v. New York Stock Exchange, Inc.*, 346 F. Supp. 217, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,573 (S.D.N.Y. 1972), *aff'd*, 466 F.2d 743, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,607 (2d Cir. 1972); *Cowen v. New York Stock Exchange*, 256 F. Supp. 462 (S.D.N.Y. 1966), *aff'd*, 371 F.2d 661, [1966-1967 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,884 (2d Cir. 1967) (discharged stockbroker's treble damage action under the antitrust laws dismissed; plaintiff made aware of precise charges against him, conceded the truth thereof, and his conduct violated both the Exchange Act and the New York Stock Exchange Rules).

(n327)Footnote 327. The holding in *Silver* was made in the context of self-regulatory activities not then subject to the appropriate federal agency's review:

Although the Act gives to the Securities and Exchange Commission the power to request exchanges to make changes in their rules, § 19(b), **15 U.S.C. § 78s(b)**, and impliedly, therefore, to disapprove any rules adopted by an exchange, See also § 6(a)(4), **15 U.S.C. § 78f(a)(4)**, it does not give the Commission jurisdiction to review particular instances of enforcement of exchange rules. See 2 Loss, *cit.*, *supra*, at 1178; *Westwood and Howard, supra.*, 17 Law & Contemp. Prob., at 525. This aspect of the statute, for one thing, obviates any need to consider whether petitioners were required to resort to the Commission for relief before coming into court. Compare *Georgia v. Pennsylvania R. Co.*, 324 U.S., at 455, 65 S. Ct. at 725. Moreover, the Commission's lack of jurisdiction over particular applications of exchange rules means that the question of antitrust exemption does not involve any problem of conflict or coextensiveness of coverage with the agency's regulatory power. See *Georgia v. Pennsylvania R. Co.*, *supra*; *United States v. Radio Corp. of America*, 358 U.S. 334, 79 S. Ct. 457, 3 L. Ed. 2d 354; *California v. Federal Power Comm.*, *supra*; *Pan American World Airways, Inc. v. United States*, 371 U.S. 296, 83 S. Ct. 476, 9 L. Ed. 2d 325. The issue is only that of the extent to which the character and objectives of the duty of exchange self-regulation contemplated by the Securities Exchange Act are incompatible with the maintenance of an antitrust action. Compare *Maryland & Virginia Milk Production Ass'n v. United States*, 362 U.S. 458, 80 S. Ct. 847, 4 L. Ed. 2d 880.

Silver v. New York Stock Exchange, 373 U.S. at 357-58, 83 S. Ct. at 1257, 10 L. Ed. 2d at 400-01. (Footnote omitted.)

(n328)Footnote 328. In *Gordon v. New York Stock Exchange, Inc.*, 422 U.S. 659, 682-83, 95 S. Ct. 2598, 2611, 45 L. Ed. 2d 463, 479, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,215 (June 26, 1975), the Supreme Court

summarized the principles which had developed in cases in which it had been argued that provisions of the securities laws constituted an implied repeal of antitrust law. Certain axioms of construction are now clearly established. Repeal of the antitrust laws by implication is not favored and not casually to be allowed. Only where there is a "plain repugnancy between the antitrust and regulatory provisions" will repeal be implied.

The starting point for our consideration of the particular issue presented by this case, whether the antitrust laws are impliedly repealed or replaced as a result of the statutory provisions and administrative and congressional experience concerning fixed commission rates, of course, is our decision in *Silver*. There the Court considered the relationship between the antitrust laws and the Securities Exchange Act, and did so specifically with respect to the action of an exchange in ordering its members to remove private direct telephone connections with the offices of nonmembers. Such action, absent any immunity derived from the regulatory laws, would be a *per se* violation of § 1 of the Sherman Act. 373 U.S. at 347, 83 S. Ct. at 1251. Concluding that the proper approach to the problem was to reconcile the operation of the antitrust laws with a regulatory scheme, the Court established a "guiding principle" for the achievement of this reconciliation. Under this principle, "[r]epeal is to be regarded as implied only if necessary to make the Securities Exchange Act work, and even then only to the minimum extent necessary."

Id., at 357, 83 S. Ct. at 1257.

See also *Thill Securities Corp. v. New York Stock Exchange*, 433 F.2d 264, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,756 (7th Cir. 1970), *cert. denied*, 401 U.S. 994, 91 S. Ct. 1232, 28 L. Ed. 2d 532 (1971).

(n329)Footnote 329. 371 F.2d 409 (7th Cir.), *cert. denied*, 389 U.S. 954 (1967), *rehearing denied*, 390 U.S. 912 (1968). See 5 Loss, *supra*, at 3164.

(n330)Footnote 330. Exchange Act, Section 19(b)(9) provided that the Commission could "alter or supplement the rules of such exchange ... in respect of such matters as ... (9) the fixing of reasonable rates of commission, interest, listing, and other charges" The Securities Acts Amendments of 1975 altered the SEC's authority with respect to commission rates, see § 2.03[2][d] *supra*. Furthermore, as a result of the 1975 Amendments, Section 19(b) now contains a new procedure for SEC review of proposed changes in the rules of self-regulatory organizations, see § 2.03[1][a] *supra*.

(n331)Footnote 331. Unlike the situation in *Silver* (see *supra*), the Supreme Court in *Gordon* was faced with an antitrust issue involving an activity over which the SEC actively exercised its direct regulatory powers.

(n332)Footnote 332. In *Gordon*, the Supreme Court, affirming the holding of the Second Circuit and district court dismissing a private action, held that the fixed commission rates utilized by the New York Stock Exchange and the American Stock Exchange were immunized from antitrust attack because of the SEC's direct regulatory power under § 19(b)(9) to approve or disapprove exchange commission rates. The Court held that to permit operation of the antitrust laws with respect to commission rates would unduly interfere with the operation of the Exchange Act.

In *Abbott Securities Corp. v. New York Stock Exchange*, 1976-2 Trade Cas. P 61,017 (D.D.C. 1976), the plaintiffs' antitrust suit against the exchange, based upon the exchange rule prohibiting the plaintiffs as nonmembers of the New York Stock Exchange from sharing commissions with members of the Exchange, was dismissed because the court, following *Gordon*, found the prohibition as part of the "regulatory scheme which specifically authorizes the SEC to oversee the fixing of Commission rates," and, as such, immune from the antitrust laws.

Cf. *Thill Securities Corp. v. New York Stock Exchange*, 433 F.2d 264, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,756 (7th Cir. 1970), *cert. denied*, 401 U.S. 994, 91 S. Ct. 1232, 28 L. Ed. 2d 532 (1971), in which the

Court of Appeals reversed a district court holding that had upheld the Exchange's anti-rebate rule--whereby members are prohibited from sharing with non-members any commission earned on purchase or sale of securities even though the non-member refers the customer. The district court held the rule was authorized by Section 19(b)(9), and was not subject to antitrust review since it fell within the scope of Commission review. The Court of Appeals held that in order for the Exchange rule to be immune from the antitrust laws, the Exchange must show that exemption from the antitrust laws "is necessary to discharge its responsibilities under the Securities Exchange Act," and the Court of Appeals remanded the case to the district court for trial on that issue. The Court of Appeals in *Thill* also held that even though the Commission exercises supervisory power over the rules of the Stock Exchange, the Exchange is not *ipso facto* granted immunity for conduct relating to those rules.

It is important to note that the Supreme Court in *Gordon v. New York Stock Exchange, Inc.*, *supra*, declined to follow *Thill* to the extent that the Seventh Circuit viewed the question of implied repeal of the antitrust laws as a question of fact, *i.e.*, whether the particular rule is necessary to make the Act work. The Supreme Court held that it was proper to decide the case on the basis of a summary record compiled on motions for summary judgment without any further evidence that might be gained from a trial on the merits because there was ample evidence regarding the extent of SEC review under a specific provision of the Securities Exchange Act.

Interpreting the "rule of reason" enunciated in *Silver*, to mean that "within the area of supervised self-regulation contemplated by the Securities Exchange Act; *per se* concepts are generally displaced and the courts are to examine whether the particular restraint, even though it would be a *per se* violation if performed by others, was reasonable," the Court of Appeals in *Jacobi v. Bache & Co., Inc.*, 520 F.2d 1231, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,253 (2d Cir. 1975), *cert. denied*, 423 U.S. 1053, 96 S. Ct. 784, 46 L. Ed. 2d 642 (1976), held that the New York Stock Exchange rule prohibiting an automatic pass-through of a portion of the service charge by member firms to registered representatives was not immune from the antitrust laws. However, the Court of Appeals found that the plaintiffs failed to show that the exchange rule constituted price fixing, by failing to meet plaintiffs' burden of showing that the rule was not "germane" to the purposes of the Exchange Act and was unreasonable.

(n333)Footnote 333. Letter from Manuel F. Cohen, Chairman, Securities and Exchange Commission, to A. Willis Robinson, Chairman, Senate Committee on Banking and Currency (July 30, 1965) (hereinafter cited as "Letter from Cohen").

(n334)Footnote 334. Letter from Cohen, *supra*.

(n335)Footnote 335. Letter from Cohen, *supra*.

(n336)Footnote 336. Letter from Cohen, *supra*.

(n337)Footnote 337. Letter from Cohen, *supra*.

(n338)Footnote 338. Letter from Cohen, *supra*.

(n339)Footnote 339. Letter from Cohen, *supra*. After the Supreme Court's decision in *Gordon*, the district court on remand in *Thill Securities Corp. v. New York Stock Exchange*, 473 F. Supp. 1364, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,185 (E.D. Wis. 1979), reaffirmed its holding that the now revoked anti-rebate rule was immune from antitrust analysis and that the Commission adequately exercised its regulatory authority.

The Seventh Circuit affirmed that decision, 633 F.2d 65, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,663 (7th Cir. 1980), and held that the anti-rebate rule was an integral part of the entire fixed-commission rate system, which required antitrust immunity from the "obvious interference" that separate private antitrust actions would cause. *Id.* at p. 98,519.

See also Shumate & Co., Inc. v. New York Stock Exchange, Inc., [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,585 (N.D. Tex. 1980) (the implied repeal of the federal antitrust laws as to the enforcement of the New York Stock Exchange's off-board trading restrictions is necessary to effectuate the purposes of the Exchange Act).

(n340)Footnote 340. Exchange commission rates are discussed in § 2.03[2][d] *supra*.

(n341)Footnote 341. Section 6(e)(1)(B). The provisions of the Securities Acts Amendments of 1975 governing commission rates are discussed in § 2.03[2][d] *supra*. Prior to the adoption of the 1975 Amendments, the Commission adopted Rule 19b-3 prohibiting a national securities exchange from fixing the rate of commission for transactions effected on, or effected by the use of the facilities of, such exchange.

(n342)Footnote 342. For discussion of the extent to which the 1975 Amendments impliedly repeal the antitrust laws with respect to both national securities exchanges and registered securities associations, *see* Note, SEC Regulation As A Pervasive Regulatory Scheme--Implied Repeal of the Antitrust Laws With Respect to National Securities Exchanges and the NASD, 44 Fordham L. Rev. 355 (1975).

In *Drayer v. Krasner*, 572 F.2d 348, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,299 (2d Cir. 1978), the Court of Appeals held that the New York Stock Exchange requirement of arbitration in a dispute between a registered representative and a member firm was immune from the antitrust laws. The plaintiff had complained that New York Stock Exchange Rule 347, compelling all member firms to include an arbitration clause in contracts with registered representatives, violated the antitrust laws. In concluding that the arbitration requirement was immune from antitrust attack, the Court of Appeals examined the effect of the Securities Acts Amendment of 1975 upon supervised exchange self-regulation. The court found that SEC review of exchange rules pursuant to Section 31(b) of the 1975 Amendments, *see* § 2.03[1][a] *supra*, had "not implicated" Rule 347. Furthermore, the Commission had not sought to exercise its power under Section 19(c), *see* § 2.03[1][b] *supra*, to initiate changes in exchange rules, to alter the New York Stock Exchange arbitration provisions. The Court of Appeals held that Rule 347 "would seem to fall within" the provisions of Sections 6(b)(5) and (8), *see* § 2.02[2][c][i] *supra*, 19(b)(2) and (3), *see* § 2.03[1][a] *supra*, and 19(c), *see* § 2.03[1][b] *supra*, these sections being the "measure of congressionally delegated authority for self regulation in the national interest:"

Whatever the relationship of this rule [New York Stock Exchange Rule 347] to the objective of investor protection, it is germane to the goal of market efficiency, reflected in § 6(b) and throughout the 1975 amendments, *see, e.g.*, §§ 2; 11A(a)(1)(C); 15A(b)(6); (9); 17A(a)(1); 19(f); 23(a)(2), and to the objective of fair administration of the Exchange, implicated in § 6(b) and an explicit standard of § 9(c). Registered representatives play an important role in the flow of business on securities exchanges. The arbitration provision enables member firms to rid themselves of registered representatives who, as they believe, are dishonest or ineffective, or who have violated rules of the NYSE, including the "know-your-customer" rule, Rule 405(1), without subjecting themselves to lengthy and costly litigation--including, as here, a request for punitive damages. *See also* Rust, *supra*, 352 F. Supp. at 718. It is likewise in the interest of fair administration and market efficiency, as well as the public interest, that honest and ethical registered representatives should have speedy, cheap and effective remedies against their employers. At least, the NYSE is entitled to think this in the absence of any indication otherwise from the SEC.

572 F.2d at 358. (Footnote omitted.)

(n343)Footnote 343. There being no showing of an implied repeal of the antitrust laws, the Court turns to defendants' contention that because they accorded Blackman procedural due process, there is no violation of the antitrust laws. Plaintiffs do not challenge the procedure whereby their application was acted upon and it appears that such procedure is adequate under the circumstances. *Cf. Crimmins v. American Stock Exchange*, 346 F. Supp. 1256

(S.D.N.Y. 1972). *Silver* teaches, however, that the granting of procedural due process does not remove the Exchange's action from scrutiny by an antitrust court: procedural due process is merely the threshold justification for exemption from the antitrust laws and having failed to grant fair procedures in *Silver*, the action of the New York Stock Exchange was treated as a per se violation of the Sherman Act.

Zuckerman v. Yount, 362 F. Supp. 858, 863, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,109 (N.D. Ill. 1973).

(n344)Footnote 344. Zuckerman v. Yount, *supra*:

In light of the fact that the antitrust laws are to be impliedly repealed only to the minimum extent necessary to make the 1934 Act work, this Court rejects defendants' contention that, based on the present record, there has been an implied repeal of the antitrust laws in this case. Blackman was charged with violation of certain Exchange rules. It appears that if the implied repeal of the antitrust laws is to be kept to the minimum, there must first be an inquiry as to whether the rules that were allegedly violated are essential enough to the operation of the 1934 Act that the anti-competitive impact that may result from their enforcement must be tolerated. In short, a preliminary question is whether the charges, if true, would justify anticompetitive restrictions on membership in light of the purposes of the 1934 Act.

Id. at 862, 863. (Footnote omitted.)

The court in Zuckerman pointed out that control over membership was one of the responsibilities imposed on a stock exchange as part of the exchange's duty of self-regulation under Section 6(b). However, since Zuckerman was decided, Congress amended the Exchange Act in 1975 to give the SEC power to review disciplinary actions, including denial of membership on an exchange, by an exchange.

(n345)Footnote 345. J.R. Williston & Beane, Inc. v. Haack, 387 F. Supp. 173, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,921 (S.D.N.Y. 1974). The district court pointed out in *Williston* that the purpose of the net capital rule of both Exchanges is to assure the financial responsibility of broker-dealers and that the rule is the kind of rule Congress had in mind in granting the SEC authority under Section 19(b)(1) to require the exchanges to provide adequate "safeguards in respect of the financial responsibility of members." The court then held:

... that since enforcement of the net capital rule is essential to the purposes of the Securities Exchange Act, and since the action of the Exchanges in the present instance satisfied constitutional standards the Exchanges are immune from antitrust liability.

387 F. Supp. at 182.

(n346)Footnote 346. The application to the Commission was pursuant to an American Stock Exchange rule governing the delisting of securities selling at a low price for a substantial period of time and resulted in an SEC order striking the stock from listing and registration on the Exchange.

(n347)Footnote 347. 527 F.2d 1366, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,461 (5th Cir. 1976). The Court of Appeals pointed out that (1) the American Stock Exchange rule governing delisting was subject to SEC authority under Section 19(b)(3) of the Exchange Act, (2) the delisting was subject to SEC approval under Section 12(d), and (3) the formal order of the SEC to delist the stock was issued pursuant to Rule 12d2-2. Therefore, immunity under the antitrust laws was "necessary in this case to make the Exchange Act viable." For discussion of delisting of securities see § 4.01[6] *infra*.

(n348)Footnote 348. 977 F.2d 1147 (7th Cir. 1992).

(n349)Footnote 349. The court noted that, "during deliberations on the 1974 Act, the House Agriculture Committee considered and rejected a provision that would have shielded for antitrust attack any conduct [taken pursuant to a regulatory rule]." 977 F.2d 1147 at 1161.

(n350)Footnote 350. 977 F.2d at 1161 (*citing* National Germicidal Hosp. & Gerontology Ctr. v. Blue Cross, 101 S.Ct 2415, 2422 (1981) (alterations in original).

(n351)Footnote 351. *Id.*, at 1167.

(n352)Footnote 352. Loomis, The Shakeout on Wall Street Isn't Over Yet, *Fortune* 59 (May 22, 1978). From the end of 1968 to May 1, 1975, the number of New York Stock Exchange member firms declined from 646 to 505, an average loss of more than twenty firms per year. By April 1978, the total number of NYSE member firms was down to 465. *Id.* at 59-60. Along with the increased concentration in the securities industry has come an increasing concentration of capital: from 1972 to 1977, the total capital of the twenty-five largest securities firms grew from \$1.7 billion to nearly \$ 2.7 billion, while the total capital of all the NYSE member firms (including the twenty-five largest firms or their subsidiaries), and of the holding companies behind some of them, has "held just about steady, at around 4.2 billion in each year. Thus, the top twenty-five have increased their share of the total capital from about 41 percent to 64 percent." *Id.* at 64.

For discussion of the effect of the 1975 Amendments on schedules, fixed rates of commissions, allowances, discounts, or other fees, *see* § 2.03[2][d] *supra*.

(n353)Footnote 353. Comment, Concentration in the Securities Industry: Antitrust Aspects of Securities Firm Mergers, 42 Albany L. Rev. 619, 624 (1978). "This may be attributable, however, to the fact that only recently have these mergers joined large, reasonable healthy competitors. Thus, the possibility of a challenge by the Justice Department is becoming more of a reality." *Id.* at 624. (Footnote omitted.)

(n354)Footnote 354. Comment, Concentration in the Securities Industry: Antitrust Aspects of Securities Firm Mergers, 42 Albany L. Rev. 619, 631 (1978). The securities firm acquired in a merger should file with the Commission on Form BDW a notice of withdrawal from registration as a broker or dealer pursuant to Section 15(b)(5). Rule 15b6-1, *see* § 3.03[6] *infra*. The acquiring securities firm should file an amendment on Form BD to its application for registration as a broker or dealer to reflect the acquisition. Rule 15b3-1(b), *see* § 3.03[2][b] *infra*. Furthermore, New York Stock Exchange Rule 313 requires all documents pertaining to a merger involving a "member corporation" (a corporation transacting business as a broker or dealer in securities, approved by the Board of Directors of the NYSE as a member corporation, having at least one NYSE member as an officer of the member corporation and holder of voting stock therein, and having all its other NYSE members as officers thereof and holders of voting stock therein, to be submitted to and be acceptable to the NYSE prior to becoming effective. NYSE Guide (CCH) P 2313 (2003). *See* Comment, Concentration in the Securities Industry: Antitrust Aspects of Securities Firm Mergers, 42 Albany L. Rev. 619 n.80 (1978).

(n355)Footnote 355. The national market system is discussed in § 2.04 *infra*.

(n356)Footnote 356. Comment, Concentration in the Securities Industry: Antitrust Aspects of Securities Firm Mergers, 42 Albany L. Rev. 619 (1978). The author of the Comment refers to this approach as the "primary jurisdiction approach."

For discussion of the primary jurisdiction of the SEC in the context of collective action by members of a self-regulatory organization.

(n357)Footnote 357. *In re* National Association of Securities Dealers, Inc., 19 S.E.C. 424, 1945 SEC LEXIS 2780 (June 11, 1995) (hereinafter cited as "NASD Price Maintenance Release").

(n358)Footnote 358. NASD Price Maintenance Release, *supra*.

(n359)Footnote 359. NASD Price Maintenance Release, *supra*.

(n360)Footnote 360. NASD Price Maintenance Release, *supra*.

(n361)Footnote 361. Letter from Peyton Ford, Assistant to the Attorney General, to Emanuel Celler, Chairman, Subcommittee on Study of Monopoly Power, House Judiciary Committee (May 3, 1950) (hereinafter cited as "Ford Letter").

(n362)Footnote 362. Ford Letter, *supra*.

(n363)Footnote 363. Ford Letter, *supra*.

(n364)Footnote 364. Ford Letter, *supra*.

(n365)Footnote 365. Ford Letter, *supra*.

(n366)Footnote 366. Ford Letter, *supra*.

(n367)Footnote 367. Ford Letter, *supra*. The NASD ultimately did make many structural and procedural changes relating to its enforcement responsibilities, in response to an SEC action closely related to a Department of Justice investigation. *See* § 2.03[5][c] *supra*.

(n368)Footnote 368. Fixed commission rates are discussed in Sec. 2.03[2][d] *supra*. For the Department's views, see Comments of the United States Department of Justice regarding Sec. Exch. Act Rel. No. 8239, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,523 (Jan. 26, 1968).

(n369)Footnote 369. *See* Statement of the United States Department of Justice, In re: Hearings on the Structure, Operation and Regulation of the Securities Markets, SEC File No. 4-147.

(n370)Footnote 370. *See* Comments of the United States Department of Justice, In the Matter of Market Structure Issues Concerning Standardized Options Trading (*See* Sec. Exch. Act Rel. No. 14854, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81, 611 (June 15, 1978)).

(n371)Footnote 371. U.S. v. Alex Brown & Sons, Inc., 963 F. Supp. 235 (S.D.N.Y. 1997), and *see* §§ 2.03[5][c] and [d] *supra*.

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Federal Securities Exchange Act of 1934

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CHAPTER 2 Regulation of Securities Markets *

1-2 Federal Securities Exchange Act of 1934 § 2.05

§ 2.05 Directions of Future Change in the Regulation of Securities Markets

For over 20 years, the Commission has struggled with providing US investors with safe access to foreign markets and with opening the US borders to foreign market participants such as broker-dealers and stock exchanges. n1 This concept has been generally known as "mutual recognition". In March 2008, the Commission announced in a press release initial steps for implementing mutual recognition by taking the following actions:

- "Exploring initial agreements with one or more foreign regulatory counterparts, which would be based upon a comparability assessment by the SEC and by the foreign authority of one another's regulatory regimes.
- Considering adoption of a formal process for engaging other national regulators on the subject of mutual recognition. This process could be accomplished through rulemaking or other appropriate mechanisms, possibly informed by one or more initial agreements with other regulators.
- Developing a framework for mutual recognition discussions with jurisdictions comprising multiple securities regulators tied together by a common legal framework, including Canada (which has no national securities regulator, but rather provincial regulators) and the European Union (whose national securities regulators are subject to supranational legislation and directives).
- Proposing reforms to Rule 15a-6 in order to improve the process by which US investors have access to foreign broker-dealers." n2

Since the March 2008 press release, the Commission issued a joint announcement with Australian Prime Minister Kevin Rudd that the Commission, the Australian Securities and Investment Commission ("ASIC"), and the Australian Treasury Department have begun formal discussions to develop a mutual recognition arrangement for the two nations' securities markets. n3 Similarly, in late May 2008, SEC Chairman Christopher Cox and Chairmen of four Canadian securities regulators announced "a schedule for the completion of a process agreement that would open the way for discussions of a potential US-Canada mutual recognition arrangement". n4

In late June 2008, the Commission also proposed amendments to Rule 15a-6 under the Securities Exchange Act of 1934 (the "Exchange Act"). n5 Rule 15a-6 provides conditional exemptions from broker-dealer registration for foreign

entities engaged in certain activities with certain US investors. Such proposals significantly expand the scope of the conditional exemptions available to foreign broker-dealers or eliminate some of the more onerous restrictions between foreign broker-dealers and US customers. The Commission is proposing such amendments due to increasing market globalization. As such, the proposed amendments are intended to remove certain barriers to access foreign markets and securities, while still maintaining investor protections. n6

As noted above, mutual recognition has a long history. In 1989, the Commission published a concept release entitled "Recognition of Foreign Broker-Dealer Regulation" that sought comments on opening the US markets to foreign broker-dealers that have comparable foreign regulation. n7 This concept release was published as a companion to the adopting release of Rule 15a-6 and noted that

The Commission believes that recognition of foreign broker-dealer regulation deserves serious consideration. Over the last decade, many institutional investors have actively participated in foreign securities markets in order to diversify their portfolios. Many foreign broker-dealers possess special expertise in foreign markets that would be of use to US institutional investors, yet they may not anticipate obtaining sufficient US business to justify registering in the United States. Recognizing foreign regulation as a substitute, in certain circumstances, for US registration would allow certain of these foreign broker-dealers to deal with US institutional investors without incurring the expense of US registration. This would substantially increase the access of US investors to the valuable services that foreign broker-dealers provide relative to foreign markets. By increasing this access, an approach involving reliance on comparable foreign regulation and cooperation with foreign securities authorities could facilitate international securities transactions, while maintaining effective broker-dealer oversight and preserving the essential protections of US broker-dealer regulation. n8

The release further stated that the conceptual approach would be based upon the following limitations:

1. A limitation on the scope of the exemption to foreign broker-dealers operating outside the United States whose business is predominantly foreign, who do not have US broker-dealer affiliates, and who limit their activities requiring US broker-dealer registration to providing cross border services to major US institutional investors.
2. The existence of investigative and financial memoranda of understanding ('MOU'), or comparable treaties, between the Commission and the foreign securities authority ('FSA'), that support the reliance by the Commission on the FSA that this conceptual approach would entail.
3. The existence of a foreign regulatory regime that is comparable to that of the United States.
4. Compliance by exempted broker-dealers with specific US regulatory requirements deemed necessary by the Commission for the protection of US investors and markets. n9

The concept release was subject to a number of negative comments "because it would not have applied to foreign affiliates of US broker-dealers and it failed to require reciprocal treatment of US intermediaries by foreign regulators." n10 As a result, no action was taken based upon this conceptual release.

The next significant, yet ineffective, effort in mutual recognition was a 1997 conceptual release by the Commission that discussed, among other things, foreign market activities in the US. n11 In this release, the Commission stated as follows:

[T]echnological advances have enabled market members themselves to trade from remote locations outside of particular markets' home countries. Many foreign markets have integrated new technology into

their trading processes in recent years, either by using computers in combination with traditional floor trading procedures, or by completely automating their trading facilities. This enhanced technology enables members of those markets to trade without being physically present on a market 'floor' or establishing a physical presence in a market's home country. As a result, several foreign markets have begun to offer their members in non-US jurisdictions 'remote' access to their trading facilities, typically by installing proprietary market terminals in the members' offices, by providing data feeds or codes for use with software operated through the members' own computers, or by allowing members to access a market's trading facilities through third party service vendors or public networks (such as the Internet). In recent years, several foreign markets have proposed permitting US broker-dealers and institutional investors to become market members through similar remote access arrangements. If this remote access were offered in the United States, US investors would have the ability to trade directly on foreign markets and to bypass broker-dealers. n12

In the release, the Commission stated that its goal was to initiate a dialogue regarding how to develop a consistent, long-term approach that clarifies the application of the US securities laws to the US activities of foreign markets. Any such approach must not impose unnecessary regulatory costs on cross-border trading and, at the same time, must allow the Commission to oversee foreign markets' activities in the United States and protect US investors under the US regulatory framework. There are several ways to achieve these goals. As discussed below, for example, the Commission could (1) rely solely on a foreign market's home country regulator; (2) require all foreign markets to register as national securities exchanges or apply for an exemption from registration; or (3) develop a tailored regulatory scheme designed to regulate the entity that provides US investors with the ability to trade directly on foreign markets, rather than regulating the foreign market itself. The Commission solicits comments on whether any other alternatives could achieve the goals discussed above." *Id.* This concept release, like the 1988 release, did not result in any action on mutual recognition.

Then, in late 2007, Ethiopis Tafara, the Commission Director of the Office of International Affairs, and Robert J. Peterson, the Senior Counsel of the Office of International Affairs, published an article in the Harvard International Law Journal entitled "A Blueprint for Cross-Border Access to US Investors: A New International Framework. n13 This article prompted a Commission roundtable to examine how retail and institutional investors, US and non-US exchanges, global and regional broker-dealers, and others may be impacted by a selective mutual recognition regulatory regime. n14 This led to the implementation of mutual recognition as discussed above.

FOOTNOTES:

(n1)Footnote 1. See, e.g., Recognition of Foreign Broker-Dealers, Release No 34-27018 (Jul. 11, 1989) including n.6.

(n2)Footnote 2. SEC Announces Next Steps for Implementation of Mutual Recognition Concept, SEC Press Release 2008-49 (Mar. 24, 2008). The press release stated that the concept of mutual recognition is premised upon the following:

Globalized markets and increased cross-border access offer many potential benefits for US investors, including broader investment choices, lower transaction costs resulting from increased competition and technology, increased efficiency of transactions, improved integration of cross-border trading and technology, greater opportunity for diversification, and more access to information about foreign investment opportunities. At the same time, taking advantage of these developments requires greater international cooperation to ensure consistent and strengthened investor protection.

Today, regulatory overlap from different national securities regulatory regimes can pose impediments to cross-border trading. This overlap can result in additional costs for US investors and regulatory compliance burdens on market participants without consideration of whether such costs afford any additional meaningful investor protections.

Even as exchanges consolidate and trading occurs without regard to borders, securities regulation remains primarily a national function, and likely will remain the province of domestic regulators for the foreseeable future.

While presiding over their own national regulatory regimes, securities regulators worldwide continue to work together to promote efforts to reach consensus on, and where possible convergence of, shared principles of high-quality securities regulation designed to promote the protection of investors globally. This does not mean that regulators will adopt one identical approach to securities regulation, but differing approaches may achieve the same desired outcomes.

(n3)Footnote 3. SEC Chairman Cox, Prime Minister Rudd Meet Amid US-Australia Mutual Recognition Talks, Press Release 2008-52 (Mar. 29, 2008).

(n4)Footnote 4. Schedule Announced for Completion of US-Canadian Mutual Recognition Process Agreement, Press Release 2008-98 (May 29, 2008).

(n5)Footnote 5. Release No. 34-58047 (Jun. 27, 2008).

(n6)Footnote 6. *Id.* at 14

(n7)Footnote 7. *See* note 1.

(n8)Footnote 8. *Id.* at 2.

(n9)Footnote 9. *Id.* at 4.

(n10)Footnote 10. Andre Owens and Greg Thomas, *Foreign Market Access: SEC Considers Mutual Recognition*, Futures Industry Magazine at 30 (Nov./Dec. 2007), available at http://www.futuresindustry.org/downloads/FIMag/2007/Outlook/Outlook-Mutal_Recog.pdf.

(n11)Footnote 11. Regulation of Exchanges, SEC Release 34-38672 (May 23, 1997).

(n12)Footnote 12. *Id.* (two citations omitted); *citing* Securities Industry Association, 1996 Securities Industry Fact Book 67 (June 1997) ("Between 1980 and 1995, the total activity by US persons in foreign securities grew from \$53.1 billion to \$2,573.6 billion, representing over a 4700 percent increase).

(n13)Footnote 13. Ethiopis Tafara and Robert J. Peterson, *A Blueprint for Cross-Border Access to US Investors: A New International Framework*, 48 Harvard International Law Journal, Number 1 (Winter 2007).

(n14)Footnote 14. The Unofficial Transcript of the Roundtable Discussion on Mutual Recognition, held on June 12, 2007, can be found at http://www.404.gov/news/openmeetings/2007/openmtg_trans061207.pdf.

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Appendix 2A: Specialist Job Description

1-2A Federal Securities Exchange Act of 1934 Appendix 2A:.syn

§ 2A.syn Synopsis to Appendix 2A: Specialist Job Description

Scope

[I] Objective

[II] Principal Duties

[III] Eligibility Requirements.



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Appendix 2A: Specialist Job Description

1-2A Federal Securities Exchange Act of 1934

The New York Stock Exchange Market: Dynamic Combination of People and Technology sets forth a job description for an exchange specialist:

Specialist Job Description



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Appendix 2A: Specialist Job Description

1-2A Federal Securities Exchange Act of 1934 [I]

[I] Objective

An Exchange who is registered as a specialist is accountable to the Exchange and the investing public for the quality of the Exchange markets in the securities in which for the quality of the Exchange markets in the securities in which he is registered and is responsible for fostering and acting to maintain liquid and continuous two-sided auction markets on the Exchange Floor in those securities. This is accomplished by his acting as agent and principal in such securities, in accordance with the provisions of Federal and Exchange rules and policies, to help insure that such markets are fair, orderly and operationally efficient in the public interest, and competitive with non-Exchange markets in those securities. A "fair" market is one which is free from manipulative and deceptive practices and which affords no undue advantage to any of the participants therein. An "orderly" market is one with regularity and reliability of operation manifested by the presence of price continuity and depth exhibited by the avoidance of large and unreasonable price variations between consecutive sales, and the avoidance of overall price movements without appropriate accompanying volume.



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Appendix 2A: Specialist Job Description

1-2A Federal Securities Exchange Act of 1934 [II]

[II] Principal Duties

As Agent

1. To act as agent on behalf of orders entrusted to him, to hold the interests of such orders above his own interest and to fulfill in professional manner all other duties of an agent of include, but not to be limited to, insuring that each such order, regardless of its size or source, receive proper representation and timely, best possible execution in accordance with the terms of the order and the rules and policies of the Exchange.
2. To act as a catalyst in the markets for the securities in which he is registered by professionally and impartially servicing the interests of other members, to be helpful, communicative, cooperative and professional, to make reasonable efforts to bring together buyers and sellers without interfering as principal unless reasonably necessary to the performance of his duties, and to act together with all members involved to insure that the equitable needs of all parties are considered.
3. To perform effectively the administrative duties with respect to orders entrusted to him as agent to include, but not be limited to, cooperating with other members in the confirmation of open orders and issuing timely and accurate status reports and execution reports.
4. To insure that his acceptance and execution of orders as agent are in compliance with applicable Federal and Exchange rules and policies; to accept as agent only those types of orders he is permitted to accept pursuant to those rules and policies, and not to accept any order for the purchase or sale of a stock in which he is registered directly from the company using such stock or any officer, director or 10% shareholder thereof, from any pension or profit-sharing fund, or from any institution such as a bank, a trust company, an insurance company or an investment company.

As Principal

1. To buy and sell securities as principal when such transactions are necessary in the public interest to minimize an actual or reasonably anticipated short-term imbalance between supply (offers at or near the last sale price) and demand (bids at or near the last sale price) in the auction market, and the absence of this transactions could otherwise result in an unreasonable lack of continuity and/or depth.

1-2A Federal Securities Exchange Act of 1934 [II]

2. To make continuous two-sided quotations and effect transactions when necessary to fulfill his duties as principal, and to insure that such quotations, if acted upon, and transactions are in the public interest by being reasonably calculated to contribute to the maintenance of price continuity with reasonable depth in view of the general market, the market in the particular security and the adequacy of his total position in such security with respect to the actual or reasonably anticipated needs of the market.

3. To make such quotations and effects such transactions in accordance at all times with applicable Federal or Exchange rules and policies, to act as principal in a manner which does not upset the natural longer-term forces of supply and demand, and to insure that each opening and reopening price reflects a professional assessment of market conditions at the time with due consideration given to the balance of supply and demand as reflected by public orders.

4. To avoid transactions in a security as principal which are excessive in view of the market for such security. To trade as principal in a manner which reflects an awareness of his financial resources and to report to the Exchange any actual or imminent financial problems.

Other Duties

1. To insure the orderly functioning of the trading Crowd by exercising leadership and objectively observing trading Crowd activity and order flow, to seek the advice and assistance of Floor Officials when required, and to request delays in opening or trading halts when called for by unusual market conditions.

2. In order to foster a positive professional relationship between the Exchange and listed companies and to educate company representatives regarding the workings of the Exchange's continuous two-way auction market system, the specialist is permitted to have periodic contact with representatives of the companies in whose securities he is registered as specialist provided he abides by applicable Federal or Exchange rules or guidelines with regard to such contacts.

3. To foster the efficient operation of the auction market process by insuring the presence of adequate manpower (professional and clerical, full-time or relief) on the Floor at all times, by efficiently processing necessary trade documents and by cooperating in the resolution of questioned trades and errors.

4. To keep records required by Federal and Exchange rules to report required information to the Exchange on timely and accurate basis and to comply with all Exchange rules which govern the financing of specialist operations.

5. To be aware of and abide by all Federal and Exchange rules and policies governing his activities in non-specialty securities and trading activities off the Exchange Floor, and to be aware of and abide by an Exchange-developed code of acceptable business practices for specialists.

6. In addition to the above, to take any other action not prohibited by Federal or Exchange rule or policy or precluded by professional judgment to foster and maintain liquid continuous two-sided auction markets on the Exchange Floor and to insure that such markets are fair, orderly and efficient in the public interest and competitive with non-Exchange markets in Exchange-listed securities and to avoid any action which would hinder the achievement of these objectives.



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Appendix 2A: Specialist Job Description

1-2A Federal Securities Exchange Act of 1934 [III]

[III] Eligibility Requirements.

An Exchange member who desires to be registered to act as an Exchange specialist must:

1. Be associated with an existing or newly created specialist unit approved by the Exchange.
2. Complete an adequate training period.
3. Pass the Exchange-administered specialist examination.
4. Insure that the specialist unit with which he is to be associated meet the Exchange's specialist capital requirements.



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Appendix 2B: Significant Developments in the Evolution of the National Market System

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Appendix 2B: Significant Developments in the Evolution of the National Market System

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Date	Description	Source
1971	Commission endorses concept of a central market system	Transmittal letter accompanying SEC Institutional Investors Study Report
August 5, 1971	New York Stock Exchange calls for the development of a central market system	Martin Report
February 2, 1972	Commission outlines goals of the central market system	SEC Policy Statements on the Future Structure of the Securities Markets
March 8, 1972	Creation of the composite tape and quotation system	Exch. Act Rel. Nos. 9529 and 9530
November 8, 1972	Commission adopts Rule 17a-15 concerning collection and dissemination of last sale information	Exch. Act Rel. No. 9850
March 29, 1973	Commission proposal for the implementation of a central market system	Policy Statement of the Securities and Exchange Commission for the structure of a central market system
May 10, 1974	Implementation of a consolidated tape plan	Exch. Act Rel. No. 10787
June 4, 1975	Enactment of the Securities Acts tape plan	P.L. 94-29, 89 Stat. 97
August 28, 1975	Members appointed to the National Market Advisory Board	Exch. Act Rel. No. 11623
January 21, 1976	Commission and the National Securities Market Advisory Board call for the adoption of an industry wide central limit order book by the end of 1976	Exch. Act Rel. No. 12158

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March 11, 1976	Commission institutes proceedings to review New York Stock Exchange Non-Member Access Rules	Exch. Act Rel. No. 12181
March 31, 1976	New York Stock Exchange implements Dot systems to allow member firms to send orders directly to Exchange Trading Post	B.N.A. Securities Regulation and Law Report
July 29, 1976	Commission proposes Rule 11 Ac1-1 to govern the dissemination of quotation for securities on the consolidated tape	Exch. Act Rel. No. 12181
September 29, 1976	National Market Association is formed by six stock exchanges and the NASD spearheading a joint industry effort toward formation of a national market system	B.N.A. Securities Regulation and Law Reports
December 1, 1976	Commission notifies the national securities exchanges and the NASD that certain of their rules hinder the establishment of a national market system and are inconsistent with the requirements of the 1975 Amendments	Exch. Act Rel. No. 13027
December 15, 1976	National Market Association publishes a proposed plan for the development of a national market system	B.N.A. Securities Regulation and Law Report
March 18, 1977	Commission proposes rules under Section 11A that would provide exchange access to all qualified persons	Exch. Act Rel. No. 13388
June 23, 1977	Commission announces proposed rule-making to consider the elimination of off-board trading restrictions	Exch. Act Rel. No. 13662
August 19, 1977	New York Stock Exchange and Pacific Stock Exchange reach agreement on the development of an intermarket execution system linking the two exchanges	B.N.A. Securities Regulation and Law Report
December 7, 1977	National Market Advisory Board submits its final report to the Commission	Final Report of the National Market Advisory Board
December 30, 1977	Commission adopts amendments to Rule 19c-1 to eliminate off-board security trading restriction except those pertaining to in-house agency cross transactions	Exch. Act Rel. No. 14325
January 26, 1978	Commission publishes a release outline guidelines for the development of a national market system	Exch. Act Rel. No. 14416
April 17, 1978	The Intermarket Trading System begins pilot operations	B.N.A. Securities Regulation and Law Report

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April 21, 1978	Commission approves Cincinnati Stock Exchange's NSTS Plan	Exch. Act Rel. No. 14694
May 10, 1978	The NASD submits to the Commission an alternative to the Inter market Trading System	B.N.A. Securities Regulation and Law Report
August 1, 1978	Rule 11Ac1-1, which sets forth rules for the collection and dissemination of quotation information, becomes effective	Exch. Act Rel. No. 14711
October 10, 1978	Commission proposes Rule 11Aa3-1 covering the collection and dissemination of transaction reports	Exch. Act Rel. No. 15250
October 10, 1978	Commission proposes Rule 11Ac1-2 concerning the collection and dissemination of transaction reports and quotation information	Exch. Act Rel. No. 15251
March 22, 1979	Commission publishes a status report on the development of a National Market System	Exch. Act Rel. No. 15617
April 26, 1979	Commission announces proposed Rule 19c-3 concerning the elimination of off-board trading restrictions with respect to certain securities	Exch. Act Rel. No. 15770
April 26, 1979	Commission announces proposed Rule 11Ac1-3 concerning price protection for public limit orders	Exch. Act Rel. No. 15770
June 15, 1979	Commission announces proposed Rule 11A2-1, which provides for designation of certain securities as National Market System securities	Exch. Act Rel. No. 15926
February 20, 1980	Commission announces plans to develop and build the MOSS system.	B.N.A. Securities Regulation and Law Report
May 1, 1980	House Commerce and Consumer Protection and Finance Subcommittee limits funding for the Commission's MOSS system	B.N.A. Securities Regulation and Law Report
June 11, 1980	Commission announces the adoption of Rule 19e-3, which prohibits the application of off-board trading restrictions to securities listed after April 26, 1979	Exch. Act Rel. No. 16888
February 5, 1981	Commission proposes an order requiring an automated interface between ITS and the NASDAQ system	Exch. Act Rel. No. 17516
February 17, 1981	Commission adopts Rule 11Aa2-1 designating certain securities as National Market System Securities	Exch. Act Rel. No. 17549

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April 21, 1981	Commission orders automated interface between ITS and the NASDAQ system	Exch. Act Rel. No. 17744
August 25, 1981	Commission issues monitoring report on the operation and effects of Rule 19c-3	Exch. Act Rel. No. 18062
February 11, 1982	Commission announces the adoption of amendments to Rule 11Ac1-1, which will allow regional exchange and third market makers to disseminate information on a voluntary rather than a mandatory basis	Exch. Act Rel. No. 18482
May 6, 1982	Commission adopts amendments to National Market System plan to allow for the implementation of the automated interface between ITS and the NASD source	Exch. Act Rel. No. 18713
May 13, 1982	Commission proposes for comment several alternative order exposure rules	Exch. Act Rel. No. 18738
May 17, 1982	Interface between the ITS and the NASDAQ system becomes operational	Exch. Act Rel. No. 18713
December 21, 1982	Commission repropose and order exposure rule designed to eliminate the internalization of trading in Rule 19c-3 securities	Exch. Act Rel. No. 19372
January 27, 1983	Commission ends the experimental status of the ITS and makes it permanent by extending its operating authority indefinitely	Exch. Act Rel. No. 19456
August 12, 1983	Commission requests comments on off-board trading pursuant to Rule 19c-3	Exch. Act Rel. No. 20074
December 18, 1984	Commission announces criteria for designating OTC securities as qualified for trading in the NMS	Exch. Act Rel. No. 21583
September 16, 1985	Commission issues policy statement extending unlisted trading privileges to OTC securities	Exch. Act Rel. No. 22412
November 17, 1986	Commission proposes amendments to rules governing NMS designation and transaction reporting	Securities and Exchange Act Release No. 23817
April 29, 1987	Commission approves reporting plan for NMS securities traded on an exchange	Securities and Exchange Act Release No. 24407
June 23, 1987	Adoption of new rules regarding the designation of NMS securities	Securities and Exchange Act Release No. 24635
June 26, 1990	Approval of a reporting plan for NAS-	Securities and Exchange Act

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	DAQ/NMS securities traded on an exchange on an unlisted or listed basis	Release No. 28146
April 10, 1992	Commission order partially approving changes to NASD By-Laws requiring NASDAQ Small-Cap securities transactions to be reported on a real-time basis	Securities and Exchange Act Release No. 30569
June 19, 1992	Approval of NASD rule change relating to NMS designation	Securities and Exchange Act Release No. 30840
October 27, 1994	Commission approves Rule 11Ac1-3, requiring notice to customers of payment for order flow.	Exch. Act Rel. No. 34902
April 11, 1996	Commission grants initial approval to the NASD restructuring plan, creating NASD Regulation and the Nasdaq Stock Market, Inc.	Exch. Act Rel. No. 31707
August 8, 1996	Commission settles with the NASD, resulting in a censure, a commitment by the NASD to spend \$100 million to enhance its systems for market surveillance and to increase its regulatory oversight staffing.	Exch. Act Rel. Nos. 37538, 37542
September 12, 1996	Commission approves the Order Handling Rules, requiring the display of customer limit orders and amending the Firm Quote Rule.	Exch. Act Rel. No. 37619A
March 31, 1997	Commission gives final approval to the operation of the OTC Bulletin Board Service. This service had been in operation on a temporary basis since 1990.	Exch. Act Rel. No. 38456
May 23, 1997	Commission issues concept release regarding the proliferation of alternative trading systems ("ATs").	Exch. Act Rel. No. 38672
May 27, 1997	Commission approves NASD proposal to reduce quotation increments to sixteenths for all Nasdaq stocks.	Exch. Act Rel. No. 38678
August 22, 1997	Commission approves changes to Nasdaq Stock Market listing standards that significantly upgrade the initial and continued listing requirements.	Exch. Act Rel. No. 38961
March 12, 1998	Commission publishes for comment NASD proposal to replace the Small Order Execution System ("SOES") and SelectNet with a new electronic trading system. The proposed system would feature a voluntary central limit order book.	Exch. Act Rel. No. 39718
April 17, 1998	Commission issues proposed amend-	Exch. Act Rel. No. 39884

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	ments to definition of "exchange" that encompass most ATSS.	
November 2, 1998	Merger completed under which Amex becomes, like Nasdaq, a subsidiary of the NASD.	<i>New York Times</i> , November 3, 1998, C10
January 14, 2000	Commission approves Nasdaq's Super-SOES system, which greatly increases automatic executions of Nasdaq orders.	Exch. Act. Rel. No. 42344
March 14, 2000	Pacific Exchange agrees to merger with ECN Archipelago.	<i>San Francisco Examiner</i> , March 15, 2000, B-1
June 28, 2000	NASD completes private placement in which approximately 40% of Nasdaq is sold.	Nasdaq Press Release
August 7, 2000	First trading of NYSE-listed stocks by ECN occurs.	Securities Industry News
November 9, 2000	Nasdaq files application for registration as a national securities exchange.	Nasdaq Press Release
November 17, 2000	Commission adopts Rules 11Ac1-5 and 11Ac1-6, relating to disclosure of order routing and execution practices.	Exch. Act Rel. No. 43590
January 19, 2001	Commission approves SuperMontage system, which will provide central order execution facility for all Nasdaq securities.	Exch. Act. Rel. No. 43863
January 25, 2001	NASD completes second phase of Nasdaq private placement, reducing NASD's ownership percentage to approximately 41%.	Nasdaq Press Release
April 9, 2001	U.S. markets complete transition to decimal pricing.	Exch. Act. Rel. No. 44568
October 25, 2001	Commission approves establishment of Archipelago as facility of Pacific Exchange.	Exch. Act Rel. No. 44983
July 24, 2002	Commission approves Alternative Display Facility, which provides a forum for collection of quotes and trade reporting separate from Nasdaq	Exch. Act Rel. No. 46249
October 14, 2002	SuperMontage begins operation	Securities Industry News, October 21, 2002
November 3, 2003	NASD announces intention of transferring ownership of Amex back to its members after sale to buyout firm fails	Daily Deal, November 5, 2003
February 26, 2004	SEC Proposes Regulation NMS	Exch. Act Rel. No. 49325
August 10, 1994	Notice of Filing of NYSE Hybrid Market Proposal	Exch. Act. Rel. No. 50173

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December 16, 2004	SEC repropose Regulation NMS	Exch. Act Rel. No. 50870
April 20, 2005	NYSE-Archipelago merger announced	Chicago Tribune April 21, 2005, C1
June 9, 2005	SEC Adopts Regulation NMS	Exch. Act Rel. No. 51808
December 6, 2005	NYSE members approve Archipelago merger	Chicago Tribune, December 7, 2005, C1
December 14, 2005	NYSE Hybrid Market Pilot Program Approved	Exch. Act. Rel. No. 52954
January 13, 2006	Nasdaq application for registration as a national securities exchange approved	Exch. Act. Rel. No. 53128



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Appendix 2C: Regulation NMS Cross-Reference Chart

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Appendix 2C: Regulation NMS Cross-Reference Chart

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The following chart contains cross-references between the provisions of the former rules relating to the national market system and the provisions of Regulation NMS. Minor, technical changes to the former rules adopted in connection with Regulation NMS are not noted in the chart, but where the substance of a rule was modified this is noted.

Former Rule	Description	Current Status
11Aa2-1	Definition of "national market system security"	Modified and moved to Rule 600(a)
11Aa3-1	Transaction Reporting	Definitions moved to Rule 600; most provisions moved to Rule 601
11Aa3-1(a)(1)	Definition of "transaction report"	Rule 600(b)(80)
11Aa3-1(a)(2)	Definition of "transaction reporting plan"	Rule 600(b)(82)
11Aa3-1(a)(3)	Definition of "effective transaction reporting plan"	Rule 600(b)(22)
11Aa3-1(a)(4)	Definition of "reported security"	Eliminated in favor of definitions of "NMS security" contained in Rule 600(b)(46) and "NMS stock" contained in Rule 600(b)(47)
11Aa3-1(a)(5)	Definition of "listed equity security"	Rule 600(b)(34)
11Aa3-1(a)(6)	Definition of "NASDAQ security"	Rule 600(b)(41) (modified)
11Aa3-1(a)(7)	Definition of "transaction reporting association"	Rule 600(b)(81)
11Aa3-1(a)(8)	Definition of "interrogation device"	Rule 600(b)(31)
11Aa3-1(a)(9)	Definition of "moving ticker"	Rule 600(b)(40)
11Aa3-1(a)(10)	Definition of "market minder"	Rule 600(b)(20) (term changed to "dynamic market monitoring device")
11Aa3-1(a)(11)	Definition of "vendor"	Rule 600(b)(83)

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11Aa3-1(a)(12)	Definition of "last sale data"	Rule 600(b)(33)
11Aa3-1(b)(1)	Requires filing of transaction reporting plans	Rule 601(a)(1)
11Aa3-1(b)(2)	Sets out requirements for amendments to plans	Rule 601(a)(2)
11Aa3-1(b)(3)	Requires Commission approval of plans	Rule 601(a)(3)
11Aa3-1(c)(1)	Prohibits broker-dealers' executing transactions in reported securities unless transaction reporting plan in effect	Rule 601(b)(1)
11Aa3-1(c)(2)	Prohibits exchanges' or members' disseminating transactions reports other than through effective transaction reporting plan	Rescinded
11Aa3-1(c)(3)	Prohibits associations' or members' disseminating transactions reports other than through effective transaction reporting plan	Rescinded
11Aa3-1(c)(4)	Requires broker-dealers to promptly transmit information required by transaction reporting plan	Rule 601(b)(2)
11Aa3-1(d)	Prohibits exchanges or associations from prohibiting or limiting retransmission of transaction data	Rule 601(c)
11Aa3-1(e)	Clarifies that uniform charges for transaction data permitted	Rule 601(d)
11Aa3-1(f)	States that Commission may hear appeals relating to transaction reporting plans	Rule 601(e)
11Aa3-1(g)	Provides for Commission's granting of exemptions	Rule 601(f)
11Aa3-2	Filing and amendment of national market system plans	Definitions moved to Rule 600; most provisions moved to Rule 608
11Aa3-2(a)(1)	Definition of "national market system plan"	Rule 600(b)(43)
11Aa3-2(a)(2)	Definition of "effective national market system plan"	Rule 600(b)(21)
11Aa3-2(a)(3)	Definition of "self-regulatory organization"	Rule 600(b)(68)
11Aa3-2(a)(4)	Definition of "joint self-regulatory organization plan"	Rule 600(b)(32)
11Aa3-2(a)(5)	Definition of "sponsor"	Rule 600(b)(70)
11Aa3-2(a)(6)	Definition of "participants"	Rule 600(b)(53)
11Aa3-2(a)(7)	Definition of "plan processor"	Rule 600(b)(55)

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11Aa3-2(a)(8)	Definition of "vendor"	Rule 600(b)(83)
11Aa3-2(b)(1)	Provides for filing with Commission of joint plans or amendments to joint plans	Rule 608(a)(1)
11Aa3-2(b)(2)	Provides for Commission's proposing amendments to plans	Rule 608(a)(2)
11Aa3-2(b)(3)	Authorizes SROs to act jointly in operating national market facilities, filing plans and amendments and implementing plans	Rule 600(a)(3)
11Aa3-2(b)(4)	Filing requirements for plans and amendments	Rule 608(a)(4)
11Aa3-2(b)(5)	Requirements for descriptions of national market system facilities accompanying filings	Rule 608(a)(5)
11Aa3-2(b)(6)	Filing requirements in connection with selection of plan processor	Rule 608(a)(6)
11Aa3-2(b)(7)	Requires that plan filed pursuant to rule comply with requirements of any other applicable rule	Rule 608(a)(7)
11Aa3-2(b)(8)	Requires up-to-date versions of plans and proposed amendments to be posted on website	Rescinded
11Aa3-2(c)(1)	Provides for filing of and public comment on national market system plans and amendments	Rule 608(b)(1)
11Aa3-2(c)(2)	Establishes time frame for approval of national market system plans and amendments	Rule 608(b)(2)
11Aa3-2(c)(3)	Provides for effectiveness on filing of certain amendments to national market system plans	Rule 608(b)(3)
11Aa3-2(c)(4)	Provides for summary effectiveness of certain amendments to national market system plans on temporary basis	Rule 608(b)(4)
11Aa3-2(d)	Requires each SRO to comply with terms of any plan in which it participates	Rule 608(c)
11Aa3-2(e)(1)	Provides for review by Commission of actions or failures to act by participants in national market system plans	Rule 608(d)(1)
11Aa3-2(e)(2)	Provides that application for review of action taken under national market system plan normally does not operate as a stay of action	Rule 608(d)(2)
11Aa3-2(e)(3)	Sets forth general standards for Commission action upon applications for re-	Rule 608(d)(3)

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	view	
11Aa3-2(f)	Provides for Commission's granting of exemptions	Rule 608(e)
11Ab2-1	Form of Application and Amendments for Registration of Securities Information Processors ("SIPs")	Moved to Rule 609
11Ab2-1(a)	Mandates use of Form SIP for applications for registration of SIPs	Rule 609(a)
11Ab2-1(b)	Requires prompt amendments for certain items of Form SIP	Rule 609(b)
11Ab2-1(c)	Provides for Commission's granting of exemptions	Rule 609(c)
11Ab2-1(d)	Provides that amendments to applications constitute reports under Sections 17(a), 18(a) and 32(a) of Exchange Act	Rule 609(d)
11Ac1-1	Dissemination of Quotations	Definitions moved to Rule 600; most provisions moved to Rule 602
11Ac1-1(a)(1)	Definition of "aggregate quotation size"	Rule 600(b)(1)
11Ac1-1(a)(2)	Definition of "association"	Changed to "national securities association" and moved to Rule 600(b)(44)
11Ac1-1(a)(3)	Definition of "best bid and best offer"	Rule 600(b)(7)
11Ac1-1(a)(4)	Definitions of "bid" and "offer"	Rule 600(b)(8)
11Ac1-1(a)(5)	Definition of "consolidated system"	Removed
11Ac1-1(a)(6)	Definition of "covered security"	Eliminated in favor of definitions of "NMS security" contained in Rule 600(b)(46) and "NMS stock" contained in Rule 600(b)(47)
11Ac1-1(a)(7)	Definition of "effective transaction reporting plan"	Rule 600(b)(22)
11Ac1-1 (a)(8)	Definition of "electronic communications network"	Rule 600(b)(23)
11Ac1-1(a)(9)	Definition of "exchange market maker"	Rule 600(b)(24)
11Ac1-1(a)(10)	Definition of "exchange-traded security"	Rule 600(b)(25)
11Ac1-1(a)(11)	Definition of "make available"	Removed
11Ac1-1(a)(12)	Definition of "odd-lot"	Rule 600(b)(49)
11Ac1-1(a)(13)	Definition of "OTC market maker"	Rule 600(b)(52)
11Ac1-1(a)(14)	Definition of "plan processor"	Rule 600(b)(55)
11Ac1-1(a)(15)	Definition of "published aggregate quotation size"	Rule 600(b)(59)
11Ac1-1(a)(16)	Definitions of "published bid" and "published offer"	Rule 600(b)(60)

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11Ac1-1(a)(17)	Definition of "published quotation size"	Rule 600(b)(61)
11Ac1-1(a)(18)	Definition of "quotation size"	Rule 600(b)(63)
11Ac1-1(a)(19)	Definition of "quotation vendor"	Rule 600(b)(83) (term changed to "vendor" and modified)
11Ac1-1(a)(20)	Definition of "reported security"	Eliminated in favor of definitions of "NMS security" contained in Rule 600(b)(46) and "NMS stock" contained in Rule 600(b)(47)
11Ac1-1(a)(21)	Definition of "responsible broker or dealer"	Rule 600(b)(65)
11Ac1-1(a)(22)	Definition of "revised bid or offer"	Rule 600(b)(66)
11Ac1-1(a)(23)	Definition of "revised quotation size"	Rule 600(b)(67)
11Ac1-1(a)(24)	Definition of "specified persons" for purposes of notifications and elections under Rule 11Ac1- 1(b)(3)or(b)(5)	Rule 600(b)(69)
11Ac1-1(a)(25)	Definition of "subject security"	Rule 600(b)(73)
11Ac1-1(a)(26)	Definition of "customer"	Rule 600(b)(16)
11Ac1-1(a)(27)	Definition of "listed option"	Rule 600(b)(35)
11Ac1-1(a)(28)	Definition of "options class"	Rule 600(b)(50)
11Ac1-1(a)(29)	Definition of "options series"	Rule 600(b)(51)
11Ac1-1(a)(30)	Definition of "trading rotation"	Rule 600(b)(79)
11Ac1-1(b)(1)	Requires exchanges and national securities associations to establish and maintain procedures for collecting quotations	Rule 602(a)(1)
11Ac1-1(b)(2)	Requires exchanges and national securities associations to establish and maintain procedures for identifying broker-dealer making best bid or offer for a security	Rule 602(a)(2)
11Ac1-1(b)(3)	Requires exchanges to notify specified persons of problems with quotation data	Rule 602(a)(3)
11Ac1-1(b)(4)	Permits exchanges and national securities associations to disseminate quotation information to vendors even when not required to do so	Rule 602(a)(4)
11Ac1-1(b)(5)	Permits exchanges and members of national securities associations to elect to treat securities as "subject securities" for purposes of Rule 11Ac1-1	Rule 602(a)(5)
11Ac1-1(c)(1)	Requires prompt dissemination of quotations by broker-dealers	Rule 602(b)(1)
11Ac1-1(c)(2)	Generally requires broker-dealer to execute orders for quoted securities	Rule 602(b)(2)

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	presented to it, i.e., to "honor" quotations	
11Ac1-1(c)(3)	Sets forth exceptions to obligation to honor quotations	Rule 602(b)(3)
11Ac1-1(c)(4)	Generally prohibits broker-dealers from disseminating, and quotation vendors from displaying, quotations for securities other than "subject securities"	Rule 602(b)(4)
11Ac1-1(c)(5)	Provides that entry of quotations into electronic communications network ("ECN") is a quotation covered by Rule 11Ac1-1; sets forth standards for ECN quotations deemed to be in compliance with rule	Rule 602(b)(5)
11Ac1-1(d)(1)	Governs collection of quotations in listed options	Rule 602(c)(1)
11Ac1-1(d)(2)	Provides that if an options exchange does not require brokers or dealers to disseminate quotations in options, brokers or dealers are relieved of dissemination obligations under Rule 11Ac1-1 and that brokers or dealers will be deemed to have complied with obligation to honor quotes if they execute orders up to size established by exchange	Rule 602(c)(2)
11Ac1-1(d)(3)	Requires thirty-second response by broker-dealer receiving order for listed option in amount greater than its quotation size	Rule 602(c)(3)
11Ac1-1(e)	Provides for Commission's granting of exemptions	Rule 602(d)
11Ac1-2	Display of Quotation and Transaction Data	Definitions moved to Rule 600; substantive provisions moved to Rule 603 but substantially modified
11Ac1-2(a)(1)	Cross-reference to definitions of "transaction report," "effective transaction reporting plan," "moving ticker," "last sale data," "market minder" and "interrogation device in Rule 11Aa3-1	Removed
11Ac1-2(a)(2)	Definition of "vendor"	Rule 600(b)(83)
11Ac1-2(a)(3)	Definition of "NASDAQ"	Removed
11Ac1-2(a)(4)	Definitions of "subject security"	Modified and moved to Rule 600(b)(73)
11Ac1-2(a)(5)	Definitions of "quotations" and "quotation information"	"Quotation" definition modified and moved to Rule 600(b)(62); "quotation information" definition eliminated

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11Ac1-2(a)(6)	Definitions of "bid" and "offer"	Modified and moved to Rule 600(b)(8)
11Ac1-2(a)(7)	Cross-reference to definitions of "quotation size," "aggregate quotation size," "third market maker" and "make available" in Rule 11Ac1-1	Removed
11Ac1-2(a)(8)	Definition of "consolidated display"	Modified and moved to Rule 600(b)(13)
11Ac1-2(a)(9)	Definition of "consolidated price"	Removed
11Ac1-2(a)(10)	Definition of "consolidated volume"	Eliminated in favor of definition of "consolidated last sale information" contained in Rule 600(b)(14)
11Ac1-2(a)(11)	Definition of "cumulative consolidated volume"	Removed
11Ac1-2(a)(12)	Definition of "individual market center display"	Removed
11Ac1-2(a)(13)	Definition of "over-the-counter market maker"	Rule 600(b)(52) (term changed to "OTC market maker")
11Ac1-2(a)(14)	Definition of "reporting market center"	Removed
11Ac1-2(a)(15)	Definitions of "best bid" and "best offer"	Modified and moved to Rule 600(b)(7)
11Ac1-2(a)(16)	Definition of "quotation montage"	Removed
11Ac1-2(a)(17)	Definition of "representative bid or offer"	Removed
11Ac1-2(a)(18)	Definition of "market information"	Removed
11Ac1-2(a)(19)	Definition of "market linkage system"	Removed
11Ac1-2(a)(20)	Definition of "reported security"	Eliminated in favor of definitions of "NMS security" contained in Rule 600(b)(46) and "NMS stock" contained in Rule 600(b)(47)
11Ac1-2(b)	Display requirements for transaction information	Substantially modified and moved to Rule 603
11Ac1-2(c)	Display requirements for quotation information	Substantially modified and moved to Rule 603
11Ac1-2(d)	Permits joint display of transaction and quotation information for a particular security	Substantially modified and moved to Rule 603
11Ac1-2(e)	Prohibits broker-dealer's displaying information that would not be permitted to be displayed by a vendor under Rule 11Ac1-2	Substantially modified and moved to Rule 603
11Ac1-2(f)	Establishes exceptions from display requirements	Substantially modified and moved to Rule 603
11Ac1-2(g)	Provides for Commission's granting of exemptions	Modified and moved to Rule 603(d)

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11Ac1-2(h)	Establishes effective date for Rule 11Ac1-2	Removed
11Ac1-3	Customer Account Statements	Moved to Rule 607
11Ac1-3(a)(1)	Requires notice to customer upon opening of account an annually thereafter of policy regarding payment for order flow	Rule 607(a)(1)
11Ac1-3(a)(2)	Requires notice to customer upon opening of account an annually thereafter of policy regarding routing of orders subject to payment for order flow arrangement	Rule 607(a)(2)
11Ac1-3(b)	Provides for Commission's granting of exemptions	Rule 607(b)
11Ac1-4	Display of Customer Limit Orders	Definitions moved to Rule 600; most provisions moved to Rule 604
11Ac1-4(a)(1)	Definition of "association"	Rule 600(b)(44) (term changed to "national securities association")
11Ac1-4(a)(2)	Cross reference to definition of "best bid" and "best offer" in Rule 11Ac1-1(a)(3)	Removed
11Ac1-4(a)(3)	Cross reference to definition of "bid" and "offer" in Rule 11Ac1-1(a)(4)	Removed
11Ac1-4(a)(4)	Definition of "block size"	Rule 600(b)(9)
11Ac1-4(a)(5)	Definition of "covered security"	Eliminated in favor of definitions of "NMS security" contained in Rule 600(b)(46) and "NMS stock" contained in Rule 600(b)(47)
11Ac1-4(a)(6)	Definition of "customer limit order"	Rule 600(b)(17)
11Ac1-4(a)(7)	Cross reference to definition of "electronic communications network" in Rule 11Ac1-1(a)(8)	Removed
11Ac1-4(a)(8)	Cross reference to definition of "exchange-traded security" in Rule 11Ac1-1(a)(10)	Removed
11Ac1-4(a)(9)	Definition of "OTC market maker"	Rule 600(b)(52)
11Ac1-4(a)(10)	Definition of "reported security"	Eliminated in favor of definitions of "NMS security" contained in Rule 600(b)(46) and "NMS stock" contained in Rule 600(b)(47)
11Ac1-4(b)(1)	Requires specialists to display customer limit orders	Rule 604(a)(1)
11Ac1-4(b)(2)	Requires OTC market makers to display customer limit orders	Rule 604(a)(2)
11Ac1-4(c)(1)	Provides exception to display require-	Rule 604(b)(1)

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	ment for limit orders executed upon receipt of order	
11Ac1-4(c)(2)	Provides exception to display requirement where customer expressly requests that order not be displayed	Rule 604(b)(2)
11Ac1-4(c)(3)	Provides exception to display requirement for odd-lot orders	Rule 604(b)(3)
11Ac1-4(c)(4)	Provides exception to display requirement for block orders, unless customer requests display	Rule 604(b)(4)
11Ac1-4(c)(5)	Provides exception to display requirement for limit orders immediately delivered to exchange or association-sponsored system or to ECN	Rule 604(b)(5)
11Ac1-4(c)(6)	Provides exception to display requirement for limit orders delivered to another broker-dealer	Rule 604(b)(6)
11Ac1-4(c)(7)	Provides exception to display requirement for "all or none" orders	Rule 604(b)(6)
11Ac1-4(d)	Provides for Commission's granting of exemptions	Rule 604(c)
11Ac1-5	Disclosure of Order Execution Information	Definitions moved to Rule 600; most provisions moved to Rule 605
11Ac1-5(a)(1)	Cross-reference to definition of "alternative trading system" in Regulation ATS Rule 300(c)	Rule 600(b)(2)
11Ac1-5(a)(2)	Definition of "average effective spread"	Rule 600(b)(5)
11Ac1-5(a)(3)	Definition of "average realized spread"	Rule 600(b)(6)
11Ac1-5(a)(4)	Definition of "categorized by order size"	Rule 600(b)(10)
11Ac1-5(a)(5)	Definition of "categorized by order type"	Rule 600(b)(11)
11Ac1-5(a)(6)	Definition of "categorized by security"	Rule 600(b)(12)
11Ac1-5(a)(7)	Definition of "consolidated best bid and offer"	Eliminated in favor of definitions of "national best bid" and "national best offer" contained in Rule 600(b)(42)
11Ac1-5(a)(8)	Definition of "covered order"	Rule 600(b)(15)
11Ac1-5(a)(9)	Definition of "exchange market maker"	Rule 600(b)(24)
11Ac1-5(a)(10)	Definition of "executed at the quote"	Rule 600(b)(26)
11Ac1-5(a)(11)	Definition of "executed outside the quote"	Rule 600(b)(27)
11Ac1-5(a)(12)	Definition of "executed with price improvement"	Rule 600(b)(28)
11Ac1-5(a)(13)	Definitions of "inside-the-quote limit or-	Rule 600(b)(29)

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	der," "at-the-quote limit order" and "near-the-quote limit order"	
11Ac1-5(a)(14)	Definition of "market center"	Rule 600(b)(38)
11Ac1-5(a)(15)	Definition of "marketable limit order"	Rule 600(b)(39)
11Ac1-5(a)(16)	Cross reference to definition of "effective national market system plan" in Rule 11Aa3- 2(a)(2)	Removed
11Ac1-5(a)(17)	Cross reference to definition of "national market system security" in Rule 11Aa2-1	Removed
11Ac1-5(a)(18)	Definition of "OTC market maker"	Rule 600(b)(52)
11Ac1-5(a)(19)	Definition of "regular trading hours"	Rule 600(b)(64)
11Ac1-5(a)(20)	Definition of "time of order execution"	Rule 600(b)(74)
11Ac1-5(a)(21)	Definition of "time of order receipt"	Rule 600(b)(75)
11Ac1-6(a)(9)	Definition of "profit-sharing relationship"	Rule 600(b)(56)
11Ac1-6(a)(10)	Cross reference to definition of "time of the transaction" in Rule 10b-10(d)(3)	Rule 600(b)(76)
11Ac1-6(b)(1)	Requires broker-dealers to make quarterly report on routing of non-directed orders available, specifies content of report	Rule 606(a)(1)
11Ac1-6(b)(2)	Requires routing reports to be available within one month of end of month	Rule 606(a)(2)
11Ac1-6(c)(1)	Requires broker-dealer, on request of customer, to disclose venue to which orders routed in prior six months, whether orders directed or non-directed and times of transactions	Rule 606(b)(1)
11Ac1-6(c)(2)	Requires broker-dealer to notify customers at least annually that information on routing of orders available	Rule 606(b)(2)
11Ac1-6(d)	Provides for Commission's granting of exemptions	Rule 606(c)



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CHAPTER 2A Registration and Regulation of Transfer Agents and Clearing Agencies *

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CHAPTER 2A Registration and Regulation of Transfer Agents and Clearing Agencies *

1-2A Federal Securities Exchange Act of 1934 § 2A.01

§ 2A.01 The National System For Clearance and Settlement

[1] Historical Overview

While trading procedures utilized in the secondary securities exchanges n1 have remained essentially unchanged since execution of the Buttonwood Tree Agreement in 1792, n2 the clearance and settlement process has undergone significant evolution. For more than 100 years, the securities industry has struggled to improve the efficiency of this labor and paper intensive process n3 to assure timely delivery of funds and securities.

As early as 1868, members of the New York Stock Exchange ("NYSE") formed a voluntary, informal clearing system, but lack of participation soon killed this project. n4 Similar attempts in 1877, 1879, and 1880 also were abandoned. n5

About 1892, active NYSE members experienced a financial crisis that threatened the continuation of their business and, ultimately, resulted in a major enhancement to the clearing and settlement process. At that time, the NYSE rules required cash payment of the purchase price in every transaction. Accordingly, brokers were dependent upon banks to extend temporary credit through certification of settlement checks. n6 In 1892, after several years of concern, n7 the president of the Bank of the State of New York threatened to suspend further certification of brokers' settlement checks unless the clearing process could be expedited. n8

In response to this pressure, the NYSE formed in 1892 the Stock Clearing House ("SCH"), an informal organization administered by a committee of the NYSE. n9 Although initially limited to four railroad stocks, participation in the SCH by NYSE members soon became compulsory. n10 On its first day of operation, the SCH obviated the need for \$7,000,000 in certified checks. n11 With such obvious success, the SCH was soon expanded and enabled many NYSE brokers to weather the subsequent market panics of 1893 and 1901. n12

The SCH continued to operate on an informal basis until the volume of transactions justified a more formal structure. The SCH was incorporated in 1920 by the NYSE as a wholly owned subsidiary, the Stock Clearing Corporation ("SCC"), with initial capitalization of \$500,000. n13

In 1913, the securities industry focused its attention on the recently formed Vienna Stock Exchange ("VSE") and the central securities depository maintained on behalf of VSE members. The NYSE reviewed the VSE clearing procedures and received a very strong endorsement of that system from the NYSE members who had toured the VSE. n14

Implementation, however, of clearing procedures by the NYSE was aborted with the commencement of World War I. n15

Since the enactment of the Securities Exchange Act of 1934, the Commission has focused from time-to-time on the clearance and settlement procedures.

In 1938, for example, the Commission addressed the issue of the need for a central securities depository system. n16 Primarily concerned with the protection of customer assets, the Commission concluded that:

[I]t is our view that the ideally effective measure for dealing with customers' free credit balances and customers' fully paid or excess collateral securities would be the establishment of trust institutions in various financial centers. * * * Such an institution would assume all banking and custodial functions now performed by brokers as an incident to their brokerage business whether conducted on a cash or on a margin basis. * * * Institutions of this character would have the advantage of placing centralized banking activities under appropriate supervision, reducing to a minimum financial risk to customers, and lessening the overhead expenses of individual brokers. Their use would also serve to remove customers' cash and securities from the risks of insolvency involved in the combination of the dealer with the brokerage function. n17

The NYSE rejected the SEC's proposal in 1939 finding the idea of a central trust too costly and difficult to implement, until trading volume increased. n18 The issue was reconsidered by the NYSE in 1955, and two years later the NYSE initiated a pilot project for central handling of securities, the Central Stock Bookkeeping Service ("CSBS"). The CSBS permitted participating member firms to exchange multiple stock certificates for one large certificate held in the name of a nominee and, thereby, expedite clearance and settlement. n19

After five years of experimentation, the NYSE in 1962 launched a program to obtain legislation in each of the 50 states to permit the transfer of title to securities by bookkeeping entry. n20

While the Commission historically has devoted little of its resources to the clearance and settlement system, during the period 1961 through 1963, the Commission, as part of a Congressionally mandated study of the securities markets, n21 scrutinized, among other things, the "manner, method, and place of making settlements, payments and deliveries, and of closing accounts. n22

The study suggested system deficiencies, which indicated that the then existing system for clearance and settlement "would prove inadequate to meet any substantial increase in [trading] volume," n23 and concluded that "late or nondelivery of securities by broker-dealers" could:

- lead to "a loss of confidence in the industry among public investors;"
- result in adverse financial stability among broker-dealers; and
- render it difficult for investors to sell when they so desire.

To remedy these potential adverse consequences, the Study recommended that:

The industry, with the cooperation of the Commission, should give continuing attention to possibilities for modernizing and improving existing securities handling, clearing and delivery systems, with the goal of evolving institutions and procedures which would permit the reduction of physical transfers of securities and centralization of functions now performed by broker-dealer back offices insofar as possible. n24

The securities industry responded favorably to the Study's recommendations. In 1964, for example, the NYSE announced plans for a Central Certificate Service ("CCS"), an electronic bookkeeping system designed to reduce by as much as 75% the physical delivery and processing of stock certificates among SCC members. n25

[2] The Paperwork Crisis of 1968 and the Regulatory Environment Prior to the Securities Acts Amendments of 1975

Before the securities industry could implement the Study's recommendations and complete its modernization program, a crisis occurred. In 1967, trading on the NYSE surged to 2.53 billion shares--an increase from 1966 of at least 33 1/3% percent. n26 The industry was not prepared for this volume. According to the Commission, "the aftermath was virtual chaos experienced by a substantial number of firms." n27 The Commission described back offices of many broker-dealers to be "a trackless forest." n28 It was "utterly impossible to keep books and records apace with the mounting speed and volume of transactions." n29 In short order, the books and records of many broker-dealers became "veritable shambles ... all elements in the processing of transactions collapsed ... " n30

To deal with this crisis, trading hours were reduced to give back office personnel more time to process back logs. n31 The Commission issued special bulletins demanding that broker-dealers comply with applicable rules regarding maintenance of current books and records and prompt clearance of securities and funds. n32 The Commission also proposed, but did not adopt, a rule that would make it unlawful for an issuer of publicly traded securities "to fail to provide appropriate facilities for the prompt transfer of securities." n33

To meet the operational demands caused by the surge in trading volume, many firms incurred significant increases in operating expenses and, accordingly, experienced serious financial problems. n34 These financial pressures placed investor funds and securities at risk and, ultimately, resulted in the enactment of the Securities Investor Protection Act of 1970. n35

Moreover, legislation was introduced in the Senate to establish a National Securities Corporation ("NSC") to be owned and operated by the United States. n36 The NSC would constitute the key element in a Congressionally mandated national depository system.

The House also conducted an independent study of Commission records on the operational and financial problems experienced by broker-dealers. n37 The study concluded that the securities industry was not prepared to handle the increased trading volume of the late 1960s and that "serious, complex and far reaching problems embrace all sectors of the securities industry." n38 The study urged, among other things, an "extensive study" of the industry by the Commission.

This recommendation led to the Commission's preparation of a special report to Congress on the unsafe and unsound practices of brokers and dealers. n39 Citing a long list of problem areas, n40 the Commission concluded that the:

[c]learance, settlement, depository and transfer functions form part of a continuous process. To ensure the prompt development of a national system, the Commission's present authority over clearance, settlement and record keeping should be extended to the depository and transfer functions ... n41

Specifically, the Commission requested the enactment of new legislation that would impose federal regulations over "the transaction handling process, particularly with a view to standardization, automation, and increased protection for industry participants and members of the investing public." n42

The Senate Committee on Banking, Housing and Urban Affairs prepared a separate study of the operational problems facing the securities industry. n43 This study recommended legislation "to require all organizations engaged in the

clearing and settlement of securities transactions to register with the SEC" and to give the Commission "clear and complete power and responsibility" to create "an integrated national system" for clearance and settlement. n44 Legislation was then introduced and extensive hearings held on the issue of direct federal regulation of the clearing and settlement process. Legislation was finally enacted in 1975. n45

While Congress and the SEC were evaluating the need for and structure of legislation, the securities industry voluntarily initiated several remedial programs. The drive for systemic improvements was spearheaded by a special committee denominated as the Banking and Securities Industry Committee ("BASIC") composed of the presidents of the NYSE, Amex and NASD, the chairmen of three major New York Clearing House banks and, executive director, a retired senior partner of Price Waterhouse & Co. n46 BASIC had analogous counterparts in various segments of the securities industry. n47

In 1971, BASIC announced that a "Memorandum of Understanding" had been executed, calling for the formation of a Comprehensive New York Securities Depository System (CNYSDS) by the NYSE, Amex, NASD, and the eleven members of the New York Clearing House Association. According to the participants, the CNYSDS would have the following major advantages:

- feasibility of relatively rapid start-up of operations, despite the likelihood of some delays in the passage of enabling legislation;
- maximum flexibility in interrelating with broker/dealer clearing systems and the constraints on fiduciaries;
- minimum cross-assumption of risks among depositor groups;
- maximum protection of certificates;
- maximum building upon--and minimum interruption of--the Central Certificate Service; and
- immobilization of the stock certificate to a degree that would enhance the feasibility of a final step of legislation to eliminate the stock certificate should that prove desirable. n48

Citing these advantages, the participants agreed to attempt to create a central depository to be linked to the various regional depositories. n49 To facilitate the operations of the Central Certificate Service ("CCS"), n50 Cede & Co., a wholly owned subsidiary of the NYSE, was formed to serve as the common nominee. n51 By mid-1972, banks and NYSE brokerage firms were utilizing the CCS for both NYSE, American Stock Exchange, and over-the-counter issues. The CCS was also utilized to expedite the delivery of cash dividends and voted about 75% of all eligible NYSE, Amex, and OTC shares by proxy or on instructions from clearing members. n52

In addition, the Stock Clearing Corporation ("SCC") n53 was authorized to permit out-of-state and foreign banks, investment companies and regional clearing corporations (as "Affiliate Members") to open an omnibus account at the CSS. Through such an account, the Affiliate Members could receive or deliver any eligible security to or from any participating regional exchange without the physical movement of securities. n54

Finally, the CCS adopted a delivery system to reduce the clerical effort and paperwork required to balance order deliveries, n55 experimented with the concept of a "locked-in-trade," n56 and computerized bond deliveries.

Notwithstanding these enhancements, the clearance and settlement system was not efficient. According to the Securities Industry Association ("SIA"), there were two causes for the industry's problems: the paper and labor intensive clearing process, particularly in the over-the-counter market; and "segmentation" of the securities processing industry. n57 The

answer, according to the SIA, "is the creation of an integrated, national clearance and settlement system. n58

[3] The Statutory Mandate of the Securities Acts Amendments of 1975

After more than three years of debate and analysis, Congress, in 1975, enacted sweeping amendments to the Securities Exchange Act of 1934. The ensuing legislation, n59 which amended the Exchange Act by adding a new Section 17A: was predicated upon a Congressional finding n60 that:

- "prompt and accurate" clearance and settlement of securities transactions "are necessary for the protection of investors;"
- inefficient clearance and settlement procedures "impose unnecessary costs" on investors;
- advances in data collection and dissemination create "the opportunity for more efficient, effective, and safe" settlement procedures; and
- the integration of all clearance and settlement facilities and the adoption of "uniform standards and procedures" will reduce unnecessary costs and enhance investor protection.

Section 17A, accordingly,

- directs the Commission to use its authority "to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities;" n61
- requires registration of clearing agencies and transfer agents; n62
- vests specific regulatory authority in the Commission with respect to all facets of the clearing and settlement process, particularly clearing agencies and transfer agents; n63
- allocates regulatory responsibility among the Commission and the various bank regulatory authorities; n64 and
- instructs the Commission to use its authority "to end the physical movement of securities certificates" in the clearance and settlement process. n65

Two basic themes underlie the legislative history of Section 17A, the prevention of another paperwork crisis and the establishment of a "safe, efficient and modern national clearing and settlement system." n66

The Senate Report on S.249, the Securities Acts Amendments of 1975, concludes, for example, that "the present uncoordinated state of affairs with respect to securities processing should not be allowed to continue" n67 and charges the Commission with responsibility for shaping a national system to remedy problem areas of excessive costs and poor service. n68 Similarly, the Conference Report observed that the goal of Section 17A is to assure "the development of a modern, nationwide system for the safe and efficient handling of securities transactions" under the guidance of the Commission. n69

[4] The Commission's Implementation of Section 17A

The Commission was well prepared to implement Section 17A. Since the back office crisis of the late 1960s, the Commission's staff had studied and evaluated virtually every aspect of the clearance and settlement process. n70 The Commission had also sponsored at least one lengthy industry conference on the handling of securities certificates in an

attempt to spur industry reform prior to the enactment of legislation. n71

The Commission's efforts toward implementation of Section 17A were directed to three areas: the adoption of registration criteria and standards of performance for transfer agents, n72 the registration of clearing agencies, n73 and the formation of a national system for clearance and settlement.

As a practical matter, each of these three areas is interrelated and, therefore, the regulatory initiatives implemented in one area have had a direct impact on other initiatives under Section 17A. Moreover, since 1975, the securities industry has experienced significant changes in its operational capacity due, primarily, to the advent of electronic communication systems. n74 Therefore, no aspect of the Commission's initiatives under Section 17A should be viewed in a vacuum.

As to the information of a national system of clearance and settlement, the Commission was reluctant to force the securities industry to adopt any particular system and preferred to offer general comments and observations while reacting to industry sponsored initiatives. n75 Therefore, initial progress towards this Congressionally mandated system was slow.

The Commission's initial direct effort toward the Congressional goal of a national system of clearance and settlement commenced in late 1975 when the Commission formally adopted registration requirements for transfer agents n76 and clearing agencies. n77

Shortly thereafter, the Commission was requested to approve the merger of the three largest clearing agencies n78 into a single entity -- the National Securities Clearing Corporation ("NSCC") -- and to grant to the NSCC final registration as a clearing agency pursuant to Section 17A(b) of the Securities Exchange Act. n79 Because the application raised "important and novel legal and policy issues" relating to the evolution of a national system for clearance and settlement and because the merger would likely have "a determinative impact on the development" of that system, the Commission instituted a public proceeding pursuant to Section 17A. n80 A second public proceeding was commenced with respect to the registration application of thirteen additional clearing agencies. n81

The Commission, in the context of the NSCC hearing, announced n82 that the national system of clearance and settlement should possess the following "minimum acceptable" characteristics:

- The ability to process securities transactions by means suitable to the character of the issues processed, including book entry. n83
- All broker-dealers and financial institutions n84 should have access, directly or indirectly, to the system. n85
- Each participant in the system should have the ability to compare, account for and settle through one entity all trades in securities included in the system, regardless of the location of the other party to the trade or the market in which the trade is executed. n86
- Each participant should be able to deposit and maintain its securities in a custodial account at the depository level that permits book entry movements between participants, settle participants' clearing obligations, effect pledges and perform other functions that may be effected by book entry. n87
- Each participant should be able to make a single daily money settlement for both clearing and depository functions, in funds valued the next day. n88
- The book entry process should permit same-day turnaround at both the clearing corporation and

depository levels. n89

During the pendency of the NSCC proceedings, the Commission received and approved n90 a proposal by the New York Stock Exchange to permit its members to utilize single denomination stock certificates ("SDSC"). n91 Because SDSCs are fed through a computer controlled high-speed reader-printer, transaction time and expense for transfer agents have been reduced significantly. n92 Moreover, the SDSC was a major step toward the immobilization of the stock certificates, a Congressionally mandated Commission objective. n93

In December 1976, the Commission released its report to Congress on the practice of recording the ownership of securities in other than the name of the beneficial owner, i.e., "street" or "nominee" record ownership. n94

The Commission concluded that the continued use of street and nominee name registration is "essential" to the development of a national system of clearance and settlement because such registration reduces significantly the volume of paperwork and greatly expedites the use of book entry transfers. n95 The Commission nevertheless recommended various steps to improve the performance of the then clearing and settlement system, including the development of better communication between issuers and beneficial owners who are represented by broker-dealers. n96

Subsequently, the Commission approved the application of the NSCC for registration as a clearing agency. n97 In its order, the Commission found that the registration of the NSCC "is an essential step toward the establishment, at an early date, of a comprehensive network of linked clearance and settlement systems and branch facilities with the national scope, efficiencies and safeguards envisioned by Congress in enacting the 1975 Amendments." n98

As to the characteristics of the evolving national clearance system, the Commission reiterated in its NCSS order the six minimum operational standards announced in mid-1976 n99 but acknowledged that the Commission's views would be influenced by "the dynamic growth process of the nation's securities markets" and "the concomitant need for a ... system with the capacity to service, and the flexibility to adapt to changes in, the nation's capital-raising mechanisms." n100 Finding that registration of NSCC was justified, the Commission granted registration; however, the Commission's order was immediately challenged and litigation quickly developed. n101

During the pendency of this litigation, the Commission adopted its initial set of performance standards for transfer agents. n102 These rules were designed to contribute to the establishment of a national system of clearance and settlement by establishing minimum performance criteria for all transfer agents and mandatory interfaces among transfer agents and between transfer agents and broker-dealers.

Notwithstanding the progress that had been made in the development of a national clearance system, some members of Congress were disappointed with the Commission's leadership. Following six days of hearings and analysis of extensive written submissions, n103 a report was issued that was very critical of the Commission. n104 In summary, the Commission was criticized for approving the merger of the three largest clearing agencies that created the NSCC n105 and, in the view of certain members, for failing to assert aggressively its leadership position within the securities industry. n106 Congressman John E. Moss, Chairman of the House Subcommittee on Oversight and Investigations, was particularly vitriolic in his criticism of the Commission. n107

Although certain members of Congress were critical of the NSCC merger, the judiciary was not. In the fall of 1978, the United States Court of Appeals for the District of Columbia Circuit affirmed the Commission's order granting registration to the NSCC but directed the Commission to reinstitute its review proceeding to reconsider certain aspects of the NSCC's pricing structure and its facilities management agreement. n108 Shortly thereafter, the Commission completed its review of the transaction completion rules of the securities exchanges and the National Association of Securities Dealers, Inc. As a result of this review, more than 100 exchange and NASD rules were amended or deleted. n109

The Commission also held extensive hearings on the national clearance and settlement system and authorized expanded interfaces among securities depositories, which further immobilized securities certificates and facilitated the use of a single depository to settle trades regardless of the location of the parties or the market site at which the trade occurred. n110

To foster participation by registered investment companies in the national system of clearance and settlement, the Commission adopted Rule 17f-4, n111 which designates the Federal Reserve/Treasury book-entry system for United States and federal agency securities as a permitted depository for securities owned by registered investment companies. n112

In 1979, the Commission issued a statement on the status of the national market system n113 and the national system for clearance and settlement of securities transactions. n114 The Commission, citing the six standards that, in its view, the clearance and settlement system should meet, n115 *further stated that "perhaps the most important of those characteristics" is "one account processing" that permits participants "to compare, clear and settle, through single accounts with a clearing agency and with a depository," all trades of securities included in the system regardless of the location of the trade or the other party to the trade.* n116

Consistent with its primary objective, the Commission announced its intention to direct its attention to three other areas:

- the establishment of regional clearing centers to permit broker-dealers to clear trades without regard to their physical location or that of the clearing agency; n117
- the interface fees charged by clearing agencies; n118 and
- the expansion of processing activities by clearing agencies. n119

By late 1979, the securities industry had made significant progress in interfacing its regional securities depositories, aided by the Commission's approval of an interface between the two principal depositories -- the Depository Trust Company ("DTC") and the Philadelphia Depository Trust Company ("PDTC"). n120 This interface eliminated the need for actual withdrawal and physical movement of securities to settle transactions among DTC and PDTC participants. Similar interfacing developed between other depositories.

The next major step occurred with the Commission's approval of various rule changes by the NSCC and Bradford Securities Processing Services, Inc. that expanded the scope of processing activities by creating processing procedures for municipal securities. n121

Similar expansion efforts developed in the over-the-counter ("OTC") market with the adoption of a uniform comparison system by three regional stock clearing corporations compatible with the system utilized by the NSCC. n122 In a further effort to compel market makers in the OTC market to participate in an efficient, low cost clearing system, the NASD in 1982 adopted a rule requiring its market makers to clear and settle through a registered clearing agency situated within 25 miles of the market maker, if such a clearing agency exists. n123

Finally, with respect to institutional trades, the Commission in 1982 approved various rule changes of the Midwest Securities Trust Company, the PDTC, and the DTC to establish a nationwide delivery system. n124 The Commission also adopted in that year minimum performance standards for transfer agents. n125

By 1983, the rudiments of a national system of clearance and settlement were in place. Securities transactions were processed largely by book entries, except when unusual circumstances required specific delivery. Brokers, dealers, and financial institutions had access to all facets of the system. One account processing was generally available and securities certificates had been greatly immobilized. Uniform performance standards had been adopted for transfer

agents that resulted in prompt turnaround.

[5] Current Development

The securities industry continues to explore new procedures for minimizing cost and expediting the settlement process. The Commission is frequently asked to approve various rules and operational changes. The Commission also monitors the clearance and settlement process and initiates regulatory proposals whenever it feels remedial action is necessary for the protection of investors.

The Commission monitors the activities of transfer agents and clearing agencies and confers frequently with the self-regulatory organizations and other elements of the securities industry to identify potential problem areas.

FOOTNOTES:

(n1)Footnote 1. These trading procedures are discussed in § 2.01[1] and [2] of the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section F.] *supra*.

(n2)Footnote 2. The Buttonwood Tree Agreement consolidated a group of individual traders into an organized entity that became known as the New York Stock Exchange.

(n3)Footnote 3. For discussion of the clearing and settlement process, see Loss & Seligman, Securities Regulation 2908-2912 (Little Brown).

(n4)Footnote 4. The early attempts to improve the clearing and settlement process are discussed in a submission by the NYSE to a Congressional Committee analyzing that issue. *See Clearance and Settlement of Securities Transactions: Hearings on S.3412, S.3297 and S.3662 Before the Subcomm. on Securities of the Senate Comm. of Banking, Housing, and Urban Affairs*, 92d Cong., 2d Sess. 189-248 (1972) [hereinafter *Clearance and Settlement Hearings*].

(n5)Footnote 5. *Clearance and Settlement Hearings*, n.4 *supra*, at 244.

(n6)Footnote 6.

When a firm delivered 100 shares of a stock, it expected payment at the time of delivery by messenger. In many cases, the buying firm had insufficient funds to meet all such payments. Of course, once the buying firm secured title to the stock, it could pledge the stock at the bank for enough money to meet the entire amount due, but it could not pledge the stock until it secured title, and it could not secure title until it paid for the stock.

This seeming impasse was broken by two expedients, neither of which pleased the bankers of that day. First, the purchasing broker could secure temporary funds by over certification of his check. In this process, the bank certified the check for more than the broker's balance. The check became, in effect, an unsecured loan, which neither the bank nor the government looked upon with approval. Another method was for the bank to give the broker a 'morning loan.' This was a loan for a few hours, which was to be secured as soon as the broker received possession of the collateral. In both cases, the banks were extending vast amounts of credit to brokers, often without sufficient credit standing.

Clearance and Settlement Hearings, n.4 *supra*, at 217-18. This certification process is also discussed in detail in S. Pratt, *The Work of Wall Street 164-66* (1975) [hereinafter "Pratt"]. *See also* R. Sobel, *The Curbstone Brokers: The Origins of The American Stock Exchange* (1970).

(n7)Footnote 7. The Bank's concern was exacerbated by the formation of a functional stock-clearing system in Frankfurt in 1867 and the swift adoption of the system in Berlin, Hamburg, Vienna and London, and by the Boston and

Philadelphia Stock Exchanges; however, the NYSE refused to adopt a similar system. Pratt, n.6 *supra*, at 164-65.

(n8)Footnote 8. Pratt n.6 *supra*, at 165.

(n9)Footnote 9. *See Clearance and Settlement Hearings*, n.4 *supra*, at 216-18, 244; *see also* Pratt, n.6 *supra*, at 164-65.

The Report of the NYSE Special Committee that recommended incorporation of the Stock Clearing House emphasized the need for prompt NYSE action.

If this Exchange is to take the proper place in the future among the stock-markets of the world, a system of doing business will be required which will stand the strain of a volume of business larger than any heretofore known. Our present system of actual payment of entire value in every transaction blocks up in active times both banks and offices to an intolerable extent, and is an obstacle to the growth of the business commensurate with the growth of the country. For causes well understood, the banking facilities for this business have not increased during recent years. A proper system of clearing by largely reducing the volume of checks and deliveries would relieve both offices and banks of much of the confusion and risk with which we are so familiar.

Pratt, n.6 *supra*, at 165-66.

(n10)Footnote 10. *Clearance and Settlement Hearings*, n.4 *supra*, at 218.

(n11)Footnote 11. *Id.*

(n12)Footnote 12. Pratt, n.6 *supra*, at 166-68.

(n13)Footnote 13. *Clearance and Settlement Hearings*, n.4 *supra*, at 218.

(n14)Footnote 14. The report to the NYSE Governing Committee described the VSE clearance procedure and concluded:

[T]he institution has also an arrangement for the clearing of stocks, issued from one party to another, by cheque. All the firms who are members have a deposit of transfers or stock with the institution just in the same way as they have a deposit of cash, and these are issued from one firm to another in the same way as with cash. The Account holder who has stocks to deliver hands over to the institution, instead of actual stocks, his check on the Giro Stock Department, where his particular stocks are being kept. In the same way, the man who is to receive these particular stocks, has also a deposit of securities with the institution, and so, he does not collect the said securities, but the same are placed with his particular deposit. Then, the account of the man who delivered the stocks is credited with the amount of the same in cash, and the receiver's account is likewise debited with a similar amount, without the necessity of any change in the amount of securities taking place in the deposits of the Giro-Cassen Verein. In this way the responsibility of the member is relieved, as he has not sent any cash or securities through the streets from one house to another. Nearly 38% of the business of buying and selling stocks, which takes place in Vienna, is done by the Giro Stock Deposit System, exceptions being made, of course, through new members joining, and not having sufficient securities or anything similar.

The proof ... of the benefits of this system is that there are over one billion kroner worth of securities always on deposit. The proof of this system against fraud is so evident that we need not mention anything on the subject.

Clearance and Settlement Hearings, n.4 *supra*, at 225-26.

(n15)Footnote 15. *Id.* at 226. *See also* Pratt, n.6 *supra*, at 164-68.

(n16)Footnote 16. As discussed in the Commission's Special Study of the Securities Market:

Two types of central securities depository systems have been suggested. In one, securities would be physically held in one place together with the associated records. In the other, the central depository would serve as a conduit through which the securities would flow to the appropriate transfer agents, who would hold them and make bookkeeping entries as to changes in ownership, delivering out such securities as were needed by firms or customers. Each system contemplates cross-pledging of securities by bookkeeping entry, upon order by member firms, so that no physical transfer of securities would be required for that purpose. Transfers between firms likewise would not require physical delivery.

SEC, Report of the Special Study of the Securities Markets, H.R. Doc. No. 95, Pt. 1, 88th Cong., 1st Sess. at 425 (1963) [hereinafter "SEC Special Study"].

(n17)Footnote 17. SEC, Report on Investigation, In the Matter of Richard Whitney, (1938).

(n18)Footnote 18. The NYSE engaged the accounting firm of Haskins & Sells ("H&S") to evaluate the feasibility of a central depository. H&S concluded that such a depository would be impractical if average daily NYSE trading volume was less than 2 million shares. *Clearance Settlement Hearings*, n.4 *supra*, at 245.

The [NYSE] board in its report on August 31, 1939, rejected the idea of a central trust institution on the grounds that it would involve reorganization of the industry at a time when it was operating unprofitably; there would be a duplication of existing recordkeeping machinery; it would interfere with the confidential broker-dealer relationship; there was doubt that banks would lend on securities without physical transfer; and it was feared that concentration of securities in one institution would create various problems in regard to handling of proxies, removal of competition among brokerage firms in servicing customer accounts, danger to the market of concentrated selling from a single source, congestion at periods of maximum activity, and handling of margin accounts mechanically with no consideration of the credit worthiness of the borrower.

The board also rejected the idea that banking functions of brokerage houses be handled by banks on the grounds that handling margin accounts is a specialized business which can be more efficiently handled by the brokerage firms themselves and that separating custodial and margin-keeping functions would offer difficulties which would outweigh any other advantages.

SEC Special Study, n.16 *supra*, at 425-26.

(n19)Footnote 19. *Clearing and Settlement Hearings*, n.4 *supra*, at 245. In his Annual Report to the NYSE Membership, the president of the NYSE observed:

An experiment which may prove as important to our industry as the establishment of the clearing function has been worked out by a Special Committee [of the Board of Governors]. Fifteen firms, twenty listed companies, and one transfer agent ... and a newly created division of Stock Clearing Corporation, the Central Stock Bookkeeping Service, are cooperating in this one-year pilot program for the centralized handling of securities. The plan holds great promise for future savings.

Under this experiment, the securities placed in the plan by member firms are held in the name of the bank nominee in large denomination certificates, subject to instructions transmitted by the Clearing Corporation. Interfirm securities movements are reflected by bookkeeping entries in the Clearing Corporation rather than by physical movement of certificates thus avoiding much of the work involved in handling, accounting, assignment and delivery of share certificates. The plan also provides for the elimination of due bills for inter-pilot firm deliveries, more effective control of dividend payments, and for channelling corporate communications to the beneficial owner of the stock held in nominee name.

Clearance and Settlement Hearings, n.4 *supra*, at 226-27.

(n20)Footnote 20. *Id.* at 227.

(n21)Footnote 21. On September 5, 1961, Exchange Act § 19(d) was enacted. This section directed the Commission "to make a study and investigation of the adequacy, for the protection of investors, of the rules of the national securities exchanges and national securities associations. ..." Pub. L. No. 87-196. The Commission was directed to report to Congress "the results of its study and investigation, together with its recommendations. ..." H.J. Res. 438, 87th Cong., 1st Sess. (1961).

The resulting Study was the most comprehensive of its kind since the enactment of the Exchange Act of 1934. *See* SEC Special Study, n.16 *supra*.

(n22)Footnote 22. SEC Special Study, n.16 *supra*, at 416-28.

(n23)Footnote 23. *Id.* at 427.

(n24)Footnote 24. *Id.* at 428.

(n25)Footnote 25. *Clearance and Settlement Hearings*, n.4 *supra*, at 245.

(n26)Footnote 26. SEC, Study of Unsafe and Unsound Practices of Brokers and Dealers, H.R. Doc. No. 231, 92d Cong., 1st Sess. 13 (1971) [hereinafter "Study of Unsafe and Unsound Practices"].

(n27)Footnote 27. *Id.*

(n28)Footnote 28. *Id.*

(n29)Footnote 29. *Id.* at 19.

(n30)Footnote 30. *Id.*

(n31)Footnote 31. 34 SEC Ann. Rep. 16 (1969).

(n32)Footnote 32. *See, e.g.*, Sec. Exch. Act Rel. No. 34-8335, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,566 (June 17, 1968); Sec. Exch. Act Rel. No. 34-8363, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,583 (July 29, 1968).

(n33)Footnote 33. Sec. Exch. Act Rel. No. 34-8413, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,608 (Sept. 25, 1968).

(n34)Footnote 34. 36 SEC Ann. Rep. 2 (1971).

(n35)Footnote 35. This Act is discussed in § 1.01[2][c][i] *supra*, and § 3.08[2] *infra* .

(n36)Footnote 36. Senator Roth, one of the sponsors of this bill (S.2551), summarized the NSC as follows:

In order to focus the industry's efforts at solving what has become a national problem; namely, the need for safer, cheaper, and more efficient means of transferring ownership in American business enterprise, I am proposing the establishment of a national program to bring into operation a nationwide system for transferring securities ownership.

This program will operate in two stages: First, it will establish a COMSAT-type, privately owned and funded, National Securities Corp. This Corporation will, as soon as practicable, commence operation as a nationwide depository system. It will act as a comprehensive settlement system, maintaining physical custody of corporate stocks and bonds placed on deposit by the Nation's financial institutions in decentralized regional depositories. Transfer of ownership of certificates will be made by bookkeeping entry, much as the Federal Reserve System accomplished for deposits of member banks.

Cong. Rec. S. 32473 (daily ed. Sept. 20, 1971) (remarks of Sen Roth concerning S. 2551).

(n37)Footnote 37. Staff of Special Subcomm. on Investigations of the House Comm. on Interstate and Foreign Commerce, 92d Cong., 1st Sess., Review of SEC Records of the Demise of Selected Broker-Dealers (Comm. Print 1971) [hereinafter "Review of Demise of Selected Broker-Dealers"].

(n38)Footnote 38. *Id.* at 5.

(n39)Footnote 39. Study of Unsafe and Unsound Practices, n.26 *supra*.

(n40)Footnote 40. The Commission identified 14 "practices" that, in the Commission's view, "permitted things to get out of control." *Id.* at 2. At least four of these focused upon the clearance and settlement system:

- (1) securities were not checked and counted frequently enough nor were they controlled tightly enough;
- (2) to respond to the paperwork crisis, new and expensive technologies were "hastily" adopted by brokerage firms "without adequate preparation, analysis of cost or mastery of technical requirements;"
- (3) "Fails" remained outstanding, causing additional delivery problems and "resulting in shock waves of loss throughout the brokerage community," and
- (4) delivery, clearance and transfer facilities became "hopelessly clogged as they proved unequal to the increased volume."

Id. at 2-3.

(n41)Footnote 41. *Id.* at 1.

(n42)Footnote 42. *Id.* at 6. The Commission also commented that:

Regulation of the process as a whole is clearly desirable, and the Commission is in the best position to furnish such regulation in that it now has jurisdiction over the broker-dealer community, investment companies, stock exchanges, securities associations, issuer companies (in certain respects), and subsidiaries of exchanges and securities association which now perform clearance, settlement and depository tasks. However, certain tasks, such as the transfer and registration of transfer of certificates, are not directly within the Commission's regulatory jurisdiction and even the depository function would

appear to be subject to direct regulation by the Commission only if performed by entities which are registered with it. Therefore, in order to ensure that the transaction handling process can be made to function efficiently as a whole, the Commission recommends that it be given authority over the qualifications, performance, business practices and rules of entities performing transfer and depository functions, but only to the extent that their performance of these specific functions is involved. The Commission, in seeking this authority, is not desirous of expanding its jurisdiction to conflict with that of Federal or state bank-regulatory agencies. Economic regulatory authority is not being sought. Rather, the Commission is merely desirous of having all necessary authority to oversee the development of a unified securities processing system and the establishment of the performance standards and access practices necessary for the development and proper functioning of such a system.

Id.

(n43)Footnote 43. Securities Industry Study, Report of the Senate Comm. on Banking, Housing, and Urban Affairs, 92d Cong., 2d Sess. (1972).

(n44)Footnote 44. *Id.* at 3.

(n45)Footnote 45. Pub. L. No. 94-29, 89 Stat. 97 (Act of June 4, 1975), discussed in § 1.01[2][d] *supra*.

See Clearance and Settlement Hearings, n.4 *supra*.

(n46)Footnote 46. *Clearance and Settlement Hearings*, n.4 *supra*, at 206, 239.

(n47)Footnote 47. *Id.* at 150.

(n48)Footnote 48. *Id.* at 240.

(n49)Footnote 49. In summary, the Memorandum of Understanding called for the "two stage evolution" of the present CCS into an expanded depository system. In the first stage, CCS would become "a direct, wholly owned subsidiary of the New York Stock Exchange, Inc.," instead of a division of Stock Clearing Corporation. A corporation that might be used for this purpose was created on March 31, 1972. The Amex, NASD, Clearing House Banks, and other users would be represented on the board of directors of that subsidiary, which was chartered as a trust company under New York State banking law. In the second stage of the expansion, "ownership of the depository will be shared by its users." The agreement contemplated that the New York Stock Exchange would be appropriately compensated for unrecovered start-up costs of the original Central Certificate Service and its successor, Central Certificate Service, Inc.

Clearance and Settlement Hearings, n.4 *supra*, at 242.

(n50)Footnote 50. *See* text at n.25 *supra*.

(n51)Footnote 51. *Clearance and Settlement Hearings*, n.4 *supra*, at 228.

Though the technical aspects of the Central Certificate Service are complex, the basic operations are quite simple. Brokerage firms maintain shares of eligible securities on deposit in their CCS accounts. These accounts are credited with the number of shares deposited, and stock certificates representing these shares are registered in the name of a common nominee, Cede & Co. CCS does not acquire any beneficial interest in these shares.

To make delivery, the selling brokerage firm instructs CCS to debit its account by, say, 500 shares of XYZ Corporation and credit the buying broker's CCS account with the same number of XYZ shares.

Title to the shares is thus transferred by a computerized bookkeeping entry while the certificates themselves remain immobilized. At the same time, in Stock Clearing Corporation, the offsetting changes in the buying and selling members' daily cash balances are also made by electronic bookkeeping entry.

Under the old system, a firm executing a sale for one of its customers would have to get the certificate; make certain that it was signed, checked, stamped, counted, then put in an envelope and make physical delivery through the Stock Clearing Corporation. Similarly, the buying brokerage firm would have to receive the certificate physically, examine it, log it in, check it, stamp it, etc.--a reciprocal sequence of many time-consuming manual steps. With CCS, it is estimated that about 75% of brokers' certificate-handling can be eliminated.

Id. at 228-29.

(n52)Footnote 52. *Id.* at 230.

(n53)Footnote 53. *See* text at n.13.

(n54)Footnote 54. *Clearance and Settlement Hearings*, n.4 *supra*, at 236.

(n55)Footnote 55. The new program, referred to as the "PDQ System," would be "aimed at cutting paperwork and clerical effort associated with balance-order deliveries." The System would also eliminate the tedious necessity for Clearing Members to notify CCS of each specific delivery to be made by computerized bookkeeping entry. Instead, a Clearing Member would preauthorize CCS to make deliveries automatically--with the exception of those deliveries which, according to the NYSE, "cannot be made because of segregation or certain other considerations--in the absence of specific instructions to the contrary." By eliminating much of the clerical activity formerly involved in initiating computerized delivery through CCS, the new system significantly expedited the delivery process. At the same time, PDQ made it possible to do away with a considerable amount of ancillary paperwork in connection with the basic CCS elimination of certificate movement.

Id. at 237.

(n56)Footnote 56.

Essentially, the locked-in-trade concept envisions a series of automatic operations, triggered by the transmission of an order to the trading floor, and following through all the steps subsequent to the execution of the order--including reporting and confirmation of trade data, clearance and settlement of the transaction, delivery (whether by computerized bookkeeping entry or physical delivery of a certificate to a customer at his request) --to complete the transaction.

In a fully developed system, after a trade is executed in the auction market, the computer would report the trade on the ticker tape and would notify the brokerage firms involved that their customers' orders to buy or sell had been executed. The names of both the buyer and seller would be recaptured automatically to provide information for the stock clearing and settlement process after execution. Ultimately, it should be possible to innovate to the point where the clearance function could be eliminated, with the trade information going directly to settlement in the depository.

Id. at p. 238.

(n57)Footnote 57. *Id.* at 145 (statement of Robert M. Gardiner on behalf of the Securities Industry Association). According to the SIA:

Segmentation of the industry refers to the fact that the clearance and settlement of every securities

transaction demands prompt and coordinated action by a number of different organizations each functioning within the processing network. These various participants include brokerage firms, banks, transfer agents, depositories, the exchanges, public corporations, institutional investors, and banknote printers. * * * We believe that segmentation has proved to be the most difficult problem to resolve, but that its resolution is absolutely essential if the paperwork question is to be laid to rest.

Although the members of that community allegedly have a common interest in making this system work for the benefit of the investor, the separate units also have individual self interests that can work against the overall desired result. The conflicts thus generated can work to increase rather than reduce 'fails, lead to excessive transfer time, place dividends in limbo, lead to incompleting trades and the rejection of partial deliveries. They also reflect the fact that the stock certificate is not merely a piece of paper. It represents a significant sum of money and that money is at interest, with one party paying the interest and the other party receiving it.

Id. at 146.

(n58)Footnote 58. *Id.* at 145.

(n59)Footnote 59. The Securities Acts Amendments of 1975, Pub. L.No. 94-29, 89 Stat. 97 (Act of June 4, 1975), discussed in § 1.01 [2][d] *supra*.

(n60)Footnote 60. Section 17A(a)(1).

(n61)Footnote 61. Section 17A(a)(2)(A) of the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section F. The clearance and settlement system would complement the national market system, which Congress also mandated. See §§ 2.01[3] and 2.04 *supra* .

As the House Report observed:

Tied to the national market system will be a national clearance and settlement system to facilitate the paperwork attendant to transactions executed in the national market system. The national clearance and settlement system will eliminate the transcontinental shipment of money and securities and will allow stock brokers to perform the clearance and settlement function in their own region. This should insure that investors receive their money or evidences of ownership in a timely fashion, and should also produce significant cost savings to stock brokers, savings which the Committee expects to be passed on to the investor under the competitive commission rate system.

It should be made clear that the statutory charge to develop a unified system for the clearance and settlement of securities transactions does not carry with it the call--nor does it grant the authority--to eliminate competition among separate entities in the performance of these functions. Many of the innovations and improvements in clearance and settlement of the last several years have been the product of vigorous and healthy competition among different service entities. Often new market entrants have been responsible for the most significant advances. The Committee believes, therefore, that a national system, through (sic) fully integrated, must make full allowance for the continuance and future entry of separate service entities.

H.R. Rep. No. 123, 94th Cong., 1st Sess. 51 (1975), [hereinafter "H.R. 94-123"], reprinted in Part 2A *infra*.

(n62)Footnote 62. The registration requirement for clearing agencies is discussed in § 2A.03 *infra* and for transfer agents in § 2A.02 *infra* .

(n63)Footnote 63. See §§ 2A.02[2][a] and 2A.03[1] *infra* .

(n64)Footnote 64. See §§ 2A.02[2][a] and 2A.03[4] *infra* .

(n65)Footnote 65. Section 17A(e). According to the accompanying House Report,

Testimony received by your Committee's Subcommittee on Commerce and Finance in the conduct of its study of the securities industry made clear that the ultimate solution to the paperwork problem is the elimination of the stock certificate as a means of settling securities transactions. Indeed, the Subcommittee found widespread agreement in the securities industry that the certificate can and should be eliminated. Accordingly, this legislation directs the securities and Exchange Commission to initiate steps to bring about the elimination of the certificate as a means of settlement among brokers or dealers of transactions in securities. Your Committee wishes to emphasize that it is only recommending that the certificate be eliminated as a means of settlement. Individual shareholders will continue to be able to demand and receive certificates as proof of ownership of their shares. While it is possible that we will proceed ultimately to eliminate the stock certificates, that result is not specifically called for in this legislation.

H.R. 94-123, n.61 *supra*, at 86.

(n66)Footnote 66. Sec. Exch. Act Rel. No. 34-13163 (1977).

(n67)Footnote 67. S. Rep. No. 75, 94th Cong., 1st Sess. 5 (1975) [hereinafter "Senate Report No. 75"], *reprinted in* Part 2A *infra*.

(n68)Footnote 68. *Id.* at 55, 126.

(n69)Footnote 69. H.R. Rep. No. 229, 94th Cong., 1st Sess. 102 (1975), *reprinted in* Part 2A *infra*.

(n70)Footnote 70. See, e.g., Study of Unsafe and Unsound Practices, n.26 *supra* ; Review of Demise of Selected Broker-Dealers, n.37 *supra*.

(n71)Footnote 71. The conference held in June 1971 discussed four approaches to handling stock certificates, problems relating to machine readable certificates, the concept of a certificateless system, and the immobilization of the stock certificate. See Sec. Exch. Act Rel. No. 34-9240, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,145 (July 2, 1971).

(n72)Footnote 72. See § 2A.02 *infra*.

(n73)Footnote 73. See § 2A.03 *infra*.

(n74)Footnote 74. See, e.g., the discussion of the trading procedures of the National Association of Securities Dealers in § 2.01[2] *supra* .

(n75)Footnote 75. In 1976, for example, the securities depositories proposed the adoption of transfer agent custodian ("TAC") programs. The Commission quickly approved of these programs and reported to Congress that:

Generally in a TAC program the depository maintains a working supply of certificates of particular issue, while depositing the remaining certificates with the transfer agent to be held in its custody in the form of a balance certificate registered in the name of the depository. As the need for certificates in the depository changes, the depository adjusts its in-house inventory by increasing or decreasing the number of shares held in-house in nominee name, correspondingly decreasing or increasing the number of shares

held by the transfer agent. Appropriate shipments of securities between the depository and the transfer agent are made to effect these adjustments.

42 SEC Ann. Rep. 102, n.77 (1976). *See also* Sec. Exch. Act Rel. No. 34-12,579 (1979), in which the Commission discusses and approves the TAC Program of the Midwest Securities Trust Company.

The industry also began to improve and expand interfaces among clearing agencies and depositories, which further immobilized securities certificates. As the Commission reported to Congress:

As a result of such improvements, as well as the increased participation in depositories by brokers and dealers, banks and other institutions, the Commission believes that progress is being made toward the development of an efficient national system for the clearance and settlement of securities transactions. This progress can be measured by the fact that securities processing mechanisms efficiently handled record trading volume during the early months of calendar year 1976. The Commission expects that the continued development and refinement of clearing and depository services will attract more persons to become participants in these systems in order to realize the substantial benefits which accrue from such participation. Increased participation will in turn further reduce the dependency of the clearance and settlement mechanisms upon the physical movement of certificates.

42 SEC Ann. Rep. 97 (1976).

(n76)Footnote 76. *See* Sec. Exch. Act Rel. No. 34-11,759, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,316 (Oct. 22, 1975) (discussed in § 2A.03[1] *infra*).

(n77)Footnote 77. *See* Sec. Exch. Act Rel. No. 34-11,787, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,320 (Nov. 3, 1975) (discussed in § 2A.04[2][a] *infra*).

(n78)Footnote 78. The three clearing agencies were the American Stock Exchange Clearing Corporation, the Stock Clearing Corporation (a wholly owned subsidiary of the New York Stock Exchange) and the National Clearing Corporation (a wholly owned subsidiary of the National Association of Securities Dealers).

(n79)Footnote 79. *See* § 2A.03 [1] *infra*.

(n80)Footnote 80. *See* Sec. Exch. Act Rel. No. 34-12,489, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,557 (May 28, 1976). The requirement of such a proceeding is discussed in § 2A.03[2][c] *infra*.

(n81)Footnote 81. Sec. Exch. Act Rel. No. 34-12,759, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,695 (Sept. 1, 1976).

(n82)Footnote 82. Sec. Exch. Act Rel. No. 34-12,954, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,785 (Nov. 3, 1976).

(n83)Footnote 83.

A National System should permit the settlement by book entry movement of all securities transactions in issues for which book entry treatment proves to be more economical than alternative forms of processing. A possible measure of the universe of issues for the book entry portion of the National System would be the number of issues which have been included in the book entry operations of existing securities depositories.

The National System should also be able to process, other than by book entry, issues (i) whose certificate float is insufficient, or whose transfer agent arrangements are not adequate, to permit inclusion in a book entry environment, or (ii) which are ineligible for inclusion in a book entry environment due to legal requirements of the jurisdiction in which the issuer is organized. Existing envelope delivery and similar settlement systems presumably could be adapted to provide the requisite non-book entry settlement capability for issues which fall into these categories.

Issues whose shareholders are concentrated in a small geographic area or which have a small number of shareholders might not require inclusion in the National System. Presumably such issues would continue to be cleared and settled outside the National System through the informal arrangements which exist today.

Id. at 87,046 (footnote omitted).

(n84)Footnote 84. The term "financial institution" is intended to include: banks; insurance companies; investment companies; clearing agencies; and any other entity (whether an organization or an individual) which "(i) satisfies financial responsibility criteria, (ii) makes the requisite clearing fund and participant fund contributions to the National System, and (iii) has the operational capability to interface and reconcile with the National System."

Id. at 87,046 n.22.

(n85)Footnote 85. According to the Commission:

All broker-dealers and financial institutions should have access to the National System. Because most transactions in active issues would be processed through the National System, any broker-dealer or financial institution excluded from participation would be at a significant competitive disadvantage.

Broad access could be achieved by the establishment of standards for direct access to the components of the National System that were the least rigorous possible consistent with the existence of adequate financial and operational safeguards. For example, in the case of broker-dealer participants the standard could be tied to the Commission's financial responsibility rules in a way which would permit participation in the National System by any broker-dealer qualified to engage in a general securities business. Alternatively, assuming establishment of a standard for participation in the National System more rigorous than the standard for participation in a general securities business, indirect access, through correspondent relationships or by other means, should be available at a reasonable cost.

Id. at 87,046 (footnote omitted).

(n86)Footnote 86.

Although the National System would include a number of different clearing and settlement depository entities, it should not be necessary for any participant to be a member of, or deal with or through, either directly or through a correspondent, more than one clearing and settlement and one depository entity. In addition to the need for interfaces between clearing and settlement entities and for interfaces between depositories, each clearing and settlement entity should be linked to a depository so that deliveries to, and receipts from, the clearing and settlement entity may be made through the depository by book entry.

The book entry clearing components of the National System should have the following characteristics: (i) an accounting function which nets participants' securities positions daily and permits netted positions to be carried forward and netted against positions established on subsequent days ("continuous netting"); (ii) a trade guarantee as of settlement date; (iii) mark-to-the-market protection

from settlement date onward, (iv) one clearing position per issue for each participant; (v) a link between the continuous netting system and a depository to make possible automatic book entry delivery to satisfy short valued positions in the continuous netting system and to permit deliveries to, and receipts from, the continuous netting system at various remote locations; and (vi) a same-day turnaround capability for both securities received by a participant from the continuous netting system and securities delivered to a participant which the participant wishes to re-deliver to the continuous netting system.

The non-book entry clearing portion of the National System, which could include low-volume clearing operations, should guarantee transactions as of, and mark them from, settlement date. In addition, subject to the limitations of certificate as opposed to book entry settlement, same-day turnaround should be available for securities settled through the non-book entry portion of the System.

The National System would permit participants to elect to use all, or only a portion of, the System's clearing and settlement services. Accordingly, while a participant should be able to compare, account for and settle all his trades through one clearing entity regardless of the location of the other party to the trade or the market in which the trade was executed, the participant should be able to (i) compare trades through the clearing entity affiliated with the marketplace in which the trade was executed and direct delivery of the compared trade to the clearing entity the participant selects to perform the accounting operation and (ii) direct delivery of the securities' settlement instructions generated by the accounting operation to the depository entity the participant elects to use for securities' settlement. While broker-dealers have indicated that their present need to deal with several securities marketplaces would require the National System to provide the ability to direct delivery of compared trades to a clearing entity other than the one which performs the comparison, broker-dealers have not insisted that the National System include an ability to direct delivery of securities' settlement instructions to a depository other than the one linked to the clearing entity which generated the instructions. Nonetheless, because of possibility of competitive innovation at the depository level--including development of a TAD system--the Commission believes the National System should have the flexibility to permit development of an ability to direct delivery of securities' settlement instructions to any depository entity.

Id. at 87,046-47 (footnote omitted).

(n87)Footnote 87.

The depository portion of the National System should be related to the book entry clearing components of the System so as to make possible the settlement by book entry of all deliveries between the participants and the clearing components of the System. Furthermore, the depository portion of the System should permit participants to deposit or withdraw securities from the System throughout the country.

The depository portion of the National System should have the following capabilities: (i) ability of a participant to make valued and free securities deliveries by book entry; (ii) dividend and proxy protection for securities left on deposit; (iii) facilities for the deposit and withdrawal of securities at locations remote from the central depository, and (iv) a same-day turn-around capability for (A) free or valued book entry deliveries to a participant's depository account from the clearing portion of the System, (B) free or valued book entry deliveries to a participant's depository account through the depository, and (C) deposits to a participant's depository account.

The depository portion of the System should have the capability to perform all securities processing functions which may be effected by book entry. To date, and without foreclosing the possibility that additional functions will be developed, these include free and valued movements of securities, movements to effect pledges and loans of securities, expedited withdrawals of certificates, withdrawals of certificates in street name and withdrawals of certificates in registered form.

The depository portion of the National System should be designed to be compatible with TAD's, transfer agent custodian ("TAC") programs, and other developments in the transfer agent area which have the effect of reducing certificate movement.

Id. at 87,046-48 (footnote omitted).

(n88)Footnote 88.

Each participant should be able to make one daily money settlement, in funds valued the next day, which would satisfy all the participant's obligations to the National System for that day, including monies due to or from the clearing portion of the System, marks to the market, state transfer taxes, dividend adjustments, and amounts payable with respect to valued depository movements.

Currently funds valued the next day are virtually uniformly used in the settlement of securities transactions, and it appears that in the near future no other medium of payment will be used. Should new developments, such as automated funds transfer techniques, make desirable the use of other media, the appropriateness of establishing another uniform medium should be considered.

Id. at 87,048-49 (footnotes omitted).

(n89)Footnote 89.

The ability to re-deliver securities on the day on which they are received--same-day turnaround--is critical to broker-dealers. If a broker-dealer receives and pays for securities which are to be redelivered against payment, failure to effect redelivery on the day on which the securities are received requires the broker-dealer to hold the securities in inventory until the next day. In order to maintain the securities in inventory during this period, the broker-dealer usually obtains bank financing. Accordingly, the availability in a National system of same-day turnaround at the clearing and depository levels, would enable broker-dealers to reduce unnecessary interest charges.

The failure of many financial institutions to participate in a book entry environment necessitates certificate deliveries by broker-dealers, a procedure which frequently entails substantial delays and which withdraws securities from the book entry environment, thereby reducing the opportunity for multiple same-day turnaround. Consequently, it appears that this failure to participate, rather than technological limitations, would be the primary impediment to the ability of participants in a National System to achieve same-day turnaround.

To maximize the same-day turnaround capability of the National System, the largest possible universe of securities handlers should participate in a book entry environment at both the clearing and depository levels. While participation at the depository level would permit bookkeeping deliveries in all cases and thereby at least bring securities handlers into the book entry environment, the failure to include participants at the clearing level would result in book entry movements at the depository level which would not have been necessary had the underlying transactions been netted in the clearing corporation operation. Assuming that unnecessary movements have a cost participation in the National System at the depository level only may prove sufficiently expensive to impel securities handlers to participate at the clearing level also.

Should same-day turnaround become generally available on a real-time basis so that a participant with a terminal in his office could know the moment securities deliveries reach his account and could redeliver them by book entry movements initiated with a terminal-originated instruction, the nature of clearing and settlement would change radically. In such an environment, clearing and settlement would occur instantaneously and could be completed by the evening of the day on which comparison of the underlying transaction were completed. And, if comparison could be completed on the transaction date,

it would be possible to complete the entire comparison, clearing and settlement process within 24 hours of the time the transaction occurred.

Id. at 87,049 (footnotes omitted).

(n90)Footnote 90. Sec. Exch. Act Rel. No. 34-12,874 P (1976).

(n91)Footnote 91.

On October 7, 1976, the Commission approved a rule proposal of the NYSE to permit its listed companies to use, along with or in place of existing stock certificates, a new single denomination stock certificate (SDSC). The three traditional forms of stock certificates include the upper left and right hand corners an engraving that limits the share denomination represented by the certificate. An odd-lot certificate is designated "less than 100 shares," a single round-lot certificate is designated "100 shares" and the third type of certificate is designated "more than 100 shares."

The NYSE proposal permits companies to add a new SDSC that contains no corner denomination limitations. Instead, the SDSC must either have an engraved punch-out panel, with the share denomination indicated by punching out numbers in the panel, or must indicate the share denomination (1) in numbers in the share counter (the small box area currently used), (2) in numbers in a five-position matrix in the "open throat" area, and (3) in words in the open throat area. All such share information must be printed with penetrating ink on top of fine-line intaglio engraving.

43 SEC Ann. Rep. 24 (1977) (footnotes omitted). *See also* SEC, Response to Questionnaire for Federal Regulatory Agencies from the Subcomm. on Oversight and Investigation of the House Comm. on Interstate and Foreign Commerce (March 1978).

(n92)Footnote 92.

Proponents of the SDSC believe it permits new certificates to be issued more efficiently and inexpensively. Issuers using the SDSC need not maintain inventories of three different stock certificates and pay the cost of three engraving plates; similarly, a transfer agent using the SDSC does not have to handle three different types of certificates to issue new certificates of varying amounts. Moreover, because the SDSC can be fed through a computer-controlled high-speed printer, the proper number of shares and other information for each new certificate can be imprinted rapidly, and certificates of varying denominations can be printed without interruption.

43 SEC Ann. Rep. 24 (1977).

(n93)Footnote 93. *See* § 2A.01[3] *supra*.

(n94)Footnote 94. SEC, Final Report on the Practice of Recording the Ownership of Securities in the Records of the Issuer in other than the Name of the Beneficial Owner of such Securities (1976) [hereinafter "Street Name Study"].

(n95)Footnote 95. 43 SEC Ann. Rep. 25 (1976). *See also* Street Name Study, n.94 *supra*, at 6-7, 53-55.

(n96)Footnote 96. In response to the Street Name Study, legislation was introduced (S.305) to amend the disclosure proxy provisions of the Exchange Act by requiring disclosure of certain information pertaining to the beneficial owner, to direct the Commission to report to Congress the effectiveness of the new ownership reporting requirements, and to amend further the reporting threshold requirements. The President signed S.305 on December 20, 1977. Pub. L. No. 95-213.

(n97)Footnote 97. Sec. Exch. Act Rel. No. 34-13163 (1977).

(n98)Footnote 98. *Id.*

(n99)Footnote 99. See text at ns. 82-89 *supra*.

(n100)Footnote 100. Sec. Exch. Act Rel. No. 34-13163 (1977).

(n101)Footnote 101. For a discussion of this litigation, see § 2A.04 [2][e] *infra*.

(n102)Footnote 102. Sec. Exch. Act Rel. No. 34-13,636, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,211 (June 16, 1977). These rules are discussed in § 2A.03[3] *infra*.

(n103)Footnote 103. See *Hearings before the Subcomm. on Oversight and Investigation and the Subcomm. on Consumer Protection and Finance of the House Comm. on Interstate and Foreign Commerce on the Functions and Administration of the Securities Acts Amendments of 1975--National Market System and National Clearance and Settlement System*, 95th Cong., 1st Sess. Serial 95-80 (1977).

(n104)Footnote 104. Subcomm. on Oversight and Investigations and the Subcomm. on Consumer Protection and Finance of the House Interstate and Foreign Commerce Comm., Oversight of the Functioning and Administration of the Securities Acts Amendments of 1975, 95th Cong., 1st Sess. (Comm. Print. 95-27) (1977) [hereinafter "Oversight Report"].

(n105)Footnote 105.

Section 17A of the Securities Exchange Act of 1934, as added by the 1975 Amendments, directs the SEC to use its authority to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities. What was contemplated was one system composed of competing entities so linked together as to allow individual brokerage firms to conduct all of their clearance and settlement activities with one entity.

What appears to be emerging, however, is something quite different. In January of this year the SEC conditionally approved a merger of the clearing operations of the New York Stock Exchange, American Stock Exchange and National Association of Securities Dealers. That merger creates a single clearing entity, the National Stock Clearing Corporation (NSCC), which would have an 85 percent share of the clearance and settlement market. The subcommittees are concerned that the entity may have the ability to drive its competitors out of existence, thus presenting the potential for a monopoly situation in the clearance and settlement field. Should such a monopoly situation exist, it would inevitably lead to higher prices and poorer service than would exist in a national system composed of competing entities. Moreover, a monopoly clearing entity would require the Securities and Exchange Commission to assume the type of regulation necessary for a public utility. The subcommittees firmly believe that such a posture would be bad for the SEC, the industry and the investing public.

The Commission's approach of approving the merger of NSCC suffers from an inherent problem. Experience with monopolists has shown that, over time, prices tend to rise and services tend to deteriorate. If the SEC's regulatory decision leads to the elimination of competing entities in the clearance and settlement area, as it appears likely to do, broker-dealers and their customers will eventually be left with higher prices and poorer service than would result in an environment of competition. While the Commission has approved the merger subject to a number of conditions intended to preserve competition, there are serious questions as to whether the conditions are adequate to place clearing corporations other than NSCC in a truly competitive position. More importantly, it is clear that compliance with the conditions is taking far longer than was initially intended. In the meantime, there are indications that the delay is exacerbating the potential for complete dominance by NSCC. Rather than to permit that trend to continue, the SEC should consider immediately revoking the registration of NSCC, and should search for ways to create a fair field of competition.

Oversight Report, n.4 *supra*, at 4-5, 6 (footnotes omitted).

(n106)Footnote 106.

It is clear that the SEC must exercise vigorous leadership in supervising the process of drawing the separate trading markets and clearing facilities into a cohesive national system. But in so doing, the SEC should not lose sight of a basic principle of the 1975 Amendments: they do not call for the preservation or favoring of any particular market or clearing facility. Nor do they require that any existing market or facility be dismantled. The subcommittees are skeptical as to the ability of the SEC or any other government agency to select among the existing markets and clearing facilities those which would best serve the investing public. The 1975 Amendments looked not to the fostering of competition among them, including any future markets and facilities.

In the national market system, whether a particular market center will continue to serve as a focal point for orders will no longer depend on its ability to maintain rules which confine orders to itself, or on the lack of efficient facilities for order flow to other locations, but on its ability to attract orders by offering useful and competitively priced services. The same is true with regard to the separate clearing facilities of the national clearance and settlement system. In an environment of true competition, those markets and clearing facilities which best serve the investing public will flourish.

The legislation and technology necessary to fashion a national market system and national clearance and settlement system are available. It is clear the industry has failed to take any effective initiative, although that is not entirely surprising in light of the divergent interests of the historically separate market centers. The SEC must now exert the necessary leadership to harness those competing interests. It must forcefully move, and move others, to erect physical connections among the separate markets and clearing facilities. It must at the same time avoid any action to promote a particular market or clearing facility over others.

As to the national system for securities trading, the SEC has moved too slowly. As to the national system for clearance and settlement, the SEC has produced more visible results, but appears to have exacerbated the potential for dominance by a single clearing facility. The SEC should act promptly to correct its misjudgment and to move forward in both areas.

Id. at 8-9.

(n107)Footnote 107.

These individual views on the SEC's actions in the clearance and settlement area are offered in addition to, but not in dissent from, the views expressed by the subcommittees in the main body of this report. I have reached similar but more emphatic conclusions, for I believe the SEC should do more than merely consider revoking NSCC's registration: it should revoke the registration immediately. I believe the subcommittees have invited the SEC to pursue an impossible task. Any effort by the SEC to justify its determination in light of the aims of the 1975 Amendments would, I am convinced, be fruitless. The approval of the NSCC is antithetical to the system envisioned by the Congress and authorized by Section 17A. The integrated system for clearance and settlement as envisioned by the Congress was to have been so structured as to permit separate entities to compete effectively.

Furthermore, the SEC's regulatory authority and expertise are not adequate to prevent NSCC from becoming a monopoly or to constrain such a monopoly to serve the public interest. The SEC is not designed for that role, has no experience at it, and should be reluctant to assume it.

If the SEC determines that the dual goals of competition among clearing agencies and competition

among broker-dealers are indeed incompatible, and that creation of a single entity is the best way to establish a national system in the public interest, the SEC is free to seek new legislation. If so, the type of legislation which authorized the creation of the Communications Satellite Corporation, which is referred to in this report in connection with the national securities market system, might be useful in the clearance and settlement area as well. Like the communications satellite system, the clearance and settlement system is a highly technical area vested with important national interests. If a single clearing entity were appropriate, it would be necessary for the Congress to carefully design that entity, to precisely balance the representation on its board of directors, perhaps to restrict allowable percentages of stock ownership and voting, and above all to provide an adequate system of accountability to a public body. In short, any single entity would have to be a quasi-governmental body which balances private initiative with public control. NSCC is not such a body; the existing statutory standards for registration of a clearing agency were not designed with that type of balance in mind; and the SEC is not well suited to protect the public interest in the face of a monopoly and a statutory framework designed for a different system.

I would unequivocally call upon the SEC to revoke the registration of NSCC and to explore alternative ways to facilitate the establishment of a national system with effective competition among both clearing agencies and broker-dealers. If the SEC finds those two types of competition irreconcilable, and determines that the single clearing entity approach is best, it should return to the Congress with a request for legislation which would permit development of that approach in a fashion consistent with the public interest.

Id. at 18-19.

(n108)Footnote 108. *Bradford Nat'l Clearing Corp. v. SEC*, 590 F.2d 1085 (D.C. Cir. 1978) , discussed in § 2A.04[2][e] *infra*.

(n109)Footnote 109. 44 SEC Ann. Rep. 4 (1978).

(n110)Footnote 110.

Progress toward a national system also was evident in other areas. The expansion of interfaces among clearing agencies has permitted most brokers and dealers to clear through a single clearing agency (one account processing) all transactions regardless of market of execution. Expanded interfaces among depositories have further immobilized securities certificates and allowed most participants to move securities throughout the country, to effect pledges and to make deliveries by book entry. These developments have reduced costs and accelerated the settlement process.

During the year, the Commission took two important steps in immobilizing certificates. First, Rule 17f-4 under the Investment Company Act was adopted. The rule established the conditions under which registered investment companies, or custodians for registered investment companies, may deposit investment company securities in a securities depository.

The Commission also worked toward increasing insurance company participation in securities depositories. Insurance companies are large holders of securities but, principally because of certain requirements of state laws, have been inhibited from widespread participation in securities depositories. The National Association of Insurance Commissioners recently formed a task force on the use of book entry and depository systems by insurance companies. Members of the Commission staff met with the task force and were appointed by the task force to serve on an advisory committee which will seek solutions to both the legal and practical problems restricting company participation.

44 SEC Ann. Rep. at 5.

(n111)Footnote 111. Inv. Co. Act Rel. No. 10,453, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,753 (Oct.

26, 1978).

(n112)Footnote 112. To invoke Rule 17f-4 under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G, the board of directors of the investment company must approve and annually review the depository agreement and should verify the technical capability of the parties to discharge their responsibilities and other safety or cost effective features.

(n113)Footnote 113. This system is discussed in § 2.01 [3] *supra*.

(n114)Footnote 114. Sec. Exch. Act Rel. No. 34-15,671, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,016 (Mar. 22, 1979).

(n115)Footnote 115. *Id.* at n.55.

See also text at ns.82-89 *supra*.

(n116)Footnote 116. *Sec. Exch. Act. Rel. No. 34-18,274, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,054 (Nov. 20, 1981). According to the Commission:*

That capability, in addition to its impact on the efficiency of clearing procedures, is essential to enable a broker-dealer to seek the best price available without concern that his choice of market of execution will result in materially increased clearance and settlement costs.

The development and expansion of interfaces during the past year, particularly the establishment of regional interfaces for the processing of over-the-counter transactions, has made one-account processing almost universally available. The Commission will seek during the coming year to complete that process so that all broker-dealers and financial institutions participating in the national clearance and settlement system have one-account processing.

Id. at 81,574.

(n117)Footnote 117.

Clearing agency branch offices or remote terminals provide broker-dealers throughout the country with access to the national clearance and settlement system without the necessity of physical presence in the principal clearing centers. The establishment of regional centers will permit each participant broker-dealer or financial institution to clear through the entity of its choice without regard to its own physical location or that of the clearing agency. Thus, in conjunction with one-account processing, a participant in the national clearance and settlement system may select any clearing agency and may clear and settle transactions with that entity effected from any market center.

Id. at 81,575.

(n118)Footnote 118.

As previously announced, the Commission intends to initiate a proceeding to consider issues associated with interface fees or charges which function as interface fees. These charges make it more expensive for a broker-dealer to clear and settle a transaction executed in a market other than the market affiliated with his clearing agency. In the context of this proceeding, the Commission must explore whether these charges would in fact affect the participant's choice of markets. In addition, the United States Court of Appeals for the District of Columbia Circuit has remanded to the Commission for further consideration the use of geographic price mutualization by the National Securities Clearing Corporation

("NSCC"). This pricing mechanism, which enables NSCC to provide services to all its participants at an equal price regardless of geographic location, was deemed by the Commission to have an important impact on competition among broker-dealers and, pursuant to the discussion of the Court of Appeals, must be reconsidered during the coming year.

Id. (footnotes omitted).

(n119)Footnote 119.

During the next year the Commission will continue to encourage clearing agencies and depositories to include in their processing activities all securities which are suitable for inclusion in the system. In addition, we will continue to encourage all broker-dealers and financial institutions to participate directly or indirectly in the national clearance and settlement system in order to reduce the physical movement of securities, increase the efficiency of the national clearance and settlement system, and otherwise advance the Congressional objectives set forth in the Act.

Id.

(n120)Footnote 120. Sec. Exch. Act Rel. Nos. 34-16352 (1979) and 34-16354 (1979)..

See also 46 SEC Ann. Rep. 3-4 (1980).

(n121)Footnote 121. Sec. Exch. Act Rel. No. 34-17343 (1980).

See also Sec. Exch. Act Rel. No. 34-17660 (1981).

(n122)Footnote 122. Sec. Exch. Act. Rel. No. 34-18,274, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,054 (Nov. 20, 1981). The three corporations are the Midwest Clearing Corp., the Pacific Clearing Corp. and the Stock Clearing Corp. of Philadelphia.

(n123)Footnote 123. Sec. Exch. Act Rel. No. 34-18689 (1982).

(n124)Footnote 124. Sec. Exch. Act Rel. No. 34-18531 (1982) and No. 34-19029 (1982).

(n125)Footnote 125. *See* § 2A.02[3] *infra*.

* This chapter was originally written by Van P. Carter, Esq. It has been updated by Dennis O'Boyle, of counsel to the firm of Shefsky & Froelich Ltd., Chicago, Illinois.



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Federal Securities Exchange Act of 1934

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CHAPTER 2A Registration and Regulation of Transfer Agents and Clearing Agencies *

1-2A Federal Securities Exchange Act of 1934 § 2A.02

§ 2A.02 Registration and Regulation of Transfer Agents

[1] The Registration Requirement

The Securities Acts Amendments of 1975 n1 amended the Securities Exchange Act of 1934 n2 by adding a new Section 17A. n3 Subsection 17A(c) requires, in substance, that every "transfer agent" register n4 with the Securities and Exchange Commission as part of the Congressionally mandated national system for clearance and settlement. n5

The term "transfer agent" is defined in Section 3(a)(25) of the Exchange Act n6 to include "any person" n7 who "on behalf of an issuer of securities or on behalf of itself as an issuer of securities" performs any of the following functions:

- countersigns securities upon issuance;
- monitors the issuance of securities "with a view to preventing unauthorized issuance," n8 i.e., functions as a registrar;
- registers the transfer of securities;
- exchanges or converts securities; or
- transfers ownership of securities by bookkeeping entry without physical issuance of a certificate.

The Commission has stated that the federal securities laws do not prohibit a registered transfer agent from also serving as a registrar. n9 The Commission cautions, however, that applicable state law or the rules of the national securities markets may require separate entities. n10

Exempted from the definition of "transfer agent" is any insurance company or "separate account" that performs any of these functions "solely" with regard to variable annuity contracts or variable life policies which it issues. Also excluded is any clearing agency registered with the Commission pursuant to Section 17A n11 that functions as a transfer agent "solely with respect to options contracts which it issues." n12

The Commission has cautioned that an issuer who performs "any one or more" of the transfer agent functions will be

deemed to be a "transfer agent" even if the issuer employs a registered transfer agent to perform other transfer agent functions. For example, an issuer which maintains the corporate security holder records is required to register as a transfer agent even if a transfer agent is engaged to countersign certificates, monitor the issuance of certificates, or prepare the data required for the security holder records. n13

Similarly, "any person" who acts as both a clearing agency n14 and a transfer agent must be registered pursuant to Section 17A n15 in both capacities. n16

The Commission may exempt "any person" or security from one or all of the provisions of Section 17A upon a finding that the exemption "is in the public interest and consistent with the protection of investors and the purposes of [Section 17A], including the prompt and accurate clearance and settlement of securities transactions and the safeguarding of securities and funds. ..." n17

[2] The Registration Process

[a] Determining Jurisdiction. Registration as a transfer agent pursuant to Section 17A is accomplished through the "appropriate regulatory agency" for the applicant. n18 Section 3(a)(34) of the Exchange Act allocates regulatory jurisdiction as follows:

En- Appropriate Regulatory
tity Agency

1. National bank or a bank operating under the Code of Law for the District of Columbia, or a Federal branch or Federal agency of a foreign bank	Comptroller of the Currency
2. State bank member of the Federal Reserve System, a foreign bank, an uninsured state branch or state agency of a foreign bank, a commercial lending company owned or controlled by a foreign bank, or a corporation organized or having an agreement with the Board of Governors	Board of Governors of the Federal Reserve System
3. Bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System) or an insured state branch of a foreign bank	Federal Deposit Insurance Corporation
4. Saving association the deposits of which are insured by the Federal Deposit Insurance Corporation	Director of the Office of Thrift Supervision
5. All other applicants	Securities and Exchange Commission

[b] Applications for Registration. In October 1975 the Commission adopted Rule 17Ac2-1, which establishes the registration procedures, and related Form TA-1, through which an applicant may seek registration. n19 Substantially similar rules were adopted by the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the FDIC. n20 Form TA-1 was designated by the four regulatory bodies as the "common form for the registration of all transfer agents. ..." n21

Rule 17Ac2-1 requires every transfer agent for which the Commission is the "appropriate regulatory agency" to file an application for registration on Form TA-1. n22 The application shall become effective forty-five days after filing with the Commission, n23 unless the Commission accelerates, denies, or postpones registration pursuant to Section 17A(c). n24

[c] Form TA-1. Form TA-1 is the form common to each "appropriate regulatory agency" for the registration of all transfer agents. n25 The form was designed "to identify, and to provide the Commission with basic information regarding the size and nature of the registrant's transfer agent activities and to assist in the development of appropriate regulatory standards." n26

The form is composed of seven questions. The questions solicit basic information concerning the identity and place of business of the applicant and where transfer agent activities are to be performed. In 1986, the Commission revised Form TA-1. n27 Revised Form TA-1 remains essentially the same as the prior form except that several questions that the Commission viewed as no longer necessary were deleted and others shifted to the new Form TA-2. n28 In addition, the Commission adopted an SEC Supplement to Form TA-1, which is to be completed only by independent, non-issuer transfer agents whose "appropriate regulatory agency" is the Securities and Exchange Commission. n29

The SEC Supplement to Form TA-1 requests background information about control persons at these transfer agencies "with particular emphasis on whether offenses have been committed by these persons, and, therefore, whether the transfer agent's association with a particular individual would have an impact on the transfer agent's ability to perform its functions properly." n30 Specifically, the SEC Supplement to Form TA-1 requires transfer agents to identify the individuals holding key management positions and to provide information concerning involvement by management in certain civil, criminal, and administrative proceedings. Moreover, registrants must submit the appropriate schedule of the SEC Supplement to Form TA-1: Schedule A for corporations; Schedule B for partnerships; and Schedule C for applicants other than partnerships and corporations. If any such applicant answers affirmatively to questions in the SEC Supplement, the applicant must also complete Schedule D, detailing any court or regulatory action. n31

If the registrant's appropriate regulatory agency is the Commission, the registrant must file the original and three copies of Form TA-1, SEC Supplement, and any amendment with the Commission. n32 If the registrant's appropriate regulatory agency is either the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or the Board of Governors of the Federal Reserve System (collectively referred to as Federal Bank Regulators or "FBRs"), the registrant must file the original and four copies of Form TA-1 and any amendment with its appropriate regulatory agency n33 *and* with the Commission. n34 The original copy of Form TA-1 must be manually signed and any additional copies may be photocopies of the original signed copy. n35

The forms and any amendments thereto must be executed by a duly authorized "official" of a corporation n36 or a duly authorized "principal" of a non-corporate registrant. n37

[d] The Review Procedure. Upon filing, the Commission will acknowledge receipt of Form TA-1 n38 and the forty-five day review period will commence. n39

Section 17A(c)(3) vests with each "appropriate regulatory agency" the power to "censure, place limitations on the activities, functions, or operations" of an applicant for registration as transfer agent. Any such action must be preceded by a finding "on the record after notice and opportunity for hearing" that the remedial action:

is in the public interest and that such transfer agent, whether prior or subsequent to becoming such, or any person associated with such transfer agent, whether prior or subsequent to becoming so associated--

(A) has committed or omitted any act enumerated in [section 15(b)(4)(A), (D), (E), or (G) of the Exchange Act], has been convicted of any offense specified in [section 15(b)(4)(B)] within ten years of

the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in [section 15(b)(4)(C)]; or

(B) is subject to an order entered pursuant to [section 17A(c)(4)(C)] barring or suspending the right of such person to be associated with a transfer agent. n40

Pending a final determination regarding an application for registration, the reviewing regulatory agency may postpone, by order, the effective date of such registration for a period not to exceed fifteen days. If, however, after notice and opportunity for hearing, the reviewing regulatory agency deems it necessary or appropriate "in the public interest or for the protection of investors," the reviewing regulatory agency shall order the effective date postponed. n41

[e] Amendments to Form TA-1. An application for registration on Form TA-1 may be amended at any time by filing an original and four copies, if the appropriate regulator is an FBR, or an original and three copies, if the appropriate regulator is the SEC. n42 The filing of an amendment recommences the thirty day review period. n43 n44

A transfer agent is required to amend its Form TA-1 within sixty days following the date upon which the information reported therein becomes "inaccurate, incomplete or misleading. ..." n45 This obligation survives the effective date of registration. n46 n47

[f] Form TA-2. In 1986 the Commission adopted Form TA-2, which requires transfer agents to disclose the volume and nature of their business activities. n48

The Form requests such basic information as the transfer agents name and its appropriate regulatory agency. In addition, the proposed text of Form TA-2 requested a variety of very specific information, some of which was not kept by all transfer agents filing Form TA-2. After reviewing the opinions of several commentators, the Commission realized the administrative problems that would be caused, and in response adopted a version of Form TA-2 that is somewhat different from the original. The adopted version of Form TA-2 allows certain categories of transfer agents to approximate statistics that they might not ordinarily have available. n49

Rule 17Ac2-2 requires all transfer agents to file Form TA-2. n50 However, those transfer agents that received, "fewer than 1,000 items for transfer in the reporting period and that did not maintain master securityholder files for more than 1,000 individual securityholder accounts as of December 31 of the reporting period are only required to supply the information requested in Items 1-5 and 11 of the Form. n51 Furthermore, a transfer agent must complete only items 1-3 of Form TA-2 if a service company performs all of the transfer agent's transfer and processing functions. n52

[3] Special Regulations Applicable to Transfer Agents

Section 17A reflects a clear Congressional mandate that the unsafe and unsound practices which precipitated the paperwork crisis of the late 1960's not recur. n53 Accordingly, through Section 17A(d)(1) Congress vested in the Commission the specific authority to adopt rules and regulations governing the conduct of all registered transfer agents. n54

Pursuant to this mandate, the Commission in 1977 adopted Rules 17Ad-1 through d-7 n55 which were intended:

- (1) to assure that registered transfer agents perform their functions in a prompt and accurate manner;
- (2) to provide early warning of inadequate transfer agent performance; (3) to provide a mechanism to limit expansion of transfer agent activities when transfer agents are unable to meet their performance time standards; (4) to assure prompt response to inquiries concerning the status of items presented for transfer; and (5) to require the maintenance and preservation of certain records necessary to monitor compliance with the ... rules. n56

To assist transfer agents in their attempts to comply with the seven complex rules, the Commission issued in 1980 a lengthy interpretative release. n57

Thereafter, in 1983 the Commission adopted seven additional rules n58 that

(1) require registered transfer agents to maintain certain information concerning securityholder records; (2) require registered transfer agents to maintain current and accurate securityholder records; (3) require registered transfer agents to post promptly all transfers, purchases, and redemptions to those securityholder records and to notify their appropriate regulatory agency if they are unable to do so; (4) require registered transfer agents to exercise diligent and continuous attention in resolving record inaccuracies; (5) require registered transfer agents to disclose directly to the issuers for whom they perform transfer agent functions and to their appropriate regulatory agency information regarding record inaccuracies; (6) require registered transfer agents to buy-in certain record inaccuracies that result in a physical overissuance of securities; (7) prescribe a minimum level of communication between registered transfer agents contractually related to the same issuer; (8) set standards for the safeguarding of funds and securities in the custody or possession of registered transfer agents; (9) require certain registered transfer agents to obtain, on an annual basis, an internal accounting control report prepared by an independent public accountant; and (10) eliminate the requirement that transfer agents whose appropriate regulatory agency is either the Commission or the Office of the Comptroller of the Currency file notices regarding their status as exempt transfer agents under Section 240.17 Ad-4(b)." n59

In 1984 the Commission adopted Rule 17Ad-14. The Rule places further responsibility on transfer agents by requiring transfer agents to establish accounts with "qualified registered securities depositories." n60

A "qualified registered securities depository" is defined as "a registered clearing agency having rules and procedures approved by the Commission pursuant to Section 19 of the Securities Exchange Act of 1934 to enable book entry delivery of the securities of the subject company to, and return of those securities from, the transfer agent through the facilities of that securities depository." n61

The established accounts are to be maintained to facilitate the transfer of securities by requiring a securities transfer to be performed by book-entry rather than the more time consuming transfer of physical certificates. n62 The book-entry system facilitates the transfer of securities as well as the return of securities should a potential transfer be canceled.

In 1992, the Commission adopted Rule 17Ad-15 which deals with signature guarantees. n63 This rule attempts to set forth a criteria by which transfer agents must adhere to when determining whether or not to accept a signature guarantee.

The rule sets forth the following:

- a transfer agent may not engage in activity in relation to a guarantee that results in inequitable treatment to any eligible guarantor institution;
- transfer agents must set forth standards and procedures upon which they base a decision to accept or reject a guarantee;
- a transfer agent must make such standards and procedures available to any person who requests a copy;

- if the guarantee is rejected the transfer agent must notify the guarantor within two business days after the rejection; and
- the rule does not infringe upon any other rights of rejection, not associated with the guarantee, that the transfer agent may have. n64

The cumulative effect of Rules 17Ad-1 through 17Ad-15 has been the creation of a sophisticated, complex matrix of substantive performance criteria which has been praised as providing "greater safeguards against abuse" and criticized as either "unnecessary or inappropriate" or generating "unnecessary costs." n65

Rules 17Ad-1 through 17Ad-15 establish the minimum performance standards and recordkeeping requirements for all registered transfer agents. These rules do not supercede any rules of self-regulatory organizations, n66 which may impose more stringent performance standards. n67

The application of these rules is triggered by the presence of an "item" for which a transfer agent is requested to perform a transfer agent function. n68

An "item" is defined n69 to mean either:

- a certificate or certificates of the same issue of securities covered by one "ticket" n70 (or, if there is no "ticket," presented by one presenter) presented for transfer, or
- an instruction to a transfer agent holding securities registered in the name of the presenter to transfer such securities or to make available all or a portion of such securities.

In the case of an outside registrar, each certificate to be countersigned is an "item." n71

The Commission has rejected arguments that the term "item" should be restricted to each "individual transfer instruction for certificates of a single issue of securities within a single ticket." n72 Also rejected by the Commission was the argument that securities not registered under Section 12 of the Exchange Act n73 should be excluded from the definition of an item. According to the Commission, "once a transfer agent is registered, the turnaround rules apply to all securities. ..." n74

[a] Turnaround, Processing and Forwarding of Items. Rule 17Ad-2 establishes the basic requirement that every registered transfer agent shall "turnaround" within three "business days" of "receipt" at least 90 percent of all "routine" items received for "transfer" during a month. n75

A "business day" is defined to include every day that a transfer agent is "normally open for business," excluding Saturdays, Sundays and legal holidays and other holidays "normally observed by the transfer agent." n76 In addition, a "business day" does not exist when the transfer agent operates on a skeleton staff due to severe inclement weather "which adversely affects other businesses *and* local transportation" or when a city, municipal or state government orders or requests businesses to close. n77

For purposes of Rule 17Ad-2, an item is deemed to be received when it "arrives at the premises at which the transfer agent performs transfer agent functions." n78 The Commission has cautioned that delivery of an item to a mail room "located in the same building" as the transfer agent is deemed to constitute "receipt" of the item by the transfer agent. n79 Therefore, the Commission has stated that "it is in the transfer agent's interest ... to ensure that a received item is promptly forwarded from the mail room to the transfer department." n80

If, however, the transfer agent maintains, at a subsidiary location, a "drop" or "window" to receive items, the agent is required to have "appropriate" procedures to assure that items delivered to such subsidiary sites are forwarded "promptly" to the processing center. n81 But such items are not deemed to be "received" until delivered to the site of processing. n82 Similarly, the tender of an item to a service bureau for the transfer agent is not "received" by the agent until the item arrives at the processing site. n83

The Commission has also concluded that items tendered, but rejected, at a "drop" or "window" are not deemed to be received. n84 Moreover, the "prompt return" of items submitted for transfer for, e.g. nonpayment of fees, rescinds the "receipt." n85

Items "received" before noon are deemed to have been received on that day, but items "received" after noon are deemed to have been received on the following business day. n86

The turnaround rule applies only to "routine" items. The Commission cautions that the definition of a "routine item" is stated in the negative, "i.e. an item received for transfer will be deemed routine unless it falls within [certain] specified exceptions. ..." n87 There are eight categories of proposed transfers that are exempt from the turnaround rules:

- Situations in which the transfer agent does not maintain a supply of certificates and must requisition additional certificates. n88
- Certificates as to which there is a stop order or other restriction on transfer. n89
- Proposed transfers that require additional instructions, endorsements, guarantees, opinions of counsel, or other documents. n90
- Proposed transfers that require review by the transfer agent of supporting documentation "other than assignments, endorsements, or stock powers, certified corporate resolutions, signature or other common and ordinary guarantees or appropriate tax or tax waivers." n91
- Transfers arising out of a reorganization, tender offer, exchange, redemption or liquidation. n92
- Transfers including a warrant, right, or convertible security presented within five business days before lapse or change. n93
- The exercise of any warrant, right, or convertible security. n94
- Transfers arising out of a public offering effected within the previous fifteen business days. n95

For purposes of Rule 17Ad-2, a "transfer" has occurred when "all acts necessary to cancel the certificate ... and to issue a new certificate ..." have been accomplished, including "the performance of the registrar function," and the release of the completed item by the transfer agent. n96

If a transfer agent acts as an "outside registrar," n97 the agent is required to "process" n98 at least 90 percent of all "items received" n99 during a month by "at least the opening of business on the next business day, in the case of items received before noon on a business day, and ... by noon of the next business day, in the case of items received after noon on a business day." n100

If a registered transfer agent fails to meet the turnaround and processing timetable mandated by Rule 17Ad-2, a written notice must be filed with the "appropriate regulatory agency" and the Commission within 10 business days after the end

of any such month. n101

The notice must state, among other things, the number of routine and non-routine items received during the month, the number of items not timely turned around or processed, the percentage which such items represent of all routine items presented to the transfer agent for the month in question, the reason for the failure, and the steps which have been or will be taken to remedy the current failure and to prevent future failures. n102

In addition, all routine items not timely turned around or processed must be handled "promptly" and all non-routine items "shall receive diligent and continuous attention and shall be turned around as soon as possible". n103

The turnaround, processing, and forwarding requirements of Rule 17Ad-2 have been the subject of an extensive interpretive release n104 in which the Commission applies these substantive performance standards to hypothetical situations and amplifies various definitions.

[b] Limitations on Expansion. Any registered transfer agent required, for three consecutive months, to file a notice of its failure to comply with the turnaround and processing rules n105 is prohibited for the succeeding three months from expanding its transfer agent business. n106

In addition, if the transfer agent fails for two consecutive months to turnaround on a timely basis at least 75% of all routine items or to process at least 75% of all items presented to it, such transfer agent is

- prohibited for the three succeeding months from expanding its business, and
- required to send a copy of the failure notice n107 to the chief executive officer of each issuer on whose behalf the transfer agent functions. n108

Once the limitation has been imposed, the transfer agent is prohibited from expanding *both* its transfer agent and registrar business until the agent's performance meets both the turnaround and processing standards of Rule 17Ad-2 for three consecutive months. n109 The restriction on new business applies to activities which the Commission does not regulate, such as dividend disbursements. n110

According to the Commission, these limitations n111 "are not intended to be a penalty" but, rather "are designed to maintain the status quo so that a transfer agent can bring its performance into compliance with the rules." n112 The Commission has reserved, however, its right to institute administrative, civil or criminal proceedings irrespective of these limitations. n113

[c] Recordkeeping. Every registered transfer agent is required by Rules 17Ad-6 and 17Ad-7 "to make and keep current" extensive records on every routine and non-routine item submitted for turnaround or processing.

According to the Commission, the recordkeeping and record retention requirements

are intended to serve a dual purpose: (1) to assure that all registered transfer agents are maintaining the minimum records necessary to monitor and keep adequate control over their own performance; and (2) to permit the appropriate regulatory authorities to examine registered transfer agents on an historical basis for compliance with applicable rules. n114

The records include, among other things:

- a "receipt, ticket, schedule, log or other record" reflecting the receipt and disposition of every item; n115

- a "log, tally, journal or schedule" reflecting the aggregate volume and disposition of all routine and non-routine items for each month; n116
- if the transfer agent acts as an outside registrar, a "receipt, ticket, schedule, log or other record" showing the date and time each item is received and processed, each "written or oral notice of refusal to perform" the registrar function, and the aggregate volume and disposition of all items for each month; n117
- every written inquiry or request, "including those not subject to the requirements of [Rule 17Ad-5]," n118 showing the date received and disposition of such matter; n119
- any "document, resolution, contract, appointment or other writing and supporting documentation" for the appointment or termination of any appointment of the transfer agent to act "in any capacity" on behalf of an issuer; n120
- A copy of every transfer journal and registrar journal prepared by the transfer agent; n121 and
- Documentation supporting the transfer agent's determination that the particular item is exempt from turnaround and processing requirements of Rule 17Ad-1(i)(5) or (8). n122

Numerous questions have been posed to the Commission concerning the scope and application of the recordkeeping requirements of Rules 17Ad-6 and 7. The Commission's responses appear in a special interpretative release issued in 1980. n123

The Commission has also adopted very explicit record retention requirements defining the time periods for which a transfer agent must retain records required pursuant to Rule 17Ad-6 and personnel fingerprints required to be retained pursuant to Rule 17f-2. n124 In general, most records are required to be "easily accessible" for at least 6 months and retained for a period of not less than two years. n125

Under certain circumstances, a microfilm copy may be substituted for the hard copy. n126 Similarly, use of a service bureau is permitted provided that the bureau undertakes in writing to provide the Commission with access "at any time" to the relevant records. n127

The Commission has discussed the record retention rules in an interpretive release that contains illustrative examples and responds to specific questions on the application of these rules. n128

[d] Exemptions from the Turnaround, Processing, Recordkeeping, and Record Retention Rules. The Commission, in response to comments from various interested parties, has exempted certain categories of transactions from the turnaround, processing, recordkeeping and record retention rules. n129

Interests in limited partnerships, redeemable securities of registered investment companies and interests in dividend reinvestment programs are exempt from the turnaround and processing provision of Rule 17Ad-2, n130 the limitation on expansion of Rule 17Ad-3, n131 and most of the recordkeeping rules. n132

If the transfer agent qualifies as an "exempt transfer agent" due to the volume of items submitted to it for transfer or processing n133 and also documents its qualification n134 with the "appropriate regulatory agency," n135 the transfer agent is exempt from the 90 percent turnaround and processing requirement n136 and certain of the recordkeeping requirements. n137

[e] Written Inquiries and Responses. Transfer agents have specific obligations to respond within prescribed time frames to written inquiries. n138 The information the inquirer must present "is the type of information that in practice is given to a transfer agent and is found sufficient to enable the agent to identify the account involved and the item presented." n139

The affirmative obligation to respond is summarized in the following table:

Nature of Inquiry	Required Response	Re-sponse Time

Status of item presented for transfer within preceding 6 months. n140	if received and not transferred, the reason for the delay and what further data is required to effect transfer; If received and transferred, the specific facts concerning the transfer, or, a declaration that the item was not received. n141	Within 5 business days after receipt of inquiry.
A request by a broker-dealer for acknowledgment of transfer instructions or possession of securities or for revalidation of a window ticket. n142	Acknowledge transfer instructions; confirm or deny possession of securities; or; revalidate window ticket. n143	Within 5 business days after receipt of inquiry.
A request for confirmation of possession of a securities certificate presented within 30 days preceding the inquiry. n144	Confirm or deny possession.	Within 10 business days after receipt of inquiry n145
A request for a transcript of an account with respect to a particular issue as it appeared on a specific date within 6 months of the date of inquiry. n146	Provide the requested transcript.	Within 20 business days after receipt of inquiry. n147

A transfer agent who receives a request which fails to provide the necessary information or which refers to a time period earlier than the time periods specified above is required to confirm the receipt of the inquiry promptly and to respond to the inquiry "as soon as possible." n148

The Commission issued an interpretive release discussing particular inquiries and their disposition under the applicable rules. n149

[f] Creation and Maintenance of Accurate Securityholder Files. Transfer agents are "an integral component" of the clearance, settlement and transfer process, and "substantial performance by a transfer agent can affect the accuracy of an issuer's securityholders records and interrupt the channels of communication between issuers and shareowners." n150 Therefore, the Commission has adopted Rule 17Ad-10 n151 which requires, among other things, that:

- every registered "recordkeeping transfer agent" n152 maintain and keep current "master securityholder files" n153 and "subsidiary files," n154 if any; n155
- all debits and credits to the master securityholder file be posted "promptly and accurately" n156 with the "minimum and appropriate certificate detail" n157 for every security transferred, purchased, redeemed or issued; n158
- the exercise of "diligent and continuous attention" by the recordkeeping transfer agent to resolve and post any "record difference" n159 between the certificate detail for any security transferral on redeemed and the corresponding detail contained in the master securityholder file; n160
- every co-transfer agent promptly dispatch or mail to the recordkeeping transfer agent (a) a record of debit and credits for every security transferred or issued, n161 and (b) a report within three business days following the end of each month setting forth the reason and dollar value of any "buy-in;" n162 and,
- every transfer agent who has knowledge of "any physical over issue that such transfer agent caused" shall within 60 days of the discovery, "buy-in securities equal to either the number of shares in the case of equity securities or the principal dollar amount in the case of debt securities." n163

The Commission has cautioned that the "performance standard" mandated by Rule 17Ad-10 "is a minimum standard" to which transfer agents must adhere.

[g] Reporting Requirements. In addition to any other report required by other rules, n164 Rule 17Ad-11 requires n165 every recordkeeping transfer agent to tender a monthly report to the issuer or its agent n166 regarding "aged record differences," n167 buy-ins, n168 and failures to post certificate detail. n169

In addition, every "recordkeeping transfer agent" n170 is required, if certain threshold volume criteria are satisfied, to file with the "appropriate regulatory agency" a quarterly report containing detailed information on its buy-ins and its aged "record differences." n171

[h] Safeguarding of Funds and Securities. To "strengthen investor protection," n172 every transfer agent with custody or possession of funds or securities is required by Rule 17Ad-12 to assure that such assets are safeguarded and protected "in light of all facts and circumstances" from misuse, loss, theft or destruction. n173

While rejecting suggestions that "minimum insurance requirements" should be required in place of a generalized standard of care, n174 the Commission agreed that the "cost of various safeguards and proceedings as well as the nature and degree of potential financial exposure are two relevant factors" in evaluating whether a transfer agent has employed adequate potential safeguards for funds and securities. n175

[i] External Evaluation of Internal Control. Unless otherwise exempt, every registered transfer agent is required to file a report annually with both the Commission and the "appropriate regulatory agency" n176 concerning the transfer agent's "internal accounting control and related procedures for the transfer of record ownership and the safeguarding of related securities and funds." n177

The report must be prepared by an independent accountant and include a detailed discussion of any deficiencies. n178

For purposes of the report, the objective of a system of internal accounting control

should be to provide reasonable, but not absolute, assurance that securities, and funds are safeguarded against loss from unauthorized use or disposition and that transfer agent functions are performed promptly and accurately. n179

A "material inadequacy" is deemed to exist when the independent accounting believes that the system of internal accounting controls

do not reduce to a relatively low level the risk that errors or irregularities, in amounts that would have a significant adverse effect on the transfer agent's [performance] ability ... would occur or not be detected within a timely period by analysis in the normal course of performing their assigned functions. n180

If a material inadequacy is found to exist by the accountant, the transfer agent is required to notify both the Commission and the appropriate regulatory agency in writing of the remedial action to be taken. n181

A transfer agent is exempt from the external evaluation requirement if it:

- performs transfer agent functions solely for its own securities or corporations or subsidiaries in which the transfer agent owns 51% or more of the capital stock; n182
- receives fewer than 500 items for transfer and fewer than 500 items for processing within six consecutive months; n183 or
- Is subject to the jurisdiction of the Board of Governors of the Federal Reserve System, the Comptroller of Currency or the Federal Deposit Insurance Corporation and provides a "report similar in scope" to either the bank's board of directors or audit committee. n184

[j] Tender Agents. Rule 17Ad-14 states that unless otherwise exempt, n185 every transfer agent must establish a 'specially designated account' with a 'qualified registered securities depository' n186 before such transfer agent can act as a depository on behalf of a bidder of securities. n187 An account is required to be established in order to facilitate transfer of securities by utilizing a book-entry system for the actual securities exchange. A book-entry system is more efficient than requiring the exchange of physical certificates.

Any account opened pursuant to Rule 17Ad-14 must be maintained for the duration of the offer period. During the offer period a "qualified registered securities depository" will hold the securities in question. When notified by the transfer agent, the depository will either tender the securities to the bidder by book-entry delivery, or if the offer is withdrawn, return the securities to the original holder.

[k] Use of Signature Guarantees Rule 17Ad-15 addresses the standards by which a transfer agent must act in regards to the acceptance or rejection of signature guarantees. The rule makes clear that a transfer agent can not engage in any activity, with regard to a guarantee, that may result in the discriminatory treatment of any guarantor institution. n188 Transfer agents must establish standards and procedures that guarantor institutions must meet in order for a guarantee to be accepted by the transfer agent. n189 The requirement, that a transfer agent have established standards, helps guarantor institutions in the preparation of the guarantee. It also provides a guideline that transfer agents must adhere to and thus decreases the likelihood of discriminatory behavior toward the guarantor institution. To facilitate review of the standards, transfer agents are required to maintain a copy of such standards and procedures and must also provide a copy of the standards and procedures to anyone who requests. n190

If the transfer agent, after determining that the guarantee fails to meet the standards set forth, rejects the guarantee, such

transfer agent must notify the guarantor of the rejection and the reasons therefor. n191 The transfer agent must also keep a record of any transfer rejected, and the reasons for rejection, for a period of three years. Nothing contained in Rule 17Ad-15 prohibits a transfer agent from rejecting a request for transfer on grounds not related to the sufficiency of the guarantee.

[4] Withdrawal from Registration

Section 17A(c) provides that a transfer agent may withdraw from registration "upon such terms and conditions" as the appropriate regulatory agency "deems necessary and appropriate in the public interest, for the protection of investors, or in furtherance of the purposes of this section. ..."

Pursuant to this section, the Commission has adopted Rule 17Ac3-1 and designated Form TA-W for use in effecting a withdrawal from registration.

Form TA-W is a one page form consisting of twelve questions which, in substance, seek verification of any pending operational problems or legal disputes, identification of any successor transfer agent and assurance that books and records will be properly maintained. n192

Withdrawal becomes effective 60 days after filing Form TA-W or such shorter time as the Commission may require. n193

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 94-29, 89 Stat. 141.

(n2)Footnote 2. 15 U.S.C. §§ 78a-78ll.

(n3)Footnote 3. 15 U.S.C. § 78q-1(c).

(n4)Footnote 4. The registration requirement became effective 180 days after enactment of the Securities Act Amendments of 1975. See Pub. L. No. 94-29, § 31, 89 Stat. 141. This legislation was signed by the President on June 4, 1975. Accordingly, § 17A became effective as of December 1, 1975.

(n5)Footnote 5. The national system for clearance and settlement is discussed in § 2A.01 *supra*.

(n6)Footnote 6. 15 U.S.C. § 78c(a)(25).

(n7)Footnote 7. "Person" is defined in Exchange Act § 3(a)(9), to include "a natural person, company, government, or political subdivision, agency, or instrumentality of a government."

(n8)Footnote 8. Section 3(a)(25)(B).

(n9)Footnote 9. Sec. Exch. Act. Rel. No. 34-17,111, 4 Fed. Sec. L. Rep. (CCH) P 26,218I (Sept. 2, 1980), reprinted in Part 2 *infra*.

(n10)Footnote 10. The New York Stock Exchange, for example, requires that issuers of listed bonds and securities evidencing indebtedness engage a bank or trust company "have capital, surplus (both capital and earned) and individual projects and capital reserves aggregating at least \$10,000,000" See NYSE Company Manual, Section 601.02 (A).

(n11)Footnote 11. The registration and regulation of clearing agencies is discussed in § 2A.03 *infra*.

1-2A Federal Securities Exchange Act of 1934 § 2A.02

(n12)Footnote 12. As a practical matter, the only clearing agency that meets this standard is the Options Clearing Corporation. For a discussion of the Options Clearing Corporation, see Report of the Special Study of the Options Markets to the Securities and Exchange Commission, 96th Cong., 1st Sess. 625-640 (Committee Print 96-IFC3, 1978).

(n13)Footnote 13. Sec. Exch. Act Rel. No. 34-11,759, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,316 (Oct. 22, 1975).

(n14)Footnote 14. The term "clearing agency" is defined in § 3(a)(23) and is discussed in § 2A.03[1] *infra*.

(n15)Footnote 15. Registration of clearing agencies is discussed in § 2A.03[2] *infra*.

(n16)Footnote 16. Section 17A(b)(1).

(n17)Footnote 17. Section 17A(c)(1).

As discussed in § 2A.02[2] *infra*, certain transfer agents are registered through the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, or the Federal Deposit Insurance Corporation. Section 17A(c)(1) provides that these regulatory bodies may not grant an exemption from registration as a transfer agent if the Commission objects to such exemption.

(n18)Footnote 18. For a discussion of the rationale underlying this allocation of regulatory jurisdiction, see § 2A.01[2] *supra*.

(n19)Footnote 19. Sec. Exch. Act Rel. No. 34-11759, n.13 *supra*. Rule 17Ac2-1 was initially proposed in August 1975. Sec. Exch. Act Rel. No.34-11,622, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,282 (Aug. 28, 1975).

The Commission amended Rule 17Ac2-1 to revise certain provisions of Form TA-1 and adopted Rule 17Ac2-2 to establish a new form TA-2. Sec. Exch. Act Rel. No. 23,084, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,975 (Apr. 1, 1986).

(n20)Footnote 20. The transfer agent registration rule adopted by the FDIC substitutes the term "Corporation" for the word "Commission" but is otherwise identical to Rule 17Ac2-1.

The Comptroller of the Currency's registration rule, which appears at 12 C.F.R. § 9.20, is also similar to Rule 17Ac2-1, except that the term "Comptroller" is substituted for the term "Commission." In addition, a new subparagraph (e) was added as follows:

Notwithstanding the provisions of paragraphs (a) and (b) of this section, if any application for registration, pursuant to section 17A(c) of the Act, is filed on or before November 17, 1975, the registration shall become effective on December 1, 1975, unless the Comptroller takes affirmative action to deny or postpone the registration in accordance with the provisions of section 17A(c) of the Act. Any amendments to an application for registration, which application has been filed on or before November 17, 1975, shall not operate to postpone the effective date of such registration as provided for in this paragraph (e).

The Federal Reserve Board's registration rule appears at 12 C.F.R. § 208.8(f) and is substantially the same as Rule 17Ac2-1.

(n21)Footnote 21. Sec. Exch. Act Rel. No. 34-11622, n.19 *supra*.

(n22)Footnote 22. Rule 17Ac2-1(a) under the Securities exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G.

(n23)Footnote 23. Section 17A(c)(2). The review period was extended to 45 days by the "Securities and Exchange Commission Authorization Act of 1987," Pub. L. No. 100-181, § 322, 1987 U.S.C.C.A.N. (101 Stat.) 1249,1257. The filing of an amendment to a pending application recommences the processing period. Rule 17Ac2-1(b).

(n24)Footnote 24. Rule 17Ac2-1(a). For a discussion of the Commission's post-filing review procedures and its authority to deny registration or place limitations on the activities of a transfer agent, *see* § 2A.03[2][d] *infra*.

Rule 17Ac2-1 and Form TA-1 were adopted on October 25, 1975. Sec. Exch. Act Rel. No. 34-11759, n.13 *supra*. Section 17A became effective as of December 1, 1975. *See* n.4 *supra*. Due to the abbreviated time period for filing and review of applications for registration, the Commission determined to enter an order as of December 1, 1975 making effective as of that date "any properly completed application for registration on Form TA-1 which is filed on or before November 17, 1975," unless the Commission initiates action to deny or postpone registration. *Id.* In addition, any amendment to an application on Form TA-1 filed on or before November 17, 1975 would not recommence the 30-day review period. *Id.*

(n25)Footnote 25. *See* Sec. Exch. Act Rel. No. 34-11759, n.13 *supra*.

(n26)Footnote 26. *Id.*

(n27)Footnote 27. Sec. Exch. Act Rel. No. 34-23,084, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,975 (Apr. 1, 1986). *See* Form TA-1, 5 Fed. Sec. L. Rep. (CCH) P 34,131.

(n28)Footnote 28. Sec. Exch. Act Rel. No. 34-23,084, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 88,065.

(n29)Footnote 29. *Id.* The term "independent, non-issuer transfer agent" is defined as "an entity which acts as a transfer agent for other than its own securities or securities of an affiliate." Instruction I.A.8. to Form TA-1.

(n30)Footnote 30. Sec. Exch. Act Rel. No. 34-23,084, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 88,066. "Completion of the SEC Supplement would not be required by issuers that act as transfer agent for their own securities or securities of an affiliate, or by transfer agents registered with the federal bank regulators." *Id.* at 88,066 n.4.

(n31)Footnote 31. *See* 5 Fed. Sec. L. Rep. (CCH) P 34,131 for reproductions of Form TA-1 and all schedules thereto.

(n32)Footnote 32. Instruction I.D.4. to Form TA-1.

(n33)Footnote 33. *Id.*

(n34)Footnote 34. Instruction I.D. to Form TA-1.

(n35)Footnote 35. Instruction I.D.4. to Form TA-1.

(n36)Footnote 36. Instruction II.C. to Form TA-1. "The term 'official' includes chairman or vice-chairman of the board of directors, chairman of the executive committee, or any officer of the corporation who is authorized by the corporation to sign Form TA-1 on its behalf." *Id.*

(n37)Footnote 37. Instruction II.C. to Form TA-1.

(n38)Footnote 38. Sec. Exch. Act Rel. No. 34-11,759, n.13 *supra*.

(n39)Footnote 39. The review period was extended to 45 days by the "Securities and Exchange Commission Authorization Act of 1987," Pub. L. No. 100-181, § 322, 1987 U.S.C.C.A.N. (101 Stat.) 1249, 1257.

(n40)Footnote 40. Section 17A(c)(3).

(n41)Footnote 41. Section 17A(c)(4)(A).

(n42)Footnote 42. Instruction ID to Form TA-1.

All items on the page must be answered. *Id.*

(n43)Footnote 43. Rule 17Ac2-1(b). *See* n.24 *supra*.

[Next Note N. 44]

(n44)Footnote 44. [Reserved]

(n45)Footnote 45. Rule 17Ac2-1(c). *See also* Instruction I F to Form TA-1.

(n46)Footnote 46. Sec. Exch. Act Rel. No. 34-17410 (1980), 21 SEC Docket 1166.

[Next Note N.48]

(n47)Footnote 47. [Reserved]

(n48)Footnote 48. *See* Sec. Exch. Act Rel. No. 34-23,084, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,975 (April 1, 1986). Form TA-2 is to be submitted by transfer agents annually and should provide the Commission with information regarding the 'volume of certain activities it performs, the number of issues it services, as well as the capacity in which the transfer agent acts.'

(n49)Footnote 49. *Id.*

(n50)Footnote 50. Rule 17Ac2-2.

(n51)Footnote 51. *Id.*

(n52)Footnote 52. *Id.*

(n53)Footnote 53. *See* Joint Exploratory Statement of the Committee of Conference to Accompany S. 249, 94th Cong., 1st Sess. 91, 102-103 (1975); H. R. Rep. No. 94-123, 94th Cong., 1st Sess. 51 (1975); Summary of Principal Provisions of Securities Acts Amendments of 1975 S. 249, 94th Cong., 1st Sess. 12-15 (Comm. Print 1975). *See also* discussion of the national system for clearance and settlement, § 2A.02[2] *supra* .

(n54)Footnote 54. The enforcement of such rules and regulations remains, however, with the "appropriate regulation agency." Section 17A(d)(2). *See* S. Rep. No. 94-75, 94th Cong., 1st Sess. 126 (1975).

"The scope of the Commission's rulemaking authority is intentionally broad covering all aspects of the securities handling process, including the safeguard of securities and funds. The Commission is expected to use this authority in order to facilitate the prompt development of an integrated national system, the clearance and settlement of securities transactions and elimination or consolidation of duplicative facilities and procedures."

Id. at pp. 125-126.

Section 17A(d)(1)(B) also authorizes the "appropriate regulatory agency" to adopt rules and regulations applicable to transfer agents under its jurisdiction with respect to "the safeguarding of securities and funds."

(n55)Footnote 55. Rules 17Ad-1 through 17Ad-7 were proposed in Sec. Exch. Act Rels. No. 34-12440, [1976-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,505 (May 12, 1976) and No. 13,293, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,986 (Feb. 24, 1977). These rules were adopted in Sec. Exch. Act Rel. No. 34-13,636, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,211 (June 16, 1976).

(n56)Footnote 56. Sec. Exch. Act Rel. No. 34-13293, n.52 *supra*.

(n57)Footnote 57. Sec. Exch. Act Rel. No. 34-17111, n.9 *supra*.

(n58)Footnote 58. Rules 17Ad-7 through 17Ad-13 were proposed in Sec. Exch. Act Rel. No. 34-19142, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,267 (Oct. 15, 1982), and adopted in Sec. Exch. Act Rel. No. 34-19,860, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,364 (June 10, 1983).

(n59)Footnote 59. Sec. Exch. Act Rel. No. 34-19860, n.55 *supra*.

(n60)Footnote 60. Rule 17Ad-14 under the Securities exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G.

(n61)Footnote 61. Rule 17Ad-14(c)(4).

(n62)Footnote 62. Rule 17Ad-14.

(n63)Footnote 63. Rule 17Ad-15.

(n64)Footnote 64. *Id.*

(n65)Footnote 65. For a summary of comments on Rules 17Ad-1 through d-16, see Sec. Exch. Act Rel. No. 34-19860 (1983), n.55 *supra*.

(n66)Footnote 66. Section 3(a)(26) defines the term "self-regulatory organization" to include any national securities exchange, registered securities association, registered clearing agency, and, under certain circumstances, the Municipal Securities Rulemaking Board. See § 2.01[2] *supra*.

(n67)Footnote 67. Sec. Exch. Act Rel. No. 34-13636, n.52 *supra*. For example, several self-regulatory organizations impose a maximum turnaround time of 48 hours, while Rule 17Ad-2 allows for three business days. See § 2A.02[3][a] *infra*.

(n68)Footnote 68. See Sec. Exch. Act Rel. No. 34-13636, n.50 *supra*.

(n69)Footnote 69. Rule 17Ad-1(a).

(n70)Footnote 70. The rules do not define the term "ticket." Within the industry a "ticket" generally refers to an instruction form that specifies the action to be effected by a transfer agent.

(n71)Footnote 71. Rule 17Ad-1(a), under the Securities exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G.

The term "outside registrar" means a "transfer agent which performs only the registrar function for the certificate[s]"

presented for transfer and includes the persons performing similar functions with respect to debt issues." Rule 17Ad-1(b). The Commission acknowledges that the federal securities do not prohibit a registered transfer agent from serving as both transfer agent and registrar, but cautions that state law or the rules of a national securities exchange may require separate entities. Sec. Exch. Act Rel. No. 17111 at n.10, n.9 *supra*.

(n72)Footnote 72. Sec. Exch. Act Rel. No. 34-13636, n.52 *supra*.

(n73)Footnote 73. For a discussion of Section 12 and the registration requirements of the Exchange Act, see § 4.01 *infra*.

(n74)Footnote 74. Sec. Exch. Act Rel. No. 34-17111, n.9 *supra*.

(n75)Footnote 75. Rule 17Ad-2(a).

(n76)Footnote 76. Rule 17Ad-1(h).

(n77)Footnote 77. Sec. Exch. Act Rel. No. 34-17111, n.9 *supra*. The Commission cautions that a union or other strike which upsets public transportation is not an adequate basis to cancel a "business day." *Ibid*.

(n78)Footnote 78. Rule 17Ad-1(g).

(n79)Footnote 79. Sec. Exch. Act Rel. No. 34-17111, n.9 *supra*.

(n80)Footnote 80. Sec. Exch. Act Rel. No. 34-13636, n.52 *supra*.

(n81)Footnote 81. Rule 17Ad-2(f).

(n82)Footnote 82. Sec. Exch. Act Rel. No. 34-17111, n.9 *supra*.

(n83)Footnote 83. *Id*.

(n84)Footnote 84. Sec. Exch. Act Rel. No. 34-13636, n.52 *supra*.

(n85)Footnote 85. Sec. Exch. Act Rel. No. 34-17111, n.9, *supra*.

(n86)Footnote 86. Rule 17Ad-2(a).

(n87)Footnote 87. Sec. Exch. Act Rel. No. 34-13636, n.52 *supra*. See also Sec. Exch. Act Rel. No. 34-17111, n.9, *supra*.

(n88)Footnote 88. Rule 17Ad-1(i)(1) under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, section G.

(n89)Footnote 89. Rule 17Ad-1(i)(2).

(n90)Footnote 90. Rule 17Ad-1(i)(3).

(n91)Footnote 91. Rule 17Ad-1(i)(4).

(n92)Footnote 92. Rule 17Ad-1(i)(5).

(n93)Footnote 93. Rule 17Ad-1(i)(6).

(n94)Footnote 94. Rule 17Ad-1(i)(7).

(n95)Footnote 95. Rule 17Ad-1(i)(8).

(n96)Footnote 96. Rule 17Ad-1(d).

(n97)Footnote 97. The term "outside registrar" is discussed and defined in n.63 *supra*.

(n98)Footnote 98. The term "process" means

the accomplishing by an outside registrar of all acts necessary to perform the registrar function and to make available to the presenting transfer agent the completed certificate or certificates or to advise the presenting transfer agent, orally or in writing, why performance of the registrar function is delayed or may not be completed.

Rule 17Ad-1(f).

(n99)Footnote 99. The term "items received" does not include any item enumerated in:

(1) Rule 17Ad-1(i)(5) (transfer in connection with a reorganization, tender offer, exchange, redemption, or liquidation);

(2) Rule 17Ad-1(i)(6) (a warrant, right, or convertible security tendered for transfer within five business days of the exercise or conversion date);

(3) Rule 17Ad-1(i)(7) (a warrant, right, or convertible security presented for exercise or conversion); or

(4) Rule 17Ad-1(i)(8) (a security of a public offering made within the preceeding fifteen business days).
Rule 17Ad-2(b).

(n100)Footnote 100. Rule 17Ad-2(b).

(n101)Footnote 101. Rules 17Ad-2(c) and (d).

(n102)Footnote 102. *Id.*

(n103)Footnote 103. Rule 17Ad-2(e).

(n104)Footnote 104. Sec. Exch. Act Rel. No. 34-17111, n.9 *supra*.

(n105)Footnote 105. Such a notice is required by Rules 17Ad-2(c) and (d), *see* § 2A.03[3][a] *supra*.

(n106)Footnote 106. Rule 17Ad-3(a).

(n107)Footnote 107. *See* n.97 *supra*.

(n108)Footnote 108. Rule 17Ad-3(b).

(n109)Footnote 109. *Id.*

(n110)Footnote 110. *Id.*

(n111)Footnote 111. The Commission has warned transfer agents that:

"It should be noted that paragraphs (a) and (b) of Section 240.17Ad-3 would apply to a transfer agent which, for example, failed for two consecutive months to turnaround within three business days 90% or more of routine items received (as required by Section 240.17Ad-2(a)) and then in the third consecutive month failed to process within the specified time frames 90% or more of items received as outside registrar (as required by Section 240.17Ad-2(b)). Similarly, if a transfer agent during a month failed to turnaround within three business days 75% or more of its routine transfer items and in the next month failed to process timely 75% or more of its outside registrar items, paragraph (b) of Section 240.17Ad-3 would attach on the fifth business day following the end of the second month."

Sec. Exch. Act Rel. No. 34-13636, n.52 *supra*.

(n112)Footnote 112. Sec. Exch. Act Rel. No. 34-13636, n.52 *supra*.

(n113)Footnote 113. *Id.*

(n114)Footnote 114. Sec. Exch. Act Rel. No. 34-13636, n.52 *supra*.

(n115)Footnote 115. Rule 17Ad-6(a)(1).

(n116)Footnote 116. Rule 17Ad-6(a)(2). This record is required to reflect:

(i) the number of routine items received;

(ii) the number of routine items received during the month that were turned around within three business days of receipt;

(iii) the number of routine items received during the month that were not turned around within three business day of receipt;

(iv) the number of non-routine items received during the month;

(v) the number of non-routine items received during the month that were turned around;

(vi) the number of routine items that, as of close of business on the last business day of each month, have been in such registered transfer agent's possession for more than four business days, aged in increments of one business day (beginning on the fifth business day); and

(vii) the number of non-routine items in such registered transfer agent's possession as of the close of business on the last business day of each month.

Id.

(n117)Footnote 117. Rule 17Ad-6(a)(3).

(n118)Footnote 118. Rule 17Ad-5 sets forth certain exceptions from the recordkeeping and record retention requirements of Rule 17Ad-6 and is discussed at § 2A.02[3][d] *infra*.

(n119)Footnote 119. Rule 17Ad-6(a)(6).

(n120)Footnote 120. Rule 17Ad-6(a)(8).

(n121)Footnote 121. Rule 17Ad-6(a)(10).

(n122)Footnote 122. Rule 17Ad-6(a)(11).

(n123)Footnote 123. Sec. Exch. Act Rel. No. 34-17111, n.9 *supra*.

See also Sec. Exch. Act Rel. No. 34-13636, n.52 *supra*.

(n124)Footnote 124. Rule 17Ad-7.

The Commission cautions that this rule is "not intended to replace longer retention periods that might be required by state law or other federal law." Sec. Exch. Act Rel. No. 34-13636, n.52 *supra*. *See also*, Sec. Exch. Act Rel. No. 34-17111, n.9 *supra*.

For discussion of fingerprinting requirements under Rule 17f-2, *see* § 3.03[1][b] *infra*.

(n125)Footnote 125. Rule 17Ad-7.

(n126)Footnote 126. For discussion of the steps a transfer agent must take if microfilm is substituted for hard copy, *see* §§ 3.03[1][b] and 3.04[2] at n.46 *infra*.

(n127)Footnote 127. Rule 17Ad-7(g) under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, section G.

(n128)Footnote 128. Sec. Exch. Act Rel. No. 34-17111, n.9 *supra*.

(n129)Footnote 129. Rule 17Ad-4.

(n130)Footnote 130. Rule 17Ad-2 is discussed at *Section 2A.03[3][a] supra*.

(n131)Footnote 131. Rule 17Ad-3 is discussed at *Section 2A.03[3][b] supra*.

(n132)Footnote 132. In particular, the transfer agent is exempt from the provisions of Rule 17Ad-6(a)(2) through (7) and (11). The transfer agent must continue to maintain records to reflect the receipt and disposition of each routine and non-routine item (Rule 17Ad-6(a)(1)), to document agreements to act on behalf of issuers (Rule 17Ad-6(a)(8)), to document any restriction on transfer (Rule 17Ad-6(a)(9)), and also to maintain a copy of every transfer or registrar journal prepared by the transfer agent (Rule 17Ad-6(a)(10)).

(n133)Footnote 133. To so qualify, the transfer agent over a period for six consecutive months must have "received fewer than 500 items for transfer and fewer than 500 items for processing." Rule 17Ad-4(b)(1).

(n134)Footnote 134. Within ten business days following the close of the sixth consecutive month, to obtain an exemption the transfer agent shall:

(i) If its appropriate regulatory agency is either the Commission or the Office of the Comptroller of the Currency, prepare and maintain in its possession a document certifying that the transfer agent qualifies as exempt under paragraph (b)(1) of [Rule 17Ad-4];" or

(ii) If its appropriate regulatory agency is either the Board of Governors of the Federal Reserve System or the Federal Deposit Insurance Corporation, file with the appropriate regulatory agency a notice certifying that it qualifies as exempt under paragraph (b)(1) of [Rule 17Ad-4].

Rule 17Ad-4(b)(3).

As originally adopted, Rule 17Ad-4(b) required a transfer agent to file with the appropriate regulatory agency a notice "certifying" that it met the volume limitations necessary to be exempt. In October 1982 the Commission proposed to eliminate the notice requirement. Sec. Exch. Act Rel. No. 34-19142, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,267 (Oct. 15, 1982). The Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation opposed the rescission of the notice requirement because these agencies utilize exemption notices in carrying out their regulatory responsibilities. Accordingly, when Rule 17Ad-4(b) was amended in 1983, the Commission retained the requirement that transfer agents whose "appropriate regulatory agency" is either the Board of Governors of the Federal Reserve System or the FDIC file an exemption notice with that agency. *See* Sec. Exch. Act Rel. No. 34-19860 (1983), n.55 *supra*. If the "appropriate regulatory agency" is the Commission, no filing is required.

(n135)Footnote 135. Rule 17Ad-4.

(n136)Footnote 136. The transfer agent is not exempt from other provisions of Rule 17Ad-2, such as the duty to turn around "promptly" any routine item not turned around within three business days and to give "diligent and continuous attention" to all non-routine items (Rule 17Ad-2(e)), the obligation to forward "promptly" to the processing or transfer center all items received at satellite facilities (Rule 17Ad-1(f)), and the duty to return "promptly" items tendered by an outside registrar (Rule 17Ad-2(g)).

(n137)Footnote 137. The exempt transfer agent is only exempt from the provisions of Rules 17Ad-6(a)(2) through (7) and (11). *See* n.124 *supra*.

(n138)Footnote 138. Rule 17Ad-5. An inquiry may come from any participant in the transfer process, including retail customers.

(n139)Footnote 139. Sec. Exch. Act Rel. No. 34-13636, n.52 *supra*. Depending upon the nature of the inquiry, however, Rule 17Ad-5 specifies the specific details that must accompany the inquiry for the transfer agent to be subject to the timetable specified in that Rule. *See* Rule 17Ad-5(a) through (d).

(n140)Footnote 140. Rule 17Ad-5(a).

(n141)Footnote 141. The response must include certain specific data, such as:

the date and manner in which the completed item was made available, the addressee and address to which it was made available and the number of any new certificate which was registered and the name in which it was registered.

Rule 17Ad-5(a).

(n142)Footnote 142. Rule 17Ad-5(b).

(n143)Footnote 143. "If a new certificate is dispatched or mailed to the presenter within five business days following receipt of a request pertaining to a certificate, no further response to the inquiry shall be required. ..."

Id.

(n144)Footnote 144. Rule 17Ad-5(c).

(n145)Footnote 145. The transfer agent may require "assurance of payment of a reasonable fee" prior to processing the inquiry. *Id.*

(n146)Footnote 146. Rule 17Ad-5(d).

(n147)Footnote 147. The transfer agent may assess a "reasonable fee" for this service. *Id.*

(n148)Footnote 148. Rule 17Ad-5(e).

(n149)Footnote 149. Sec. Exch. Act Rel. No. 34-17111, n.9 *supra*.

(n150)Footnote 150. Sec. Exch. Act Rel. No. 34-19142, n.126 *supra*.

(n151)Footnote 151. For a discussion of the origin and application of this rule, *see* Sec. Exch. Act Rel. No. 34-19142, n.126 *supra*. and Sec. Exch. Act Rel. No. 34-19860, n.55 *supra*.

(n152)Footnote 152. A "recordkeeping transfer agent" is "the transfer agent that maintains and updates the master securityholder file." Rule 17Ad-9(h). *See* n.145 *infra*.

(n153)Footnote 153. The "master securityholder file" is "the official list of individual securityholder accounts." Rule 17Ad-9(b). For uncertified securities of registered investment companies, the master securityholder file "may consist of multiple, but linked, automated files." *Ibid*.

(n154)Footnote 154. A "subsidiary file" is "any list or record of accounts, securityholders, or certificates that evidence debits or credits that have not been posted to the master securityholder file." Rule 17Ad-9(c).

(n155)Footnote 155. Rule 17Ad-10(b).

(n156)Footnote 156. The term "promptly" means the following time period "after issuance, purchase, transfer or redemption of a security":

(i) With respect to recordkeeping transfer agents (other than transfer agents that perform transfer agent functions with respect to redeemable securities issued by investment companies registered under Section 8 of the Investment Company Act of 1940) that are exempt transfer agents under Section 240.17Ad-4(b), 30 calendar days;

(ii) With respect to recordkeeping transfer agents (other than transfer agents that perform transfer agent functions with respect to redeemable securities issued by investment companies registered under Section 8 of the Investment Company Act of 1940) that (A) perform transfer agent functions solely for their own or their affiliated companies' securities issues, and (B) employ batch posting systems, ten business days; and

(iii) With respect to all other recordkeeping transfer agents, five business days; Provided, however, that all securities transferred, purchased, redeemed or issued prior to record date, but posted subsequent thereto, shall be posted as of the record date.

Rule 17Ad-10(a)(2).

(n157)Footnote 157. The term "certificate detail" is defined as follows:

with respect to certificated securities, at minimum, all of the following, and with respect to uncertificated securities, includes items (2) through (8):

(1) The certificate number;

(2) The number of shares for equity securities or the principal dollar amount for debt securities;

(3) The securityholder's registration;

(4) The address of the registered securityholder;

(5) The issue date of the security;

(6) The cancellation date of the security;

(7) In the case of redeemable securities of investment companies, an appropriate description of each debit and credit (i.e., designation indicating purchase, redemption, or transfer); and

(8) Any other identifying information about securities and securityholders the transfer agent reasonably deems essential to its recordkeeping system for the efficient and effective research of record differences.

Rule 17Ad-9(a).

(n158)Footnote 158. Rule 17Ad-10(a)(1).

(n159)Footnote 159. A "record difference" exists when

either (1) The total number of shares or total principal dollar amount of securities in the master security-holder file does not equal the number of shares or principal dollar amount in the control book; or
(2) The security transferred or redeemed contains certificate detail different from the certificate detail currently on the master security-holder file, which difference cannot be immediately resolved.

Rule 17Ad-9(g).

(n160)Footnote 160. Rule 17Ad-10(a)(1).

(n161)Footnote 161. Rule 17Ad-10(c)(1).

(n162)Footnote 162. Rule 17Ad-10(c)(2). The report must state the "principal dollar amount of debt securities or the number of shares and related market value of equity securities comprising any buy-in. ..." *Id.*

The Commission has noted that there appear to be only three common instances that necessitate a buy-in:

(1) a transfer in violation of a stop order, *see* § 2.01[1] *supra*;

(2) the issuance of a new certificate that exceeds in dollar or share amount the former certificate, or

(3) the erroneous issue of a certificate upon cancellation of a certificate for a different issue. Sec. Exch. Act Rel. No. 19860, n.55 *supra*.

(n163)Footnote 163. Rule 17Ad-10(g).

(n164)Footnote 164. *See* discussion at § 2A.02[3][e] *supra*.

(n165)Footnote 165. According to the Commission, Rule 17Ad-11 will foster two objectives:

First, the reports would provide issuers with information necessary to make informed decisions about whether the transfer agent is performing its recordkeeping functions in a satisfactory manner, and whether the amount of aged record differences is sufficiently serious to require disclosure to securityholders. In this manner, the reports should enhance the ability of issuers to monitor transfer agent performance, thereby reducing the need for direct government intervention.

Second, the reports provide regulatory authorities with timely information concerning the source and extent of aged record differences and buy-ins and the identity of registered transfer agents who are experiencing serious difficulties in posting their records. Armed with such reports regulatory authorities should be able to focus their limited resources more effectively on those transfer agents whose performance may represent potential harm to investors or a threat to the smooth operation of the national system for clearance and settlement of securities transactions.

Sec. Exch. Act Rel. No. 34-19860, n.55 *supra*.

(n166)Footnote 166. If required, the report shall be sent

(i) By every recordkeeping transfer agent (other than a recordkeeping transfer agent that performs transfer agent functions solely for its own securities):

(A) To the official performing corporate secretary functions for the issuer of the securities for which the aged record difference exists or for which the buy-in occurred;

(B) With respect to an issue of municipal securities, to the chief financial officer of the issuer of the securities for which the aged record difference exists or for which the buy-in occurred; or

(C) If it acts as a service company, to the named transfer agent; and

(ii) By every named transfer agent that is engaged by an issuer to maintain and update the master securityholder file:

(A) To the official performing corporate secretary functions for the issuer of the securities for which the aged record difference exists or for which the buy-in occurred; or

(B) With respect to an issue of municipal securities, to the chief financial officer of the issuer of the securities for which the aged record difference exists or for which the buy-in occurred.

Rule 17Ad-11(a)(3).

(n167)Footnote 167. For a definition of "record difference," *see* n.151 *supra*.

(n168)Footnote 168. *See* Rule 17Ad-10(g) and § 2A.02[3][f] *supra* .

(n169)Footnote 169. *See* n.149 *supra*.

(n170)Footnote 170. *See* n.144 *supra*.

(n171)Footnote 171. Pursuant to Rule 17Ad-11(c), the trigger point to require submission of a quarterly report is:

(i) \$300,000 if the transfer agent is a recordkeeping transfer agent for 5 or fewer issues;

- (ii) \$500,000 for 6-24 issues;
- (iii) \$800,000 for 25-49 issues;
- (iv) \$1 million for 50-74 issues;
- (v) \$1.2 million for 75-99 issues;
- (vi) \$1.4 million for 100-499 issues;
- (vii) \$1.6 million for 500-999 issues;
- (viii) \$2.6 million for 1000-1999 issues; and
- (ix) An additional \$1 million for each additional 1000 issues.

A report concerning buy-ins of all issues for which a transfer agent acts as recordkeeping transfer agent is required when the aggregate market value of all mandatory buy-ins during that calendar quarter exceeds \$100,000.

Finally, when a recordkeeping transfer agent has any debits or credits for securities transferred, purchased, redeemed or issued that are unposted to the master securityholder and subsidiary files for more than five business days after debits and credits are required to be posted, the agent is required to report such fact to its appropriate regulatory agency and shall state in that report what steps have been, and are being, taken to correct the situation.

(n172)Footnote 172. Sec. Exch. Act Rel. No. 34-19860, n.55 *supra*. According to the Commission:

Registered transfer agents, in addition to possessing securities in transfer, may have custody and possession of substantial amounts of funds and securities for a variety of reasons. First, some transfer agents maintain balanced certificates in their capacity as transfer agent custodians. Second, an increasing number of transfer agents are becoming administrators of dividends reinvestment plans ('DRPs'), which require the handling and safeguarding of both funds and securities. Third, dividend checks and certificates of securityholders who cannot be located must be retained by transfer agents for various periods of time under state law. Fourth, transfer agents often maintain a substantial working supply of unissued securities certificates for each issue. Fifth, some transfer agents, as authorized by their issuers, distribute cash dividends to the securityholders shown on the master securityholder file. Finally, some transfer agents may be the entities through which mutual fund shares are redeemed.

Id.

(n173)Footnote 173. Rule 17Ad-12.

(n174)Footnote 174. Sec. Exch. Act Rel. No. 34-19860, n.55 *supra*.

(n175)Footnote 175. Rule 17Ad-12(a)(2).

(n176)Footnote 176. For a discussion of the "appropriate regulatory agency," *see* § 2A.02[2][a] *supra*.

(n177)Footnote 177. Rule 17Ad-13. In mandating this report, the Commission stated that it:

believes that the goal of the external Evaluation, ultimately, is to enhance securityholder protection. The safe and accurate performance of transfer agent functions depends on the accuracy and reliability of the systems and procedures used by registered transfer agents in performing transfer agent activities, and the Commission believes it is imperative that there be systematic verification that transfer agents operate safely and accurately. The Commission also believes that an adequate system of internal accounting control is critical to the accurate and safe clearance and settlement system for securities transactions. Moreover, through the discipline associated with an External Evaluation, transfer agents will be informed on a timely basis about any inadequacies in their system of internal accounting control for transfer agent activities and for safeguarding related funds and securities and should, as a result, be able to make any needed changes on a timely basis.

The Commission believes that the External Evaluation is a critical feature of the scheme of internal disciplines that the rules adopted today are designed to promote. The External Evaluation provides an important objective review and should promote uniform high-quality transfer agent performance. Moreover, the External Evaluation should increase public confidence in the national clearance and settlement system

Sec. Exch. Act Rel. No. 34-19860, n.55 *supra*.

(n178)Footnote 178. Rule 17Ad-13. The report is required to be filed within 90 calendar days of date of the study. *Id.*

(n179)Footnote 179. Rule 17Ad-13(a)(3).

(n180)Footnote 180. *Id.* Rule 17Ad-13(a)(3) further provides: "Occurrence of errors or irregularities more frequently than in isolated instances may be evidence that the system has a material inadequacy. A significant adverse effect on a transfer agent's ability promptly and accurately to transfer record ownership and safeguard related securities and funds could result from any condition or conditions that individually, or taken as a whole, would reasonably be expected" to:

(1) Inhibit the transfer agent from promptly and accurately discharging its responsibilities under its contractual agreement with the issuer;

(2) Result in material financial loss to the transfer agent; or

(3) Result in a violation of Sections discussed in § 2A.03[3][a], [f] and [h] respectively, *supra*.

(n181)Footnote 181. Rule 17Ad-13(b).

(n182)Footnote 182. Rule 17Ad-13(d)(1)(i) through (iii).

(n183)Footnote 183. Rule 17Ad-13(d)(2). In addition, if the transfer agent functions pertain to redeemable securities issued by a registered investment company, the transfer agent is exempt from Rule 17Ad-13 if it

"maintains a master securityholder file consisting of fewer than 1000 shareholder accounts, in the aggregate, for each of such issues. ..."

Id.

(n184)Footnote 184. Rule 17Ad-3(d)(3).

(n185)Footnote 185. The Commission may exempt specific transfer agents or certain transactions for a broad range of reasons including the protection of investors, the maintenance of fair markets, or for the overall public good. Rule 17Ad-14(d) under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G.

(n186)Footnote 186. *See § 2A.03[3]* for the definition of a 'qualified registered transfer agent.'*See also* Rule 17Ad-14(c)(4).

(n187)Footnote 187. Rule 17Ad-14(a). Before a transfer agent is required to open an account, the securities of the subject company must be declared eligible for the services of a qualified registered securities depository. Thereafter, once a tender or exchange offer is made, the transfer agent has two days to open the account.

(n188)Footnote 188. Rule 17Ad-15.

(n189)Footnote 189. Such procedures should include guidelines to ensure that the transfer agents standards are being used when deciding whether to accept or reject a guarantee. Rule 17Ad-15(c)(2).

(n190)Footnote 190. Rule 17Ad-15.

(n191)Footnote 191. Notification of rejection must be made within two business days after rejection of a guarantee and can be accomplished through notification by fax, phone, or mail. Rule 17Ad-15(d)(2).

(n192)Footnote 192. Certain transfer agent records are required to be retained subsequent to the termination or withdrawal from registration. *See § 2A.02[3][c] supra*.

(n193)Footnote 193. Rule 17Ac3-1(b).

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Federal Securities Exchange Act of 1934

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CHAPTER 2A Registration and Regulation of Transfer Agents and Clearing Agencies *

1-2A Federal Securities Exchange Act of 1934 § 2A.03

§ 2A.03 Registration and Regulation of Clearing Agencies

[1] The Registration Requirement

Section 17A of the Securities Exchange Act of 1934 provides for federal regulation of the securities handling process, specifically the registration and regulation of both clearing agencies and transfer agents. n1 Section 17A(b) requires every clearing agency to register with the Commission if it performs any clearing agency function for any security other than an exempted security. n2

The term "clearing agency" is defined in Section 3(a)(23) of the Exchange Act to include "any person" n3 who

- is an intermediary for payments or deliveries or both in connection with transactions in securities; or
- provides "facilities for comparison of data respecting the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities." n4

The term "clearing agency" also includes any person, such as a securities depository, who

- functions as a "custodian of securities" in connection with a system for the central handling of securities by which all securities of a particular class or series of any issuer deposited within the system are treated as fungible and may be "transferred, loaned or pledged by bookkeeping entry" without physical delivery of securities certificates; or
- otherwise "permits or facilitates" the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates. n5

Excluded from the definition of a "clearing agency" n6 is any:

- federal reserve bank, federal home loan bank or federal land bank;
- national securities exchange or registered securities association, n7 which provides facilities only

"for comparison of data respecting the terms of settlement of securities transactions effected on such exchange or by means of any electronic system operated or controlled by such association"; n8

- bank, broker, dealer, savings and loan association or cooperative bank that functions "solely" as an agent for another clearing agency or that performs clearing agency services "solely" as a part of its "customary" professional activities unless the Commission, by rule, mandates registration; n9

- life insurance company, its registered separate account or subsidiary that performs clearing agency functions "solely" for variable annuity contracts or variable life insurance policies; n10

- registered open-end investment company or unit investment trust that functions as a clearing agency "solely" for the shares that it issues; n11 and

- person who functions "solely" as a transfer agent. n12

The Commission "by rule or order, upon its own motion or upon application" is empowered to exempt "conditionally or unconditionally" any clearing agency or security or class of clearing agencies or securities from any provision of Section 17A and the rules and regulations thereunder upon a finding that such exemption "is consistent with the public interest, the protection of investors and the purposes of [Section 17A], including the prompt and accurate clearance and settlement of securities transactions and the safeguarding of securities and funds." n13

Unless otherwise exempt, every clearing agency is required by Section 17A to register with the Commission. In this regard, the registration process for clearing agencies differs from that applicable to transfer agents. While transfer agents are registered through the Commission, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System or the Federal Deposit Insurance Corporation, depending upon which of these four regulatory agencies oversees the day-to-day affairs of the transfer agent, all clearing agencies are registered through the Commission. The bank regulatory agencies nevertheless have the authority to object to registration of any entity over which an agency has direct jurisdiction and also to adopt and enforce rules and regulations applicable to clearing agencies subject to their respective jurisdiction. n14

[2] The Registration Process

[a] Application for Registration. Every clearing agency seeking registration is required to file with the Commission an application for registration on Form CA-1. n15

An applicant is required to file four "completed copies" of this Form. n16 Each copy must bear an "original, manual signature." n17 In the case of a corporation, Form CA-1 must be executed by a "principal officer." n18 For all other applicants, the Form must be signed by a "duly authorized principal." n19

The date upon which the Commission receives a Form CA-1 is deemed to be its filing date "if all the requirements with respect to the filing have been complied with." n20 The processing period commences upon the filing date. n21

[b] Form CA-1. The Form consists of nine questions and requires submission of eighteen exhibits and possibly one additional exhibit if this is an application for exemption from registration as a clearing agency. n22 The questions solicit basic information about the applicant, e.g. name, business address, type of business organization, fiscal year and the number of employees engaged in clearing agency activities.

In addition, the applicant must provide certain information regarding its insurance carrier, and discuss "the operational, organizational or other rules, procedures or practices" that (a) create exposure to the applicant, or (b) protect the applicant against losses n23 if a participant fails to perform its obligations to the clearing agency. n24

Moreover, the applicant must discuss its internal policies and procedures for reconciling differences in its clearing agency activities, n25 and state, "the dollar amount of the potential exposure of registrant ... as a result of differences ... in its clearing agency activities not resolved after twenty business days." n26

An application for registration must be accompanied by various exhibits that provide supplemental information concerning the applicant's business organization, n27 financial condition, n28 *operational capacity* n29 and accessibility to the clearing agency services. n30

[c] The Review Procedure and Criteria for Granting Registration. The Commission will acknowledge receipt of an application for registration; n31 however, a Form CA-1 that is not properly prepared and executed may be returned "as not acceptable for filing." n32

Registered clearing agencies are deemed to be "self-regulatory organizations," n33 and, therefore, the registration procedure is governed by Section 19 of the Exchange Act. n34 This section requires that the Commission, upon the filing of an application for registration, "shall" publish notice of the filing and afford interested persons an opportunity to comment. Notices of applications are published in the Federal Register.

Section 19(a)(1) also requires that the Commission, within ninety days after publication of a notice, either grant such registration or institute a proceeding to determine whether to deny registration. If a proceeding is commenced, the Commission is required to issue a notice specifying "the grounds for denial under consideration" and schedule a hearing on the application. A final decision is required within 180 days after publication of the notice of filing. n35

If the Commission is not the "appropriate regulatory agency" for the applicant, n36 three special provisions apply.

First, the Commission is required, before granting an application, to wait at least sixty days after publication of the notice of application unless the "appropriate regulatory agency" has notified the Commission that the applicant is organized and has the capacity "to safeguard securities and funds in its custody or control" and that the rules of the applicant are designed to assure the safeguarding of such securities and funds. n37

Second, the Commission is required, if requested by the appropriate regulatory agency, to institute a proceeding to determine whether to grant an application for registration. n38

Finally, the Commission is required to deny registration if the appropriate regulatory agency makes a determination, prior to the conclusion of the Commission's proceeding, that the applicant "is not ... organized or does not have" the capacity to safeguard securities or funds in its control or custody or for which it has responsibility and the reasons for such determination. n39

In addition to the procedural mandate of Section 19(a), the Commission is required by Section 17A(b) to make nine determinations before granting registration to any applicant. n40

The first determination is that the applicant's organization and operational capacity enable the applicant to:

- facilitate the clearance and settlement of securities transactions;
- safeguard securities and funds;
- carry out the provisions of the Exchange Act.
- enforce compliance by its participants with the rules of the steering agency; and

- carry out the purposes of Section 17A. n41

The remaining determinations focus upon the applicant's rules and require a finding by the Commission that, among other things, the rules:

- provide reasonable access, fair representation of participants in the applicant's affairs and an equitable allocation of dues and fees;
- do not impose a schedule of prices for services rendered by participants;
- provide for appropriate discipline of participants;
- assure fundamental fairness in disciplinary actions and denials of access; and
- carry out the purposes of Section 17A and do not impose any burden on competition "not necessary or appropriate in furtherance of the purposes of the Exchange Act." n42

The Commission, if requested by the applicant, may grant temporary registration without making all nine of the determinations required by Section 17A, but such temporary registration is effective for only eighteen months. n43 Within nine months after permitting temporary registration, the Commission is required either to grant permanent registration or to commence a proceeding concerning the application. n44

After more than three years of debate, over the registration standards to be imposed by the Commission and the scope and impact of such registration, the Commission in 1980 announced specific standards that applicants would be required to satisfy before the Commission would render the determinations required by Section 17A. n45 If an applicant believes that a standard is "inappropriate," a waiver of that standard may be requested by submitting to the Division of Market Regulation "a detailed description" of:

- the reasons why the standard is inappropriate;
- a proposed alternative to achieve the stated objective of the standard; and
- why the proposed alternative satisfies the statutory criteria. n46

[d] Updating and Amending Form CA-1. An applicant may update or amend its Form CA-1 by filing with the Commission four copies of the page on which the amended or revised answer appears. n47 The amended page must be accompanied by properly completed cover and execution pages. n48 The page must be completed in full, including all unamended items. n49

Form CA-1 is required to be amended "promptly" if the information reported at Items 1 to 3 becomes "inaccurate, incomplete or misleading." n50 This obligation survives the effective date of registration. n51

The filing of additional information or documents prior to the effective date of registration extends by ninety days the processing period. n52

Every amendment or supplement to a Form CA-1 is deemed to be a "report" or "application" within the meaning of Section 17, n53 and, therefore, the clearing agency is required to file a copy of the amendment or supplement with the "appropriate regulatory agency." n54

If a registered clearing agency intends to amend any of the rules or operating policies that originally were submitted as part of its application on Form CA-1, the clearing agency is required, due to its classification as a "self-regulatory organization," n55 to comply with special Commission rules and procedures. n56

[e] Clearing Agency Registrations to Date. Although Section 17A was adopted in 1975 (effective December 1st of that year) n57 the Commission did not grant full registration to any clearing agency until September 1983. n58 This eight year period witnessed an unusual maelstrom of legal maneuvers by the Commission and various clearing agencies.

The drama commenced in November 1975, when the Commission announced that it would not be able, by the effective date of Section 17A, either to grant registration or to determine whether to grant exemptions from registration to all clearing agencies. n59 To permit existing clearing agencies to continue in operation, the Commission concluded that temporary registration would be granted to clearing agencies which had applications on file as of November 24, 1975, and had requested such status. n60

By the end of November 1975, thirteen clearing agencies had requested temporary registration, n61 and additional requests by other clearing agencies continued for several months. n62

In May 1976, the Commission instituted proceedings to determine whether to deny or grant registration to the National Securities Clearing Corporation ("NSCC"). n63 A similar proceeding was instituted in September 1976 with respect to thirteen other clearing agencies. n64

After more than a year of deliberation, the Commission granted registration to the NSCC in January 1977. n65 The Commission's action came under sharp Congressional criticism n66 and ignited litigation by Bradford National Clearing Corporation challenging the Commission's order granting registration. n67 In the midst of these developments, the Commission released a statement of proposed standards by which the Division of Market Regulation would evaluate pending and future applications for registration, excluding NSCC which had already been registered. n68 These proposed standards were revised in March 1978. n69

In the fall of 1978, the United States Court of Appeals for the District of Columbia Circuit affirmed the Commission's order granting registration to NSCC, but directed that the Commission reinstitute its review proceeding to reconsider certain aspects of the NSCC's pricing structure and its facilities management agreement. Pursuant to this mandate, the Commission requested public comments on these issues. n70

By the summer of 1980, the Commission had adopted final standards to be applied in evaluating registration applications of clearing agencies. n71 The Commission subsequently requested that all clearing agencies temporarily registered resubmit a Form CA-1 complying with the new standards for registration. n72

In February 1981, the Commission concluded its reconsideration of the NSCC application for registration and once again decided in favor of NSCC. n73

Finally, in September 1983, full registrations were granted by the Commission to nine clearing agencies, including NSCC and Bradford. n74

[f] Exemptions from Registration. The Commission is empowered to grant exemptions from registration upon a finding that such exemption "is consistent with the public interest, the protection of investors" and the purposes of Section 17A. n75 Applications for an exemption must be made on Form CA-1 with all applicable items answered "in full." n76

In addition, the exemption application must be accompanied by a statement "demonstrating" why the grant of an exemption is consistent with the applicable statutory criteria. n77

[3] Special Regulations Applicable to Clearing Agencies

[a] Clearing Agencies as Self-Regulatory Organizations. Congress has defined the concept of a "self regulatory organization" n78 ("SRO") to include all registered clearing agencies. n79 Therefore, clearing agencies are subject to a wide variety of special statutory and regulatory requirements that are not applicable to transfer agents.

As an SRO, a registered clearing agency must comply with the provisions of Section 19 of the Exchange Act. Section 19:

- establishes a procedural framework for the consideration of applications for registration; n80
- requires that a copy of every proposed SRO rule or rule change be filed with and approved by the Commission, after interested persons are given and opportunity to comment; n81
- directs that an SRO file with the appropriate regulatory agency a notice of any final disciplinary action, denial of membership or right of participation, or order barring a person from association with a member, n82 which notice "shall" be subject to review by the agency; n83
- establishes standards to be applied by the appropriate regulatory agency in reviewing notices filed with it n84 and authorizes the agency to modify a disciplinary sanction under certain circumstances; n85
- mandates that every SRO enforce compliance by its participants with its own rules; n86 and
- grants to the appropriate regulatory agency the authority to sanction an SRO for violating any provision of the Exchange Act or for failure to enforce its rules, n87 and the authority to sanction members and participants for violating the rules of the SRO. n88

The Commission is also empowered to allocate regulatory responsibilities among SRO's, including clearing agencies, to foster cooperation and coordination with respect to regulation of participants in more than one SRO. n89

[b] Participation--Statutory Disqualification. A registered clearing agency *may* deny participation, and *must* deny participation if directed by the Commission, to any person subject to a "statutory disqualification." n90 In this context, a clearing agency is required to file a notice with the Commission at least 30 days prior to admitting to participation a statutorily disqualified person if the agency knew "or in the exercise of reasonable care should have known" that the person was disqualified. n91

In addition, a clearing agency *may* deny or condition participation if a person fails to meet "standards" of financial responsibility, operational capacity, experience and competence. n92 Examinations may be conducted to verify the qualifications of an applicant. n93

[c] Disciplinary Actions and Denial of Participation. As discussed above, n94 clearing agencies are required to enforce compliance with their rules by participants. In any disciplinary proceeding, the clearing agency is required to state the "specific charges" and to give the respondent an opportunity to defend himself. n95

To impose a sanction, the clearing agency must issue a "statement" that specifies the improper acts, practices or omissions, the rules that have been violated, the sanction imposed "and the reasons therefor." n96

A similar "statement" must be issued when a clearing agency denies, limits, or prohibits participation. n97

To assure the integrity of the clearing and settlement system, clearing agencies are authorized n98 to "summarily

suspend and close the accounts" of any person who is

- expelled or suspended from any self-regulatory organization; or
- has defaulted in his obligation to deliver funds or securities to the clearing agency.

In addition, the clearing agency must notify the appropriate regulatory agency that suspension and closing of accounts are necessary for the protection of the clearing agency and its participants, creditors, or investors. n99

If such a suspension is ordered, the suspended participant must be given a "prompt" hearing by the clearing agency. n100 In addition, the agency, on its own motion or upon request of any interested person, may stay the suspension if the agency concludes that the stay is "consistent" with the public interest and the protection of investors. n101

[d] Access to Services. When Congress adopted the Securities Acts Amendments of 1975, there was substantial debate and evaluation over the competitive impact of the legislation and the anticompetitive forces within the securities industry. n102 Consistent with this concern, Section 17A(b)(6) prohibits a clearing agency from prohibiting or restricting access by any person to the services offered by any participant.

[e] Securities Position Listing. The Commission in 1979 adopted Rule 17Ad-8 n103 which requires that clearing agencies furnish to issuers a securities position listing upon request. n104 The origin of the rule was a recommendation in the Final Report of the Street Name Study n105 that issuers have access to a list of persons on whose behalf depositories hold issuer securities. n106 In the Commission's view, access to such a list would facilitate communication between issuers and their shareholders. Clearing agencies may impose a "reasonable" fee for providing such a list. n107

[f] Books and Records. A registered clearing agency is required to maintain such books and records as the Commission may prescribe. n108 The "appropriate regulatory agency" may also adopt supplemental recordkeeping requirements. n109

All books and records are subject to inspection "at any time" by the Commission and the appropriate regulatory agency. n110 The Commission is required, however, to give notice to and "consult with" the appropriate regulatory agency before conducting any "examination" of a clearing agency to avoid "unnecessary regulatory duplication or undue regulatory burdens." n111

[4] Coordination and Cooperation Among the Regulatory Agencies

Several provisions of the Exchange Act are designed to promote cooperation and coordination among the various agencies that regulate clearing agencies. Applications for registration, for example, are required to be filed with *both* the Commission and the appropriate regulatory agency. n112 The same filing requirement applies to every notice, proposal, and report. n113

The Commission may not grant an application for registration without notice to the appropriate regulatory agency. n114 Similarly, the Commission may not conduct an "examination" of a clearing agency for which it is not the appropriate regulatory agency without notice to and consultation with such agency. n115

Moreover, Congress specifically directed the Commission and the various bank regulatory agencies to "consult and cooperate with each other" in sharing their regulation of clearing agencies. n116 This includes giving at least 15 days advance notice before public issuance of any proposed rule or regulation. n117 Congress further directed the agencies that, in adopting rules and regulations, they should ensure that, to the extent possible, such regulatory standards are "in accord with sound banking practices" insofar as they affect banking institutions. n118 In an effort to minimize potential jurisdictional conflicts, Congress also directed that the appropriate regulatory agency has "primary responsibility" for examination of clearing agencies under its control and related compliance action. n119

[5] Withdrawal from Registration

Because registered clearing agencies are deemed to be self-regulatory organizations, n120 withdrawal from registration is governed by Section 19(a)(3) of the Exchange Act. This Section mandates that a written notice be filed with the Commission, but authorizes the Commission to adopt rules governing the withdrawal process. Section 19(a) also authorizes the Commission to impose "terms and conditions" prior to permitting withdrawal. Moreover, the Commission may cancel registration upon a finding that the SRO has ceased to do business or is no longer existence.

FOOTNOTES:

(n1)Footnote 1. Registration and regulation of transfer agents is discussed in § 2A.02 *supra*. A description of the operational problems that motivated Congress to adopt Section 17A are discussed in § 2A.01 *supra*.

(n2)Footnote 2. The term "exempted security" is defined in Section 3(a)(12) of the Exchange Act and discussed in § 4.01 *infra*. For purposes of Section 17A, however, municipal securities are not classified as "exempted securities." Section 3(a)(12) of the Securities Exchange Act of 1934 reprinted in the Primary Law Sourcebook, Volume B, section F. Therefore, persons acting as clearing agents for municipal securities are required to register pursuant to Section 17A even though the securities are exempted from various provisions of the Exchange Act.

(n3)Footnote 3. The term "person" means a "natural person, company, government or political subdivision, agency or instrumentality of a government." Section 3(a)(9).

(n4)Footnote 4. Congress specifically intended Section 17A to encompass "every facet of the securities handling process in the United States--clearing agencies, securities depositories, corporate issuers and transfer agents." Conference Report concerning the Securities Acts Amendments of 1975, 94th Cong., 1st Sess. 102 (1975). Accordingly, the definition of the term "clearing agency" encompasses an unusually wide range of administrative functions.

(n5)Footnote 5. Section 3(a)(23)(A).

(n6)Footnote 6. Section 3(a)(23)(B).

(n7)Footnote 7. National securities exchanges and securities associations are discussed in § 2.02 *supra*.

(n8)Footnote 8. Section 3(a)(23)(B)(ii).

(n9)Footnote 9. Section 3(a)(23)(B)(iii).

To mandate registration, the Commission must find that registration is necessary or appropriate "to assure the prompt and accurate clearance and settlement of securities transactions or to prevent evasion" of the Exchange Act. *Id.*

(n10)Footnote 10. Section 3(a)(23)(B)(iv).

(n11)Footnote 11. Section 3(a)(23)(B)(v).

(n12)Footnote 12. Section 3(a)(23)(B)(vi).

Transfer agents are discussed in § 2A.03 *supra*. If, however, a "person" functions as both a transfer agent and a clearing agent, registration in both capacities is required. Section 17A(b)(1).

(n13)Footnote 13. Section 17A(b)(1).

(n14)Footnote 14. Section 17A(b)(2).

See §§ 2A.02[2][a], 2A.02[3][c] and [e], *supra* and 2A.03[2][c] *infra* .

(n15)Footnote 15. In November 1975, the Commission adopted Rule 17Ab2-1 which specifies the registration procedures applicable to clearing agencies. Sec. Exch. Act Rel. No. 34-11787, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,320 (Nov. 3, 1975). Simultaneously, the Commission designated Form CA-1 as the appropriate registration form. *Id.* Final standards were adopted in 1980. Sec. Exch. Act Rel. No. 34-16,900, Fed. Sec. L. Rep. (CCH) P 26,303G (June 17, 1980).

(n16)Footnote 16. Instruction I.2 to Form CA-1.

In addition, if the Commission is not the "appropriate regulatory agency" for the applicant, see § 2A.02[2][a] *supra*, a "signed copy" of the application must be filed with the "appropriate regulatory agency." Section 17(c)(1) of the Exchange Act. See also Instruction I.1 to Form CA-1.

(n17)Footnote 17. Instruction I.4 to Form CA-1.

(n18)Footnote 18. For purposes of Form CA-1, the term "principal officer" means "the president, vice president, treasurer, secretary, comptroller or any other person performing a similar function." Instruction I.5 to Form CA-1.

(n19)Footnote 19. *Id.*

(n20)Footnote 20. Instruction I.3 to Form CA-1. But see § 2A.03[2][c] *infra*.

(n21)Footnote 21. For a discussion of the review procedures and processing timetable, see § 2A.03[2][c] *infra*.

(n22)Footnote 22. Applicants are warned by the Commission that "intentional misstatements or omissions of fact constitute Federal Criminal Violations." Form CA-1, citing 15 U.S.C. 78ff(a) and 18 U.S.C. 1001.

(n23)Footnote 23. Such protective measures might include maintenance of a clearing or participant's fund or marking to the market open obligations, i.e., computing the purchase price of disputed transfers based upon the closing price of the security in order to estimate the amount at risk and, thereafter, establishing a reserve account in an amount equal to all or a percentage of the "at risk" proceeds.

(n24)Footnote 24. Items 5(c)(i) and (d)(i) of Form CA-1.

(n25)Footnote 25. This reconciliation must focus specifically upon "long and short stock record differences and dividend differences." Item 7(a) to Form CA-1.

(n26)Footnote 26. In calculating this potential exposure, the applicant is not to offset long differences against short differences and is not to offset any suspense account items. Item 7(b) to Form CA-1.

(n27)Footnote 27. In summary, the applicant must provide information concerning:

(1) any person who, directly or indirectly, "may control or direct the management or policies of the registrant" (Exhibit A to Form CA-1);

(2) every officer, trust officer, manager or person performing a similar function, including name, title, area of responsibility and summary of business experience for preceding five years (Exhibit B to Form CA-1);

1-2A Federal Securities Exchange Act of 1934 § 2A.03

- (3) the registrant's organizational structure. This description should be in "narrative and graphic" form (Exhibit C to Form CA-1);
- (4) persons who, directly or indirectly, are controlled by or are under common control with the clearing agency (Exhibit D to Form CA-1);
- (5) the "currently effective" constitution, articles of incorporation, bylaws and "all dues, fees and other charges imposed by registrant for its clearing agency activities" (Exhibit E of Form CA-1);
- (6) any material pending legal proceeding "other than ordinary and routine litigation incidental to the business ...", including any such proceeding known to be contemplated by the Commission (Exhibit F to Form CA-1);
- (7) all contracts with any national securities exchange, national securities association, clearing agency, or securities market for which the clearing agency acts as a clearing agency or performs clearing agency functions (Exhibit G to Form CA-1); and
- (8) all offices in which clearing agency functions are performed (Exhibit I to Form CA-1).

For Exhibits E and G copies of relevant documents must be submitted to the Commission.

(n28)Footnote 28. Each applicant is required to submit a balance sheet and statement of income and expenses for its most recent fiscal year, certified by an independent accountant (Exhibit H to Form CA-1). "If certified financial information is not available, uncertified financial information should be submitted." *Id.*

(n29)Footnote 29. *In summary, the applicant must provide operational capability information consisting of:*

- (1) a narrative description of each clearing agency service or function to be performed by the applicant (Exhibit J to Form CA-1);
- (2) a description of the "measures or procedures" employed by the applicant to provide for "the security of any system which performs the function of a clearing agency" (Exhibit K to Form CA-1);
- (3) a description of the "measures or procedures" to provide for "the safeguarding of securities and funds" in the applicant's custody or control (Exhibit L to Form CA-1); and
- (4) a description of "all back-up systems or subsystems" that are designed to prevent interruptions in the performance of any clearing agent function as a result of technical or other malfunction, if the applicant utilizes automated facilities or systems to perform clearing agency functions, (Exhibit M to Form CA-1).

Exhibits K and L must "identify any instances" within the past year in which the security measures or safeguards failed to prevent unauthorized access and the measures taken to prevent a recurrence of any such incident.

(n30)Footnote 30. *In summary, the applicant must provide:*

- (1) a list of the persons who participate or who have applied for participation in the applicant's clearing agency activities (Exhibit N to Form CA-1);
- (2) a description of any "specifications, qualifications or other criteria" that "limit, are interpreted to

limit, or have the effect of limiting" access to or use of the clearing agency services and a statement of the reasons for imposing such limitations (Exhibit O to Form CA-1);

(3) a copy of every form of contract "governing the terms on which persons who subscribe to clearing agency services ..." (Exhibit P to Form CA-1);

(4) a schedule of "any prices, rates or fees" for services to be rendered by the applicant (Exhibit Q to Form CA-1); and

(5) a schedule of "any prohibitions or limitations" imposed by the applicant on access "by any person" to services to be offered by the applicant (Exhibit R to Form CA-1).

See § 2A.03[3][d] infra.

(n31)Footnote 31. Sec. Exch. Act Rel. No. 34-11787, n.15 *supra*.

(n32)Footnote 32. Instruction I.3 to Form CA-1.

Moreover, acceptance of a Form CA-1 for filing "shall not constitute a finding that it has been filed as required or that the information submitted is true, current or complete." *Id.*

(n33)Footnote 33. Section 3(a)(26).

For a general discussion of the duties and responsibilities of clearing agencies as self-regulatory organizations, *see § 2A.03[3][a] infra.*

(n34)Footnote 34. Section 19(a)(1).

In 1975, after lengthy debate, Congress amended the Securities Exchange Act of 1934 to classify as "self-regulatory organizations" ("SROs") certain components of the securities industry, i.e., national securities exchanges and associations and registered clearing agencies. *See § 2.01[2] supra.*

(n35)Footnote 35. The 180-day period may be extended by consent of the applicant or for an additional 90 days by the Commission "for good cause" provided that the Commission "publishes its reason for so finding ..." Section 19(a)(1)(B).

(n36)Footnote 36. For a definition and discussion of the term "appropriate regulatory agency," *see § 2A.02[2][a] supra.*

(n37)Footnote 37. Section 19(a)(2)(A) of the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, section F.

(n38)Footnote 38. Section 19(a)(2)(B).

The appropriate regulatory agency, to trigger a proceeding, must notify the Commission that the agency has determined that the applicant "may not be" organized or have the capacity to be able to safeguard funds or securities in its possession and the reasons for such determination. *Id.*

(n39)Footnote 39. Section 19(a)(2)(C).

(n40)Footnote 40. Section 17A(b)(3). The Securities Acts Amendments of 1975, which added Section 17A to the

Exchange Act, became effective December 1, 1975. *See* § 2A.02 n.4 *supra*. Accordingly, all clearing agencies were required to be registered by that date. In November 1975, the Commission concluded that it would not be able, by that date, either to make the requisite determination or to grant exemptions from registration. *See* n.15 *supra*. Accordingly, the Commission decided to exempt temporarily from registration all applicants whose application were filed with the Commission on or before November 24, 1975. *Id.* In addition, upon application, the Commission undertook to grant temporary registration to selected clearing agencies based upon partial determinations. Thirteen clearing agencies qualified for this temporary registration. *See* Sec. Exch. Act Rel. No. 34-16900, Fed. Sec. L. Rep. (CCH) P 26,203G.

Thereafter, in 1977 and 1978, the Commission released for comment proposed standards to be applied in evaluating registration applications. *See* Sec. Exch. Act Rel. Nos. 34-13584, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,183 (June 1, 1977) and 14,531, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,525 (Mar. 6, 1978). Final standards were adopted in 1980. Sec. Exch. Act Rel. No. 34-16,900, Fed. Sec. L. Rep. (CCH) P 26,203G (June 17, 1980). Then, all clearing agencies that had been temporarily registered were required to submit a new Form CA-1 to demonstrate compliance with these standards. *See* Sec. Exch. Act Rel. No. 17231, Fed. Sec. L. Rep. (CCH) P 26,203H (1980).

For a discussion of registrations pursuant to Section 17A from 1975 through early 1984, *see* § 2A.03[2][e] *infra*.

(n41)Footnote 41. Section 17A(b)(3)(A).

(n42)Footnote 42. Section 17A(b)(3)(B)-(I).

(n43)Footnote 43. Rule 17Ab2-1(c)(1) under the Securities Exchange Act of 1934, reprinted in the Primary Law sourcebook, Volume C, Section I. The Commission, by order, may extend the eighteen month period.

(n44)Footnote 44. Rule 17Ab2-1(c)(2).

(n45)Footnote 45. Sec. Exch. Act Rel. No. 34-16900, Fed. Sec. L. Rep. (CCH) P 26,203G (1980).

(n46)Footnote 46. *Id.*

(n47)Footnote 47. Instruction III.13 to Form CA-1.

(n48)Footnote 48. *Id.*

(n49)Footnote 49. *Id.*

(n50)Footnote 50. Instruction III.12 to Form CA-1. Items 1-3 of Form CA-1 focus on the name, address, telephone number and place of organization of the applicant.

(n51)Footnote 51. Rule 17Ab2-1(e).

(n52)Footnote 52. Rule 17Ab2-1(d).

(n53)Footnote 53. Rule 17Ab2-1(f). Section 17(a)(1) provides for the recordkeeping requirements of clearing agencies.

(n54)Footnote 54. Section 17(c).

(n55)Footnote 55. *See* § 2A.03[2][c] *supra*.

(n56)Footnote 56. *See* § 2A.03[3][a] *infra*.

(n57)Footnote 57. *See* § 2A.02 n.4 *supra*.

(n58)Footnote 58. Sec. Exch. Act Rel. No. 34-20221, n.43 *supra*.

(n59)Footnote 59. Sec. Exch. Act Rel. No. 34-11787, n.15 *supra*.

(n60)Footnote 60. *Id*.

(n61)Footnote 61. Sec. Exch. Act Rel. No. 34-11875 (1975).

The thirteen agencies were the Depository Trust Company; Bradford Securities Processing Services, Inc.; American Stock Exchange Clearing Corporation; Stock Clearing Corporation of Philadelphia; Boston Stock Exchange Clearing Corporation; Stock Clearing Corporation; Midwest Securities Trust Company; The Options Clearing Corporation; Midwest Clearing Corporation; Pacific Securities Depository Trust Company; National Clearing Corporation; and TAD Depository Corporation.

(n62)Footnote 62. *See, e.g.*, Sec. Exch. Act Rel. No. 34-12274 (1976).

(n63)Footnote 63. Sec. Exch. Act Rel. No. 34-12,489, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,557 (May 28, 1976).

(n64)Footnote 64. Sec. Exch. Act Rel. No. 3412,759, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,785 (Nov. 3, 1976).

(n65)Footnote 65. Sec. Exch. Act Rel. No. 34-13163 (Jan. 13, 1977). The Commission announced its proposed conditions for approval in 1976. Sec. Exch. Act Rel. No. 34-12954, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,785 (Nov. 3, 1976).

(n66)Footnote 66. *See Oversight of the Functioning and Administration of the Securities Acts Amendments of 1975*, Report of the Subcommittee on Oversight and Investigations and the Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce (Committee Print 95-27), 95th Cong., 1st Sess. 4-8 (1977).

(n67)Footnote 67. *Bradford National Clearing Corporation v. SEC*, 590 F. 2d 1085 (D. C. Cir. 1978) .

(n68)Footnote 68. Sec. Exch. Act Rel. No. 34-13584, n.40 *supra*.

(n69)Footnote 69. Sec. Exch. Act Rel. No. 34-14531, n.40 *supra*.

(n70)Footnote 70. *See* Sec. Exch. Act Rel. No. 34-15,640 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,028 (Mar. 14, 1979) and No. 15,760 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,065 (April 24, 1979).

(n71)Footnote 71. Sec. Exch. Act Rel. No. 34-16900, n.15 *supra*.

(n72)Footnote 72. Sec. Exch. Act Rel. No. 34-17,231, Fed. Sec. L. Rep. (CCH) P 26,203H (Oct. 20, 1980)

(n73)Footnote 73. Sec. Exch. Act Rel. No. 34-17,562, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,833 (Feb. 20, 1981).

(n74)Footnote 74. Sec. Exch. Act Rel. No. 34-20221, n.43 *supra*.

(n75)Footnote 75. Section 17A(b)(1).

(n76)Footnote 76. Rule 17Ab2-1(a) and Instruction II.10 to Form CA-1.

(n77)Footnote 77. Instruction II.11 to Form CA-1.

(n78)Footnote 78. Self-regulatory organizations are discussed and defined in §§ 2.02[2] and 2.03 *supra* .

(n79)Footnote 79. Section 3(a)(26).

(n80)Footnote 80. Section 19(a)(1) requires, for example, that the Commission publish notice of the filing of an application for registration and afford interested persons an opportunity to comment. *See* § 2.01[2][c] *supra*. *See also* § 2A.03[2][e] *supra*.

(n81)Footnote 81. Section 19(b)(1), which is discussed at § 2.02[1][a] *supra*. Although Section 19(c) authorizes the Commission to "abrogate, add to, and delete from" the rules of an SRO, *see* § 2.02[1][b] *supra*, this authority does not extend to registered clearing agencies.

(n82)Footnote 82. Section 19(d)(1), which is discussed at § 2.03[5][d] and § 2.03[4] *supra* .

(n83)Footnote 83. Section 19(d)(2), which is also discussed at § 2.03[5][d] and § 2.03[4] *supra* .

(n84)Footnote 84. Section 19(e)(1). *See* § 2.03[5][d] and § 2.03[4] *supra* .

(n85)Footnote 85. Sections 19(e)(2) and (f). *See* § 2.03[5][d] and § 2.03[4] *supra* .

(n86)Footnote 86. Section 19(g)(1)(C). While clearing agencies need only enforce compliance with their own rules, other categories of SRO's (i.e. national securities exchanges and associations) are required also to enforce compliance with the provisions of the Exchange Act. *See* § 2.02[4] *supra*.

(n87)Footnote 87. Section 19(h)(1). *See* § 2.02[6][c] *supra*.

If a clearing agency's registration is suspended or revoked, the appropriate regulatory agency may apply to a "court of competent jurisdiction," as defined in Section 21(d) or 27 of the Exchange Act, for the appointment of a trustee. Section 19(i). If an application is filed, the Exchange Act authorizes the court to assert "exclusive jurisdiction" over all records and assets of the clearing agency "wherever located." *Ibid*. The court may appoint the appropriate regulatory agency or any other person to serve as trustee with the power "to take possession and continue to operate or terminate the operations" of the clearing agency. *Id*.

(n88)Footnote 88. Section 19(h)(2).

(n89)Footnote 89. Section 17(d). *See* § 2.02[6][b] *supra*.

(n90)Footnote 90. For a definition and discussion of the term "statutory disqualification," *see* § 2.02[2][a] *supra*.

(n91)Footnote 91. Section 17A(b)(4)(A).

(n92)Footnote 92. Section 17A(b)(4)(B).

(n93)Footnote 93. *Id*.

(n94)Footnote 94. *See* § 2A.03[3][a] *supra*.

(n95)Footnote 95. Section 17A(b)(5)(A) of the Securities Exchange Act of 1934 reprinted in the Primary Law Sourcebook, Volume B, Section F.

(n96)Footnote 96. *Id*.

(n97)Footnote 97. Section 17A(b)(5)(B).

(n98)Footnote 98. Section 17A(b)(5)(C).

(n99)Footnote 99. *Id.*

(n100)Footnote 100. *Id.*

(n101)Footnote 101. *Id.*

(n102)Footnote 102. *See* n.66 *supra*.

(n103)Footnote 103. Sec. Exch. Act Rel. No. 34-16,443, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,390 (Dec. 20, 1979).

(n104)Footnote 104. A "securities position listing" is a list of the participants in the clearing agency on whose behalf the clearing agency holds the issuer's securities and the positions held by these participants as of a specified date. Rule 17Ad-8(a).

(n105)Footnote 105. *Final Report of the Securities and Exchange Commission on the Practice of Recording the Ownership of Securities in the Records of the Issuer in Other than the Name of the Beneficial Owner of such Securities* 6 (SEC 1976).

(n106)Footnote 106. The Commission proposed initially that clearing agencies be required to mail listings to issuers at least annually. Sec. Exch. Act Rel. No. 34-14493, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,514 (Feb. 22, 1978). The Commission also proposed that certain non- issuers (such as law enforcement agencies) be permitted access to a security position listing. *Id.* Both proposals were deleted from the final rule.

(n107)Footnote 107. Rule 17Ad-8(b) under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, section G.

(n108)Footnote 108. Section 17(a)(1).

(n109)Footnote 109. Section 17(a)(2).

(n110)Footnote 110. Section 17(b).

(n111)Footnote 111. *Id.*

(n112)Footnote 112. *See* § 2A.03[2][c] *supra*.

(n113)Footnote 113. Section 17(c)(1).

(n114)Footnote 114. *See* § 2A.03[2][c] *supra*.

(n115)Footnote 115. *See* § 2A.03[3][f] *supra*.

(n116)Footnote 116. Section 17A(d)(3)(A).

(n117)Footnote 117. Section 17A(d)(3)(A)(i).

(n118)Footnote 118. Section 17A(d)(3)(A).

(n119)Footnote 119. Section 17A(d)(3)(A)(ii).

(n120)Footnote 120. *See* § 2A.03[3][a] *supra*.

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CHAPTER 3 Regulation of Brokers and Dealers

1-3 Federal Securities Exchange Act of 1934 3.syn

AUTHOR: W. Reece Bader

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W. Reece Bader n*

FOOTNOTES:

(n1)Footnote *. This chapter was revised and updated by W. Reece Bader, a partner at the law firm of Orrick, Herrington & Sutcliffe LLP. Mr. Bader is the past Co-Chair of both the Securities Litigation Committee and the Alternative Dispute Resolution Committee of the Litigation Section of the ABA, and a former member of the National Arbitration and Mediation Committee of the NASDR.



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CHAPTER 3 Regulation of Brokers and Dealers

1-3 Federal Securities Exchange Act of 1934

AUTHOR: W. Reece Bader

Summary of This Chapter

Federal regulation of brokers and dealers is part of the regulation of the securities markets mandated by the Securities Exchange Act of 1934 ("Exchange Act"). Section 15(c)(3) of the Exchange Act directs the Securities and Exchange Commission ("SEC" or "Commission") to prescribe rules and regulations for the financial responsibility and related practices of broker-dealers, including the custody and use of customers' securities, deposits, and credit balances. Section 15(h)(1) of the Exchange Act bars states from imposing requirements on broker-dealers, municipal securities dealers or government securities dealers which differ from or are in addition to the Exchange Act requirements in these areas. The Commission also oversees the regulation of broker-dealers' conduct by subjecting broker-dealers to the rules of the self-regulatory organizations of which they are members. Broker-dealers are also subject to the regulation of credit, as implemented by the rules and regulations of the Federal Reserve Board, and to the registration and post-registration provisions of the Exchange Act and the blue sky laws. Section 18(c)(1) of the Securities Act of 1933 ("Securities Act"), preserves state authority to investigate and bring enforcement actions under state law with respect to fraudulent, deceitful or otherwise unlawful broker-dealer sales practices in connection with any securities transaction.

The Commission is empowered to adopt rules to maintain fair and orderly markets and to ensure equal regulation of transactions on the exchange and over-the-counter markets. The Commission has determined that the combination of broker and dealer functions performed by broker-dealers may lead to the abuse of the fiduciary relationship between broker-dealers and their customers. To address this conflict, the Commission has adopted rules under Section 11(a) and (b) of the Exchange Act for the regulation of floor traders, odd-lot dealers, and specialists. *See § 3.02 infra.*

Section 15(a)(1) requires all brokers and dealers that use any means of interstate commerce to effect transactions in securities to register on Form BD. Registration subjects the registrant to rigorous recordkeeping, reporting and financial requirements. Brokers and dealers are also subject to fingerprinting requirements and net worth and capital requirements. Brokers and dealers who participate in regulated activities but fail to register are subject to injunctive or disciplinary action, denial of registration, and criminal prosecution. *See § 3.03 infra.*

Registered brokers and dealers are required to make and keep current the books and records set forth in Rule 17a-3

under the Exchange Act and to preserve them for the length of time prescribed by Rule 17a-4. Registered brokers and dealers that clear transactions or carry customer accounts are required to file monthly reports on the Financial Operational Combined Uniform Single (FOCUS) Report. Broker-dealers are required to file annually with the Commission monthly reports of their financial condition and to provide customers statements as to that condition. *See § 3.04 infra.*

The Financial Industry Regulatory Authority ("FINRA") is the sole self-regulatory organization of over-the-counter brokers and dealers. n1 Any registered broker or dealer that meets prescribed standards and that regularly transacts business in the investment banking or securities business is eligible for membership in the FINRA. Broker-dealers that are FINRA members are subject to surveillance by the FINRA. *See § 3.05 infra.*

Section 15B of the Exchange Act requires municipal securities dealers, including banks, to register with the Commission. The Municipal Securities Rulemaking Board ("MSRB") promulgates rules governing the municipal securities industry, subject to oversight by the Commission. Section 15B(b)(1) of the Exchange Act requires that the MSRB rules contain provisions dictating, *inter alia*, standards of operation capability, training, and competence, prevention of fraud and manipulation, and periodic examination of municipal securities brokers and dealers. *See § 3.06 infra.*

Because of the special characteristics and importance of the government securities market, Section 15C of the Exchange Act, added by the Government Securities Act of 1986, provides a different regulatory scheme for government securities brokers and dealers. The Secretary of the Treasury has the authority to adopt rules which are administered and enforced by the SEC or the banking or financial regulator that otherwise has jurisdiction over the particular broker or dealer. The most significant difference between the regulation of registered brokers and dealers under Section 15 of the Act and government securities brokers and dealers under Section 15C is that the latter are subject to a different set of capital requirements and a separate set of requirements concerning custody of customer securities. *See § 3.07 infra.*

Effective May 12, 2001, the Gramm-Leach-Bliley Act of 1999 integrated the regulation of banks acting in a broker-dealer capacity with the Federal Securities regulation scheme. n2

Finally, in addition to the net worth and capital requirements, the financial responsibility rules promulgated by the Commission subject registered brokers and dealers to restrictions on the hypothecation and loan of customers' securities and requirements concerning bank reserves and physical possession and control of customers' securities. Failure to comply with the financial responsibility rules, designed to protect the assets of customers, is one ground for Commission action against registered broker-dealers and associated persons. The Securities Investor Protection Corporation is available to protect qualifying customers' assets in the event of broker-dealer insolvency. *See § 3.08 infra.*

FOOTNOTES:

(n1)Footnote 1. FINRA was created in 2007 through the consolidation of the National Association of Securities Dealers, Inc. ("NASD") and the member regulation, enforcement and arbitration functions of the New York Stock Exchange ("NYSE"), <http://www.finra.org/AboutFINRA/CorporateInformation/index.htm> (last visited Apr. 7, 2008). Because FINRA is currently consolidating NASD and NYSE rules into a single set of FINRA rules, the citations contained herein will be to NASD and NYSE rules. The reader should be aware that, at some point in the future, the NASD and NYSE rules will become FINRA rules. Firms that were members only of NASD as of July 30, 2007, along with firms that join FINRA only, are currently subject only to NASD rules. NYSE rules apply to firms that join the NYSE, <http://www.finra.org/RulesRegulation/FINRARules/index.htm> (last visited Apr. 7, 2008). This chapter contains numerous pre-2007 references to FINRA; the reader should understand that FINRA was known as NASD prior to July 2007. However, formal names, such as NASD committees or publications, will retain their NASD titles herein.

(n2)Footnote 2. The Commission adopted various rules following the Gramm-Leach-Bliley Act and extended time

for bank compliance to May 12, 2002.



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CHAPTER 3 Regulation of Brokers and Dealers

1-3 Federal Securities Exchange Act of 1934 § 3.01

AUTHOR: W. Reece Bader

§ 3.01 Introduction

Broker-dealers are organized in various forms, operating as individual proprietorships, partnerships, and corporations. n1 Federal regulation of brokers and dealers is part of the regulation of securities markets mandated by the Securities Exchange Act of 1934 ("Exchange Act"). n2 A broker or dealer subject to Section 15(a) of the Exchange Act, which includes any broker or dealer doing business in interstate commerce in nonexempt securities, must register with the Securities and Exchange Commission ("Commission" or "SEC") on Form BD and meet the standards of professional competence, operational capability, and financial responsibility established by the Commission and often implemented by self-regulatory organizations. n3

A broker-dealer's obligations under the Exchange Act do not end with registration. Once registered, the broker-dealer must maintain and preserve the books and records prescribed by the Commission. n4 A registered broker-dealer is subject to the monthly, quarterly, and annual reporting requirements of Rule 17a-5 n5 and the FOCUS reporting system designed to simplify the reporting obligations of brokers and dealers. n6

The Exchange Act is designed to regulate and control transactions in securities conducted upon securities exchanges and in the over-the counter ("OTC") market and to regulate practices and matters related to such transactions. n7 In particular, the Commission is directed to prescribe rules and regulations establishing safeguards concerning the financial responsibility and related practices of brokers and dealers, including the custody and use of customers' securities, deposits, and credit balances. n8 The financial responsibility rules of the Commission subject registered brokers and dealers to minimum net capital requirements, n9 restrictions on hypothecation and loan of customers' securities, n10 and bank reserve and physical possession or control of customers' securities requirements. n11 The financial responsibility rules are designed to protect, directly and indirectly, the assets of customers. Failure to comply with the financial responsibility rules is one of the grounds for Commission action against a registered broker-dealer or person associated with a broker or dealer. n12

Should a registered broker or dealer encounter financial difficulty because, for instance, the broker or dealer is not in compliance with the financial responsibility rules of the Commission, the Securities Investor Protection Corporation ("SIPC") may be available to protect the customers' assets. n13 SIPC maintains a fund financed in part by the regulated industry, available to protect qualifying customers' funds in cases of broker-dealer insolvency. n14

Not only does the Commission regulate the conduct of brokers and dealers directly, the Commission also oversees the regulation of their conduct by organizations in the securities industry of which they are members. n15 Brokers and dealers that are members of the Financial Industry Regulatory Authority ("FINRA") are subject to the rules, regulations, and on-site inspections of FINRA. n16 Brokers and dealers transacting business on exchanges are also subject to the rules and regulations of the exchanges of which they are members.

The Securities Acts Amendments of 1975 n17 expanded broker-dealer regulation under the Exchange Act to include municipal securities brokers and dealers; created a new category of dealer, a municipal securities dealer; provided that municipal securities dealers that are banks must register under new Section 15B of the Exchange Act; and established a new rulemaking self-regulatory organization, the Municipal Securities Rulemaking Board ("MSRB"), to promulgate rules concerning the municipal securities industry. n18 In 1986 the Exchange Act was further amended, adding Section 15C, which required the registration of brokers and dealers in U.S. government securities. n19

Broker-dealers are also subject to the regulation of credit under the Exchange Act, as implemented by the rules and regulations of the Federal Reserve Board. n20 The regulation of fraudulent market activities and fraudulent practices involving the broker-client relationship is also part of broker-dealer regulation under the Exchange Act. n21

As though the regulation of brokers and dealers under the Exchange Act and through self-regulation by industry groups were not enough, brokers and dealers must also comply with the registration and post-registration provisions of the blue sky laws. n22

The National Securities Markets Improvement Act of 1996 n23 significantly revised the federal securities laws. The predominant purpose of the new law was to reduce overlapping federal and state regulation, preempt state regulation of many offerings, n24 divide regulation of investment advisors, n25 and impose significant limits on state regulation of broker-dealers.

The 1996 legislation added a new Section 15(h)(1) to the Exchange Act which prohibits inconsistent state regulation of capital, margin, custody, books and records or financial responsibility. n26

Sections 15(h)(2) and 15(h)(3) bar any state from prohibiting an unregistered representative from effecting transactions for customers so long as the person is not ineligible to be registered, is registered with FINRA and one other state, and the broker-dealer is registered in the state.

Finally, in new Section 18(c)(1) n27 of the Securities Act, state authority to investigate and file enforcement actions for unlawful conduct by a broker-dealer in connection with a securities transaction, is preserved. n28

On November 11, 1999, Congress passed the Gramm-Leach-Bliley Act, n29 also known as the Financial Modernization Act of 1999. The Act, effective at various future dates, imposes additional obligations on broker-dealers, especially with respect to privacy matters. n30 The Act also repeals the blanket exception of banks from the definition of "broker" and "dealer" in the Exchange Act, replacing such with more functional definitions of such terms. Rules adopted by the Commission, effective May 12, 2002, then create certain exceptions.

FOOTNOTES:

(n1)Footnote 1. *Report of the Special Study of Securities Markets of the Securities and Exchange Commission*, H. Doc. No. 95, 88th Cong., 1st Sess., Pt.1, 15-19 (1963) (hereinafter referred to as "Special Study"). The various capacities in which brokers and dealers operate are discussed in § 3.02 *infra*.

(n2)Footnote 2. 15 U.S.C. §§ 78a-78mm. The regulation of securities markets under the Exchange Act is discussed in Ch. 2 *supra*. The Securities Exchange Act of 1934 is reprinted in the Securities Primary Law Sourcebook, Volume B,

Section F (Matthew Bender).

(n3)Footnote 3. The registration of brokers and dealers is discussed in § 3.03 *infra*.

(n4)Footnote 4. The recordkeeping and preservation requirements under the Exchange Act are discussed in § 3.04 *infra*. The books and records that must be made and preserved are subject to inspection by the Commission, see § 3.04 *infra*.

(n5)Footnote 5. The reporting requirements of Rule 17a-5 are discussed in § 3.04 *infra*. The rules under the Securities Exchange Act of 1934 are reprinted in the Securities Primary Law Sourcebook, Volume B, Section G (Matthew Bender).

(n6)Footnote 6. The FOCUS Report on Form X-17A-5 is discussed in § 3.04 *infra*. The forms under the Securities Exchange Act of 1934 are reprinted in the Securities Primary Law Sourcebook, Volume B, Section H (Matthew Bender).

(n7)Footnote 7. Section 2.

(n8)Footnote 8. Section 15(c)(3).

(n9)Footnote 9. The net capital requirements of Rule 15c3-1 are discussed in § 3.08[2] *infra*.

(n10)Footnote 10. Hypothecation and loan of customers' securities are discussed in § 3.08 *infra*.

(n11)Footnote 11. The reserve and custody of securities requirements of Rule 15c3-3 are discussed in § 3.08[2][c] *infra*. For discussion of the Lost and Stolen Securities Program, see § 3.08 *infra*.

(n12)Footnote 12. Commission action against a broker-dealer is discussed in § 3.03 *infra*.

(n13)Footnote 13. The Securities Investor Protection Corporation is discussed in § 3.08 *infra*.

(n14)Footnote 14. See § 3.08 *infra*.

(n15)Footnote 15. See §§ 2.03, 2.04 *supra* for discussion of Commission oversight of self-regulatory organizations.

(n16)Footnote 16. FINRA is discussed in § 3.05 *infra*.

(n17)Footnote 17. P.L. 94-29, 89 Stat. 97 (Act of June 4, 1975).

(n18)Footnote 18. Municipal securities dealers and brokers are discussed in § 3.06 *infra*.

(n19)Footnote 19. 21 P.L. 99-571, 100 Stat. 3208 (Act of Oct. 28, 1986), effective July 25, 1987. Government securities brokers and dealers are discussed in § 3.07 *infra*.

(n20)Footnote 20. The regulation of credit is discussed in Ch. 3A *infra*.

(n21)Footnote 21. See Ch. 6 *infra*.

(n22)Footnote 22. For discussion of state securities laws governing the registration and regulation of brokers and dealers, see Robert N. Rapp, Blue Sky Regulation, Ch. 11 (Matthew Bender).

(n23)Footnote 23. Pub. L. No. 104-290, 110 Stat. 3416 (Jan. 3, 1996).

(n24)Footnote 24. See R. Rapp, Blue Sky Regulation, Ch. 11 *supra* .

(n25)Footnote 25. See Ch. 5C.

(n26)Footnote 26. Section 15(h) of NSMIA is codified at 15 U.S.C. § 78o(h).

(n27)Footnote 27. NSMIA Section 18(c)(1) is codified at 15 U.S.C. § 77r(c)(1).

(n28)Footnote 28. For example, in *United States v. Schulman*, 1998 U.S. Dist. LEXIS 2013 (S.D.N.Y. Feb. 24, 1998) , the court rejected a defendant's motion to dismiss, premised upon an argument that Section 15 preempts state regulation of securities laws. The Court explained that Section 15, also known as 15 U.S.C. § 78o, "By its terms, it is limited to the establishment of "financial or operational *reporting* requirements for brokers" that differ from the requirements set forth elsewhere in the Exchange Act. 15 U.S.C. § 78o(h)(1). It does not apply to disclosure requirements or purport to restrict the state's ability to prosecute the undisclosed receipt of bribes by brokers under state commercial bribing statutes. *Id.* at *5-6. States may not, however, rely on Section 18(c)(1) to regulate the registration and offering process, which the 1996 legislation removed from state authority. See 142 Cong. Rec. H12047 (daily ed. Sept. 28, 1996). For example, in *Myers v. Merrill Lynch & Co.*, 1999 U.S. Dist. LEXIS 22642 (N.D. Cal. Aug. 23, 1999) , *aff'd* 249 F.3d 1087 (9th Cir. 2001) , the Court held that a plaintiff's claims against a broker dealer for violation of California's unfair business practices statutes were preempted by NSMIA and rejected the plaintiff's argument that by authorizing states to investigate and prosecute acts of broker dealer fraud, Section 18(c)(1) defeated the defendant's preemption argument.

(n29)Footnote 29. Pub. L. No. 106-102, 113 Stat. 1338 (1999).

(n30)Footnote 30. In 2000, the SEC promulgated proposed privacy rules for broker-dealers pursuant to Gramm-Leach-Bliley. See Exch. Act Rel. No. 34-42, 848 (Mar. 2, 2000). The Commission adopted final rules such that financial institutions must provide customers with written notice of its privacy policies and practices and must not disclose personal information of consumers to non-affiliated third parties, absent satisfaction of certain requirements. Exch. Act Rel. No. 34-42, 974 (June 22, 2000).



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CHAPTER 3 Regulation of Brokers and Dealers

1-3 Federal Securities Exchange Act of 1934 § 3.02

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§ 3.02 Separation of Broker-Dealer Functions--Sections 11(a) and (b)

At the time of the adoption of the Securities Exchange Act, Congress was deeply concerned over brokers and dealers acting interchangeably as principal and agent. Specifically, where a single person acts in the capacity of both broker and dealer, that person's own interests may conflict with the interests of those to whom the broker/dealer owes a fiduciary duty. While the Exchange Act defines the terms separately, n1 Congress originally considered including a provision prohibiting any broker from also acting as a dealer. Since Congress did not have enough information, however, to determine what, if anything, should be done to segregate these functions, it directed the Commission to study the segregation of functions. n2 In its final report, the Commission concluded that the combination of the broker and dealer functions involves an inherent conflict of interest which may lead to the abuse of the fiduciary relationship between the broker and the customer, but recommended that no legislation be enacted at that time. n3

In three particular fields, however, Congress felt that some direct action should be taken. It empowered the Commission to adopt rules for the regulation of floor traders, odd-lot dealers, and specialists. The Securities Acts Amendments of 1975 further amended Section 11(a) of the Act to add more specific trading restrictions.

[1] Floor Traders

A floor trader is an exchange member who deals on the floor of the exchange for his or her own account. Although floor trading still exists, its activity is quite limited. The original 1934 bills contained an absolute prohibition of floor trading. n4 However, the final Act provided only that the Commission prescribe rules it deems necessary or appropriate to regulate or prevent floor trading. n5

In 1964, as a result of the 1963 Special Study, n6 the Commission adopted Rule 11a-1. The rule provides that no member is permitted to buy or sell for his or her own account on the floor except where the transactions involve specialists, odd-lot dealers, stabilizing syndicates, arbitrageurs and a few others, including persons acting in conformity with a Commission-approved exchange plan designed to eliminate floor trades not beneficial to the market. n7 Such plans have been adopted by the major exchanges. n8

Section 11(a), n9 as amended in 1975, is directed in large part at the problems presented by the combination of

1-3 Federal Securities Exchange Act of 1934 § 3.02

brokerage and money management. Historically, exchange members with managed accounts have enjoyed competitive advantages over nonmember money managers. The rules of the New York and American Stock Exchanges barred financial institutions and their affiliates from membership but did not prohibit exchange members from engaging in money management. The exchange member, therefore, could go into the business of managing money and obtain brokerage income from the managed accounts, while the money manager was unable to earn brokerage income.

Fixed commission rates then in effect added impetus to the efforts of money managers to obtain brokerage income or to reduce brokerage expenses. Under a fixed rate system, commissions on institution-sized orders were sufficiently profitable that brokerage firms were willing to assume the management function for a nominal fee in order to obtain the resulting brokerage income.

The combination of brokerage and money management is still viewed as having undesirable aspects. A customer's account may be managed with a view to the production of brokerage income rather than in the best interests of the customer. For example, production income can be generated by engaging in an excessive number of transactions ("churning") or by executing those orders in which the largest commission can be realized. Moreover, preferences can be given to certain accounts over other accounts by providing advance information of new developments in a security or priority in executing orders. Finally, the elimination of fixed commission rates in 1975 presented a new conflict of interest: determination by the broker-manager of fair commission charges for managed accounts' transactions. n10

The approach adopted by the 1975 Amendments was to prohibit an exchange member from trading on the exchange for the member's own account, the account of an associated person, or an account with respect to which the member or an associated person exercises investment discretion. n11

There are specific exemptions from the prohibition of Section 11(a)(1). These concern:

- market maker transactions; n12
- trades by odd-lot dealers;
- stabilizing transactions by a participant in the distribution of a security;
- certain arbitrage and hedge transactions, expressly including "risk arbitrage"; n13
- transactions for the account of a natural person, the estate of a natural person, or a trust created by a natural person for himself or another natural person;
- transactions to offset errors;
- transactions for a member's own account provided: (a) the member is primarily engaged in underwriting and distributing securities, selling securities, and acting as broker, or any one or more of those activities, and whose gross income normally is derived from that business and related activities; and (b) the transactions are in accordance with Commission Rules which assure transactions will be consistent with the maintenance of fair and orderly markets and yields priority, parity and precedence to orders of nonmembers;
- certain transactions for an account over which the member or an associated person exercises investment discretion; and
- other transactions exempted by Commission Rules. n14

Section 11(a)(2) n15 empowers the Commission, consistent with the public interest, to maintain fair and orderly markets, or to assure "equal regulation" of exchange markets and other markets by regulating or prohibiting:

- transactions by exchange members not unlawful under Section 11(a)(1) (except if members are acting as market makers or odd-lot dealers);
- transactions effected otherwise than on a national securities exchange by an exchange member, a broker or dealer: (a) for its own account (except those acting as market makers), (b) an account of an associated person, or (c) an account with respect to which the member, broker, dealer or associated person exercises investment discretion;
- transactions on a national exchange by a nonmember broker or dealer for: the member's own account (unless acting as a market maker); the account of an associated person; and an account as to which the broker, dealer or associated person exercises investment discretion. n16

Under the authority of Section 11(a)(1), the Commission adopted Rule 11a1-1(T) which provides that a transaction for the account of an exchange member, which meets the "business mix" test of paragraph (G)(i) of section 11(a)(1), n17 will satisfy the requirements of paragraph (G)(ii) of that section if the member discloses, to all other members involved in communicating or effecting the bid or offer, that it is for the account of a member. In addition, the executing floor member, immediately before executing the order, must disclose to the specialist and other members then present that it is for the account of a member, and, notwithstanding any other applicable rules of parity, priority and precedence, the executing broker must grant priority to any bid or offer at the same price for the account of a non-member (or non-affiliate of a member) regardless of the size or time of entry of such public order.

Rule 11a1-1(T)(b) also clarifies the meaning of Section 11(a)(1)(G)(i)'s requirement that the member be "primarily" engaged in certain kinds of business.

Rule 11a1-2, the "Look-Through" rule, permits a member to effect a transaction for its associated person (or for an account carried by such associated person) if the member could have effected the transaction for its own account. For purposes of this rule, the associated person must independently meet the test of being "primarily engaged" in the kinds of business covered by Section 11(a)(1)(G)(i).

Perhaps the most important exemptive rule adopted by the Commission under Section 11(a)(1) is Rule 11a2-2(T), the "Effect v. Execute" rule. This rule permits a transaction to be effected for the account of a member or its associated person (the "initiating member") if it is "executed" on the floor of the exchange by a member *not* associated with the initiating member. The rule also requires that the initiating member (or its associated person) have investment discretion over the account and does not retain any compensation in connection with the transaction, except pursuant to a written contract that makes specific reference to section 11(a) and Rule 11a2-2(T), and which is signed by the initiating member (or its associated person) and the person who has granted the discretionary authority. The rule also requires annual reporting of any compensation retained by the initiating member or its associate. n18

[2] Odd-Lot Dealers

The unit of exchange trading is usually 100-share lots (round lots), a mechanism developed on the New York Stock Exchange ("NYSE") whereby certain odd-lot firms act as dealers to fill orders for less than a round lot for other brokerage houses, adjusting their own inventory by round-lot transactions on the floor. Such transactions have been handled somewhat differently on the other exchanges, where the specialist acts as the odd-lot dealer. In 1976, the NYSE acquired the computerized odd-lot system operated by Carlisle De Coppet & Co. This system is operated on behalf of the NYSE's specialist units, which have, in effect, become the NYSE's odd-lot dealers in the stocks assigned to them. These specialists absorb stock when odd-lot customers are selling, and supply stock from their inventories when odd-lot

customers are buying. Odd-lot orders were previously priced on the next effective round-lot sale. In December 1987, the Commission approved a NYSE proposal modifying odd-lot pricing procedures under Rule 124 so that odd-lot market orders immediately received a price based on the prevailing NYSE quote, with no differential charged on the quote, while odd-lot limit orders were still charged a differential. n19 Odd-lot limit orders are still charged a differential. The odd-lot business was studied in some detail by the Special Study Group. n20 In June 2004, the Commission approved amendments to NYSE Rule 124 so that odd-lot orders would be priced and executed at the price of subsequent round-lot transactions. n21 The new pricing was phased in beginning on June 21, 2004, with all odd-lot orders to be priced in compliance as of June 28, 2004. n22

[3] Specialists

The place of the specialist in the exchange is described as follows:

[T]he major American exchanges are, for the most part, "continuous auctions" rather than call markets. On the larger exchanges the various securities are allocated to different localities or "posts" on the "floor," and buy or sell orders may be brought to the appropriate post at any time during the trading session for immediate or later execution. Since there may not be matching buy and sell orders from public customers at the same moment, a continuous auction market requires mechanisms for linking the buy and sell interests during the trading sessions, and the main cog in the established mechanisms is the specialist who joins the orders in specific securities. n23

The functions and activities of the floor specialists were given special attention by the Special Study group. n24 In general, the Special Study group found the role of the specialist to be necessary, although it almost inevitably involved certain conflicts of interest. The Special Study group recommended some changes in exchange rules to minimize the effects of conflicts of interest. Accordingly, in 1965, the SEC ordered the adoption by the national securities exchanges of Commission-approved rules in this area. n25 The major exchanges have adopted these rules. n26

The Securities Acts Amendments of 1975 amended Section 11(b) to grant the Commission plenary power over all aspects of specialists' activities and to eliminate the statutory requirement that a specialist acting as a dealer limit his or her transactions to those necessary to maintain a fair and orderly market. The Commission is also authorized to limit a specialist's activities to that of a broker or dealer.

Section 11(b) authorizes an exchange, consistent with Commission Rules, to permit members: to be registered as odd-lot dealers and buy and sell as reasonably necessary to carry on odd-lot transactions; or to be registered as specialists.

Specialists are prohibited by Section 11(b) from disclosing information concerning orders placed with them to any person other than an official of the exchange, a representative of the Commission or a specialist acting for the specialist. The Commission, however, may require disclosure of orders placed with a specialist to all members of an exchange. Moreover, a specialist permitted to act as a broker or dealer may not effect any transaction as a broker except upon a market or a limited order.

Section 15(c)(5), intended to be complementary to Section 11(b), provides that dealers (other than registered specialists acting in the capacity of market makers or otherwise) are subject to such rules as the Commission may prescribe in the public interest or for the protection of investors. The Commission may prohibit a dealer in a security from acting as a broker in that security. n27

FOOTNOTES:

(n1)Footnote 1. Section 3(a)(4), 15 U.S.C. § 78c(a)(4), defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others" Section 3(a)(5), 15 U.S.C. § 78c(a)(5), defines a dealer

as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise," excluding those who do not buy or sell as part of a regular business. The Securities Exchange Act of 1934 is reprinted in the Securities Primary Law Sourcebook, Volume B, Section F (Matthew Bender).

(n2)Footnote 2. Former Section 11(e), repealed by Securities Acts Amendments of 1975, Sec. 6(3), 1975 U.S.C.C.A.N. (89 Stat. 97) 111.

(n3)Footnote 3. SEC, Report on the Feasibility and Advisability of the Complete Segregation of the Functions of Broker and Dealer, Exch. Act Rel. No. 73967 (June 22, 1936).

(n4)Footnote 4. S. 2693 & H.R. 1383, 73d Cong., 2d Sess. section 10 (1934), reprinted in the Securities Primary Law Sourcebook, Volume C (Matthew Bender).

(n5)Footnote 5. Former Section 11(a), amended by Securities Acts Amendments of 1975, Sec. 6(2), 1975 U.S.C.C.A.N. (89 Stat. 97) 111.

(n6)Footnote 6. *See* Special Study, Pt. 2. Excerpts from this study follow:

Members participating in the trading of securities on the floor of the NYSE are of four types: specialists, odd-lot dealers and their associate brokers, floor brokers, and floor traders. In the ranks of these floor members the floor trader is unique, for he is the only such member who is not assigned, and does not assume, any responsibility in the handling of orders on the Exchange. Floor brokers and specialists must meet fiduciary standards of behavior in executing agency orders. Associate brokers consider themselves obligated to fill every odd-lot order placed with them. Specialists must, in certain situations, buy stock from or sell stock to willing sellers or buyers. The floor trader, on the other hand, is no one's agent, and under no conditions is he required to buy or sell stock. His presence on the floor is dictated only by his personal desire to trade profitably, for his own account, on the floor of the Exchange.

In acting on a pure profit motive, the floor trader is on firm free enterprise footing. Highly controversial, however, is the propriety of his trading *on the floor*, in view of the fact he is not assigned any role in the execution of orders on the Exchange. Critics of floor trading maintain that his competitive trading advantage is unwarranted, and that floor traders accentuate price movements by selling stock on price declines and purchasing stock on price rises. The Exchange, on the other hand, has contended that floor traders produce certain beneficial "byproducts," enumerated as improved market liquidity, stability, and continuity, which warrant their presence on the floor.

A "floor trade," according to NYSE regulations, is any transaction initiated by a member, while on the floor of the Exchange, for his own account or for an account in which he or his member organization has an interest, except for transactions effected by a specialist in stocks in which he specializes or by an odd lot dealer in stocks in which he is registered. A floor trade may thus be effected by a specialist in stocks in which he is not specializing, by an odd-lot dealer in stocks in which he is not registered, by any floor broker, by a "floor trader" or by any other member who happens, for whatever reason, to be on the floor. In classifying members, the Exchange designates them as "floor traders," "floor brokers," etc., according to each member's principal activity. When evaluating the propriety of floor trading, however, it is necessary to include all member trading on the floor, with the exception of specialist and odd-lot dealer trading in stocks in which they are registered.

Id. at 203-41.

(n7)Footnote 7. Rule 11a-1, 17 C.F.R. § 240.11a-1, reprinted in the Securities Primary Law Sourcebook, Volume B, Section G (Matthew Bender).

(n8)Footnote 8. *Exch. Act Rel. No. 34-7330, Fed. Sec. L. Rep. (CCH) P 77,001* (June 2, 1964); *Exch. Act Rel. No. 34-7375, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,110* (July 23, 1964).

(n9)Footnote 9. *15 U.S.C. § 78k(a)(1)*.

(n10)Footnote 10. *See S. Rep. No. 94-75, 94th Cong., 1st Sess. Section 8 (1975)*, reprinted in the *Securities Primary Law Sourcebook*, Volume C (Matthew Bender).

(n11)Footnote 11. Section 11(k)(a)(1), *15 U.S.C. § 78k(a)(1)*. Investment discretion is defined in Section 3(a)(35). A person exercises investment discretion with respect to an account if the following applies, directly or indirectly. The person is authorized to determine the securities or other property to be purchased or sold by or for the account. In addition, investment discretion is shown if the person exercises influence with respect to the purchase and sale of securities or other property by or for the account and it is of a type which the Commission, by rule, determines (in the public interest or for the protection of investors) should be subject to the operation of the Exchange Act (and the rules and regulations thereunder).

Therefore, if an associated person (but not a member) has discretion only as to the timing of a transaction but not as to the kind or amount of security to be bought or sold, neither Section 11(a)(1) nor Rule 11a-1 would apply.

(n12)Footnote 12. Rule 11a1-5 exempts transactions by a registered competitive market maker on the New York Stock Exchange or a registered equity market maker on the American Stock Exchange.

(n13)Footnote 13. Rule 11a1-3(T) confirms the availability of the exemption for bona fide hedge transactions.

(n14)Footnote 14. Rule 11a1-4(T) exempts transactions in debt securities.

(n15)Footnote 15. *15 U.S.C. § 78k(a)(2)*.

(n16)Footnote 16. Although the Commission has the power under Section 11(a)(2) to prohibit exchange trading that is exempted under Section 11(a)(1), Congress stressed that the Commission would not have authority to prohibit a member's transactions on the basis of the type of business done or the type, amount or mix of transactions effected. The Conference Committee warned that a Rule such as the Commission's Rule 19b-2, which limits exchange memberships on the basis of the type and amount of business done on an 80-20 business mix, "would violate both the letter and the spirit of the Exchange Act." *See H.R. Conf. Rep. No. 229, 94th Cong., 1st Sess. 106 (1975)*, reprinted in the *Securities Primary Law Sourcebook*, Volume C (Matthew Bender). The Committee also warned that the Commission cannot grant exemptions to member firms that are "unrelated to the market impact of the specific transactions at issue." *Id.*

The Conference Committee Report stated that members believed that the Department of Labor and the Internal Revenue Service, in administering the Employee Retirement Income Security Act ("ERISA"), should provide an exemption from the prohibited transactions provisions of that statute. The exemptions would "permit securities firms to continue providing brokerage services to accounts with respect to which they exercise investment discretion until May 1, 1978," permitting the firms to phase out combined services in an orderly way. The Committee suggested that the Department of Labor and the Internal Revenue Service, to the maximum extent consistent with the policies of ERISA, conform the prohibitions in that statute applicable to securities firms and municipal securities dealers to the policies of the Securities Acts Amendments of 1975. *Id.* at 107.

(n17)Footnote 17. The "business mix" test of Section 11(a)(G)(i) requires that the member be primarily engaged in "the business of underwriting and distributing securities issued by other persons, selling securities to customers, and acting as broker, or any one or more of such activities" In addition, the member's gross income must be normally derived from such business and related activities.

(n18)Footnote 18. The SEC has issued three major interpretative releases with respect to Section 11(a)(1) and the

rules thereunder. *Exch. Act Rel. No. 14,563, 3 Fed. Sec. L. Rep. (CCH) P 22,808* (Mar. 14, 1978) deals with the meaning of the term "investment discretion;" the "Effect v. Execute" Rule, 11a2-2(T); the "Look-Through" Rule, 11a1-2; and members' proprietary transactions, Rule 11a1-1(T). *Exch. Act Rel. No. 34-14713, 3 Fed. Sec. L. Rep. (CCH) P 22,808A* (Apr. 27, 1978), discusses the exemptive rule for bond transactions, 11a1-4(T); the Proprietary Trading Rule, 11a1-1(T); the "Look-Through" Rule, 11a1-2; the "Effect Versus Execute" Rule, 11a2-2(T); the exemption for natural persons, Section 11(a)(1)(E); and the relationship of various exemptions to each other. *Exch. Act Rel. No. 34-15,533, 3 Fed. Sec. L. Rep. (CCH) P 22,808B* (Jan. 30, 1979), discusses the relationship between Section 11(a)(1) and the development of a national market system (Section 11A and the rules thereunder); exemptions under Section 11(a)(1)(A) (market makers) and (D) (arbitrage and hedge transactions); Rule 11a1-3(T) covering certain hedge transactions; and the Proprietary Trading Rule, 11a1-1(T).

(n19)Footnote 19. See *Exch. Act Rel. No. 34-25,177* (Dec. 7, 1987).

(n20)Footnote 20. Special Study Pt. 2, pp. 171-202. An excerpt from this part of the report follows:

The unit of trading in most stocks on the exchanges is the "round lot" of 100 shares. Trading in the regular auction market on the floor of an exchange is conducted in round lots, or multiples thereof. An order to buy or sell a security on an exchange in any amount less than the round lot is an "odd-lot" order. Under this system, odd-lot orders do not enter the flow of buy and sell orders in the regular auction market. The business of the odd-lot dealer consists of filling odd-lot orders by buying or selling for his own account as principal. He transacts business exclusively with other brokerage firms, and not with the public.

The conduct of the odd-lot business is nevertheless very significant for the public investor, particularly the small investor, although odd lots also include any portion of a larger order that is not a multiple of 100. ... Almost all odd-lot orders are executed at prices determined automatically by round-lot sales in the same securities. The odd-lot buyer pays a fraction of a point more per share and the odd-lot seller receives a fraction of a point less per share than the controlling round-lot price. This fraction is called the "odd-lot differential," and the odd-lot dealer's compensation is derived from it. A public customer purchasing or selling an odd lot pays, in addition to the differential which is passed on to him, a standard commission to his brokerage firm.

On the New York Stock Exchange, where the price of an odd lot is determined by the next ("triggering") round-lot sale, the differential for stocks in which the round-lot unit is 100 shares is 1/8 of a point (12 1/2 cents) if the controlling round-lot sale is at 39 7/8 or below or 1/4 of a point (25 cents) if the round-lot sale is at 40 or above ("quarter stocks"). Almost 99 percent of the volume of odd-lot transactions on that exchange is handled by two member firms.

On the American, and most regional stock exchanges, odd-lot transactions are handled by the specialists in their respective stocks; most exchanges have no dealers handling odd lots exclusively. The specialist odd-lot dealer fills all odd-lot orders in the securities in which he specializes, by taking for or supplying from his own account the stock involved in such orders. On the American Exchange, like the New York Stock Exchange, odd-lot orders are filled at a fraction of a point above or below the next round-lot price for active stocks, and on the American and regional exchanges, the differential is the same amount as on the New York Stock Exchange.

Id. at 171-174.

(n21)Footnote 21. NYSE Info Memo, Number 04-32.

(n22)Footnote 22. NYSE Info Memo, Number 04-32.

(n23)Footnote 23. NYSE Info Memo, Number 04-14 at 8.

(n24)Footnote 24. NYSE Info Memo, Number 04-32, Pt. 2, at 57-170. An excerpt from the Report follows:

Although centralized securities exchanges have been in existence for several centuries, the specialist system, as presently in effect on major American exchanges, is less than 100 years old. About a century ago the American exchanges adopted the continuous auction method of trading, which is responsible for the present specialist system. Under the continuous auction system, each issue is traded at one designated place on the floor called the "post." There are 19 such posts on the New York Stock Exchange (NYSE), 21 on the American Stock Exchange (Amex), 7 on the Midwest Stock Exchange (MSE), and 31 on the Los Angeles and San Francisco floors of the Pacific Coast Stock Exchange (PCSE). At each trading post are one or more exchange members who "specialize" in some or all of the issues traded at the particular post, and who are registered with their exchange as "specialists" in their particular securities. Their activities are circumscribed by Section 11 of the Exchange Act and the rules of the different exchanges.

The specialist performs two basic functions with respect to the issues in which he specializes. As a broker, he holds and executes orders for the public (usually forwarded to him by other exchange members). As a dealer he is a "market maker" and trades for his own account in the securities in which he is registered.

The service that the specialist performs as broker derives from the nature of the continuous auction market and an exchange which trades a large number of issues. It is the basic obligation of a broker to execute a customer's order expeditiously when, according to its terms and under the rules and procedures of the market, the order is capable of execution. Many investors use "limited price" orders specifying a price above which the customer will not buy or below which he will not sell. Until the market moves to the point set by the customer, such orders are not capable of execution. A floor broker cannot carry limited orders with him as he moves about the floor since he may be elsewhere as the limit is reached and may "miss the market." It is likewise not feasible to have floor brokers wait at a post for a limit to be reached since in some cases the market may never move to the limit, and in others it may take hours, days, or weeks until such orders can be executed. Under existing trading methods it is a practical solution for floor brokers to transmit limited orders to a single broker who stations himself at the post and acts as a central repository of such orders. The utility of this function has never been questioned.

The specialist who holds an order is a subagent in a fiduciary relationship with his principal, the customer who originated the order. Thus, in the event of an erroneous execution a customer may hold both the specialist and his own broker liable for any damages. Section 11 of the Exchange Act prohibits a specialist from disclosing information regarding orders placed with him. In the alternative, a proviso grants authority to the exchanges or the Commission to require full disclosure of *all* orders which the specialist holds. The unexecuted public orders entrusted to the specialist for execution comprise what is known as the "book."

Section 11 of the Exchange Act also permits the specialist to act as a dealer, but his dealer transactions must be restricted "so far as practicable to those reasonably necessary to permit him to maintain a fair and orderly market." An Exchange rule reiterates this limitation; at the same time, as discussed below, specialists are encouraged to engage in dealer transactions in order to maintain a fair and orderly market. As a reflection of the specialists' obligation to maintain fair and orderly markets, their dealer participation extends fairly evenly over all types of stocks rather than being concentrated in particular stocks classified by price or volume.

* * *

[T]he conduct of specialists directly affects the interests of a large proportion of investors and illustrate the specialists' importance in the auction market. But in addition to their volume of trading, no other class of exchange member is so intimately connected with the trading process and in so crucial a position to affect trading as to prices and as to manner and speed of execution of orders. Thus, the rules and practices defining the functions and conduct of the specialist business are of vital significance to the health of the entire auction market and affect all of those who deal in it.

Id. at 57-59.

In the staff report on the Amex, the specialist's crucial position was described as follows:

In his unique capacity the specialist stands at the heart of the Exchange market mechanism. He has intimate knowledge of the past market action of the stocks in which he specializes. He also has sole access to the specialist book showing outstanding orders both below and above the market, which affords him a great competitive advantage over the public. In addition, he exercises a significant influence on the public appraisal of a security, since he is the one who quotes the market. For all these reasons, it is a matter of tremendous importance in the maintenance of a fair and orderly market that a specialist's transactions as principal be only of such kinds and in such amounts as are consistent with his function of acting as broker at the vital center of the auction market.

The statutory scheme and the rules of the Exchange have attempted to establish a workable regulatory pattern whereby the specialist is permitted to trade for his own account in addition to acting as a broker. These provisions were designed to resolve the inherent conflict arising from the combination of functions by maintaining the fiduciary standards which are expected of a broker and yet permitting him to trade as a principal to maintain the continuity of a fair and orderly market.

See also Wolfson and Russo, *The Stock Exchange Specialist: An Economic and Legal Analysis*, 1970 *Duke L.J.* 707 (1970), in which the functions of the stock exchange specialist are explored and the Commission rules and NYSE rules regulating specialists receive comment.

(n25)Footnote 25. Rule 11b-1. *See* Exch. Act Rel. No. 34-7465, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,156 (Nov. 23, 1964). The rule, as then in effect, permitted exchanges to authorize their members to act as specialists and dealers, if their rules contained adequate minimum capital requirements, requirements as to maintenance of an orderly market, surveillance procedures, and similar matters. Paragraph (d) authorizes the SEC to exempt any exchange from the rule. In adopting the rule, the SEC, by order, exempted all of the exchanges except the New York and American Stock Exchanges with respect to securities listed solely on one or more regional exchanges. *Id.* In 1981, by order, the SEC eliminated this exemption for the Boston, Cincinnati, Midwest, Pacific and Philadelphia Stock Exchanges. Exch. Act Rel. No. 34-18,157, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,040 (Oct. 7, 1981). The rule as adopted also required exchanges to file copies of their rules with the SEC. This requirement was eliminated in 1981 in light of the requirements of Section 19(b) and Rule 19b-4. [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,834 (Feb. 25, 1981). The rule was also amended to make it applicable to "securities" (including options), instead of just "stocks." *Id.*

The Commission has modified the exemption of the Boston, Cincinnati, Midwest, Pacific, and Philadelphia Stock Exchanges from Rule 11b-1 by making these exchanges subject to Rule 11b-1 as to any security that is listed on any of these exchanges and not listed on either the American or New York Stock Exchanges. Exch. Act Rel. No. 34-18,157, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,040 (Oct. 7, 1981).

(n26)Footnote 26. Exch. Act Rel. No. 34-7432, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,134

(Sept. 24, 1964); Exch. Act. Rel. No. 34-7465, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,156 (Nov. 23, 1964).

(n27)Footnote 27. In 1977, the SEC proposed few rules pursuant to Section 15(c)(5), which have not been withdrawn or adopted. *See* Exch. Act Rel. No. 34-13,662, Fed. Sec. L. Rep. (CCH) Report No. 700, Extra Edition (June 23, 1977). These proposed rules would provide (in the alternative):

- Rule 15c5-1[A]--A dealer could not effect a principal transaction in a "reported security" in the over-the-counter market except with a "financial institution."
- Rule 15c5-1[B]--A dealer could not effect such a transaction with a retail customer at a price less favorable to the customer than the best "composite quotation execution."
- Rule 15c5-1[C]--A dealer could not effect such a transaction without disclosure of the current bid and offer prices for the security.
- Rule 15c5-1[D]--A dealer could not effect such a transaction with a retail customer at a price less favorable to the customer than if the transaction had been effected on an agency basis.



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CHAPTER 3 Regulation of Brokers and Dealers

1-3 Federal Securities Exchange Act of 1934 § 3.03

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§ 3.03 Registration of Brokers and Dealers

[1] Introduction

Section 15(a)(1) of Exchange Act n1 requires the registration with the Commission of all brokers and dealers n2 who use the mail system or any other means or instrumentality of interstate commerce to effect transactions in, or induce or attempt to induce the purchase or sale of, securities. n3 The section extends to a web site operated by a foreign broker-dealer if the broker-dealer does not take steps to reasonably ensure that it does not effect transactions with people in the United States. n4

Registration is effected by filing Form BD with the Commission. Form BD requires the disclosure of general business information and of any previous securities acts violations. n5 Once registered, brokers and dealers are subject to inspection to determine their compliance with the Act by the Commission or a self-regulatory organization under the Commission's direction. n6

Registration of a broker or dealer under Section 15, subjects the registrant to rigorous recordkeeping, reporting and financial requirements. n7 Further, standards of operational capability, training, and experience, as set and tested by the Commission, must be met. Additionally, registrants must comply with net worth and capital requirements, which ensure sufficiency of liquid assets by requiring a minimum ratio of net capital to aggregate indebtedness. n8 All registered brokers and dealers must also submit their fingerprints to the United States Attorney General. n9 Individuals who engage in regulated activities but fail to register are subject to injunctive or disciplinary action, n10 denial of registration when an application is finally submitted, n11 criminal prosecution, n12 and possible prejudice in civil litigation. n13

[2] Who Must Register.

Section 3(a)(4) of the Exchange Act classifies a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." n14, While someone who executes transactions for others on an exchange is clearly a broker, not all situations present such clarity. There are business brokers, or "finders" who, for a fee make referrals to a variety of financial entities; persons who market real estate or insurance products which may be securities; placement agents; and a variety of similar enterprises. Whether these

1-3 Federal Securities Exchange Act of 1934 § 3.03

individuals are brokers required to be registered depends on the specifics of the activity being conducted. While there is no "bright line" test, the Commission poses questions on its web-site to assist in the evaluation:

- Do you participate in important parts of a securities transaction, including solicitation, negotiation, or execution of the transaction?
- Does your compensation for participation in the transaction depend upon, or is it related to, the outcome or size of the transaction or deal. Do you receive trailing commissions, such as 12b-1 fees? Do you receive any other transaction-related compensation?
- Are you otherwise engaged in the business of effecting or facilitating securities transactions?
- Do you handle the securities or funds of others in connection with securities transactions?

A "yes" answer to any of these questions indicates that you may need to register as a broker. n15 The term "dealer" is defined as "any person engaged in the business of buying and selling securities for such person's account, through a broker or otherwise, ... but a bank shall not be considered to be such a dealer [when engaged] in [certain] activities" n16 The definition of a "dealer" also excludes any person who buys or sells securities for one's own account, either individually or in a fiduciary capacity, as long as the transactions are not a part of a regular business. n17 Obviously, a firm holding itself out as a market-maker in securities is a dealer. Other situations are less clear. Again the Commission web-site is instructive:

Here are some of the questions you should ask to determine whether you are acting as a dealer:

- Do you advertise or otherwise let others know that you are in the business of buying and selling securities?
- Do you do business with the public (either retail or institutional)?
- Do you make a market in, or quote prices for both purchases and sales of, one or more securities?
- Do you participate in a "selling group" or otherwise underwrite securities?
- Do you provide services to investors, such as handling money and securities, extending credit, or giving investment advice?
- Do you write derivatives contracts that are securities?

A "yes" answer to any of these questions indicates that you may need to register as a dealer. n18

With the rapid advances in technology that have occurred over the last two decades, "alternative trading systems" have become increasingly common. An alternative trading system is defined as follows:

any organization, association, person, group of persons, or system: (1) that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of Rule 3b-12 of the Exchange Act; and (2) that does not (A) set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system, or (B) discipline subscribers other than by exclusion from trading. n19

In general, alternative trading systems offer many of the same services as traditional exchanges but are regulated as broker-dealers. Thus, currently, the systems are not subject to the same checks and balances or public scrutiny as traditional exchanges. As a result, in April 1998, the SEC published proposed rules regarding alternative trading systems. n20 Following, final rules were adopted allowing alternative trading systems the option of registering as exchanges or as broker-dealers with additional requirements under the new Regulation ATS. n21 Notwithstanding the broad registration language, there are groups of persons or entities exempt from registration. For example, as discussed in § 3.03[4] infra, "stock brokers" or "associated persons," employed by broker-dealers usually do not have to register, although they are subject to supervision by a registered broker-dealer. Similarly, a broker-dealer who conducts all of its business in one state does not have to register, although the exemption is quite narrow. The single state exemption flows from the Commission's territorial approach to registration, which is also applicable to international activities of broker-dealers. Broker-dealers operating outside the United States are exempt from registration n22 so long as they do not solicit securities transactions by U.S. citizens, do not use the interstate commerce of the United States or use the internet to accomplish the same purpose. n23

[3] Application for Registration as a Broker and Dealer

[a] Form BD. Form BD, the Uniform Application for Registration as a Broker and Dealer, is the general form used to apply either for original registration as a broker or dealer or to amend a prior application.

The form has been revised substantially to make it compatible with other forms such as those required by various states and self-regulatory organizations as well as other SEC forms. n24 Form BD is compatible with the Central Registration Depository ("CRD") system, a computer database maintained by the Financial Industry Regulatory Authority ("FINRA") for the retention of current registration information about all broker-dealers who are members of FINRA or registered with a state participant. In 1992, the Commission adopted a new system which permits the submission of one Form BD to FINRA, which enters the information in the CRD. n25 The information is then electronically forwarded to the Commission. Thus, one centralized database contains all registrant information and is easily accessible by both agencies. In 1996, FINRA delayed the implementation of a redesigned version of the CRD. One of the benefits of the new CRD will be the increased availability to the public of information regarding broker-dealers. In mid-1999, the Commission made final amendments to Form BD. n26

The amendments, which modify the 1996 version of Form BD, are technical in nature, designed principally to meet the changes required by the new Internet-based CRD system. The Web CRD was effective August 16, 1999.

The amendments modify the general filing instructions and the disclosure reporting forms and will assist implementation of the electronic filing of registration information regarding broker-dealers and registered persons. The changes essentially direct how broker-dealers are to transition to the new system and comply with their filing obligations. Rules 15b3-1, 15Ba2-2 and 15Ca2-1, which contained "temporary filing instructions," are also being modified. The rule delineates how the changes will occur during an initial sixteen-day transition and also provides that enforcement action will not be taken if broker-dealers respond within certain time frames.

The application for registration is filed with either the Commission's Washington, D.C. office in triplicate or with FINRA. Each execution page must be manually signed and the signatory must certify the accuracy of all information contained in the form and attest to the broker-dealer's compliance with bonding requirements and consent to service of process. n27 No registration fees are required. n28

In sum, Form BD requires rigorous detail regarding the identification information about the applicant, identification of entities or persons subject to control of the management or policies of the applicant, and descriptions of previous judicial or regulatory agency disciplinary action in connection with investment activities or any willful nondisclosure of information to a regulatory agency. Additionally, any outside services used for a recordkeeping or financial repository

must be identified, and the identities of executive officers, directors and significant shareholders (direct owners of more than 5% of the applicant's stock) must also be furnished.

A registrant's failure to keep current the information submitted on the form may result in disciplinary, injunctive, administrative, or criminal action. Intentional misstatements or omissions on the form may result in criminal penalties.

[b] Registration of Successors and Fiduciaries. Successors to registered broker-dealers are entities which intend to "succeed" to the business of the registered entity. Successors may be registered prior to their succession in order to prevent the disruption of the business during a subsequent registration period. n29 The application must contain information and documents regarding the applicant, successor, and persons associated with them. n30

If the successor continues the business of the predecessor, the predecessor's registration is deemed to remain effective as to the successor for a period of 75 days after the succession. n31 However, to adopt his predecessor's registration, the successor must file a new application for registration on Form BD within 30 days of the succession. n32

The registration of a broker or dealer may be deemed to be the registration of a fiduciary appointed or qualified by a court of competent jurisdiction to continue the business of the registered broker or dealer if the fiduciary files with the Commission a statement setting forth the information required by Form BD within 30 days after beginning performance of his or her duties. n33

[c] Registration of Separately Identifiable Department or Division. Any person who is classified as a broker or dealer because of activities as a municipal securities dealer or municipal securities broker and who so acts through a separately identifiable department or division may register (on Form BD) the separately identifiable department or division under Section 15. n34 The separately identifiable department or division must have been in operation on June 4, 1975. n35 If the separately identifiable department or division is so registered and the Commission grants the registration, the department or division, rather than the individual, is deemed to be the broker or dealer for purposes of the Exchange Act. n36

[d] Amendments to Form BD. Information contained in Form BD is considered cumulative and ongoing, and must be promptly updated or amended at the time of any changes regarding the required information. Amendments are required to be filed on Form BD. Amendments consist of an execution page containing original signatures, and the original pages with any revisions attached, with the affected question numbers circled. n37

[e] Grant or Denial of Application. Prior to 1975, registration applications automatically became effective 30 days after the Commission received the application, unless they were denied. Presently, an affirmative act on the Commission's part is required before the registration takes effect.

The Commission must, within 45 days of the date of filing the application or a longer period to which the applicant consents, either issue an order granting the application or institute proceedings to determine whether registration should be denied. n38 The applicant must be given notice of the grounds for denial as well as an opportunity for hearing. If it appears that the applicant is unable to satisfy the broker-dealer registration requirements, or, if registration is granted, it would be subject to revocation or suspension, the application must be denied. n39 The hearing must be concluded within 120 days of the filing of the application. n40

The Commission must grant the registration if it is satisfied that the applicant has complied with all of the broker-dealer registration requirements.

[4] Fingerprinting Requirements

In the early 1970s, after the results of two studies were disclosed, one prepared by Congress n41 and the other by the Commission, attention was drawn to the problem of theft of securities by brokerage firm employees. n42 In order to

discourage and minimize such thefts, Congress enacted a fingerprinting requirement to assist in identifying certain securities industry employees who potentially pose security risks. n43

Section 17(f)(2) of the Exchange Act requires every partner, director, officer, or employee of a member of a national securities exchange, broker, dealer, registered transfer agent, or registered clearing agency to be fingerprinted and to submit the fingerprints to the Attorney General of the United States for identification. n44 For virtually all registered broker-dealers, this requirement is satisfied by submission of fingerprint cards to a registered national exchange or registered national securities association, which in turn forwards the fingerprint cards to the United States Attorney General. n45 The Act grants the Commission authority to exempt, by rule, any class of partners, directors, officers or employees from the fingerprinting requirements. n46

Fingerprint cards may be turned into a registrant's exchange or registered national securities organization who have had a fingerprinting "plan" approved by the Commission. n47 The fingerprinting plans of FINRA, as well as the American, Midwest, Pacific, Boston, Philadelphia, and New York Stock Exchanges have been so approved. n48

[a] Permissive Exemptions. Pursuant to its statutory authority to grant exemptions to the fingerprinting requirements, the Commission promulgated Rule 17f-2 to provide for certain permissive exemptions. n49 Rule 17f-2(a)(1) sets forth four permissive exemptions from the fingerprinting requirements that may be claimed by any member of a national securities exchange, broker, dealer, registered transfer agent, and registered clearing agency as long as they comply with the notice requirement of the rule. n50

First, every member of a national securities exchange, broker, dealer, or registered clearing agency may claim an exemption for any partner, director, officer, or employee who: is not engaged in the sale of securities; does not regularly have access to the keeping; handling, or processing of securities, monies, or the original books and records relating thereto; and does not have any direct supervisory responsibility over persons engaged in those activities.

Second, a registered transfer agent n51 may claim an exemption for any partner, director, officer, or employee who does not: perform "transfer agent functions;" n52 regularly have access to the keeping, handling, or processing of securities, monies, or the original books and records relating to such securities or monies; and have any direct supervisory responsibility over persons engaged in those activities.

Third, a registered broker-dealer may claim an exemption for any partner, director, officer, or employee who does not regularly have access to the keeping, handling, or processing of securities, monies, or the related original books and records if the broker-dealer: is engaged exclusively in the sale of shares of registered open-end management investment companies, variable contracts, or interests in limited partnerships, unit investment trusts, or real estate investment trusts, provided these securities usually are not evidenced by certificates; is current in its obligation to update Item 10 of Form BD to disclose the existence of any statutory disqualifications set forth in the Act; n53 maintains insurance or bonding, indemnifying it for losses to customers caused by the fraudulent or criminal acts of any of its partners, directors, officers, or employees for whom an exemption is being claimed under this subsection; n54 and is subject to the jurisdiction of a state insurance regulator concerning its sale of variable contracts.

Finally, any partner, director, officer, or employee who is required to be fingerprinted will be exempt if the organization can demonstrate that, on at least three occasions: it has attempted in good faith n55 to obtain from the partner, director, officer, or employee a complete set of fingerprints acceptable to the Attorney General for identification and processing by having the person's fingerprints rolled by a person competent to do so and submitting the fingerprint cards to the Attorney General in accordance with proper procedures; the person's fingerprint cards have been returned to it by the Attorney General without the person's fingerprints having been identified because the fingerprints were not legible; and the fingerprint cards that were rejected as illegible by the Attorney General have been retained by the organization. n56

[b] Exemptions by Application. The Commission may grant an exemption from the fingerprinting requirements,

upon specified terms, conditions and periods, to any class of partners, directors, officers, or employees of a subject organization if the Commission determines that the grant of the exemption is not inconsistent with the public interest or the protection of investors. n57

[c] Satisfaction of the Fingerprinting Requirements by Fulfilling other Law or Rule. An organization may satisfy the fingerprinting requirements of Section 17(f)(2) as to any partner, director, officer, or employee if that person, in connection with his or her employment with the subject organization, has been fingerprinted pursuant to any other law, rule, or regulation of any state or federal government or agency thereof. The fingerprint cards must have been processed by the Attorney General or his or her designee and maintained in accordance with Rule 17f-2(d). n58

[d] Record Maintenance. Regardless of the method used to fulfill the fingerprinting requirements, each organization must keep the processed fingerprint cards or other substitute records (*e.g.*, when the card is not returned after processing) n59 to be maintained. In addition, the organization must keep any information received from the Attorney General pertaining to the fingerprinting of all partners, directors, officers, and employees. n60

All processed cards, substitute records, and information received from the Attorney General should be kept in an easily accessible place at the organization's principal office for inspection, upon request, by the Commission, an appropriate regulatory agency (if not the Commission itself), or other designated examining authority. The organization's principal office must furnish the regional, branch, or satellite office actually employing the person with written evidence that the person's fingerprints have been processed by the FBI together with a copy of any criminal history record information received from the FBI. n61

All fingerprint cards, records, and information required to be maintained should be retained for a period of at least three years after termination of that person's employment or relationship with the organization. n62

The processed fingerprint cards and other records may be maintained on microfilm if the organization at all times:

- has facilities for the immediate and easily legible projection of the microfilm and for the production of clear legible facsimile enlargements;
- files and indexes the films in a manner that permits the immediate location and retrieval of any particular record;
- is ready to immediately provide a clear facsimile enlargement of any records requested by the Commission, appropriate regulatory agency, or designated examining authority or their examiners or other representatives; and
- stores a copy of the microfilm records separately from the original microfilm records. n63

[5] Exemptions from Broker-Dealer Registration Requirements

Exemptions from registration requirements are either statutorily derived from the express language of the Exchange Act n64 or made pursuant to the

Commission's authority to make exemptions for a particular broker or dealer or class of brokers or dealers. n65 The Exchange Act itself provides exemptions for any person whose securities activities are exclusively intrastate n66 in that they do not use a national securities exchange or any means of interstate commerce such as the mail system to transact their business. n67 Rule 15a-6 of the Act exempts foreign broker dealers who limit their activities to those proscribed in the rule. In essence a foreign broker dealer who effects unsolicited transactions or deals with major U.S. institutional investors under certain specified conditions is exempt. n69 Guidance is available from the Commission for these foreign

broker-dealers. n70 In addition, foreign broker dealers who do not solicit securities transactions with U.S. persons or who do not use the instrumentalities of U.S. interstate commerce may also be exempt from registration.

Several classes of securities are also expressly exempt by the Act. n71 Such exemptions remove from registration requirements any broker or dealer who engages solely in transactions involving the exempt securities.

The Commission has exercised its exemption power to exclude from registration requirements the following securities and entities:

- shares of cooperative apartment corporations that represent ownership or entitle the holders to possession and occupancy of specific apartment units owned by the corporations, when the shares are sold by or through licensed real estate brokers of the political subdivision in which the property is located; n72
- exchange members who have become disassociated from registered broker-dealers and have submitted a Form BD and meet certain other requirements; and n73
- certain non-bank lenders participating in the Small Business Administration's guaranteed loan program. n74

The Commission has denied requests for exemption when granting an exemption would be inconsistent with either the general interests of the public or the protection of investors. n75

The Gramm-Leach-Bliley Act ("GLB Act") repealed the blanket exception of banks from the definition of "broker" and "dealer" under the Exchange Act and replaced it with functional exceptions incorporated in amended definitions of "broker" and "dealer." Under the GLB Act, banks that engage in securities activities either must conduct those activities through a registered broker-dealer or ensure that their securities activities fit within the terms of a functional exception to the amended definitions of "broker" and "dealer."

The GLB Act provided that the amended definitions of "broker" and "dealer" were to become effective May 12, 2001. On May 11, 2001, the Commission issued interim final rules ("Interim Rules") to define certain terms used in, and grant additional exemptions from, the amended definitions of "broker" and "dealer." n76 Since that time, the Commission has been wrestling with the task of drafting rules to govern the securities broker and dealer activities of banks under the GLB Act. n77 In February 2003, the Commission issued final rules governing certain bank securities dealer activities. Specifically, under the final rules of bank securities dealer activities, banks have been granted an exemption from dealer registration for a de minimus number of riskless principal transactions and certain asset-backed transactions, and certain securities lending transactions. These changes became effective September 30, 2003 and alter Rules 3a5-1, 3b-18, 15a-8 and 15a-11. n78

As to final rules related to bank securities broker activities, in June 2004, the Commission unanimously voted to propose new Regulation B, which will interpret various of the bank securities activities exceptions from the definition of "broker" in Section 3(a)(4) of the Exchange Act. Regulation B does not provide interpretive guidance on all the bank broker exceptions contained in Section 3(a)(4) of the Exchange Act. n79

The Interim Rules included a temporary exemption that gave banks time to come into full compliance with the more narrowly-tailored exceptions from broker-dealer registration. n80 To further accommodate the banking industry's continuing compliance concerns, the Commission delayed the effective date of the bank "broker" and "dealer" rules through a series of orders that, among other things, ultimately extended the temporary exemption from the definition of "broker" to January 15, 2007. n81

[6] Inspection of Newly-Registered Broker-Dealers

In 1975, the Commission determined that all newly-registered brokers and dealers must submit to an inspection within six months of their registration to ensure compliance with the Exchange Act and applicable regulations. n82 Originally, either the Commission itself or a self-regulatory organization to which the new broker belonged would conduct the inspection. However, in 1982, the Commission delegated the entire responsibility for conducting these inspections to the self-regulatory organizations, after having determined that these organizations typically conducted their own inspection of new members. n83

Accordingly, Rule 15b2-2(b) authorizes the self-regulatory organizations to conduct inspections to determine compliance with financial responsibility rules n84 within six months of registration, and to conduct an inspection to ensure conformity with the remaining provisions of the Exchange Act and the rules relating to it within twelve months of registration. n85 The organizations are permitted to conduct both inspections at once within the first six months. n86

The new registrant inspection may be delayed up to an additional six months following registration for registrants who have not yet initiated sufficient operations to provide the necessary books and materials for inspection. n87

[7] Withdrawal from Registration

Withdrawal from registration is a formal process requiring Commission approval. Absent such an approved withdrawal, a broker or dealer remains subject to all of the requirements of a registered entity or person. Withdrawal may be desired for several reasons, including avoidance of disciplinary action which would affect registration such as suspension or revocation of registration pursuant to the Act, n88 termination of brokerage business, or denial of a registration application. Withdrawal is accomplished by filing a written notice on Form BDW. n89 Withdrawal will be approved as long as the withdrawal meets with the terms and conditions of withdrawal which the Commission has deemed appropriate or necessary to further the public interest or to protect investors. n90

Rule 15(b)6-1 sets forth the terms and conditions established by the Commission for withdrawal. n91 In 1993, this rule was revised to allow brokers or dealers who belong to the FINRA to file Form BDW with the FINRA's central data processing system, the Central Registration Depository (CRD). Previously, a withdrawal application was required to be made with both the Commission and the FINRA. n92 A statement describing the applicant's financial condition within 10 days before the filing of the form must also be submitted. n93 Granting withdrawal is completely discretionary if a disciplinary proceeding is underway at the time withdrawal is sought. n94

Form BDW requires information pertaining to the date a brokerage business ceased its operations, a description of money or securities owed to any customers, brokers, or dealers, as well as any complaints, proceedings, or unsatisfied judgments or liens against the entity seeking withdrawal.

[a] When Withdrawal Becomes Effective. Until recently, withdrawal became effective on the 60th day after filing Form BDW, unless the Commission instituted a proceeding prior to that date to censure, suspend, or revoke the registration of such broker or dealer, or imposes any other terms and conditions on the withdrawal. n95 In its April 30, 1999 Release, the Commission amended its prior rule to allow a broker-dealer and the Commission to agree to extend that 60 day period to permit the Commission further time to investigate a broker-dealer without being forced to institute a proceeding rather than lose jurisdiction over the withdrawing broker-dealer. n96

The Commission may shorten the time after which the withdrawal becomes effective. n97 The existence of customer claims against a broker or dealer who has filed a notice of withdrawal from registration may result in an extension of the effective date of the withdrawal by six months or such shorter period as the Commission may determine. n98 Such extensions are available only where outstanding customer claims exist against the broker or dealer which arose prior to the effective date of withdrawal. This rule operates to extend the withdrawal period in order to allow the broker to carry

out the purposes of the Securities Investor Protection Act of 1970 (SIPA). n99 Beyond this qualification, the broker or dealer may not operate or engage in any securities business as a broker or dealer during the extension period.

[8] Suspension, Revocation, and Cancellation of Registration

[a] Violations Triggering Disciplinary Action. The Commission may censure, place limits on the activities or functions of, suspend (for a period not exceeding twelve months), or revoke the registration of any broker or dealer, or any person associated with a broker or dealer, if it finds that after a properly noticed hearing, the individual has committed any of the violations specified in the Exchange Act n100 and that the sanction n101 is in the public interest. The violations which trigger the Commission's disciplinary authority include:

- an act of willfully making or causing to be made any false or misleading statement or omission of any material facts in any application for registration or report to the Commission; n102
- any criminal conviction within ten years preceding the filing of an application for registration, or any time thereafter, for any felony or misdemeanor:
- involving the purchase or sale of any security, taking a false oath, making a false report, bribery, perjury, burglary, or conspiracy to commit any such offense; n103
- arising out of the conduct of a business of a broker, dealer, government securities broker, government securities dealer, investment adviser, municipal securities dealer, bank, insurance company, fiduciary or person or entity required to be registered under the Commodity Exchange Act ("CEA"); n104
- involving larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities; n105 or
- involving the violation of § 152 (bankruptcy: concealment of assets, false oaths or claims and bribery), § 1341 (mail frauds: frauds and swindles), § 1342 (mail frauds: fictitious name or address), § 1343 (mail frauds: fraud by wire, radio or television) of Title 18, U.S.C., or Ch. 25 (counterfeiting and forgery), or Ch. 47 (fraud and false statements) of Title 18, U.S.C., or a substantially equivalent foreign statute. n106
- a temporary or permanent ban from acting in various capacities related to the securities field, including engaging in any practice in connection with any activity as an investment adviser, underwriter, broker, dealer, municipal securities dealer, government securities broker, government securities dealer, transfer agent or person or entity registered under the CEA, or an affiliated person or employee of any investment company, bank entity or person registered under such Act, or insurance company, or in connection with the purchase or sale of any security; n107
- willful violation of certain federal securities laws, n108 or the CEA, the rules and regulations thereunder, or the rules of the MSRB, or inability to comply with any such provisions; n109
- willful aiding, abetting, counselling, commanding, inducing, or procuring violations by any other person of federal securities laws, or the CEA, the rules and regulations thereunder, or the rules of the MSRB, or failing reasonably to supervise another person who commits such a violation, with a view to preventing violations, if such other person is subject to his supervision; n110
- being subject to a Commission order or injunction pursuant to Section 15(b)(6). n111

[b] Grounds for Sanctioning Associated Persons. All persons associated with (or seeking to become associated with) brokers or dealers are subject to the penalties previously enumerated for brokers and dealers. n112 The Commission is empowered to censure, limit, or bar anyone from associating with a broker or dealer should it find that such measures further the public interest. n113 Notice and opportunity to be heard by the prospective associate of a broker or dealer is required. n114

[c] Suspension and Revocation of Registration. The Commission may, by order, suspend any registration under Section 15(b) pending its final determination on whether the registration should be revoked. n115 To suspend the registration, it must appear to the Commission, after a properly noticed hearing, that suspension is necessary or appropriate for furtherance of the public interest or for the protection of investors. n116 Should revocation be justified, the Commission will make a final determination at the end of the suspension period. Section 15(b)(4) permits suspensions of up to twelve months subject to the Commission's discretion. n117

[d] Cancellation of Registration. If the Commission finds that a registrant or applicant is no longer in existence or has ceased to do business as a broker or dealer, it may cancel the application or registration of the broker or dealer. n118 A registrant may not, however, avoid or nullify revocation proceedings by corporate dissolution or by withdrawal of registration. n119 The purpose of the cancellation provision is merely to enable the Commission to get rid of "dead wood" in its files. n120

[9] Readmission

The Commission may grant applications for readmission to regular securities activities for individuals or firms it has previously barred pursuant to its statutory authority. n121 To have the disqualification lifted, the applicant must make a showing satisfactory to the Commission that, in the light of changed circumstances, re-entry into the securities business would be consistent with the public interest. n122 The application for readmission is made by filing a copy of the Commission order imposing the bar, the appropriate readmission form, providing an update of all information, and a written statement from a prospective employer describing the terms and conditions of proposed employment and supervision of the applicant, the qualifications and background of the proposed supervisor(s), the disciplinary history of the office of proposed employment, and the names of any other associated persons who have been previously barred. n123 These documents must be filed as exhibits to an affidavit addressing the following factors:

- the period of time that has elapsed since the disqualification was entered;
- the applicant's attempt to undo any injury resulting from his prior misconduct, such as restitution;
- the applicant's compliance with the disqualification order;
- the applicant's employment during the period subsequent to the entry of the order;
- the capacity or position in which the applicant proposes to be associated;
- the manner and extent of supervision to be exercised over the applicant and, where applicable, by such applicant;
- any relevant courses, seminars or other actions completed by the applicant subsequent to the bar, to prepare for return to the securities business; and
- any other information material to the application. n124

Additionally, the Commission will consider the nature of the findings that resulted in the bar, and will not consider any

application that attempts to re-argue or collaterally attack those findings. n125

Where the applicant is also subject to the rules of a self-regulatory organization, approval for readmission by that organization is required as well, pursuant to Rule 19h-1. n126 The Commission will not consider a readmission application if another application to a self-regulating organization is pending at the same time. However, if the Commission application is filed first and granted, it may be used as a basis for application for readmission to the organization. n127

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C. § 78o(a)(1)*, reprinted in the Primary Law Sourcebook, Volume B, Section F (Matthew Bender). *See also SEC v. WACO Fin., Inc.*, 518 F. Supp. 651 (W.D. Mich. 1981) (registration is required before brokers or dealers may engage in securities transactions).

(n2)Footnote 2. Previously, brokers and dealers who engaged solely in transactions involving municipal securities or traded exclusively on the floor of a national securities exchange were exempt from registration requirements. The Securities Acts Amendments of 1975 eliminated both of these prior exemptions. Pub. L. No. 94-29, 1975 U.S.C.C.A.N. (89 Stat. 97) 111.

(n3)Footnote 3. Section 15(a)(1) specifically excludes certain securities from these requirements. These include commercial paper, bankers' acceptances, and commercial bills. *15 U.S.C. § 78o(a)(1)*. Other securities are excluded because of their status as "exempt" under the Act's general definition of a security. These include currency, as well as any note, draft, bill of exchange, or banker's acceptance which has a maturity date not exceeding nine months of the date of issuance (excluding grace periods or renewals which are similarly limited). *15 U.S.C. § 78c(a)(10)*.

The Commission is empowered to exempt such other securities as it determines are "consistent with the public interest and the protection of investors" that would not otherwise be subject to exemption. *15 U.S.C. § 78c(a)(12)*. For example, the Commission has recognized an exemption for foreign brokers and dealers meeting certain requirements. *See Rule 15a-6, 17 C.F.R. § 240.15a-6*, reprinted in the Securities Primary Law Sourcebook, Volume B, Section G (Matthew Bender).

(n4)Footnote 4. *See Exch. Act Rel. Nos. 33-7516, 34-39,779, IA-1710, IC-23,071* (Mar. 23, 1998).

(n5)Footnote 5. *See 17 C.F.R. § 240.15b1-1*.

(n6)Footnote 6. In 1982, the Commission adopted Rule 15b2-2, which authorizes and directs self-regulatory organizations to conduct the inspections of newly registered brokers and dealers required by the Act. *See Exch. Act Rel. No. 34-18,556* [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,109 (Mar. 10, 1982).

(n7)Footnote 7. These include daily records describing all securities transactions, including receipt and disbursement of funds, the identities of buyers and sellers, and the name and type of securities, *17 C.F.R. § 240.17a-3*; quarterly financial reports that must be filed with the Commission, *17 C.F.R. § 240.17a-5*; and the preparation of balance sheets for customers, *17 C.F.R. § 240.17a-5*.

(n8)Footnote 8. *See 15 U.S.C. § 78o(c)(3)*. These requirements are discussed in § 3.04 *infra*.

(n9)Footnote 9. *See 15 U.S.C. § 78q(f)(2)*.

(n10)Footnote 10. *See SEC v. Howard J. Hansen*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,426 (Apr. 6, 1984) (substantial likelihood existed that unregistered broker with history of securities law violations would continue to violate laws, thereby warranting an injunction).

(n11)Footnote 11. *See, e.g., In re Assurance Inv. Co.*, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) P

77,337 (Apr. 15, 1966) (revoking registration of broker-dealer for engaging in securities transactions prior to registration date).

(n12)Footnote 12. *See, e.g., United States v. Queen*, 4 F.3d 925 (10th Cir. 1993) (salesman's nonregistration as a broker warranted increased criminal penalties for wire fraud violations).

(n13)Footnote 13. In some cases, courts have ordered the rescission of transactions facilitated by unregistered brokers. *See, e.g., Eastside Church of Christ v. Nat'l Plan, Inc.*, 391 F.2d 357 (5th Cir. 1968) .

Contracts entered into by a broker who has failed to register will be subject to rescission under Section 29(b), 15 U.S.C. § 78cc(b), if the party seeking rescission is in privity with the broker and is in the class of persons that the Exchange Act was designed to protect. *See Reg'l Properties, Inc. v. Fin. & Real Estate Consulting Co.*, 678 F.2d 552 (5th Cir. 1982) .

Civil liability under *Rule 10b-5* is discussed in § 5.04 *infra*.

(n14)Footnote 14. "Banks" include banking institutions organized under the laws of the United States, member banks of the Federal Reserve System, or any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of which consists of receiving deposits or exercising a fiduciary power similar to those permitted to national banks. 15 U.S.C. § 78c(a)(6). Gramm-Leach-Bliley integrated the securities activities of banks within the federal securities regulatory scheme. *See, e.g.,* Section 15(j) of the Exchange Act, effective May 12, 2001.

(n15)Footnote 15. www.sec.gov/divisions/marketreg/bdguide.htm (April 24, 2008). Questions concerning broker-dealer registration have often arisen in circumstances where an issuer of securities elects to distribute securities through its officers, directors, or other personnel in lieu of a registered broker or dealer. This method of distribution is frequently employed by promoters of tax-sheltered interests such as real estate syndications or oil and gas drilling programs. In such cases, the Exchange Act has customarily been interpreted to not require the issuer itself to register as either a broker or dealer because the issuer is not itself deemed to be in the business of effecting transactions for the account of others or in the general business of buying and selling securities for its own account. *See* 43 SEC Ann. Rep. 147 (1977). For example, Rule 15a-6 under the Exchange Act permits a broker-dealer operating outside the United States (*i.e.*, a non-US broker-dealer) to conduct certain activities in the United States and with U.S. persons without Commission registration or affiliation with a Commission-registered broker-dealer. In particular, pursuant to Rule 15a-6, a non-US broker-dealer may (i) effect "unsolicited" securities transactions with U.S. persons, (ii) solicit and effect securities transactions for specified categories of counterparties, and (iii) subject to certain conditions, provide research to certain large institutional investors. *See* Rule 15a-6(a)(1),(2) and (4). However, as a practical matter, solicitation has traditionally been viewed quite broadly by the Commission and would generally include any action intended to induce securities transactions, develop goodwill or make the non-US broker-dealer known in the United States. *See* Exch. Rel. No. 34-27017 (July 11, 1989) at note 103.

A related issue is identifying whether particular employees of an issuer are themselves subject to registration requirements for brokers and dealers. Various SEC no-action letters have shaped the criteria commonly applied in this regard. Such factors have included whether or not the persons acting on the issuer's behalf are employees or an independent contractors; whether they receive a salary or a commission-type pay; whether they perform other non-securities-related functions, and whether the involvement is one-time only or ongoing. *See, e.g.,* Wilson & Sons Energy, SEC No-Action Letter, SEC No Act. LEXIS 2845 (1982) (publicly available Sept. 11, 1982) (reviewing criteria for identifying employees subject to registration requirements).

In 1985, the Commission adopted Rule 3a4-1 to provide direction on which persons who distribute securities on an issuer's behalf need register as brokers or dealers. *See* Exch. Act Rel. No. 34-22,172 [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,792 (June 27, 1985). The rule establishes a "safe harbor" within which persons associated with

an issuer will not be deemed to be brokers, as long as these persons are not subject to disqualification based upon securities act violations, do not receive commissions based upon sales, and are associated with a registered broker-dealer. *See* 17 C.F.R. § 240.3a4-1(a)(1)-(3). Generally, an associated person of the issuer may avail himself or herself of this safe harbor in one of three ways:

- by limiting activities to certain kinds of transactions which do not evoke the same need for protection as broker-dealer activities, such as offers and sales made through a registered broker-dealer or to financial institutions and their intermediaries;
- by being a *bona fide* employee meeting criteria, such as performance of duties other than selling securities, and limiting the frequency of such sales to once a year; or
- by engaging only in passive involvement, such as administrative or clerical functions. 17 C.F.R. § 240.3a4-1(a)(4).

Cf. Grayson, Burger & Co., SEC No-Action Letter, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,520 (June 11, 1987) which found that a brokerage firm's corporate partners and individual shareholder employees who formed and controlled the corporate partners would not have to register as broker-dealers because of representation that, *inter alia*, neither the corporate partners nor the shareholder employees would engage in any securities business outside the firm; all securities transactions would be effected solely by the firm and not by a corporate partner; all books and records would be maintained solely by the firm; and the firm would be liable for the acts of each shareholder employee arising from any of the firm's securities transactions.

(n16)Footnote 16. 15 U.S.C. § 78c(a)(5).

(n17)Footnote 17. 15 U.S.C. § 78c(a)(5).

(n18)Footnote 18. www.sec.gov/divisions/marketreg/bdguide.htm (April 24, 2008).

(n19)Footnote 19. Exch. Act Rel. No. 34-39,884 (Apr. 17, 1998).

(n20)Footnote 20. Exch. Act Rel. No. 34-39,884, *supra*.

(n21)Footnote 21. Exch. Act Rel. No. 34-40760 (Dec. 8, 1998). 17 C.F.R. § 242.300, *et seq.*

(n22)Footnote 22. Rule 15a-6, § 240.15a-6.

(n23)Footnote 23. Securities Exchange Act Release No. 39779 (March 23, 1998).

(n24)Footnote 24. Exch. Act Rel. No. 34-20,406 [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,453 (Nov. 22, 1983). Form BD under the Securities Exchange Act of 1934 is reprinted in the Securities Primary Law Sourcebook, Volume B, Section H (Matthew Bender).

(n25)Footnote 25. *See* Exch. Act Rel. No. 34-31,660 [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,101 (Dec. 28, 1992).

(n26)Footnote 26. *See* Exch. Act Rel. No. 34-41,594 (July 2, 1999).

(n27)Footnote 27. Previously, a statement of the applicant's financial condition was also required to be filed along with Form BD. The Commission eliminated this requirement in 1992. *See* Exch. Act Rel. No. 34-31,660 [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,101 (Dec. 28, 1992).

(n28)Footnote 28. Section 31 of the Exchange Act requires every registered broker and dealer to pay the Commission on or before March 15 of each year a fee equal to one three-hundredths of 1 percent of the aggregate dollar amount of the sales of securities registered on a national securities exchange (other than bonds, debentures, and other instruments of indebtedness) transacted by the broker or dealer in a manner other than on such an exchange during the preceding calendar year. If this amount is less than one hundred dollars, no fee is required. The Commission may exempt any sale of securities from fee requirements if it determines that the exemption is consistent with the public interest, the equal regulation of markets and brokers and dealers, and the development of a national market system. 15 U.S.C. § 78e.

(n29)Footnote 29. 15 U.S.C. § 78o(b)(2)(A).

(n30)Footnote 30. 15 U.S.C. § 78o(b)(2)(A). See also Rule 15b1-3, 17 C.F.R. § 240.15b1-3.

(n31)Footnote 31. Rule 15b1-3(a), 17 C.F.R. § 240.15b1-3(a).

(n32)Footnote 32. *Id.* A Form BD filed by a successor is considered an application filed by the predecessor and adopted by the successor, even though designated as an amendment, if it is filed within 30 days of the succession, and if it is filed to reflect a change of date, state of incorporation, form of organization, or composition of a partnership. 17 C.F.R. § 240.15b1-3(b).

(n33)Footnote 33. Rule 15b1-4, 17 C.F.R. § 240.15b1-4.

(n34)Footnote 34. 15 U.S.C. § 78o(b)(2)(B).

(n35)Footnote 35. This is the enactment date of the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 1975 U.S.C.C.A.N. (89 Stat. 97) 111.

(n36)Footnote 36. 15 U.S.C. § 78o(b)(2)(B).

(n37)Footnote 37. See General Instruction 1, Form BD.

(n38)Footnote 38. See 15 U.S.C. § 78o(b)(1)(A)-(B).

(n39)Footnote 39. See 15 U.S.C. § 78o(b)(1).

(n40)Footnote 40. See 15 U.S.C. § 78o(b)(1)(B). The Commission may extend the time for conclusion of such proceedings for up to 90 days, or such longer period to which the applicant consents, if it finds good cause for the extension and publishes its reasons therefor. *Id.*

(n41)Footnote 41. See Organized Crime--Stolen Securities, Hearings Before the Permanent Subcomm. on Investigations of the Senate Comm. on Government Operations, S. Rep. No. 71, 92d Cong., 1st Sess. (1971).

(n42)Footnote 42. See Study of Unsafe and Unsound Practices of Brokers and Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc. No. 231, 92 Cong., 1st Sess. (1971).

(n43)Footnote 43. 15 U.S.C. § 78q(f)(2).

(n44)Footnote 44. 15 U.S.C. § 78q(f)(2).

(n45)Footnote 45. See 17 C.F.R. § 240.17f-2 (1993).

(n46)Footnote 46. See § 3.03[3][b] *infra*.

(n47)Footnote 47. See Exch. Act Rel. No. 34-18,645 [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,205

(Apr. 14, 1982) at Part II(B)(3).

(n48)Footnote 48. Exch. Act Rel. No. 34-18,645.

(n49)Footnote 49. *See 17 C.F.R. § 240.17f-2 (1993).*

(n50)Footnote 50. This is satisfied by preparation of a current statement entitled "Notice Pursuant to Rule 17f-2" which contains such information as the names of all persons for whom exemption is claimed, their duties, and security measures in effect. *See 17 C.F.R. § 240.17f-2(e)(1)(1993).*

A copy of the notice must be kept at both the organization's principal office and the office actually employing the person for whom exemption is claimed. The notice need not be filed with the Commission or reviewed by it, although it must be made available upon request for inspection by either the Commission, an appropriate regulatory authority, or other designated authority. *See Rule 17f-2(e)(2); 17 C.F.R. § 240.17f-2(e)(2)(1993).*

(n51)Footnote 51. The Act defines a transfer agent as one who engages in the following on behalf of an issuer of securities or on behalf of itself as an issuer:

- countersigning securities upon issuance;
- monitoring the issuance of securities with a view to preventing unauthorized issuance;
- registering the transfer of securities;
- exchanging or converting securities; or
- transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates.

See 15 U.S.C. § 78c(a)(25).

(n52)Footnote 52. *15 U.S.C. § 78c(a)(25).*

(n53)Footnote 53. Item 11 of Form BD pertains to any history of court or regulatory agency disciplinary action against the applicant taken in connection with investment activities or failures to disclose information to any regulatory agency.

(n54)Footnote 54. Persons who qualify for the first permissive exemptions, such as outside directors or partners, are not subject to the insurance and bonding requirements. *See Exch. Act Rel. No. 34-19,268 [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,280 (Nov. 18, 1982).*

(n55)Footnote 55. A factor indicating lack of good faith might be the failure to ensure that persons required to be fingerprinted do not purposefully create impediments to the production of legible fingerprints. Exch. Act Rel. No. 34-18,645 [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,205 (Apr. 14, 1982).

(n56)Footnote 56. *17 C.F.R. § 240.17f-2(a)(1)(i)-(iv) (1993).*

(n57)Footnote 57. *Rule 17f-2(a)(2), 17 C.F.R. § 240.17f-2(a)(2) (1993).*

(n58)Footnote 58. Rule 17f-2(d) is discussed in § 3.03[3][d] *infra*. Rule 17f-2(b), however, cannot be used to satisfy the fingerprinting requirements of Section 17(f)(2) if the state or federal agency does not disclose any record of

conviction or arrest uncovered as a result of its fingerprinting process. The rule is also inapplicable to persons whose fingerprint cards were submitted to the FBI in connection with other employment. Exch. Act Rel. No. 34-18,645 [1981-1982 Transfer Binder] Fed. Sec. L. Rep (CCH) P 83,205 (Apr. 14, 1982).

(n59)Footnote 59. Every substitute record should state:

- the name of the person whose fingerprint card was submitted to the Attorney General;
- the name of the organization that submitted the fingerprint card;
- the name of the person or organization that rolled the fingerprints;
- the date the fingerprints were rolled; and
- the date the fingerprint card was submitted to the Attorney General. *Id.*

(n60)Footnote 60. Rule 17f-2(d)(1); 17 C.F.R. § 240.17f2(d).

(n61)Footnote 61. Rule 17f-2(d)(1); 17 C.F.R. § 240.17f2(d).

(n62)Footnote 62. *Id.* A self-regulatory organization that is also the designated examining authority for the subject organization may provide for the storage and maintenance of records required to be kept under Rule 17f-2(d)(1) on behalf of the subject organization, provided that:

- the organization has filed a fingerprinting plan that has been declared effective by the Commission;
- the records are subject at any time, or from time to time, to reasonable periodic, special, or other examinations by representatives of the Commission; and
- the self-regulating organization (SRO) furnishes the Commission, upon demand, at either the principal office or at the regional office, copies of the records.

Rule 17f-2(d)(2); 15 U.S.C. § 78q(f)(2).

(n63)Footnote 63. Rule 17f-2(d)(3); 17 C.F.R. § 240.17f2(d).

(n64)Footnote 64. Section 3(a)(12) of the Act includes a lengthy list of exempted securities which includes: government securities; interests in common trust funds maintained by banks for collective investment and reinvestment of assets for which the bank is trustee, administrator, executor or guardian; securities arising from contracts issued by insurance companies in connection with pension or profit-sharing plans meeting the qualifications set forth in the Internal Revenue Code (26 U.S.C. § 401 (1994)); and any other security which the Commission may designate as exempt. *See* 15 U.S.C. § 78c(a)(12).

(n65)Footnote 65. *See* 15 U.S.C. § 78o(a)(2). Such exemptions must be consistent with the public interest and investor safety.

(n66)Footnote 66. This follows naturally from the registration requirement's express coverage of those engaging in *interstate* securities activities. *See* 15 U.S.C. § 78o(a)(1).

(n67)Footnote 67. The exemption does not, however, appear to preclude a state from investigating or bringing an

enforcement proceeding against an exempt person for fraud, deceit or unlawful conduct in connection with a securities transaction. *See* Section 18(c) of the Securities Act. The Conference Committee expressly noted that the new section preserved state authority to protect investors pursuant to state antifraud laws. H.R. Rep. No. 104-622 (June 17, 1996).

(n68)Footnote 69. *Ibid.*

(n69)Footnote 70. Securities Exchange Act Release No. 27017, 54. Fed. Reg. 30013 (August 15, 1999).

(n70)Footnote 71. *See* 15 U.S.C. § 78o(a)(1). *See also* § 3.03[1] at n.3 *supra*.

(n71)Footnote 72. *See* Rule 15a-2, 17 C.F.R. § 240.15a-2 (1993).

(n72)Footnote 73. Rule 15a-4 contains a 45-day exemption for members of a national securities exchange to continue transactions in that exchange when they become disassociated from a registered broker or dealer and who have filed Form BD themselves, are in compliance with all rules applicable to registered brokers and dealers, and are members of an exchange which has filed a statement with the Commission which attests that it has reviewed their application and does not believe grounds exist which may result in denial of the member's application. *See* Exch. Act Rel. No. 34-12,372 [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,467 (Apr. 26, 1976).

(n73)Footnote 74. *See* Rule 15a-5, 17 C.F.R. § 240.15a-5 (1993). Under the rule, the securities activities of the non-bank lenders must be limited to buying and selling for their own account only those securities for which the lender receives a note evidencing loans to small businesses qualifying under the Small Business Administration's (SBA) guaranteed loan program, and sells the portion guaranteed by the SBA.

The purpose of this exemption is to facilitate participation by qualified lending institutions in the SBA's guaranteed loan program by exempting such institutions from regulatory requirements in light of the SBA's intended encouragement of a secondary market in the guaranteed portion of those loans. Rule 15a-5, therefore, represents an effort by the Commission to reduce duplicative regulation which might frustrate the goals of the SBA. Exch. Act Rel. No. 34-12,967 [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,806 (Nov. 11, 1976).

(n74)Footnote 75. *See* Exch. Act Rel. No. 34-39,291 (Nov. 3, 1997).

(n75)Footnote 76. *See* Exch. Act Rel. No. 34-44291 (May 11, 2001)

(n76)Footnote 77. *See, e.g.,* Exch. Act Rel. No. 34-44291 (May 11, 2001); Exch. Act Rel. No. 34-46745 (Oct. 30, 2002); and Exch. Act Rel. No. 34-47364 (Feb. 13, 2003). *See also* Exch. Act Rel. No. 34-44570 (July 18, 2001); Exch. Act Rel. No. 34-45897 (May 8, 2002); Exch. Act Rel. No. 34-46751 (Oct. 30, 2002); Exch. Act Rel. No. 34-47694 (Apr. 8, 2003).

(n77)Footnote 78. *See* Exch. Act Rel. No. 34-47364 (Feb. 13, 2003).

(n78)Footnote 79. Exch. Act Rel. No. 34-49879 (June 17, 2004).

(n79)Footnote 80. 17 C.F.R. § 240.15a-7.

(n80)Footnote 81. *See* Exch. Act Rel. No. 34-44570 (July 18, 2001); Exch. Act Rel. No. 34-45897 (May 8, 2002); Exch. Act Rel. No. 34-46751 (Oct. 30, 2002); Exch. Act Rel. No. 34-47694 (Apr. 8, 2003); Exch. Act Rel. No. 34-50618 (Nov. 1, 2004); Exch. Act Rel. No. 34-51328 (Mar. 8, 2005); Exch. Act Rel. No. 34-52405 (Sept. 9, 2005); and Exch. Act Rel. No. 34-54544 (Sept. 29, 2006).

(n81)Footnote 82. *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 122 (1975).

(n82)Footnote 83. *See* Exch. Act Rel. No. 34-18,248 [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P

83,048 at 84,613 (Nov. 10, 1981).

(n83)Footnote 84. Rule 15b2-2(a) enumerates the applicable financial responsibility rules to include any rules promulgated pursuant to Sections 8, 15(c)(3), 17(a), or 17(e)(1)(A) of the Exchange Act, any rules relating to hypothecation or lending of customer securities, and any rules relating to the protection of funds or securities. *See 15 U.S.C. § 78o(b)*.

(n84)Footnote 85. *See* Rule 15b2-2(c); 17 C.F.R. § 240.15b2-2 (1993).

(n85)Footnote 86. *See* Exch. Act Rel. No. 34-18,556 [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,109 (Mar. 10, 1982).

(n86)Footnote 87. *Id.* These inspections, and other examinations by the self-regulatory organizations are now designed to be coordinated. *See* Section 17(i) of the Exchange Act. That section, added by the National Securities Markets Improvement Act of 1996, is designed to eliminate duplication and promote coordination of oversight activities and sharing of information.

(n87)Footnote 88. *15 U.S.C. § 78o(b)(4)*.

(n88)Footnote 89. Form BDW under the Securities Exchange Act of 1934 is reprinted in the Securities Primary Law Sourcebook, Volume B, Section H (Matthew Bender). On April 30, 1999, the Commission amended form BDW in connection with its efforts to enact a broker-dealer registration systems that operates on the World Wide Web. SEC Release No. 34-41,356, p. 2. The Commission characterized its changes as procedural only.

(n89)Footnote 90. *See 15 U.S.C. § 78o(b)(5)*.

(n90)Footnote 91. *17 C.F.R. § 240.15b6-1 (1993)*.

(n91)Footnote 92. *See* Exch. Act Rel. No. 34-31,660 [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,101 (Dec. 28, 1992).

(n92)Footnote 93. *See* Question 5(E), Form BDW.

(n93)Footnote 94. Rule 15b6-1(b); *17 C.F.R. § 240.15b6-1(b) (1993)*.

(n94)Footnote 95. Rule 15b6-1(b); *17 C.F.R. § 240.15b6-1(b)(1993)*.

(n95)Footnote 96. *17 C.F.R. § 240.15b6-1(b)(1999)*; Exch. Act Rel. No. 34-41,356, pp. 6-8 (Apr. 30, 1999.)

Suspension, revocation, and cancellation of registration is discussed in § 3.03[7] *infra*.

(n96)Footnote 97. Rule 15b6n1(b); *17 C.F.R. § 240.15b6-1(b) (1993)*.

(n97)Footnote 98. Rule 15b6-1(c); *17 C.F.R. § 240.15b6-1(c) (1993)*.

(n98)Footnote 99. Pub. L. 91-598, 84 Stat. 1905 (1970), codified as amended in scattered sections of *15 U.S.C. Section 3(a)(2)* of the SIPA states who shall be a member of the Securities Investor Protection Corporation (SIPC). Members of the SIPC must be registered as brokers or dealers pursuant to Section 15(b) of the Exchange Act. *Id.*

Section 5 of the SIPA concerns the protection of customers; Section 6 governs a liquidation proceeding under the SIPA; and Section 7 provides for the powers and duties of a trustee. SIPA is reprinted in the Securities Primary Law Sourcebook, Volume D, Section R (Matthew Bender).

(n99)Footnote 100. *See* 15 U.S.C. § 78o(b)(4). Prior to the Securities Acts Amendments of 1975, n.69 *supra*, the sanctions the Commission could impose included censure, denial of registration, suspension or revocation of registration. The 1975 Amendments added the power to place limitations upon a broker's or a dealer's activities, functions, or operations to the Commission's enforcement tools.

(n100)Footnote 101. SIPA is described more fully in § 3.08, Protection of Customers' Assets, *infra*.

(n101)Footnote 102. Section 15(b)(4)(A) also applies to any false or misleading statement with respect to any material fact willfully made or caused to be made in any proceeding before the Commission with respect to registration. *See* 15 U.S.C. § 78o(b)(4). "Willfully" has been interpreted to mean intentionally committing the act which constitutes the violation, regardless of the actor's knowledge or awareness that a particular rule has been violated. *See Tager v. Securities and Exch. Comm'n*, 344 F.2d 5, 8 (2d Cir. 1965) .

(n102)Footnote 103. 15 U.S.C. § 78o(b)(4)(B)(i).

(n103)Footnote 104. 15 U.S.C. § 78o(b)(4)(B)(ii).

(n104)Footnote 105. 15 U.S.C. § 78o(b)(4)(B)(iii).

(n105)Footnote 106. 15 U.S.C. § 78o(b)(4)(B)(iv).

(n106)Footnote 107. 15 U.S.C. § 78o(b)(4)(C).

(n107)Footnote 108. These include the Securities Act, 15 U.S.C. §§ 77a-77aa; the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1-80b-21; and the Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-80a-52.

(n108)Footnote 109. 15 U.S.C. § 78o(b)(4)(D).

(n109)Footnote 110. 15 U.S.C. § 78o(b)(4)(E).

No person may be deemed to have failed reasonably to supervise another person if:

- appropriate procedures and a system of supervision exist that would reasonably be expected to prevent and detect, insofar as practicable, any violations by such other person; and
- such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that the procedures and system were not being complied with.

Id. See also Smith v. Christie [1980-1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,828 (N.D. Cal. 1980) (brokerage firms that maintained and enforced a reasonable and proper system of supervision and control over employees to prevent possible violations of § 10(b) acted in good faith and were not liable as controlling persons under Section 20(a) even though the control mechanisms failed to uncover alleged securities law violations).

(n110)Footnote 111. 15 U.S.C. § 78o(b)(4)(F).

(n111)Footnote 112. 15 U.S.C. § 78o(b)(6) governs the sanctioning of persons associated with a broker or dealer.

(n112)Footnote 113. 15 U.S.C. § 78o(b)(6).

(n113)Footnote 114. 15 U.S.C. § 78o(b)(6).

(n114)Footnote 115. 15 U.S.C. § 78o(b)(5). See *Hinkle Northwest, Inc. v. SEC*, 641 F.2d 1304 (9th Cir. 1981) (finding that the temporary suspension of the right to underwrite activities and associate with brokers was justified by registrant broker's violation of customer protection and recordkeeping resolutions); see § 3.03[7][c] *infra* for a discussion of revocation of registration.

(n115)Footnote 116. 15 U.S.C. § 78o(b)(5).

(n116)Footnote 117. 15 U.S.C. § 78o(b)(5).

(n117)Footnote 118. 15 U.S.C. § 78o(b)(5).

(n118)Footnote 119. See *A.J. White & Co. v. SEC*, 556 F.2d 619 (1st Cir. 1977) (holding it not improper for the Commission to decline to accept broker-dealer's attempts to voluntarily withdraw registration during revocation proceeding).

(n119)Footnote 120. See *Peoples Sec. Co. v. SEC*, 289 F.2d 268, 275 (5th Cir. 1961) .

(n120)Footnote 121. The Commission's policy on readmission to the securities business of brokers and dealers it has previously barred is set forth in Exch. Act Rel. No. 34-11,267 [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,115 (Feb. 26, 1975).

(n121)Footnote 122. In the case of a disqualified person seeking to become employed by a broker or dealer, once readmitted to the securities business, the disqualification is removed only as long as the applicant remains in the employ of the broker or dealer in the capacity and under the supervision specified in the application. Exch. Act Rel. No. 34-11,267 at 85,124.

(n122)Footnote 123. Exch. Act Rel. No. 34-11,267.

(n123)Footnote 124. Exch. Act Rel. No. 34-11,267.

(n124)Footnote 125. Exch. Act Rel. No. 34-11,267

(n125)Footnote 126. See 17 C.F.R. § 240.19h-1 (1993); Exch. Act Rel. No. 34-20,783 [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,509 (Mar. 22, 1984).

(n126)Footnote 127. Exch. Act Rel. No. 34-11,267.



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CHAPTER 3 Regulation of Brokers and Dealers

1-3 Federal Securities Exchange Act of 1934 § 3.04

AUTHOR: W. Reece Bader

§ 3.04 Post-registration Recordkeeping and Reporting Requirements

When a broker-dealer becomes registered with the Commission under Section 15(b), it becomes subject to record maintenance, record preservation, and reporting requirements under the Exchange Act. SEC rules govern these recordkeeping requirements, and the SEC may inspect the records and discipline broker-dealers and their associates for any violations.

The statutory provisions governing registered broker-dealers' recordkeeping and reporting requirements under the Exchange Act are as follows:

- Section 17(a)(1) authorizes the SEC to tell registered broker-dealers what books and records they must keep and preserve and what reports they must make and disseminate.
- Section 17(b) sets forth the Commission's power to examine (through its representatives) all records the registered broker-dealers are required to keep. n1
- Section 17(e)(1) requires registered broker-dealers to file annual financial condition reports with the Commission and provide financial condition statements to each customer.
- Section 17(e)(2) allows the Commission to specify the form and content of the financial statement filings required by section 17(e)(1).

The Commission has issued rules requiring registered broker-dealers to maintain and preserve records and make and disseminate reports. n2 These rules are based on the Commission's findings of what is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. n3 For example, one of the Exchange Act's purposes, as set forth in Section 2 of the Act, is the perfecting of the mechanisms of national market systems for securities, the clearance and settlement of securities transactions, and the safeguarding of related securities and funds--a purpose obviously furthered by broker-dealer recordkeeping.

Recent amendments to Section 15(h) of the Exchange Act give further weight to the Commission's rules by prohibiting states from imposing recordkeeping requirements inconsistent with those imposed by the Commission. In return, the Commission is obligated to consult periodically with state officials with respect to the state regulatory scheme, but does not require the Commission to change or conform its regulatory framework in response to state regulators.

A registered broker-dealer who disobeys the post-registration recordkeeping and reporting requirements can face injunctive action or administrative proceedings by the Commission. ⁿ⁴ However, the Supreme Court held in *Touche Ross & Co. v. Redington* ⁿ⁵ that the Section 17(a) recordkeeping and reporting requirements do not create an implied cause of action for damages in favor of anyone (*i.e.* private parties). ⁿ⁶

[1] Recordkeeping Requirement

The Commission keeps track of securities transactions by registered broker-dealers through its Section 17 authority, granted by Congress, to prescribe what books and records registered broker-dealers must keep and preserve and to set forth how long they should be preserved. Though these recordkeeping requirements may seem to be dry technicalities, the SEC has described them as "a keystone of the surveillance of brokers and dealers by our staff and by the securities industry's self-regulatory bodies." ⁿ⁷ Clearly, the recordkeeping requirements are not to be taken lightly. ⁿ⁸

Rule 17a-3, one of the rules adopted pursuant to this authority, sets forth what books and records must be made and kept current by registered broker-dealers, exchange members transacting a business in securities directly with nonmembers, and broker-dealers transacting a business in securities through exchange members. ⁿ⁹ The records Rule 17a-3 covers include (in the numbering used in the rule):

- (1) Records related to inflow or outflow of cash or securities, specifically, records of original entry (*e.g.*, blotters) containing itemized daily records of all securities transactions, receipts and deliveries of securities (including certificate numbers), receipts and disbursements of cash, and all other debits and credits. The records must show the account involved, name and amount of securities, unit and aggregate purchase/sale prices, trade date, and name of purchaser, seller, recipient, or deliverer.
- (2) Ledgers or other records reflecting all assets, liabilities, income, expense, and capital accounts.
- (3) Customer ledger accounts, specifically, ledger accounts or other records itemizing all purchases, sales, receipts, deliveries of securities and commodities, and other debits and credits. The ledger accounts must list these transactions separately for each cash and margin account of every customer as well as those of the broker-dealer and its partners.
- (4) Ledgers or other records showing securities currently in transfer, dividends and interest received, loans and borrowings of securities and money, the collateral for money loans, securities failed to receive or deliver, stock record differences (that is, all long and short securities record differences found after the examination, count, verification, and comparison required by Rules 17a-5 and 17a-13), and repurchase and reverse repurchase agreements.
- (5) Ledgers showing long and short positions carried as of the clearance dates by the broker-dealer, its partners, its customers, or others, and related information.
- (6) Customer-transaction memoranda of brokerage orders (whether executed or not) showing the terms and conditions, time of entry, price, general description, and any modification or cancellation of each brokerage order or other instruction given or received for any securities sale or purchase. Orders based on a broker-dealer or employee's discretionary power should be noted. The rule defines "instruction" to include internal instructions among broker-dealer partners and employees, and "time of entry" as time of

1-3 Federal Securities Exchange Act of 1934 § 3.04

the instruction's transmission for execution (or, if no transmission, time of receipt).

(7) Transaction memoranda of purchases and sales for the broker-dealer's account, showing the price and (as feasible) time of execution. If the transaction is with a customer who is not a broker-dealer, the broker-dealer must prepare a memorandum of each order received, showing its time of receipt, terms and conditions, and the account to which it was entered.

(8) Copies of purchase and sale confirmations (including repurchase and reverse repurchase agreements) and of notices of all other debits or credits for cash, securities, or other items for the accounts of customers and partners.

(9) Customer cards showing the name and address of cash and margin accounts' beneficial owner, and, for margin accounts, bearing the owner's signature. The card must also show whether the beneficial owner objects to the disclosure of its identity (*e.g.*, for proxy solicitations). n10

(10) Options market transactions in which the broker-dealer has a direct or indirect interest or has granted or guaranteed an option. This includes puts, calls, spreads, and straddles, and must at least show an identification of the security and the number of units involved.

(11) Records of the proof of trial balances of all ledger accounts, and of computations of aggregate indebtedness and net capital as of the trial balance date, pursuant to Rule 15c3-1. These trial balances and computations must be made monthly. Of course, any broker-dealer benefiting unconditionally from the exemptions of Rule 15c3-1(b)(1) and (3) need not make the Rule 15c3-1 computations. Equally sensibly, members of any exchange exempted by Rule 15c3-1(b)(2) should make aggregate indebtedness and net capital computations according to the capital rules of an exchange listed in the rule and to which the member belongs.

(12) An employment application or questionnaire for each associated person (defined in the rule to include partners, officers, directors, sales agents, traders, managers, or any employee handling funds, securities or soliciting transactions or accounts). The questionnaire or application must be approved in writing by an authorized representative of the broker-dealer, and must contain exhaustive minimum information listed in the rule. n11 The broker-dealer can satisfy this requirement by maintaining a copy of the registration application it filed on the associated person's behalf with FINRA or one of six listed exchanges.

(13) Records required to be maintained pursuant to Rule 17f-2(d) and (e), relating to fingerprinting.

(14) Copies of all Forms X-17F-1A filed under Rule 17f-1 for the reporting of and inquiry about missing, lost, counterfeit, or stolen securities. The broker-dealer must also maintain copies of all agreements among reporting institutions relating to registration or other aspects of Rule 17f-1, as well as all confirmations or other information received from the SEC or a designee as a result of inquiry.

(15) Records required pursuant to paragraph (e) of Rule 17f-2.

(16) Records relating to any internal broker-dealer system of which such a broker-dealer is the sponsor, including records of customers with access to internal broker-dealer systems, daily summaries of trading in such systems, and time-sequenced transaction records.

(17) Basic customer information which identifies the customer and their investment objectives. n12

[a] Exemptions. Paragraph (b) of Rule 17a-3 lists a few exemptions to the record maintenance requirements. Exchange members or broker-dealers who transact securities business through members, and registered broker-dealers need not make or keep the records of transactions cleared for them if such records would customarily be made and kept by a clearing broker-dealer under 17a-3 and 17a-4, as long as the clearing broker-dealer satisfies some net capital requirements specified in Rule 17a-3(b)(1).

Similarly, for transactions cleared for them by a bank, exchange members, broker-dealers who transact securities business through members, and registered broker-dealers need not make or keep the type of records that would customarily be kept by a clearing broker-dealer. However, the member or broker-dealer has to get an agreement in writing from the bank that the records, although made and kept by the bank, are the property of the member or broker-dealer. The bank must also file with the SEC a promise that the bank will make the records available, or even furnish them to the SEC, for examination. The form of this undertaking is specified in the rule at paragraph (b)(2). The rule further notes that the ultimate responsibility for seeing that records are accurately maintained and preserved remains with the member or broker-dealer.

The recordkeeping requirements do not apply to exchange member or registered broker-dealer transactions in U.S. Tax Savings Notes, U.S. Defense Savings Stamps, or U.S. Defense Savings Bonds, Series E, F, and G, which are all exempted by Rule 17a-3(c). Rule 17a-3(d) exempts cash transactions of \$100.00 or less involving only subscription rights or warrants expiring within 90 days after their issuance.

Municipal securities broker-dealers can satisfy the Rule 17a-3 and 17a-4 recordkeeping requirements for municipal securities transactions by complying with MSRB Rule G-8. Otherwise, municipal securities broker-dealers would be subject to at least two sets of recordkeeping rules.

Though nonresident broker-dealers are subject to section 17(a) recordkeeping requirements, they need not keep the records inside the United States, if they undertake to provide the records to the SEC upon request. ⁿ¹³ Otherwise, under Rule 17a-7(a), a nonresident broker-dealer who has not filed such an undertaking must file a written notice with its application for registration specifying the address within the United States where the records are located.

[b] Other Section 17 Recordkeeping Requirements. Rule 17a-2 specifies the records to be maintained by anyone engaging in "stabilizing" activities. "Stabilizing," also referred to as pegging or fixing, is the practice of facilitating the distribution of a security by trading in it. ⁿ¹⁴

Rule 17a-8 requires broker-dealers to file reports and make and preserve records specified in Treasury regulations promulgated under the Currency and Foreign Transactions Reporting Act of 1970, ⁿ¹⁵ as amended by the USA Patriot Act. These Treasury regulations require broker-dealers to file three reports:

- a report with the Internal Revenue Service of any currency transaction exceeding \$10,000; ⁿ¹⁶
- a report with the Commissioner of Customs when a person exports or imports currency or monetary instruments worth over \$10,000; ⁿ¹⁷ and
- for persons subject to United States jurisdiction, a report with the Treasury regarding any financial interest in or authority over a securities, bank, or other financial account in a foreign country. ⁿ¹⁸ These broad obligations relating to anti-money laundering laws also require broker-dealers to implement extensive, written anti-money laundering compliance programs. The programs must be designed reasonably to detect and cause reporting of suspicious transactions and achieve compliance with the law and regulations.

The Treasury regulations also require a broker-dealer to maintain for a period of five years:

- a record of its customers' taxpayer identification numbers;
- a copy of each document granting authority over a customer's account;
- the records described in Rule 17a-3(a)(1)-(9); and
- a record of any transaction exceeding \$10,000 to or from a person, account, or place outside the United States n19

Other records that financial institutions, defined in the Treasury regulations to include broker-dealers, must make and preserve for five years are specified in the regulations. For, example, financial institutions must preserve records of extensions of credit in excess of \$10,000. n20

If the Treasury regulations and Rule 17a-4 have different required lengths of preservation, Rule 17a-8 states that broker-dealers must retain the records for the longer period of time.

[2] Record Preservation Requirement

Rule 17a-4 tells registered broker-dealers how long they must preserve the books and records they are required to maintain under Rule 17a-3 and other documents listed in Rule 17a-4. Each of the rule's provisions assist the Commission's goal of ensuring its access for specified periods to the records required to be maintained under Rule 17a-3. The records listed in Rule 17a-3(1)-(3) and (5) must be preserved for at least six years, the first two years in an easily accessible place. n21

The broker-dealer must also preserve the books and records specified in Rule 17a-3(a)(4), (6)-(10) for at least three years, the first two years in an accessible place. Other records the broker-dealer must preserve for at least three years (the first two years in an easily accessible place) include:

- checkbooks, bank statements, cancelled checks, and cash reconciliations;
- bills receivable or payable;
- originals of communications received and copies of communications sent, including inter-office memoranda and communications;
- trial balances, computations of aggregate indebtedness and net capital as of trial balance date (and related working papers), financial statements, branch office reconciliations, and internal audit working papers;
- guarantees of accounts, powers of attorney, and resolutions authorizing agents to act on behalf of a corporation;
- written agreements;
- detailed reports prepared as of the audit date on the FOCUS Report (Form X-17A-5), Part II or IIA and in the annual financial statements required by Rule 17a-5; n22 and
- records required under Rule 15c3-3(d)(4). n23

Paragraph (c) of Rule 17a-4 requires a broker-dealer to preserve, for at least six years after a customer's account closes, all account cards or records concerning the terms and conditions for the opening and maintenance of the customer's account. Under Rule 17a-4(d), broker-dealers must preserve all partnership articles (or, if a corporation, all articles of incorporation or charter, minute books, and stock certificate books) for the life of the enterprise and any successor enterprise.

The required length of preservation under Rule 17a-4(e) for the records required by Rule 17a-3(a)(12), concerning broker-dealer associated persons, is at least three years after the termination of the associated person's employment or other connection with the broker-dealer. Rule 17a-4(e) also requires the broker-dealer to preserve the information required by Rule 17a-3(a)(13) (concerning records of required fingerprinting under Rule 17f-2(d)) for at least three years after the termination of the associated person's employment or association with the broker or dealer. If the firm has claimed an exemption under Rule 17f-2 from any of that rule's fingerprinting requirements, Rule 17a-4(e) requires it to preserve the records specified under 17a-3(a)(15) (the records specified in Rule 17f-2(e)) for the life of the enterprise.

Rule 17a-4(e) also requires that Form X-17F-1A information be preserved in an easily accessible place for three years. Form X-17F-1A records, concerning required reporting of missing, lost, counterfeit, or stolen securities and the confirmations of inquiry under Rule 17f-1, must be maintained by broker-dealers under Rule 17a-3(a)(14).

All of these Rule 17a-3 and 17a-4 records may be maintained and preserved in microfilm, electronic storage media or hard copy. In 1997, the SEC amended Rule 17a-4(f) to permit records to be stored by electronic media, including images of handwritten documents. n24 Recognizing the ever-changing nature of technology, the SEC established a flexible definition for approved electronic media storage mechanisms that approves of any mode of electronic storage that meets the SEC's goals. n25 Finally, in its 1997 update approving of electronic media storage methods, the SEC also addressed for the first time, storage requirements of electronic communications such as e-mail. The Commission noted that broker-dealers utilize e-mail both for business and non-business purposes. n26 The SEC, thus, requires that broker-dealers retain records of e-mail and internet communications, including inter-office communication, which relate to the broker-dealer's "business as such." n27 Furthermore, Rule 17a-4(f) requires that a broker-dealer using microfilm or an electronic storage medium have readily available at all times appropriate equipment for SEC examination of the records and to arrange storage records so that any particular record can be immediately located. In addition, broker-dealers must maintain up-to-date duplicates of the microfilm or electronic record, to be provided to the Commission on request, and store these extra copies separately for the required preservation time. n28 The Commission has recently published its views on the operation of its rule permitting storage of records in electronic form and guidance on how the storage requirements are consistent with the Electronic Signatures in Global and National Commerce Act of 2000. n29

Preservation requirements continue even if a broker-dealer no longer transacts business in securities directly with nonmembers or through exchange members, or ceases to be registered under Section 15. n30 Rule 17a-4(g) provides that such a broker-dealer still must preserve the records it was required to preserve while subject to Rule 17a-4 for the remainder of the Rule 17a-4 prescribed period.

Municipal securities broker-dealers may satisfy Rule 17a-4's record preservation requirement through compliance with MSRB recordkeeping and preservation requirements, set forth in Rules G-8 and G-9.

Even external recordkeeping services, such as outside service bureaus, depositories, and banks not operating under Rule 17a-3(b)(2), used by broker-dealers for the preparation and maintenance of records, face some record preservation responsibilities. Such organizations must file with the Commission a written undertaking specifying that:

- the records prepared or maintained for a broker-dealer are the property of that broker-dealer;
- the records will be surrendered immediately upon the broker-dealer's request; n31

- the records are available for examination at any time by the Commission and its designees; n32
- true, correct, complete, and current hard copies of the records will be promptly furnished upon request to the Commission or its designees.

The form of the undertaking is specified in Rule 17a-4(i). It must be in writing, in a form acceptable to the Commission, and signed by a duly authorized person. Commission access to the books and records must be allowed "at any time or from time to time during [the outside entity's] business hours." The undertaking must be made directly in favor of the Commission and not as a separate agreement between the service bureau and the broker-dealer, though it may incorporate the substance of such an agreement.

In determining who must file an undertaking with the Commission, it is immaterial that a service bureau merely prepares but does not "maintain" broker-dealer records, or that the hard copy of the record is given to the broker-dealer while the service bureau only retains tapes or disks. n33 Since records may not always be available at the offices of the broker-dealer, Rule 17a-4(i) requires that the undertaking be filed by all service bureaus that prepare *or* maintain the records, whether as hard copy or in other media. The undertaking ensures the records' availability for Commission examination under all circumstances.

Rule 17a-4(i) provides that, despite the above provisions ensuring Commission access to records possessed by outside entities, a broker-dealer is still responsible under Rules 17a-3 and 17a-4 to prepare, maintain, and preserve records regardless of any agreement with an outside entity.

Finally, Rule 17a-4(j) requires broker-dealers, upon reasonable request, to furnish SEC staff promptly with legible copies of the records required to be maintained and preserved.

[3] Inspection of Records

Accompanying the Section 17(a) record maintenance and preservation requirement is the Section 17(b) provision authorizing the Commission to examine the records. Section 17(b) provides that all records required to be made or kept are subject at any time to reasonable examinations by SEC representatives. The Commission's examination authority under Section 17(b) is statutorily self-executing. The Commission need not, as a precondition to inspection of records, issue rules requiring people covered by Section 17(a) to keep such records. n34 Moreover, Commission authority to examine broker-dealer records includes the authority to make or require copies of the records.

Section 17(b) empowers the Commission to examine records on any reasonable basis (periodic, special, or other) the Commission considers necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. n35

In addition, Section 17(b) authorizes the Commission to examine even records of entities for which it is not the appropriate regulatory agency (*e.g.*, a bank that is a municipal securities dealer). To do so, the Commission must first notify and consult with the appropriate regulatory agency (*e.g.*, a federal banking agency) concerning the feasibility and desirability of coordinating, to the maximum extent practicable, the Commission's examination with any examination proposed or planned by the regulatory agency itself. This notice-and-consultation requirement does not mean that the Commission must obtain agency approval or wait for the agency to conduct an examination before the Commission conducts its own, nor is it to be construed to limit or in any way affect the Commission's power to examine or otherwise inspect and investigate such a person. Rather, the requirement is designed to minimize the regulatory burdens or duplication to which broker-dealers that are banks may be subject. n36

The Senate Committee on Banking, Housing and Urban Affairs expected that the Commission would generally conduct

examinations of, for example, bank municipal securities dealers simultaneously with examination by federal bank authorities. However, Congress did not limit the Commission's power to examine bank operations by restricting it to such joint occasions. The Committee emphasized that "[s]hould the Commission find it necessary for the proper performance of its responsibilities under this section, it may conduct an examination at any time after consultation with the bank agency without waiting for the appropriate regulatory agency to conduct an examination and without waiting for approval." n37

[4] Reporting Requirements: Rule 17a-5 Financial Reports

Section 17(a)(1) grants the Commission broad authority to require registered broker-dealers to make and disseminate whatever reports the Commission prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. Section 17(e) requires registered broker-dealers to file annually with the Commission certified balance sheets and income statements and other information concerning their financial condition as required. Section 17(e) also authorizes the Commission to prescribe the form and content of these required financial statements and the accounting standards to be followed in their preparation.

Reports pursuant to Sections 17(a) and (e), along with inspections and other information, enable the Commission to ensure broker-dealer compliance with the net capital rule. The net capital rule is the principal regulatory device the Commission uses to monitor the financial condition of broker-dealers and to protect customers from the risks involved in leaving cash and securities with broker-dealers. n38

The SEC adopted Rule 17a-5 to implement the Section 17(a) and (e) reporting requirements. n39 In early 1998, the SEC proposed a temporary amendment to Rule 17a-5 to require certain broker-dealers to file reports relating to Year 2000 compliance. The amendment was proposed in response to concerns from Congress regarding Year 2000 compliance both in general and as it relates to the securities industry. n40 In addition, the Commission adopted Form BD-Y2K for broker-dealers to utilize in supplying the required information to the Commission regarding their Year 2000 compliance. All broker-dealers were required to file Form BD-Y2K in accordance with Rule 17a-5 by April 30, 1999 (as of March 15, 1999). The Commission also issued Form X-17A-5 (the "FOCUS" Report Form) for use in connection with the Rule 17a-5 reporting requirements. The FOCUS (Financial and Operational Combined Uniform Single) Report is the basic financial and operational report required of broker-dealers subject to Rule 15c3-1 minimum net capital requirements. It was adopted by the Commission in 1975 in an effort to consolidate and simplify the then duplicative and unnecessarily burdensome reporting requirements imposed by self-regulatory organizations and the Commission. n41 Though current plans filed by eight national exchanges to file information on behalf of their member firms have more or less obviated broker-dealer filing of FOCUS reports directly with the SEC, the provisions still merit review. n42

[a] Form X-17A-5: The FOCUS Report (Periodic Financial Reports).

The FOCUS reporting system (Form X-17A-5) simplifies the reporting obligations of all broker-dealers subject to Rule 15c3-1 net capital requirements by superseding the existing and often uncoordinated reporting systems of the Commission and self-regulatory organizations and replacing them with an integrated reporting system based upon general-purpose financial statements. The FOCUS Report is structured on "layering": the complexity of the broker-dealer's business determines the amount and frequency of filing of required information. The Report contains three parts--Part I, the Monthly Report, Parts II and IIA, the Quarterly Report, and Part III, the Annual Audited Report--and Schedule I.

[i] Part I: Monthly Report. Part I of Form X-17A-5 is filed monthly, under Rule 17a-5(a)(2), by broker-dealers who clear transactions or carry customer accounts. Part I contains 40 key indicators of financial condition structured to facilitate a trend analysis of the indicators over a calendar year. n43 An SEC interpretive release described Part I as:

[A] summary report containing key financial and operational information consisting of core line items for all broker-dealers and supplementary items for small broker-dealers. These line items will provide regulators with timely information needed for the continued viability of the present-day early warning system. This part is designed so that the trend for a full year in any of the line items is shown on a horizontal line on the report. n44

Under Rule 17a-5(a), every registered broker-dealer who clears transactions or carries customer accounts must file Part I of the FOCUS Report (Form X-17A-5) monthly, within ten business days after the end of each month. n45 Broker-dealers who neither clear transactions nor carry customer accounts are not required to file the Part I monthly report.

[ii] Parts II and IIA: The Quarterly Report. Part II of the FOCUS Report is a general-purpose financial and operational report designed to obtain essential regulatory information quarterly from broker-dealers who clear transactions or carry customer accounts. n46

Part IIA, an abbreviated version of Part II, is available under Rule 17a-5(a) to broker-dealers who neither clear transactions nor carry customer accounts but introduce their customers' business to other brokers and dealers on a fully disclosed basis. Broker-dealers subject to the requirements of Rule 15c3-1(a)(2) and (3) must also file Part IIA. n47 However, Parts II and IIA must be filed monthly by broker-dealers not clearing or carrying customer accounts and brokers and dealers subject to Rule 15c3-1(a)(2) and (3) if they have received written notices pursuant to Rule 17a-5(a)(2)(iv) that they have exceeded the parameters of financial and operational condition set by the self-regulators. n48

If the broker dealer has not received a written notice pursuant to Rule 17a-5(a)(2)(iv) that it exceeded the parameters of financial and operational condition it must file Part II every quarter. n49 Part II must be filed within 17 business days after the end of the calendar quarter and, if the date of the annual audited financial statements does not coincide with the calendar quarter, within 17 business days of that date.

Broker-dealers who neither clear transactions nor carry customer accounts are not required to file the Part I monthly report. They must, however, file Part IIA of the FOCUS Report quarterly, subject to the same deadlines as Part II filings, that is, within 17 business days after the end of the calendar quarter and within 17 business days after the annual financial statements' audit date, if it differs from the calendar quarter. If broker-dealers using Part IIA rather than Part II exceed the financial and operational condition parameters, they must file Part IIA monthly rather than quarterly. n50 The FINRA also generally requires new non-clearing member firms to file Part IIA monthly for the first six months of their membership. FINRA may also require backup information (*e.g.*, bank statements) during this initial period.

Broker-dealers subject to Rule 17a-5(a) monthly or quarterly reporting requirements must file Schedules I and II of Form X-17A-5 with their FOCUS Report for the calendar quarter ending December 31 of each year. n51

[iii] Part III: The Annual Audited Report. Part III of the FOCUS Report contains a facing page calling for information concerning the registrant's identity and that of the independent public accountant whose opinion is contained in the annual report. Part III also contains an oath or affirmation that, to the registrant's best knowledge and belief, the accompanying financial statements and supporting schedules are true and correct. Attached to Part III are the audited financial statements required by Rule 17a-5(d). n52

[iv] Schedule I. The FOCUS Report also contains Schedule I, a calendar-year unconsolidated report that must be filed by all registrants as a supplement to the regular fourth quarter Part II or IIA of Form X-17A-5 within 17 business days of the end of the quarter.

Brokers and dealers exempt from the Rule 17a-5(a)(2)(i)-(iii) filing requirements must submit an annual report that

contains the facing page, balance sheet, and Revenue Expense Statement from Part IIA and Schedule I of Form X-17A-5 within 17 business days after the close of the calendar year.

The execution page of the form requires the broker-dealer to state: the registrant's SEC file number; the period covered by the report; what part of the form is being filed; the full name and address of the registrant's principal place of business; the name and telephone number of a person to contact concerning the report; and identification of the independent public accountant whose opinion is contained in the report.

[v] Exemptions, Extensions, and Alternatives to Filing. Rule 17a-5(a)(5) allows the SEC, through its regional administrators, to grant or deny broker-dealer requests for extensions of time to file Parts I, II, and IIA of the form. n53 Extensions of time or exemptions from Rule 17a-5 requirements may be granted on the Commission's own motion or on written request from any national securities exchange, any broker-dealer, or FINRA. The extension or exemption may specify terms and conditions, or may be unconditional.

A broker-dealer may satisfy Rule 17a-5(a)(2) reporting requirements without filing Form X-17A-5 if the broker-dealer's national securities exchange or registered securities association maintains records containing the information required by Form X-17A-5 about the broker-dealer under a plan approved by the Commission, and, pursuant to the plan, sends the Commission a copy of the applicable broker-dealer-related parts of the form. n54 The member firms' direct filing requirement with the Commission was eliminated when the Commission approved the plans of eight self-regulatory organizations to collect the Rule 17a-5 required monthly and quarterly reports directly from their members. n55

Until 1983, Section 15(b)(8) required registered broker-dealers who were not members of FINRA or any national securities exchange to file "SECO" (SEC Only) forms with the Commission. Public Law No. 98-38 repealed former section 15(b)(8) in 1983, in effect requiring all registered broker-dealers to belong to FINRA or an exchange. This virtually eliminated the filing of FOCUS reports with the Commission.

[b] Report of Termination of Membership Interest. Registered broker-dealers who cease to be members in good standing of a national securities exchange or national security association must report the termination of their membership interest to the Commission. n56 Within two business days after the termination of their membership interest, they must file Part II or IIA of the FOCUS Report (Form X-17A-5). Registered broker-dealers who were clearing or carrying firms at the time of termination and had not received notice that they had exceeded the safe parameters of financial and operational condition must file Part II. Those who did not clear transactions or carry customer accounts as of termination must file Part IIA.

The report must be filed at the Commission's Washington, D.C. office or with the regional office. n57 *The report must include the broker-dealer's oath or affirmation that, to its best knowledge and belief, the information contained in the report is true and correct.*

An exchange or association that causes a member broker-dealer to cease being in good standing, or an exchange that learns of any action by the member or any other person that causes the member broker-dealer to cease being in good standing, is required under Rule 17a-5(b) to notify the SEC of the event and surrounding circumstances. The exchange or association must also notify the broker-dealer of its obligation to report the termination of membership interest.

A broker-dealer required to report the termination of its membership interest in a self-regulatory organization other than its designated examining authority may request an exemption by submitting a written request to the Commission not later than five business days before the termination date. Rule 17a-5(b)(6) provides that the request for exemption must indicate whether the broker-dealer is in violation of the applicable requirements under Rule 15c3-1 or 15c3-3; state whether the broker-dealer is experiencing any significant financial, operational, or recordkeeping problems; affirm the broker-dealer's compliance with applicable SEC and self-regulatory organization rules; and describe in detail the reasons for the requested exemption.

[c] Annual Financial Statements for Customers. Section 17(e) of the Exchange Act requires registered broker-dealers to send their customers annually a certified balance sheet and other financial statements and information, as the Commission prescribes by rule under section 17(a), concerning the broker-dealer's financial condition. Specifically, Rule 17a-5(c) prescribes the form and content of statements to be furnished to customers by all registered broker-dealers required to file an annual audited financial statement. n58 However, certain brokers or dealers need not furnish any customer statements if they engage in any of the limited activities listed in Rule 17a-5(c)(1). n59

Within 105 days after the date of the audited financial statements required by Rule 17a-5(d), Rule 17a-5(c)(2) requires that the broker-dealer furnish the following audited statements to its customers (as well as to the SEC, the regional office, the FINRA, and each exchange of which it is a member).

First, the broker-dealer must furnish a balance sheet, accompanied by appropriate notes and prepared in accordance with generally accepted accounting principles, and (if the Rule 17a-5(d) financial statements must be certified) audited.

Second, a footnote indicating its net capital and required net capital under Rule 15c3-1, and including summary financial statements of subsidiaries consolidated pursuant to Appendix C of Rule 15c3-1, where material, and the effect of the subsidiaries on the actual and required net capital of the broker-dealer must be provided.

Third, the broker-dealer must provide a notice that a copy of material inadequacies (if any) for the most recent annual audit report commented upon by the independent public accountant pursuant to Rule 17a-5(g) and (h) and Rule 17a-11(d) is currently available for customer inspection at the SEC's Washington, D.C. office and the regional office. n60

Finally, a statement that its Statement of Financial Condition for the most recent annual audit report pursuant to Rule 17a-5 is similarly available for inspection must be furnished.

In addition, Rule 17a-5(c)(3) states that, six months after the date of the audited statements mentioned above, unaudited statements of the balance sheet and the footnote indicating the broker-dealer's actual and required net capital computed in accordance with Rule 15c3-1 must be furnished (within 65 days of its preparation) to the broker-dealer's customers (as well as to the SEC, the regional office, and each national securities exchange or registered securities association of which it is a member).

[d] Annual Audited Financial Statements.

Section 17(e)(1) requires registered broker-dealers to annually file, with the Commission, a balance sheet and income statement, prepared on a calendar or fiscal year basis and certified by an independent public accountant, as well as other financial data and information concerning their financial condition. The SEC may require the other financial statements and financial condition information to be certified as well.

Rule 17a-5(d) states that any annual audited financial statements filed on a calendar or fiscal year basis must be audited by an independent public accountant. n61 Rule 17a-5(e) requires the auditor to give its opinion concerning the financial statements. Rule 17a-5(g) through (m) further governs audit objectives, the extent and timing of audit procedures, general provisions of the accountant's reports, accountant's report on material inadequacies, the use of certain statements filed with the SEC, and the granting of extensions and exemptions, and requires broker-dealers to notify the SEC of changes in their fiscal year.

If a broker-dealer files a Rule 17a-5(d) statement without an accountant's opinion, it must describe in the oath of affirmation required under Rule 17a-5(e) the facts and circumstances supporting an exemption from the requirement that Rule 17a-5(d) financial statements and schedules be supported by an accountant's opinion. However, the financial statements need not be audited if the broker-dealer engages in a limited securities business. n62

Broker-dealers required to file an annual report under Rule 17a-5(d) must file an additional Part II or IIA of Form X-17A-5 (as applicable) as of the date of the annual report if the date does not coincide with a calendar quarter. This fifth filing allows the annual report to be integrated into the surveillance programs of the Commission and the self-regulators. n63

Some broker-dealers receive an exemption from the annual filing of audited financial statements. Under Section 17(e)(1)(C), the SEC may exempt, conditionally or unconditionally, any class of broker-dealers from the annual financial reporting requirements. For example, Rule 17a-5(d) states that a successor broker-dealer need not file an annual report the year of its succession if its predecessor filed a report that year. Another 17a-5(d) exemption exists for exchange members who transacted business in securities solely with or for other exchange members without carrying margin accounts, credit balances, or securities for customers (as "customer" is defined in Rule 17a-5(c)(4)).

[i] Contents of the Annual Report. Section 17(e)(2) authorizes the SEC to prescribe the form and content of required financial statement filings and the accounting principles and standards to be used in their preparation. Through Rule 17a-5(d)(2), the Commission requires annual reports to include the following financial data:

- Statement of Financial Condition, in a format and on a basis consistent with the total reported on the Statement of Financial Condition in Part II or IIA of the FOCUS Report (Form X-17A-5);
- Statement of Income (Loss);
- Statement of Cash Flows;
- Statement of Changes in Stockholders', Partners', or Sole Proprietor's Equity; and
- Statement of Changes in Liabilities Subordinated to Claims of General Creditors.

If the Statement of Financial Condition is not consolidated, Rule 17a-5(d)(2) requires a summary of financial data (including assets, liabilities, and net worth or stockholders' equity) for subsidiaries not consolidated in the FOCUS Report (Form X-17A-5) Part II or IIA Statement of Financial Condition to be included in the notes to the consolidated statement of financial condition reported on by the independent public accountant.

The annual report must also include, according to Rule 17a-5(d)(3), the following supporting Schedules from Part II or IIA of Form X-17A-5:

- Computation of Net Capital under Rule 15c3-1
- Computation for Determination of the Reserve Requirements under Exhibit A of Rule 15c3-3
- Information Relating to the Possession or Control Requirements under Rule 15c3-3

In addition, if differences exist between the audited report and the corresponding unaudited one, a reconciliation must be provided pursuant to Rule 17a-5(d)(4) of the Computation of Net Capital and Computation for Determination of Reserve Requirements mentioned above. If no differences exist, the broker-dealer must file a statement to that effect. Rule 17a-5(e)(2) and (4) require the broker-dealer to file additional material attesting to the truth and correctness of the financial statements and reporting on the broker-dealer's status in the Securities Investor Protection Corporation. n64

[iii] Accountant-Related Reports. A broker-dealer must initially file a Rule 17a-5(f)(2) statement within 30 days of its effective date of registration as broker-dealer. The statement, indicating that the broker-dealer has secured a

contractual commitment from an independent accountant to conduct the broker-dealer's annual audit, must be filed with the SEC, the regional office, and the examining authority. In addition, unless the agreement provides for an ongoing relationship beyond a specific year's audit, broker-dealers subject to the Rule 17a-5(d) annual reporting requirement must file by December 10 of each year a statement of an agreement (dated no later than December 1) with an independent public accountant to conduct the annual audit during the following calendar year. Rule 17a-5(f)(2) sets forth the specific information that the statements must contain, such as name and address of broker-dealer and accountant and audit year covered by the agreement.

A broker-dealer must file a similar notice within fifteen days with the Commission, its regional office, and the examining authority in the following situations: if a new accountant is engaged without notice to the existing accountant; if the accountant terminated is one whose opinion covered the most recent financial filings or who was engaged to give an opinion covering statements to be filed; or if the accountant terminates such an engagement.

Even broker-dealers who are exempt from the annual audit reporting requirement must nevertheless file a Rule 17a-5(f)(2) notice indicating the date on which the unaudited report will be prepared.

[iii] Filing of Annual Report. Rule 17a-5(d)(5) requires that the annual report must be filed within 60 days after the date of the financial statements. The audited annual financial statements must be reported as of the same fixed or determinable date each year, unless the Commission approves a change of date. If the new report date will not be more than fifteen months from the former report date, Regional Administrators may grant a broker-dealer's request to change its annual audited report filing date. Under Rule 17a-5(d), filing is accomplished at the Commission's Washington, D.C. office, the regional office, and the principal office of the broker-dealer's examining authority. Copies of the annual report must be provided to the broker-dealer's self-regulatory organizations.

All financial statements and schedules must be filed publicly except those bound separately in accordance with Rule 17a-5(e)(3). Under Rule 17a-5(e)(3), all statements filed pursuant to Rule 17a-5(d) are public. However, if the Statement of Financial Condition is in a format consistent with Part II or IIA of Form X-17A-5 and is bound separately from the balance of the annual audited financial statements filed, the balance of the annual audited financial statements is deemed confidential. This provision, however, is not intended to impinge upon any national securities association or exchange rules allowing a member broker-dealer's customers to request and receive from the member broker-dealer information relative to its financial condition. The SEC, under Rule 17a-5(l), may grant extensions of time for the filing of annual reports, as well as exemptions from any of the Rule 17a-5 requirements.

[5] Special Reports

[a] Report of Revenue and Expenses. Broker-dealers exempted from filing monthly and quarterly FOCUS reports under Rule 17a-5(a) are required under Rule 17a-10 to file with the Commission, within 17 business days after the close of the calendar year, the Facing Page, a Statement of Income (Loss) and a balance sheet from Part IIA as well as Schedule I from Form X-17A-5 for the calendar year.

Broker-dealers who are subject to the Rule 17a-5(a) monthly and quarterly filing requirements must submit Schedule I of Form X-17A-5 with the form for the calendar quarter ending December 31 of each year, as required by Rule 17a-10(a)(2).

Under Rule 17a-10(b), a member of an exchange or a registered securities association need not file a report of income and expenses if the organization maintains records containing the information required by Form X-17A-5 for the member and transmits a copy to the Commission, pursuant to an effective plan approved by the Commission under the rule. Thus, as with FOCUS Reports, most broker-dealers do not file Reports of Revenue and Expenses directly with the SEC. If a member broker-dealer is also a member of FINRA and one or more exchanges, the plan may provide that only one specified institution need file the plan on behalf of the member.

Reports of income and expenses are confidential, under Rule 17a-10(c). The rule also provides at paragraph (d) that a broker-dealer who cannot file the annual report of income and expenses within the specified time without undue hardship may apply, before the due date, to the Commission's principal office for an extension of time. The applicant must give reasons for the requested extension and agree to file the report on or before the new due date, which may not be more than sixty days after the close of the calendar year for which the report is to be made.

[b] Reports of Financial or Records Problems (Telegraphic Notice Requirement). Broker-dealers are required under Rule 17a-11 to give the SEC telegraphic notice of any net capital or recordkeeping violations. Failure to do so exposes a broker-dealer to disciplinary action. ⁿ⁶⁵ For example, under Rule 17a-11(b), a broker-dealer subject to the Rule 15c3-1 net capital requirements who has less than the required minimum capital, or fails to meet the Rule 15c3-1(d) debt-equity ratio requirement for more than 90 days, must give telegraphic notice on the day the problem arises to the SEC describing the condition that exists, and must file Part II or Part IIA of the FOCUS Report (Form X-17A-5) within 24 hours. ⁿ⁶⁶

The net capital rule permits a broker-dealer's aggregate indebtedness to be as high as 15 times its net capital. However, under Rule 17a-11(c)(1), if at any time the broker-dealer's aggregate indebtedness exceeds 12 times its net capital, or if its total net capital is less than 120% of the minimum net capital amount required, the broker-dealer enters the "early warning" phase and must file Part II or IIA of the FOCUS Report (Form X-17A-5) within fifteen calendar days after every month, until it has made three consecutive monthly filings showing that its ratio of aggregate indebtedness to net capital is less than 12-to-1 and its net capital has not fallen below 120% of the required amount.

Similarly, Rule 17a-11(c)(2) states that, if the net capital of a broker-dealer using the alternate net capital computation pursuant to Rule 15c3-1(e) is ever less than 5% of its aggregate debit items computed in accordance with Rule 15c3-3's Exhibit A (Formula for the Determination of Reserve Requirements), or its total net capital is less than 120% of the minimum required net capital, the broker-dealer must file Part II or IIA of the FOCUS Report (Form X-17A-5) within fifteen calendar days after the end of each month, until three consecutive monthly reports do not show either of these problems.

If a broker-dealer is carrying the account of a specialist or market maker operating pursuant to Rule 15c3-1(a)(6), and the specialist or market maker fails to make timely deposit of collateral with the broker-dealer as prescribed in that rule, Rule 17a-11(c)(3) requires the carrying broker-dealer to give immediate telegraphic notice of that failure to the SEC's principal and regional offices and the broker-dealer's and specialist's or market maker's designated examining authority.

Likewise, under Rule 17a-11(c), a member, broker, or dealer subject to Rule 15c3-1(c)(2)(x)(F)(3), (x)(B)(1) or 15c3-1d(c)(2) fails to comply with those provisions' financial responsibility standards, the member, broker, or dealer must immediately give notice of the event as specified in those provisions. Rule 17a-11(c) further provides that, if the repayment obligations of a broker-dealer under its subordination agreements scheduled to become due within six months would cause its aggregate indebtedness to exceed 12 times its net capital, or its net capital to be less than 120% of the required minimum, or, in the case of a broker-dealer using the alternate net capital computation of Rule 15c3-1(c), if its net capital has to be less than 5% of aggregate debit items pursuant to Rule 15c3-3 or (if it is also a registered futures commission merchant) less than 7% of the funds required to be segregated under the Commodity Exchange Act, it must immediately notify its examining authority.

Rule 17a-11(d) states that, if a broker-dealer subject to Rule 17a-3 fails to keep current any of the records specified in that rule, it must give immediate telegraphic notice of the deficiency to the SEC, and within 48 hours of the telegram notify the SEC what steps are being taken to correct the situation.

If a broker-dealer discovers or is notified by an independent auditor that a "material inadequacy" as defined in Rule 17a-5(g) exists in its accounting system, controls, or procedures, Rule 17a-11(e) requires it to give telegraphic notice of

this fact to the SEC within 24 hours of the discovery, and within 48 hours notify the SEC what has been done to correct the situation.

Similarly, if a national securities exchange or association learns that a member broker-dealer has failed to file a telegraphic notice or report required by a provision of Rule 17a-11, the organization must immediately report that failure to the SEC's principal and regional office and to the broker-dealer's examining authority.

[c] Quarterly Security Counts. Rule 17a-13 subjects exchange members who transact a business in securities directly with or for non-exchange members, nonmembers who transact a business in securities through exchange members, and broker-dealers registered under Section 15 of the Act to quarterly security counts. Rule 17a-13(a) exempts certain dealers and brokers. n67 Rule 17a-13(b) requires those members or broker-dealers subject to this requirement to perform the following at least once per calendar quarter:

- physically examine and count all securities held (both firm and customer securities), including those subject to repurchase and reverse repurchase agreements;
- account for all securities in transfer, in transit, pledged, loaned, borrowed, deposited, failed to receive, failed to deliver, subject to repurchase or reverse repurchase agreements, or otherwise not physically held by the broker-dealer but subject to its control or direction, by examination and comparison of the supporting detail records with the appropriate ledger control accounts;
- verify all the securities listed above, where the securities have been in that status for more than 30 days;
- compare the results of the count and verification with the firm's records; and
- record the unresolved differences in the broker-dealer's books and records, including a description of the security and date of comparison, in a security count difference account within seven business days.

The quarterly examinations, counts, verifications, and comparisons must be made, under Rule 17a-13(b), between two and four months apart. The SEC permits cyclical counts under Rule 17a-13(c), provided the exercise does not extend beyond one calendar quarter-year.

Rule 17a-13(d) states that the quarterly examinations, counts, verifications, and comparisons must be conducted and supervised by persons not normally responsible for handling securities or making or preserving the subject records. The security count difference account is subject to the Commission's record maintenance requirements under Rule 17a-3(a)(4), and, under Rule 17a-4(a), must be preserved for at least six years, the first two years in an accessible place.

If a broker-dealer can satisfy the SEC that no public interest and investor protection purposes of the Exchange Act will be served to subject it to the quarterly security count requirement because of some appropriate reason (*e.g.*, the special nature of its business, or safeguards it has established for the protection of customers' funds and securities), Rule 17a-13(e) allows the Commission to grant the broker-dealer's written request to be exempt from the Rule 17a-13 requirement.

[d] Reporting of Currency and Foreign Transactions. Rule 17a-8 requires registered broker-dealers subject to the Currency and Foreign Transactions Reporting Act of 1970 to comply with related reporting and recordkeeping rules.

[e] OFAC Requirements Broker-dealers also have the duty to comply with the sanctions programs administered by the Treasury Department's Office of Foreign Assets Control ("OFAC"). n68 These sanctions are separate and distinct from anti-money laundering requirements, involve strict liability and provide no safe-harbors. While not a defense, a

well implemented compliance program will be considered in assessing a penalty. In particular, screening of all new accounts, existing accounts and client relationships against the OFAC lists is prudent for any broker-dealer.

[f] Business Continuity Planning In 2003 the Commission, Federal Reserve Board and Comptroller of the Currency published an interagency White Paper emphasizing the need for business continuity planning in the event of wide-scale disruption. n69 Subsequently the Commission, NYSE and NASD (now FINRA) adopted similar policies and rules. n70

[6] Certifications

On July 24, 2002, preceding the passage of the Sarbanes-Oxley Act ("Sarbanes-Oxley"), the Commission proposed Regulation Analyst Certification ("AC"). n71 "Regulation AC is intended to complement existing SRO rules governing research analyst conflicts of interest, including Rule 277 of the National Association of Securities Dealers, Inc. and Rule 472 of the New York Stock Exchange, Inc." Regulation AC, as adopted, requires brokers and dealers that publish, circulate or provide research reports to make certain clear and prominent certifications. In particular, they must certify that the report accurately reflects their personal views and whether any portion of their compensation is related to the views and recommendations contained in the report. The regulation also requires broker-dealers to make and keep certain records related to public appearances by research analysts. "Regulation AC requires each research analyst who is primarily responsible for the preparation of the content of a research report to execute two types of certifications: (a) individual research report certifications; and (b) quarterly public appearance certifications."

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 78q(a), (b). Section 17(g), 15 U.S.C. § 78q(g), gives the Federal Reserve Board a similar power to examine records kept by those broker-dealers engaged in extensions of credit and subject to the rules and regulations issued by the Federal Reserve System's Board of Governors under the Exchange Act. The Exchange Act is reprinted in the Primary Law Sourcebook, Volume B, Section F (Matthew Bender).

(n2)Footnote 2. Note that "records" are statutorily defined in § 3(a)(37), 15 U.S.C. § 78c(a)(37), to include "accounts, correspondence, memorandums, tapes, discs, papers, books, and other documents or transcribed information of any type, whether expressed in ordinary or machine language." The statutory definition appears to include electronic mail, though the SEC has not addressed this issue.

(n3)Footnote 3. This statutory purpose is set forth in § 17(a)(1). For a Supreme Court discussion of the intent of § 17(a), see *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979), in which the Court held that § 17 does not imply a private right of action.

(n4)Footnote 4. See, e.g., *Whiteside & Co., Inc., v. SEC*, Fifth Circuit Court of Appeals No. 88-4921, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,720 (July 24, 1989) (broker-dealer fined for violations of recordkeeping and reporting requirements); *United States v. Bednar*, 728 F.2d 1043 (8th Cir. 1984) (broker-dealer sentenced to five years imprisonment and \$1,000 fine for backdating account card in violation of § 17(a)(1) and Rule 17a-3(9)); *Sinclair v. SEC*, 444 F.2d 399 (2d Cir. 1971) (broker-dealer's order clerk permanently barred from association with any broker or dealer for violation of § 17(a) recordkeeping requirements); *Bradford v. SEC*, 278 F.2d 566, (9th Cir. 1960) (action to enjoin broker's transaction for alleged failure to keep required books and records); *United States v. Regan*, 713 F. Supp. 629 (S.D.N.Y. 1989) (upholding charges for conspiracy to violate recordkeeping requirements); *United States v. Sloan*, 389 F. Supp. 526 (S.D.N.Y. 1975) (false entries in books and records); *In re the Application of James Michael Brown*, Exch. Act Rel. No. 34-31,223, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,408, (Sept. 24, 1992) (brokerage firm and president censured and fined \$2,500, despite firm's inactivity, for violations of reporting and recordkeeping requirements); *In re the Application of Peter R. Schellenbach*, Exch. Act Rel. No. 34-30,030, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,902 (Dec. 4, 1991) (principal of brokerage firm censured, fined \$50,000, suspended for sixty days from association with any FINRA member, and barred from acting in any principal, supervisory, or managerial capacity for any FINRA member for violations of recordkeeping and reporting requirements).

through scheme to conceal net capital deficiencies); *In re* the Applications of W.N. Whelen & Co., Inc. and William N. Whelen, Jr., Exch. Act Rel. No. 34-28,390, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,620 (Aug. 28, 1990) (broker-dealer and its president censured and fined and president temporarily suspended from association with any FINRA member for violations of reporting requirements); *In re* the Application of Charles L. Campbell, Exch. Act Rel. No. 34-26,510, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,601 (Feb. 1, 1989) (brokerage firm president held personally responsible for firm's violation of reporting requirements and censured, fined, and barred from association with FINRA members in any principal capacity); *In re* the Application of David R. Williams, Exch. Act Rel. No. 34-21,788, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,747 (Feb. 26, 1985) (broker barred from SEC association for three months for aiding and abetting violation of § 17(a)); *In re* Frank W. Humphrys, Exch. Act Rel. No. 34-21,991, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,768 (Apr. 26, 1985) (back-office supervisor censured for aiding and abetting violation of recordkeeping requirements); *In re* the Application of Lowell H. Listrom & Company, Inc., and Lowell H. Listrom, Exch. Act Rel. No. 34-22,689, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,946 (Dec. 5, 1985) (broker-dealer and firm censured and fined for violations of Rules 17a-2, 17a-3(11), 17a-5, 17f-1(c), among others).

Under § 15(b)(4)(D), 15 U.S.C. § 78o(b)(4)(D), the Commission may take action against a broker or dealer, including suspending or revoking its registration, for a willful violation of the Exchange Act or the SEC rules or regulations thereunder (*e.g.*, § 17 and related rules and regulations). Similarly, the SEC may sanction any person associated with a broker-dealer under § 15(b)(6) for willfully violating the Exchange Act or related rules or regulations.

(n5)Footnote 5. 442 U.S. 560, 99 S. Ct. 2479, 61 L. Ed. 2d 82 (1979) .

(n6)Footnote 6. In finding that no private or public right of action for damages existed, the Court noted Congress' silence on the question, pointed out that neighboring sections of the Act, *i.e.*, § 16(b) and § 18 (a), explicitly grants private causes of action while § 17(a) does not, and emphasized the exclusive nature of § 18 as remedy for misstatements in reports filed with the Commission. *Touche Ross & Co.*, 442 U.S. at 568-75 .

(n7)Footnote 7. *In re* the Application of David R. Williams, Exch. Act Rel. No. 34-21,788, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,747 (Feb. 26, 1985).

(n8)Footnote 8. Notwithstanding the state regulatory bar in Section 15(h)(1) of the Exchange Act, a state probably can require a broker-dealer to retain certain records in state, where a state regulator may access them. 142 Cong. Rec. S12094 (daily ed. Oct. 1, 1996 (statement by Sen. Dodd)).

(n9)Footnote 9. Rule 17a-3, reprinted in the Securities Primary Law Sourcebook, Volume B, Section G (Matthew Bender), generally "represents a codification of bookkeeping practices now followed by many exchange firms and over-the-counter brokers and dealers in that it specifies the various items of information required to be reflected in the firm's books. The rule does not, however, require that books and records be kept in any prescribed form or type of book, ledger, or card system. Nor does the rule regulate accounting practices." Regulation T and SEC Rules, NASD Manual (CCH).

Though data required by Rule 17a-3 can be derived from other records, this fact does not relieve a broker-dealer of its obligation to maintain the records specified by the rule. *See, e.g., In re* Frank W. Humphrys, Exch. Act Rel. No. 34-21,991, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,768 (Apr. 26, 1985); *In re* Voss & Co., Inc., Exch. Act Rel. No. 34-18,028, *Fed. Sec. L. Rep. (CCH) P 83,021* (Aug. 11, 1981).

(n10)Footnote 10. A broker-dealer employee who causes his or her employer to violate this subsection faces liability as an aider and abettor of the employer's violation. *See, e.g., In re* David R. Williams, Exch. Act Rel. No. 34-21,788, *Fed. Sec. L. Rep. (CCH) P 83,747* (Feb. 26, 1985) (employee suspended from association with any broker-dealer for three months for falsifying addresses on customer account cards so that customers could purchase securities not registered for sale in their state of residence).

(n11)Footnote 11. Required information includes: the associated person's name, address, social security number; starting date of affiliation with broker-dealer; date of birth; complete and consecutive statement of all business associations (part-time or full-time) for the previous decade; record of any denial of membership or registration; disciplinary action taken or sanction imposed by any federal or state agency or any national securities exchange or association (including any finding of violation of the law or cause of disciplinary action); record of any denial, suspension, expulsion, or revocation of membership or registration of any member, broker, or dealer with whom the person was associated at the time; record of any permanent or temporary injunction entered against the person or any member, broker, or dealer with whom the person was associated at the time; record of any arrest or indictment for any felony, or for any misdemeanor related to securities, commodities, banking, insurance, or real estate, fraud, false statements or omissions, wrongful taking of property or bribery, forgery, counterfeiting or extortion, and the disposition of such an arrest or indictment; and a record of any other name or names the person has been known by or has used.

(n12)Footnote 12. This new rule was added in 2001, effective in May of 2003, and also requires that broker-dealers furnish this information to their customers periodically for review. In May of 2003, the Commission also published interpretive guidance as to some of the October 2001 amendments. See SEC Interpretive Rel. No. 34-47910.

(n13)Footnote 13. Rule 17a-7(c)(3) defines "nonresident broker or dealer" as, for individuals, a person residing, or having a principal place of business, in any place not subject to the jurisdiction of the United States; for corporations, an entity incorporated, or having its principal place of business, in any place not subject to the jurisdiction of United States; and for partnerships or other unincorporated organizations or associations, one having its principal place of business in any place not subject to United States jurisdiction.

To be eligible for this provision, the nonresident broker-dealer must be registered with the Commission or have filed its application for registration. In addition, it must have filed an undertaking pursuant to Rule 17a-7(b), in a form acceptable to the Commission and signed by a duly authorized representative, to submit, on demand and at its own expense, to the Commission's principal or regional office (as it specifies), any or all of the books and records under its control. The rule provides that the nonresident broker-dealer must be able to furnish the information within 14 days after the Commission's written demand. Of course, the undertaking will not be in effect when the nonresident broker or dealer is maintaining the books and records in the United States and has filed a written notice specifying the address of the place where they are kept, as required by rule 17a-7(a).

See *In re Cochran Murray & Wisener, Inc.*, SEC No-Action Letter, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,640 (May 1, 1978) (no-action position allowing the maintenance of broker-dealer's books and records at its nonresident parent company's main offices outside the United States, in compliance with Rules 17a-3 and 17a-4).

(n14)Footnote 14. See Rule 10b-7 for provisions governing the practice of stabilizing.

(n15)Footnote 15. 31 U.S.C. § 5311 *et seq.* The regulations are set forth in C.F.R. Part 103.

(n16)Footnote 16. 31 C.F.R. § 103.22.

(n17)Footnote 17. 31 C.F.R. §§ 103.23, 103.25(b) and (c).

(n18)Footnote 18. 31 C.F.R. § 103.24.

(n19)Footnote 19. 31 C.F.R. §§ 103.35, 103.36.

(n20)Footnote 20. 31 C.F.R. §§ 103.33(a), 103.36.

(n21)Footnote 21. Included are records of information listed in Rule 17a-4(b)(8)(i)-(xv) concerning, *e.g.*, money balance and position, long or short, in customer and non-customer accounts; amount of secured demand note; aged fails to deliver requiring a charge in the computation of net capital pursuant to Rule 15c3-1; possession or control

requirements under Rule 15c3-3 reported on the schedule in Part II or IIA of Form X-17A-5; and other schedules specifically prescribed by the Commission and necessary to support the information required by Rule 17a-5.

(n22)Footnote 22. *See* § 3.04[4][a] *infra*.

(n23)Footnote 23. Rule 17a-4(b)(9). The requirement that broker-dealers subject to Rule 15c3-3 maintain a current and detailed description of the procedures they use to comply with Rule 15c3-3 is consistent with the FOCUS reporting system.

Rule 15c3-3(d)(4) requires broker-dealers subject to Rule 15c3-3 with respect to physical possession or control of fully paid and excess margin securities to prepare and maintain a detailed description of the procedures they follow to comply with the Rule 15c3-3 possession or control requirements.

(n24)Footnote 24. 17 C.F.R. § 240.17a(4)(f); Exch. Act Rel. No. 34-38,245, pp. 7-8 (Feb. 5, 1997). The rule prohibits electronic retention of written acknowledgments from customers related to penny stocks required by Rules 15g-2 and 15g-9. *See* Exch. Act Rel. No. 34-38245 at p. 15.

(n25)Footnote 25. Exch. Act Rel. No. 34-38,245 at p. 7. Pursuant to Rule 17a-4(f), any electronic storage medium may be used so long as the following requirements are met: (1) the media must preserve records exclusively in a non-rewritable, non-erasable format; (2) the media must verify automatically the quality and accuracy of the recording process; (3) the media must serialize and time-date the records for the required retention period; and (4) the media must have the capacity to readily download indexes and records preserved to any medium required by the SEC or self-regulatory organizations of which the member, broker or dealer is a member. *See* Rule 17a-4(f)(2)(ii).

(n26)Footnote 26. Exch. Act Rel. No. 34-38,245 at pp. 16-17.

(n27)Footnote 27. Exch. Act Rel. No. 34-38245 at p. 17.

(n28)Footnote 28. *See* Equitable Life Assurance Soc'y, SEC No-Action Letter, [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,926 (Div. Mkt. Reg. 1974) (no-action position taken by Commission staff allowing the maintenance of customer confirmation forms as required by Rule 17a-4(b)(1) in hard copy on a computer printout).

(n29)Footnote 29. *See* SEC Interpretive Releases Numbers 34-47806 and 34-44238.

(n30)Footnote 30. *See, e.g., In re the Application of James Michael Brown*, Exch. Act Rel. No. 34-31223, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,048, (Sept. 23, 1992) (brokerage firm and president censured and fined \$2,500, despite firm's inactivity, for violations of reporting and recordkeeping requirements).

(n31)Footnote 31. The SEC does not allow production of the records to the broker-dealer to be conditioned on payment of the outside service bureau's fees and charges. *See* Exch. Act Rel. No. 34-13,962 [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,302 (Sept. 15, 1977), effective January 1, 1978 (provision ensures SEC access to records and furthers SEC and examining authority in performing oversight responsibilities and protecting customers).

(n32)Footnote 32. The Commission's right of examination is independent of the records' availability at the broker-dealer's office or prior notification of the broker-dealer. *See* Exch. Act Rel. No. 34-13,962, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,302 (Sept. 15, 1977). The Release explains that, although the Commission intends generally to conduct examinations at service bureaus only where broker-dealer records are not otherwise available, the service bureau's undertaking is made directly in favor of the Commission and the Commission is not required to order the service bureau records through the broker-dealer.

The Release also defines "designee" to include a trustee appointed for a broker or dealer by the SIPC, a court-appointed receiver, a self-regulatory organization, or the examining authority designated to inspect the

broker-dealer for compliance with financial responsibility rules under Rule 17d-1 and the Securities Investor Protection Act of 1970.

(n33)Footnote 33. Exch. Act Rel. No. 34-13,962, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,302 (1977).

(n34)Footnote 34. Legislative history supports this proposition. *See* R. Rep. No. 75, 94th Cong., 1st Sess. 120 (1975), reprinted in the Primary Law Sourcebook, Volume C, Section I (Matthew Bender). Of course, the Commission has issued rules requiring recordkeeping and preservation, as discussed in § 3.04[2] *supra*.

(n35)Footnote 35. One source for the statutory purposes of the Exchange Act is § 2 of the Act, 15 U.S.C. § 78b.

(n36)Footnote 36. S. Rep. No. 75, 94th Cong., 1st Sess. 120 (1975), reprinted in the Securities Primary Law Sourcebook, Volume C. Section I (Matthew Bender).

(n37)Footnote 37. *Id.*

(n38)Footnote 38. *See, e.g.*, Study of Unsafe and Unsound Practices of Brokers and Dealers, Report and Recommendations of the Securities and Exchange Commission, H.R. Doc. No. 231, 92d Cong., 2d Sess. 7-8, 15, 22, 24 (1971); Exch. Act Rel. No. 34-11,497, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,212 (June 26, 1975).

(n39)Footnote 39. *See* Exch. Act Rel. No. 34-11,935, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,375 (Dec. 17, 1975).

(n40)Footnote 40. *See* Exch. Act Rel. No. 34-39,724 (Mar. 5, 1998). Subsequent thereto, the self-regulatory organizations also adopted rules to deal with the Y2K issue. *See, e.g.*, NYSE Rule 437 ("Participation in Year 2000 Testing"), adopted December, 1998.

(n41)Footnote 41. The FOCUS Report was adopted in Exch. Act Rel. No. 34-11,935, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,375 (Dec. 17, 1975).

(n42)Footnote 42. *See* Exch. Act Rel. No. 34-11,935, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,375 (Dec. 17, 1975).

(n43)Footnote 43. *See id.* Some of the forty key indicators included are subordinated loans and secured demand notes; starting and ending ownership equity; income, expenses and profit (loss) for the month; certain adjustments to capital; added charges from customer and non-customer securities and commodities accounts; operational deductions from net capital; non-allowable assets; proprietary charges on commodities; other charges and deductions; haircuts on securities positions; net capital before and after haircuts; capital scheduled for withdrawal within six months and net capital after such withdrawals; total equity subordinations; aggregate indebtedness; minimum capital requirement; net capital ratios; Rule 15c3-3 reserves; Commodity Exchange Act segregation requirements; proprietary positions in long and short securities and commodities; security and commodity concentrations; total tickets; aged fails; total fails; equity markets; clearing agency balances; unrestricted cash; customers' accounts; and securities borrowed.

(n44)Footnote 44. *Id.* at 86,003.

(n45)Footnote 45. The FINRA requires member firms whose customers' accounts are introduced, on a fully disclosed basis, to and carried by another firm that also clears all the transactions to file Part I monthly, despite the fact that such firms are not themselves clearing or carrying.

(n46)Footnote 46. The following financial statements and schedules are contained in Part II of Form X-17A-5:

(1) Statement of Financial Condition

- (2) Computation of Net Capital and Aggregate Indebtedness
- (3) Statement of Income (Loss)
- (4) Statement of Changes in Ownership Equity
- (5) Statement of Changes in Liabilities Subordinated to Claims of General Creditors
- (6) Computation for Determination of Reserve Requirements under Rule 15c3-3
- (7) Form 1-FR-Schedule of Segregation Requirements (under the Commodities Exchange Act)
- (8) Capital Scheduled for Withdrawal Within Six Months
- (9) Financial and Operational Data.

The financial statements and schedules contained in Part IIA include:

- (1) Statement of Financial Condition for Noncarrying, Nonclearing and Certain Other Brokers or Dealers
- (2) Computation of Net Capital and Aggregate Indebtedness
- (3) Statement of Income (Loss)
- (4) Statement of Changes in Ownership Equity
- (5) Statement of Changes in Liabilities Subordinated to General Creditors
- (6) Schedule of Details of Total Capital and Subordinated Capital Maturing or Proposed to be Withdrawn Within the Next Six Months.

(n47)Footnote 47. Rule 17a-5(a)(2)(ii); Exch. Act Rel. No. 34-11935, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,375 (Dec. 17, 1975).

(n48)Footnote 48. In addition to the information listed below, Part II or IIA requires the broker-dealer to indicate whether the report is being filed pursuant to Rule 17a-5(a) or (b) or for some other reason (*e.g.*, upon special request by the broker-dealer's designated examining authority). Other required information includes the name, SEC number, firm identification number, address of principal place of business, period covered by and names of subsidiaries consolidated in the report, whether the registrant carries its own customer accounts, and whether the registrant is filing an audited report.

The FINRA requires member firms whose customers' accounts are introduced on a fully disclosed basis to and carried by another firm that also clears all the transactions to file Part I monthly, despite the fact that such firms are neither clearing nor carrying. Practically speaking, all FINRA member firms except those qualifying under Rule 15c3-1(a)(3) must file Part I monthly.

The term "self-regulators" includes the SEC as well as the broker-dealer's designated examining authority.

"Examining authority" refers to a national securities exchange or registered securities association to which the broker-dealer belongs, or, if the broker-dealer is a member of more than one self-regulatory organization, the organization the Commission designates as the broker-dealer's examining authority, or, if the broker-dealer is not a member of any self-regulatory organization, the Commission's Regional Office for the region where the broker-dealer has its principal place of business. General Instructions, Parts II and IIA, Form X-17A-5.

(n49)Footnote 49. Rule 17a-5(a)(2)(iv) provides that broker-dealers who have received written notice from the Commission or the examining authority designated under § 17(d) that they have exceeded the financial and operational condition parameters must file monthly (or as otherwise specified) Part II or IIA of Form X-17A-5, as well as any other financial or operational information the Commission or the examining authority requires.

(n50)Footnote 50. Exch. Act Rel. No. 34-11935, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,375 (Dec. 17, 1975).

(n51)Footnote 51. Rule 17a-10(a)(2). There is also an annual filing requirement under Rule 17a-10(a)(1) for broker-dealers exempted from the Rule 17a-5 filing requirements.

(n52)Footnote 52. *See* § 3.04[4][c]-[d] *infra* for discussion of the required audited financial statements.

(n53)Footnote 53. The SEC has proposed amendments to Rule 17a-5 that would shift to designated examining authorities the responsibility for granting extensions of time for broker-dealers to file FOCUS reports and audited financial reports and for approving changes of the date as of which audited financial reports must be filed. The proposed amendments would not, however, alter the Division of Market Regulation's authority to grant requests for extensions of time or for exemptions from the provisions of Rule 17a-5 when it deems appropriate. *See* Exch. Act Rel. No. 34-31897, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,114 (Feb. 22, 1993).

(n54)Footnote 54. The plan may permit the information about a broker-dealer who is a member of more than one exchange, or of one or more exchanges and the FINRA, to be submitted by one specified exchange or the FINRA. A plan filed with the Commission is not effective unless the Commission so declares. In declaring any plan effective, the Commission may impose additional terms and conditions, including time limitations within which various parts of Form X-17A-5 must be filed, as it deems necessary or appropriate in the public interest, for the protection of investors, or to carry out its duties and responsibilities under the Exchange Act. *See* Rule 17a-5(a)(4).

(n55)Footnote 55. The eight organizations are the American Stock Exchange, the Boston Stock Exchange, the Chicago Board Options Exchange, the Midwest Stock Exchange, the NASD, the NYSE, the Pacific Stock Exchange, and the PBW Stock Exchange. Exch. Act Rel. No. 34-11935, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,375 (Dec. 17, 1975).

The Commission simultaneously approved plan modifications and new plans filed by eight self-regulatory organizations pursuant to paragraph (b) of Rule 7a-10, effective January 1, 1976, to dispense with a separate filing under Rule 17a-10 with the Commission. The Commission also approved modifications of plans in effect by the NASD and the NYSE pursuant to Rule 17a-20 to dispense with a separate filing with the Commission of the reports required by Rule 17a-20.

(n56)Footnote 56. "Membership interest" includes full membership, allied membership, associated membership, floor privileges, and any other interest that entitles a broker-dealer to exercise any privilege on an exchange or with an association. Rule 17a-5(b)(3).

Under Rule 17a-5(b)(4), a broker or dealer is deemed to have ceased to be a member in good standing of an exchange when it has resigned, withdrawn, or been suspended or expelled from a membership interest in the exchange, or has directly or through any associated person sold (or agreed to sell) a membership interest that would result in the

termination of its membership interest in the exchange.

(n57)Footnote 57. "Regional office," as used here, refers to the regional office for the region in which the broker-dealer's principal place of business is located. The Regional Offices are listed in Appendix 1A *supra* .

(n58)Footnote 58. Rule 17a-5(c)(4) defines "customer" to exclude, for purposes of Rule 17a-5(c), another broker or dealer exempt by Rule 17a-5(c)(1); a general, special, or limited partner, director, or officer of the broker-dealer; and any person to the extent that he/she has a claim for property or funds which, by contract, agreement, understanding, or operation of law, are part of the broker-dealer's capital or are subordinated to the broker-dealer's creditors' claims, for or with whom the broker-dealer has effected a securities transaction in a particular month (either before the balance sheet date, or after it if the month in which the statement is sent). "Customer" does include any person for whom the broker-dealer holds securities for safekeeping or as collateral, or for whom the broker-dealer carries a free credit balance in the month in which customers are determined under Rule 17a-5(c), as well as anyone not excluded by the above list.

In Cahill Gorden & Reindel, SEC No-Action Letter, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,541 (Aug. 23, 1983), in response to a request for interpretation of when a person is deemed a customer under Rule 17a-5(c)(4) for purposes of furnishing customer statements as required by Rule 17a-5(c)(1), the Division stated that broker-dealers may choose any of the following dates when determining who is a customer entitled to receive a financial statement:

- the month of the balance sheet date, if it is at month end;
- the 30-day period preceding the balance sheet date, if not at month end;
- any month following the balance sheet date, if it is the month in which the statements are mailed and the mailing date is at month end; or
- the 30-day period preceding the mailing date, if the date the statements are being mailed is not at month end.

(n59)Footnote 59. The Rule 17a-5(c)(1) exception applies to:

- an introducing broker-dealer who forwards all of its customer transactions on a fully disclosed basis to a clearing broker-dealer who keeps books and records of the transactions and receives the customers' funds and securities promptly from the introducing broker-dealer;
- a broker-dealer who promptly forwards subscriptions for securities to the issuer, underwriter, or other distributor of the securities and who does not otherwise hold funds or securities for or owe money or securities to customers;
- a broker-dealer who sells and redeems redeemable shares of registered investment companies, solicits share accounts of savings and loans associations in the manner contemplated by the \$2,500 minimum net capital requirement of Rule 15c3-1, or offers to extend credit to or participate in arranging a loan for a customer to purchase insurance concerning the sale of redeemable shares of registered investment companies; or
- a broker-dealer exempt from the provisions of Rule 17a-13 concerning quarterly security counts.

(n60)Footnote 60. Rule 17a-5(g) prescribes general audit objectives to be followed in the preparation of annual financial statements, and states that the audit be made in accordance with generally accepted auditing standards. The scope of the audit must be sufficient to detect material inadequacies, as defined in Rule 17a-5(g)(3), in the accounting system, internal accounting control, procedures for safeguarding securities, and obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.

Rule 17a-5(h) permits the independent public accountant to exercise its professional judgment concerning the extent and timing of audit procedures. The accountant must inform the SEC of material inadequacies discovered in the course of the audit or interim work that the broker-dealer has not reported promptly or accurately to the Commission.

The Commission has the authority, under § 17a-5(e)(2), to prescribe the form and content of financial statements filed pursuant to the Exchange Act and to prescribe the accounting principles and accounting standards used in the preparation of the financial statements. In addition to Rules 17a-5(g) and (h), Rule 17a-5(e) governs the nature and form of the annual audited financial statements, Rule 17a-5(f) concerns the qualification of accountants, including their independence, Rule 17a-5(i) sets forth the general requirements for the accountant's reports; and Rule 17a-5(j) governs the accountant's report on material inadequacies.

(n61)Footnote 61. Rule 17a-5(f) requires accountants to be independent (in accordance with the provisions of Rules 2-01(b) and (b) of Regulation S-X (17 C.F.R. Part 210)), as well as duly registered and in good standing.

(n62)Footnote 62. Under Rule 17a-5(e), Rule 17a-5(d) financial statements need not be audited if, since the previous financial statements or reports filed under Rules 15b1-2 or 17a-5, (1) the broker-dealer's securities business has been limited to acting as an issuer's broker (agent) in soliciting subscriptions for securities and promptly transmitting all funds and securities received to the issuer without otherwise holding funds or securities or owing money or securities to customers; or (2) the broker-dealer's securities business has been limited to buying and selling evidences of indebtedness secured by mortgage, deed, trust, or other lien upon real estate or leasehold interests, and the broker-dealer does not carry any margin account, credit balance, or security for any securities customer.

(n63)Footnote 63. Exch. Act Rel. No. 34-11,935, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,375 (Dec. 17, 1975).

(n64)Footnote 64. Rule 17a-5(e)(2) requires the broker-dealer to attach to the report an oath or affirmation that, to its best knowledge and belief, neither it nor any partner, officer, or director (as the case may be) has any proprietary interest in any customer account, and the financial statements and schedules are true and correct. If the broker-dealer is a sole proprietorship, the oath or affirmation must be made by the proprietor; if a partnership, by a general partner; or, if a corporation, by a duly authorized officer. Rule 17a-5(e)(4) requires the broker-dealer to file with the report a supplemental report (covered by the opinion of the independent accountant, if required under Rule 17a-5(e)(1)) concerning the status of the broker-dealer's membership in the Securities Investor Protection Corporation.

(n65)Footnote 65. *See, e.g., In re the Applications of W.N. Whelen & Co., Inc. and William N. Whelen, Jr.*, Exch. Act Rel. No. 34-28,390 [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,620 (Aug. 28, 1990) (brokerage firm and president sanctioned for net capital deficiency and telegraphic notice violation); *In re Charles L. Campbell*, Exch. Act Rel. No. 34-26,510, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,601 (Feb. 1, 1989) (brokerage firm sanctioned for net capital deficiency and telegraphic notice violation).

(n66)Footnote 66. The SEC has proposed to eliminate the requirement that broker-dealers file a FOCUS report after a net capital deficiency. *See Exch. Act Rel. No. 34-31,355, Fed. Sec. L. Rep. (CCH) P 85,055* (Oct. 26, 1992).

(n67)Footnote 67. Rule 17a-13 exempts from its provisions broker-dealers:

- who limit their dealer (principal) transactions to the purchase, sale, and redemption of redeemable

shares of registered investment companies;

- whose transactions as broker (agent) are limited to
 - the sale and redemption of redeemable securities of registered investment companies or interests or participations in an insurance company separate account,
 - the solicitation of accounts for federally insured savings and loans associations, and
 - the sale of securities for customer accounts for funds to be immediately reinvested in redeemable securities of registered investment companies; and
- who promptly transmit all funds and securities and hold no customer funds or securities. Rule 17a-13(a)(1)-(3).

In addition, under Rule 17a-13(a)(3), the quarterly security count requirement does not apply to insurance companies that register as broker-dealers solely because they purchase and sell securities on behalf of their general and separate accounts as part of the insurance business, if they otherwise meet the three above conditions.

(n68)Footnote 68. See www.treas.gov/ofac. FINRA also offers a tool to assist firms in compliance, <http://apps.fnra.org/RulesRegulation/OFAC/i/default.aspx>.

(n69)Footnote 69. *Securities Exchange Act Release No. 47638, 68 Fed. Reg. 17809 (April 11, 2003)* .

(n70)Footnote 70. NYSE Rule 446; NASD Rule 3510.

(n71)Footnote 71. See *17 C.F.R. §§ 242.500, et seq.*; see also *Exch. Act Rel. No. 33-8193 (Feb. 20, 2003)*.



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Federal Securities Exchange Act of 1934

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CHAPTER 3 Regulation of Brokers and Dealers

1-3 Federal Securities Exchange Act of 1934 § 3.05

AUTHOR: W. Reece Bader

§ 3.05 FINRA (Formerly NASD)

One purpose of the Exchange Act is to regulate the conduct of brokers and dealers and persons associated with them through direct SEC control and through self-regulation by industry groups with appropriate SEC oversight. n1 The Exchange Act permits self-regulatory organizations to add to investor protection through supervision and discipline of member brokers and dealers and persons associated with them. n2 The addition of Section 15A to the Exchange Act in 1938 extended self-regulation in the securities industry to the over-the-counter ("OTC") securities market. n3 Section 15A governs registration with the Commission of national securities associations, representing organizations of over-the-counter brokers and dealers, established primarily to provide a medium for self-regulation in the OTC market comparable to that provided by securities exchanges in the listed market. n4

The Financial Industry Regulatory Authority ("FINRA") is the sole registered self-regulatory organization of OTC brokers and dealers. FINRA's predecessor became qualified on August 7, 1939 after applying to the Commission for registration under Section 15A(a) and filing papers that conformed with the requirements of Section 15A(b). n5 The objects of the FINRA are best stated in the organization's certificate of incorporation, the third article of which provides:

(1) To promote through cooperative effort the investment banking and securities business, to standardize its principles and practices, to promote therein high standards of commercial honor, and to encourage and promote among members observance of Federal and State securities laws;

(2) To provide a medium through which its membership may be enabled to confer, consult, and cooperate with governmental and other agencies in the solution of problems affecting investors, the public, and the investment banking and securities business;

(3) To adopt, administer and enforce rules of fair practice and rules to prevent fraudulent and manipulative acts and practices, and in general to promote just and equitable principles of trade for the protection of investors;

(4) To promote self-discipline among members, and to investigate and adjust grievances between the public and members and between members;

(5) To establish, and to register with the Securities and Exchange Commission as, a national securities association pursuant to Section 15A of the Securities Exchange Act of 1934, as amended, and thereby to provide a medium for effectuating the purposes of said section;

(6) To transact business and to purchase, hold, own, lease, mortgage, sell and convey any and all property, real and personal, necessary, convenient, or useful for the purposes of the Corporation;

The objects and purposes specified in the foregoing clauses shall, except where otherwise expressed, in nowise be limited or restricted by reference to, or inference from, the terms of any other clause in this certificate of incorporation, but the objects and purposes specified in each of the foregoing clauses of this article shall be regarded as independent objects and purposes. n6

In January 1996, in response to the 1995 NASD Select Committee on Structure and Governance recommendations, n7 the FINRA created two independent operating subsidiaries, NASD Regulation, Inc. ("NASDR") and the Nasdaq Stock Market, Inc. ("Nasdaq"). FINRA delegated to NASDR responsibility for regulation of broker/dealer professional activities. Nasdaq continues to be primarily responsible for operation of The Nasdaq Stock Market. n8 As the Select Committee noted, FINRA's "existing governance structure ... blurs the distinction between the broker-dealer profession and overseeing the Nasdaq stock market. Both missions are thereby deserved." n9 Accordingly, while the Select Committee recognized that the two broad functions should not be totally divorced, it concluded that "regulation of the broker-dealer profession should otherwise be separated from and performed independently of regulation of the Nasdaq and other OTC markets." n10 While each subsidiary has its own governing board and staff, the FINRA retains authority to review all policies and decisions of both subsidiaries, thereby "ensuring that the Association's statutory and self-regulatory obligations and functions are fulfilled." n11 In November 1997, the SEC approved a further reorganization to the corporate structure of FINRA designed to streamline the operations of FINRA while at the same time increase the level of accountability to the public. Under the reorganization, the number of members of its governing boards was reduced, and the structure was changed so that the subsidiary boards consists entirely of people who serve as governors on the FINRA Board. In addition, each board is balanced between "Public," "Non-Industry," and "Industry" members. Finally, the SEC approved amendments to FINRA's Delegation Plan to allow for FINRA to act more quickly and efficiently in response to time-sensitive matters. n12

The mission of FINRA is to "regulate securities markets for the ultimate benefit and protection of the investor." n13 FINRA responsibilities include:

- establishing rules and regulations for FINRA members, including fees and membership requirements;
- arbitration of disputes among and between FINRA members, associated persons, and customers;
- regulation of public and private sale or distribution of securities including underwriting arrangements and compensation;
- establishing policies for clearance and settlement of securities transactions;
- review of FINRA member advertising practices;
- administration, interpretation and enforcement of FINRA rules;
- administration and enforcement of Municipal Securities Rulemaking Board ("MSRB") rules and federal securities laws;

1-3 Federal Securities Exchange Act of 1934 § 3.05

- establishing standards of proof for violations and sanctions imposed on FINRA members and associated persons in connection with disciplinary actions;
- administration of FINRA enforcement and disciplinary programs including investigation, adjudication of cases and the imposition of fines and other sanctions; and
- operation of the Central Registration Depository ("CRD").

Nasdaq, as a registered securities association, is responsible for:

- operation of the Nasdaq Stock Market and automated systems supporting the Nasdaq Stock market and other markets or systems for non-Nasdaq securities;
- maintenance of a telecommunications network infrastructure linking market participants;
- providing to FINRA information required to operate the surveillance audit trail;
- development and adoption of rule changes applicable to collection, processing, and dissemination of quotation and transaction information for securities traded on the Nasdaq Stock Market, on other markets operated by the Nasdaq Stock Market, in the market for securities listed on a registered exchange, and in the over-the-counter market, to establish trading practices for these securities;
- through the development of rules, policies, interpretations and procedures to maintain and enhance the integrity, fairness, efficiency, and competitiveness of the Nasdaq Stock Market and other markets operated by the Nasdaq Stock Market; and
- acting as a Securities Information Processor for quotations and transaction information related to securities traded on the Nasdaq Stock Market and other markets operated by the Nasdaq Stock Market.

[1] Qualification and Admission of Members and Associated Persons

Any registered broker, dealer, or municipal securities broker or dealer, or government securities broker or dealer that meets prescribed standards of training, experience, competence, and conduct, and who is authorized to and regularly transacts business in any branch of the investment banking or securities business within the United States, is eligible for membership in the FINRA. n14 An application for membership in the FINRA is filed on the same Form BD used for registration as a broker-dealer with the SEC. n15 The application must be duly signed and contain a membership agreement. When filed with FINRA, this form must be accompanied by a letter stating whether waiver of the two-principal requirement or exemption from the financial and operations principal requirement is requested. The applicant must agree to abide by applicable rules, pay its dues and other assessments, keep its Form BD up to date, and waive certain claims against the FINRA and its personnel. The application must also be accompanied by a statement of financial condition showing compliance with Rule 15c3-1, n16 two FINRA assessment reports, an application on Form U-4 for registration of each principal and representative, and a fingerprint card for each individual required by Rule 17f-2 to be fingerprinted. In addition, fees must be submitted for membership, as well as for each required examination and each fingerprint card. A fee must be submitted for membership, as well as for each U-4, each required examination and each fingerprint card. In addition, a fee must be submitted for registration of each branch office. n17

FINRA has authority to impose restrictions on admissions to or continued membership in the FINRA. n18 The FINRA has adopted two standards governing qualifications of persons associated with members: one for principals and the

other for registered representatives.

[a] Registration of Principals. The FINRA requires each member broker-dealer, except sole proprietors, to have at least two registered principals and, in addition, depending on its business, a Financial and Operations Principal and a Registered Options Principal ("ROP").ⁿ¹⁹ The two-principal requirement may be waived if FINRA finds waiver appropriate, generally on the basis of the small size of the member's operations.ⁿ²⁰ The registration of a Financial and Operations Principal can be waived if the firm complies with paragraph (a)(2) or (b)(1)(iii) of Rule 15c3-1.ⁿ²¹

A ROP is required if the firm does option business with the public. The firm must designate a Senior Registration Option Principal ("SROP") and a Compliance Registered Options Principal ("CROP") in accordance with the provisions of Rule 2860(b)(20) of the NASD Conduct Rules.ⁿ²² All principals, including sole proprietors, officers, partners, office managers, and corporate directors of a member who actively engage in the management of the member's investment banking or securities business must be registered.ⁿ²³ Every principal must pass a written Qualification Examination for Principals appropriate to his or her principal classification before registration is effective.ⁿ²⁴

[b] Registration of Representatives. All non-management personnel engaged in sales of securities, including persons associated with a member who are designated as representatives, must be registered and pass a Qualification Examination for Registered Representatives before their registration becomes effective.ⁿ²⁵

[2] Conduct Rules

The FINRA has adopted detailed rules for supervising activities of its members under the authority given it by Securities Exchange Act Section 15A(b)(6), which requires observation by its members and associated persons of members of "high standards of commercial honor and just and equitable principles of trade in the conduct of their business."ⁿ²⁶ The principles of business conduct contained in the FINRA Conduct Rules reflect a codification of statutory provisions, court decisions, administrative proceedings, and SEC rules and interpretations.ⁿ²⁷ FINRA applies its rules on just and equitable principles of trade to failures by members and associated persons to follow the Conduct Rules as well as its Uniform Practice Code.ⁿ²⁸ and to breaches to trade contracts.ⁿ²⁹ Most recently, for example, the SEC approved amendments to the rules to attempt to ensure that members of the public have a fair chance to purchase "hot issue" securities.ⁿ³⁰ The Conduct Rules also apply to measures designed primarily to prevent or aid in the detection of abuses that may not always represent general principles of proper business conduct. Such measures include FINRA rules concerning hypothecation and lending of securities, payments to employees and others, and margin maintenance and various filing and recordkeeping requirements.ⁿ³¹

Violations of the Conduct Rules are grounds for disciplinary proceedings.ⁿ³² Such proceedings do not violate the *Fourteenth Amendment* and are proper to supplement the oversight power of the Commission.ⁿ³³ However, the Ninth Circuit Court of Appeals has found no implied private cause of action for violation of the FINRA Conduct Rules.ⁿ³⁴ In mid-1998, FINRA proposed rules that would authorize FINRA to initiate temporary cease-and-desist proceedings to combat serious rule violations, particularly those that raise concerns of investor protection. The rule proposal has generated significant opposition from the securities industry.ⁿ³⁵

[3] Investigative Powers

[a] Internal Procedures. The Report of the NASD Select Committee on Structure and Governance, dated September 15, 1995, was the culmination of nearly a year of review of the FINRA operations and included numerous recommendations with respect to the FINRA's enforcement program and disciplinary procedures.

After appropriate notice and opportunity for public comment,ⁿ³⁶ these changes became effective on August 7, 1997.ⁿ³⁷ In the new NASDR Rule 9100 series, procedural enhancements were made to the rules. These enhancements include requirements for service and notice, a rule prohibiting ex parte communications, the separation of prosecutorial and adjudicatory functions, and rules related to conduct of counsel and withdrawal of counsel. Some of the new rules

are very specific. Rule 9136 describes in detail the specifications for formatting pleadings.

Under the 9200 series rules, the manner in which disciplinary proceedings are conducted has changed dramatically. In the past, most disciplinary actions were initiated by the local District Business Conduct Committee ("DBCC") or the Market Regulation Committee. Proceedings held before the DBCC with a right of review by the National Business Conduct Committee ("NBCC"). NBCC determinations were reviewable by the FINRA Board, followed by SEC review under Section 15A(h)(3) of the Securities Exchange Act. n38

The earlier criticisms n39 as well as the Select Committee Report have resulted in an entirely new system. A disciplinary proceeding will first be investigated by the Department of Enforcement of FINRA, and a complaint will be initiated by them. n40 The matter will be heard by a Hearing Panel n41 composed of a Hearing Officer, who will be a professional FINRA staff person and two other panelists, either from the DBCC or current or former members of disciplinary panels, the NBCC, one of the FINRA's corporate boards, or in limited cases a current or former member of the Market Regulation Committee. n42

Other rules provide procedural enhancements by way of prehearing procedures, discovery, summary disposition and settlement procedures. n43

Finally, the Acceptance, Waiver and Consent form of settlement is preserved and enhanced. n44

The appellate process is also changed in the 9300 Series Rules. Although much is retained, including the usual chain of appeal to the NBCC, the Board and the SEC, the Department of Enforcement now has the unlimited right of appeal. n45 The FINRA Board may also call a disciplinary proceeding for review. n46

[b] Surveillance of Brokers and Dealers. Brokers and dealers who are members of the FINRA are subject to surveillance by NASDR, including on-site inspections. FINRA members who engage in a general securities business are subject to a minimum on-site routine examination each year.

Under agreements with most stock exchanges, including the New York and American Stock Exchanges, FINRA has regulatory responsibility for on-site examinations of certain firms that are joint FINRA/exchange members. FINRA also has a joint examination program with the New York Stock Exchange to save members the unnecessary burden of being examined separately for their activities in OTC and listed securities. Section 17(i) of the Exchange Act, added in 1996, requires the Commission to work with FINRA, as well as the exchanges, to eliminate duplication in the routine examination process by coordinating examinations. The section requires the self regulatory organizations to share information, including customer complaints, examination results, and other "non-public regulatory information." While each regulatory authority retains the right to conduct an examination for cause, the intent of the new law is to promote cooperation in regulatory oversight.

During a routine examination, a member's books and records are examined for currency and accuracy. Sales practices are reviewed to determine fairness in dealings with customers concerning the suitability of recommendations, best execution, and mark-ups. Market making and underwriting activities, activities in bonds, municipal securities, market fund shares, options, tax shelters, and variable contracts are examined. The inspection also covers compliance with the anti-fraud provisions of the Exchange Act, registration requirements of the Securities Act, disclosure of capacity requirements, and advertising rules.

The District Business Conduct Committees review the examination reports prepared by FINRA staff, conduct hearings, and impose penalties ranging from a warning to expulsion of a broker or dealer from the FINRA and the barring of an individual from association with FINRA members. All penalties imposed by the District Business Conduct Committees are reviewed by the NBCC, which may modify them. FINRA penalties may be appealed to the Commission and, ultimately, to a United States Court of Appeals. n47

[4] Arbitration

FINRA sponsors an arbitration forum for the resolution of disputes that involve public customers, broker-dealers, or persons associated with broker-dealers. All FINRA arbitration procedures are governed by the NASDR Code of Arbitration Procedure. n48

In 1996, a blue-ribbon panel, appointed by the FINRA Board, issued a report on the FINRA arbitration process. The Arbitration Policy Task Force n49 made numerous recommendations regarding changes in procedure and improvements to the system. Since then NASD Dispute Resolution Inc.'s National Arbitration and Mediation Committee, as well as its full time dispute resolution staff have proposed numerous changes in the Code of Arbitration Procedure, including early appointment of arbitrators, an enhanced mediation program, improved arbitrator training, as well as procedural rules regarding eligibility of claims, punitive damages and discovery. Most of the changes have been approved.

In 2007, the FINRA arbitration forum merged with the NYSE arbitration forum. Nearly all securities arbitrations are now conducted under the auspices of FINRA Dispute Resolution. Cases filed with the NYSE prior to July 31, 2007 are administered by former NYSE staff now employed by FINRA using NYSE rules. Existing FINRA cases are now administered under three sets of rules: customer code, member code and a mediation code.

FOOTNOTES:

(n1)Footnote 1. See S. Rep. No. 379, 88th Cong., 1st Sess. 1-106 (1963), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I (Matthew Bender).

Self-regulatory organizations exercise governmental-type powers in carrying out their responsibilities under the Exchange Act. They do so in basically three ways: imposing a disciplinary sanction, broadly defined, on a member or person affiliated with a member; denying membership to an applicant; and requiring members to cease doing business entirely or in specified ways with a particular nonmember or with respect to a particular security. S. Rep. No. 75, 94th Cong., 1st Sess. 24-25 (1975), reprinted in the Primary Law Sourcebook, Volume C, Section I (Matthew Bender).

(n2)Footnote 2. For example, Sections 6(b)(7) and 6(d) of the 1934 Act, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F (Matthew Bender), require that the rules of an exchange provide for the disciplining of its members and that the rules be adequate to insure fair dealing and to protect investors. 15 U.S.C. § 78f(b)(7) and (d).

(n3)Footnote 3. 15 U.S.C. § 78o-3. This is the Maloney Act, named after the late Senator Maloney of Connecticut, its sponsor. Actually, only one such association has ever been formed--the National Association of Securities Dealers, Inc. Any other result was not expected by Congress. Section 15A was radically amended in 1964 to conform to other changes, particularly those affecting broker-dealer proceedings and sanctions. Section 15A was amended again in the Securities Acts Amendments of 1975.

(n4)Footnote 4. See n.1 *supra*.

(n5)Footnote 5. 10 SEC Ann. Rep. 77 (1944).

(n6)Footnote 6. Certificate of Incorporation, NASD Manual (CCH).

(n7)Footnote 7. Executive Summary, *Report of the NASD Structure and Governance to the NASD Board of Governors*.

(n8)Footnote 8. NASD Notice to Members No. 96-35 (May 22, 1996).

(n9)Footnote 9. *Id.* at 21.

(n10)Footnote 10. *Id. at 22.*

(n11)Footnote 11. *Id.*

(n12)Footnote 12. *See* Exch. Act Rel. No. 34-39,326; File Nos. SR-NASD-97-71, SR-NASD-96-20, SR-NASD-96-29 (Nov. 14, 1997).

(n13)Footnote 13. *NASD Manual (CCH) at 151.*

(n14)Footnote 14. Art. III, Sec. 1, NASD By-Laws, NASD Manual (CCH). Sections 3(a) and (b) of Article II exclude persons who fail or cease to satisfy the qualification requirements.

(n15)Footnote 15. Form BD, Uniform application for registration as a broker or dealer, reprinted in the Securities Primary Law Sourcebook, Volume B, Section H (Matthew Bender), is discussed in § 3.03 *supra*.

(n16)Footnote 16. Failure of a member to register an employee who is required to be registered is ground for expulsion, censure, bar from association with another FINRA member, or revocation of his or her registration. *See, e.g., In re Donald W. Collins*, Exch. Act Rel. No. 34-12,823 (1976) (member employed salesmen not properly registered with FINRA).

Exemptions from the registration requirements apply to clerical and ministerial personnel; nominal corporate officers; limited partners; and associated persons whose functions are limited solely to transactions on an exchange and who are registered with the exchange, transactions in exempted securities, and commodity transactions. Rule 1060, NASD By-Laws, NASD Manual (CCH).

Schedule A, NASD By-Laws, NASD Manual (CCH) Sections 1-2, provides for the specified assessments and fees.

The FINRA uses gross income assessment levy as a means to provide for equitable allocation of dues among its members. *Id.* Sec. 1(c), NASD Manual (CCH).

(n17)Footnote 17. The term "branch office" is defined in Art. I, Sec. (d), NASD By-Laws, NASD Manual (CCH).

(n18)Footnote 18. Art. III, Sec. 2, NASD By-Laws, NASD Manual (CCH).

(n19)Footnote 19. Rule 1021(e)(1), Rule 1022(b)(1) and Rule 1022(f)(1), NASD By-Laws, NASD Manual (CCH). One individual can be registered in several capacities.

(n20)Footnote 20. Rule 1021(e)(2), NASD By-Laws, NASD Manual (CCH).

(n21)Footnote 21. Rule 1022(b)(4), NASD By-Laws, NASD Manual (CCH).

(n22)Footnote 22. Rule 1022(f)(1), NASD By-Laws, NASD Manual (CCH).

(n23)Footnote 23. Rule 1022(a)(1), NASD By-Laws, NASD Manual (CCH).

The managerial functions may include supervision, solicitation, conduct of business, or the training of persons associated with a member to function as a supervisor or engage in solicitations. *Id.*

(n24)Footnote 24. Rule 1021(a), NASD By-Laws, NASD Manual (CCH). A person associated with a member as a registered representative, discussed in § 3.05 *infra*, whose duties change so as to require registration in any principal classification has 90 calendar days following the change in his or her duties to pass the appropriate Qualification Examination for Principals. *Id.*, Rule 1021(d)(1).

A principal whose most recent registration as principal has been terminated for two or more years immediately preceding the date of receipt by the FINRA of a new application must pass an examination for principal classification before the registration becomes effective. *Id.* Rule 1021(c).

In addition, FINRA administers the uniform securities agent state law examination under a joint program with the North American Securities Administrators Association. This test is accepted by almost all the states. NASD 1986 Ann. Rep. 11.

(n25)Footnote 25. Rule 1031(a), (b), NASD By-Laws, NASD Manual (CCH).

A "representative" is a person associated with a member, including assistant officers other than principals, who is engaged in the investment banking or securities business for the member. *Id.* Rule 1031(b). If the most recent registration of a representative has been terminated for two or more years immediately preceding the filing of a new application, he or she must pass a Qualification Examination for Representatives before the application becomes effective. *Id.* Rule 1031(c).

In *Exchange Servs., Inc. v. SEC*, 797 F.2d 188 (4th Cir. 1986), the court, affirming a SEC order, held that a discount brokerage firm's order-takers who executed trades but did not perform market-making or advisory role of full service brokers, must register with FINRA and pass the examination required of broker-dealers' representatives. Although they were not permitted to solicit orders or make recommendations, their extensive contact with the public made their qualification and registration matters of public interest.

(n26)Footnote 26. Conduct Rules, Rule 2110, NASD Manual (CCH).

On principles of trade and standards of commercial honor, the SEC has stated:

"Just and equitable principles of trade" and "high standards of commercial honor," however, are not phrases which originated in the Act or the Commission's rule but rather are concepts which have long characterized the level of professional integrity expected of persons in the securities business. Moreover, they are evolving standards of ethical conduct about as old as the securities business itself, which have grown in breadth and with increasing definition over the years. They therefore cannot be considered apart from their historical development.

The concepts predate the federal securities laws by many years. As early as 1848 the Chicago Board of Trade announced one of its purposes to be to "inculcate principles of justice and equity in trade." By 1900 the constitution of nearly every stock exchange, including the New York Stock Exchange, provided that its purposes were "to furnish members with facilities for trading and to maintain high standards of commercial honor and integrity among its members and to promote and inculcate just and equitable principles of trade and business."

Section 6(b) of the Exchange Act has provided since 1934 that:

No registration [of a national securities exchange] shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

In 1938, in the Maloney Act amendments to the Act, Congress sought to create a type of regulation for the over-the-counter markets similar to that provided by the exchanges for their members. In

furtherance of this purpose, it chose the media of registered national securities associations. Testifying at the hearings preceding the passage of the Maloney Act former SEC Commissioner Mathews stated: "An association of this sort, if it is successful, must be able to control those practices of its members which, in the language of the stock exchange rule, are inconsistent with just and equitable principles of trading."

Thus, the concept of just and equitable principles of trade in the regulatory pattern adopted for those doing business in the over-the-counter markets has been embodied in both Section 15A of the Act and in the rules of the NASD, the only association registered under that section. Section 15A(b)(8) [currently Section 15A(b)(6)] of the Act provides that an association shall not be registered unless it appears to the Commission that, among other things, "the rules of the association are designed ... to promote just and equitable principles of trade." Rule 2110 of the NASD Conduct Rules, which was adopted pursuant to Section 15A(b)(8), reflects both of the concepts here involved: "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

* * *

Since its inception in 1939 the NASD has been the principal catalyst in the development of the scope and meaning of just and equitable principles of trade and high standards of commercial honor for the over-the-counter markets. There have been a number of avenues through which this development has occurred, including adoption by the Association of rules of fair practice, promulgation by the Board of Governors, through its powers to administer and interpret NASD Rules, of statements of policy, guidelines and interpretations, and case by case adjudication in Association disciplinary actions. The particular avenue utilized has depended in large measure on the nature of the regulatory problem concerned as well as other factors. In general, rules have been adopted where the principles of business conduct could be stated in general or reasonably specific terms. For the most part, these rules codified settled standards of behavior or embodied new standards or requirements designed to prevent recognized abuses. Promulgation of statements of policy, interpretations and guidelines regarding the implementation of existing rules has normally been the vehicle used (1) where the basic or underlying principles have been established (*e.g.*, by rules) or have, over a period of time, been generally understood as appropriate norms of conduct and (2) where the enunciation of specific, detailed rules was unnecessary or impractical but (3) where the Board of Governors nevertheless considered it desirable to inform the membership of the guidelines... as they developed and evolved, that were being or would be applied by the Board and operating committees in administering such norms. Finally, the evolutionary development of business ethics has occurred through the disciplinary route where conduct recognized as patently contrary to professional standards has been found, but where, for example, the applicable norms previously were not or could not readily be reduced to written rules or guidelines.

There have been many examples throughout the NASD's history of the use of each of the approaches or avenues described above. However, it is important to bear in mind that in all phases of NASD regulatory activity with regard to the development of the concepts of business ethics here involved, the Commission has played an active role both in formulation of standards and in supervising their implementation. The Commission, as part of the Congressional design for "cooperative regulation" of the over-the-counter markets, has been an active participant with the NASD in the development of the concepts of "just and equitable principles of trade" and "high standards of commercial honor." Just as the courts have recognized for some time that the limits of fraud cannot be precisely defined and accordingly have interpreted the anti-fraud provisions as general proscriptions against myriad forms of deception and manipulation, so too "just and equitable principles of trade" is a standard of great elasticity intended to circumscribe a wide variety of conduct which may operate as an injustice to investors or other participants in the market place.

Exch. Act Rel. No. 34-9420, 4 Fed. Sec. L. Rep. (CCH) P 25,592, at 18,575-78 (Dec. 20, 1971) .

(n27)Footnote 27. *Id.*

(n28)Footnote 28. Business practices relating to such matters as the confirmation, settlement, or closing out of securities transactions, as codified in the NASD's Conduct Rules and its Uniform Practice Code, are an expression of the customs and usages of the trade that must be followed in transactions among NASD members or between members and nonmembers. *Exch. Act Rel. No. 34-9420, 4 Fed. Sec. L. Rep. (CCH) P 25,592 (Dec. 20, 1971).*

For provisions of the NASD Uniform Practice Code, see Rules 11000-11800, NASD Manual (CCH).

See also In re Application of E.F. Hutton & Co., Inc., Exch. Act Rel. No. 34-25,887, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,303 (July 6, 1988), in which the SEC affirmed the FINRA's findings that when brokerage firm competed with a customer by selling stock for its own account at prices equal to or higher than the price of the customer's limit order, the brokerage firm violated FINRA rules requiring "high standards of commercial honor and just and equitable principles of trade."

See also In re the Application of Charles D. Tom, Exch. Act Rel. No. 34-31,081, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,030 (Aug. 24, 1992), in which the SEC affirmed the FINRA's censure and one-year suspension of a securities salesman who effected transactions in a discretionary account without written authorization from the customers. The SEC held that the salesman violated the NASD's Rules of Fair Practice).

In In re Michael D. Borth, Exch. Act Rel. No. 34-31,602, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,106 (Dec. 16, 1992), the SEC upheld FINRA findings that a registered representative and a branch manager violated the NASD Rules of Fair Practice and "substantially undermined" the FINRA's ability to carry out its self-regulatory functions when they neglected their responsibility to respond to the FINRA's requests for information concerning commission payment practices and customer complaints. Neither the belief that the information was no longer needed nor brokerage firm policy that responses be made by legal counsel excused the individuals' failure to provide the requested information.

See also In re Thomas G. Kibler, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,130 (Feb 23, 1993). Sanctions were properly levied against a former registered representative of a brokerage firm who violated the NASD's Rules of Fair Practice. The representative who entered transactions for the purchase of a company's common stock in three customer accounts without the customer's authorization was properly sanctioned. The representative claimed that he engaged in this practice because he was directed to do so by his employer. The SEC stated that evidence was not given to support these accusations, and even if it were, a registered representative cannot excuse unauthorized trading on the grounds that it was directed by the representative's employer.

(n29)Footnote 29. *See n.27 supra.*

(n30)Footnote 30. *See NASD Notice to Members No. 98-48.*

(n31)Footnote 31. The NASD Conduct Rules cover the following areas:

- (1) business conduct of members, (2) recommendations to customers ("suitability rule"), (3) charges for services performed, (4) fair prices and commissions, (5) publication of transactions and quotations, (6) offers at stated prices, (7) disclosure of price in selling agreements, (8) securities taken in trade, (9) use of information obtained in fiduciary capacity, (10) influencing or rewarding employees of others, (11) payment designed to influence market prices other than paid advertising, (12) disclosure on confirmations, (13) disclosure of control, (14) disclosure of participation or interest in primary or secondary distribution, (15) discretionary accounts, (16) offerings "at the market," (17) solicitation of

purchases on an exchange to facilitate a distribution of securities, (18) use of fraudulent devices, (19) customers' securities or funds, (20) installment or partial payment sales, (21) books and records, (22) disclosure of financial condition, (23) net prices to persons not in investment banking or securities business, (24) selling concessions, (25) dealing with nonmembers, (26) investment companies, (27) supervision, (28) transactions for personnel of another member, (29) variable contracts of an insurance company, (30) margin accounts, (31) securities "failed to receive" and "failed to deliver," and (32) fidelity bonds, (33) options, (34) direct participation programs, (35) communications with the public, (36) options communications with the public, (37) transactions with related persons, and (38) regulation of activities of members experiencing financial and/or operational difficulties. See Rules 2100-3370, NASD Manual (CCH).

(n32)Footnote 32. Rule 8310, NASD Conduct Rules, NASD Manual (CCH).

See *In re Graham Loving & Co.*, Exch. Act Rel. No. 34-12,182, 9 SEC Docket (CCH) No. 3, p. 137 (Mar. 9, 1976) (fine of \$4,000 imposed by FINRA on member for violation of rules of fair practice in failing to report sales on FINRA questionnaire); *In re P.K. Hickey & Co.*, Exch. Act Rel. No. 34-12,164, 9 SEC Docket (CCH), No. 2, p. 91 (Mar. 4, 1976) (imposition of \$6,000 fine on member and its general partner for violation of rules of fair practice pertaining to free-riding and withholding).

(n33)Footnote 33. See Benjamin Werner, Exch. Act Rel. No. 34-9242, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,149 (July 9, 1971). Compare Note, *Governmental Action and the NASD*, 47 *Fordham L. Rev.* 585 (1979). The article examines whether the FINRA should be subject to the requirements of substantive due process and the fourth amendment.

(n34)Footnote 34. See *Jablon v. Dean Witter & Co.*, 614 F.2d 677 (9th Cir. 1980), in which the court of appeals found no private action implied under Exchange Act Section 15A(b)(6) for violation of FINRA Rules. Plaintiff alleged violation of the FINRA "suitability rule," Rule 2310 of the NASD Conduct Rules; see generally, 4 *Fed. Sec. L. Rep.* (CCH) P 25,591 .50. The Ninth Circuit continues to take that position, while the Second Circuit has expressed disagreement. See *Leist v. Simplot*, 638 F.2d 283, 298 (2d Cir. 1980); but see Lashbrooke, Jr., *Implying a Cause of Action for Damages: Rule Violations by Registered Exchanges and Associations*, 48 *U. Cin. L. Rev.* 949 (1979), in which the author concludes that the Supreme Court should find a private right of action for damages suffered by investors as a result of violations of exchange or FINRA rules. Cf. *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38 (2d Cir. 1978), cert. denied, 439 U.S. 1039 (1978) (private cause of action available for violation of exchange "know-your-customer" rule).

The FINRA rule violations are, of course, frequently cited and made the basis of claims against registered brokers and dealers and registered representatives in actions brought in its customers' arbitration forum.

(n35)Footnote 35. See NASD Notice to Members No. 98-42, Exch. Act Rel. No. 34-40836.

(n36)Footnote 36. See Exch. Act Rel. No. 34-38,545; File NO. SR-NASD-97-28 (Apr. 24, 1997).

(n37)Footnote 37. See Rules 8000-9790, NASD Manual (CCH). Old Rules 9100 through 9642 were rescinded entirely while amendments were made to the Rule 8000 series. Rescinded Rules 9100 through 9642 do apply, however, to certain proceedings, depending upon the status of the matter as of August 7, 1997. All proceedings initiated on or after that date are governed by the new rules.

(n38)Footnote 38. Former Rule 9317, Code of Procedure, NASD Manual (CCH).

(n39)Footnote 39. FINRA disciplinary proceedings have been the subject of controversy. The critics maintain that

self-regulatory organization disciplinary procedures have been deficient and unfair, and lack adequate procedures. See Lowenfels, *A Lack of Fair Procedures in the Administrative Process: Disciplinary Proceedings at the Stock Exchanges and the NASD*, 64 *Cornell L. Rev.* 375 (1979). See also Note, *Governmental Action and the NASD*, 47 *Fordham L. Rev.* 585 (1979). Other participants in the process disagree. See Poser, *Reply to Lowenfels*, 64 *Cornell L. Rev.* 402 (1979).

(n40)Footnote 40. Rule 9211.

(n41)Footnote 41. Rules 9213; 9231-32.

(n42)Footnote 42. Rule 9231(b).

(n43)Footnote 43. See, e.g., Rules 9240-42; 9250-53; 9264; and 9270.

(n44)Footnote 44. Rule 9216.

(n45)Footnote 45. Rule 9311.

(n46)Footnote 46. Rule 9351.

(n47)Footnote 47. E.g., Rule 3130, Conduct Rules, NASD Manual (CCH), which restricts the activities of members for which the FINRA is the examining authority when the member's capital is less than 150% of the applicable minimum in Rule 15c3-1, its aggregate indebtedness exceeds ten times its net capital, or other financial limits are exceeded. Rules 9510-9515, Code of Procedure, NASD Manual (CCH), set forth the procedures to be followed by the Surveillance Committee in determining whether to impose or lift such restrictions. See also Rules 9260 and 9610, Code of Procedure, NASD Manual (CCH), governing proceedings to revoke or summarily suspend NASD membership.

(n48)Footnote 48. NASDR Rules 10000-10336, Customer Code of Arbitration Procedure, NASD Manual (CCH).

(n49)Footnote 49. "Securities Arbitration Reform," Report of the Arbitration Policy Task Force to the Board of Governors, NASD, Inc. (Jan. 1996).



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Federal Securities Exchange Act of 1934

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CHAPTER 3 Regulation of Brokers and Dealers

1-3 Federal Securities Exchange Act of 1934 § 3.06

AUTHOR: W. Reece Bader

§ 3.06 Municipal Securities Dealers and Brokers

Before 1975, the SEC had little to do with municipal securities. Municipal brokers and dealers were not subject to the registration requirements of Sections 15(a)(1) and 15A(f) of the Exchange Act and Section 202(a)(11)(E) of the Advisers Act, and municipal securities themselves were exempted from registration under the 1933 Act. In 1975, Section 15B was added to the Exchange Act, requiring all municipal dealers including banks to register with the SEC. n1 In addition, the Municipal Securities Rulemaking Board ("MSRB") was established by Congress to promulgate rules governing the municipal securities industry, subject to oversight by the Commission. n2

The 1975 amendments did not change the fact that municipal securities are exempt from the substantive requirements of the federal securities laws, except for the general anti-fraud provisions of the Securities Act and the Exchange Act. Most significantly, this means that state and local governments are not subject to the registration and disclosure requirements of the Securities Act of 1933. n3 Also, the Securities Acts Amendments did not affect the exemptions for issuers of municipal securities. n4

In 1994, the SEC issued three releases stating its interpretive views regarding disclosure in the municipal securities market. n5 As part of these releases, the SEC proposed amendments to Rule 15c2-12 under the Securities Exchange Act of 1934. n6 Rule 15c2-12 was adopted by the SEC in 1989 to prevent fraud in the municipal securities market by enhancing the quality, timing, and dissemination of disclosure in connection with the offer or sale of municipal securities. n7

The amendments n8 to Rule 15c2-12 became effective in mid-1995 and on January 1, 1996. They include a requirement that a participating underwriter cannot purchase or sell municipal securities in connection with an offering unless the participating underwriter has reasonably determined that the issuer has contracted in the trust indenture or bond resolution to provide to municipal securities repositories annual current information about the issuer and each "significant obligor," including audited financial statements and pertinent operating information. In addition, as revised, the rule makes it unlawful for a participating underwriter to recommend the purchase or sale of a municipal security without having reviewed the information the issuer has undertaken to provide.

In addition, in 1995 the MSRB rules regarding the prohibition of political contributions by brokers, dealers and

municipal securities dealers to issuers and officials of issuers became effective. n9

[1] Definitions

[a] Municipal Securities Dealer. A municipal securities dealer is a person engaged in the business of buying and selling municipal securities for his or her own account through a broker or otherwise. n10 A bank (or its separately identifiable department or division) n11 may be a municipal securities dealer if it is engaged in the business of buying and selling municipal securities for its own account, other than in a fiduciary capacity, through a broker or otherwise. n12 If a bank is engaged in the business of buying and selling municipal securities for its own account through a separately identifiable department or division, however, the department or division rather than the bank itself is deemed to be the municipal securities dealer required to register with the Commission pursuant to Section 15B. n13

MSRB Rule G-1 defines the phrase "separately identifiable department or division of a bank" for purposes of Section 3(a)(30) of the Exchange Act as that unit of a bank conducting all municipal securities dealer activities, of the bank, provided that the unit is under the direct supervision of a designated officer responsible for the daily conduct of the bank's municipal securities dealer activities, including the supervision of all bank employees engaged in the performance of such activities. In addition, such activities must be separately maintained in, or extractable from, the facilities of either the unit itself or the bank, all records relating to the bank's municipal securities dealer activities, if the records are so maintained or otherwise accessible to permit independent examination thereof and subject to enforcement of applicable provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the MSRB. n14

Types of activities of a bank or a separately identifiable department or division of a bank that constitute municipal securities dealer activities for purposes of MSRB Rule G-1 include:

- underwriting, trading and sales of municipal securities;
- financial advisory and consultant services for issuers in connection with the issuance of municipal securities;
- processing and clearance activities with respect to municipal securities;
- research and investment advice with respect to municipal securities, insofar as the advice relates to activities enumerated in paragraphs (1) and (2) above;
- activities involving communication, directly or indirectly, with public investors in municipal securities, insofar as such activities relate to paragraphs (1) and (2) above; and
- maintenance of records pertaining to activities described in paragraphs (1) through (5) above. n15

The directors and senior officers of the bank may from time to time set broad policy guidelines for the bank that are not directly related to the daily conduct of the bank's municipal securities dealer transactions without subjecting the unit of the bank conducting business as a separately identifiable department or division to a disqualification or requiring that the directors or officers be deemed part of the unit. n16 Even though a bank's municipal securities dealer activities may be conducted in several geographic, organizational or operational units of the bank, that, in itself, would not preclude a finding that the bank has a separately identifiable department or division for purposes of MSRB Rule G-1, as long as all the units are clearly identifiable and each of the units meets the requirements of subparagraphs (a)(1) and (2) of the rule. n17 For purposes of the rule, all the geographic, organizational or operational units of a bank are considered in the aggregate as the separately identifiable department or division of the bank. n18

Neither any person who transacts municipal securities business for his or her own account, either individually or in

some fiduciary capacity, but does so not as a part of a regular business, n19 nor a bank that buys and sells municipal securities for its own account, but engages in the municipal securities transaction only in a fiduciary capacity, are considered municipal securities dealers. n20

[b] Municipal Securities Broker. A municipal securities broker is a broker engaged in the business of effecting transactions in municipal securities for the account of others. n21 A person associated with a municipal securities dealer that is a bank or a division or department of a bank is any person directly engaged in the management, direction, supervision, or performance of a bank's municipal securities activities with respect to municipal securities, and any person directly or indirectly controlling the municipal securities activities or controlled by the municipal securities dealer in connection with the activities. n22

Generally, the municipal securities industry consists of securities firms (dealers) that buy and sell municipal securities for their own account; banks (bank dealers) that buy and sell municipal securities for their own trading account; and brokers (bond brokers) who act only as agents for buyers and sellers of municipal securities and do not buy or sell municipal securities for their own account. n23

[2] Regulatory Environment Prior to 1975

Prior to the Securities Acts Amendments of 1975, trading in municipal securities and the qualifications and conduct of municipal securities professionals were exempt from regulation by the Commission. n24 In fact, Section 3(a)(12) of the Exchange Act included municipal securities in the definition of an "exempted security." Consequently, banks, brokers and dealers trading exclusively in municipal securities were not required to register with the Commission. Subsection (f) of Section 15A of the Act, which governs the establishment of national securities associations, specified that nothing in the section "shall be construed to apply with respect to any transaction by a broker or dealer in any exempted security." n25 In addition, Section 17(a), which authorized the Commission to prescribe recordkeeping and reporting requirements, applied only to brokers and dealers registered with the Commission. Therefore, neither the Commission nor the FINRA had authority to prescribe for municipal securities professionals rules and regulations governing such matters as registration, professional qualifications, recordkeeping and reporting, financial responsibility to safeguard customer funds and securities and impose minimum capital standards, or just and equitable principles of trade.

Municipal securities professionals, including banks, were, however, subject to Section 10(b) of the Act. Section 10(b) prohibits the use of manipulative or deceptive devices or contrivances in the purchase or sale of any security in violation of Commission rules. In addition, they were subject to Section 15(c)(1) of the Act, which precludes brokers and dealers (whether or not registered with the Commission) from effecting any transaction in or inducing the purchase or sale of any security (exempt or not) in the over-the-counter market by means of any manipulative, deceptive, or other fraudulent device or contrivance, as defined by the Commission. n26

Nonetheless, Commission control of trading in municipal securities and the conduct of municipal securities professionals was limited to only *post hoc* enforcement of the anti-fraud prohibitions under the various federal securities laws. The absence of effective regulation reflected both an historical concern that the costs of regulation would be borne by state and local issuers of municipal securities and a belief that self-regulation by sophisticated municipal securities institutions would provide adequate protection for investors. n27

[3] Nature of Abuses in the Trading Markets for Municipal Securities Prior to 1975

Although the municipal securities markets generally performed their debt financing functions for state and local governments and other municipal agencies with commendable efficiency and integrity, fraud actions brought against municipal securities professionals during the early 1970s indicated that unwary investors were often exposed to illegal trading practices. n28

The pattern of professional misconduct that justified federal regulation of the municipal securities business included "unconscionable markups, churning of customers' accounts, misrepresentations concerning the nature and value of municipal securities, disregard of suitability standards, and scandalous high-pressure sales techniques." n29 Absent additional statutory authority, the reputable and forward-looking firms in the municipal securities industry and the Commission appeared unable to halt such fraudulent trading practices.

The Securities Acts Amendments of 1975 were intended to prevent the pattern of abuses, provide a suitable regulatory framework that would respond to the needs of the industry, and protect the interests of investors and governmental issuers in healthy and efficient municipal securities markets. n30

[4] Changes Effected by the Securities Acts Amendments of 1975

The Securities Acts Amendments of 1975 n31 subjected municipal securities professionals to essentially the same regulatory scheme applicable to other securities activities, by amending the Exchange Act in various respects. n32

First, municipal securities were excised from the Exchange Act's definition of "exempted securities" for purposes of several provisions of the Act, n33 with the result that, for the first time, brokers and dealers engaged exclusively in a municipal securities business became subject to the registration requirements of Section 15(a). n34 In addition, Section 15B was added to the Securities Exchange Act of 1934. Section 15B provides for the registration of municipal securities dealers (including banks or their separately identifiable departments or divisions acting as dealers), and creates the MSRB with authority to adopt rules governing trading in municipal securities and activities of municipal securities brokers and municipal securities dealers subject to Commission oversight. n35

Further, new definitions for municipal securities professionals were added to Sections 3(a) (30), (31), and (32). Sections 15(c)(1) and 15(c)(2) (concerning manipulative, deceptive, and fraudulent acts, practices, devices and contrivances) were amended to grant the Commission rulemaking authority over municipal securities dealers (including banks) that use the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in the over-the-counter market or on any exchange of which it is not a member. n36 Finally, Section 17 was amended to give the Commission the authority to prescribe records to be maintained and reports to be disseminated by municipal securities dealers and the MSRB. n37

Additionally, the 1975 Amendments subject, for the first time, brokers and dealers who transact business in municipal securities to all existing rules under Sections 15(c)(2) and 15(c)(3) of the Exchange Act with respect to their municipal securities transactions. n38 Since Commission rules under Section 15(c)(3) currently apply only to brokers and dealers, however, banks and their separately identifiable departments or divisions fall outside the scope of such rules. n39 Commission rules under Section 15(c)(2) can apply to banks that are municipal securities dealers but do not, except for Rule 15c2-4 concerning the transmission or maintenance of payments received in connection with underwritings. n40

Rules adopted pursuant to Sections 10(b) and 15(c)(1), previously applicable to transactions in municipal securities effected by brokers and dealers, continue to apply after the 1975 Amendments. These rules also apply to banks (or separately identifiable departments or divisions of banks) that are municipal securities dealers as a result of the 1975 Amendments. n41

[a] Registration of Municipal Securities Dealers.

Unless exempted by the Commission under its broad exemptive authority in Section 15B(a)(4), a municipal securities dealer not registered as a broker or dealer under Section 15 of the Exchange Act must register with the Commission under Section 15B n42 before engaging in a municipal securities business. n43 Persons already registered with the Commission as a broker or dealer pursuant to Section 15 because of their general securities business need not re-register

under Section 15B with respect to their municipal securities business. n44

Acts, practices, or courses of business of registered brokers or dealers prohibited by other provisions of the Exchange Act in connection with the use of the mails or any means or instrumentality of interstate commerce are equally prohibited if performed by a registered municipal securities dealer or any person acting on behalf of the municipal securities dealer, regardless of any use of the jurisdictional means in connection with the act, practice, or course of business. Acts or practices prohibited by Section 5, which governs transactions on unregistered national securities exchanges, and paragraph (1) of Section 15B(a), are excepted from this requirement. n45

Only municipal securities dealers that are banks or separately identifiable departments or divisions thereof, and municipal securities dealers that are engaged in an exclusively intrastate business but utilizing jurisdictional means are subject to registration under Section 15B. All non-bank municipal securities dealers and brokers must register under Section 15. n46

The Commission may, by rule or order, upon its own motion or upon application, conditionally or unconditionally exempt any broker, dealer, or municipal securities dealer or any class thereof from the registration requirements, rules or regulations under Section 15B, if the Commission finds that the exemption is consistent with the public interest, the protection of investors, and the purposes of the Act. n47

[i] Application for Registration under Section 15B.

A municipal securities dealer subject to registration under Section 15B registers with the Commission by filing an application for registration containing such information and documents about the municipal securities dealer and any persons associated with him or her and in such form as the Commission may, by rule, prescribe as necessary or appropriate in the public interest or for the protection of investors. n48 Within 45 days of the date of filing the application (or within a longer period to which the applicant consents), the Commission must either grant the application or institute proceedings to determine whether registration should be denied. n49

The Commission must grant the registration if it finds that the municipal securities dealer has satisfied all the registration requirements. The application for registration must be denied, however, if the Commission makes no such finding, or upon a finding that if the applicant is registered, the registration would otherwise be subject to suspension or revocation pursuant to Section 15B(c). n50

[A] Banks--Form MSD. Regulation 15B(a)(2)-1 requires a municipal securities dealer that is a bank or a separately identifiable department or division of a bank to apply for registration under Section 15B(a) with the Commission on Form MSD. n51 A statement of financial condition need not be filed with the application. n52 If the applicant is a department or division of a bank, the application is deemed to have been made by the bank on behalf of the applicant. n53 A registrant whose registration is either currently effective or pending may update the registration or application on Form MSD. n54

Form MSD contains twelve items and the following three schedules:

- Schedule A, used to respond to Item 5 (persons who manage the applicant's municipal securities dealer activities) and Item 7 (whether any person who manages the applicant's municipal securities dealer activities has ever been sanctioned by the SEC, a court, or a self-regulatory organization);
- Schedule B, used to respond to Item 6 (control persons of the applicant's municipal securities dealer activities); and
- Schedule C, used to respond to Item 9 (services performed by persons other than the applicant with

respect to the applicant's municipal securities dealer activities, Item 10 (whether the applicant maintains a municipal securities investment portfolio or buys and sells municipal securities in a fiduciary capacity or as agent for customers), and Item 12 (identification of Schedule C of each geographic, organizational, and operational unit of the bank of which the applicant is a part and a description of the recordkeeping and preservation procedure relating to the applicant's municipal securities dealer activities).

Certain persons named in response to Item 5 of Form MSD who are required to complete a separate Schedule A may file in lieu thereof Form MSD-4, "Uniform Application for a Municipal Securities Principal or Municipal Securities Representative Associated with a Bank Securities Dealer." n55 The information called for by Form MSD-4 is substantially the same as that required by Schedule A. Every bank municipal securities dealer must file a Form MSD-4 with the appropriate regulatory agency on behalf of each principal or associated representative. Applicants must still complete a Schedule A for any disciplined personnel named in response to Item 7 of Form MSD even if the persons involved have also completed a Form MSD-4, since Schedule A solicits additional disciplinary information not available on Form MSD-4.

If the applicant is a department or division of a bank, information concerning the applicant must be given in response to Items 2(a) and 2(b) of Form MSD. Information with respect to the bank of which the applicant is a part must be given in response to Item 2(d) of Form MSD. n56

Information contained in Form MSD must be updated or amended periodically when the information becomes incomplete or inaccurate. When any item is amended, all other items on the page being amended must be answered in full. n57 An amendment filed under Rule 15B(a)(2)-1(b) constitutes a report within the meaning of Sections 17 and 32(a) of the Exchange Act. n58

[B] Subsidiaries of Banks--Form BD. Municipal securities dealers that are subsidiaries of banks or of bank holding companies are required to register with the Commission under Section 15 of the Exchange Act, rather than Section 15B, on Form BD. n59

[C] Intrastate Non-bank Municipal Securities Dealers--Form BD. Rule 15B(a)(2)-2 requires a non-bank municipal securities dealer whose business is exclusively intrastate to register with the Commission on Form BD. n60 The applicant must file a statement with the Commission indicating that he is applying for registration as an intrastate dealer. In addition, a statement of financial condition setting forth the nature and amount of assets, liabilities, and net worth concerning the applicant must be filed with the application. n61

[ii] Registration of Successors and Fiduciaries. In the event that a municipal securities dealer succeeds to and continues the business of a registered municipal securities dealer, the registration of the predecessor shall be deemed to remain effective as the registration of the successor if the successor, within 30 days after such succession, files an application for registration. A bank or a separately identifiable department or division of a bank files on Form MSD. Any other municipal securities dealer files on Form BD, and the predecessor files a notice of withdrawal from registration on Form MSDW or Form BDW. n62 The predecessor's registration is deemed to remain effective as the registration of the successor for 45 days after the application for registration on Form MSD or Form BD is filed. n63

A fiduciary (including any executor, administrator, guardian, conservator, assignee for the benefit of creditors, receiver, trustee in insolvency or bankruptcy) or other fiduciary appointed or qualified by order, judgment or decree of a court of competent jurisdiction, who continues the business of a registered municipal securities dealer, must file a statement setting forth the information about the fiduciary required by Form MSD or Form BD within 30 days after entering upon the performance of the duties. n64 The registration of a municipal securities dealer is deemed to be the registration of the fiduciary upon the filing of the information statement with the Commission within the prescribed period. n65

The Government Securities Act of 1986 n66 added Section 15C to the Act that requires the registration of certain

government securities brokers and dealers that were not required to be registered under prior law. While Section 15B requires the registration of brokers and dealers of municipal securities, Section 15C extends the registration requirement to brokers and dealers trading in United States government securities, certain securities issued or guaranteed by corporations in which the United States government has a direct or indirect interest, and certain securities issued or guaranteed by corporations designated by statute to be exempt securities within the meaning of the laws administered by the Commission.

Section 15C grants authority to the Secretary of the Treasury to adopt rules regarding financial responsibility; custody and use of customers' securities; the transfer and control of government securities in repurchase transactions; financial statements; recordkeeping; and exemption from registration. The enforcement of the rules is the responsibility of the Commission as to currently registered brokers and dealers and those brokers and dealers required to register under Section 15C. The enforcement of the rules as to primary dealers, banks and other institutions specified by Section 15C is the responsibility of other appropriate regulatory agencies.

The Commission has adopted rules under Section 15C. n67 Under Rule 15Cal-1, every government securities broker and dealer (other than financial institutions) registered under Sections 15 or 15B of the Act is required to notify the Commission on Form BD that it is a government securities broker or dealer. A broker or dealer that plans to begin government securities activities must file notice with the Commission on or before the date that it begins such activities, n68 and must notify the Commission on Form BD within 30 days after it has ceased to act as a government securities broker or dealer. n69

[b] Withdrawal from Registration. Section 15B(c)(3) permits any registered municipal securities dealer, upon such terms and conditions as the Commission deems necessary in the public interest or for the protection of investors, to withdraw from registration by filing a written notice of withdrawal with the Commission. n70

The notice of withdrawal from registration as a municipal securities dealer pursuant to Section 15B(c) and Rule 15Bc3-1 thereunder is filed on Form MSDW, in the case of a bank or a separately identifiable department or division of a bank, or Form BDW in the case of any other municipal securities dealer. n71

Form MSDW requires the registrant to indicate whether it is a bank or department or division of a bank n72 and to state: its full name; any separate name under which municipal securities dealer activities are conducted; and the address of the principal place of business and telephone number of the registrant, bank, or department or division of a bank. n73

In addition, the registrant must state whether it owes any money or securities to any customer, broker, dealer, or municipal securities dealer in connection with its activities as a municipal securities dealer. n74 If the answer is in the affirmative, the registrant must specify: the amount of money owed; the market value of securities owed; and the arrangements made for payment thereof. n75 If the registrant is a party to any legal action or proceeding n76 or there are unsatisfied judgments or liens against the registrant, the registrant must provide complete information as to each. n77

The name and address of the person having custody or possession of the registrant's books and records pertaining to its municipal securities dealer activities and the address of the place where the books and records are preserved must also be reported. n78 The registrant must also undertake to make the books and records he or she is required to preserve available for examination by authorized representatives of the Commission, and to authorize the person having custody of the books and records to make them available. n79

Form MSDW must be signed in the name of the registrant by a principal officer of the registrant, bank or department or division of a bank, who is duly authorized to sign the form, and is directly engaged in the management, direction, or supervision of the registrant's municipal securities dealer activities. n80 One signed original and one signed copy (both duly executed with a manual signature) of the form must be filed with the Commission at its Washington D.C. office

before registration as a municipal securities dealer may be terminated. n81 The registrant must retain an exact copy of the form and file an original signed copy with its appropriate regulatory agency. n82 Registrants that are banks or departments or divisions of banks (including national banks and banks operating under the Code of Law of the District of Columbia), must file the original signed copy of Form MSDW with the Federal Reserve Board in Washington D.C. or with the FDIC, if the registrants are banks insured by the FDIC and not members of the Federal Reserve System. n83

The notice on Form MSDW or Form BDW generally becomes effective on the 60th day after the filing with the Commission or within such shorter time as the Commission may determine. n84

The Commission may, however, impose terms or conditions on the withdrawal. If a notice of withdrawal from registration is filed at any time after the date of issuance of a Commission order instituting proceedings under Section 15B(c) to censure, place limitations on the activities, functions or operations of, or suspend or revoke the registration of, the municipal securities dealer, or if, prior to the effective date of the notice of withdrawal, the Commission institutes any of the above proceedings or a proceeding to impose terms or conditions on the withdrawal, the notice of withdrawal will not become effective except at a time and on terms and conditions as the Commission deems necessary or appropriate in the public interest or for the protection of investors. n85

[c] Suspension, Revocation, and Cancellation of Registration; Readmission. Under Section 15B(c)(3) and (4) the Commission has the authority to impose sanctions, including censure; placing limitations on activities, functions, or operations; suspension for a period not exceeding twelve months; revocation of registration; and barring association with a municipal securities dealer on any municipal securities dealer or any person associated or seeking association with a municipal securities dealer on the grounds of acts or omissions, convictions, or injunctions specified in Section 15(b)(4). n86

The Commission, pending final determination whether to revoke a registration, may suspend registration if the suspension appears to the Commission, after notice and opportunity for hearing, to be necessary or appropriate in the public interest or for the protection of investors. n87 Further, if the Commission finds that a registered municipal securities dealer is no longer in existence or has ceased to do business as a municipal securities dealer, the Commission may cancel the registration of the municipal securities dealer. n88

The Commission may grant applications for readmission to the municipal securities business or some aspect thereof. n89

[d] Cooperation and Consultation in Inspection and Enforcement. Because the Securities Acts Amendments of 1975 enlarge the scope of the Exchange Act to encompass certain functions of banks with respect to securities, the statutory scheme has been modified to provide for administration and inspection, and, in certain instances, the imposition of sanctions and responsibility for other matters by the federal bank regulatory agencies. The Act uses the concept of "appropriate regulatory agency" as a means of allocating such functions between the Commission and the banking agencies. The allocation is contained in the definition in Section 3(a)(34):

(A) When used with respect to a municipal securities dealer:

(i) the Comptroller of the Currency, in the case of a national bank or a bank operating under the Code of Law for the District of Columbia, or a subsidiary or a department or division of any such bank;

(ii) the Board of Governors of the Federal Reserve System, in the case of a State member bank of the Federal Reserve System, a subsidiary or a department or division thereof, a bank holding company, a subsidiary of a bank holding company which is a bank other than a bank specified in clause (i) or (iii) of this subparagraph, or a subsidiary or a department or division of such subsidiary;

1-3 Federal Securities Exchange Act of 1934 § 3.06

(iii) the Federal Deposit Insurance Corporation, in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System), or a subsidiary or department or division thereof; and

(iv) the Commission in the case of all other municipal securities dealers.

The primary inspection and enforcement authority over municipal securities dealers that are banks is vested directly in the bank regulatory agencies. n90 In addition, bank regulatory agencies may compel bank municipal securities dealers under Section 8 of the Federal Deposit Insurance Act (FDIC) n91 to comply with Sections 15B and 17 of the Exchange Act, and rules of the Commission and the MSRB concerning municipal securities dealers, persons associated with municipal securities dealers, and transactions in municipal securities. n92 In addition, any violations of the provisions specified in Section 15(b)(4) in the case of municipal securities dealers under Section 15B(c)(2) and in the case of persons associated with municipal securities dealers under Section 15B(c)(4) constitute grounds for issuance of an order under Section 8(b) or 8(c) of the Federal Deposit Insurance Act. The customers of the municipal securities dealer are deemed to be "depositors" within the meaning of Section 8(c) of the FDIC. n93

Although the Commission has no review authority over enforcement actions by bank regulatory agencies as it does over FINRA actions, it has authority to institute an independent action against any municipal securities dealer that is a bank. n94

Prior to the entry of an order of investigation or the commencement of any proceedings against any municipal securities dealer or a person associated with a municipal securities dealer for violation of any provision of Section 15B(c), rules of the MSRB, or rules and regulations of the Commission pertaining to municipal securities dealers, associated persons thereof, or transactions in municipal securities, the Commission or the appropriate federal bank agency must:

- give notice to the other entity of the identity of the municipal securities dealer or person associated with the municipal securities dealer and the nature of and basis for the proposed action; and
- consult with such other entity concerning the effect of the proposed action on the protection of investors and the feasibility and desirability of coordinating the action with any proceeding or proposed proceeding by the other entity against the same municipal securities dealer or associated person. n95

The coordination requirements applicable to the Commission and the federal bank agencies are intended to avoid unnecessary regulatory duplication or undue regulatory burdens. However, the requirement of prior consultation does not in any way impair or limit the power of the Commission to investigate or commence proceedings against any municipal securities dealer or person associated with any municipal securities dealer. n96

Examinations as to professional qualifications and standards under Section 15B are administered by:

- a registered securities association, in the case of municipal securities brokers and municipal securities dealers that are members of the FINRA; and
- the appropriate federal bank agency for any municipal securities broker or municipal securities dealer, in the case of all other municipal securities brokers and municipal securities dealers. n97

To foster coordinated enforcement and assure an efficient and uniform regulatory structure, the agencies that inspect and enforce compliance by municipal securities dealers, including the FINRA, the Commission and the federal bank regulatory agencies, are required to exchange examination and inspection reports and related data. n98 In addition, the Commission must, upon request, furnish to the MSRB copies of examination reports made or received by the

Commission. n99

[5] Continuing Disclosure and Political Contributions

In the early 1990's, a series of events contributed to significant changes in the regulation of brokers and dealers in the municipal securities business. In 1989, in response to what was deemed to be delay in the dissemination of information in connection with primary municipal offerings, the SEC adopted Rule 15c2-12 n100 regarding underwriter obligations for official statements. The SEC continued to review municipal market disclosure and, in 1993, released its *Staff Report on the Municipal Securities Market*, regarding the need for improved disclosure practices in the municipal market. The Staff Report served as the basis for the SEC's decision to amend Rule 15c2-12 in significant respects, effective in 1995. n101

At the same time, through news items, SEC investigations and some questionable municipal securities offerings, the "pay for play" abuses in the municipal market became the subject of public scrutiny. As a result the MSRB adopted Rule G-37, subsequently approved by the SEC, n102 relating to the linkage between political contributions and municipal securities business. In late 1993 and 1994 other initiatives by the MSRB served to heighten the regulatory climate for the municipal securities industry. n103

In addition, the SEC created a special municipal securities group within its enforcement division and initiated extensive enforcement activity beginning in 1995 and continuing, directed specifically at alleged fraudulent conduct in the relationships between municipal issuers and the professionals underwriters, financial advisers, investment providers, bond counsel who advise them.

[a] Continuing Disclosure under Rule 15c2-12.

Issuers and other obligated persons are subject to the SEC's continuing disclosure rules for offerings of municipal securities in a principal amount of \$1 million or more that are sold on or after July 3, 1995, unless an exemption applies. n104 The amendments to SEC Rule 15c2-12 requiring continuing disclosure are directed at underwriters for jurisdictional reasons, but the burden of compliance will be on state and local government issuers and other obligated persons.

Rule 15c2-12, after the effective date, prohibits broker-dealers who participate in primary market offerings of municipal securities (participating underwriters) from acting as underwriters of municipal securities, in a principal amount of \$1 million or more, unless the participating underwriter has reasonably determined that the issuer of the municipal securities or an obligated person has undertaken to provide the marketplace with the required ongoing information. The exemptions, in addition to the \$1 million threshold, are described below.

There are five documents or types of documents that must include language addressing the requirements of the 1994 amendments to Rule 15c2-12:

- the preliminary and final official statements;
- the bond purchase agreement, underwriting agreement or notice of sale;
- the trust indenture, bond resolution or bond ordinance;
- the disclosure agreement;
- the annual report or notice of a material event; and the SEC 2000 Interpretive Release.

[i] Preliminary and Final Official Statements.

The 1994 amendments to Rule 15c2-12 prohibit participating underwriters from "purchasing or selling" municipal securities subject to the rule unless there is a written agreement or contract obligating issuers or other obligated persons to provide the required continuing disclosure. The SEC uses the words "purchasing or selling" to mean that the written agreement or contract must be executed at the time of closing. n105

Participating underwriters are also required by Rule 15c2-12 to obtain and review an official statement that an issuer deems final prior to "bidding for" or "offering" municipal securities subject to the rule. The SEC uses these terms to refer to the date bids are submitted in an advertised sale and the date the securities are "offered" through the mailing of a preliminary official statement in a negotiated sale. n106 The SEC has further stated that it expects participating underwriters to review the official statement "with a view to ascertaining that it contains information satisfying the definition of a final official statement in Rule 15c2-12." n107

The 1994 amendments to Rule 15c2-12 contain a new definition of a final official statement that has substantive requirements related to continuing disclosure. A final official statement is defined as a document that includes a description of the contractual undertakings for continuing disclosure required of issuers and other obligated persons. However, an official statement deemed final must be reviewed by the participating underwriter prior to the date of submitting bids in an advertised sale or distributing a preliminary official statement in a negotiated sale if the preliminary official statement is part of an offering. Since the "deemed final" official statement must contain all the information in a final official statement other than pricing information, the preliminary official statement will generally be required to include a description of the contractual undertakings for continuing disclosure.

The underwriter must determine what information will be subject to annual continuing disclosure. It must first identify the obligated persons and then analyze what information *about those persons* is financial information and operating data. n108 There may be information in an official statement that is financial or operational, but if it does not relate to the finances or operations of an obligated person it is not subject to the continuing disclosure rules.

[A] Obligated Persons. An obligated person is defined by two tests. First, an obligated person is a person committed by contract or other arrangement to support payment of all or a part of the debt service obligation on the municipal securities. The second test limits ongoing disclosure to those persons for which the issuer and underwriters determine it is necessary to provide financial information or operating data under the antifraud standards applicable to the final official statement. If there is no information in the official statement about a person (unless the financing is for an undetermined pool for which a special rule applies), no updating is required.

[B] Financial Information. The SEC has limited the continuing disclosure requirement to "annual financial information," a term defined as "financial information or operating data." The term "financial information" is described in the Release as the type of information that is provided in the financial statements of a corporation subject to generally accepted accounting principles. Nonetheless, the Release recognizes that many governments do not report their financial information in the form of a corporate balance sheet, income statement or changes in fund balances. In view of the comments received by the SEC in proposing continuing disclosure, the 1994 amendments do not adopt the earlier draft that would mandate audited financial statements on an annual basis with respect to each issuer or obligated person. Instead, the 1994 amendments continue to require annual financial information, which may be unaudited, and may, where appropriate and consistent with the presentation in the final official statement, be other than full financial statements.

[C] Operating Data. The operating data required to be provided annually, like the financial information, is the operating data that is set forth in the official statement.

[ii] The Bond Purchase Agreement, Underwriting Agreement or Notice of Sale. The 1994 Amendments to Rule 15c2-12 do not allow a participating underwriter to close a financing unless the required contractual undertakings

have been executed. As described above, the participating underwriter is also required to review, as part of its due diligence, the summary of the contractual undertakings in an official statement deemed final (presumably the preliminary official statement) prior to bidding in an advertised sale or offering in a negotiated sale.

The third obligation for participating underwriters is that at the time of sale they must be assured that the contractual undertakings will be executed at or before closing. The 1994 amendments require the participating underwriter to determine, prior to the sale date, that the issuer or one or more obligated persons will undertake in a written contract for the benefit of the holders of the securities to provide the following four categories of continuing disclosure:

- annual financial information updating the quantitative financial information and operating data set forth in the final official statement related to each obligated person;
- audited financial statements for each obligated person, when and if available;
- in a timely manner, the occurrence of any one or more of eleven specified events, if material; and
- in a timely manner, notice of the failure of any person making an undertaking to provide the required annual financial information. This requirement is described in the Release as being satisfied by a covenant in the bond purchase agreement or underwriting agreement or notice of sale signed by the persons who will be making the contractual undertakings that the required continuing disclosure will be made.

For a participating underwriter there are three key dates for purposes of rule compliance. Prior to bidding on an advertised sale or offering municipal securities by a preliminary official statement in a negotiated sale, the participating underwriter must review a deemed final (usually the preliminary) official statement to determine that there is an adequate description of the continuing disclosure obligations. The participating underwriter must assure itself that if the issuer and other obligated persons fulfill the undertakings described, the requirements of Rule 15c2-12 will be met. This may usefully be viewed as a specific due diligence procedure dictated by the SEC.

On the date an award is made in an advertised sale, or the sale date in a negotiated sale, the participating underwriter should be the beneficiary of contractual obligations evidencing that the contractual undertakings necessary to satisfy the continuing disclosure obligations of the issuer and other obligated persons will be executed at or prior to the closing. The covenant to the participating underwriter should be worded so that it is clear the participating underwriter can refuse to close if the continuing disclosure undertakings are not executed.

Finally, on the closing date, the participating underwriter must be satisfied that contractual undertakings have been executed sufficient for compliance with Rule 15c2-12.

[iii] The Trust Indenture, Bond Resolution and Bond Ordinance. The 1994 amendments to Rule 15c2-12 require the contractual undertakings for continuing disclosure to be in a written agreement or contract for the benefit of the holders of the municipal securities being offered. The necessary provision in the trust indenture, bond resolution or bond ordinance should be a simple agreement that the issuer (and the trustee) will agree to comply with the continuing disclosure agreement, which can be accomplished by incorporating the continuing disclosure agreement by reference into the trust indenture, bond resolution or bond ordinance.

[iv] The Continuing Disclosure Agreement. The continuing disclosure agreement is at the heart of the system of documentation necessary to implement the amendments to Rule 15c2-12. It is the document that will determine whether the participating underwriter is able to close the financing.

The continuing disclosure agreement will list the items from the official statement that will be updated and identify the

issuer or an obligated person as responsible for the item in an annual report. The continuing disclosure agreement creates a set of instructions for "line item" annual reporting similar to the line item instructions of the SEC for reporting companies subject to the reporting system of the 1934 Act. Unlike the corporate reporting system that has the same line item reporting requirements for all 10-Q and 10-K (quarterly and annual) corporate reports, the system under Rule 15c2-12 provides for different line item requirements for each financing as determined by the official statement. The financial information and operating data about the issuer or an obligated person, which is reflected in the continuing disclosure agreement as items for annual updating, creates, in effect, a line item regulatory system for each financing. The theory of Rule 15c2-12 is that public finance disclosure varies enormously and it would be unworkable for the SEC to impose the same line item disclosure requirements for each financing. Therefore, what is determined to be material in the official statement by those drafting the official statement provides the line items for continuing disclosure.

The 1994 amendments to Rule 15c2-12 also require that the continuing disclosure agreement specify, in reasonable detail, the accounting principles pursuant to which financial statements will be prepared, and whether financial statements will be audited. If audited financial statements are not submitted as part of the annual financial information, then when and if available, audited financial statements must be submitted by each obligated person subject to the annual reporting requirements.

The continuing disclosure agreement must specify the date by which the annual financial information for the preceding fiscal year will be provided identifying the repositories to which it will be provided. As a practical matter, issuers and obligated persons who have their financial statements audited each year will select a date after the anticipated receipt of the audit report for the submission of the Rule 15c2-12 annual report.

In addition to the annual disclosure of quantitative financial information and operating data, the 1994 amendments require an undertaking to disclose, "in a timely manner," the occurrence of any of eleven specific events. These events are required to be disclosed when they occur to prevent trading in the secondary market based on lack of information about events most likely to affect prices. This requirement should not be misconstrued by issuers, underwriters and their lawyers as requiring the timely disclosure of all material information. General securities law concepts do not require the disclosure of material information unless there is a duty to disclose. The 1994 amendments create a duty to disclose only if one or more of the eleven specifically enumerated events occur, n109 and, except in limited circumstances in which the parties decide to add to the list an item that would be particularly important in a financing, the continuing disclosure agreement should not be drafted to expand the disclosure responsibility beyond what is required.

[v] The Annual Report or Notice of Material Events. The formatting of the annual report is not specified in Rule 15c2-12. Some guidance can be gleaned from the format of the annual 10-K in the corporate reporting system. The cover should identify the person submitting the report and enough information derived from the cover of the final official statement to clearly identify the financing being covered by the annual report. It must be remembered that the annual report relates to issues of securities, not the issuers of securities. Some issuers, however, may have numerous financings with clearly identical categories of financial information and operating data. These issuers may consider a single annual report for several issues. The cover to the annual report should reference each issue being included, and the person preparing the annual report should still refer to each continuing disclosure agreement to be certain there is compliance with each.

The annual report and the notice of material events are statements that, under federal securities law, are expected to reach investors and the trading markets. As such, they are subject to the standard of care required by the antifraud rules of federal securities law. This has been expressed quite bluntly by the SEC with respect to other municipal statements as follows:

A municipal issuer may not be subject to the mandated continuous reporting requirements of the Exchange Act, but when it releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions. The fact that

they are not published for purposes of informing the securities markets does not alter the mandate that they not violate antifraud proscriptions. Those statements are a principal source of significant, current, information about the issuer of the security, and thus reasonably can be expected to reach investors and the trading market. n110

Rule 15c2-12 also requires the annual report and audited financial statements, if separately filed, to be submitted to each nationally recognized municipal securities information repository n111 and to the appropriate state information depository, if any.

In contrast, notices of material events, as well as notices of a failure by an issuer or other obligated person to provide annual reports are to be filed either with each repository or the MSRB, and the appropriate state information depository. These notices may be filed with the MSRB rather than the repositories if it is considered useful to assure prompt and wide disclosure.

[vi] Exemptions. The continuing disclosure requirements, like the information dissemination requirements, do not apply to a primary offering of municipal securities in authorized denominations of \$100,000 or more, in any of the following three circumstances:

- The municipal securities are sold to no more than 35 persons each of whom the participating underwriter reasonably believes (i) has such knowledge and experience in financial and business matters to evaluate the merits and risks of the investment and (ii) is not purchasing for more than one account or with a view to distributing.
- The municipal securities have a maturity of nine months or less.
- At the option of the holder, the municipal securities may be tendered to an issuer at least as frequently as every nine months.

There is also a separate small issuer exemption to the continuing disclosure requirements. The requirements do not apply if at the date of closing:

- no obligated person will be an obligated person with respect to more than \$10,000,000 in aggregate amount of outstanding municipal securities, including the offered securities and excluding municipal securities that were offered in a transaction exempt as described immediately above;
- an issuer of municipal securities or obligated person has undertaken, either individually or in combination with other issuers of municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such municipal securities, to provide: (1) upon request to any person or at least annually to the appropriate state information depository, if any, financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official statement, as specified in the undertaking, which financial information and operating data shall include, at a minimum, that financial information and operating data which is customarily prepared by such obligated person and is publicly available; and (2) in a timely manner, to each nationally recognized municipal securities information repository or to the MSRB, and to the appropriate state information depository, if any, notice of the eleven events described above; and
- the final official statement identifies by name, address, and telephone number the persons from which the foregoing information, data, and notices can be obtained.

It will be noted that this exemption requires more specificity in the final official statement than does the general rule

regarding the source of information.

[vii] The SEC Interpretive Release. In its May 4, 2000 Interpretative Release Use of Electronic Media, n112 the SEC paid some attention to municipal disclosure issues. In effect, municipal securities underwriters may rely on issuers to identify which documents placed on or connected to the issuers Web site can be considered preliminary or official statements. The use of hyperlinks, however, creates an automatic situation: hyperlinks in an official statement which electronically link to documents outside the site are part of the official statement.

[b] MSRB Rule G-37: Prohibiting "Pay for Play." To curb the abuses created by the making of political contributions in return for municipal securities business ("pay for play"), the MSRB adopted Rule G-37 in 1994. n113 Rule G-37 prohibits a broker, dealer or municipal securities dealer (an "underwriting firm") from engaging in municipal securities business with an issuer within two years after any contribution to an official of the issuer made by such underwriting firm, any municipal finance professional associated with such underwriting firm, or any political action committee controlled by the underwriting firm. n114

Municipal securities business is defined to include:

- the purchase of a primary offering of municipal securities from the issuer in a negotiated underwriting;
- the offer or sale of a primary offering of municipal securities in a private placement;
- the provision of financial advisory services with respect to a primary offering of municipal securities; or
- the provision of remarketing agent services (on other than competitive bid basis) with respect to a primary offering of municipal securities. n115

The inclusion of financial advisory and consultant services in the definition of municipal securities business emphasizes that the rule includes firms that are in the advisory and consulting business even if the firm does not underwrite municipal securities. Nevertheless, it should also be recognized that the prohibition of the rule extends to brokers, dealers and municipal securities dealers, the entities within the jurisdictional rulemaking power of the MSRB. If a consulting firm is not a broker, dealer or municipal securities dealer, such as feasibility firms, engineering firms and accounting firms that are not broker-dealers, the rule is not applicable.

Rule G-37 does not prohibit contributions made by municipal finance professionals to officials of the issuer for whom such municipal finance professionals were entitled to vote *and* were not in excess of \$250 in the aggregate to each official of the issuer per election. n116

The rule applies to those firms which are brokers, dealers and municipal securities dealers. The term "broker, dealer and municipal securities dealer" *does not* include its "associated persons." n117 As defined in the Securities Exchange Act of 1934, an associated person of a broker, dealer and municipal securities dealer would include any corporate entity that directly or indirectly controls, is controlled by, or is under common control with such broker or dealer. Therefore, provided that such entities do not intend to engage in the municipal securities business, parent corporations, subsidiaries and affiliated corporations of a broker, dealer or municipal securities dealer, are not affected by the prohibition on campaign contributions. In a Notice of Interpretation issued by the MSRB in mid-1998, the MSRB answered a question regarding the application of Rule G-37 in a merger situation. n118 The specific question posed involved a person who worked for a dealer in a non-municipal finance position and made a political contribution. The dealer was then acquired and the contributor assumed a municipal finance position in the new company. The MSRB stated that under the letter of G-37, the new company would be subject to the restrictions imposed by the rule. However, the MSRB went on to state

that the regulatory agency (*e.g.* FINRA) overseeing the broker-dealer should seriously consider granting an exemption to the rule in such circumstances.

Rule G-37 applies to the following four categories of individuals:

(1) Any person associated with an underwriting firm who is primarily engaged in "municipal securities representative activities." A municipal securities representative's activities must include one or more of the following:

- (a) underwriting, trading or sales of municipal securities;
- (b) financial advisory or consultant services for issuers in connection with the issuance of municipal securities;
- (c) research or investment advice with respect to municipal securities; or
- (d) any other activities which involve communication, directly or indirectly, with public investors in municipal securities.

A municipal securities representative does not include persons whose responsibilities involve the management, direction or supervision of municipal finance activities or the supervision of sales to and purchases from customers of municipal securities. In addition, persons whose functions are solely clerical or ministerial are not municipal securities representatives.

(2) Any person associated with an underwriting firm who solicits municipal securities business.

(3) Any direct supervisor of the persons identified in (1) and (2) up through and including, in the case of a broker, dealer or municipal securities dealer other than a bank dealer, the Chief Executive Officer or similarly situated official, and in the case of a bank dealer, the officer or officers designated by the board of directors of the bank as responsible for the day-to-day conduct of the bank's municipal securities dealer activities.

(4) Any member of the broker, dealer or municipal securities dealer (or, in the case of a bank dealer, the separately identifiable department or division of the bank) executive or management committee or similarly situated officials, if any. n119

Officials covered by the rule include an incumbent, a candidate, or a successful candidate for elective office, where the office of such person is directly or indirectly responsible for, or can influence the outcome of, the hiring of an underwriting firm for municipal securities business.

Rule G-37 clearly attempts to cover not only cash contributions to political campaigns, but loans and in-kind contributions as well. Thus, the term "contribution" is defined in the rule to mean any gift, subscription, loan, advance, or deposit of money or *anything of value*. n120 The contribution must be made, however, for any of the following purposes: influencing any election for federal, state or local office; the payment of debt incurred in connection with any such election; or transition or inaugural expenses incurred by the successful candidate for state or local office.

Contributions are covered when directed not only to the official, but also to any election committee for such person. Likewise, contributions are covered when directed not only to the office that the official then holds, but also to any other office the official may then be seeking, whether federal or state.

The rule does not limit volunteer work for a candidate, and if the candidate is a person for whom the municipal finance professional is entitled to vote, expenditures can be made that might constitute contributions if they are within the \$250 limitation. However, if the municipal finance professional were to seek reimbursement from the underwriting firm for such expenditures, the underwriting firm would be in violation of the contribution rule since there is no \$250 exception available to the underwriting firm.

Moreover, no underwriting firm nor any municipal finance professional may solicit any person or any political action committee to make any contribution, or shall coordinate any contributions, to an official of an issuer with which the underwriting firm is engaging or is seeking to engage in municipal securities business. n121 Violation of the solicitation or bundling provisions results in an immediate violation of the rule with the likelihood that the appropriate regulatory authority will implement statutory enforcement procedures. Unlike the contribution rule, the solicitation and bundling rule has no *de minimis* exception for municipal finance professionals acting on behalf of officials for whom they are entitled to vote.

In 1995, the District of Columbia Circuit Court of Appeals dismissed a dealer's constitutional challenge to the G-37 provisions. n122 Since then the MSRB and SEC have taken an active enforcement posture with respect to Rule G-37. Municipal securities dealers have been fined and barred from municipal business for extended periods of time in certain geographical areas for violations of Rule G-37. n123 In late 1997, the SEC refused to grant Morgan Stanley a Rule G-37 exemption that had been denied by the FINRA. Specifically, the SEC determined it did not have jurisdiction to review an exemption denial. While Section 19(d) states that the SEC can review any final disciplinary sanctions, the SEC held that the Rule 37 disqualification occurred automatically. Consequently, neither the triggering of Rule 37, nor the exemption denial, could be categorized as a disciplinary sanction subject to review. n124

On December 18, 1999, the MSRB filed with the Commission certain proposed amendments related to Rules G-37 and G-38. The Commission approved the amendments on February 8, 1999 which did the following: 1) exempted brokers, dealers, and municipal securities dealers who were not engaged in the municipal securities business for a period of at least two years from the G-37 disclosure requirements and related G-38 record-keeping requirements; 2) required those invoking such an exemption to disclose certain political contributions and payments in the preceding two-year period; 3) codified the submission exemption for Forms G-37/G-38 which had previously been recognized for dealers with no information to report in a calendar quarter; and 4) made technical and clarifying amendments to Rules G-37 and G-38.

[6] The Municipal Securities Rulemaking Board

[a] Creation and Composition. The Securities Acts Amendments of 1975 authorized the Commission to establish a new, but limited, self-regulatory organization, the MSRB, within 120 days after the enactment of the 1975 Amendments. n125 Pursuant to that authority, the Commission appointed the initial 15 members of the MSRB for two-year terms, n126 ending on September 4, 1977. n127 The MSRB's members include five public representatives (not associated with any broker, dealer, or municipal securities dealer), five broker-dealer representatives, and five bank representatives. n128 Since 1979, the term of one-third of the 15 members expires each year. A Nominating Committee, including the five members whose terms are due to expire, nominates three candidates for each of the five impending vacancies. The MSRB then selects one of the three names for each vacancy. Additional candidates may be nominated by vote of 20% of the MSRB. Vacancies are filled by the MSRB, which may also remove members by a two-thirds vote (including at least one vote from each of the public, broker-dealer and bank categories) for violation of the Act or rules or other misconduct.

The operation and administration of the MSRB are the responsibility of the MSRB. n129 No member, other than a public representative elected to fill a vacancy, who has served for less than 18 months, may succeed himself in office, and no broker-dealer or bank representative may be succeeded in office by any person associated with the municipal securities broker or municipal securities dealer with whom the member was associated at the end of his term of office. n130

The MSRB is not a membership organization like an exchange or the FINRA, nor does it have any inspection or enforcement powers. Inspection and enforcement of activities of all persons engaged in the municipal securities business is the responsibility of the FINRA, the federal bank regulatory agencies, and the Commission. n131

[b] Minimum Requirements for MSRB Rules. The MSRB has primary rulemaking authority (subject to Commission oversight) over transactions in municipal securities by brokers, dealers, and municipal securities dealers. Specifically, the MSRB may adopt rules, limited only by the requirement that they "effect the purposes of [the Exchange Act] with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers." n132 Such rules, at a minimum, must contain provisions including:

- standards of operational capability, training, experience and competence; n133
- fair procedures for the nomination and election of members of the MSRB and fair representation of municipal securities dealers and brokers; n134
- prevention of fraud and manipulation and the promotion of just and equitable principles of trade; n135
- fostering cooperation with persons who regulate, clear, settle or facilitate securities transactions or who process information regarding transactions; n136
- removing impediments to, and perfecting, a free and open market and generally protecting investors; n137
- periodic examination of municipal securities dealers and brokers in a manner designed to prevent unnecessary duplication or regulatory burden; n138
- the form and content of quotations concerning municipal securities distributed or published by municipal securities brokers or dealers or persons associated with such brokers or dealers; n139
- the persons to whom quotations are to be supplied; n140
- the records to be kept by municipal securities dealers and brokers; n141
- definition of the term "separately identifiable department or division" as used in Section 3(a)(30) in connection with banks; n142
- operation and administration of the MSRB; n143
- fees payable by municipal securities dealers and brokers to defray the costs of administering and operating the MSRB; n144 and
- the terms and conditions under which a municipal securities dealer may sell, or is prohibited from selling, part of a new issue of municipal securities to a "municipal securities investment portfolio" during the underwriting period. n145

The rules of the MSRB may not permit: unfair discrimination between customers, issuers, municipal securities dealers and brokers; n146 the fixing of minimum profits or the imposition of schedules fixing commissions or other fees; n147 the regulation of matters not related, the purposes of the Act or the Rules thereunder, or the administration of the

MSRB; n148 the arbitration of claims; n149 and the imposition of any burden on competition not necessary or appropriate to further the Act's purposes. n150 A broker, dealer, or municipal securities dealer cannot use the mails or interstate commerce to effect any transactions in any municipal security in contravention of MSRB Rules. n151

The Commission and the MSRB cannot require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of municipal securities from the issuer, to file with the Commission or the MSRB any application, report, or document concerning the issuance, sale, or distribution of the securities. n152 Additionally, the MSRB may not require an issuer, directly or indirectly through a municipal securities broker or municipal securities dealer, to furnish to the MSRB or to a purchaser or prospective purchaser of municipal securities from the issuer any application, report, document, or information concerning the issuer. n153 However, the MSRB may require municipal securities brokers and municipal securities dealers, but not the issuer, to furnish to the MSRB or to purchasers or prospective purchasers of municipal securities, applications, reports, documents, and information concerning the issuer thereof that is generally available from a source other than the issuer. n154

[c] Commission Authority over MSRB Members and Employees. Section 15B(c)(8) empowers the Commission to remove from office or censure any MSRB member or employee if, after notice and opportunity for hearing, the Commission finds that the member or employee has willfully violated any provision of Section 15B, the rules and regulations thereunder, or the rules of the MSRB, n155 or abused his or her authority. n156

[d] Compliance Examinations and Availability of Examination Reports. The Commission, the FINRA, and the appropriate regulatory agencies are authorized to conduct periodic examinations of municipal securities brokers and dealers to determine compliance with the Exchange Act, the rules and regulations thereunder, and the MSRB Rules. n157 MSRB Rule G-16 provides that municipal securities brokers and municipal securities dealers must be examined in accordance with Section 15B(c)(7) at least once every two years.

Rule 15Bc7-1, adopted pursuant to Section 15B(c)(7), permits the establishment of a system for making available to the MSRB copies of reports of compliance examinations of municipal securities brokers and municipal securities dealers made by the Commission or furnished to the Commission by other appropriate regulatory agencies pursuant to Section 17(c)(3) n158 or the FINRA pursuant to Section 15B(c)(7)(B).

The information made available to the MSRB must not identify the municipal securities broker, municipal securities dealer, or associated person that is the subject of the examination report. n159 The MSRB is required to establish, by rule, procedures to maintain the confidentiality of all examination information furnished under the rule. n160

Under Rule 15Bc7-1, the Commission must, upon written request, furnish to the MSRB copies of examination reports of municipal securities brokers and municipal securities dealers made by the Commission or received from a federal bank agency under Section 17(c)(3) or from the FINRA under Section 15B(c)(7)(B). n161

Within 60 days of every six month period ending May 31 and November 30, each appropriate regulatory agency and the FINRA must submit two copies of a form containing composite statistical and analytical information to the Commission summarizing the compliance examinations made during the preceding six month period. n162 The Commission is obligated to supply one copy of the form to the MSRB. n163 The purpose behind this rule is to provide a mechanism for a continuous source of current information to the MSRB so that it could determine the need for additional rulemaking. n164

The information supplied to the MSRB on the form must include the following:

- the report period; n165
- the number of examinations that formed the basis of the report and, of these examinations, the

number that were routine, special, and financial/operational; n166

- with respect to a bank agency, the number of examinations that formed the basis of the report of bank dealers and the number of examinations of separately identifiable departments or divisions of banks effecting municipal securities transactions; n167

- indications of the violations of each MSRB rule found in examinations that formed the basis for the report; n168

- any comments concerning any questionable practices relating to municipal securities activities, whether or not covered by provisions of the Exchange Act and the rules and regulations thereunder, including the rules of the MSRB; n169

- descriptions of any significant or recurring customer complaints relating to municipal securities activities they received during the report period or by municipal securities dealers during the 12 month period preceding the examination; n170

- description of any novel issues or interpretations arising under the rules of the MSRB; n171

- description of any changes to existing rules of the MSRB or additional rules that would improve the regulatory scheme for municipal securities professionals or assist in the enforcement of the MSRB's rules. n172

Copies of any examination reports and separate forms furnished to the Commission by each appropriate regulatory agency and the FINRA must be maintained in a nonpublic file. n173

[7] Yield Burning

In 1998, the SEC increased its efforts to eliminate the illegal practice of "yield burning." Yield burning occurs when an open-market dealer of Treasury securities sells the securities to municipal bond issuers at above-market prices. The dealer then keeps the difference between the actual price and the market-price as profit according to the SEC. *Rule 10b-5* of the Federal Securities Exchange Act of 1934 prohibits securities fraud. In selling securities at above-market prices, the dealer violates *Rule 10b-5*. Under the *Internal Revenue Code 1.148-5*, if the yield of the Treasury securities at market price exceeds the yield of the bonds, the municipal bond issuers must refund the excess profit to the federal government. Consequently, dealers have engaged in yield burning so that they may keep the profit. While the bond issuers get the same net yield on the securities regardless of who retains the profit, if the securities are excessively marked up, the IRS may determine that the bonds for which the securities were purchased do not qualify for tax-exempt status.

During the first half of 1998, the SEC instituted three major actions against dealers accused of yield burning. In the first matter, filed in federal court in Arizona in January 1998, the SEC charged Dain Rauscher Inc., Rauscher Pierce Refsnes, Inc. and certain officers the companies with making a "secret" and unreasonable profit in connection with the sale of Treasury securities to the State of Arizona. Among the central issues in this case are how a fair mark-up is determined and what level of scienter with respect to the alleged unreasonableness of the mark-up is required in order to assign liability to a dealer. An initial motion to dismiss was denied in August 1998. The case was settled in April 2000. Rauscher paid \$13 million in disgorgement, a \$100,000 fine and agreed to cease and desist from future yield burning practices. n174

In April 1998, the SEC instituted proceedings against Meridian Securities and its successor, CoreStates Capital Markets for adding excessive mark-ups to Treasury securities being sold to municipalities in Pennsylvania and West Virginia.

The case was settled for \$3.8 million shortly after the proceedings had begun. In June 1998, the City of New Orleans initiated a yield burning complaint against Smith Barney, Inc. and BT Alex Brown, Inc. Notably, unlike the Rauscher and CoreStates complaints, this case was initiated by the municipality and not the SEC. New Orleans opened its investigation of the transactions after the SEC subpoenaed records from the city and the IRS determined that Smith Barney and Alex Brown had excessively marked up the securities. Other enforcement actions were settled in 1999, including actions against BT Alex Brown, Lazard Freres JMS Associates and individual investment bankers. On April 6, 2000 the SEC also announced global settlements with seventeen firms involving payments of nearly \$150,000,000. n175 Another global settlement with eight municipal firms occurred in August, 2000, leaving only a few remaining actions.

FOOTNOTES:

(n1)Footnote 1. S. Rep. No. 75, 94th Cong., 1st Sess. 45 (1975), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I (Matthew Bender).

(n2)Footnote 2. The Senate Banking, Housing and Urban Affairs Committee summarized the need for legislation in its legislative report:

The Committee feels that the lack of federal regulation governing the qualifications and conduct of municipal securities professionals, and the trading market for municipal securities, has encouraged the proliferation of fraudulent trading practices resulting in substantial losses to public investors ... Fraud actions against municipal securities professionals during the last four years reveal that unwary investors are often exposed to sharp and illegal practices. During that period the Commission brought seven injunctive actions, involving over 72 defendants, to halt fraudulent municipal securities trading practices. Perusal of the commission's complaints in these actions (summarized in Commission Litigation Release Nos. 5583 and 5584 (Oct. 26, 1972), 6005 (Aug. 2, 1973), 6032 (Aug. 22, 1973), 6451 (July 24, 1974), 6575 (Nov. 6, 1974), and 6733 (Feb. 13, 1975)) reveals a disturbing pattern of professional misconduct by a significant number of broker-dealers. This pattern is characterized by unconscionable markups, churning of customers' accounts, misrepresentations concerning the nature and value of municipal securities, disregard of suitability standards, and scandalous high-pressure sales techniques. The selling practices of these firms involved all the characteristics of the classic "boiler room" operation. These practices are intended to induce hasty investment decisions with respect to securities unfamiliar to potential customers. Furthermore, it appears that certain firms exerted extraordinary pressures on their salesmen to increase sales without regard to the welfare of the firm's customers. In some instances, bonds have been promoted as general obligations of the issuer whereas, in fact, they have been revenue bonds, sometimes in default.

S. Rep. No. 75, 94th Cong., 1st Sess. 38, 43 (1975).

(n3)Footnote 3. *See* S. Rep. No. 75, 94th Cong., 1st Sess. 44-45 (1975). A unique quality of municipal securities is their tax-free nature; interest on municipal securities is not subject to federal income tax. Unlike corporate securities that are relatively homogeneous within major categories (*e.g.*, common stocks, preferred stocks, debentures, or warrants), municipal bonds constitute a highly individualized type of securities. S. Rep. No. 75, 94th Cong., 1st Sess. 38 (1975).

The term "municipal bonds" embraces a multi-faceted, complex array of state and local public debt, including securities that are general obligations of the issuer, backed by the "full faith and credit" of the issuing government to the extent of its powers of taxation; revenue bonds, payment of which is secured only by funds generated by use of the facility financed by the proceeds of the bond issue; or special assessment and industrial revenue bonds. *Id.*

(n4)Footnote 4. *Id.*

(n5)Footnote 5. Exch. Act Rel. No. 34-33,741, 7 *Fed. Sec. L. Rep. (CCH)* P 72,442 (March 9, 1994); Exch. Act Rel. No. 34-33,742, [1993-1994 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* P 85,324 (March 9, 1994); Exch. Act Rel. No. 34-33,743, [1993-1994 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* P 85,326 (March 9, 1994). Selected recent SEC releases are reprinted in the Securities Primary Law Sourcebook, Volume E, Section V (Matthew Bender).

(n6)Footnote 6. Exch. Act Rel. No. 34-33,742, [1993-1994 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* P 85,324. Rule 15c2-12 is reprinted in the Securities Primary Law Sourcebook, Volume B, Section G (Matthew Bender).

(n7)Footnote 7. *See* Exch. Act Rel. No. 34-26,985, 4 *Fed. Sec. L. Rep. (CCH)* P 25,098, (June 28, 1989).

(n8)Footnote 8. *See* § 3.06[5][a] *infra*.

(n9)Footnote 9. *See* § 3.06[5][b] *infra*.

(n10)Footnote 10. Section 3(a)(30) of the Securities Exchange Act of 1934, reprinted in the Securities Primary Law Sourcebook, Volume B, Section F (Matthew Bender).

(n11)Footnote 11. Section 15B(b)(2)(H) of the Securities Exchange Act of 1934 authorizes the MSRB to define the phrase "separately identifiable department or division [of a bank]" as the phrase is used in Section 3(a)(30) of the Exchange Act, in accordance with specified and appropriate standards to assure that the bank is not deemed to be transacting municipal securities business through a separately identifiable department or division unless the department or division is organized and administered to permit independent examination and enforcement of the applicable provisions of the Exchange Act, the rules and regulations thereunder, and the rules of the MSRB.

(n12)Footnote 12. Section 3(a)(30)(B). *See In re* United Trust Company, [1979 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* P 81,995 (January 9, 1979) (registration as a municipal securities dealer is required if a bank purchases municipal securities for its own account and then sells them to customers); *Community Bank*, [1979 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* P 82,035 (1979).

(n13)Footnote 13. Section 3(a)(30)(B).

(n14)Footnote 14. MSRB Rule G-1(a)(1), (2), MSRB Manual (CCH) P 3501.

(n15)Footnote 15. MSRB Rule G-1(b)(1)-(6), MSRB Manual (CCH) P 3501.

(n16)Footnote 16. Rule G-1(c), MSRB Manual (CCH) P 3501.

(n17)Footnote 17. Rule G-1(d), MSRB Manual (CCH) P 3501.

(n18)Footnote 18. *Id.*

(n19)Footnote 19. Section 3(a)(30)(A).

(n20)Footnote 20. Section 3(a)(30)(B).

(n21)Footnote 21. Section 3(a)(31).

(n22)Footnote 22. Section 3(a)(32). The category "person associated with a municipal securities dealer" in Section 3(a)(32) added by the 1975 Amendments, is subject to the Commission's disciplinary sanctions. S. Rep. No. 75, 94th Cong., 1st Sess. 45 (1975), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I (Matthew Bender).

(n23)Footnote 23. S. Rep. No. 75, 94th Cong., 1st Sess. 38, 39 (1975). As of 1975, approximately four times as

many nonbanks were engaged in municipal securities business as there were banks. *Id. at 39*. Prior to 1960, individuals were the largest identifiable portion of purchasers of municipal securities. Other principal purchasers were commercial banks and fire and casualty companies. Since 1960, commercial banks have replaced individuals as the biggest purchasers of municipal bonds. *Id. at 41*. Between 1960 and 1974, the dollar amount of municipal securities outstanding grew from \$70.8 billion to \$207 billion. Of the total bonds outstanding in 1974, households owned approximately \$62.3 billion while commercial banks owned \$99.8 billion. *Id.*

(n24)Footnote 24. *Id. at 42*.

(n25)Footnote 25. *Id.*

(n26)Footnote 26. *Id. at 42-43 (1975)*. Rules adopted pursuant to Section 15(c)(1) have always applied to municipal securities transactions effected by brokers and dealers (but not by banks or their separately identifiable departments or divisions acting as dealers), since Section 15(c)(1) does not (and did not prior to 1975) expressly exclude transactions in exempted securities, as do Section 15(c)(2), which prohibits brokers and dealers from engaging in fraudulent, deceptive or manipulative acts or practices or making of fictitious quotations, and Section 15(c)(3), which precludes brokers and dealers from acting in violation of Commission rules and regulations regarding financial responsibility and related practices. *See Ch. 6 infra*. The rules under the Securities Exchange Act of 1934 are reprinted in the Primary Law Sourcebook, Volume B, Section G (Matthew Bender).

Prior to 1975, Commission rules under Section 15(c)(1) could not reach the conduct of banks that were municipal securities dealers because they were specifically exempted from the Exchange Act's definitions of broker or dealer. S. Rep. No. 75, 94th Cong., 1st Sess. 43 (1975).

(n27)Footnote 27. *Id.*

(n28)Footnote 28. *Id. at 43*.

(n29)Footnote 29. *Id.*

The selling practices of the municipal securities firms prior to 1975 involved all the characteristics of the classic "boiler room" operation intended to induce hasty investment decisions concerning securities unfamiliar to potential customers. *Id.* Bonds were promoted as general obligations of the issuer when, in fact, they were revenue bonds, sometimes in default. *Id.* In addition, certain municipal securities firms exerted extraordinary pressures on their salespeople to increase sales regardless of the welfare of the firm's customers. *Id.*

(n30)Footnote 30. *Id.*

(n31)Footnote 31. Act of June 4, 1975, P.L. 94-29, 89 Stat. 97.

(n32)Footnote 32. S. Rep. No. 75, 94th Cong., 1st Sess. 43 (1975).

(n33)Footnote 33. Section 3(a)(12) was amended, effective December 1, 1975, to provide, *inter alia*, that municipal securities shall not be deemed to be "exempted securities" for purposes of certain sections of the Act.

(n34)Footnote 34. Brokers and dealers already registered with the Commission because of their general securities business were not required to re-register. S. Rep. No. 75, 94th Cong., 1st Sess. 45 (1975).

(n35)Footnote 35. The result of the 1975 Amendments was to create certain areas in which the MSRB and the Commission have concurrent jurisdiction over municipal securities activities. The MSRB, however, is intended to be the primary medium for regulating the municipal securities industry and the Commission is required to give the MSRB ample opportunity to develop responsible rules for the industry. S. Rep. No. 75, 94th Cong., 1st Sess. 48 (1975).

(n36)Footnote 36. The 1975 Amendments expanded the Commission's rulemaking authority under Sections 15(c)(1) and (2) with respect to municipal securities professionals and transactions in municipal securities. S. Rep. No. 75, 94th Cong., 1st Sess. 50 (1975).

(n37)Footnote 37. Section 17(a), as amended in 1975, subjects the Municipal Securities Rulemaking Board and registered municipal securities dealers to the recordkeeping and reporting requirements already applicable to securities exchanges, members, brokers, dealers, and securities associations. Records of the MSRB and municipal securities dealers are subject to periodic, special, and other examinations by the Commission and, in the case of municipal securities dealers for whom the Commission is not the appropriate regulatory agency, such as banks, by the appropriate federal regulatory agency. Where the Commission is not the appropriate regulatory agency, it must give notice to and consult with the other agency prior to a proposed Commission examination to avoid unnecessary regulatory duplication or undue regulatory burdens. The requirement of prior consultation, however, does not in any way impair the power of the Commission to examine any municipal securities dealer. Section 17(b).

Municipal securities dealers for whom the Commission is not the appropriate regulatory agency must file with the appropriate regulatory agency for such municipal securities dealer applications, notices, proposals, reports, or documents filed with the Commission by reason of being a municipal securities dealer; and file with the Commission similar documents filed with the appropriate regulatory agency by reason of being a municipal securities dealer. Section 17(c)(1).

Section 17(c)(1) requires the Municipal Securities Rulemaking Board to file with the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation (FDIC) (*i.e.*, the "appropriate regulatory agencies" for municipal securities dealers as enumerated in Section 3(a)(34)(A)) copies of every proposed rule change filed with the Commission under Section 19(b) of the Exchange Act.

The Comptroller of the Currency (in the case of national banks or banks operating under the Code of Law for the District of Columbia), the Federal Reserve Board, and the FDIC are the appropriate regulatory agencies for municipal securities dealers that are banks or separately identifiable departments or divisions of banks regulated by those agencies. The Commission is the appropriate regulatory agency for municipal securities brokers and the remaining municipal securities dealers (non-banks). Section 3(a)(34)(A).

The appropriate regulatory agency for a municipal securities dealer must file with the Commission a notice of the commencement of proceedings and a copy of any order entered against the municipal securities dealer. Section 17(c)(2). If the Commission initiates a proceeding against a municipal securities dealer for whom it is not the appropriate regulatory agency, the Commission, in turn, must file the prescribed notice with and transmit a copy of any order entered in connection therewith to the appropriate regulatory agency. *Id.*

The Commission and the appropriate regulatory agency must notify the other of, make a report of, and, upon request, furnish to the other a copy of the report of, any examination conducted by either of the municipal securities dealer and any data received concerning the examination. Section 17(c)(3).

(n38)Footnote 38. Municipal securities are no longer "exempted securities" for this purpose under Section 3(a)(12) of the Exchange Act.

The 1975 Amendments amended Section 15(c)(3) to require the Commission to establish minimum financial responsibility requirements for *all* brokers and dealers not later than September 1, 1975. While subjecting brokers and dealers who effect transactions in municipal securities to Commission financial responsibility regulation, Congress realized that the unique structure of the municipal securities industry may require regulation different from that applicable to other members of the securities industry. In particular, Congress cautioned that "it may not be appropriate to apply the existing net capital rules to firms that are solely brokers in municipal securities, whose only customers are

professional securities dealers and banks. The limited risks in this form of business may justify less stringent rules without danger to the public." S. Rep. No. 75, 94th Cong., 1st Sess. 48 (1975).

(n39)Footnote 39. Banks are not normally brokers or dealers under the Exchange Act.

(n40)Footnote 40. The application of Rule 15c2-4, providing significant protections to issuers and purchasers in "best-efforts" and "all-or-none" offerings, to bank municipal securities dealers was announced in Exch. Act Rel. No. 34-12,468, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,544 (May 20, 1976).

(n41)Footnote 41. *Id.*

(n42)Footnote 42. Exchange Act Section 15B(a)(1). *See In re ONB Securities Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,987 (1979) (non-bank dealer in government securities must register with the Commission under Section 15(a)); *In re Community Bank*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,035 (1979) (submission of joint bids by banks on municipal securities not, in itself, sufficient to require banks to register as municipal securities dealers).

(n43)Footnote 43. S. Rep. No. 75, 94th Cong., 1st Sess. 45 (1975).

In the first year after enactment of the Securities Acts Amendments of 1975, approximately 310 bank municipal securities dealers, 10 other municipal securities dealers conducting an exclusively intrastate business but utilizing the jurisdictional means, and 232 brokers and dealers required to register under Section 15 solely because of their municipal securities activities, registered with the Commission. 42 SEC Ann. Rep. 14 (1976).

(n44)Footnote 44. S. Rep. No. 75, 94th Cong., 1st Sess. 45 (1975).

(n45)Footnote 45. Section 15B(a)(3). Unlike Section 15(a), Section 15B(a) does not exempt from registration municipal securities dealers utilizing the jurisdictional means to conduct an exclusively intrastate business. 42 SEC Ann. Rep. 49 n.66 (1976).

(n46)Footnote 46. *See* S. Rep. No. 75, 94th Cong., 1st Sess. 45 (1975); Exch. Act. Rel. No. 34-11,742, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,312 (Oct 15, 1975).

(n47)Footnote 47. Section 15B(a)(4).

(n48)Footnote 48. Section 15B(a)(2).

(n49)Footnote 49. *Id.* The proceedings to determine whether registration should be denied must include notice of the grounds for denial under consideration and opportunity for hearing. The proceedings must be concluded within 120 days of the date of the filing of the application. At the conclusion of the proceedings, the Commission, by order, must grant or deny the registration. The Commission may extend the time to conclude the proceedings for up to 90 days for good cause and must publish its reasons for doing so, or may extend the proceedings for a longer period if the applicant consents. Section 15B(a)(2)(A), (B).

(n50)Footnote 50. Section 15B(a)(2).

(n51)Footnote 51. The adoption of Rule 15B(a)(2)-1, related Form MSD, and Rule 15B(a)(2)-2 was announced in Exch. Act. Rel. No. 34-11,742 [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,312, (Oct 15, 1975).

(n52)Footnote 52. A proposal that an applicant file with the Commission a statement of financial condition in connection with his or her application for registration was omitted when Rule 15Ba2-1 was adopted. Exch. Act. Rel. No. 34-11,742, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,312 (1975).

(n53)Footnote 53. Exch. Act Rel. No. 34-17,100, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,643 (Aug 28,1980).

(n54)Footnote 54. Rule 15B(a)(2)-1(b).

(n55)Footnote 55. Exch. Act. Rel. No. 34-17,100, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,643 (Aug 28, 1980).

(n56)Footnote 56. General Instruction L(a), Form MSD.

(n57)Footnote 57. General Instruction H, Form MSD. *See* Exch. Act Rel. No. 34-17,100, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,643 (Aug. 28, 1980).

(n58)Footnote 58. Rule 15B(a)(2)-1(c). Section 32(a) prescribes criminal penalties for willful violations of the Exchange Act, including willfully and knowingly making a false or misleading statement of a material fact in a report required to be filed under the Exchange Act or the rules and regulations thereunder.

(n59)Footnote 59. Exch. Act Rel. No. 34-11,742, [1976-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,312 (Oct 15, 1975).

Subsidiaries of banks and of bank holding companies that are dealers in municipal securities meet the definition of a "dealer" under Section 3(a)(5) and are subject to Rules 15b1-1 and 15b1-2. Note that a non-bank municipal securities dealer that registers under Section 15 automatically becomes subject to assessments by the SIPC.

(n60)Footnote 60. Municipal securities brokers must register under Section 12 on Form BD. Form BD, the standard registration form for brokers and dealers is discussed at § 3.03[2][a] *supra*.

(n61)Footnote 61. Rule 15B(a)(2)-2(b) requires each applicant to file with the application for registration the statements listed in paragraphs (a) through (d) of Rule 15b1-2. The statements of financial condition and intrastate dealer status are deemed part of the application for registration. Rule 15Ba2-2(b). Amendments to the application must be made on Form BD. Rule 15Ba2-2(c). Amendments must constitute a report within the meaning of Sections 17 and 32(a) of the Act. Rule 15Ba2-2(d).

Persons associated with non-bank municipal securities dealers are subject to Commission control pursuant to Section 3(a)(18) defining "persons associated with a broker or dealer."

(n62)Footnote 62. Rule 15Ba2-4.

(n63)Footnote 63. Rule 15Ba2-4.

(n64)Footnote 64. Rule 15Ba2-5.

(n65)Footnote 65. *Id.*

(n66)Footnote 66. P.L. 99-571, 100 Stat. 3208, 99th Cong., 2d Sess. (1986).

(n67)Footnote 67. Rule 15Ca1-1.

(n68)Footnote 68. Rule 15Ca1-1(a).

(n69)Footnote 69. *Id.*

(n70)Footnote 70. Rule 15Bc3-1(a).

(n71)Footnote 71. *Id.*

(n72)Footnote 72. Item 1, Form MSDW.

(n73)Footnote 73. Items 2 through 5, Form MSDW.

(n74)Footnote 74. Item 6, Form MSDW.

(n75)Footnote 75. *Id.*

(n76)Footnote 76. Item 7, Form MSDW.

(n77)Footnote 77. Item 8, Form MSDW.

(n78)Footnote 78. Items 9 and 10, Form MSDW.

(n79)Footnote 79. Item 11, Form MSDW.

(n80)Footnote 80. General Instruction 3, Form MSDW.

(n81)Footnote 81. General Instructions 2 and 3, Form MSDW.

(n82)Footnote 82. General Instruction 2, Form MSDW.

(n83)Footnote 83. *Id.*

(n84)Footnote 84. Rule 15Bc3-1(c). Every notice of withdrawal filed constitutes a report for purposes of Sections 15(B), 17(a) and all other applicable provisions of the Act. Rule 15Bc3-1(d).

(n85)Footnote 85. Rule 15Bc3-1(c).

(n86)Footnote 86. Section 15B(c)(2), (4). For discussion of the grounds for action under Section 15(b)(4) against a broker-dealer registered under Section 15, see § 3.03[7] *supra*.

For discussion of grounds for sanctioning associated persons of broker-dealers pursuant to Section 15(b)(6), see § 3.03[7][b] *supra*.

(n87)Footnote 87. Section 15B(c)(3).

(n88)Footnote 88. *Id.*

(n89)Footnote 89. The same reentry policy is applicable to municipal securities dealers and persons associated with municipal securities dealers who may be barred from the municipal securities business or some aspect of it, except that the proposed application for reentry of the disqualified individual or firm takes the form of a notice by the MSRB rather than the NASD to the Commission.

(n90)Footnote 90. Section 15B(c)(5); S. Rep. No. 75, 94th Cong., 1st Sess. 52 (1975). The role of bank regulatory agencies in ensuring compliance with federal securities laws and the rules of the MSRB is in no way intended to diminish the Commission's overall responsibility concerning the municipal securities industry. S. Rep. No. 75, 94th Cong., 1st Sess. 52 (1975).

(n91)Footnote 91. 12 U.S.C. § 1818.

(n92)Footnote 92. Section 15B(c)(5). Under Section 17(b), the Commission must give notice to and consult with

the federal bank agency prior to inspecting a municipal securities dealer that is a bank. S. Rep. No. 75, 94th Cong., 1st Sess. 52 (1975).

(n93)Footnote 93. Section 15B(c)(5).

(n94)Footnote 94. S. Rep. No. 75, 94th Cong., 1st Sess. 52-53 (1975); Section 15B(c)(2) and 15B(c)(6).

(n95)Footnote 95. Section 15B(c)(6)(A), (B).

(n96)Footnote 96. Section 15B(c)(6)(C).

(n97)Footnote 97. Section 15B(c)(7)(A)(i), (ii).

(n98)Footnote 98. Section 15B(c)(7)(B).

(n99)Footnote 99. *Id.* Rule 15Bc7-1, adopted pursuant to Section 15B(c)(7), establishes a system for making information from examination reports concerning municipal securities brokers and municipal securities dealers available to the MSRB, subject to limitations designed to protect the confidentiality of the information. Exch. Act Rel. No. 34-16,282, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,333 (1979).

(n100)Footnote 100. 17 C.F.R. 240.15c2-12. See Exch. Act Rel. No. 34-26,100, 4 Fed. Sec. L. Rep. (CCH) P 25,097 (Sept. 22, 1988); and Exch. Act Rel. No. 34-26,985, 4 Fed. Sec. L. Rep. (CCH) P 25,098 (June 28, 1989).

(n101)Footnote 101. Exch. Act Rel. No. 34-33,741, 7 Fed. Sec. L. Rep. (CCH) P 72,442 (Mar. 9, 1994) (the "Interpretative Release") and Exch. Act Rel. No. 34-34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,456 (Nov. 10, 1994) (the "Adoptive Release"). Selected SEC releases are reprinted in the Securities Primary Law Sourcebook, Volume E, Section V (Matthew Bender).

(n102)Footnote 102. Exch. Act Rel. No. 34-33,868 (Apr. 7, 1994).

(n103)Footnote 103. In 1994, the SEC approved amendments to MSRB Rule G-19 (designed to ensure that dealers take appropriate steps to determine if a transaction is suitable for a customer) and Rule G-8 (enhanced recordkeeping requirements), Exch. Act Rel. 34-33,869 (Apr. 7, 1994).

(n104)Footnote 104. The requirement to provide annual financial information does not apply to fiscal years ending prior to January 1, 1996. For fiscal years ending after January 1, 1996, financial information and operating data must be provided annually by a date contractually specified at the time of closing. For example, if any issuer's fiscal year ends June 30, 1996, the contract could provide that annual financial information for the preceding fiscal year will be provided February 1, 1997 and each February 1 thereafter.

(n105)Footnote 105. Exch. Act Rel. No. 34-34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85456, (Nov. 10, 1994) at note 26.

(n106)Footnote 106. The view that a mailing of a preliminary official statement is an "offering" is legally controversial, but it is the view of the SEC staff. See Exch. Act Rel. No. 34-34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,456 (Nov. 10, 1994), at note 27. Selected recent SEC releases are reprinted in the Securities Primary Law Sourcebook, Volume E, Section V (Matthew Bender).

(n107)Footnote 107. Exch. Act Rel. No. 34-34,961, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,456 (Nov. 1, 1994), at note 29.

(n108)Footnote 108. Rule 15c2-12(f)(9), reprinted in the Securities Primary Law Sourcebook, Volume B, Section G (Matthew Bender), defines the term "annual financial information" as "financial information or operating data ... of

the type included in the final official statement with respect to an obligated person"

(n109)Footnote 109. The eleven events required to be disclosed in a timely manner, if material, are: (1) Principal and interest payment delinquencies; (2) Non-payment related defaults; (3) Unscheduled draws on debt service reserves reflecting financial difficulties; (4) Unscheduled draws on credit enhancements reflecting financial difficulties; (5) Substitution of credit or liquidity providers, or their failure to perform; (6) Adverse tax opinions or events affecting the tax-exempt status of the security; (7) Modification to rights of security holders; (8) Bond calls; (9) Defeasances; (10) Release, substitution, or sale of property securing repayment of the securities; and (11) Rating changes. Rule 15c2-12(b)(5)(C).

(n110)Footnote 110. Exch. Act Rel. No. 34-33,741, 7 *Fed. Sec. L. Rep. (CCH)* P 72,442 (Mar. 9, 1994).

(n111)Footnote 111. In 1995, there were five Nationally Recognized Municipal Securities Information Repositories (NRMSIRs): Bloomberg, Thomson, Disclosure, Inc., JJ Kenny and Moodys. In mid 1997, Disclosure Inc. announced it was withdrawing as a NRMSIR. As of 2003, the NRMSIRs included: Bloomberg, J.J. Kenny, DPC Data, Inc., and FT Interactive Data.

(n112)Footnote 112. Sec. Act Rel. No. 33-7857(May 10, 2000) and Sec. Exch. Act Rel. No. 42,728 (Apr. 28, 2000).

(n113)Footnote 113. Exch. Act Rel. No. 34-33,868 (Apr. 7, 1994).

(n114)Footnote 114. MSRB Rule G-37(b), MSRB Manual (CCH) P 3681.

(n115)Footnote 115. MSRB Rule G-37(g)(vii).

(n116)Footnote 116. MSRB Rule G-37(b).

(n117)Footnote 117. MSRB Rule G-37(g)(iii).

(n118)Footnote 118. See Exch. Act Rel. No. 34-40,167; File No. SR-MSRB-98-10 (July 2, 1998).

(n119)Footnote 119. MSRB Rule G-37(g)(iv).

(n120)Footnote 120. MSRB Rule G-37(g)(viii) (emphasis added).

(n121)Footnote 121. MSRB Rule G-37(b).

(n122)Footnote 122. See *Blount v. SEC*, 61 F.3d 938 (D.C. Cir. 1995), *cert. denied*, 116 S. Ct. 1351 (1996) (MSRB regulation prohibiting municipal securities dealers from engaging in municipal securities business within two years after any contribution to an official of the issuer does not violate dealers' *First* and *Tenth Amendment* rights).

(n123)Footnote 123. See, e.g., Hume, "Political Donation Triggers G-37 Ban for Morgan Stanley," BOND BUYER, p. 1, Sept. 17, 1997.

(n124)Footnote 124. See Exch. Act Rel. No. 34-39459 (Dec. 17, 1997).

(n125)Footnote 125. Section 15B(b)(1) of the Exchange Act, reprinted in the Primary Law Sourcebook, Volume B, Section F (Matthew Bender); S. Rep. No. 75, 94th Cong., 1st Sess. 46 (1975), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I (Matthew Bender).

(n126)Footnote 126. Members currently serve terms lasting three years.

(n127)Footnote 127. *Id.* The selection of the initial membership of the MSRB was announced in Exch. Act Rel.

No. 34-11,635, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,291 (Sept 5, 1975).

(n128)Footnote 128. Section 15B(b)(1). This section permits a person under common control with, or indirectly controlling, a broker, dealer or municipal securities dealer to be a public member. Rule A-3(a)(i)-(iii), MSRB Manual (CCH) P 3011.

Two closely related principles guided the Committee on Banking, Housing and Urban Affairs in establishing the MSRB:

The first principle, emanating from the legislative background of the Maloney Act of 1938, is that of a democratic organization. ... The second principle is what has been customarily called the "businessperson's judgment." The need to raise the level of conduct in the municipal securities business to a highly professionalized plane can, in the Committee's view, best be met through ethical standards adopted by individuals actually engaged in the business rather than through rigid proscriptions imposed by "outsiders." S. Rep. No. 75, 94th Cong., 1st Sess. 46 (1975).

(n129)Footnote 129. MSRB Rule A-2, MSRB Manual (CCH) P 3006.

(n130)Footnote 130. Rule A-3(c)(i), MSRB Manual (CCH) P 3011.

(n131)Footnote 131. S. Rep. No. 75, 94th Cong., 1st Sess. 47 (1975). See MSRB Rule G-16, MSRB Manual (CCH) P 3576.

(n132)Footnote 132. Section 15B(b)(2) of the Exchange Act.

(n133)Footnote 133. Section 15B(b)(2)(A). See MSRB Rule G-3, MSRB Manual (CCH) P 3511 which, *inter alia*, requires qualification of and prescribes examinations for Municipal Securities Principals and Representatives and Financial Operations Principals.

The MSRB may classify municipal securities dealers, to establish qualifications standards under Section 15B(b)(2)(A), by types of business done, nature of securities other than municipal securities sold, and character of business organization. Section 15B(b)(A)(i). The MSRB may also classify municipal securities brokers and persons associated with municipal securities brokers and municipal securities dealers; specify what standard is applicable to any class; require entry standards, including tests for persons in any class; and require that persons in any class other than municipal securities brokers, municipal securities dealers and partners, officers, and supervisory employees thereof be qualified solely on the basis of compliance with the standards of training and such other qualifications as the MSRB finds appropriate. Section 15B(b)(2)(A)(i)-(iv). The MSRB has interpreted Rule G-3 to prohibit solicitation of orders by clerical or other personnel (including appointees) not qualified as Municipal Securities Principals to solicit public customers. MSRB Manual (CCH) P 3511 at 3509-2-3509-3.

(n134)Footnote 134. Section 15B(b)(2)(B). See MSRB Rule A-3(c), MSRB Manual (CCH) P 3011.

The MSRB rules may specify that term members may serve or provide for an increase in the number of members constituting the entire MSRB membership, provided the total number is an odd number. Section 15B(b)(2)(B).

(n135)Footnote 135. Section 15B(b)(2)(C). See MSRB Rule G-12, MSRB Manual (CCH) P 3556, prescribing uniform practices with respect to settlements, confirmations, comparisons, delivery of securities, and other business dealings. See also MSRB Rule G-2B, MSRB Manual (CCH) P 3611, governing performance of financial advisory services by municipal securities dealers.

See The MSRB's fair practice rules, MSRB Rules G-13, and G-17 through G-33, MSRB Manual (CCH) PP 3561,

3581-3661. *See also* MSRB Manual (CCH) P 10,030.

(n136)Footnote 136. *Id.*

(n137)Footnote 137. *Id.*

(n138)Footnote 138. Section 15B(b)(2)(E).

See MSRB Rule G-16, MSRB Manual (CCH) P 3576, which provides for an examination of each municipal securities broker and municipal securities dealer at least once every 2 years by the FINRA or the appropriate regulatory agency in accordance with Section 15B(c)(7).

(n139)Footnote 139. Section 15B(b)(2)(F). *See* MSRB Rule G-13, MSRB Manual (CCH) P 3561. The MSRB rules relating to quotations are designed to produce fair and informative quotations, prevent fictitious or misleading quotations, and promote orderly procedures for collecting, distributing and publishing quotations. Section 15B(b)(2)(F).

(n140)Footnote 140. *Id.*

(n141)Footnote 141. This requirement includes the periods during which the records must be preserved. Section 15B(b)(2)(G).

See MSRB Rule G-8, MSRB Manual (CCH) P 3536 (what records must be made); Rule G-9, MSRB Manual (CCH) P 3541 (preservation of records).

Municipal securities brokers and municipal securities dealers that are *not* banks and are in compliance with Rules 17a-3 and 17a-4 are deemed in compliance with MSRB Rules G-8 and G-9. MSRB Rule G-8(f) (with the proviso that certain information concerning customers and syndicate transactions be maintained in any event); MSRB Rule G-9(g).

Municipal securities brokers and dealers that comply with MSRB Rules G-8 and G-9 in connection with transactions in municipal securities are deemed in compliance with the Commission's recordkeeping and record preservation requirements. *See* Rules 17a-3(e) and Rule 17a-4(h).

Registered municipal securities dealers that are banks satisfy the recordkeeping and record preservation requirements to which they are subject under Section 17(a) by complying with MSRB Rules G-8 and G-9. A municipal securities broker is required to designate one or more qualified principals as responsible for the recordkeeping required by Rules G-8 and G-9, MSRB Rule G-10, MSRB Manual (CCH) P 3546.

(n142)Footnote 142. Section 15B(b)(2)(H). *See* § 3.06[1] *supra* for the MSRB Rule G-1 definition.

(n143)Footnote 143. This includes the selection of a chairperson from members of the MSRB, compensation of members, and appointment and compensation of employees, attorneys and consultants. Section 15B(b)(2)(I).

See MSRB Rules A-1-A-11, MSRB Manual (CCH) PP 3001-3051.

(n144)Footnote 144. Section 15B(b)(2)(J). *See* MSRB Rule A-14, MSRB Manual (CCH) P 3066 (annual fee); Rule A-13, MSRB Manual (CCH) P 3061 (underwriting assessment); Rule A-12, MSRB Manual (CCH) P 3056 (initial fee); Rule A-7, MSRB Manual (CCH) P 3031 (assessments for costs and expenses of MSRB operation and administration); Rule A-16, MSRB Manual (CCH) P 3077 (arbitration fees and deposits).

(n145)Footnote 145. Section 15B(b)(2)(K).

See MSRB Rule G-11, MSRB Manual (CCH) P 3551. The MSRB was given the power under Section 15B(b)(2)(K)

to adopt rules to establish the terms and conditions under which a municipal securities dealer may sell a new issue during the underwriting period to a "municipal securities investment portfolio." A municipal securities investment portfolio is defined in Section 3(a)(33) as "all municipal securities held for investment and not for sale as part of a regular business by a municipal securities dealer or by a person, directly or indirectly, controlling, controlled by, or under common control with a municipal securities dealer."

The rulemaking power granted to the MSRB by Section 15B(b)(2)(K) was designed to prevent the application of the FINRA's Board of Governors "Free-Riding and Withholding" interpretation (which prohibits the sale of a "hot issue" to an account of any member or any person associated with a member) to municipal bond offerings:

Application of this interpretation to municipal bond offerings could in certain circumstances prohibit the portfolio department of a bank which was a municipal securities dealer from buying municipal bonds being distributed during the underwriting period. Because of the significance of bank investment portfolio buying, however, the Committee believes that such a prohibition could adversely affect the ability of the municipalities to obtain the lowest possible rate of interest on their bonds.

S. Rep. No. 75, 94th Cong., 1st Sess. 49 (1975).

(n146)Footnote 146. Section 15B(b)(2)(C).

(n147)Footnote 147. Section 15B(b)(2)(C).

(n148)Footnote 148. Section 15B(b)(2)(C).

(n149)Footnote 149. Although arbitration was permitted by Rule G-35, since 1996 the MSRB has no longer maintained an arbitration forum.

(n150)Footnote 150. Section 15B(b)(2)(C).

(n151)Footnote 151. Section 15B(c)(1).

(n152)Footnote 152. Section 15B(d)(1).

(n153)Footnote 153. Section 15B(d)(2).

(n154)Footnote 154. Section 15B(d)(2).

(n155)Footnote 155. Section 15B(c)(8)(A).

(n156)Footnote 156. Section 15B(c)(8)(B).

(n157)Footnote 157. Sections 15B(b)(2)(E), (c)(7)(A). Municipal securities brokers and municipal securities dealers that are not banks (or separately identifiable departments or divisions thereof) and are not FINRA members are examined for compliance with the Exchange Act, the rules and regulations thereunder, and the MSRB Rules by the Commission. The FINRA conducts compliance examinations of its members. *See* Exch. Act Rel. No. 34-16282, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,333 (1979).

(n158)Footnote 158. Section 17(c)(3) is discussed in n.37 *supra*.

(n159)Footnote 159. Rule 15Bc7-1(a)(2).

(n160)Footnote 160. Rule 15Bc7-1(a)(1). The MSRB adopted Rule A-17, "Confidentiality of Examination

Reports," in response to this requirement. *See* MSRB Manual (CCH) P 3081.

(n161)Footnote 161. Rule 15Bc7-1(a).

(n162)Footnote 162. Rule 15Bc7-1(b).

(n163)Footnote 163. Rule 15Bc7-1(b).

(n164)Footnote 164. *See* Exch. Act Rel. No. 34-22601, [1985-1986 Transfer Binder] Fed Sec. L. Rep. (CCH) P 83,934 (1985).

(n165)Footnote 165. Rule 15Bc7-1(b)(1).

(n166)Footnote 166. Rule 15Bc7-1(b)(2)(i).

(n167)Footnote 167. Rule 15Bc7-1(b)(2)(ii).

(n168)Footnote 168. Rule 15Bc7-1(b)(3). Copies of public notices issued during the report period of any formal actions and nonpublic information about any actions taken on violations of MSRB rules must also be included. Rule 15Bc7-1(b)(4).

(n169)Footnote 169. Rule 15Bc7-1(b)(5).

(n170)Footnote 170. Rule 15Bc7-1(b)(6).

(n171)Footnote 171. Rule 15Bc7-1(b)(7).

(N172)Footnote 172. Rule 15Bc7-1(b)(8).

(n173)Footnote 173. Rule 15Bc7-1(c). MSRB Rule A-17(4), MSRB Manual (CCH) P 3081, requires examination reports to be maintained in locked cabinets with limited access.

(n174)Footnote 174. SEC Litigation Release 16505 (April 6, 2000); *SEC v. Rauscher Pierce Refsnes, Inc.*, Civ. No. 98-0027 PHX-ROS (August 12, 1998).

(n175)Footnote 175. *See, e.g., In re* Goldman, Sachs & Co., SEC Release 42636 (April 6, 2000).

See Grandon v. Merrill Lynch & Co., Inc., No. 97cv9027, 1998 U.S. App. LEXIS 13027, at *15 (2d Cir. June 19, 1998). In *Grandon*, the court held that broker-dealers must disclose to municipal bond issuers when markups are excessive. The court further held that the issue of whether a markup is excessive must be determined on a case-by-case basis. According to the MSRB, the relevant factors include: (1) the judgment of the broker-dealer regarding the fair market value at the time of the transaction; (2) the expense involved in completing the transaction; (3) the fact that the broker-dealer is entitled to a profit; (4) "the total dollar amount of the transaction;" (5) "the availability of the security in the market;" (6) "the price or yield of the security;" and (7) "the nature of the professional's business." *Id.*



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Federal Securities Exchange Act of 1934

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CHAPTER 3 Regulation of Brokers and Dealers

1-3 Federal Securities Exchange Act of 1934 § 3.07

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§ 3.07 Government Securities Brokers and Dealers

Prior to 1986, broker-dealers who dealt only in government securities were exempt from registration under Section 15(a) of the Exchange Act. n1 After the collapse of several government securities firms in the 1980s and the resulting major losses to customers, n2 the need for regulation of government securities brokers and dealers became apparent. Since many of the government securities customers were financial institutions, these losses had a domino effect that led to an interruption of business in important segments of the economy. n3 At the same time that the need for regulation became apparent, Congress also became aware of the special nature of the government securities market, the cornerstone of U.S. fiscal and monetary policy. n4

The size of the government securities market dwarfs the market for corporate debt and equity securities. According to a House of Representatives Energy and Commerce Committee Report issued in 1985, the U.S. government securities market is the largest securities market in the world. "Through this market, the U.S. government raises more than \$200 billion of new funds each year and refinances hundreds of billions more of maturing debt, raising an average of \$4 billion a day." n5

Because of the special character of this market and its crucial importance to the economy, Congress chose not to subject government securities brokers and dealers to the same regulation as other brokers and dealers under Section 15 of the Exchange Act. Instead, it enacted the Government Securities Act of 1986 ("GSA"), n6 which added a completely new Section 15C to the Exchange Act.

Exchange Act section 3(a)(42) defines "government securities" to mean:

- (A) direct obligations of, or obligations guaranteed as to principal or interest by, the United States;
- (B) securities which are issued or guaranteed by corporations in which the United States has a direct or indirect interest and which are designated by the Secretary of the Treasury for exemption as necessary or appropriate in the public interest or for the protection of investors;
- (C) securities issued or guaranteed as to principal or interest by any corporation the securities of which

are designated, by statute specifically naming such corporation, to constitute exempt securities for purposes of the federal securities laws; and

(D) for purposes of Section 15C of the Exchange Act (with respect to registration of government securities brokers and dealers) and Section 17A (with respect to securities transfer agents and clearing agencies), n7 any put, call, straddle, option or privilege on a security described in clauses (A), (B) or (C) above, that (i) is not traded on a national securities exchange and (ii) is not one for which quotations are disseminated through an automated quotation system operated by a national securities association. n8

A "government securities broker" is defined in Exchange Act Section 3(a)(43) of the Exchange Act to include a person regularly engaged n9 in the business of effecting transactions in government securities for the account of others, but does not include:

- a corporation which is the issuer of securities described in clauses (B) and (C) of Section 3(a)(42); n10 or
- a person registered with the Commodity Futures Trading Commission ("CFTC"), any contract market designated by the CFTC, such contract market's affiliated n11 clearing organization, or any floor trader on such contract market, solely because such person effects transactions in government securities that the SEC, after consultation with the CFTC, n12 has determined by rule or order to be solely incidental to such person's futures-related business. n13

A "government securities dealer" is defined in Exchange Act Section 3(a)(44) to mean any person engaged in the business of buying and selling government securities for his own account, through a broker or otherwise, but does not include:

- any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business;
- an issuer of government securities as defined in clauses (B) and (C) of Section 3(a)(42);
- any bank, unless the bank is engaged in the business of buying and selling government securities for its own account other than in a fiduciary capacity, through a broker or otherwise; or
- any person registered with the CFTC, any contract market designated by the CFTC, such contract market's affiliated clearing organization, or any floor trader on such contract market, solely because such person effects transactions in government securities that the Commission, after consultation with the CFTC, has determined by rule or order to be incidental to such person's futures related business.

Pursuant to the direction implicit in Section 3(a)(43)(B) and (D), the SEC consulted with the CFTC and adopted Rules 3a43-1 and 3a44-1. These rules identify activities "incidental" to futures-related business, the performance of which would not subject futures commission merchants and other persons subject to CFTC jurisdiction to registration as government securities brokers or dealers. n14

Rule 3a43-1 exempts a futures commission merchant from registering as a government securities broker or dealer, provided the futures commission merchant maintains all funds and securities involved in government securities transactions in a customer segregation account subject to the CFTC's rules. n15 In addition, the futures commission

merchant may not advertise that it is in the business of effecting government securities transactions, and the transactions in which it engages would have to be unsolicited. n16 Subject to these limitations, the following kinds of agency transactions in government securities by a futures commission merchant are deemed to be "incidental" to the futures business:

- transactions to effect delivery pursuant to a futures contract; n17
- transactions for risk reduction or arbitrage of existing or contemporaneously created positions in futures or options on futures; n18
- transactions for the investment of margin and excess funds related to futures or options on futures subject to CFTC jurisdiction which meet any of the following criteria: the transaction is in a Treasury security having a maturity at the time of the transaction of less than 93 days; n19 or the transaction generates no monetary profit for the FCM in excess of the cost of executing the transaction; n20 or the transaction is unsolicited and the total revenues of the FCM from this type of transaction do not exceed 2% of its total commission revenues. n21

In addition, Rule 3a43-1 covers transactions effected on either a principal or agency basis in which a futures commission merchant simultaneously buys (or sells) a futures contract with a customer and effects an offsetting or closing transaction with the customer in the underlying government security. n22

The SEC also adopted Rule 3a44-1 to exempt six types of principal transactions by certain CFTC regulated persons. n23 In order to come under this rule, the CFTC regulated person effecting the transactions may not advertise that it is a government securities dealer but could solicit particular transactions. n24 The categories are:

- Sale or purchase of government securities to effect delivery pursuant to a futures contract; n25
- exchange of futures for physical transactions with a CFTC-regulated person, or a registered government securities dealer, or one that has given notice to the SEC pursuant to Section 15C(a); n26
- transactions (including repurchase agreements and reverse repurchase agreements) involving segregated customer funds and securities, or funds and securities held by a clearing organization with a government securities broker or dealer which has registered or given notice under Section 15C(a) or a bank; n27
- transactions for risk reduction or arbitrage of existing or contemporaneously created positions in futures or options on futures with a registered government securities broker or dealer or one that has filed notice pursuant to Section 15C(a), or a CFTC-regulated person; n28
- repurchase and reverse repurchase agreement transactions between a futures commission merchant and another CFTC-regulated person (both acting in a proprietary capacity), and a contemporaneous offsetting transaction between the FCM and a registered government securities broker or dealer or one that has given notice pursuant to Section 15C(a), or a CFTC-regulated person acting in a proprietary capacity; n29 and
- other transactions exempted by the SEC. n30

The GSA gives the Secretary of the Treasury authority to exempt any government securities broker or dealer from

registration if the Secretary finds that such exemption is consistent with the public interest. n31 Pursuant to this authority, entities whose activities fall within one or more of the following categories have been exempted from registration under Section 15C(a)(5):

- Organizations that handle United States Savings Bond transactions; n32
- depository institutions that submit tenders for the account of customers for purchase on original issue of U.S. Treasury securities on a fully disclosed basis; n33
- financial institutions that do not hold themselves out as a government securities broker, *or* that engage in fewer than 500 solicited government securities transactions per year, *or* that engage in such transactions through "networking" arrangements with one or more government securities dealers; n34
- financial institutions that engage only in the following kinds of dealer transactions: (i) sales or purchases in a fiduciary capacity; and (ii) sales and purchases pursuant to repurchase and reverse-repurchase agreements, n35
- corporate credit unions whose only government securities dealer activities are the sale and purchase, pursuant to repurchase and reverse-repurchase agreements, of government securities to or from other credit unions; n36 and
- branches or agencies of foreign banks, if all the customers with which they do government securities transactions are foreign governments or their agencies, and other persons who are not U.S. citizens or residents or, in the case of entities, have their principal place of business outside the United States. n37

[1] Registration of Government Securities Dealers

The GSA makes it unlawful for a government securities broker or dealer to make or induce or attempt to induce a transaction in a government security unless it is a "registered broker-dealer," a "financial institution," or registered under the GSA. n38

[a] Registered Broker-Dealers. This category includes all persons registered under Sections 15 and 15B of the Exchange Act. n39 A registered broker or dealer acting as a government securities broker or dealer is required to file a written notice to this effect with the SEC, its "appropriate regulatory agency." n40 Item 13 of Form BD constitutes the required form of written notice from registered broker-dealers. n41 A registered broker-dealer that ceases to act as a government securities broker or dealer must file an amendment to Form BD giving an affirmative answer to Item 13B. n42

[b] Financial Institutions. This category of government securities brokers and government securities dealers is defined in Section 3(a)(46) to mean banks (as defined in Section 3(a)(6)), foreign banks (as such term is used in the International Banking Act of 1978), and savings associations (as defined in section 3(b) of the Federal Deposit Insurance Act) the deposits of which are insured by the Federal Deposit Insurance Corporation. Their respective "appropriate regulatory agencies" are defined in Section 3(a)(34)(G)(i) through (v).

Each of these financial institutions is required to file a notice on Form G-FIN when it begins acting as a government securities broker and/or dealer and Form G-FINW, when it ceases acting in this capacity. n43

[c] All Others. All other government securities brokers and government securities dealers are required to register with the SEC. n44 The procedure for registration is similar to registration under Section 15. n45 Form BD is the required form of application. n46 Within 45 days of the filing of the application, the SEC must grant registration or institute proceedings to determine whether registration should be denied. The proceedings must be concluded within

120 days of filing the application for registration (subject to a 90-day extension for good cause). n47

The provisions of Rule 15Ca2-3, which establishes procedures for registration of a successor to a government securities broker or dealer, are substantially identical with the provisions of Rule 15b1-3 which relates to successors to registered broker-dealers. n48 Rule 15Ca2-4, which establishes procedures for the registration of a fiduciary of a registered government securities broker, is substantially identical to Rule 15b1-4. Each deems the registration of the type of person in question to be the registration of any executor, administrator, guardian, conservator, assignee for the benefit of creditors, receiver, trustee in insolvency or bankruptcy, or other duly appointed fiduciary for such person, provided the fiduciary files a Form BD with the SEC within 30 days after entering upon the performance of its duties. Rule 15Ca2-5 requires a consent to service of process by any nonresident government securities broker or dealer and is substantially identical with Rule 15b1-5 which is applicable to nonresident broker-dealers registered under Section 15. Rule 15Cc1-1 prescribes the filing of Form BDW n49 for withdrawal from registration as a government securities broker or dealer.

[2] Suspension, Revocation and Cancellation of Registration

The SEC is given authority to censure, limit the activities of, suspend for up to 12 months, or revoke the registration of a government securities broker or dealer that is required to register under Section 15C(a)(1)(A), if the SEC finds that the government securities broker or dealer, or any person associated with it: n50

- has willfully made or caused to be made a false or misleading statement, or omitted any material fact required to be stated, in an application or report required to be filed with the SEC or any other appropriate regulatory agency, or in any proceeding before the SEC with respect to registration; n51

- has been convicted of any felony, misdemeanor or a substantially equivalent crime within 10 years which the SEC finds involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, or conspiracy to commit any of the foregoing offenses; or arises out of the conduct of the business of a broker, dealer, municipal securities dealer, government securities broker, government securities dealer, investment advisor, bank, insurance company, fiduciary, or any entity registered under the CEA; involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds or securities; or involves violation of federal wire or mail fraud statutes (§§ 152, 1341, 1342 or 1343, or ch. 25 or 47 of 18 U.S.C.); n52

- is permanently or temporarily enjoined from acting as an investment advisor, underwriter, broker, dealer, entity or person (or as an employee thereof) required to be registered under the CEA, municipal securities dealer, government securities dealer or government securities broker; or as an employee or affiliated person of any investment company, bank, or insurance company; or from engaging in any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security; n53

- has willfully violated, or is unable to comply with, any provision of the Securities Act of 1933, the Investment Advisors Act of 1940, the Investment Company Act of 1940, the CEA, the Exchange Act, or the rules and regulations under any of such statutes, or the rules of the MSRB, n54 or has aided or abetted, or failed to reasonably supervise another person who is subject to his or her supervision and who commits such violations; n55

- is subject to an order of the SEC entered pursuant to Section 15(b)(6); n56 or

- has been found by a foreign financial regulatory authority to have filed a false or misleading statement in a registration report; violated any foreign statute or regulation regarding transactions in

securities; or aided or abetted, or failed to reasonably supervise another person who commits such violations. n57

The SEC can also impose sanctions directly upon, or limit the activities of, persons associated, or seeking to become associated, with a government securities broker or dealer on the same grounds as it can base an action against the government securities broker or dealer. n58 The government securities broker or dealer is prohibited from employing or being associated with such disqualified persons without the approval of the appropriate regulatory agency. n59

Financial institutions and brokers and dealers registered under Sections 15 and 15B, but not required to be registered under Section 15C(a)(1)(A), and their associated persons, are subject to the same sanctions described above. However, in each case, the appropriate regulatory agency (which, in the case of financial institutions is not the SEC) is authorized to make the appropriate findings and impose the sanctions. n60 In addition, such appropriate regulatory agencies may, where applicable, enforce the provisions of the GSA under Section 8 of the Federal Deposit Insurance Act, n61 Section 5 of the Home Owners' Loan Act of 1933, n62 or Section 407 of the National Housing Act. n63

The SEC has focused increased attention on violative activities affecting the government securities market. In an action against Salomon, Inc., the SEC claimed that Salomon repeatedly submitted false bids in auctions for U.S. Treasury securities, allowing Salomon to circumvent U.S. Treasury Department limitations on obtaining such securities. n64 Salomon consented to the entry of an order requiring it to pay \$290 million and enjoining it from submitting these false bids.

Related administrative proceedings were also instituted against Salomon Brothers, Inc. n65 and three senior members of management of Salomon Brothers, Inc. including its chairman and CEO and its General Counsel. n66 The Commission alleged that senior management was aware that a managing director of the firm had submitted a false bid in an auction of U.S. Treasury securities and took no action to investigate the matter or to discipline the managing director. The defendants consented to an entry of an order barring the former chairman and chief executive officer from holding the positions of chairman or chief executive officer with any regulated entity and suspending the other two executives for a period of three to six months. All three executives were required to pay civil penalties.

[3] Relationships among Regulators under the Government Securities Act

The legislative process that led to the passage of the GSA involved consideration of various alternatives about which existing, or possibly newly created, agencies should have authority to implement the new statute. n67 These debates were heightened by the fact that many entities governed by the new law were already subject to regulation by one or more government agencies with wide-ranging goals, such as the safety and soundness of the banking system, the effectuation of federal fiscal and monetary policies, the financing of public debt, the protection of customers and depositors, and, to the extent that foreign financial institutions are affected, international economic policy. The resolution of this debate is reflected in several provisions of the GSA that divide or limit roles of various agencies.

The Secretary of the Treasury has the authority to create exemptions from the GSA for particular government securities brokers and government securities dealers or classes thereof. n68 The Secretary also has plenary rulemaking authority under the GSA, subject only to the duty to consult with and consider the views of the SEC and the Board of Governors of the Federal Reserve System, except in emergency situations. n69 Moreover, the SEC does not have authority to interfere with the enforcement of the GSA with respect to entities for which it is not the appropriate regulatory authority, although it continues to have authority to enforce other provisions of the federal securities laws against such entities. n70 Under regulations adopted by the Secretary of the Treasury governing interpretation of the GSA, the Department of the Treasury retains authority to enforce, interpret and grant exemptions, but interpretations by the SEC and its staff, including no-action positions, and by the other designated examining authorities, of SEC regulations adopted by reference in the Treasury's regulations, are given the same weight as interpretations of regulations that are solely those of the SEC. However, if the Treasury issues a contradictory interpretation it "understands that the

Commission will give that interpretation appropriate deference." n71

Finally, those government securities brokers and government securities dealers that are required to register with the SEC under Section 15C(a)(1)(A) are, like broker-dealers registered under Section 15, n72 required to be members of a national securities exchange or a national securities association registered under Section 15A. n73 The only national securities association registered under Section 15A is the FINRA. n74

Effective June 5, 1987, the FINRA amended Article III, Section 35(c) of its Rules of Fair Practice to extend certain of its requirements with respect to filing and review of advertisements to government securities. n75 In addition, Form U-4, the personnel form required to be filed by members of the FINRA or associated persons of such broker-dealers, has been amended to be used for applications for registration of a Government Securities Representative or Government Securities Principal. n76 No examination is required in connection with these registrations. All member firms, whether registered with the SEC under Section 15 or Section 15C, that act as brokers or dealers in government securities, are required to file Form BD. n77

[4] Capital Requirements

The most significant difference between the regulation of registered broker-dealers under Section 15 and government securities brokers and government securities dealers under Section 15C is that the former are subject to the Uniform Net Capital Rule n78 and the latter are subject to a different set of regulations, promulgated by the Secretary of the Treasury and referred to as the "Liquid Capital Rule," with respect to financial responsibility. n79 These rules apply to all government securities brokers and government securities dealers, whether required to register under Section 15C(a)(1)(A), or to give notice under Section 15C(a)(1)(B). The rules do not apply to registered broker-dealers, n80 financial institutions that are subject to the rules and regulations of their appropriate regulatory agency concerning capital requirements, n81 branches or agencies of foreign banks subject to regulation, supervision, and examination by state or federal authorities having regulatory or supervisory authority over commercial banks and trust companies, n82 and futures commission merchants that are not registered brokers or dealers if they meet the capital requirements of the CFTC or the SEC, whichever is greater. n83 In addition, a "government securities interdealer broker" n84 may elect not to be subject to the Treasury's capital rules but rather to be subject to the SEC's net capital rule, 15c3-1, n85 in which case it must maintain net capital, as defined therein. n86 Effective August 20, 2004, the Commission adopted alternative net capital requirements for brokers-dealers that are part of consolidated supervised entities. n87 Included in these changes were new net capital requirements and additional reporting and supervision requirements. The Treasury has provided for certain modifications and adjustments of the net capital rule as applied to interdealer brokers. n88

The Treasury's capital requirements for government securities dealers and brokers registered under Section 15C require minimum capital requirements. For introducing brokers, the rules require a minimum liquid capital requirement of \$50,000, after haircuts under the Treasury's own haircut provision. n89 This provision resembles Rule 15c3-1(a)(2), to which it refers for definition of the term "introducing broker." The concept of "liquid capital" is substantially the same as "net capital" in Rule 15c3-1(c)(2). However, instead of the deductions on contracts failed to deliver, (pursuant to Rule 15c3-1(c)(2)(ix)) and the haircuts (pursuant to Rule 15c3-1(c)(2)(vi)(B)), the firm must take a deduction pursuant to the "net position haircut factors," n90 if the instrument underlying the contract is a "Treasury market risk instrument." n91

The following deductions required by Rule 15c3-1 are omitted from the Liquid Capital Rule:

- Securities haircuts--subparagraph (c)(2)(vi); n92
- haircuts on open contractual commitments--subparagraph (c)(2)(iii); n93
- deductions required by subparagraph (c)(2)(iv)(F)(3)(i) relating to repurchase agreement deficits;

n94

- deductions from net worth on options and commodities positions--Appendices A and B; n95
- net pair-off receivables and money differences outstanding no more than one business day and give-up receivables outstanding no more than 30 days from the billing date, which must be no later than the last day of the month in which they arise, need not be deducted as would be required by subparagraph (c)(2)(iv)(B); n96 and
- loans to commercial banks for one business day or immediately available funds held by the government securities broker or dealer in connection with the clearance of securities on the day the loan is made. n97

Unlisted options that are Treasury market risk instruments are valued in the same way as listed options under subparagraph (c)(2)(i)(B)(1). n98

For non-introducing brokers, the minimum liquid capital maintenance requirement is \$250,000 after haircuts under the Treasury's own haircut provisions. n99 The rules also require maintenance of liquid capital equal to 120 percent of total haircuts for all government securities brokers and government securities dealers. n100

[5] Treasury Haircut Rules

The Treasury has deliberately taken a different approach to haircuts than the SEC's formula under Rule 15c3-1. In its initial announcement of proposed rules under the GSA it noted that it had "consulted extensively with the SEC and the federal supervisory agencies for financial institutions, and with the Federal Reserve Bank of New York ("FRBNY"), which has developed and published a voluntary capital adequacy guideline for brokers and dealers in government securities." n101 Although the Treasury decided to adopt most of the regulations under Sections 15 and 17 of the Exchange Act, with minor modifications, "in the area of financial responsibility [it] determined that the capital adequacy model designed by the FRBNY, which effectively recognizes certain types of risks as well as risk-mitigating hedging techniques is, with modifications, better suited for brokers and dealers transacting business solely in government securities, other exempted securities, and CFTC-regulated commodity interests than SEC Rule 15c3-1." n102

The Treasury has noted that its methodology is in some instances more generous, and in others less generous, than the SEC methodology. n103 "The major innovation and element of complexity is the haircut calculation. However, the haircut calculation is in fact simpler than it appears on the surface, and it is relatively simple to write a computer program to calculate the numbers." n104

The Treasury rule classifies all non-zero coupon and zero-coupon Treasury market risk instruments into the following "haircut categories": n105

Category	Term or type for non-zero coupon instruments	Term or type for zero coupon instruments
_____	_____	_____
—		
A	Less than 45 days	Less than 45 days
B	At least 45 days but less than 135 days	At least 45 days but less than 135 days
C	At least 135 days but less than 9 months	At least 135 days but less than 9 months

1-3 Federal Securities Exchange Act of 1934 § 3.07

D	At least 9 months but less than 1 year, 6 months	At least 9 months but less than 1 year, 6 months
E	At least 1 year, 6 months but less than 3 years, 6 months	At least 1 year, 6 months but less than 3 years
F	At least 3 years, 6 months but less than 7 years, 6 months	At least 3 years but less than 5 years, 6 months
G	At least 7 years, 6 months but less than 15 years	At least 5 years, 6 months but less than 9 years
H	15 years and over	At least 9 years but less than 12 years
I		At least 12 years but less than 21 years
J		21 years and over
WB	All fixed rate mortgage-backed securities that are Treasury market risk instruments.	
AR	AR All adjustable rate mortgage-backed securities that are Treasury market risk instruments.	

The rule also establishes "haircut" factors for the various haircut categories, n106 as follows:

Category	Net position haircuts (percent)	Hair cut Fact ors Offsets (percent)
A	None	None
B	0.12	0.02
C	0.20	0.03
D	0.45	0.07
E	1.10	0.22
F	2.20	0.44
G	3.30	0.50
H	4.50	0.90
I	7.75	1.55
J	11.25	3.38
MB	3.30	0.66
AR	1.10	0.22

The rule also establishes "Category pair hedging disallowance haircut factors," n107 as follows:

Percent Disallowed									
Category	C	D	E	F	G	H	I	J	MB
B	30	40							

1-3 Federal Securities Exchange Act of 1934 § 3.07

C	20	30					
D		20	30	40			
E			20	30	40		
F				20	30	40	30
G					20	30	30
H						20	40
I							40

Then it identifies "total haircuts" as the sum of "credit risk haircuts" and "market risk haircuts." n108

A Credit Risk Haircut is the sum of total counterparty exposure haircut, total concentration of credit haircut, and credit volatility haircut. n109

A total counterparty exposure haircut is the computation of the "net credit exposure" to each counterparty. The net credit exposure is the excess, if any, of the amount the firm would lose if the counterparty defaults, over the amount of certain offsets the firm has against the counterparty, n110 multiplied by a factor of 5% (to the extent that the net credit exposure to that counterparty does not represent more than 15% of the firm's liquid capital). The total counterparty of exposure haircut is the sum of all of these counterparty haircuts.

If the net credit exposure to any counterparty exceeds 15% of the firm's liquid capital, the amount of such excess is multiplied by a "concentration of credit haircut factor" of 25%, to give the concentration of credit haircut for that counterparty. The sum of all of the concentration of credit haircut for all counterparties is the "total concentration of credit haircut." n111

To arrive at the credit volatility haircut, the firm must determine its gross long and gross short positions in certificates of deposit, bankers acceptances and commercial paper that come within the definition of Treasury market risk instruments and that have a term to maturity greater than 44 days, including futures and forwards thereon, settled on a cash or delivery basis. In each case, it must compute 0.15% of the dollar amount of the larger of the gross long or gross short position. n112

The Market Risk Haircut is the other component of total haircuts. It is computed in accordance with Appendix A to the Treasury's Liquid Capital Rule and is the sum of (a) the "Treasury market risk haircut" and (b) the "other securities risk haircut." n113

The calculation of Treasury market risk haircut involves use of the haircut categories in 17 C.F.R. § 402.2(f). n114 It is the sum of four separate calculations: the "total governments offset portion haircut"; the "total futures and options offset haircut"; the "total hedging disallowance haircut"; and the "residual net positions haircut." n115

To calculate the total governments offset portion haircut portion, the firm must first determine its "gross long immediate position" and its "gross short immediate position" in each haircut category listed in subparagraph (f)(1). n116 The firm must identify the smaller of these two factors for each category in subparagraph (f)(1) and, for each category, multiply it by the offset haircut factor for that category, as listed in subparagraph (f)(2). n117 The sum of the government offset haircuts, as so computed, for all categories is the total government offset haircut.

To calculate the total futures and options offset haircut portion of the haircuts, the firm must first determine the positive and negative aggregate interim haircuts for each of the 10 categories in subparagraph (f)(1). n118 To do this, for each category the firm must compute:

- the "positive net immediate position interim haircut";
- the "gross long futures and forward interim haircut"; and
- the "positive gross options interim haircut." n119

These figures are then totaled.

The total hedging disallowance is the sum of the product of the net of each pair of categories covered in subparagraph (f)(3) multiplied by the percent of disallowance shown for that pair of categories in subparagraph (f)(3). n120 The residual net positions haircut is the sum of the absolute values of all haircuts remaining after the calculation of permissible nettings to arrive at the Total Hedging Disallowance. n121

The sum of the results of these four calculations is the Treasury market risk haircut. To that is added the "other securities haircut," which is the sum of the deductions specified in paragraphs (c)(2)(vi) (haircuts), (c)(2)(viii) (open contractual commitments), Appendix A (relating to options), and Appendix B (relating to commodities transactions) for all long and short positions in securities, future contracts, options, and other inventory which are not Treasury market risk instruments. n122 The total of the Treasury market risk haircut and the other securities haircut is the market risk haircut, which is added to the credit risk haircut to get the total haircuts. n123

Thus, the total haircut includes elements addressing the risk of doing business with a particular counterparty and elements (to a great extent offsetting long and short positions) reflecting an estimation of the risk of holding various kinds of inventory.

The Treasury rules also contain a debt-equity requirement, which is based on the similar Appendix D to the SEC Rule 15c3-1, as modified by Appendix D to the Treasury rule. n124 In addition, the rules limit the withdrawal of equity capital, n125 if, as a result of such withdrawal, a firm's ratio of liquid capital to total haircuts would be less than 150%; n126 or liquid capital minus total haircuts would be less than 120% of the required minimum; n127 or debt capital would exceed 70% of the debt equity total as defined in Rule 15c3-1(d).

[6] Protection of Customer Securities and Credit Balances

The Treasury's rules for the protection of customer securities and credit balances are substantially based on the Commission's rules in this area. Registered broker-dealers n128 are deemed to be in compliance with the Treasury's rules if they comply with the Commission's hypothecation Rules 8c-1 and 15c2-1, Rule 15c3-2 with respect to use of customers' free credit balances, and 15c3-3 with respect to custody of securities and establishment of reserve accounts, with minor modifications to make those rules clearly applicable to government securities brokers and dealers. n129 The same rules are made applicable to all registered government securities broker-dealers. n130 The principal modifications of the Commission rules are as follows. Rule 8c-1(d), which exempts certain liens of a clearing corporation, is expanded to include liens of a clearing bank, but limited to liens arising from loans to acquire the securities subject to the lien. n131 For purposes of Rule 15c3-3, the term "fully paid securities" is defined as all securities held for a customer who has made full payment therefore. n132 "Margin securities" are defined as securities which have not been paid for in full and as to which the government securities broker or dealer has made an extension of credit. n133 The phrase "excess margin securities" means all margin securities having a market value in excess of 140% of the customers' debit balances. n134

In addition, paragraph (b)(4) is added to Rule 15c3-3, to require government securities brokers or dealers that have custody of securities that are the subject of a repurchase agreement with a public customer n135 to: obtain the repurchase agreement in writing; confirm in writing the specific securities that are the subject of the repurchase

agreement at the end of the day the transaction is initiated and each day that there is a substitution of different securities; in the case of a registered broker-dealer, advise the customer that the Securities Investor Protection Corporation n136 has taken the position that the Securities Investor Protection Act does not protect the customer with respect to the repurchase agreement; and maintain possession or control of the subject securities. For purposes of this last requirement, the only acceptable control locations are a clearing corporation or custodian bank in connection with the clearance process; n137 a bank which acknowledges that it has no lien on the securities; n138 or in transit between the firm's offices or in a suitable corporate subsidiary of the firm. n139 The requirement of maintaining custody does not preclude substitution of securities subject to certain recordkeeping requirements and the requirement of an express written disclosure. n140

[7] Custody Requirements for Financial Institutions Not Registered with the Commission

Section 403.5 of the Treasury rules n141 sets forth the requirements for custody of customer securities that are applicable to government securities brokers or dealers that are financial institutions, *i.e.*, those not required to register with the Commission under Section 15, 15B or 15C. As noted in the Treasury's Release publishing the proposed rules for comment:

As a general rule, these financial institutions are directed to comply with [17 C.F.R.] Part 450 with respect to custody of securities held for customers or counterparties. For securities that are held for others by the financial institution in its capacity as a government securities broker or dealer, certain additional requirements are imposed that generally parallel the requirements of SEC Rule 15c3-3.

For example, a financial institution that is a government securities broker or dealer that engages in repurchase transactions is required to comply with provisions that parallel the requirements of § 403.3(e). In addition, the financial institution is required to make daily determinations of the amount of shortfall, if any, of securities required to be in its possession or control and to take steps to obtain securities to cover a shortfall. Section 403.5 does not, however, contain any provisions similar to the requirements of SEC Rule 15c3-2 concerning use of customer funds or SEC Rule 15c3-3 concerning a special reserve bank account for holding customer balances. Rule 15c3-2, by its terms, does not apply to supervised banking institutions and the [Treasury] Department concluded that the exemption should be extended to all supervised financial institutions that are government securities brokers or dealers. Furthermore, because financial institutions generally maintain customer funds as a fundamental part of their business, and because they are supervised in large part to protect their deposits, the Department concluded that it would serve no useful investor protection purpose to impose the added requirement of Rule 15c3-3(e) to require a financial institution to establish a special account for customer funds at another financial institution.

A separate rule was drafted for financial institutions that are government securities brokers or dealers primarily because neither financial institutions nor their regulatory agencies are familiar with Rule 15c3-3. However, the proposed rule is intended to parallel the relevant requirements of Rule 15c3-3. Although the requirements of the proposed rule are stated in less detail than is found in Rule 15c3-3, it is anticipated that its enforcement by the financial institutions supervisory agencies will follow, in practical effect, the Commission's rule. n142

Significant exceptions exist to the rules for other government securities brokers and government securities dealers made applicable to financial institutions. For example, to ensure that a financial institution makes a good faith effort to obtain a security sold to a customer, Section 403.5(b) n143 142 requires that if the purchase of the security has not been initiated by the close of the next business day after receipt of the customer's funds, the institution is required to place the funds in a deposit account belonging to such customer. This provision was inserted because such institutions are not subject to Rule 15c3-3 requiring the setting aside of funds in a Reserve Account.

The required disclosure to be given if the institution has the right to substitute securities under repurchase agreement is the same as for registered government securities brokers and government securities dealers, n144 except that it refers to potential liens of "third persons" instead of to the seller's clearing bank. n145 Branches and agencies of foreign banks that do not qualify for the exemption in Section 401.6 n146 must, in addition to other requirements, pledge assets at an insured bank n147 equal to the net amounts relating to government securities owed to customers, computed in accordance with Rule 15c3-3(e) and Exhibit A thereto. n148

Section 403.6 of the Treasury rules n149 makes it clear that a futures commission merchant that is also a government securities broker or dealer must comply with 17 C.F.R. Part 403, except to the extent that its custody of customer's securities is incidental to its futures business. n150

[8] Recordkeeping and Record Preservation

As in the case of capital requirements, compliance with the SEC's recordkeeping requirements n151 by registered broker-dealers is sufficient to satisfy the Treasury's rules. n152 These requirements have been adopted for government securities brokers and dealers registered under Section 15C with some modifications. Significant among the requirements is the requirement that a ledger account of repurchase and reverse repurchase agreements with customers must be maintained, and these positions must be reflected in the security position ledgers and confirmations. n153 In addition, the requirement of Rule 17a-3(a)(11) to make trial balances is modified to require the balances to reflect computations under the appropriate capital responsibility requirements for government securities brokers and dealers. n154

No records are required with respect to the sale and redemption of U.S. Savings Bonds, Notes and Stamps. n155 Similarly, the record retention rule has been somewhat modified by the Treasury rules to refer to special provisions applicable to government securities brokers and government securities dealers with respect to capital requirements and possession and custody of customers' assets. n156

Government securities brokers and dealers that are financial institutions, and thus required only to give notice to their appropriate regulatory authority under Section 15C(a)(1)(B), are subject to the same record keeping and retention requirements as registered government securities brokers and government securities dealers, except those exempted pursuant to section 401 of the Treasury regulations. n157 In addition, national and state banks, and certain branches or agencies of foreign banks subject to specified federal bank regulations (provided that those regulations are complied with without regard for exemptions therein for government securities transactions) n158 are exempted if they make and keep current the following additional records:

- a securities ledger, which also covers repurchase and reverse-repurchase positions, complying with Rule 17a-3(a)(5); n159 and
- a Form MSD-4, or G-FIN-4, for each associated person, a Form U-5, MSD-5 or G-FIN-5 for each terminated associated person, n160 and Form G-FIN and, if applicable, G-FINW, for the firm. n161

[9] Securities Counts

Registered government securities brokers and government securities dealers must comply with Rule 17a-13, with respect to securities counts, as modified by the Treasury regulations expressly to include repurchase and reverse-repurchase agreements. n162

[10] Reporting Requirements

Compliance by registered broker-dealers with SEC Rules 17a-5 (financial reporting) and 17a-11 (supplemental

reporting of financial or record keeping problems) constitutes compliance with the Treasury regulations on these matters. n163

Registered government securities brokers and government securities dealers are generally required to make the same kinds of reports. However, significant modifications exist. Instead of Form X-17A-5 (the FOCUS Report), the Treasury has promulgated Form G-405 for reporting financial condition. n164 163 The format of Form G-405 is similar to the FOCUS Report, but it has been designed to relate to the government securities broker or dealers' computation of liquid capital instead of the net capital computation under Rule 15c3-1. n165

Adjustments have been made in Rule 17a-5 to make the Treasury reporting requirement relate to requirements applicable to government securities brokers and government securities dealers with respect to custody and control of customer securities n166 and liquid capital n167 and to delete reference to the Securities Investor Protection Act. n168 Similar modifications in the SEC rule have been made for government securities interdealer brokers n169 and government securities brokers and government securities dealers that are futures commission merchants. n170

Most of the provisions of Rule 17a-11, which relates to supplemental reports when a firm's capital falls below specified levels or it discovers a material inadequacy in its recordkeeping system, have been made applicable to government securities brokers and government securities dealers with minor modifications to substitute the relevant references to the Treasury regulations with respect to liquid capital, recordkeeping and audit requirements. n171

[11] Forms

The Treasury has promulgated several filing and reporting forms, which follow the pattern of SEC forms. These are:

- Form G-FIN--Similar to Form BD--for notification of states by a government securities broker or dealer under Section 15C(a)(1)(B). n172
- Form G-FINW--Similar to Form BDW--for notification of cessation of status as a government securities broker or dealer under Section 15C(a)(1)(B). n173
- Form G-FIN-4--Similar to Form U-4--for notification by persons associated with a government securities broker or dealer under Section 15C(a)(1)(B). n174
- Form G-FIN-5--Similar to Form U-5, for notification of termination of affiliated person status under Section 15C(a)(1)(B). n175
- Form G-405--Similar to Form X-17A-5--the FOCUS Report--for reporting financial condition of government securities brokers and government securities dealers. n176

FOOTNOTES:

(n1)Footnote 1. Former Section 15(a).

(n2)Footnote 2. S. Rep. 426, 99th Cong., 2d Sess. (1986), reprinted in the Primary Law Sourcebook, Volume C, Section I (Matthew Bender), estimated the pre-tax losses at about \$800 million, including losses of \$325 million by banks, \$375 million by thrift institutions, and \$100 million by municipalities. *Id. at 6 n.15* .

(n3)Footnote 3. *Id.*

(n4)Footnote 4. The Treasury borrows in the government securities market to cover the deficit between budgetary needs and tax revenue, and to refinance maturing federal debt, as a means of carrying out monetary policy through the Federal Reserve System, and as a resource for day-to-day cash management. *Id. at 5* and accompanying text.

(n5)Footnote 5. H.R. Rep. No. 258, 99th Cong., 1st Sess. 12 (1985).

(n6)Footnote 6. Pub. L. No. 99-571, Sec. 101, 100 Stat. 3208 [hereinafter the "GSA"]. Citations of the GSA, unless otherwise stated, are to its provisions as found in the Exchange Act.

(n7)Footnote 7. *See* §§ 2A.02 and 2A.03 *supra* .

(n8)Footnote 8. Section 3(a)(42), reprinted in the Securities Primary Law Sourcebook, Volume B, Section F (Matthew Bender), added by the GSA. Clauses (A) and (B) were formerly included in the definition of "exempted security" in Section 3(a)(12), which was also amended by the GSA. The substance of clause (D) was found in Rule 3a12-7, which applied to such options and privileges if the securities underlying them represented a principal amount of at least \$250,000. The only automated quotation system that currently satisfies the criteria of clause (D) is the FINRA's NASDAQ system.

(n9)Footnote 9. *Compare* the definition of "broker" in Section 3(a)(4), which does not contain the word "regularly." This may permit a greater degree of "irregular" activity before a person would be deemed a government securities broker.

(n10)Footnote 10. *See* text accompanying ns. 6-7 *supra*.

(n11)Footnote 11. The CFTC's staff has advised the SEC that many commodities clearing corporations are not legally "controlling, controlled by, or under common control with," designated contract markets. The quoted terms are the usual SEC definition of "affiliates." Nevertheless, the SEC has said that it will interpret the term "affiliates" to cover those clearing organizations that have a contractual or customary arrangement to clear futures contracts traded on a particular futures contract market. Exch. Act Rel. No. 34-24135 [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,105, at 88,535 n.3 (Feb. 25, 1987).

(n12)Footnote 12. *See* text accompanying n.17 *infra*.

(n13)Footnote 13. *Compare* the definition of "broker" in Section 3(a)(4), which excludes a "bank."

(n14)Footnote 14. Exch. Act Rel. No. 34-24726 [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,147 (July 22, 1987).

(n15)Footnote 15. Rule 3a43-1(b). CFTC rules are in 17 C.F.R. §§ 1.20-1.30.

(n16)Footnote 16. *Id.*

(n17)Footnote 17. Rule 3a43-1(b)(1)(i), reprinted in the Securities Primary Law Sourcebook, Volume B, Section G (Matthew Bender).

(n18)Footnote 18. Rule 3a43-1(b)(1)(ii). Exch. Act Rel. No. 34-24135 [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,105 (Feb. 15, 1987).

(n19)Footnote 19. Rule 3a43-1(b)(2)(i).

(n20)Footnote 20. Rule 3a43-1(b)(2)(ii).

(n21)Footnote 21. Rule 3a43-1(b)(2)(iii).

(n22)Footnote 22. Rule 3a43-1(b)(3).

(n23)Footnote 23. A "CFTC-regulated person" is a person registered with the CFTC, a contract market designated

by the CFTC, an affiliated clearing organization of such a contract market, or a floor trader on such a contract market. Rule 3a44-1(a).

(n24)Footnote 24. Rule 3a44-1(b). *Compare* text accompanying n.16 *supra*.

(n25)Footnote 25. Rule 3a44-1(b)(1).

(n26)Footnote 26. Rule 3a44-1(b)(2).

(n27)Footnote 27. Rule 3a44-1(b)(3).

(n28)Footnote 28. Rule 3a44-1(b)(4).

(n29)Footnote 29. Rule 3a44-1(b)(5).

(n30)Footnote 30. Rule 3a44-1(b)(6).

(n31)Footnote 31. Section 15C(a)(5).

(n32)Footnote 32. 17 C.F.R. § 401.1.

(n33)Footnote 33. 17 C.F.R. § 401.2. Such depository institutions would nevertheless be subject to 17 C.F.R. § 450, concerning custodial holdings of government securities.

(n34)Footnote 34. 17 C.F.R. § 401.3. Such institutions would nevertheless be subject to 17 C.F.R. § 450, concerning custodial holdings of government securities.

The exemption for financial institutions that do not hold themselves out as a government securities broker is independent of the 500-transaction and networking exemptions. However, in adopting this exemption, the Treasury noted that "even though inclusion of brokerage services on a summary list of services available to customers would not be considered 'holding out,' any financial institution that performs substantially more than 500 such transactions per year may wish to analyze carefully whether it is in fact actively soliciting such transactions." 17 C.F.R. ch. IV, Part B(3), May 26, 1987. The 500-transaction exemption includes the networking exemption. Any networking transactions count against the 500-transaction limitation. *Id.* However, transactions exempt under 17 C.F.R. §§ 401.1 and 401.2 do not count against the 500-transaction limitation. The exemption expressly applies to insured federal credit unions, 17 C.F.R. § 401.3(c), but not to registered broker-dealers and branches or agencies of a foreign bank. In addition, the exemption applies only insofar as the firm acts as a broker, not as a dealer. The Treasury has noted that it may be difficult to distinguish between activities as a broker and as a dealer, particularly in a book-entry environment where all customer securities must be held on the books of another entity. Two major characteristics of an agency transaction are that the transacting broker does not sell from, or purchase for, his own inventory and that an explicit, transaction-based fee or commission is charged. Transactions in a fiduciary capacity which are initiated by the fiduciary rather than the customer are generally not brokerage transactions but reflect the financial institution acting as investor. *See* n.33 *supra*.

(n35)Footnote 35. 17 C.F.R. § 401.4. This exemption, like 17 C.F.R. § 401.3, is not available to registered broker-dealers or branches or agencies of foreign banks but is expressly available to insured credit unions. 17 C.F.R. § 401.4(c). Financial institutions relying on this exemption must comply with 17 C.F.R. § 450, with respect to custodial holdings of government securities, and 17 C.F.R. § 403.5(d), concerning repurchase transactions with customers. In addition, 17 C.F.R. § 401.4(a)(3) also contemplates exemption for "such other activities as have been exempted by regulation under this subchapter."

The Treasury has noted that in adopting these exemptions for activities as a "dealer," it has not identified the line of demarcation between an investor or trader, who would not be required to register, and a dealer, who would. It referred

to the SEC staff's no-action position that an entity may be regarded as a trader even if it buys and sells a high volume of government securities on a fairly regular basis, as long as the transactions are done by the entity as principal and not directly or indirectly for or at the request of customers, and the entity does not hold itself out or otherwise act as a dealer. The Treasury recommended that institutions that have concerns about their status as traders or dealers should address these concerns to the Chief Counsel of the SEC's Division of Market Regulation under SEC staff no-action procedures. 17 C.F.R. ch. IV, Part B(4), May 26, 1987.

(n36)Footnote 36. 17 C.F.R. § 401.5. Such credit unions would be subject to 17 C.F.R. § 450 with respect to custodial holdings of government securities and 17 C.F.R. § 403.5(d) concerning repurchase transactions with customers.

(n37)Footnote 37. 17 C.F.R. § 401.6. Such foreign bank agencies or branches would be subject to 17 C.F.R. § 450 with respect to custodial holdings of government securities.

(n38)Footnote 38. Section 15C(a)(1)(A).

(n39)Footnote 39. Section 3(a)(48). For a discussion of the registration requirements of Section 15, *see* § 3.03 *supra*. For a discussion of the registration requirements of Section 15B, which applies to municipal securities brokers and dealers, *see* § 3.06[4][a] *supra*.

(n40)Footnote 40. Section 15C(a)(1)(B)(i); Section 3(a)(34)(G)(v).

(n41)Footnote 41. Rule 15Ca1-1(a). *See* § 3.03[2][a] *supra* for a discussion of Form BD. Form BD is reprinted in the Securities Primary Law Sourcebook, Volume B, Section H (Matthew Bender).

(n42)Footnote 42. Section 15C(a)(1)(B)(i); Rule 15Ca1-1(b).

(n43)Footnote 43. Section 15C(a)(1)(B)(i) and (ii).

(n44)Footnote 44. Section 15C(a)(1)(A).

(n45)Footnote 45. *See* § 3.03 *supra*.

(n46)Footnote 46. Rule 15Ca2-1(a). *See* § 3.03[2][a] *supra* for a discussion of Form BD. The rule does not specify that the form must be amended when it becomes inaccurate, because such amendments are deemed to be "reports" under the GSA, and only the Secretary of the Treasury has authority to adopt reporting requirements. Rule 15Ca2-1(b); Exch. Act Rel. No. 34-24372 [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,120 at 88,631 (April 21, 1987). The Treasury has adopted a rule requiring Form BD to be amended within 30 days of when it becomes inaccurate. 17 C.F.R. § 400.5, May 26, 1987.

(n47)Footnote 47. Section 15C(a)(2).

(n48)Footnote 48. *See* § 3.03[2][b] *supra*.

(n49)Footnote 49. *See* § 3.03[6] *supra*.

(n50)Footnote 50. Section 3(a)(45) defines person associated with a government securities broker or government securities dealer to mean:

any partner, officer, director, or branch manager of such government securities broker or government securities dealer (or any person occupying a similar status or performing similar functions), and any other employee of such government securities broker or government securities dealer who is engaged in the management, direction, supervision, or performance of any activities relating to

government securities, and any person directly or indirectly controlling, controlled by, or under common control with such government securities broker or government securities dealer.

(n51)Footnote 51. Section 15(b)(4)(A).

(n52)Footnote 52. Section 15(b)(4)(B).

(n53)Footnote 53. Section 15(b)(4)(C).

(n54)Footnote 54. Section 15(b)(4)(D).

(n55)Footnote 55. Section 15(b)(4)(E).

(n56)Footnote 56. Section 15(b)(4)(F).

(n57)Footnote 57. Section 15(b)(4)(G).

(n58)Footnote 58. Section 15C(c)(3).

(n59)Footnote 59. *Id.*

(n60)Footnote 60. Sections 15(c)(4), 15C(c)(3).

(n61)Footnote 61. 12 U.S.C. § 1818.

(n62)Footnote 62. 12 U.S.C. § 1464.

(n63)Footnote 63. 12 U.S.C. § 1730; Section 15C(c)(2)(B), 15 U.S.C. § 780-5(c)(2)(B).

(n64)Footnote 64. *In re Salomon, Inc. Sec. Litig.*, No. 91cv5442, 1992 U.S. Dist. LEXIS 17280 ; *Fed. Sec. L. Rep. (CCH)* 97,254 (Nov. 12, 1992) .

(n65)Footnote 65. *In re Salomon Brothers, Inc.*, 51 SEC Docket (CCH) 1025 (May 20, 1992).

(n66)Footnote 66. *In re John Gutfreund*, 52 SEC Docket (CCH) 4370 (Dec. 3, 1992).

(n67)Footnote 67. *See, e.g.*, H.R. 2032, as initially passed by the House of Representatives in September, 1985, which would have created a Government Securities Rulemaking Board.

(n68)Footnote 68. Section 15C(a)(5).

(n69)Footnote 69. Section 15C(b):

(1) The Secretary [of the Treasury] shall propose and adopt rules to effect the purposes of this chapter with respect to transactions in government securities effected by government securities brokers and government securities dealers as follows:

(A) Such rules shall provide safeguards with respect to the financial responsibility and related practices of government securities brokers and government securities dealers including, but not limited to, capital adequacy standards, the acceptance of custody and use of customers' securities, the carrying and use of customers' deposits or credit balances, and the transfer and control of government securities subject to repurchase agreements and in similar transactions.

(B) Such rules shall require every government securities broker and government securities dealer to make reports to and furnish copies of records to the appropriate regulatory agency, and to file with the appropriate regulatory agency, annually or more frequently, a balance sheet and income statement certified by an independent public accountant, prepared on a calendar or fiscal year basis, and such other financial statements (which shall, as the Secretary specifies, be certified) and information concerning its financial condition as required by such rules.

(C) Such rules shall require records to be made and kept by government securities brokers and government securities dealers and shall specify the periods for which such records shall be preserved.

* * *

(4) Rules promulgated and orders issued under this section shall--

(A) be designated to prevent fraudulent and manipulative acts and practices and to protect the integrity, liquidity, and efficiency of the market for government securities, investors, and the public interest; and

(B) not be designated to permit unfair discrimination between customers, issuers, government securities brokers, or dealers, or to impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title.

(5) In promulgating rules and issuing orders under this section, the Secretary--

(A) may appropriately classify government securities brokers and government securities dealers (taking into account relevant matters, including types of business done, nature of securities other than government securities purchased or sold, and character of business organization) and persons associated with government securities brokers and government securities dealers;

(B) may determine, to the extent consistent with paragraph (2) of this subsection and with the public interest, the protection of investors, and the purposes of this chapter, not to apply, in whole or in part, certain rules under this section, or to apply greater, lesser, or different standards, to certain classes of government securities brokers, government securities dealers, or persons associated with government securities brokers or dealers;

(C) shall consider the sufficiency and appropriateness of then existing laws and rules applicable to government securities brokers, government securities dealers, and persons associated with government securities brokers and government securities dealers; and

(D) shall consult with and consider the views of the Commission and the Board of Governors of the Federal Reserve System, except where the Secretary determines that an emergency exists requiring expeditious or summary action and publishes its reasons for such determination.

(6) If the Commission or the Board of Governors of the Federal Reserve System comments in writing on a proposed rule of the Secretary that has been published for comment, the Secretary shall respond in writing to such written comment before approving the proposed rule.

(7) No government securities broker or dealer shall make use of the mails or any means or

instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any government security in contravention of any rule under this section.

In October 1993, the House passed H.R. 618 to reauthorize permanently the Secretary of the Treasury's rulemaking authority under the Government Securities Act of 1986. 1993 SEC Ann. Rep. 27.

(n70)Footnote 70. Section 15C(g)(2).

(n71)Footnote 71. 17 C.F.R. § 400.2(d).

(n72)Footnote 72. See Section 15(b)(8), which was amended by the Government Securities Act of 1986 to extend its scope to brokers and dealers in government securities.

(n73)Footnote 73. Section 15C(e)(1). The SEC, after consultation with the Secretary of the Treasury, can exempt any government securities brokers or dealers from this requirement. Section 15(C)(e)(2).

(n74)Footnote 74. See § 3.05 *supra*.

(n75)Footnote 75. NASD Manual (CCH) P 2195. See NASD Notice to Members No. 87-24 (Apr. 14, 1987), proposing amendments of subparagraphs (4), (5), (7) and (9) of Section 35(c).

(n76)Footnote 76. NASD Notice to Members No. 87-33 (June 30 1987); NASD Q & A Report, vol. 7, No. 5 (June 30, 1987).

(n77)Footnote 77. NASD Notice to Members No. 87-33 (June 30, 1987). See n.75 *supra* (with respect to filing Form BD with NASD).

(n78)Footnote 78. Rule 15c3-1. See § 3.03[4] *supra*.

(n79)Footnote 79. The Liquid Capital Rule is codified at 17 C.F.R. §§ 402.1, 402.2.

(n80)Footnote 80. 17 C.F.R. § 402.1(b). This means registered under Section 15 or Section 15B. See Section 3(a)(48).

(n81)Footnote 81. 17 C.F.R. § 402.1(c)(1). See Section 3(a)(34) for the definition of "appropriate regulatory agency." This exception does not apply to any government securities broker or dealer required to register under Section 15C(a)(1)(A); the rule is intended to apply only to those not regulated before the effectiveness of the GSA. See 17 C.F.R. ch. IV (II)(c), February 19, 1987. This was done to avoid the imposition on adequately regulated entities of potentially conflicting and unduly burdensome regulations. The Treasury has cited the following kinds of financial institutions as being "adequately regulated": banks and bank holding companies that are subject to supervision of the Federal Reserve Board, Comptroller of the Currency, and Federal Deposit Insurance Corporation, and thrift institutions insured through the Federal Savings and Loan Corporation or the Federal Deposit Insurance Corporation. However, government securities brokers and government securities dealers which are subsidiaries and affiliates of such companies would not be exempt unless they are also directly subject to capital regulations of an appropriate regulatory authority. *Id.*

(n82)Footnote 82. 17 C.F.R. § 402.1(c)(2).

(n83)Footnote 83. 17 C.F.R. § 402.1(d). The CFTC capital requirements are in 17 C.F.R. § 1.17; the SEC capital requirement is in Rule 15c3-1.

(n84)Footnote 84. "Government securities interdealer broker" means an entity engaged exclusively in business as a

broker effecting transactions in government securities, on a fully disclosed or partially disclosed basis, for counterparties that are government securities brokers or dealers that have registered or given notice under Section 15C(a)(1), and that promptly transmits all funds and delivers all securities received in connection with these activities and does not otherwise hold funds or securities for or owe money or securities to its counterparties, and (except as provided in 17 C.F.R. § 402.1(e)(2)(ii)) does not have or maintain any government securities in its proprietary or other accounts. 17 C.F.R. § 402.1(e)(2)(i).

In transactions effected on a "fully disclosed basis," the firm knows the identity of its counterparty for which the transaction is effected. In transactions effected on a "partially disclosed basis," the counterparties, if not aware of the exact identity of each other, have the right to obtain such information, or are aware and have consented to the identity of a specific group of entities from which the counterparty is chosen. *Id.*

The kinds of proprietary positions which can be maintained pursuant to 17 C.F.R. § 402.1(e)(2)(ii) are:

- overnight reverse repurchase or securities borrowed transactions solely for the purpose of facilitating, or deducting its financing expense in connection with, clearance of government securities transactions;
- subordinated loans pursuant to the Uniform Net Capital Rule 15c3-1(d);
- compliance with collateral or depository requirements of a clearing corporation with which it participates for clearance of government securities transactions; and
- investment of excess cash.

The maturities of the government securities held for these purposes (except overnight reverse repurchase or securities loaned transactions) must be not more than one year.

(n85)Footnote 85. 17 C.F.R. § 402.1(e)(2)(i).

(n86)Footnote 86. 17 C.F.R. § 402.1(e)(3).

(n87)Footnote 87. See Exch. Act Rel. No. 34-49830, and amendments to 17 C.F.R. §§ 200, 240.

(n88)Footnote 88. 17 C.F.R. § 402.1(e)(4)-(8).

(n89)Footnote 89. 17 C.F.R. § 402.2(c). See § 3.07[5] *infra*.

(n90)Footnote 90. See 17 C.F.R. § 402.2(f)(2). See also § 3.07[5] *infra*.

(n91)Footnote 91. 17 C.F.R. § 402.2(d)(1) and (2). A "Treasury market risk instrument" is defined to mean the following dollar denominated securities, debt instruments and derivative instruments:

- (i) government securities, except equity securities and mortgage-backed securities that do not pass through to security holders a pro-rata portion of monthly payments of principal and interest;
- (ii) zero-coupon receipts or certificates based on marketable Treasury notes or bonds;
- (iii) certificates of deposit of no more than one year to maturity;

(iv) bankers acceptances;

(v) commercial paper of no more than one year to maturity, rated in one of the three highest categories by at least two nationally recognized standard rating services; and

(vi) futures (and options thereon), forwards, and options on any of the instruments in paragraphs (i) through (v), or on time deposits whose changes in yield are closely correlated with certificates of deposit described in paragraph (iii), transactions in which are settled on a cash or delivery basis.

17 C.F.R. § 402.2(e)(1).

(n92)Footnote 92. *17 C.F.R. § 402.2(d)(4).*

(n93)Footnote 93. *17 C.F.R. § 402.2(d)(4).*

(n94)Footnote 94. *17 C.F.R. § 402.2(d)(3).*

(n95)Footnote 95. *17 C.F.R. § 402.2(d)(4).*

(n96)Footnote 96. *17 C.F.R. § 402.2(d)(5), (6).*

(n97)Footnote 97. *17 C.F.R. § 402.2(d)(7).*

(n98)Footnote 98. *17 C.F.R. § 402.2 (d)(8).*

(n99)Footnote 99. *17 C.F.R. § 402.2(b).* The Treasury haircut requirement is discussed in § 3.07[5] *infra*. *Compare* the \$250,000 net capital requirement of Rule 15c3-1(a)(1).

(n100)Footnote 100. *17 C.F.R. § 402.2(a).*

(n101)Footnote 101. *17 C.F.R. Part IV(I) p. 6, February 19, 1987.*

(n102)Footnote 102. *Id. at 8-9 .*

(n103)Footnote 103. *17 C.F.R. Part IV(I)(C)(2), p. 15, May 26, 1987.*

(n104)Footnote 104. *Id.*

(n105)Footnote 105. *17 C.F.R. § 402.2(f)(1).*

(n106)Footnote 106. *17 C.F.R. § 402.2(f)(2).*

(n107)Footnote 107. *17 C.F.R. § 402.2(f)(3).*

(n108)Footnote 108. *17 C.F.R. § 402.2(g).*

(n109)Footnote 109. *17 C.F.R. § 402.2(g)(1).*

(n110)Footnote 110. *17 C.F.R. § 402.2(g)(1)(i), (ii).*

(n111)Footnote 111. *17 C.F.R. § 402.2(g)(1)(iii).*

(n112)Footnote 112. *17 C.F.R. § 402.2(g)(1)(iv).*

(n113)Footnote 113. 17 C.F.R. § 402.2(g)(2).

(n114)Footnote 114. See chart, *supra*.

(n115)Footnote 115. 17 C.F.R. § 402.2a(a).

(n116)Footnote 116. 17 C.F.R. § 402.2(f)(1). The quoted terms are defined in 17 C.F.R. § 402.2a(a)(1)(i) through (iv). This calculation can be done using Schedule B to 17 C.F.R. § 402.2a(c).

(n117)Footnote 117. 17 C.F.R. § 402.2(f)(2). See text accompanying n.108 *supra*. This calculation can be done by using Schedule C to 17 C.F.R. § 402.2a(c).

(n118)Footnote 118. 17 C.F.R. § 402.2a(a)(3). This calculation can be done by using Schedule D to 17 C.F.R. § 402.2a(c).

(n119)Footnote 119. 17 C.F.R. § 402a(a)(3)(i).

(n120)Footnote 120. 17 C.F.R. § 402.2a(a)(4). Schedule E, 17 C.F.R. § 402.2a(c), can be used to make this calculation.

(n121)Footnote 121. 17 C.F.R. § 402.2a(a)(5). Schedule E can be used to make this calculation.

(n122)Footnote 122. 17 C.F.R. § 402.2a(b). Treasury market risk instruments are defined in 17 C.F.R. § 402.2(e).

(n123)Footnote 123. 17 C.F.R. § 402.2(g).

(n124)Footnote 124. 17 C.F.R. § 402.2(h), and Appendix D, 17 C.F.R. § 402.2d.

(n125)Footnote 125. 17 C.F.R. § 402.2(i).

(n126)Footnote 126. The *minimum* requirement is that liquid capital be not less than 120% of total haircuts. 17 C.F.R. § 402.2(a).

(n127)Footnote 127. \$250,000 or \$50,000; 17 C.F.R. § 402.2(b) and (c). Compare Appendix D, 17 C.F.R. § 402.2d, with Rule 15c3-1.

(n128)Footnote 128. As defined in Section 3(a)(48), this means broker-dealers registered under Section 15 or 15B.

(n129)Footnote 129. 17 C.F.R. § 403.1. The modifications are in 17 C.F.R. §§ 403.2 through 403.4.

(n130)Footnote 130. 17 C.F.R. § 403.2 through 403.4.

(n131)Footnote 131. 17 C.F.R. § 403.2(b).

(n132)Footnote 132. 17 C.F.R. § 403.4(b).

(n133)Footnote 133. 17 C.F.R. § 403.4(c).

(n134)Footnote 134. 17 C.F.R. § 403.4(d).

(n135)Footnote 135. This does not include a registered broker or dealer or another government securities broker or dealer. 17 C.F.R. § 403.4(e).

(n136)Footnote 136. See § 3.08[3][a] *infra*.

(n137)Footnote 137. Rule 15c3-3(c)(1).

(n138)Footnote 138. Rule 15c3-3(c)(5).

(n139)Footnote 139. Rule 15c3-3(c)(6).

(n140)Footnote 140. The disclosure, which must be prominently displayed, must read as follows:

REQUIRED DISCLOSURE

The [seller] is not permitted to substitute other securities for those subject to this agreement and therefore must keep the [buyer's] securities segregated at all times, unless in this agreement the [buyer] grants the [seller] the right to substitute other securities. If the [buyer] grants the right to substitute, this means that the [buyer's] securities will likely be commingled with the [seller's] own securities during the trading day. The [buyer] is advised that, during any trading day that the [buyer's] securities are commingled with the [seller's] securities, they will be subject to liens granted by the [seller] to its clearing bank and may be used by the [seller] for deliveries on other securities transactions. Whenever the securities are commingled, the [seller's] ability to resegment substitute securities for the [buyer] will be subject to the [seller's] ability to satisfy the clearing lien or to obtain substitute securities.

Rule 15c3-3(b)(4)(iii)(B).

(n141)Footnote 141. 17 C.F.R. § 403.5.

(n142)Footnote 142. 17 C.F.R. ch. IV (p. 76-77) Fed. Reg., Feb. 25, 1987.

(n143)Footnote 143. 17 C.F.R. § 403.5(b).

(n144)Footnote 144. 17 C.F.R. § 403.4(e).

(n145)Footnote 145. 17 C.F.R. § 403.5(d)(1)(v).

(n146)Footnote 146. 17 C.F.R. § 401.6

(n147)Footnote 147. As defined in 12 U.S.C. 1813(h).

(n148)Footnote 148. 17 C.F.R. § 403.5(e).

(n149)Footnote 149. 17 C.F.R. § 403.6.

(n150)Footnote 150. See Rules 3a43-1 and 3a44-1, discussed in § 3.07[1] *supra*, and reprinted in the Securities Primary Law Sourcebook, Volume B, Section G (Matthew Bender), which define government securities activities "incidental" to the principal business of commodities firms.

(n151)Footnote 151. Rules 17a-3 (recordkeeping); 17a-4 (record retention); 17a-13 (quarterly securities counts); and 17a-7 (records of nonresident broker-dealers). See § 3.04[1], [2] and [5][b] *supra*.

(n152)Footnote 152. 17 C.F.R. § 404.1.

(n153)Footnote 153. 17 C.F.R. § 404.2(a)(4), (5).

(n154)Footnote 154. 17 C.F.R. § 404.2(a)(3)(i).

(n155)Footnote 155. 17 C.F.R. § 404.2(a)(6).

(n156)Footnote 156. 17 C.F.R. § 404.3. For capital and custody requirements, see § 3.07[4], [7] *supra*.

(n157)Footnote 157. 17 C.F.R. Part 401. See ns. 31-42 *supra* and accompanying text.

(n158)Footnote 158. 17 C.F.R. § 404.4(a)(1).

(n159)Footnote 159. 17 C.F.R. § 404.4(a)(3)(i)(A).

(n160)Footnote 160. 17 C.F.R. § 404.4(a)(3)(i)(B) and (C).

(n161)Footnote 161. 17 C.F.R. § 404.4(a)(3)(i)(D).

(n162)Footnote 162. 17 C.F.R. § 404.5.

(n163)Footnote 163. 17 C.F.R. § 405.1.

(n164)Footnote 164. The forms under the Securities Exchange Act are reprinted in the Securities Primary Law Sourcebook, Volume B. Section H (Matthew Bender).

(n165)Footnote 165. 17 C.F.R. §§ 405.2(a)(3), 449.5.

(n166)Footnote 166. 17 C.F.R. § 405.2(a)(8).

(n167)Footnote 167. 17 C.F.R. § 405.2(a)(7).

(n168)Footnote 168. 17 C.F.R. § 405.2(a)(10).

(n169)Footnote 169. 17 C.F.R. § 405.2(b).

(n170)Footnote 170. 17 C.F.R. § 405.2(c).

(n171)Footnote 171. 17 C.F.R. § 405.3.

(n172)Footnote 172. 17 C.F.R. § 449.1.

(n173)Footnote 173. 17 C.F.R. § 449.2.

(n174)Footnote 174. 17 C.F.R. § 449.3.

(n175)Footnote 175. 17 C.F.R. § 449.4.

(n176)Footnote 176. 17 C.F.R. § 449.5.



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Federal Securities Exchange Act of 1934

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CHAPTER 3 Regulation of Brokers and Dealers

1-3 Federal Securities Exchange Act of 1934 § 3.08

AUTHOR: W. Reece Bader

§ 3.08 Protection of Customers' Assets

[1] Background

Safeguards for the protection of customers from some of the risks inherent in trading in a highly-volatile market in which assets and purchases are often held by their brokers or dealer for extended periods of time are most easily thought of in two dimensions: protection during broker-dealers' normal operating periods; and protection during periods of broker-dealer financial difficulty or insolvency. Both types of protection stem from the Securities Investor Protection Act of 1970 ("SIPA"), n1 a comprehensive reform of the securities market enacted by Congress at the height of a period of liquidations, failures and mergers of broker-dealer firms which resulted in heavy customer losses. n2

The backdrop for the troubled situation prompting SIPA began with Wall Street's unprecedented "boom" in trading volume between 1965 and 1968. n3 The rapid increase in volume brought about rapid and unstructured expansion in the size and number of brokerage houses, but without an accompanying increase in systems, procedures, and skilled personnel to accommodate the massive growth. n4

As a result, a sharp reduction in the traffic in and market for securities occurred between 1968 and 1970, prompted in large part by the inability of the expanded brokerage houses to accommodate customer needs during the high growth period. n5 The resulting problems, decreases in commissions and decreased value of securities, caused the failure, merger, and involuntary acquisition of nearly 100 brokerage houses which were members of the New York Stock Exchange. n6 The circumstances led Congress to enact SIPA. The original purpose of SIPA was to provide replacement funds to customers facing losses from such failures. This led to the creation of the Federal Deposit Insurance Corporation and the now-defunct Federal Savings and Loan Insurance Corporation, which maintained funds to insure customer assets in the face of federal financial institution failures. n7

The primary function of SIPA was the creation of the Securities Investor Protection Corporation ("SIPC"). SIPC is a public corporation which establishes and administers a fund to secure the assets of securities customers, and conducts liquidation proceedings of member brokerages facing financial difficulties. n8

SIPA also provided for the promulgation of Rule 15c3-3, the "Customer Protection Rule." Rule 15c3-3 installs controls

intended to safeguard customers' assets prior to broker-dealer financial difficulty. The rule first requires that broker-dealers deposit sufficient reserves of cash or cash equivalent to equal their customers' secured cash balances in order to protect these funds against potential losses arising from the broker-dealers' own transactions. The rule also imposes restrictions which preclude the broker-dealers' use of customer's fully paid and excess margin securities.

[2] Regulations in Force Prior to Broker-Dealer Financial Difficulty

Several provisions of the Exchange Act and the rules promulgated thereunder are designed to govern how customer assets are handled by a broker or dealer during periods of normal operation.

The primary mechanism in place to protect customers is found in the Customer Protection Rule, Rule 15c3-3. n9 The Commission promulgated Rule 15c3-3 in response to the problems which eventually led to SIPA's enactment, in particular, brokers' use of customer assets to finance their own transactions. n10 The rule serves two purposes. First, it prohibits the use of customers' excess or fully-paid margin securities for a broker-dealer's own transactions. Second, it requires that customers' credit balances be secured by the segregation of sufficient cash or assets to cover the broker-dealers' net liabilities to his customers, to allow the immediate satisfaction of any claims made against customers funds or securities. n11 The Commission amended the customer protection rule in April of 2003, such that by order of the Director of the Division of Market Regulations, the Commission could expand the categories of permissible collateral. n12

Another mechanism placed for customer asset protection is the net capital requirements found in Rule 15c3-1, n13 which ensures that a broker-dealer's aggregate indebtedness does not exceed its net capital by more than 15 times. n14 Sufficient capitalization is thought to provide some security against insolvency or broker failure. However, this approach has been less than completely adequate in achieving this goal. n15 It is for this reason that the stringent requirements for protection of customer assets *after* insolvency or financial difficulty were put in place. n16 The following is an overview of the regulations, intended to safeguard customer assets under the Exchange Act, imposed on broker-dealers prior to financial difficulty. The hypothecation of customers' securities by exchange members and other brokers and dealers are governed by Section 8(b) (and Rule 8c-1 adopted pursuant thereto) n17 and Rule 15c2-1 (adopted pursuant to Section 15(c)(2)). n18 Lending of customers' securities is governed by Section 8(c). n19 Regulatory safeguards which protect customers' funds and securities held by brokers and dealers are set forth in Section 15(c)(3) and Rule 15c3-3 which is promulgated thereunder. n20 Comprehensive net capital standards for the securities industry are set forth in Rule 15c3-1, which was adopted pursuant to Section 15(c)(3). Borrowing by exchange members and other brokers and dealers is controlled by Section 8(a). n21 Credit regulation is governed by Sections 7 and 11(d)(1). n22 Rules relating to the Commission's inspection of records of brokers and dealers and broker-dealer reports to customers and the Commission are set forth in Section 17 and Rule 17a-5 adopted thereunder. n23 The requirements for reporting and making inquiries regarding missing, lost, counterfeit, or stolen securities are described in Section 17(f)(1) and related Form X-17F-1A and Rule 17f-1. n24

[a] Net Capital Requirements and Alternative Net Capital Requirements

[i] Net Capital Requirements. Protecting the assets of securities investors has always been of paramount concern to the Commission. The early approach to this problem was found in original Section 8(d) of the Exchange Act, in which a limitation was placed on the aggregate indebtedness, in relation to net capital, of all broker-dealers who were members of national exchanges. n25 The Commission's promulgation of Rule 15c3-1 extended the protection of the Act's net capital scheme to all broker-dealers regardless of exchange affiliation. n26

In its present form, Rule 15c3-1 requires that a broker or dealer's aggregate indebtedness not exceed fifteen times its net capital. n27 Net capital is adjudged after eliminating non-liquid assets as well as any appropriate "haircuts" for the broker or dealer's securities held for its own account. Further, broker-dealers must maintain minimum net capital of \$100,000. n28

In December 1997, the SEC began considering whether or not to modify the Net Capital Rule. Specifically, the SEC issued a concept release seeking comments regarding how net capital requirements for broker-dealers should be determined. The release queried commenters as to whether the current "haircut" approach should be modified, and if so, whether risk management statistical models should be employed. n29 At the same time that the SEC issued the comment release, the SEC proposed amendments to Rule 15c3-1 to alter the computation method of "haircuts" to more accurately take into account the risk involved with specific types of securities. n30 Finally, later in December 1997, the SEC proposed an amendment that would formally define the term "nationally recognized statistical rating organization" ("NRSRO"). NRSROs are important organizations in terms of the Net Capital Rule because the SEC utilizes their evaluations of particular securities to determine whether a broker-dealer can reduce its "haircut." The SEC began utilizing NRSROs in 1975, but in 1997, the SEC proposed to officially define the term because of concerns regarding arbitrariness in the current procedure for designating NRSRO status. n31 In June 2003, the Commission issued a concept release and request for comment on credit rating agencies, the appropriate agencies for inclusion, and supervision thereof. n32 No definitive action had been taken as of June 2004.

[iii] Alternative Net Capital Requirements. As an alternative to the foregoing requirements, the Commission established a standard which requires broker-dealers to prevent net capital from falling below the greater of either \$250,000, or 2 percent of aggregate debit items. The debit items that are permissibly calculated toward this are the same as those used in ascertaining the cash deposit required of broker-dealers under Rule 15c3-3. n33

The Net Capital Requirements provide one form of protection for investors against financial problems arising from undercapitalization. The most aggressive safeguards, those found in Rule 15c3-3, are described in the following sections.

On August 20, 2004, the Commission adopted amendments to the net capital rule under the Exchange Act to establish a voluntary, alternative method of computing market and credit deductions for certain broker-dealers. Under the amended Rule, a broker-dealer that maintains \$1 billion of tentative net capital and \$500,000,000 of net capital may apply to the Commission for a conditional exemption from the net capital rule that would permit the broker-dealer to use an alternative, risk-based method of calculating deductions from net capital for market and derivatives-related credit risk. As conditions for the exemption, the broker-dealer must comply with a number of specific requirements. In addition, the broker-dealer's holding company and affiliates must consent to group-wide Commission supervision and comply with certain requirements. n34

[b] Hypothecation and Loan of Customers' Securities.

Prior to 1941, most customer agreements permitted brokers or dealers to commingle customers' securities with their own as collateral for loans used by the firm in its business as a dealer or trader for its own account. n35 Further, such agreements also typically provided that a broker or dealer could borrow more against customers' securities than the customers actually owed. n36 Under the type of loan agreement customarily used between a broker-dealer and a bank or other lender, the lender held a specific lien against the particular securities earmarked for each loan. n37 Additionally, the lender often held a general lien for the total amount of all of the broker-dealer's loans, some of which represented borrowings on the broker-dealer's own securities to finance its own trading activities. n38 A general lien runs against all securities deposited as collateral, even though customers' securities are included among them. n39 The danger in the practice of pledging all securities (including customers' securities) under a single lien was that if a firm experienced financial difficulties, the customers' securities were equally at risk and faced the same losses. n40

Even though customer's agreements and the practices of banks and other lenders in the making and handling of broker-dealers' loans are subject to the antifraud provisions of the federal securities laws, financial difficulties not encompassed in these provisions significantly increased the customer's risk of loss. Additional protection for customers was critically necessary in order to prevent losses that could result from brokerage failures. Accordingly, Section 8 of

the Exchange Act represented an attempt by Congress to limit the exposure of customers to any impairment of a broker-dealer's solvency by making it unlawful for any broker or dealer to risk the securities of its customers as collateral to finance its own trading, speculating, or underwriting ventures. n41

The National Securities Markets Improvement Act of 1996 brought a significant change to this philosophy. That legislation greatly increased the options available to broker-dealers to finance their business operations. Section 104(b) of the 1996 Act eliminated Section 8(a) of the Exchange Act, and renumbered subsections (b) and (c) as (a) and (b). n42 Congress also amended Section 7. n43

Redesignated Section 8(a) of the Exchange Act prohibits the pledge without delivery of title or possession to the pledgee, or any arrangement for the hypothecation of customers' securities by a registered broker or dealer, an exchange member, or a broker or dealer transacting securities business through the medium of an exchange member, in contravention of such rules and regulations as the Commission shall prescribe for the protection of investors, if the hypothecation will, directly or indirectly:

- permit the commingling of a customer's securities without the customer's written consent with the securities of other customers;
- permit the customer's securities to be commingled with the securities of any person other than a bona fide customer; or
- permit liens or claims of pledges on customers' securities to exceed the aggregate indebtedness of all the broker-dealer's customers in respect of securities carried for their accounts. n44

Redesignated Section 8(b) precludes any registered broker or dealer, exchange member, or broker or dealer transacting business through the medium of an exchange member from lending or arranging for the lending of securities carried for the account of any customer without the customer's written consent *or* in violation of Commission rules and regulations prescribed for investor protection. n45

The Commission adopted Rules 8c-1 and 15c2-1 to provide uniformity of regulation for all branches of the brokerage industry, irrespective of whether those subject to the rules are exchange members, brokers or dealers doing business in securities through the medium of an exchange member, or over-the-counter brokers or dealers not transacting business through the medium of an exchange member. n46 Specifically, Rule 8c-1 applies to all exchange members and all brokers and dealers transacting securities business through the medium of an exchange member. n47 Rule 15c2-1 applies to all brokers or dealers regardless of whether they are exchange members or transact business through the medium of an exchange member. Rule 15c2-1 defines a "fraudulent, deceptive, or manipulative act or practice" as used in Section 15(c)(2) to mean any direct or indirect hypothecation of customers' securities under the same circumstances specified by Rule 8c-1. Compliance with Rule 8c-1 will, thus, automatically constitute compliance with Rule 15c2-1, and *vice-versa*. n48

[i] The Hypothecation Rules. Rules 8c-1 and 15c2-1, the "hypothecation rules," n49 are similar in scope and text and contain, with some exceptions, n50 three prohibitions that coincide with the principles established in redesignated Section 8(a). n51 The hypothecation rules provide that no registered broker or dealer, exchange member, or broker or dealer transacting a business in securities through the medium of an exchange member may:

- hypothecate his customers' n52 securities in such a way as to permit the commingling of securities carried for the account of any such customer n53 with securities of other customers, unless he first obtains the written consent of each customer; n54

- hypothecate his customers' securities under a lien for a loan made to him that will permit the securities to be commingled with the securities of any person other than a bona fide customer of the exchange member or applicable broker-dealer under a lien for a loan made to such member, broker or dealer; n55 and
- hypothecate his customers' securities so as to permit the liens or claims thereon to exceed the aggregate indebtedness of all his customers in respect of securities carried for their accounts. n56

A broker or dealer, an exchange member, and a broker or dealer transacting business through the medium of an exchange member cannot hypothecate customers' securities unless, at or prior to the hypothecation, he gives written notice to the pledgee that the security pledged is carried for the account of a customer and that the hypothecation does not contravene Rule 8c-1 or Rule 15c2-1. n57 However, different rules apply in the case of an omnibus account, n58 where written notice to the exchange member or broker-dealer carrying the account is not feasible before each transaction that results in a pledging of securities bought for the account. In these instances, the broker or dealer for whom the account is carried need only furnish a signed statement to the person carrying the omnibus account that all securities in the account will be customers' securities and that hypothecation thereof will not contravene the hypothecation rules. Day loans secured by hypothecated securities under lien or claim of a pledgee made and to be repaid on the same calendar day are exempt from the notice requirements. n59

Commingling of securities in violation of paragraphs (a)(1) or (a)(2) of the hypothecation rules will not be found because the securities carried for the accounts of both customers and non-customers are represented by one or more certificates in the custody of a clearing corporation or other subsidiary organization of an exchange or the FINRA, or a custodian bank under an established system for the central handling of securities. In addition, pursuant to the system for the central handling of securities, the hypothecation is effected by bookkeeping entries without physical delivery of the securities. n60

[iii] Exemptions from the Hypothecation Rules. There is a limited exemption from the requirements of paragraph (a)(1) of Rules 8c-1 and 15c2-1 for securities carried for the account of a customer in a special cash account within the meaning of Section 4(c) of Regulation T of the Board of Governors of the Federal Reserve System. n61

Any lien or claim of a clearing corporation or similar department or association of a national securities exchange or the FINRA for a loan made and to be repaid on the same calendar day is exempt from the operation of paragraphs (a)(2), (a)(3), and (f) (notice and certification requirements) of Rules 8c-1 and 15c2-1, if the lien is incidental to the clearing of securities or loans through the clearing house. n62

The prohibition against commingling customers' securities with non-customers' securities under a lien for a loan to the broker or dealer n63 does not bar the broker or dealer from permitting securities not carried for the account of a customer to be subjected to a lien for a loan made against securities carried for the account of customers or a lien for a loan made and to be repaid on the same calendar day. n64

[c] Cash Reserves and Custody of Securities--Rule 15c3-3.

Following the financial crisis in the securities industry from 1968 through 1970, Congress enacted SIPA n65 to protect investors in the event that their brokers or dealers encounter financial troubles. n66 Section 7(d) of SIPA amended Section 15(c)(3) of the Exchange Act. As amended, the section authorizes the Commission to: regulate brokers and dealers as to the acceptance, custody, carrying, and use of customers' securities, deposits, or credit balances; and require brokers and dealers to establish and maintain reserves against customers' deposits and credit balances. n67

To effectuate these goals, the Commission adopted Rule 15c3-3, the "Customer Protection Rule," n68 in 1972. The rule has several facets. Most significantly, it obliges brokers and dealers to promptly obtain physical possession or control

over fully-paid n69 or excess margin securities n70 carried for the account of customers, n71 or to act within specified time periods where possession or control has not been established. In addition, it requires brokers and dealers, through the Formula for Determination of Reserve Requirements of Brokers and Dealers ("the Reserve Formula"), n72 to maintain cash reserves with respect to customers' funds and funds realized through the use of customers' securities.

Rule 15c3-3 is designed to:

- ensure that customers' funds held by a broker or dealer are used only in safe areas of a broker-dealer's business relating to the servicing of customers, or deposited in a reserve bank account;
- accomplish a separation of the brokerage operation of a firm's business from other firm activities such as underwriting and trading;
- require the maintenance of current records, including a daily determination of security locations and periodic computations of reserves;
- motivate brokers and dealers to process securities transactions expeditiously;
- inhibit unwarranted expansion of a broker-dealer's business through the use of customers' funds;
- ensure that all fully-paid and excess margin securities in the possession or control of a broker or dealer will constitute property of customers entitled thereto, as evidenced by the broker-dealer's records or as otherwise established;
- augment a broad program of financial responsibility for brokers and dealers; and
- facilitate the liquidation of insolvent brokers and dealers and protect customer assets during SIPC liquidation through a clear delineation of specifically identifiable property of the customer in Rule 15c3-3. n73

The Securities Acts Amendments of 1975 amended Section 15(c)(3) to require the Commission to adopt minimum financial responsibility standards for all brokers and dealers. n74 As a result of these amendments, the Commission amended the uniform net capital rule, Rule 15c3-1, n75 that, while preserving the traditional aggregate indebtedness concept, added an alternative net capital requirement (Rule 15c3-1(f)) n76 based on the aggregate debit items in the Reserve Formula as well. n77

The adoption and implementation of the financial responsibility standards necessitated further amendments to the net capital rule and the Reserve Formula. Accordingly, the Commission amended Rules 15c3-1 and 15c3-3 to, *inter alia*:

- require brokers and dealers to reflect the risk to customers' funds and securities that results from the regular maintenance for extended periods short security positions in fail to receive or stock loan accounts and in omnibus accounts established under Section 4(b) of Regulation T n78 or otherwise in the computation of net capital, or mark to the market the short positions;
- clearly reflect the risks associated with transactions in options; and
- add an optional financial responsibility standard (Rule 15c3-1(a)(6)) for certain dealers. n79

[i] Physical Possession or Control of Fully Paid and Excess Margin Securities.

Before discussing the physical possession or control requirements of Rule 15c3-3, it should be noted that a customer's account with a broker or dealer is either a cash account or a margin account. A margin transaction occurs when the broker-dealer extends credit to the customer purchasing the securities. n80 A margin transaction creates a debit balance in the customer's account in the amount of the loan on which the customer pays interest. n81 When a broker-dealer participates in his customer's trading with a margin account, the broker is a creditor of his customer and, if applicable, a debtor of the financier of the transaction. n82 The securities in a margin account are collateral for the customer's indebtedness and may have been pledged by the broker-dealer as collateral to raise the amount of margin extended to the customer. n83

A broker or dealer must promptly obtain and maintain the physical possession or control of all fully-paid n84 and excess margin securities n85 carried for the account of customers. n86 However, temporary lags between the time a customer's fully-paid or excess margin security is required to be in the broker-dealer's possession or control and the time of actual possession or control, occurring solely as a result of normal business operations, will not be deemed to violate the physical possession or control requirement of Rule 15c3-3. This is applicable only as long as the broker or dealer takes timely steps in good faith to establish prompt physical possession or control. n87

The burden of proof is on the broker or dealer to show that the failure to secure physical possession or control of customers' fully-paid or excess margin securities in accordance with Rule 15c3-3(b)(1) is temporary and solely a result of normal business operations, including same day receipt and redelivery (turnaround), and that he has taken timely steps in good faith to establish physical possession or control. n88

Rule 15c3-3(b)(3) provides that a broker or dealer will not be in violation of the rule with respect to physical possession or control of fully-paid or margin securities borrowed from any person if the broker or dealer and the lender enter a written agreement, at or before the time of the loan, that at a minimum sets forth in a separate schedule the basis of compensation for any loan and the rights and liabilities of the parties and provides that the lender will be given a schedule of the securities actually borrowed at the time of borrowing. In addition, the agreement must specify that the broker or dealer must provide the lender collateral pursuant to the rule, *i.e.*, cash or Treasury bills and notes or irrevocable letters of credit issued by a bank, fully securing the loan, and must mark the loan to the market not less than daily so that the loan remains fully collateralized. Finally, the agreement must set forth that the lender of the securities may not be protected by the Securities Investor Protection Act and that any collateral received by the lender may be its sole source of protection in the event of default. n89

Rule 15(c)3-3(b)(4) enumerates procedures which are applicable to broker-dealers when they retain custody of securities that are the subject of a repurchase agreement between the broker-dealer and a counterparty. These procedures include obtaining a written copy of the repurchase agreement; providing a written confirmation of the securities which are the subject of the repurchase agreement pursuant to such agreement at the end of the trading day on which the transaction is initiated or the end of any other day during which the securities are substituted if change in issuer, maturity date, par amount or coupon rate occurs; advising the counterparty that the SIPA does not protect it with respect to the repurchase agreement; and maintaining possession or control of securities that are the subject of the agreement. n90

[A] Control of Securities. Under Rule 15c3-3 a broker or dealer is deemed to have sufficient control over any securities under several circumstances. First, control is found where the securities are represented by one or more certificates in the custody or control of a clearing corporation or other subsidiary organization of either an exchange, a national securities association, or a custodian bank under a Rule 8c-1(g) or Rule 15c2-1(g) system for central handling of securities. In addition, the delivery of the certificates to the broker or dealer must not require the payment of money or value, and the books or records of the broker or dealer must identify the customers entitled to receive the securities. n91 Second, sufficient control is found where the securities are customer securities carried in a special omnibus account n92 by one broker or dealer in the name of another broker or dealer in compliance with Section 4(b) of Regulation T

n93 and the carrying broker or dealer has been instructed to maintain physical possession or control of the securities free of any charge, lien, or claim of any kind in favor of the carrying broker, dealer, or persons claiming through the carrying broker or dealer. n94

The third circumstance in which a broker or dealer is deemed to have sufficient control under Rule 15c3-3 is where the securities are the subject of bona fide items of transfer within 40 calendar days. n95 However, a written confirmation of the items of transfer must be obtained within 40 calendar days. n96 No reconfirmation is required, however, after the first 40 day period to continue the item's status as an item under the broker-dealer's control. n97 Sufficient control is also found where the securities are in custody in a foreign location, including a foreign depository, foreign clearing agency, or foreign custodian bank that the Commission, upon application by a broker, dealer, registered exchange, or the FINRA, or upon its own motion, designates as a satisfactory control location for securities. n98 The securities are held in the custody or control of a bank (as defined in Section 3(a)(6)), subject to no right, charge, security interest, lien or claim of any kind, and must be delivered to the broker or dealer upon demand without payment of money or other value. n99

Sufficient control is deemed to exist under Rule 15c3-3 where the securities are held by a branch office or are in transit between offices of the broker or dealer, or are held by a guaranteed corporate subsidiary under the control of and operated as a branch office of the broker or dealer. n100 Finally, a broker or dealer is deemed to have sufficient control over securities that are held in locations that the Commission, upon application by a broker or dealer, finds and designates as adequate for the protection of customer securities. n101

[B] Requirement to Reduce Securities to Possession or Control. Paragraph (d) of Rule 15c3-3 requires a daily determination from a broker-dealer's books or records of the quantity of fully-paid and excess margin securities in the possession or control of the broker or dealer and the quantity not in his possession or control. A determination of inactive margin accounts (accounts having no activity by reason of purchase or sale of securities, receipt or delivery of cash or securities or similar type events) may be computed at least weekly.

If the records indicate that a customer's fully-paid or excess margin security has not been reduced to the possession or control of the broker or dealer in compliance with Rule 15c3-3(d), and that there are securities of the same issue and class with a broker or dealer or a clearing corporation, then the broker or dealer must promptly issue instructions for the release or return of a security of the same class that is subject to a lien securing moneys borrowed by the broker or dealer. In addition, the security must be released from the lien within two business days after the date the instructions are issued, n102 or has been loaned to another broker-dealer or a clearing corporation and the security must be returned within five business days after the date the instructions issued. n103 If a security of the same class not reduced to possession or control is included in the books or records as failed to receive over 30 days, prompt steps must be taken to buy-in or otherwise acquire the security. n104

If a security of the same class is receivable by the broker or dealer as stock dividend, stock split, or similar distribution for more than 45 days, prompt steps must similarly be taken to obtain physical possession or control of the security through a buy-in procedure or otherwise. n105

A broker or dealer subject to the Rule 15c3-3 physical possession or control requirements must prepare and maintain a current and detailed description of the procedures used to obtain physical possession or control of customers' fully-paid and excess margin securities. The records must be made available, upon request by the Commission and the designated examining authority for the broker or dealer. n106

[C] Buy-in of Short Security Differences. A broker or dealer must, within 45 calendar days after the date of the examination, count, verify, and compare securities, pursuant to Rule 17a-13 n107 or to the annual report of financial condition in accordance with Rule 17a-5, n108 buy-in all short security differences not resolved during the 45-day period. n109

[D] Delivery of Securities. Paragraph (1) of Rule 15c3-3 delineates the right of a customer of a broker or dealer to the physical delivery of certificates for fully-paid and excess margin securities. n110 However, a broker or dealer has the right under Section 7(b) n111 of Regulation T to retain collateral for his own protection beyond the requirements of Regulation T for excess margin securities not reasonably required to collateralize the customer's indebtedness to the broker or dealer. n112

[E] Completion of Sell Orders on Behalf of Customers. If a broker or dealer executes a sell order but does not obtain possession of the securities from the customer within 10 business days n113 after the settlement date, the broker or dealer must immediately purchase securities of like kind and quantity to close the transaction. n114 For purposes of the 10 business day limitation, a broker or dealer who maintains a special omnibus account with another broker or dealer in compliance with Section 11 of Regulation T n115 is not deemed a customer of the other broker or dealer. n116

[F] Extension of Time. A broker or dealer may apply to a registered securities exchange or the FINRA for an extension of any period specified in paragraphs (d)(2) (securities listed as failed to receive over 30 calendar days), (d)(3) (security dividend receivable, stock split or similar distribution for more than 45 calendar days), (h) (short security differences not resolved within 45 calendar days pursuant to Rule 17a-5 or Rule 17a-13), and (m) (customer must promptly deposit with the broker or dealer the securities sold within 10 business days) of Rule 15c3-3 relating to the period of time a broker or dealer is required to buy-in a security.

The exchange or the FINRA may grant the extension for one or more limited periods commensurate with the circumstances, if it is satisfied that the broker or dealer has acted in good faith in making the application and that exceptional circumstances warrant the action. n117 Any extension granted, together with the justification therefor, must be recorded and preserved for at least three years by the exchange or the FINRA. n118

[ii] Special Reserve Bank Account for the Exclusive Benefit of Customers.

Paragraph (e)(1) of Rule 15c3-3 requires every broker or dealer to maintain, at all times, with a bank, a "Special Reserve Bank Account for the Exclusive Benefit of Customers" ("Reserve Bank Account"), separate from any other bank account of the broker or dealer, into which must be deposited all cash and qualified securities n119 in amounts computed in accordance with the Reserve Formula. n120

No broker or dealer may accept or use any of the amounts under items comprising Total Credits under the Reserve Formula except for the purposes specified under items comprising Total Debits under the formula. n121 To the extent that Total Credits exceed Total Debits under the formula, at least the net amount of the excess must be maintained in the Reserve Bank Account. n122

The broker or dealer must compute the net amount weekly at the close of the last business day of the week and deposit it in the Reserve Bank Account no later than one hour after the opening of banking business on the second following business day. n123

[A] Notification of Banks. A broker or dealer required to maintain a Reserve Bank Account or who maintains a Special Account referred to in paragraph (k) of Rule 15c3-3 must obtain from each bank in which he has a Reserve Bank Account or Special Account a written notification that the bank was informed that all cash and qualified securities so deposited are being held for the exclusive benefit of the broker-dealer's customers in accordance with Commission regulations, and are being kept separate from any other accounts maintained by the broker or dealer with the bank. n124 In addition, the broker or dealer must contract in writing with the bank that the cash and qualified securities will never be used directly or indirectly as security for a loan made by the bank to the broker or dealer, and will not be subject to any right, charge, security interest, lien, or claim of any kind in favor of the bank or any person claiming through the bank. n125

[B] Withdrawals from the Reserve Bank Account. A broker or dealer may make withdrawals from the Reserve

Bank Account provided, at the time of withdrawal, the amount remaining in the account is not less than the amount then required by paragraph (e) of Rule 15c3-3. n126 The bank may presume that a request for withdrawal conforms with Rule 15c3-3. n127 The broker or dealer must, on the day of the withdrawal, record the computation that is the basis for the withdrawal and preserve the computation in accordance with Rule 17a-4, which provides for record preservation. n128

[C] Notification of Failure to Make a Required Deposit. If a broker or dealer fails to make a deposit in the Reserve Bank Account or Special Account as required by Rule 15c3-3, he must immediately send notice to the Commission and the regulatory authority that examines the broker or dealer as to financial responsibility, to report the failure. n129 The broker or dealer must promptly issue a written confirmation of the notice. n130 In addition, in January of 2004, the Commission adopted a new rule requiring every transfer agent to establish and implement written procedures for the cancellation, storage, transportation, destruction, or other disposition of securities. n131

[D] Formula for Determination of Reserve Requirement--Exhibit A. The formula contained in Rule 15c3-3a for the determination of the reserve requirement for brokers and dealers contains 14 Items and six Notes. Items 1 through 9 are the Credits under the Reserve Formula; Items 10 through 13 are the Debits. Item 14 is the excess of total Credits (sum of Items 1 through 9) over total Debits (sum of Items 10 through 13) that must be deposited n132 in the Reserve Bank Account according to paragraph (e) of the Rule. n133

The formula in Exhibit A to Rule 15c3-3 counts as Credits those funds for which the broker-dealer must be accountable, and regards as Debits those permissible areas where the funds may be freely deployed. The excess of total Credits over total Debits n134 must be deposited in a Special Reserve Bank Account. n135

The following nine Items constitute the Credits portion of the Reserve Formula:

- free credit balances n136 and other credit balances in customers' security accounts; n137
- monies borrowed that are collateralized by securities carried for the accounts of customers; n138
- monies payable against customers' securities loaned; n139
- customers' securities failed to receive; n140
- credit balances in firm accounts attributable to principal sales to customers;
- market value of stock dividends, stock splits, and similar distributions receivable outstanding over 30 calendar days;
- market value of short security count differences over 30 calendar days old;
- market value of short securities and credits (not to be offset by longs or by debits) in all suspense accounts over 30 calendar days; and
- market value of securities that are in transfer in excess of 40 calendar days and have not been confirmed to be in transfer by the transfer agent or the issuer during the last 40 days.

Items which constitute Debits under the Reserve Formula are:

- debit balances in customers' cash and margin accounts excluding unsecured accounts and accounts doubtful of collection; n141

- securities borrowed to effectuate short sales by customers and securities borrowed to make delivery on customers' securities failed to deliver;
- undelivered customers' securities not older than 30 calendar days; and
- margins required and on deposit with the Options Clearing Corporation for all option contracts written or purchased in customer accounts. n142

[iii] Exemptions. Paragraph (k) of Rule 15c3-3 exempts, from the provisions of the rule, a broker or dealer meeting *all* of the following three conditions. First, the broker or dealer's transactions as principal for his own account are limited to the purchase, sale, and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account. n143 However, a broker or dealer transacting business as a sole proprietor may also effect occasional transactions in other securities for his own account with or through another registered broker or dealer. n144 Second, the broker or dealer's transactions as a broker (agent) are limited to: the sale and redemption of redeemable securities of registered investment companies or of interests or participations in an insurance company separate account; the solicitation of share accounts for insured savings and loan associations; and the sale of securities for the account of a customer to obtain funds for immediate reinvestment in redeemable securities of registered investment companies. n145 Third, the broker or dealer must promptly transmit all funds and deliver all securities received while acting as a broker or dealer, and hold no funds, or securities for, or owe money or securities to, customers. n146

An additional exemption from Rule 15c3-3 applies to a broker or dealer satisfying *either* of the following two conditions. First, the broker or dealer must: carry no margin accounts; promptly transmit all customer funds and deliver all customer securities received as part of his broker-dealer activities; not otherwise hold funds or securities for, or owe money or securities to, customers; and effect all financial transactions with customers through one or more bank accounts, each designated as "Special Reserve Account for the Exclusive Benefit of Customers." n147 Second, the broker or dealer's transactions with customers must consist exclusively of acting as an introducing broker-dealer to a clearing broker-dealer on a fully disclosed basis. The broker or dealer must promptly transmit all customer funds and securities to the clearing broker-dealer who, in turn, carries all the accounts of the customers and customarily maintains and preserves the books and records pertaining thereto in accordance with Rules 17a-3 and 17a-4. n148

The exemptions afforded by paragraphs k(1) and k(2) are parallel to the provisions of paragraphs (a)(2) and (a)(3) of Rule 15c3-1, which authorizes broker-dealers engaging only in specified business activities involving relatively little risk of default on obligations to public customers, to maintain lower (\$5000 or \$2500) amounts of net capital.

In addition, a broker or dealer may apply in writing to the Commission for an exemption from a portion or all of Rule 15c3-3. The Commission may grant the exemption if the broker or dealer demonstrates to the satisfaction of the Commission that he has established procedures for the safeguarding of customer funds and securities comparable with the prescribed safeguards under Rule 15c3-3, and that the public interest or investor protection do not require him to be subject to the Rule. n149

[d] Program for Missing, Lost, Counterfeit, or Stolen Securities.

A long-standing problem in the securities business concerns missing, lost, counterfeit, or stolen securities. In a 1971 *House Report entitled Study of Unsafe and Unsound Practices of Brokers and Dealers*, a list of contributing factors to the missing securities problem included: failure to identify losses; failure to report losses; failure to identify stolen securities; failure to identify security-risk employees; and failure to uncover and eliminate channels for the disposition of stolen securities. n150

The Securities Acts Amendments of 1975 indicated a congressional determination to create a centralized scheme for dealing with the disruptive effects of the loss, theft, or counterfeiting of securities. Section 17(f)(1), added to the Exchange Act in 1975, directed the Commission to establish a program for the reporting of missing, lost, counterfeit and stolen securities and to adopt rules for making inquiry concerning securities coming into the possession or control of certain financial institutions, securities professionals, the FINRA, exchanges, and others including most banks, n151 to determine whether the securities have been reported as missing, lost, counterfeit, or stolen. Congress directed the Commission to balance the benefits of mandating inquiry in any specific situation against the cost and effect on efficient business practices, and to avoid imposing requirements that may affect the legal status of bona fide purchasers in a manner unjustifiably disruptive of normal commercial transactions. n152

In December 1976, the Commission adopted Rule 17f-1 pursuant to Section 17(f)(1) requiring enumerated person, known as reporting institutions, to report all incidents of missing, lost, counterfeit, or stolen securities to an appropriate instrumentality. n153 The Federal Reserve Bank, or any of its branch[es], is the appropriate instrumentality with respect to United States government securities or securities issued by an agency of the United States (such as the Small Business Administration) and the Commission is the appropriate instrumentality for all other securities. n154

To implement Rule 17f-1, the Commission instituted a pilot lost and stolen securities program to monitor the effectiveness of the rule, and initially designated the Securities Information Center, Inc. ("SIC") of Wellesley Hills, Massachusetts n155 to establish and operate a database for receiving reports and inquiries concerning the loss, counterfeit or theft of securities for which the Commission is the appropriate instrumentality for a one-year period ending December 31, 1978. n156 The SIC continues to operate this program for the Commission. n157

In 1979, the Commission abandoned the concept of dual appropriate instrumentalities by deleting the definition of that term from Rule 17f-1, established registration requirements n158 for all reporting institutions subject to Section 17(f)(1) with certain exceptions, n159 created a central database of reported securities thefts and losses through a merger of the SIC and the Federal Reserve Board data bases, and adopted modifications to Form X-17F-1A for reporting missing, lost, counterfeit, or stolen securities. n160

The various self-regulatory organizations have fidelity bonding requirements for their members covering, among other things, misplacement, forgery and alteration, and fraudulent trading of securities.

[i] Registration in the Lost and Stolen Securities Program. Rule 17f-1 requires every reporting institution, including every national securities exchange, exchange member, registered securities association (*i.e.*, the FINRA), broker, dealer, municipal securities dealer, registered transfer agent, registered clearing agency, participant therein, Federal Reserve System member, and bank whose deposits are insured by the Federal Deposit Insurance Corporation to register with the Commission or its designee in accordance with instructions issued by the Commission concerning the lost and stolen securities program. n161

An exchange member who transacts business exclusively on the floor of the exchange solely for other members and does not receive or hold customers' securities need not register. n162 Exemptions exist for brokers or dealers that limit their activities to bond coupons, uncertificated securities, global securities issues, and any securities issue for which neither record nor beneficial owners can obtain a negotiable securities certificate. n163

Registration in the lost and stolen securities program is accomplished by filing a registration form with the SIC, Inc., which the Commission has designated to handle the lost and stolen securities program. Proof of SIC filing is a prerequisite to approval as a member firm of the FINRA and national securities exchanges. A reporting institution may register as a "direct inquirer," or, if its securities transactions are cleared by a direct inquirer, it may register as an "indirect inquirer." n164

[ii] Reporting of Missing, Lost, Counterfeit, or Stolen Securities.

In general, a reporting institution must report securities missing, lost, or stolen from its possession or control and, if the securities have not been reported by another reporting institution, securities missing, lost, or stolen from the possession or control of a person not a reporting institution. n165

For example, if securities are missing from the control of a broker, the broker is required to report pursuant to Rule 17f-1. The transfer agent who receives a copy of Form X-17F-1A concerning the securities need not make a report. n166 By contrast, where a loss of securities is communicated to a transfer agent by a non-reporting entity, such as an individual, the transfer agent must make a report when it receives the information. n167

Section 17(f)(1) requires reports to be made in such form and within such time as the Commission determines by rule as necessary or appropriate in the public interest or for the protection of investors. Information contained in reports about missing, lost, counterfeit, or stolen securities may be obtained on request for a reasonable fee by every reporting institution and other persons as the Commission may designate by rule. n168

[A] Stolen Securities. All reporting institutions are required to report, to the SIC on Form X-17F-1A and to a registered transfer agent for the issue, the discovery of the theft or loss of any security where criminal activity is suspected. n169 The report must be made within one business day of the discovery; the certificate numbers, if known, must be promptly reported. n170 The Federal Bureau of Investigation must be promptly informed of the circumstances of the theft, including the basis for believing that the loss involved criminal activity. n171

[B] Missing or Lost Securities. All reporting institutions must report, to the SIC on Form X-17F-1A and to a registered transfer agent for the issue, the discovery of the loss of any security where no criminal activity is suspected when the security has been missing or lost for two business days. n172 The report must be made within one business day after the end of the two-day period, except that securities lost in transit to customers, transfers agents, banks, brokers, or dealers must be reported by the delivering institution not later than two business days after notice or nonreceipt, or as soon after the notice of nonreceipt as the certificate numbers are known. n173

Securities considered lost or missing following securities counts or verifications required by rule, regulation, or otherwise (such as firm policy or internal audit function report) must be reported not later than ten business days after completion of the count or verification or as soon thereafter as the certificate numbers of the securities can be ascertained. n174

Where securities being delivered through a clearing agency are not received, the delivering institution must supply the receiving institution with the certificate numbers of the securities within two business days from the date of request by the receiving institution. n175 The receiving institution must report the facts within one business day after notification of the certificate numbers to the SIC. n176

Where securities being delivered over the window are not received and the delivering institution has a receipt, the delivering institution must supply the receiving institution with the certificate numbers of the securities within two business days from the date of request by the receiving institution. The receiving institution must report the facts to the SIC within one business day after notification of nonreceipt of the certificate numbers. n177 Where delivery over the window is not received and the delivering institution has no receipt, the delivering institution must report the nonreceipt of the securities to the SIC within two business days after notification of nonreceipt by the receiving institution. n178

Finally, where securities are delivered by mail, or via draft, and payment is not received within ten business days, the delivering institution must confirm with the receiving institution whether the securities were delivered. If the nonreceipt of the securities is confirmed, the delivering institution must report the facts concerning the securities believed missing within two business days after the confirmation to the SIC. n179

[C] Counterfeit Securities. The discovery of any counterfeit security must be reported within one business day of the discovery to the SIC on Form X-17F-1A, to the registered transfer agent for the issue, and to the appropriate law enforcement agency. n180

[D] Recovery of Previously Reported Security. If any security previously reported to be missing, lost, or stolen is recovered or found, it must be reported to the SIC and to a registered transfer agent for the issue on Form X-17F-1A within one business day of the recovery. n181 If a report of loss was previously made to the FBI, recovery of the missing securities must be so reported as well. n182

Recovery must be reported by the institution that reported the security as missing, lost or stolen. However, a report of recovery may be made by a successor institution, trustee, or the recovering institution where the reporting institution no longer exists.

[E] Information to be Reported. All reports made pursuant to Rule 17f-1 on Form X-17F-1A must include, if applicable and available, the following information concerning each security:

- the issuer;
- type of security and series;
- date of issue;
- maturity date;
- denomination;
- interest rate;
- certificate number including prefix or suffix;
- name in which registered;
- distinguishing characteristics, if counterfeit;
- date of discovery of loss or recovery;
- CUSIP number;
- FINS number; and
- type of loss. n183

[iii] Required Inquiries of the SIC. Every reporting institution other than a registered transfer agent must inquire of the SIC whether securities which come into the possession or control of the reporting institution for which it is responsible, or in which the reporting institution is effecting, clearing, or settling a transaction, have been reported as missing, lost, counterfeit or stolen. n184 An inquiry must be made whenever securities certificates are received, whether by pledge, transfer, or in some other manner, unless:

- they are received directly from the issuer or issuing agent on original issue; n185

1-3 Federal Securities Exchange Act of 1934 § 3.08

- they are received from another reporting institution or a Federal Reserve Bank or branch thereof; n186
- they are received from a customer and the securities are registered in the name of the customer or his nominee or were previously sold to the customer, as verified by the internal records of the reporting institution; n187
- they are part of a transaction having an aggregate face value of \$10,000 or less in the case of bonds, or market value of \$10,000 or less in the case of stocks; n188 or
- they are received directly from a drop affiliated with a reporting institution for the purposes of receiving and delivering certificates on behalf of the reporting institution. n189

Inquiries must be made in the manner prescribed by the Commission or its designee. n190

[iv] Permissive Reports and Inquiries. A reporting institution may report or inquire of the SIC about any security not otherwise required by Rule 17f-1 to be the subject of a report or inquiry. n191 The Commission on written request or on its own motion may permit reports and inquiries by any other person or entity on such terms and conditions deemed appropriate and necessary in the public interest and for the protection of investors. n192

[v] Exempt Securities. The following securities are exempt from the reporting and mandatory inquiry requirements of the lost and stolen securities program:

- security issues not assigned CUSIP numbers;
- bond coupons;
- uncertificated securities;
- global securities issues;
- any securities issue for which neither the record nor beneficial owners can obtain a negotiable securities certificate. n193

[vi] Recordkeeping Requirement. Every reporting institution must maintain and preserve, in an easily accessible place for three years, all reports of missing, lost, stolen, or counterfeit securities on Form X-17F-1A filed pursuant to Rule 17f-1, agreements between reporting institutions regarding any aspect of the lost and stolen securities program, and all information received from the Commission or the SIC as a result of inquiry. n194

[vii] Form X-17F-1A. All reports pursuant to Rule 17f-1 are made on Form X-17F-1A. The form contains 23 Items. In addition to the list of information to be reported under paragraph (c)(6) of Rule 17f-1 with respect to each security, n195 there must be reported:

- the name, address, telephone number, and the FINS number with the SIC identifier number of the reporting institution in response to Item 1;
- the type of report, including whether it is a new report (Loss), a report of recovery of previously reported loss (Recovery), or a correction of a report other than a recovery (Update) in response to Item 2;
- the type of loss; whether through the mail, during delivery, on premises of the reporting institution, during clearance or other (Item 4);

- whether the document is a bearer security; and the full name of the registered holder (Item 10);
- whether additional pages are attached (Item 14);
- total current market value for stocks, rights, and warrants; total current face value for bonds (Item 15);
- if reporting a loss, whether a substantial belief of criminality is indicated (Item 17);
- indicate whether a report is filed as required with the FBI (Item 18) or with local police (Item 19);
- identity of a transfer or pay agent to whom a copy of the report is sent (Item 20);
- identity of insurance company to which a copy of the report is sent (Item 21);
- authorized signature (Item 22); and
- date when the form is signed (Item 23).

Form X-17F-1A, "Missing, Lost, Stolen, Counterfeit Securities Report" should be sent to the SIC, the Commission's designee. n196

[3] Procedures Applicable when Broker-Dealer Faces Financial Difficulty

The following summarizes the securities market conditions which prompted the regulatory measures which now govern financially-troubled broker-dealers:

The aftermath of the 1968-70 crisis in the securities industry brought home to the investing public the need for protective measures to safeguard their assets from the claims of other creditors of broker-dealers. The crisis was induced by the two-fold assault of a paper crunch, created by a sudden increase in trading activities, followed by financial overextension during a subsequent market decline. As a result, many broker-dealers were forced to merge, to seek outside financial support and, in all too many cases, to liquidate and go out of business.

The causes of such failures of broker-dealers have been analyzed as being primarily: (1) inadequacies of management; (2) deplorable bookkeeping methods and recording of trades; (3) excessive trading and a concentration on sales rather than service to the customer; and, most importantly, (4) a weakness in the capital structure of the broker-dealer. n197

Prior to 1971, the New York Stock Exchange, the American Stock Exchange, and most of the regional exchanges assumed liability for the customer obligations of insolvent member firms and established guaranty funds to cover these debts at the discretion of the exchanges on the usage of such funds. This created an anomalous situation in which the customers of insolvent nonmember firms were not protected, and affected customers did not have a cognizable legal theory by which to sue an exchange directly to recover from its guaranty fund. n198

As the result of this situation, and following some very substantial failures among both member and nonmember firms, Congress enacted the SIPA n199 in December 1970, and thereby established the SIPC. The SIPC is a nonprofit membership corporation, which, *inter alia*, facilitates the liquidation of financially-troubled broker-dealers n200 and maintains a fund which secures, to a statutory limit, qualifying customer funds in the event of broker-dealer failure.

n201 Since SIPA does not confer upon customers or creditors a private right of action, n202 SIPC initiates liquidation proceedings in federal district court on behalf of aggrieved customers or creditors. n203 Thereafter, if the court determines that protection is appropriate and necessary, a trustee and trustee's counsel is appointed and the matter proceeds as a liquidation overseen by the United States Bankruptcy Court. n204 The SIPC is authorized to protect qualifying customer funds in an amount not to exceed \$500,000 to compensate the amount by which the net equity of each customer exceeds his ratable share of customer property. n205 SIPA's enactment virtually eliminated broker-dealer self-regulation once financial difficulties arise. n206

SIPA was amended in 1978 n207 to boost investor confidence in the securities markets by enhancing SIPA to resolve certain shortcomings that prevented it from being fully effective in its original form. n208 In particular, Congress intended to improve the SIPC's efficiency in liquidating claims by streamlining the procedures to lessen the amount of time during which customers with claims against a failed broker-dealer were unable to proceed with investment activity because their assets were tied up in liquidation proceedings. n209

Specific areas enhanced by the amendments include delaying liquidation proceedings to allow trustees to transfer customer accounts to a solvent broker-dealer, as promptly as possible, redefining SIPA's definition of customer property to include a broader range of protected assets, and increasing available funds per individual claim. n210

[a] The Securities Investor Protection Corporation. The SIPC is a non-profit corporation comprised of a general membership and a Board of Directors. Its membership is comprised of all broker-dealers (on a compulsory basis) who are registered with the Commission. n211 The SIPC's membership is assessed annually to maintain the SIPC's fund which secures certain customer assets in the event of broker-dealer difficulty.

The SIPC's administrative affairs are handled by its seven-member Board of Directors consisting of five Presidential appointees, one appointed by the Secretary of the Treasury, and one by the Federal Reserve Board. n212 Two of the Presidential appointees, who are designated chairman and vice chairman of the SIPC, are members of the general public. The other three represent the securities industry and must be from different regions of the country. n213

The SIPC may, through its Board of Directors, sue and be sued and adopt by-laws as necessary to, *inter alia*, carry out its business; indemnify its directors, officers, employees, and trustees from liability arising from defense or settlement of an action or suit; n214 promulgate rules which define terms used in SIPA, n215 the procedures for liquidating member firms and establishing direct payment procedures, and procedures for the adoption, amendment, and repeal of the SIPC bylaws and rules. n216

Although established pursuant to federal law, the SIPC is neither an agency nor an office of the United States Government. n217 However, the Commission does play a crucial role in the SIPC's operation. For instance, the Commission has oversight powers over any proposed rule changes by the SIPC and thus may require the SIPC to adopt, amend, or repeal any SIPC bylaw or rule. n218 The Commission is also empowered to make loans to the SIPC Fund if it appears insufficient n219 and to participate as a party in any proceeding under SIPA.

[b] The SIPC Fund. Initially, the SIPC Fund balance was to be maintained at a minimum level of \$75 million. n220 Assessments of each member in the amount of one-eighth of one percent of their gross revenues from the securities business was collected shortly after the 1970 enactment of the enabling legislation to form this initial capital. n221

The SIPC Fund balance is now comprised of the assessments collected from SIPC members, n222 in addition to interest earned on investments in United States Government securities, and confirmed lines of credit. n223 The SIPC Board is authorized to borrow money from private capital markets and evidence such funds by the issuing of bonds, notes, or other evidences of indebtedness. n224 As of September 1994, the SIPC has a billion-dollar line of credit from a consortium of private banking and lending institutions. n225

The Commission is authorized to lend the SIPC up to \$1 billion, which the Commission, in turn, is authorized to borrow from the United States Treasury, if the Commission determines that the loan is necessary for the protection of customers of brokers or dealers and the maintenance of confidence in the United States securities markets, and that the SIPC has a plan that reasonably assures prompt repayment of the loan. n226 The SIPC has not yet needed to borrow in this manner. n227 The fund also increases due to interest earned on government securities it holds. n228

The SIPC Board convened a task force in April 1991 to assess the Fund's needs for the future and to establish a target annual growth rate. A target of \$1 billion was set for April 1997, and ten percent was established as the annual growth rate goal. n229

[c] Responsibility for Assessments. All persons registered as brokers or dealers under Section 15(b) of the Exchange Act are required to become SIPC members except:

- persons whose principal business, in the SIPC's determination, is conducted outside the United States; n230 and
- persons whose business as a broker or dealer consists exclusively of the distribution of shares of registered open end investment companies or unit investment trusts; the sale of variable annuities; the business of insurance; or rendering investment advisory services to registered investment companies or insurance company separate accounts. n231

Membership in the SIPC is optional for the exempt classes of brokers and dealers.

Section 4(c)(2) of SIPA empowers the SIPC, by bylaw, to impose on its members assessments as, after consultation with self-regulatory organizations, the SIPC deems necessary and appropriate to maintain the SIPC Fund and repay any borrowings by the SIPC. The assessments may be based upon gross revenues from the securities business n232 or the amount or composition of gross revenues from securities business, dollar volume of transactions, number of customer accounts maintained or amounts of cash and securities in customer accounts, net capital, nature of activities (whether securities business or otherwise) and consequent risks, and other relevant factors. n233

An assessment may not include any charge based on a SIPC member's activities in: the distribution of shares of registered open-end investment companies or unit investment trusts; the sale of variable annuities; the business of insurance; or the business of rendering investment advisory services to one or more registered investment companies or insurance company separate accounts. n234

An assessment pursuant to Section 4(c)(2) at a rate exceeding one-half of one percent during any twelve-month period may be made if the SIPC determines that the assessment will not have a material adverse effect on the financial condition of its members and their customers. n235 A maximum assessment on SIPC members for any twelve-month period may not exceed in the aggregate one percent of a member's gross revenues from the securities business for such period. n236 In addition to the limitations on assessments described above, the SIPC may not impose any assessment other than those described pursuant to its general assessment authority. n237

Presently, SIPC member assessments are calculated by multiplying the member's net operating revenues from the securities business for the fiscal year by an assessment rate established by the SIPC for that fiscal year. n238 The assessment rate is arrived at by deducting the SIPC's projected Fund balance from the target balance for the following year. Annual target balances are based on a net annual growth rate of 10 percent set in 1991 by the SIPC Task Force. n239 The projected Fund amount is determined by taking the Fund balance as of September 30 and adjusting it as follows:

- deducting the SIPC's assessment collections for the period from the prior April to September 30;
- adding the amount of the SIPC's estimated interest income from that September 30 through the end of the following March; and
- deducting the SIPC's estimated liquidation costs and operating expenses from that September 30 through the end of the following March. n240

Once these deductions are made, the assessment rate will equal the amount of needed assessment income divided by the projected assessable revenues of NYSE members. n241 In any event, all members are subject to a minimum annual assessment of \$150. n242 The national securities exchanges and FINRA are the authorized agents for collecting the SIPC Fund assessments. Failure to pay assessments after notice results in the member being barred from engaging in business as a broker or dealer, unless specifically authorized by the Commission. n243

[d] Customer Protection.

SIPA's objective is the protection of members of the investing public, rather than troubled broker-dealers. Congress did not intend SIPA as a "bail-out" of the securities industry, n244 despite the industry's mounting problems in the 1960s-1970s. The Congressional intent is evident from the absence of procedures to reorganize or rehabilitate troubled brokers or dealers who have been subject to a SIPA liquidation proceeding. The sole emphasis is on satisfying qualifying customer claims to the extent possible. n245

[i] Determination of Need and Court Action under Section 5 of SIPA. Section 5(a)(1) of SIPA requires the Commission or any self-regulatory organization to notify n246 the SIPC immediately after the discovery of facts indicating that a broker or dealer subject to its regulation is in or is approaching financial difficulty. n247 Once a referral is received, the SIPC determines whether liquidation proceedings are appropriate. n248 Potential subjects of an SIPC liquidation proceeding include only current members of the SIPC or persons who have been members within the past 180 days.

A member of the SIPC who is the subject of a "5(a) referral" may reduce or terminate his or her securities business voluntarily or under the direction of a self-regulatory organization. n249 A self-regulatory organization may assist or oversee the business reduction or self-liquidation by a member in financial difficulty without being deemed to have assumed any of the member's obligations or liabilities to customers, other creditors, shareholders, or partners of the debtor broker or dealer. n250 Additionally, the self-regulatory organization's participation in the business reduction or self-liquidation, to the extent the self-regulatory organization considers it necessary in order to protect customers, may obviate the need for an SIPC liquidation proceeding. n251 However, the self-regulatory's participation does not necessarily preclude subsequent action by the SIPC.

Before initiating a liquidation proceeding, the SIPC must determine that a member has failed or is in danger of failing to meet its obligations to customers n252 and that any one or more of the following four conditions specified in Section 5(b)(1) of SIPA exist:

- the member is insolvent within the meaning of the Bankruptcy Code, *11 U.S.C. § 101*, or is unable to meet his obligations as they mature;
- the member is the subject of a proceeding pending in any court or before any agency of the United States or any State in which a receiver, trustee, or liquidator for the member has been appointed;
- the member is not in compliance with the financial responsibility n253 or hypothecation rules of the Commission or any self-regulatory organization or the applicable provisions of the Exchange Act; n254

or

- the member is unable to make computations required to comply with the financial responsibility or hypothecation rules. n255

If the SIPC determines that customers of a member need protection under SIPA, it may follow one of three alternatives. If the member to be liquidated has 500 or more customers and obligations to general creditors and subordinated lenders are \$750,000 or more, a trustee other than the SIPC or an employee of the SIPC must be designated by the SIPC. n256 If the member to be liquidated has less than 500 customers and obligations to general creditors and subordinated lenders are less than \$750,000, the SIPC or an SIPC employee may be designated as trustee. n257 Finally, the SIPC may employ the Direct Payment Procedure under Section 10 of SIPA if it determines that the claims of all customers of the member aggregate less than \$250,000, n258 and the claim of each customer is within the limits of protection provided in Section 9(a) (which are \$500,000 per customer, not more than \$100,000 of which may be for cash). n259 In addition, the SIPC may employ the Direct Payment Procedure if the SIPC's cost of satisfying customer claims will be less than the cost of a court-supervised liquidation proceeding n260 and the member's registration as a broker or dealer under Exchange Act Section 15(b) has been terminated or the member has consented to the SIPC's use of the Direct Payment Procedure. n261

[ii] Appointment of Trustee and Attorney. Once the SIPC determines that a member's customers need protection, it may, upon notice to the member, apply to a federal district court for a protective order. n262 Usually, the SIPC files an application for a protective decree at the same time that the Commission seeks an injunction against a broker or dealer for violation of the net capital or recordkeeping rules. If the protective decree is granted, the court will then appoint as trustee and counsel to the trustee such individuals as recommended by the SIPC. n263 The trustee and his counsel may be associated with the same law firm. n264

A person may not be appointed a trustee or attorney for the trustee if he is not disinterested within the meaning of Section 5(b) of SIPA. n265 An attorney who is not disinterested may, with the approval of the SIPC and the court, be employed by the trustee for any purpose other than to represent the trustee in conducting a liquidation proceeding. n266

A hearing on the question of disinterestedness must be promptly held after the appointment of a trustee. Due notice must be given to all persons appearing from the debtor's books and records to have been the debtor's customers with open accounts within the last 12 months, creditors, stockholders, the SIPC, and such other persons as a court may designate. n267

The SIPC is deemed to be a party in interest in any liquidation proceeding. n268 The Commission may participate in the proceeding if it, on its own motion, files a notice of appearance. Thereafter, the Commission may participate as a party. n269 Only the SIPC, not aggrieved customers, may initiate customer protection proceedings under SIPA. n270

SIPA gives the court exclusive jurisdiction of: the debtor and its property, including property located outside the territorial limits of the court and property held as security for a debt or subject to a lien; n271 and any action against the trustee with respect to the liquidation proceedings. n272

In addition, except where inconsistent with SIPA, the court has jurisdiction, powers, and duties conferred on federal courts under the Bankruptcy Code, as well as such other powers and duties as are prescribed by SIPA. n273

The court may stay: any pending bankruptcy, mortgage foreclosure, equity receivership, or other proceeding to reorganize, conserve, or liquidate the debtor or its property, and continue the stay on appointment of a trustee; any proceeding to enforce a lien against the debtor; n274 and the enforcement of, and, upon appointment of a trustee, may continue the stay for an appropriate period, but not abrogate, any right of setoff (except to the extent the right is affected under *Section 553 of The Bankruptcy Code*) and the right to enforce a valid, nonpreferential lien or pledge against the

debtor's property. n275

Provisions exist for removal of all or part of a liquidation proceeding to a referee in bankruptcy to expedite the proceeding n276 and for appointment of a temporary receiver. n277

[iii] Powers and Duties of a Trustee. Section 7(a) gives the trustee the same powers and title with respect to the debtor n278 and his property, and the same rights to avoid preferences, as a trustee in bankruptcy. n279 In addition, the trustee may, with SIPC approval, hire and fix the compensation for all personnel and accountants or other persons needed in connection with the liquidation proceeding. n280 The use of the SIPC employees to aid the trustee is specifically authorized. n281 The trustee may also maintain customer accounts of the debtor to facilitate prompt transfer of accounts to other brokers or dealers pursuant to Section 8(f) of SIPA. n282

A trustee is subject to the same duties as a trustee under the Bankruptcy Code, plus special duties relating to the satisfaction of customer claims for securities by the distribution of securities to the maximum extent possible. n283 The trustee must, with SIPC approval, pay or guarantee loans from banks or other lenders collateralized by securities if the indebtedness does not appear to be greater than the aggregate market value of the securities. n284

The trustee must conduct an investigation to ascertain facts concerning the debtor's fraud, misconduct, mismanagement, irregularities and any causes of action available to the estate, and report to the court and the SIPC in accordance with Chapter 7 of the Bankruptcy Code. n285

[iv] Special Provisions for Liquidation Proceedings.

SIPA requires trustees to notify customers of the commencement of proceedings and to publish notice in one or more newspapers of general circulation. n286 The duty to give notice of his or her appointment to customers applies only to customers who appear to have had an open account with the debtor within 12 months preceding the filing date. n287 Notice to creditors other than customers is the same as that required by the Bankruptcy Code, except that the notice is given by the trustee rather than by the court. n288

A customer must file a written statement of claim within six months after the date of publication of the notice of commencement of liquidation proceeding. n289 A court may, upon application within the six-month period and for good cause shown, extend the time for the filing of a claim by the United States, a state or political subdivision thereof, or an infant or incompetent without a guardian. n290 A trustee is authorized to satisfy claims of a customer for net equity n291 in the most economical and efficient way (*i.e.*, the trustee may decide not to settle all claims from customer property but can use SIPC-advanced monies, cash, securities, or both, at his discretion.) n292 The claims must be received after the expiration of a period of time fixed by a court, not exceeding 60 days after the date of publication of notice.

Section 8(b) requires the trustee to promptly discharge all customer claims relating to, or net equity claims based on, securities or cash that may be ascertained from the debtor's books and records or are established to the trustee's satisfaction. Such claims may be discharged by the delivery of securities to a customer or the making of payments for or to the account of a customer. n293

In 1983, the Commission adopted SIPC Rule 400, "Claims for Standardized Options." The rule provides a uniform procedure for determining what customers may receive in a liquidation proceeding or a direct payment procedure in satisfaction of a claim based upon standardized options positions for purposes of SIPA Sections 7(b)(1), 8(d), and 16(11).

Rule 400, which is still in force in its original form, states that liquidation of all standardized options positions should occur as promptly as practicable after initiation of proceedings. n294 Upon liquidation the dollar amount of all

standardized options positions should be calculated in accordance with Section 16(11) and then credited or debited accordingly to the customer's account. n295 Notwithstanding Rule 400(b), there is no requirement for liquidation of any short position in standardized options covered by the deposit of the underlying securities, in the case of a call option, or treasury bills, in the case of a put option. Any position not liquidated is excluded from the Rule 400(c) calculation. n296 No standardized options positions will be delivered to customers in satisfaction of Section 7(b)(1) claims, or purchased for delivery to customers pursuant to Section 8(d). n297 The rule is not a restriction of any rights of a broker or registered clearing agency to liquidate standardized options positions. n298 The term "standardized options" refers to options traded on a national securities exchange, an automated quotation system of a registered securities association, or a foreign exchange. n299

[A] Customer Related Property. Section 8(c) establishes the priority in which customer property of the debtor may be allocated. First, the SIPC must be reimbursed for discretionary advances made to recover securities through the payment or guarantee of any indebtedness of the debtor to a bank, lender or other person to the extent the securities are apportioned to customer property under Section 6(d) of SIPA. n300

Second, remaining customer property is allocated ratably among customers to satisfy their respective net equity claims. n301 To the extent that a customer's net equity claim is not satisfied by customer property, the customer is entitled to an advance of funds from the SIPC up to \$100,000. n302

Third, the SIPC must then be reimbursed as subrogee for claims of customers that it has satisfied with its own funds. n303 Finally, the SIPC must be reimbursed for any advances made to guarantee or secure any indemnity pursuant to Section 9(c)(2) of SIPA. n304 Any customer property remaining after the satisfaction of customer and SIPC claims becomes part of the general estate.

Section 8(c)(2) requires the trustee to deliver customer name securities n305 to customers if the customers are not indebted to the debtor. If a customer has an outstanding indebtedness, he or she may pay the trustee, and, with the trustee's approval, reclaim customer name securities within a period set by the trustee. n306 If a customer fails to liquidate any existing indebtedness, the trustee may net the customer's account and pay to the customer his net equity on the filing date. n307 Transfers that are void or voidable under the Bankruptcy Code and those that have the effect of granting preferential treatment to individual customers are recoverable claims under SIPA. n308

To restore customer accounts to their filing date positions, Section 8(d) authorizes the trustee to purchase securities in the open market or otherwise obtain them to satisfy customer claims for net equities based on securities n309 and for the transfer of customer accounts. n310 Customer property and moneys advanced by the SIPC may be used by the trustee to pay for securities so purchased. n311

[B] Closeouts. Section 8(e) provides for the closing out or completion of contracts with other brokers or dealers left open by the insolvency of the debtor. n312 If the other broker or dealer closes-out the contract pursuant to Section 8(e) and derives a net profit, he must pay it to the trustee. n313 If he realizes a net loss, he may file a claim against the debtor with the trustee for the loss. To the extent that the loss of the broker or dealer arises from contracts in which he was acting for a customer, he is entitled to SIPC advances up to \$40,000 per customer to cover the loss. n314 Any losses suffered by a broker or dealer not acting for a customer constitutes a claim against the general estate not payable from SIPC advances. n315

The closeout provisions under Section 8(e) are not applicable to a registered clearing agency that has its own rules on close-outs for its members or to participants in the clearing agency, to the extent their claims may be processed within the clearing agency, unless the SIPC specifically rules otherwise. n316 If the registered clearing agency or a participant suffers a loss, it may claim such loss against the general estate only and may not be paid from SIPC funds. n317

Section 8(f) permits the trustee, subject to SIPC approval, to sell or otherwise transfer all or part of a customer's account

of the debtor to another broker or dealer without the customer's consent.

[v] SIPC Advances. To accelerate the payment of net equity claims of the debtor's customers, Section 9 permits the SIPC to advance to the trustee monies to satisfy customer claims for the excess of net equity of each customer over the customer's ratable share of customer property, up to \$500,000. If all or any portion of the excess is a claim for cash, the amount of the SIPC advance may not exceed \$100,000 for such cash claim of each customer. n318 A customer who holds accounts with the debtor in *bona fide* separate capacities is deemed a different customer in each capacity. n319

No advance may be made by the SIPC to satisfy, directly or indirectly, net equity claims of a customer who is: a general partner, officer, or director of the debtor; a beneficial owner of five percent or more of any equity security of the debtor (other than a nonconvertible stock having fixed preferential dividend and liquidation rights); a limited partner with a participation of five percent or more in the net assets or net profits of the debtor; or a person who, directly or indirectly, and through agreement or otherwise, exercised or had the power to exercise a controlling influence over the management or policies of the debtor. n320

In addition, the SIPC may not advance funds to satisfy the net equity claims of a customer who is a broker, dealer, or bank unless the net equity claims, as established from the books and records of the debtor, broker, dealer, bank, or otherwise to the satisfaction of the trustee, arose out of transactions for customers n321 of the broker, dealer or bank. n322 In that event, each customer is deemed a separate customer of the debtor. n323

To the extent that monies are advanced to the trustee by the SIPC to satisfy customers' claims, the SIPC is subrogated to the claims with rights and priorities provided under SIPA. n324 The SIPC may not assert as subrogee any claim against customer property until the *pro rata* share of customer property has been allocated to all net equity claimants under Section 8(c). n325

[vi] Direct Payment Procedure. The "Direct Payment Procedure" approved in 1978 was intended to shorten delays incident to a liquidation by eliminating the requirement of judicial supervision under certain limited circumstances. To use the direct payment procedure, the SIPC must determine, in addition to the factors previously listed, n326 that the member has failed or is in danger of failing to meet his obligations to customers, n327 and that one or more of the conditions specified in Section 5(b)(1) n328 exist with respect to the member. n329

If the enumerated conditions exist, a decision to institute the direct payment procedure is within the SIPC's discretion. n330 The direct payment procedure, however, is available only where the member's registration as a broker or dealer under Exchange Act Section 15(b) has been terminated or where the member has consented to the use of the procedure. n331

Section 10(b) requires the SIPC to give notice to customers that the direct payment procedure is to be used for them. Notice of the direct payment procedure must also be published in one or more newspapers of general circulation. The SIPC's duty to give notice of the direct payment plan to customers applies only to customers who appear, from the books and records of the SIPC member, to have had an open account with the member within the last 12 months. n332 Claims filed more than six months after publication of notice of the direct payment procedure are barred, except for certain claims by the United States, one of the states or its political subdivision, or an infant or incompetent. n333

The SIPC must seek to discharge promptly all obligations of the member to customers relating to securities or cash to the extent the obligations may be established from the books and records of the member. n334

There is provision for judicial resolution of contested claims. n335 In addition, there is provision for the discontinuance of the direct payment procedure if the SIPC determines that it is no longer appropriate. n336

[vii] Prohibited Acts. A broker or dealer for whom a trustee has been appointed or a direct payment procedure has

been initiated may not engage in business as a broker or dealer unless the Commission otherwise determines it to be in the public interest. n337 The Commission may, by order, after notice and opportunity for hearing, ban or suspend for any period any officer, director, general partner, owner of 10 percent or more of voting securities, or controlling person of any broker or dealer for whom a trustee has been appointed or a direct payment procedure has been initiated, from association with a broker or dealer. n338

A person may be fined not more than \$50,000 or imprisoned for not more than five years, or both, if he, directly or indirectly, in connection with a liquidation proceeding or direct payment procedure employs any device, scheme or artifice to defraud; n339 or engages in any act, practice, or course of business that operates as a fraud or deceit on any person. n340 The criminal penalties are also imposed if the person, fraudulently or with intent to defeat SIPA:

- conceals or transfers any property belonging to the estate of a debtor;
- makes a false statement or account;
- presents or uses any false claim for proof against the estate of a debtor;
- receives any material amount of property from a debtor; gives, offers, receives, transfers, or obtains any money or property, remuneration, compensation, reward, advantage, other consideration, or promise thereof, for acting or failing to act;
- conceals, destroys, mutilates, falsifies, makes a false entry in, or otherwise falsifies any document affecting or relating to the property or affairs of a debtor;
- withholds from any person entitled to its possession any document affecting or relating to the property or affairs of a debtor; n341 or
- steals, embezzles, or converts to his own use or to the use of another any of the monies, securities, or other assets of the SIPC, or otherwise defrauds or attempts to defraud the SIPC or a trustee by any means. n342

[e] Relation to Bankruptcy Code. Chapter 2 (Subchapter III) of the Bankruptcy Code contains special provisions for the liquidation of stockbrokerage firms. n343 However, if the SIPC files an application for a protective decree under the SIPC, n344 the pending bankruptcy liquidation is suspended and the SIPC takes charge of the liquidation. n345 The liquidation proceeds under SIPA with the SIPC acting to protect the customers of the broker-dealer by giving the customers preference over general creditors and allowing customers' claims to be satisfied by funds advanced by the SIPC. n346

The provisions of the Bankruptcy Code control a liquidation proceeding under SIPA only to the extent that the Code provisions are consistent with SIPA. n347 If the SIPC completes the liquidation, then the case under the Bankruptcy Code is dismissed. n348

Since most broker-dealers are members of the SIPC n349 virtually all stockbroker liquidations will be conducted under SIPA. n350 However, members of the SIPC may be liquidated under the Bankruptcy Code provisions governing stockbroker liquidation if the SIPC does not file an application in a pending bankruptcy case, or the court finds the customers of the SIPC member not in need of protection under SIPA. n351

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 78aaa-III. SIPA was amended by the Bankruptcy Reform Act of 1978, Pub. L. 95-598, 92 Stat. 2549 (1978), in order to conform the cross-references in SIPA with the Bankruptcy Code. See S. Rep. No. 589,

95th Cong., 2d Sess. 197 at 161. SIPA, and the rules and forms under SIPA, are reprinted in the Securities Primary Law Sourcebook, Volume D, Section R (Matthew Bender).

(n2)Footnote 2. The legislative history of SIPA provides a summary of the grave situation prompting its enactment.

The serious and persistent financial problems besetting the securities industry in recent months have led to the voluntary liquidations, mergers, receiverships or, less frequently, bankruptcies of a substantial number of brokerage houses. Such failures may lead to loss of customers' funds and securities with an inevitable weakening of confidence in the U.S. Securities markets. Such lessened confidence has an effect on the entire economy.

H.R. Rep. 1613, 91st Cong., 2d Sess. (1970), *reprinted in* 1970 U.S.C.C.A.N. 5254, 5254-55 [hereinafter "HR 1613"].

(n3)Footnote 3. *See Study of Unsafe and Unusual Practices of Brokers and Dealers*, H.R. Doc. No. 231, 92d Cong., 1st Sess. (1971) [hereinafter *Study of Unsafe and Unsound Practices*].

(n4)Footnote 4. *See* Staff of Special Subcommittee on Investigations of the House Committee on Interstate & Foreign Commerce, 92d Cong., 1st Sess., *Review of SEC Records of the Demise of Selected Brokers-Dealers 1* (Comm. Print 1971).

(n5)Footnote 5. *Study of Unsafe and Unsound Practices*, n.3 *supra*, at 8.

(n6)Footnote 6. *Id.* at 8 , 39.

(n7)Footnote 7. *See* H.R. 1613, n.2 *supra*, at 5255.

(n8)Footnote 8. The SIPC has various other powers which allow it to carry out the purposes of SIPA. All registered broker-dealers are members of SIPC and subject to its rulemaking and liquidation powers. *See* 15 U.S.C. § 78ccc(a)(2)(A). *See* § 3.03 for a discussion of the broker-dealer registration requirements.

(n9)Footnote 9. 17 C.F.R. § 240.15c3-3, reprinted in the Primary Law Sourcebook, Volume B, Section G (Matthew Bender).

(n10)Footnote 10. *See Study of Unsafe and Unsound Practices*, n.3 *supra*, at 65,505.

(n11)Footnote 11. 17 C.F.R. § 240.15c3-3(b), (e).

(n12)Footnote 12. Exch. Act Rel. No. 34-47480.

(n13)Footnote 13. 17 C.F.R. § 240.15c3-1.

(n14)Footnote 14. 17 C.F.R. § 240.15c3-1 (a)(1)(i).

(n15)Footnote 15. *See* § 3.08[2][a] *infra* for a discussion of the net capital rule.

(n16)Footnote 16. *See* § 3.08[3] *infra*.

(n17)Footnote 17. Note that the Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97, repealed old Section 8(b) of the Exchange Act, and redesignated former Sections 8(c) and 8(d) as present Sections 8(b) and 8(c) respectively.

(n18)Footnote 18. Section 8(b), reprinted in the Securities Primary Law Sourcebook, Volume B, Section F (Matthew Bender); Rule 8c-1, and Rule 15c2-1, reprinted in the Securities Primary Law Sourcebook, Volume B,

Section G (Matthew Bender), are discussed in § 3.08[2][b] *infra*.

(n19)Footnote 19. Section 8(c) is discussed in § 3.08[2][b] *infra*.

(n20)Footnote 20. Section 15(c)(3) and Rule 15c3-3 promulgated thereunder are discussed in § 3.08[2][a] *infra*.

(n21)Footnote 21. Section 8(a) is discussed in § 3.08[2] *infra*.

(n22)Footnote 22. Regulation of credit is discussed in Ch. 3A *infra*.

(n23)Footnote 23. The Commission's examination of broker-dealer records pursuant to Section 17(b) is discussed in § 3.04[3] *supra*.

Broker-dealer reports to the Commission pursuant to Sections 17(a) and (e) are discussed in § 3.04[4] *supra*.

Included within the distribution of reports to customers is information designed to enable them to formulate their own opinion as to the financial stability of the broker-dealer.

(n24)Footnote 24. Section 17(f)(1) and related Form X-17F-1A and Rule 17f-1 are discussed in § 3.08[2][d] *infra*.

(n25)Footnote 25. *See* Act of June 6, 1934, Ch. 404, § (d), 48 Stat. 888 (1934). The Commission, however, never regarded Section 8(d) as wholly successful because it did not reach over-the-counter brokers, nor did it apply to debts incurred outside of the normal broker-dealer course of business. *See* Hearings Before the Subcommittee of the Senate Committee on Banking and Currency on S.1178, S.1179, S.1180, S.1181, and S.1182, 86th Cong., 1st Sess. (1952).

(n26)Footnote 26. *See* *Exch. Act Rel. No. 34-3323*, 3 *Fed. Sec. L. Rep. (CCH)* P 25,126 (Oct. 29, 1942).

(n27)Footnote 27. 17 *C.F.R.* § 240.15c3-1.

(n28)Footnote 28. For purposes of this rule, the brokers and dealers subject to this requirement include those that endorse or write options otherwise than on a registered national securities exchange, or an associated facility of such exchange, and those who effect more than ten transactions in any one year for its own investment accounts. *See* 17 *C.F.R.* § 240.15c3-1(a)(2)(iii)(A)-(B).

The rule sets forth other minimum requirements for particular brokers and dealers. Brokers and dealers that carry customer accounts must maintain a net capital of \$250,000. A broker-dealer is said to "carry" customer accounts if it receives or holds funds or securities for customers or broker-dealers. 17 *C.F.R.* § 240.15c3-1(a)(2)(i).

Brokers and dealers who introduce transactions and accounts of customers or other brokers or dealers to another registered broker or dealer that carries such accounts on a fully disclosed basis, and receives, but does not hold, customer or other broker-dealer securities must maintain net capital of not less than \$50,000. 17 *C.F.R.* § 240.15c3-1(a)(2)(iv).

Brokers and dealers who qualify as "market makers" are subject to the steep net capital requirement of \$1,000,000. "Market makers" are those brokers and dealers that: regularly publish bona fide, competitive bids and offer quotations in a recognized inter-dealer quotation systems; furnish bona fide competitive bid and offer quotations on request; and are ready, willing and able to effect transactions in reasonable quantities at their quoted prices with other brokers or dealers. *See* *Exch. Act Rel. No. 31,511*, [1992 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* P 85,064 (Nov. 24, 1992).

Broker-dealers who are engaged in the sale of redeemable shares of registered investment companies or of interest or participations in an insurance company's separate account that are directly from or to the issuer other than on a subscription basis must maintain net capital of at least \$25,000.

Municipal securities brokers and dealers must maintain minimum net capital of \$150,000. Broker-dealers so qualifying are those who act exclusively as an undisclosed agent in the purchase or sale of municipal securities for a registered broker, dealer or municipal securities dealer, who does not have their own customers, and who do not have or maintain any municipal securities in their proprietary or other accounts.

Broker-dealers who do not either directly or indirectly receive, or hold funds or securities (or owe funds or securities to) for customers and do not carry accounts for customers require minimum net capitalization of only \$5,000.

The rule also describes special capitalization requirements for self-clearing options specialists, 17 C.F.R. § 240.15c3-1(a)(7), and for brokers or dealers engaging in reverse repurchase agreements, 17 C.F.R. § 240.15c3-1 (a)(9).

(n29)Footnote 29. See Exch. Act Rel. No. 34-39,456; File No. S7-32-97 (Dec. 17, 1997).

(n30)Footnote 30. See Exch. Act Rel. No. 34-39,455; File No. S7-31-97 (Dec. 17, 1997).

(n31)Footnote 31. See Exch. Act Rel. No. 34-39,457; File No. S7-33-97 (Dec. 30, 1997).

(n32)Footnote 32. Sec. Act Rel. Nos. 33,8236, 34,47972.

(n33)Footnote 33. Rule 15c3-3. See § 3.08[2][c] *infra*. Certain adjustments to this reserve account formula are made for the alternative net capital calculation. These adjustments include a reduction of aggregate debit items by 3 percent, rather than 1 percent as required in the reserve account calculation; a requirement that the market value of short securities and credits and short security count differences more than seven days old, rather than 30 days old, be included in the formula; the exclusion of credit balances in accounts representing amounts payable for securities not yet received from the issuer or agent; and deductions of 1 percent of the contract value of all undelivered contracts or securities. 17 C.F.R. § 240.15c3-1(a)(1)(ii).

(n34)Footnote 34. See Exch. Act Rel. No. 34-49830 (June 8, 2004). The amended Rules amend the net capital rule and add to the rule new Appendix E, Deductions for Market and Credit Risk for Certain Brokers and Dealers, 17 C.F.R. § 240.15c3-1e, and new Appendix G, Conditions for Ultimate Holding Companies of Certain Brokers or Dealers, 17 C.F.R. § 240.15c3-1g. The amended Rules also amend Exchange Act Rules 17a-4, Records To Be Preserved by Certain Exchange Members, Brokers and Dealers, 17 C.F.R. § 240.17a-4; 17a-5, Reports To Be Made by Certain Brokers and Dealers, 17 C.F.R. § 240-17a-11; 17h-1T, Risk Assessment Recordkeeping Requirements for Associated Persons of Brokers and Dealers, 17 C.F.R. § 240.17h-1T; and 17h-2T, Risk Assessment Reporting Requirements for Brokers and Dealers, 17 C.F.R. § 240.17h-2T.

(n35)Footnote 35. See Exch. Act Rel. No. 34-2690 [1940 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 22,423 (November 15, 1940) [hereinafter "Exch. Act Rel. No. 2690"].

(n36)Footnote 36. See *id.*

(n37)Footnote 37. See *id.*

(n38)Footnote 38. See *id.*

(n39)Footnote 39. See *id.*

(n40)Footnote 40. See *id.*

(n41)Footnote 41. H.R. Rep. No. 1383, 73 Cong., 2d Sess. (1934), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I (Matthew Bender).

(n42)Footnote 42. Section 8(a) prohibited borrowing by any broker dealer who transacted securities business through an exchange, thus giving banks a monopoly on lending money to broker-dealers. The repeal should expand the field of lenders and make it easier to borrow for capital market activities such as underwriting and market making.

(n43)Footnote 43. See Ch. 3A, *infra*.

(n44)Footnote 44. See 15 U.S.C. § 78h(a).

(n45)Footnote 45. See 15 U.S.C. § 78h(b). The Securities Acts Amendments of 1975, Pub. L. 94-29, 89 Stat. 97 (1975), added at the end of prior Section 8(c) the phrase "or in contravention of such rules and regulations as the Commission shall prescribe for the protection of investors." The Securities Industry Study Report pointed out that a loophole existed in the law, in that hypothecation of customers' securities was subject to appropriate regulation, but lending was not. The provision authorizing the Commission to promulgate rules concerning the lending by brokers and dealers of securities carried for the accounts of their customers closed that loophole. H.R. Rep. No. 123, 94th Cong., 1st Sess. (1975), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I (Matthew Bender).

(n46)Footnote 46. The adoption of Rules 8c-1 and 15c2-1 was announced in Exch. Act Rel. No. 34-2690. The FINRA has adopted a Conduct Rule governing customer's securities and funds. See Rule 2330, NASD Manual (CCH).

(n47)Footnote 47. Rule 8c-1 was adopted pursuant to former Section 8(c), which was originally redesignated Section 8(b) pursuant to the Securities Acts Amendment of 1975, Pub. L. 94-29, 89 Stat. 97 (1975), and is now redesignated as 8(a). The Commission proposed amendments to Rule 8c-1 to expand the scope of paragraph (a) of the rule to include the direct or indirect hypothecation, loan, or borrowing by a broker or dealer, or his arranging for or permitting, directly or indirectly, the continued hypothecation or loan of customers' securities where, *inter alia*: the loan or hypothecation includes more of the securities than is fair and reasonable in light of the customer's indebtedness to the broker or dealer with respect to the securities; and the securities loaned, borrowed, or hypothecated are fully paid securities or excess margin securities, unless the broker or dealer first obtains for fair and adequate consideration the specific authorization of the customer in writing, designating the particular securities to be loaned or borrowed and specifying the terms and conditions under which the securities may be loaned or borrowed. See Exch. Act Rel. No. 34-9388, Special Report No. 395 (CCH) at 6-7 (Nov. 8, 1971) [hereinafter "Exch. Act Rel. No. 34-9388"].

The Commission also proposed the addition of a new paragraph (5) to Rule 8c-1(b) that would define the term "lien" to include the possession of securities borrowed from a broker or dealer if the borrower has deposited cash with the broker or dealer to be returned to the borrower on his return of the borrowed security to the broker or dealer. *Id.*

(n48)Footnote 48. See Exch. Act Rel. No. 34-2690. The Commission proposed to amend Rule 15c2-1(a) to broadly define the phrase "fraudulent, deceptive, or manipulative act or practice," as used in Section 15(c)(2) of the Exchange Act, to include the direct or indirect hypothecation, loan, or borrowing of customers' securities as specified in proposed Rule 8c-1. See Exch. Act Rel. No. 9388, at 6.

(n49)Footnote 49. For a discussion of the hypothecation rules, see § 3.08[2][b] *supra*.

(n50)Footnote 50. For discussion of exemptions from the hypothecation rules, see § 3.08[2][b][ii] *infra*.

(n51)Footnote 51. See § 3.08[2][b] *supra* for the three prohibitions enumerated in redesignated Section 8(a).

(n52)Footnote 52. The term "customer" does not include general or special partners, directors or officers of the broker-dealer, or any participant as such in any joint, group or syndicate account with the broker-dealer or with any partner, director or officer thereof. See Rules 8c-1(b)(1); 15c2-1(b)(1). The term, however, includes other exchange members, brokers or dealers. See Exch. Act Rel. No. 34-2690, at 22,427. By excluding from the term "customer" any participants in joint, group or syndicate accounts with a broker or any partner, officer or director of the broker, Rules 8c-1(b)(1) and 15c2-1(b)(1) permit the broker-dealer or any partner, director or officer thereof to participate with others

in such accounts. *Id.*

(n53)Footnote 53. The phrase "securities carried for the account of any customer" means: securities received by or on behalf of the broker or dealer for the account of any customer; securities sold and earmarked or otherwise appropriated to a customer (if the securities were subject to a lien when appropriated to a customer, they are not deemed to be "securities carried for the account of any customer" pending their release from the lien as promptly as practicable); and securities sold, but not appropriated by a broker-dealer to a customer who has made any payment for the securities, to the extent that the broker-dealer owns and has received similar securities. However, if the securities are sold to a customer and are subject to a lien when payment was made, they do not become "securities carried for the account of any customer" pending their release from the lien as promptly as possible. Rules 8c-1(b)(2)(i)-(iii); 15c2-1(b)(2)(i)-(iii).

Securities that are not "carried for the account of customers," of course, are not subject to Rules 8c-1 and 15c2-1.

Cf. United States v. Schwartz, 464 F.2d 499, 507-08 (2d Cir. 1972) , in which the court found that where some of stock underwriter pledged to lender to obtain funds to pay issuer had been sold to and paid for by underwriter's customers, the stock was "securities carried for the account of any customer" at the time of the pledge within the meaning of old Section 8(c) (presently Section 8(b)), notwithstanding the fact that all of the stock was not sold); see *In re Cortlandt Investing Corp.*, Exch. Act Rel. No. 34-7682 [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,273 (Aug. 24, 1965), upholding expulsion of a firm by FINRA in part for two violations of Rule 15c2-1, even though violations were found inadvertent.

(n54)Footnote 54. Rules 8c-1(a)(1); 15c2-1(a)(1).

(n55)Footnote 55. Rules 8c-1(a)(2); 15c2-1(a)(2). Even with customer consent, brokers and dealers are forbidden under Rule 8c-1 and Rule 15c2-1 to pledge customers' securities with those of persons who are not customers. See H.R. Rep. No. 1383, 73 Cong., 2d Sess. (1934), reprinted in the Primary Law Sourcebook, Volume C, Section I (Matthew Bender).

In addition, paragraph (a)(2) of Rules 8c-1 and 15c2-1 prohibit pledging customers' securities under a general lien if the broker-dealer's securities are also pledged under the same lien to obtain or increase the loan or as substituted collateral for customers' securities. See Exch. Act Rel. No. 34-2690, at P 22,433.

(n56)Footnote 56. See Rules 8c-1(a)(3); 15c2-1(a)(3). Good brokerage practice requires the broker-dealer to maintain a "cushion" of his own capital between the amount of customers' debits and the amount of his bank loans on customers' securities. This cushion must be sufficient to offset any reasonably anticipated reductions in customers' indebtedness. In the exceptional situation where customers' indebtedness is paid off in an amount which depletes the cushion and reduces the total of customers' debit balances below the broker-dealer's current borrowings on customers' securities, the rule contains the following exemption. Paragraph (a)(3) of Rule 8c-1 and of Rule 15c2-1 will not be considered as violated if, as a result of reductions in the aggregate indebtedness of customers on any day, the amount of liens to which customers' securities are subject during that day exceeds the total indebtedness of customers in respect of securities carried for their accounts. Rules 8c-1(a)(3); 15c2-1(a)(3). A payment by a customer on any day that reduces the amount the customer would owe the broker-dealer on that day had the payment not been made is regarded as a reduction of indebtedness on that day within the meaning of the rules. See Exch. Act Rel. No. 34-2690, at 22,439.

The exemption is applicable only if funds or securities in an amount sufficient to eliminate the excess of the liens or claims to which customers' securities are subject over the aggregate indebtedness are paid or placed in transfer to pledgees to reduce the sum of the liens or claims to which customers' securities are subject as promptly as practicable after the reduction occurs. See Rules 8c-1(a)(3); 15c2-1(a)(3).

However, if it is not practicable to eliminate the excess of liens over customers' indebtedness on the day the excess occurs, funds sufficient to eliminate the excess must be paid or placed in transfer to pledgees either before one-half hour

after the commencement of banking hours on the next banking day at the place where the exchange member, broker, or dealer carries his largest principal amount of loans or before the exchange member, broker, or dealer obtains or increases any bank loan collateralized by customers' securities, whichever is earlier. *See id.*

In computing the sum of liens or claims to which customers' securities are subject, the broker or dealer may disregard any rehypothecation thereof by another broker also subject to either Rule 8c-1 or Rule 15c2-1. *See* Rules 8c-1(b)(4) and 15c2-1(b)(4).

See United States v. Eucker, 537 F.2d 718, 718 (2d Cir. 1976) (defendant unlawfully, willfully and knowingly hypothecated fully-paid securities carried for the account of customers under circumstances that permitted securities to be subjected to liens of up to \$7 million in violation of Rule 8c-1); *SEC v. Charles Plohn & Co.*, 433 F.2d 376, 379 (2d Cir. 1970) (appointment of a receiver was justified by, among other things, evidence that defendant broker-dealer was fined for illegal hypothecation of customers' securities and suspended from stock exchange for failure to rectify hypothecation problem).

(n57)Footnote 57. *See* Rules 8c-1(f); 15c2-1(f).

(n58)Footnote 58. *Id.* An omnibus account is a special account that a broker-dealer may establish to effect and finance transactions for another broker or dealer registered under Section 15 from whom the person establishing the account receives written notice pursuant to the hypothecation rules that all securities carried in the account are carried for customers of the broker or dealer and written notice that any short sales in the account will be made on behalf of the customers of the broker or dealer other than his partners. *See* Regulation T, 12 C.F.R. § 220.10.

Regulation T and the accounts established thereunder are discussed in § 3A.02[1][a] *infra*.

(n59)Footnote 59. Rules 8c-1(f); 15c2-1(f).

(n60)Footnote 60. *See* Rules 8c-1(g); 15c2-1(g). However, any custodian must agree that it will not for any reason, including the assertion of any claim, right or lien, refuse or refrain from promptly delivering any securities (other than securities hypothecated in accordance with the established system) to the clearing corporation or other subsidiary organization or as directed by the corporation or organization. *Id.* Nothing in the agreement may be deemed to require a custodian to deliver securities in violation of any notice of levy, seizure or similar notice, order, or judgment issued by a governmental agency, court, or officer thereof with competent jurisdiction over the custodian, which on its face affects the securities. *Id.*

Furthermore, there must be safeguards under the system for handling, transfer and delivery of securities, including fidelity bonding requirements for employees and agents of, and periodic examinations by independent public accountants of, the clearing corporation or other subsidiary organization. A particular system for the central handling of securities will not be deemed effective unless compliance with the requirements for the agreement and safeguards discussed above are deemed adequate by the Commission for the protection of investors. *Id.*

(n61)Footnote 61. *See* Rules 8c-1(c); 15c2-1(c). The provisions of Section 4(c) of Regulation T which relate to special cash accounts are in 12 C.F.R. § 220.8. *See* Complete Revision and Simplification of Regulation T, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,352, at 85,953 (May 16, 1983).

Generally, a special cash account is one in which an exchange member or a broker or dealer purchases securities for, or sells securities to, a customer only if funds sufficient for the purpose are already held in the customer's account or if the purchase or sale is effected in reliance on an agreement, accepted in good faith, that the customer will promptly make full cash payment for the securities. *See* Exch. Act Rel. No. 34-2690, at 22,431. Credit is not extended by the broker-dealer to the customer for these transactions.

The exemption under Rules 8c-1(c) and 15c2-1(c) is subject to the condition that at or before the completion of the transaction of the purchase of the securities for, or the sale of the securities to, the customer, written notice is given or sent to the customer disclosing that the securities are or may be hypothecated under circumstances that will permit the commingling of the securities with securities of other customers. Rules 8c-1(c); 15c2-1(c). The phrase "the completion of the transaction" has the same meaning as in Rule 15c1-1(b). Special cash accounts under Regulation T are discussed in § 3A.02[1][a][ii] *infra*.

(n62)Footnote 62. Rules 8c-1(d); 15c2-1(d). For all practical purposes, a broker or dealer operating under paragraphs (a)(2) and (a)(3) or Rules 8c-1 and 15c2-1 may disregard his pledges of customers' securities under clearing house liens. Exch. Act Rel. No. 34-2690, at 22,432 (1941). However, in computing aggregate indebtedness, he must also disregard any securities subject to a clearing house lien exempted by paragraph (d) of Rules 8c-1 and 15c2-1.

See National Clearing Corporation, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,652 (Jan. 31, 1972).

(n63)Footnote 63. See n.52 and accompanying text *supra* for a similar prohibition in the hypothecation rules.

(n64)Footnote 64. Rules 8c-1(e); 15c2-1(e). For the purpose of the exemption, a loan is deemed to be "made against securities carried for the account of customers" if only securities carried for the account of customers are used to obtain or increase the loan or as substitutes for other securities carried for the account of customers. *Id*.

(n65)Footnote 65. Pub. L. 91-598, 84 Stat. 1636 (1970).

(n66)Footnote 66. For the legislative history of SIPA, see S. Rep. No. 1218, 91st Cong., 2d Sess. 1970; H.R. Rep. No. 1613, 91st Cong., 2d Sess. (1970), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I (Matthew Bender).

(n67)Footnote 67. 15 U.S.C. § 78o(c)(3).

(n68)Footnote 68. The adoption of Rule 15c3-3 pursuant to Section 15(c)(3), as it existed prior to the Securities Acts Amendments of 1975, was announced in Adoption of Rule 15c3-3 under the Securities Exchange Act of 1934, Exch. Act Rel. No. 34-9856, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,083 (Nov. 10, 1972).

(n69)Footnote 69. The phrase "fully-paid securities" refers to all securities carried for the account of a customer in a special cash account as defined in Regulation T, as well as margin equity securities within the meaning of Regulation T that are carried for the account of a customer in a general account or any special account under Regulation T during any period for which Section 8 of Regulation T specifies that margin equity securities must have no loan value in a general account or special convertible debt security account and all the margin equity securities in the account if fully paid. See § 3A.02[1][a][ii] *infra*. However, the phrase "fully-paid securities" does not refer to any securities purchased in transactions for which the customer has not made full payment. See Rule 15c3-3(a)(3).

A customer may opt to keep fully paid securities in the possession of his broker to save time in disposing of the securities and to avoid the cost of safety-deposit rental. See Guttman, *Broker-Dealer Bankruptcies*, 48 N.Y.U. L. Rev. 887, 891 (1973) [hereinafter *Broker-Dealer Bankruptcies*]. Broker-dealers like the customer to keep fully paid securities with them because, if the customer decided to sell the securities, the customer is most likely to do so through the broker holding the securities. *Id*.

(n70)Footnote 70. The phrase "excess margin securities" means margin securities carried for the account of a customer in a general account as defined in Regulation T, as well as securities carried in any special account other than fully paid securities, having a market value in excess of 140 percent of the total of the debit balances in the customer's account or accounts encompassed by Rule 15c3-3(a)(4) (includes both general and special accounts) that the broker or dealer identifies as not constituting margin securities. Rule 15c3-3(a)(5).

The term "margin securities" refers to securities which are carried for the account of a customer in a general account as defined in Regulation T, as well as securities carried in any special account (such general or special accounts hereinafter referred to as "margin accounts") other than fully paid securities as defined in Rule 15c3-3(a)(3). *See* note 66 *supra*; Rule 15c3-3(a)(4).

(n71)Footnote 71. The phrase "securities carried for the account of a customer" or "customer securities" means: securities received by or on behalf of a broker or dealer for the account of any customer and securities carried long by a broker or dealer for the account of any customer; and securities sold to, or bought for, a customer by a broker or dealer. Rule 15c3-3(a)(2)(i)-(ii).

(n72)Footnote 72. The Reserve Formula, which is set forth in Exhibit A to Rule 15c3-3, is discussed in § 3.08[2][c][ii][D] *infra*.

(n73)Footnote 73. *See, e.g.*, Exch. Act Rel. No. 34-9622 [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,801 (May 31, 1972).

(n74)Footnote 74. H.R. Conf. Rep. No. 229, 94th Cong., 1st Sess. (1975), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I (Matthew Bender).

(n75)Footnote 75. The net capital requirements are discussed in detail in § 3.08[2][a] *infra*.

(n76)Footnote 76. Brokers or dealers operating under paragraph (f) of Rule 15c3-1 determine their net capital requirement based on the aggregate debit items computed pursuant to the Formula for Determination of Reserve Requirement of Brokers and Dealers as set forth in Rule 15c3-3a, discussed in § 3.08[2][c][ii][D] *infra*.

For a discussion of the alternative net capital requirement, *see* § 3.08[2][a].

(n77)Footnote 77. *See* Exch. Act Rel. No. 34-11497 [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,212 (June 26, 1975).

(n78)Footnote 78. For a discussion of omnibus accounts under Section 220.11 of Regulation T, *see* n.55 *supra*.

(n79)Footnote 79. *See* Exch. Act Rel. No. 34-11969 [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,351 (Jan. 2, 1976).

(n80)Footnote 80. *See Broker-Dealer Bankruptcies*, n.66 *supra*, at 889.

(n81)Footnote 81. *Id.* A debit balance may also be created by a "short sale," a sale by a customer of a security the customer does not own or does not deliver, requiring the borrowing of securities to be delivered to the buyer. *Id.*

(n82)Footnote 82. *Id.*

(n83)Footnote 83. *Id.* at 889, 891. The Commission's hypothecation rules are discussed in § 3.08[2][b][i] *supra*.

(n84)Footnote 84. *See* n.66 *supra* for definition of "fully-paid securities."

(n85)Footnote 85. *See* n.67 *supra* for definition of "excess margin securities."

(n86)Footnote 86. Rule 15c3-3(b)(1). For the definition of "securities carried for the account of a customer," *see* n.68 *supra*.

See Chesapeake Equity Sales, Inc., [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,335 (Mar. 25, 1973) (unissued shares of a fund that would be long in customer accounts maintained for the fund by its underwriter deemed

to be securities in the underwriter's possession pursuant to Rule 15c3-3(b)(1)).

(n87)Footnote 87. Rule 15c3-3(b)(2).

(n88)Footnote 88. *Id.*

(n89)Footnote 89. Rule 15c3-3(b)(3).

(n90)Footnote 90. Rule 15c3-3(b)(4)(i)(A)-(D).

(n91)Footnote 91. Rule 15c2-1(d).

(n92)Footnote 92. Rule 15c2-1(g).

(n93)Footnote 93. Omnibus accounts are discussed in n.55 *supra*. The provisions of Regulation T with respect to special omnibus accounts are set forth in 12 C.F.R. § 220.10.

(n94)Footnote 94. Rule 15c3-3(c)(2).

(n95)Footnote 95. Rule 15c3-3(c)(3).

(n96)Footnote 96. *Id.*

(n97)Footnote 97. If a written confirmation within the 40-day period is not obtainable, an extension of time may be obtained under Rule 15c3-3(n). *See, e.g., In re Brager & Co.*, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,337 (Mar. 28, 1973).

(n98)Footnote 98. Rule 15c3-3(c)(4).

(n99)Footnote 99. Rule 15c3-3(c)(5).

(n100)Footnote 100. Rule 15c3-3(c)(6). In addition to guaranteeing all of the subsidiary's obligations and liabilities, the broker or dealer must assume full responsibility for compliance by the subsidiary and all its associated persons with the applicable provisions of the Exchange Act. *Id.*

(n101)Footnote 101. Rule 15c3-3(c)(7). For purposes of subparagraphs (c)(4) and (c)(7) of Rule 15c-3, the Commission may find an entity to be an unsatisfactory control location if it determines that it will not be in the public interest or for the protection of investors to permit the entity to continue to be a control location for customers' securities. *See* Exch. Act Rel. No. 34-9969 [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 72,210 (Jan. 30, 1973).

(n102)Footnote 102. Rule 15c3-3(d)(1).

(n103)Footnote 103. *Id.*

(n104)Footnote 104. Rule 15c3-3(d)(2).

(n105)Footnote 105. Rule 15c3-3(d)(3).

(n106)Footnote 106. Rule 15c3-3(d)(4).

(n107)Footnote 107. For a discussion of quarterly security counts pursuant to Rule 17a-13, see § 3.04[5][c] *supra*.

(n108)Footnote 108. For discussion of the annual report of financial condition of brokers and dealers under Section

17(a), reprinted in the Primary Law Sourcebook, Volume B, Section F (Matthew Bender), and Rule 17a-5 promulgated thereunder, reprinted in the Securities Primary Law Sourcebook, Volume B, Section G (Matthew Bender), see § 3.04[4][d] *supra*.

(n109)Footnote 109. Rule 15c3-3(h).

(n110)Footnote 110. See Exch. Act Rel. No. 34-9856 [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,083, at 82,344 (Nov. 10, 1972).

(n111)Footnote 111. This provision of Regulation T is set forth in 12 C.F.R. § 220.3(c).

(n112)Footnote 112. Rule 15c3-3(l)(2). Section 220.3(c) of Regulation T permits a creditor (in this case, a broker or dealer) to maintain credit initially extended regardless of, *inter alia*, a reduction in the customer's equity caused by a change in the market price of the securities of the customer. In maintaining this credit, the broker-dealer may either accept or retain for his own protection additional collateral, including nonmargin securities. 12 C.F.R. § 220.3(c).

The maintenance and other margin requirements permitted by former Section 7(b) of Regulation T must be imposed "equitably and reasonably." Exch. Act Rel. No. 34-9856 [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,083 (Nov. 10, 1972).

(n113)Footnote 113. An amendment to Rule 15c3-3(m) proposed on June 7, 1987, would extend this time to 30 calendar days for mortgage-backed securities. See Exch. Act Rel. No. 34-24,554, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,133 at 88,718 (June 4, 1987). This proposal was never adopted.

(n114)Footnote 114. Rule 15c3-3(m). Paragraph (m) does not apply to orders which execute sales of securities that the seller does not own. *Id.*

Paragraph (m) of Rule 15c3-3 has been suspended indefinitely with respect to exempted securities because of possible operational hardships that could result from attempts to buy in exempted securities, particularly municipal obligations. See Exch. Act Rel. No. 34-10,093 [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,310 (Apr. 10, 1973).

(n115)Footnote 115. For a discussion of omnibus accounts under Section 4(11) of Regulation T, see n.55 *supra*.

(n116)Footnote 116. Rule 15c3-3(m). Regulation T requires a customer who sells securities to "promptly deposit" the securities in the special cash account. 12 C.F.R. § 220.4(c)(1)(ii). Paragraph (m) of Rule 15c3-3 defines the period within which the broker or dealer must act if the customer fails to immediately deliver the securities as required by Regulation T. The Commission staff is of the view that paragraph (m) of Rule 15c3-3 does not place brokers or dealers in a position of additional loss exposure as a result of the cancellation provision in Section 4(c)(2) of Regulation T; Rule 15c3-3(m) merely defines "promptly deposit" as used in Section 4(c)(1)(ii) of Regulation T. See Wheat First Securities, Inc., [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,345 (Mar. 18, 1973).

See § 3A.02[1][a][ii] for a discussion of special cash accounts under Section 4(c) of Regulation T.

(n117)Footnote 117. Rule 15c3n-3(n).

(n118)Footnote 118. *Id.*

(n119)Footnote 119. The term "qualified security" means a security issued by the United States or a security in respect of which the principal and interest are guaranteed by the United States. Rule 15c3-3(a)(6).

(n120)Footnote 120. For a discussion of the Reserve Formula, see § 3.08[2][c][ii][D] *infra*.

(n121)Footnote 121. Rule 15c3-3(e)(2).

(n122)Footnote 122. *Id.*

(n123)Footnote 123. Rule 15c3-3(e)(3). If a broker or dealer has aggregate indebtedness not exceeding 800 percent of net capital and carries aggregate customer funds not exceeding \$1 million, he may, in the alternative, compute the net amount monthly at the close of the last business day of the month. *Id.* Not less than 105 percent of the net amount must be deposited in the account within one hour after the opening of banking business on the second following business day. *Id.*

If the aggregate indebtedness of a broker or dealer required to compute on a monthly basis exceeds 800 percent of net capital, he must thereafter compute the net amount weekly until four successive weekly computations are made, none of which are made when aggregate indebtedness exceeds 800 percent of his net capital. *Id.*

A broker or dealer may make computations in addition to the computations required by subparagraph (e)(3) of Rule 15c3-3 at the close of any other business day and deposit the net amount within one hour after the opening of banking business on the second following business day. *Id.*

The broker or dealer must make and maintain a record of each computation made under subparagraph (e)(3) of Rule 15c3-3 or otherwise, and preserve the record in accordance with Rule 17a-4, discussed in § 3.04 *supra*.

The calculation of aggregate indebtedness and net capital is discussed in § 3.08[2] *supra*.

(n124)Footnote 124. Rule 15c3-3(f). The notification must be preserved in accordance with Rule 17a-4. Subparagraph (k) of Rule 15c3-3 concerning exemptions is discussed in § 3.08[2][c][iii] *infra*.

(n125)Footnote 125. Rule 15c3-3(f).

(n126)Footnote 126. Rule 15c3-3(g). The amount required by paragraph (e) is the amount computed in accordance with the reserve formula in Exhibit A to Rule 15c3-3.

(n127)Footnote 127. Rule 15c3-3(g).

(n128)Footnote 128. *Id.*

(n129)Footnote 129. Rule 15c3-3(i). *See In Re G.C. George Securities, Inc.*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,498 (Feb. 7, 1984) (finding that failure to deposit sufficient funds in Special Reserve Account is willful violation of Rule 15c3-3).

(n130)Footnote 130. *See Exch. Act Rel. No. 34-16,847* [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,603 (May 28, 1980).

(n131)Footnote 131. *See Exch. Act Rel. No. 34-48931.*

(n132)Footnote 132. In the case of firms permitted to make this computation monthly, 105% of the excess of total Credits over total Debits must be deposited.

(n133)Footnote 133. The requirements for a Special Reserve Bank account are discussed in § 3.08[2][c][ii] *supra*.

(n134)Footnote 134. *See n.128 supra*.

(n135)Footnote 135. *See Exch. Act Rel. No. 34-9856*, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,083 (Nov. 13, 1972). The total Debits comprise those areas of the broker-dealer's business relating to customer

service that the Commission considers safe and for which the broker or dealer may use any of the amounts that constitute total Credits. See *Broker-Dealer Bankruptcies*, n.66 *supra*, at 900-901.

(n136)Footnote 136. A "free credit balance" occurs when a broker-dealer holds cash, available to the customer on demand, in a customer's account. A free credit balance arises in the normal course of a broker-dealer's business, often from the sale of the customer's securities or receipt of dividends due the customer. See *Broker-Dealer Bankruptcies*, n.66 *supra*, at 890.

(n137)Footnote 137. All outstanding drafts payable to customers that have been applied against free credit balances or other credit balances and checks drawn in excess of bank balances indicated in the records of the broker or dealer must be included in Item 1. Rule 15c3-3a, Note A.

(n138)Footnote 138. The amount of Letters of Credit obtained by members of Options Clearing Corporation that are collateralized by customers' securities to the extent of the member's margin requirement at OCC, must be included in Item 2. Rule 15c3-3a, Note B.

(n139)Footnote 139. In addition to monies payable against customer's securities loaned, the amount by which the market value of securities loaned exceeds the value of the collateral value received from the borrower of securities must be included in Item 3. Rule 15c-3a, Note C.

(n140)Footnote 140. The amount by which the market value of securities not received and outstanding more than 30 calendar days exceeds their contract value must be included in Item 4 in addition to the amount of customers' securities failed to receive. Rule 15c-3a, Note D.

(n141)Footnote 141. Debit balances in margin accounts must be reduced by the amount by which a specific security (other than an exempted security) that is collateral for margin accounts exceeds in aggregate value 15 percent of all securities that collateralize all margin accounts receivable. Rule 15c3-3a, Note E(1). However, this reduction of debit balances may not exceed the Debits that must be excluded by Item (10) of Exhibit A (unsecured accounts and doubtful accounts). *Id.*

A specified security is deemed to be collateral for a margin account insofar as its value is not more than 140 percent of the customer debit balance in a margin account. *Id.*

Debit balances in special omnibus accounts, maintained under Section 4(b) (now Sec. 11) of Regulation T, or similar accounts carried on behalf of another broker or dealer, must be reduced by any deficits in the accounts (or increased, in the case of a credit) less any calls for margin, marks to the market, or other required deposits outstanding 5 business days or less. Rule 15c3-3a, Note E(2).

Debit balances in customers' cash and margin accounts included in the formula under Item 10 must be reduced by an amount equal to 1 percent of their aggregate value. Rule 15c3-3a, Note E(3).

In 1985, in light of two recent failures of broker-dealers, the Commission added the following paragraphs to Note E:

(4) Debit balances in cash and margin accounts of household members and other persons related to principals of the broker-dealer are excluded, unless such debit balances are demonstrably related to credit items in the formula.

(5) If any single customer's debit balance exceeds the greater of \$50,000 or 25% of the broker-dealer's tentative net capital, the amount of such excess is excluded from the debit side of the Special Reserve Formula, unless the debit is directly related to credit items included in the Formula. Accounts related to each other are aggregated under this provision, and exceptions can be granted by the

broker-dealer's examining authority.

When a non-customer and a customer are joint participants in an account (*e.g.*, an account for a limited partnership) specified percentages of the debit balance of the joint account would be excluded, depending on the level of participation by the non-customer. Exch. Act Rel. No. 34-22499, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,921, at 87,832 (Oct. 3, 1985).

(n142)Footnote 142. The amount of margin deposited with the Options Clearing Corporation represented by cash, proprietary qualified securities, and letters of credit collateralized by customers' securities must be included in Item 13. *See* Rule 15c3-3a, note F.

A "qualified security" is a security issued, or guaranteed as to principal and interest, by the United States. Rule 15c3-3(a)(6).

(n143)Footnote 143. Rule 15c3-3(k)(1)(i).

(n144)Footnote 144. *Id.*

(n145)Footnote 145. Rule 15c3-3(k)(1)(ii).

(n146)Footnote 146. Rule 15c3-3(k)(1)(iii). Notwithstanding the provisions of paragraphs (k)(1)(i)-(iii) Rule 15c3-3 does not apply to an insurance company that is a registered broker or dealer, and that otherwise meets all the conditions in paragraphs (k)(1)(i)-(iii) of the rule, solely by reason of its participation in transactions that are part of the business of insurance, including the purchasing, selling, or holding of securities for or on behalf of the insurance company's general and separate accounts. *Id.*

(n147)Footnote 147. Rule 15c3-3(k)(2)(i). As with the Reserve Bank Accounts, a broker or dealer maintaining a Special Account must receive and preserve a notification from the bank that the deposits are for the exclusive benefit of the broker-dealer's customers and are not subject to any lien or charge in favor of the bank or any person claiming through the bank, *see supra* § 3.08[2][c][ii][A]. *See* Exch. Act Rel. No. 34-9856 [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,083, at 82,344 (Nov. 10, 1972).

(n148)Footnote 148. Rule 15c3-3(k)(2)(ii). The recordkeeping and preservation requirements of Rules 17-a and 17a-4 are discussed in § 3.04[1], [2] *supra*.

The exemption in paragraph (k)(2), discussed in the text of ns. 139-140 *supra*, is designed to alleviate the difficulty many small and medium brokers and dealers may have in complying with Rule 15c3-3, achieving the complete separation of customer funds and property, and affording customer assets protection comparable with that attainable under the rule. *See* Exch. Act Rel. No. 34-9856 [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,083, at 82,344 (Nov. 10, 1972). The procedures outlined in the paragraph (k)(2) exemption are consistent with one of the principal objectives of the SIPA that customer funds and securities must not be exposed to risk of loss through the insolvency of a broker or dealer. *Id.*

(n149)Footnote 149. Rule 15c3-3(k)(3).

(n150)Footnote 150. H.R. Doc. No. 231, 92d Cong., 1st Sess. (1971), at 145-150 (prepared pursuant to Section 11(h) of the Securities Investor Protection Act of 1970).

(n151)Footnote 151. The persons, financial institutions, and organizations covered by the program are listed as reporting institutions required to register under Rule 17f-1. *See* § 3.08[2][d][i] *infra*.

(n152)Footnote 152. H.R. Rep. No. 229, 94th Cong., 1st Sess. (1975), reprinted in the Securities Primary Law Sourcebook, Volume C, Section I (Matthew Bender).

In exercising its rulemaking authority with respect to the duty to inquire as to lost, stolen or counterfeit securities, the Commission is expected to focus on those instances where the circumstances are or appear to be suspicious and where, in the exercise of good judgment, appropriate inquiry should be made. *Id.*

Sections 17(f)(2)-(5) were also added in 1975. Section 17(f)(2) requires that partners, directors, officers, and employees of exchange members, brokers, dealers, transfer agents, and clearing agencies be fingerprinted and that the fingerprints be submitted to the Attorney General. The fingerprinting requirements of Section 17(f)(2) are discussed in § 3.03 *supra*.

Section 17(f)(3) authorizes the Commission to enter into an agreement with the Attorney General to use the services of the National Crime Information Center. The Government Securities Act of 1986, P.L. 99-571, 100 Stat. 3208 (Oct. 28, 1986) authorized the Commission to enter into an agreement with the Secretary of the Treasury to receive, store and disseminate information generated by the Department of the Treasury in regard to missing, lost, counterfeit or stolen securities.

Section 17(f)(4) authorizes the Commission to delegate its authority under paragraphs (1)-(3) of Section 17(f) with respect to any bank or member of the Federal Reserve System to the federal bank regulatory agencies. Section 17(f)(5) requires the Commission to encourage insurance companies to require persons insured by them to promptly report missing, lost, counterfeit or stolen securities to the Commission or other person designated by the Commission.

(n153)Footnote 153. See Exch. Act Rel. No. 34-13,053, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,829 at 87,179 (Dec. 10, 1976).

(n154)Footnote 154. See Exch. Act Rel. No. 34-13,832, 4 Fed. Sec. L. Rep. (CCH) P 26,139B (Aug. 5, 1977) .

(n155)Footnote 155. The designation of AutEx, Inc. as the entity to receive reports and inquiries required to be made under Rule 17f-1 was announced in Lost and Stolen Securities Program, Exch. Act Rel. No. 34-13538, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,167, at 87,997 (May 12, 1977). AutEx, Inc. was subsequently acquired by ITTEL Corporation and SIC was created as a wholly-owned subsidiary of ITTEL AutEx, Inc. See Exch. Act Rel. No. 34-13832, 4 Fed. Sec. L. Rep. (CCH) P 26,139B (Aug. 5, 1977) . SIC is now an operating division of Xerox Corp.

(n156)Footnote 156. See Exch. Act Rel. No. 34-13,538, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,167, at 87,997 (May 12, 1977).

(n157)Footnote 157. See Exch. Act Rel. No. 34-15,289, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,755, at 81,029 (Nov. 1, 1978).

(n158)Footnote 158. For a discussion of registration requirements under Rule 17f-1, see § 3.08[2][d][i] *infra*.

(n159)Footnote 159. For a discussion of brokers and dealers exempt from the lost and stolen securities program, see ns.139-142 and accompanying text.

(n160)Footnote 160. See Amendments to the Lost and Stolen Securities Program, Exch. Act Rel. No. 34-15,867, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,093, at 81,855 (May 23, 1979).

(n161)Footnote 161. Rule 17f-1(a),(b).

(n162)Footnote 162. Rule 17f-1(b)(1)(3), which recognizes exceptions for members of national securities

exchanges who effect securities transactions through the trading facilities of the exchange and have not held or received customer securities within the prior six months; reporting institutions that within the prior six months limited their securities activities exclusively to uncertified securities, global securities issues, or any securities issue for which neither record nor beneficial owners can obtain a negotiable securities certificate; and reporting institutions whose business activities within the prior six months did not involve the handling of securities certificates.

(n163)Footnote 163. Rule 17f-1(f).

(n164)Footnote 164. See Exch. Act Rel. No. 34-15867, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,093, at 81,855 (May 23, 1979). Registration forms are still being accepted.

(n165)Footnote 165. See Exch. Act Rel. No. 34-13,832, 4 Fed. Sec. L. Rep. (CCH) P 26,139B (Aug. 5, 1977) .

(n166)Footnote 166. *Id.*

(n167)Footnote 167. *Id.*

(n168)Footnote 168. Section 17(f)(1)(A).

(n169)Footnote 169. Rule 17f-1(c)(1)(i).

(n170)Footnote 170. *Id.*

(n171)Footnote 171. Rule 17f-1(c)(1)(ii).

(n172)Footnote 172. Rule 17f-1(c)(2). For the purpose of paragraph (c)(2) but not including paragraphs (b)(2)(i)-(iii) of Rule 17f-1, the time periods for reporting begin to run when, on the basis of all relevant circumstances, the reporting institution believes a certificate to be missing or lost as opposed to a belief that the certificate is merely misplaced or misfiled. See Exch. Act Rel. No. 34-13,832, 4 Fed. Sec. L. Rep. (CCH) P 26,139B (Aug. 5, 1977) .

(n173)Footnote 173. Rule 17f-1(c)(2)(i).

(n174)Footnote 174. Rule 17f-1(c)(2)(ii).

(n175)Footnote 175. Rule 17f-1(c)(2)(iii)(A).

(n176)Footnote 176. *Id.*

(n177)Footnote 177. Rule 17f-1(c)(2)(iii)(B).

(n178)Footnote 178. Rule 17f-1(c)(2)(iii)(C).

(n179)Footnote 179. Rule 17f-1(c)(2)(iii)(D).

(n180)Footnote 180. Rule 17f-1(c)(3).

(n181)Footnote 181. Rule 17f-1(c)(4), (6).

(n182)Footnote 182. See Exch. Act Rel. No. 34-13,832, 4 Fed. Sec. L. Rep. (CCH) P 26,139B (Aug. 5, 1977) .

(n183)Footnote 183. Rule 17f-1(c)(5). The FINS number is the Financial Industry Numbering System which is published by the Depository Trust Company in New York City. The CUSIP number is an identification number assigned each security by the Committee on Uniform Security Identification Procedures (CUSIP) Service Bureau of Standard & Poor's. The number has nine digits, consisting of a six-digit issuer number; a two-digit (or letter) issue

number; and an issue (not issuer) check digit.

(n184)Footnote 184. Rule 17f-1(d)(1).

(n185)Footnote 185. Rule 17f-1(d)(1)(i).

(n186)Footnote 186. Rule 17f-1(d)(1)(ii).

(n187)Footnote 187. Rule 17f-1(d)(1)(iii).

(n188)Footnote 188. Rule 17f-1(d)(1)(iv). If securities of several issuers are received as part of a single deposit to a trust or estate account and the aggregate value of these securities is more than \$10,000, inquiry is required on all securities certificates being deposited, because the securities of each issuer are not considered as separate and distinct transactions for the purposes of the \$10,000 or less exemption. Trust Co. of Georgia, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,865 (Div. Mkt. Reg. 1981). For example, if a single deposit of securities into a trust account contains \$6,000 of X securities, \$4,000 of Y securities, and \$1,000 of Z securities, inquiry would be required of all securities certificates comprising that deposit.

(n189)Footnote 189. Rule 17f-1(d)(i)-(v).

(n190)Footnote 190. Rule 17f-1(d)(2).

(n191)Footnote 191. Rule 17f-1(e).

(n192)Footnote 192. Rule 17f-1(e)(l)-(5).

(n193)Footnote 193. Rule 17f-1(f).

(n194)Footnote 194. Rule 17f-1(g). For a discussion of the recordkeeping and record preservation requirements for brokers or dealers under Rule 17a-3 and Rule 17a-4 respectively, see § 3.04[1], [2] *supra*.

(n195)Footnote 195. For the information that must be reported as required by Rule 17f-1(c)(5), see n.179 and accompanying text *supra*.

(n196)Footnote 196. Note to Instructions, Form X-17F-1A.

(n197)Footnote 197. See Guttman, *Broker-Dealer Bankruptcies*, 48 N.Y.U. L. Rev. 887, 887-88 (1973) [hereinafter *Broker-Dealer Bankruptcies*].

(n198)Footnote 198. See, e.g., *Goldberg v. First Devonshire Corp.*, 320 F. Supp. 780, 783 (S.D.N.Y. 1970) (no legal right existed which compelled Exchange to compensate losses of customers of financially-distressed, suspended member firm).

In addition to nonprotection of customers of insolvent broker-dealers who were not members of the exchange that established the guarantee trust fund, the use of the fund was voluntary so that there was no legal obligation for the exchange to protect the customers of its members and the NYSE fund was rapidly depleted "to the point of virtual exhaustion." See Sowards and Mofsky, *The Securities Investor Protection Act of 1970*, 26 Bus. Law. 1271, 1275-76 (1971) [hereinafter Sowards & Mofsky].

(n199)Footnote 199. Pub. L. No. 91-598, 81 Stat. 1636 (1970).

(n200)Footnote 200. SIPA, 15 U.S.C. § 78fff. Hereinafter all citations to SIPA will be to official code section only. SIPA, and the rules and forms under SIPA, are reprinted in the Securities Primary Law Sourcebook, Volume D, Section

R (Matthew Bender).

(n201)Footnote 201. *Id.* at § 78fff-3(a).

(n202)Footnote 202. *See Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412, 421 (1975) (no implied private right of action for customers facing pending insolvency of their broker-dealer).

(n203)Footnote 203. *Id.* at § 78eee(a)(3). The SEC may also require SIPC to bring about a liquidation or carry out its other powers. *See Barbour*, 421 U.S. at 425 .

(n204)Footnote 204. 15 U.S.C. § 78eee(b)(1)-(4).

(n205)Footnote 205. *Id.* at § 78fff-3(a). Insofar as any portion of a customer's net equity claim in excess of his ratable share of property is represented by a cash claim, the outer limit of the SIPC Fund protection is \$100,000. *Id.* at § 78fff-3(a)(1).

(n206)Footnote 206. *See Sowards & Mofsky, supra note 194, at 1277.*

(n207)Footnote 207. *See Securities Investor Protection Act Amendments of 1970*, Pub.L. No. 95-283, 92 Stat. 249 (1978).

(n208)Footnote 208. S. Rep. No. 763, 95th Cong., 2d Sess. 1 (1978).

(n209)Footnote 209. *Id.* at 2-3.

(n210)Footnote 210. 15 U.S.C. § 78fff-2(f); § 78111(4); § 78fff-3(a). The present \$500,000 maximum on protected claims was established in 1980, an increase over the previous \$100,000 limit. *See Act of Oct. 16, 1980*, Pub. L. 96-433, 94 Stat. 1855 (1980).

(n211)Footnote 211. *See § 3.03 supra* for a discussion of broker-dealer registration requirements; 15 U.S.C. § 78o(a).

(n212)Footnote 212. 15 U.S.C. § 78ccc(c)(2)-(3), reprinted in the Primary Law Sourcebook, Volume D, Section R (Matthew Bender). Each director is appointed to a term of three years. *Id.* at § 78ccc(c)(4). A vacancy in the Board of Directors is filled in the same manner as the original appointment was made. *Id.* at § 78ccc(c)(4)(C). A director may serve after the expiration of his term until his successor takes office. *Id.*

(n213)Footnote 213. *Id.* at § 78ccc(c)(2)(C)(i).

(n214)Footnote 214. Including those incurred by trustees or other persons acting in a liquidation proceeding. *Id.* at § 78ccc(b)(3)(B). To be entitled to indemnification for liabilities and expenses incurred in the defense or settlement of an action, the director, officer, employee, trustee, or other person must have acted in good faith and in a manner reasonably believed to be consistent with the purposes of SIPA.

(n215)Footnote 215. Except for those terms which are statutorily defined at 15 U.S.C. § 78111.

(n216)Footnote 216. *See Broker-Dealer Bankruptcies, n.193 supra, at 929*; 15 U.S.C. § 78ccc(b). The SIPC may also take whatever steps are necessary to dispose of both real and personal property, appoint employees, agents, or attorneys, and to execute instruments or contracts as necessary to carry out its duties.

(n217)Footnote 217. *See Sowards & Mofsky, n.194 supra, at 1279.*

(n218)Footnote 218. 15 U.S.C. § 78ccc(e)(3).

(n219)Footnote 219. *Id.* at § 78ddd(g).

(n220)Footnote 220. *Id.* at § 78ddd(b).

(n221)Footnote 221. *Id.* at § 78ddd(c)(1).

(n222)Footnote 222. *Id.* at § 78 ddd(a)(2). The amount of confirmed lines of credit that the SIPC may maintain at any time is the aggregate amount that the SIPC has the right to borrow from banks and other financial institutions under confirmed lines of credit or other written agreements and that are repayable not less than one year from the time of the borrowings (including, for purposes of determining when the amounts are repayable, all rights of extension, refunding, or renewal at the election of the SIPC). *Id.* at § 78ddd(a)(3).

The SIPC may maintain such other confirmed lines of credit separate from the fund as it considers necessary or appropriate and, thereby, diminish its need to borrow from the United States Treasury. Money from the lines of credit may be disbursed as though the amounts were part of the general fund. *Id.* at § 78ddd(a)(4).

Confirmed lines of credit must not constitute more than \$50 million of the balance of the SIPC Fund. *Id.* at § 78ddd (d)(2)(A). When the balance of the SIPC Fund aggregates \$150 million, the SIPC must phase out all confirmed lines of credit. *Id.* at § 78ddd(d)(2)(B).

(n223)Footnote 223. During 1993, the SIPC initiated liquidation proceedings against three members, a record low over the average 9-10 liquidations annually over the previous ten years. As of September 1994, liquidation proceedings had been initiated against only one member. Telephone Interview with Joseph F. Marino, SIPC Vice President of Operations and Finance and Chair of Former SIPC Task Force on Assessments (September 20, 1994) [hereinafter Marino Interview].

(n224)Footnote 224. 15 U.S.C. § 78ddd(f).

(n225)Footnote 225. *Id.* This credit line is as yet untapped.

(n226)Footnote 226. *Id.* at § 78ddd(g)-(h).

(n227)Footnote 227. *Id.*

(n228)Footnote 228. As of September 15, 1994, the Fund had earned approximately \$48 million in interest on government securities. Telephone Interview with Stephen Harbeck, Senior Associate General Counsel, SIPC (Sept. 19, 1994) [hereinafter Harbeck Interview].

(n229)Footnote 229. *Marino Interview, n.219 supra. See also* SIPA Rel. No. 157, 50 SEC Dkt. No. 4 at 386 (Nov. 20, 1991) [hereinafter SIPA Rel No. 157]. The Task Force, comprised of SIPC officials, SEC members, and representatives from private securities firms, presented their recommendations to the SIPC Board on September 26, 1991. *Id. See also Marino Interview, n.219 supra.*

(n230)Footnote 230. The Commission may review the SIPC's determination that a person's principal business is conducted outside the United States and its territories and possessions. 15 U.S.C. § 78ccc(a)(2)(B).

(n231)Footnote 231. 15 U.S.C. § 78ccc(a)(2)(A)(ii).

(n232)Footnote 232. *Id.* at § 78ddd(c)(2). 15 U.S.C. § 78lll(9) defines the phrase "gross revenues from the securities business":

The term "gross revenues from the securities business" means the sum of (but without duplication)--

1-3 Federal Securities Exchange Act of 1934 § 3.08

- (A) commissions earned from securities transactions effected for customers as agent (net of commissions paid to other brokers and dealers in connection with such transactions) and markups with respect to purchases or sales of securities as principal;
- (B) charges for executing or clearing transactions;
- (C) net realized gain, if any, from principal transactions in securities in trading accounts;
- (D) net profit, if any, from the management of or participation in the underwriting or distribution of securities;
- (E) interest earned on customers' securities accounts;
- (F) fees for investment advisory services (except when rendered to one or more registered investment companies or insurance company separate accounts) or account supervision of securities;
- (G) fees for proxy solicitation with respect to, or tenders or exchanges of, securities;
- (H) income from service charges or other surcharges with respect to securities;
- (I) except as otherwise provided by Commission rule, dividends and interest received on securities in investment accounts of the broker or dealer;
- (J) fees in connection with put, call, and other option transactions in securities;
- (K) commissions earned from certificates of deposit and Treasury bills, bankers acceptances, or commercial paper having a maturity at issuance of not exceeding nine months (except that the SIPC may by bylaw include in the aggregate of gross revenues only an appropriate percentage of commissions based on SIPC's loss experience over at least the preceding five years with respect to such instruments); and
- (L) fees and other income from such other categories of the securities business as the SIPC may provide by bylaw.

The phrase does not include revenues received by a broker or dealer in connection with distribution of shares of a registered open end investment company or unit investment trust or revenues derived from the sale of variable annuities or the business of insurance.

Gross revenues from the securities business of SIPC members may be computed on a consolidated basis for the members and any subsidiaries. *15 U.S.C. § 78ddd(i)*. Consolidation includes the operations of any business to which the member has succeeded but excludes foreign subsidiaries. *Id.*

(n233)Footnote 233. *15 U.S.C. § 78ddd(c)(2)*.

(n234)Footnote 234. *15 U.S.C. § 78ddd(c)(3)(C)*.

(n235)Footnote 235. *15 U.S.C. § 78ddd(c)(3)(B)*.

(n236)Footnote 236. *Id.*

(n237)Footnote 237. 15 U.S.C. § 78ddd(c)(3)(A).

(n238)Footnote 238. See SIPA Rel. No. 157, n.225 *supra* at 387.

(n239)Footnote 239. *Id.* The projected Fund balance for 1995 is \$890,000,000. *Harbeck Interview*, n.224 *supra*.

(n240)Footnote 240. *Id.* See SIPA Rel. No. 157, n.225 *supra* at 388.

(n241)Footnote 241. *Id.* However, if a member's assessment as determined by this formula exceeds one-half of one percent of its gross revenues from the securities business, the assessment shall be half of one percent of that member's gross revenues from the securities business. *Id.*

(n242)Footnote 242. *Id.*

(n243)Footnote 243. 15 U.S.C. § 78jjj(a).

(n244)Footnote 244. See S. Res. 1218, 91st Cong., 2d Sess. 4 (1970). See also *SEC v. Packer, Wilbur & Co.*, 498 F.2d 978, 984 (2d Cir. 1974) .

(n245)Footnote 245. *Packer, Wilbur & Co.*, 498 F.2d at 984 .

(n246)Footnote 246. The purpose of the notice known as a "5(a) referral," is to afford the SIPC ample time to prepare for the selection of a trustee and supporting personnel capable of handling the problems of a particular case and to prepare to assume the financial burden that it be required in order to satisfy customer claims. See SIPC, *SIPC: A History and Explanation of Operations* 9 (2d ed. 1980).

(n247)Footnote 247. Interestingly, the statute does not define "financial difficulty." However, because Congress did delineate factors by which SIPC should adjudge the necessity of a liquidation proceeding, it is usually the case that the same factors should serve as indicia that referral of broker-dealers to the SIPC is warranted by the Commission or a self-regulatory organization. *Harbeck Interview*, n.224 *supra*.

(n248)Footnote 248. 15 U.S.C. § 78eee(a)(3).

(n249)Footnote 249. 15 U.S.C. § 78eee(a)(2).

(n250)Footnote 250. *Id.*

(n251)Footnote 251. The term "liquidation proceeding" means any proceeding for the liquidation of a debtor under SIPA in which a trustee has been appointed. 15 U.S.C. § 78lll(10).

(n252)Footnote 252. The term "customer" of a debtor means any person (including a person with whom the debtor deals as principal or agent) who has a claim on account of securities received, acquired or held by the debtor in the ordinary course of his business as a broker or dealer from or for the securities accounts of the person for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security, or to effect transfer. 15 U.S.C. § 78lll(2).

The term "customer" also includes any person who has a claim against the debtor arising out of sales or conversions of the securities, and any person who has deposited cash with the debtor for purchasing securities, but does not include: any person whose claims arise out of transactions with a foreign subsidiary of an SIPC member; or any person who has a claim for cash or securities that by contract, agreement, understanding, or operation of law, is part of the capital of the debtor or is subordinated to the claims of any or all creditors of the debtor, notwithstanding that some ground exists for declaring the contract, agreement, or understanding void or voidable in an action between the claimant and the debtor. *Id.*

Various cases have construed these provisions to determine who qualifies as a "customer" and is thereby entitled to protection. *See, e.g., In re Brentwood Secs., Inc.*, 96 B.R. 1002 (9th Cir. 1989) ; *aff'd in part and rev'd in part* 925 F.2d 325 (9th Cir. 1991) ("customer" status must be established for each transaction in order to qualify for SIPA protection); *SEC v. Ambassador Church Finance/Development Group, Inc.*, 679 F.2d 608 (6th Cir. 1982) ; *cert. denied*, 479 U.S. 850 (1986) (a church, unsophisticated in financial affairs, which entrusted bonds issued by itself to a broker-dealer for sale to the public qualified as a "customer").

(n253)Footnote 253. The term "financial responsibility rules" under SIPA includes:

- (a) Any rule adopted by the Commission pursuant to sections 8, 15(c)(3), 17(a), or 17(e)(1)(A) of the Securities Exchange Act of 1934;
- (b) Any rule adopted by the Commission relating to hypothecation or lending of customer securities;
- (c) Any rule adopted by any self-regulatory organization relating to capital, margin, recordkeeping, hypothecation, or lending requirements; and
- (d) Any other rule adopted by the Commission or any self-regulatory organization relating to protection of funds or securities.

Exchange Act Rule 3a40-1.

(n254)Footnote 254. 15 U.S.C. § 78eee(b)(1)(A)-(D).

(n255)Footnote 255. 15 U.S.C. § 78eee(a)(3)(A)-(B); 15 U.S.C. § 78eee(b)(1)(A)-(D).

(n256)Footnote 256. 15 U.S.C. § 78eee(b)(3).

(n257)Footnote 257. *Id.*

(n258)Footnote 258. 15 U.S.C. § 78fff-4(a)(4). The Commission has cautioned broker-dealers against soliciting customers to deposit or leave funds with a broker-dealer solely for the purpose of creating or maintaining cash balances to earn interest. *See Exch. Act Rel. No. 18262, 4 Fed. Sec. L. Rep. (CCH) P 25,134B (November 17, 1981)* . Although SIPA protects customers' cash claims of up to \$100,000, that protection is available only if the cash is in an account for the purpose of purchasing securities or as a result of a sale of securities. Cash balances created or maintained solely for the purpose of earning interest are not protected by SIPA. Accordingly, broker-dealers that pay interest on cash balances should review their procedures to ensure that they are not misleading their customers as to the existence of SIPA coverage. *Id.*

(n259)Footnote 259. 15 U.S.C. § 78fff-4(a)(3).

(n260)Footnote 260. 15 U.S.C. § 78fff-4(a)(5).

The direct payment procedure is discussed further in § 3.08[3][d][vi] *infra* .

(n261)Footnote 261. 15 U.S.C. § 78fff-4(a)(6).

(n262)Footnote 262. 15 U.S.C. § 78eee(b)(1).

(n263)Footnote 263. 15 U.S.C. § 78eee(b)(3).

(n264)Footnote 264. 15 U.S.C. § 78eee(b)(3).

(n265)Footnote 265. A person is considered not disinterested if:

- (i) such person is a creditor (including a customer), stockholder, or partner of the debtor;
- (ii) such person is or was an underwriter of any of the outstanding securities of the debtor or, within five years prior to the filing date, was the underwriter of any securities of the debtor;
- (iii) such person is, or was within two years prior to the filing date, a director, partner, officer, or employee of the debtor or such an underwriter, or an attorney for the debtor of such an underwriter; or
- (iv) it appears that such person has, by reason of any other direct or indirect relationship to, connection with, or interest in the debtor or underwriter, or for any other reason, an interest materially adverse to the interests of any class of creditors (including customers) or stockholders, except that SIPC shall in all cases be deemed disinterested, and an employee of the SIPC may be deemed disinterested if he would, except for his association with the SIPC, meet the standards set forth in this subparagraph.

15 U.S.C. § 78eee(b)(6)(A).

(n266)Footnote 266. 15 U.S.C. § 78eee(b)(3).

(n267)Footnote 267. 15 U.S.C. § 78eee(b)(6)(B).

(n268)Footnote 268. 15 U.S.C. § 78eee(d).

(n269)Footnote 269. 15 U.S.C. § 78eee(c).

(n270)Footnote 270. See n.199 *supra* and accompanying text.

(n271)Footnote 271. SIPA gives the court authority to protect property located outside the territorial limits of the court but within the actual or constructive possession of the debtor. 15 U.S.C. § 78eee(b)(2)(A)(i).

(n272)Footnote 272. *Id.*

(n273)Footnote 273. 15 U.S.C. § 78eee(b)(2)(A)(iii).

(n274)Footnote 274. This includes suits by stockholders of the debtor that may interfere with prosecution by the trustee of claims against former directors, officers, or employees of the debtor. 15 U.S.C. § 78eee(b)(2)(B)(ii).

(n275)Footnote 275. 15 U.S.C. § 78eee(b)(2)(B)(iii).

(n276)Footnote 276. 15 U.S.C. § 78eee(b)(4).

(n277)Footnote 277. 15 U.S.C. § 78eee(b)(3).

(n278)Footnote 278. The troubled SIPC member thus becomes a "debtor" as construed by the Bankruptcy Code. In *SEC v. ChristianPaine & Co., Inc.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,959 (3d Cir. 1985), it was held that an SIPA trustee has general authority under the Act to conduct a debtor's examination about property in the hands of a third party by applying the same powers as a bankruptcy trustee. Trustees may also obtain release of grand jury testimony relevant to their role of protecting investors. See *In re Application of Executive Secs. Corp.*, 702 F.2d 406 (2d Cir. 1983) ; *cert. denied*, 464 U.S. 818 (1983) .

(n279)Footnote 279. 15 U.S.C. § 78fff-1(a)(1).

(n280)Footnote 280. 15 U.S.C. § 78fff-1(a).

(n281)Footnote 281. 15 U.S.C. § 78fff-1(a)(2).

(n282)Footnote 282. 15 U.S.C. § 78fff-1(a)(3).

(n283)Footnote 283. 15 U.S.C. § 78fff-1(b)(1).

(n284)Footnote 284. 15 U.S.C. § 78fff-1(b)(2).

(n285)Footnote 285. 15 U.S.C. § 78fff-1(c), (d)(1)-(4).

(n286)Footnote 286. 15 U.S.C. § 78fff-2(a)(1). For the definition of "customer" under Section 16(2) of SIPA, see n.248 *supra*.

(n287)Footnote 287. The "filing date" is the date on which an application for a protective decree is filed; the date on which notice of the direct payment procedure was published; the date on which a bankruptcy petition was filed; or the date on which a proceeding pending in any court or before any federal or state agency in which a receiver, trustee, or liquidator for the debtor has been appointed, was commenced. 15 U.S.C. § 78lll(7).

(n288)Footnote 288. 15 U.S.C. § 78fff-2(a)(1).

(n289)Footnote 289. 15 U.S.C. § 78fff-2(a)(2).

(n290)Footnote 290. 15 U.S.C. § 78fff-2(a)(3).

(n291)Footnote 291. The term "net equity" means the dollar amount of the account or accounts of a customer, to be determined by:

(A) calculating the sum the debtor would have owed to the customer if the debtor had liquidated, by sale or purchase on the filing date, all securities positions of the customer (other than customer name securities reclaimed by the customer); minus

(B) any outstanding indebtedness of the customer to the debtor on the filing date; plus

(C) any payment by the customer of the indebtedness to the debtor made with the trustee's approval and within such period as the trustee may determine (but in no event more than 60 days after the publication of notice under section 78fff-2(a).

In determining net equity under this paragraph, accounts held by a customer in separate capacities are deemed to be accounts of separate customers.

15 U.S.C. § 78lll(11).

(n292)Footnote 292. 15 U.S.C. § 78fff-2(a)(3). This provision is designed to protect the SIPC against speculation by customers who might otherwise withhold their claims to see if a change in the market might increase the value of what they receive from the estate. See S. Rep. No. 763, 95th Cong., 2d Sess. (1978).

The customer claim must be received by the trustee within six months after the date of publication of the notice of commencement of the liquidation proceeding.

(n293)Footnote 293. 15 U.S.C. § 78fff-2(b).

(n294)Footnote 294. See SIPA Rel. No. 113, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,441 (Oct. 21, 1983).

(n295)Footnote 295. Rule 400(b), reprinted in the Securities Primary Law Sourcebook, Volume D, Section R (Matthew Bender).

(n296)Footnote 296. Rule 400(c).

(n297)Footnote 297. Rule 400(d).

(n298)Footnote 298. Rule 400(e), (f).

(n299)Footnote 299. Rule 400(g).

(n300)Footnote 300. Rule 400(h). See 15 U.S.C. § 78fff-2(c)(1)(A).

(n301)Footnote 301. 15 U.S.C. § 78fff-2(c)(1)(B). Net equity claims are settled in the following manner. "Customer name securities" are distributed first. See 15 U.S.C. § 78lll(3) for the definition of "customer name securities." SIPA's protections apply to most types of securities, such as notes, stocks, bonds, debentures and certificates of deposit, but excludes specifically unregistered investment contracts or for any interest in a commodity contract, or commodity options. 15 U.S.C. § 78lll(14). Next, the customer's "net equity" is computed for those whose claims were not completely satisfied by the distribution of customer name securities. "Net equity" is the filing date value of securities and cash the debtor owes the customer less any amount the customer owes the debtor. 15 U.S.C. § 78lll(11).

Customers who have debit balances may, with the trustee's approval and within a time period determined by the trustee, pay the debit balance in order to have a claim for the securities in the account. 15 U.S.C. § 78fff-2(c)(2).

Once calculated, net equity claims are satisfied, to the extent possible, by allocating "customer property" to the claimants. "Customer property" means cash and securities (except "customer name securities" at any time received, acquired, or held by or for the account of a debtor from or for the securities accounts of a customer. 15 U.S.C. § 78lll(4). This includes the proceeds of any property transferred by the debtor, including property unlawfully converted. 15 U.S.C. § 78fff-2(c)(3).

If there are insufficient securities to satisfy claims from "customer property," the trustee is obliged to purchase other securities from the open market if it is "fair and orderly." If that cannot be done, the trustee allocates the available securities pro-rata and makes up the shortage by paying customers cash instead. The amount paid is based on the value of the securities on the filing date. 15 U.S.C. § 78fff-2(d).

If the customer's remaining net equity reflects a long securities position and/or a credit balance, the trustee is obliged to satisfy the claim by making SIPC advances up to a maximum of \$500,000. Claims for cash are limited to \$100,000. 15 U.S.C. § 78fff-3(a).

Once customer name securities have been returned, customer property distributed *pro rata* and SIPC advances have been provided up to the limits, remaining customer claims may be satisfied against the general estate of the debtor. 15 U.S.C. § 78fff-2(c). Additionally, the trustee has the option, with SIPC approval, of selling or otherwise transferring all or any part of a customer's account to another SIPC member instead of applying the previous steps. The trustee may enter into an agreement to indemnify the member receiving the accounts against shortages of cash or securities in the accounts being sold or transferred. SIPC funds may be made available to guarantee or secure the indemnification. 15 U.S.C. § 78fff-2(f).

Once a brokerage firm has been liquidated, the SIPC may sue any party liable for the losses it reimbursed, including individual broker-dealers, in a subsequent civil action. Thus, in *SIPC v. Vigman*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,983 (9th Cir. 1986), the court stated that the SIPC could recover under *Rule 10b-5* against a liquidating broker-dealer and certain of its officers and employees for losses reimbursed to customers which arose from the unauthorized defendants' use of customers' assets to purchase securities.

(n302)Footnote 302. 15 U.S.C. § 78fff-2; § 78fff-3.

(n303)Footnote 303. 15 U.S.C. § 78fff-2. In *SIPC v. Poirer*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep (CCH) P 92,752 (D. Or. 1986), it was held that the SIPC is a proper plaintiff in a securities fraud action brought against third parties on behalf of the debtor estate, since as an insurer it is subrogated to the rights of the debtor against third parties.

(n304)Footnote 304. 15 U.S.C. § 78fff-2(c)(1)(D).

(n305)Footnote 305. See n.297 for the definition of "customer name securities."

(n306)Footnote 306. 15 U.S.C. § 78fff-2(c)(2).

(n307)Footnote 307. S. Rep. No. 763, 95th Cong., 2d Sess. (1978).

(n308)Footnote 308. 15 U.S.C. § 78fff-2(c)(3).

(n309)Footnote 309. See n.287 *supra*.

(n310)Footnote 310. *Id.*

(n311)Footnote 311. Monies advanced by SIPC for each account of a separate customer may not be used to purchase securities to the extent that the aggregate value of the securities on the filing date exceeded the amount permitted to be advanced by SIPC under SIPA. 15 U.S.C. § 78fff-2(d), reprinted in the Primary Law Sourcebook, Volume D, Section R (Matthew Bender).

(n312)Footnote 312. The 1978 amendments to SIPA authorized SIPC to adopt rules concerning the close-out of open contractual commitments. 15 U.S.C. § 78fff-2(e)(1).

The requirements and procedures for closing out or completing open contractual commitments for the purchase or sale of securities between an SIPC member undergoing liquidation and other brokers and dealers are set forth in SIPA Rel. No. 113 [1983- 1984 Transfer Binder], Fed. Sec. L. Rep. (CCH) P 83,441 (Oct. 21, 1983).

Form 300-A must be filed with the trustee in a proceeding under Section 5 of the SIPA by a broker or dealer who executed transactions leading to open contractual commitments as defined under Rule 300(e) of the SIPC.

The Commission approved Series 100 Rules (Accounts of "Separate" Customers of SIPC members) and Series 200 Rules (Accounts Introduced by Other Brokers or Dealers) in SIPA Rel. No. 83 [1979 Transfer Binder], Fed. Sec. L. Rep. (CCH) P 81,920 (Jan. 17, 1979); Form 300-B for the reporting of all fails to deliver, and Form 300-C, for the reporting of all fails to receive, in SIPA Rel. No. 87, Fed. Sec. L. Rep. (CCH) P 82,039 (March 30, 1979).

(n313)Footnote 313. 15 U.S.C. § 78fff-2(e)(2)(A).

(n314)Footnote 314. 15 U.S.C. § 78fff-2(e)(2)(B).

(n315)Footnote 315. *Id.* In addition, persons with contracts not wholly executory may claim any losses against the general estate. S. Rep. No. 763, 95th Cong., 2d Sess. (1978). Closeouts must be for the benefit of a "customer," and

need not be performed if this would result in furtherance of a fraud. See SEC v. Havener Securities Corp., [1981 Transfer Binder], Fed. Sec. L. Rep. (CCH) P 97,958 (S.D.N.Y. 1980).

(n316)Footnote 316. 15 U.S.C. § 78fff-2(e)(3).

(n317)Footnote 317. 15 U.S.C. § 78fff-2(e).

(n318)Footnote 318. *Id.*

(n319)Footnote 319. 15 U.S.C. § 78fff-3(a)(2). See 17 C.F.R. §§ 300.100-300.105, which sets forth the procedure for determining which accounts maintained by a customer with a SIPC member will be deemed "separate" customer accounts for SIPC protection.

(n320)Footnote 320. 15 U.S.C. § 78fff-3(a)(4).

(n321)Footnote 321. The customers themselves cannot be brokers, dealers or banks. 15 U.S.C. § 78fff-3(a)(5).

(n322)Footnote 322. *Id.*

(n323)Footnote 323. *Id.*

(n324)Footnote 324. *Id.*

(n325)Footnote 325. *Id.*

(n326)Footnote 326. See ns.248-251 and accompanying text *supra*.

(n327)Footnote 327. See n.248 *supra*.

(n328)Footnote 328. 15 U.S.C. § 78fff-4(a)(2).

(n329)Footnote 329. See ns. 246-249 and accompanying text *supra*.

(n330)Footnote 330. 15 U.S.C. § 78fff-4(a).

(n331)Footnote 331. S. Rep. No. 763, 95th Cong., 2d Sess. (1978).

(n332)Footnote 332. 15 U.S.C. § 78fff-4(b).

(n333)Footnote 333. *Id.*

(n334)Footnote 334. 15 U.S.C. § 78fff-4(c). All securities may be valued as of the close of business on the date of publication. *Id.*

(n335)Footnote 335. 15 U.S.C. § 78fff-4(e). Federal courts with jurisdiction over cases under the Bankruptcy Code have original and exclusive jurisdiction of any civil action for adjudication of a claim under Section 10(c). *Id.* The action must be brought in the judicial district where the head office of the debtor is located. *Id.*

(n336)Footnote 336. 15 U.S.C. § 78fff-4(f). For purposes of Section 10, any reference to the trustee in Sections 7(b)(1), 8(d), 8(f), 9(a), 16(5) and 16(12) is deemed to refer to SIPC and any reference to the date of publication of notice under Section 8(a) is deemed to refer to the publication of notice under Section 10. 15 U.S.C. § 78fff-4(g).

(n337)Footnote 337. 15 U.S.C. § 78jjj(b).

(n338)Footnote 338. *Id.*

(n339)Footnote 339. 15 U.S.C. § 78jjj(c)(1)(A).

(n340)Footnote 340. 15 U.S.C. § 78jjj(c)(1)(B).

(n341)Footnote 341. 15 U.S.C. § 78jjj(c)(1)(C)(i)-(vii). If a person pursues a claim in bad faith and contrary to fact against the estate of a debtor, and thereafter against the trustee in objecting to the trustee's determination, that person may be required to bear the trustee's attorneys fees incurred in connection with the trustee's extensive investigation of the claim and the court proceedings on the claim. *See* Havener, n.311 *supra*.

(n342)Footnote 342. 15 U.S.C. § 78jjj(c)(2).

(n343)Footnote 343. 11 U.S.C. §§ 741-752. Subchapter III, "Stockbroker Liquidation," is the successor to § 60e of the Bankruptcy Act of 1898 and, like § 60e, is independent of SIPA. *See* 6 Collier on Bankruptcy-15th Edition Revised (Matthew Bender).

(n344)Footnote 344. SIPA § 5(a)(3) governs the filing by SIPA of an application for a protective decree; SIPA § 5(b) governs the issuance of a protective decree by a court. 15 U.S.C. § 78eee(a)(3).

(n345)Footnote 345. S. Rep. No. 989, 95th Cong., 2d Sess. (1978) at 7.

(n346)Footnote 346. 6 Collier on Bankruptcy-15th Edition Revised (Matthew Bender).

(n347)Footnote 347. As a general provision of a liquidation proceeding under SIPA, the statute requires that the proceeding shall be conducted in accordance with, and as though it were being conducted under, Chapters 1 (General Provisions), 3 (Case Administration), and 5 (Creditors, the Debtor, and the Estate) and Subchapters I (Officers and Administration) and II (Collection, Liquidation and Distribution of the Estate) of the Bankruptcy Code, to the extent it is consistent with SIPA. *Id.* at § 78fff(b).

(n348)Footnote 348. S. Rep. No. 989, 95th Cong., 2d Sess. 7, 101 (1978).

(n349)Footnote 349. Membership in SIPA is discussed in § 3.08[3] *supra*.

(n350)Footnote 350. *See* 6 Collier on Bankruptcy-15th Edition Revised (Matthew Bender).

(n351)Footnote 351. *Id.*



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CHAPTER 3A Regulation of Credit

1-3A Federal Securities Exchange Act of 1934 3A.syn

AUTHOR: W. Reece Bader

§ 3A.syn Synopsis to Chapter 3A: Regulation of Credit

§ 3A.01 Introduction

§ 3A.02 Controls on Credit

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[1] Damage Actions

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W. Reece Bader n*

FOOTNOTES:

(n1)Footnote *. This chapter was revised and updated by W. Reece Bader, a partner at the law firm of Orrick, Herrington & Sutcliffe LLP in Paris, France. Mr. Bader is the past Co-Chair of the Securities Litigation Committee of the Litigation Section of the ABA, the present Co-Chair of the Alternative Dispute Resolution Committee of the Litigation Section of the ABA, and a former member of the National Arbitration and Mediation Committee of the NASDR.



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CHAPTER 3A Regulation of Credit

1-3A Federal Securities Exchange Act of 1934 § 3A.01

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§ 3A.01 Introduction

At the time of the calamitous stock-market crash of October 1929, a very large number of shares of stock were held by brokers in margin accounts. The amount of cash which many customers had paid was relatively small, some of the brokers carrying accounts with as little as 10 percent equity. When market prices began to decline, these slim equities were quickly wiped out, resulting in heavy margin calls which many customers were unable to meet; the brokers were then forced to sell out. These distress sales further depressed market prices, touching off a new series of margin calls, and so on. Furthermore, the high rate being paid for call money had attracted a large share of the country's available free credit for use in these operations. In fact, the necessity for regulation of the use of credit in securities transactions was cited in the Securities Exchange Act of 1934 ("Exchange Act") as being one of the reasons for its enactment. n1

One case stated: n2

Having in mind the 1929 collapse of the stock market and the depression years which followed, Congress was anxious to use credit control to prevent undue fluctuations in the securities market. At the same time, Congress hoped to protect the investor, especially the small investor, by making it impossible to buy securities on too small, or 'thin,' a margin.

Section 7 of the Exchange Act regulates the amount of credit that may be extended on any non-exempted security and authorizes the Board of Governors of the Federal Reserve System ("Federal Reserve Board" or "Board") to make rules implementing its provisions. To that purpose, the Board of Governors adopted Regulations T, U, G, n3 and X. Brokers and dealers are required to satisfy these regulations as to both the extension and maintenance of credit.

Regulation T governs the extension of credit by and to brokers and dealers. Regulation U imposes credit restrictions upon both bank lenders and non-bank lenders that extend credit for the purpose of buying or carrying margin stock. Former Regulation G, related to credit restrictions for persons other than brokers, dealers, and banks, was merged into, and is now covered by, Regulation U. Regulation X prohibits borrowers from obtaining credit from brokers, dealers, and banks for the purposes of purchasing or carrying securities except in compliance with Regulations T and U.

Sections 11(d)(1) and Rule 10b-16 are corollaries to the credit restrictions contained in Section 7. Section 11(d)(1)

generally prohibits broker-dealers from making sales on credit of issues for which the broker-dealer is acting as underwriter. Under Rule 10b-16, broker-dealers must disclose to borrowers the terms of the loans extended to them.

Between 1996 and 1998 significant changes occurred with respect to credit controls. The National Securities Markets Improvement Act of 1996ⁿ⁴ repealed Section 8(a) and exempted the extension of credit to certain broker-dealers from the Board's margin regulations. As a result, changes were made to Regulations G, T and U.ⁿ⁵

The New York Stock Exchange and The Financial Industry Regulatory Authority ("FINRA") also are components of the credit regulation over broker-dealers. New York Stock Exchange Rule 431 and NASD Conduct Rule 2520 regulate "maintenance" margin, i.e., whether a customer has sufficient margin on a continuing basis, since the federal regulations deal principally in borrowing limitations on the initial transaction.

As previously noted, the federal margin rules were adopted to prevent investor leverage from inflating the stock market. The SRO rules have a different purpose. They are intended to protect the broker-dealer from over-extending credit to customers, and significant effort is made to insure consistency between the SRO rules regarding maintenance margin.
ⁿ⁶

The federal and SRO rules relating to margin also impact the broker-dealer's net capital position under SEC Rule 15c3-1ⁿ⁷ as well as the broker-dealers FOCUS reports. SEC Rule 15c3-1 imposes complex, detailed obligations on broker-dealers in determining their net capital. These obligations are constantly impacted by the margin rules, requiring regular and updated filings.

FOOTNOTES:

(n1)Footnote 1. Section 2(1)(d).

See Robert G. Lane, *Securities Exchange Act of 1934-Civil Remedies Based Upon Illegal Extension of Credit in Violation of Regulation T*, 61 Mich. L. Rev. 940, 945-946 (1963):

Three primary objectives were advanced during the legislative hearings as being the basic purposes for the enactment of legislation governing margin requirements. First, it was advocated that the principal objective should be the protection of the margin trader, sometimes referred to as the "innocent lamb," in contra-distinction to the protection of the broker-dealer afforded by the exchange and private margin requirements. The Senate report asserted that the main objective of the margin regulations was to protect the margin trader by making it impossible for him to buy on too thin a margin, since in the event of unfavorable developments in the financial world such loans are promptly called and may result in the forced sale of the margin trader's securities. Indeed, margin traders are frequently sold out near the bottom of a market decline, thereby maximizing their losses. Secondly, the opinion was expressed that margin regulations should be instruments of credit policy designed to stabilize stock market fluctuations and thus contribute to business stability. In theory, when security prices rise the margin trader has more available credit to buy more securities on margin, and, in addition, more investors may be induced to buy on margin. Such purchases, in turn, tend to raise prices further and so increase again the ability of the margin trader to borrow, whereas a decline in security prices frequently results in forced selling to meet margin calls which, in turn, increases the volume of sell orders and intensifies the decline in prices. Finally, the House committee took the position that the margin regulations were to be designed as selective credit controls to regulate the aggregate amount of credit which could be directed into the stock market and out of the more productive uses of commerce and industry. There was a desire to prevent a recurrence of the pre-crash situation where capital which would have otherwise been available to supply the needs of commerce, industry and agriculture was attracted by the high interest rates in the stock market. (footnotes omitted)

(n2)Footnote 2. *United States v. Weisscredit Banca Commerciale E D'Investimenti*, 325 F. Supp. 1384, 1388 (S.D.N.Y. 1971) .

(n3)Footnote 3. Former Regulation G imposed credit restrictions upon persons other than brokers, dealers and banks. That regulation was later repealed and Regulation G currently is an implementation of the Gramm-Leach-Bliley Act provisions regarding disclosure and reporting of agreements related to the Community Reinvestment Act.

(n4)Footnote 4. Pub. L. No. 104-290, 110 Stat. 3416 (1996).

(n5)Footnote 5. The changes are all set forth in the final rule report, 63 FR 2806 (Jan. 16, 1998). Following the amendments to Regulations T and U, various self-regulatory organizations filed proposed changes to their rules concerning margin requirements. *See* 64 FR 48882 (Sept. 8, 1999) (American Stock Exchange); 63 FR 24580 (May 4, 1998) (Chicago Board Options Exchange); 65 FR 70854 (Nov. 28, 2000) (National Association of Securities Dealers); 64 FR 13620 (Mar. 19, 1999) (New York Stock Exchange).

(n6)Footnote 6. In 2005, the SEC approved plot programs proposed by the NASD and NYSE under which "portfolio margin," based upon mathematical models, would be used for equity securities based portfolios consisting of listed market index options, index warrants, futures, futures options and exchange traded funds. This historic change in the leveraging of securities purchasing was still in its pilot stage through mid-2008. *See* SR NASD 2007-045. And, with the United States' economy faced with crises such as the subprime meltdown, SEC support for the proposal could diminish.

(n7)Footnote 7. CFR § 240.15c3-1



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CHAPTER 3A Regulation of Credit

1-3A Federal Securities Exchange Act of 1934 § 3A.02

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§ 3A.02 Controls on Credit

[1] Margin Requirements--Section 7

Section 7 basically sets forth rules relating to margin requirements, *i.e.*, the amount of credit that may be extended on any security. n1 In Section 7(a) the Federal Reserve Board is directed to prescribe rules governing the amount of credit initially extended and subsequently maintained on any nonexempt security. The initial minimum requirements are specifically described in Section 7(a), while Section 7(b) gives the Board power to raise or lower these requirements from time to time.

Section 7(c) makes it unlawful for any broker, dealer, or member of a national securities exchange to extend or arrange for credit in contravention of Board rules. n2 Persons not subject to Section 7(c) are forbidden by Section 7(d) from violating Board rules adopted "to prevent the excessive use of credit for the purchasing or carrying of or trading in securities in contravention of the other provisions of this section." Section 7(d) does not apply to (1) loans made not in the ordinary course of business; (2) loans on an exempted security; (3) loans made to a dealer to finance its activities as a market maker or underwriter; (4) bank loans on non-equity securities; and (5) loans conditionally or unconditionally, exempted by the Federal Reserve Board. Section 7(f), added in 1970, n3 makes it unlawful to enjoy the beneficial use of a loan made to purchase or carry securities in violation of Section 7 or the rules thereunder, thereby applying Section 7 to customers as well as to brokers and other lenders. n4 Thus, customers could no longer freely borrow from foreign lenders not subject to United States jurisdiction. As originally enacted, Section 7 applied only to listed securities. Thus, brokers could originally extend credit only on securities traded on a national securities exchange. As amended in 1968, n5 the power of the Federal Reserve Board was extended to cover all non-exempt securities, including the over-the-counter market.

Effective January 1, 1999, all Nasdaq securities are marginable. Since that date, the Federal Reserve Board has ceased publication of its "OTC Margin Stock List" that formerly included all OTC securities covered by Section 7. n6 To be included on this list prior to 1999, a stock must have met certain criteria designed to determine if it had a sufficiently strong market. n7

The 1996 amendments also created status exemption for all borrowing by broker-dealers "a substantial portion of whose

business consists of transactions with persons other than brokers or dealers." n8 The exemption applies to borrowers although the margin regulations generally apply to lenders. Safe harbor tests have been established to provide guidance for lenders as to what broker-dealers qualify for exempt status. n9 Another exemption is now provided for broker-dealers whose non-proprietary business is limited to transactions with market makers and specialists. n10 Since this exemption is described in Regulation U, broker-dealers who qualify for the exemption will not be limited by the margin regulations if they borrow from a lender other than a broker-dealer, but borrowings from broker-dealers will be subject to Regulation T.

Finally, because the 1996 legislation repealed Section 8, which had mandated a distinction between bank and nonbank lenders, Regulations G and U have become merged into a revised Regulation U. Lenders under Regulation G, formerly known as "nonbank lenders" are now simply "lenders" under Regulation U. Other changes are detailed elsewhere in this chapter.

[a] Regulation T.

Pursuant to the requirements of Section 7(c), the Board of Governors adopted Regulation T. n11 Pursuant to the rules under Regulation T, accounts are set up for recording all transactions between a broker-dealer and a customer. Purchases by customers for cash are recorded in cash accounts; credit purchases are made in margin accounts. A series of special purpose accounts are set up for accounting of certain other transactions. n12

Every extension of credit on a nonexempt security is presumed to be for the purpose of trading in securities and, consequently, subject to Regulation T. However, this presumption may be overcome by the filing of an appropriate representation; the creditor may, in the absence of bad faith, rely upon such representation. n13 The broker-dealer can follow his customer's instructions, but may not be involved in any other way in a loan not in accordance with Regulation T. n14 A broker who violates Regulation T by means of an accidental miscalculation will be excused if, upon discovery of the error, the broker acts promptly to remedy the situation. n15

[i] General Accounts.

Regulation T forbids a broker to effect any transaction in a customer's general margin account that, with other transactions effected in the account on the same day, creates an excess of the debit balance of such account over the maximum loan value of the securities in such account, or increases any such excess. n16 The "debit balance" is the amount the customer owes the broker and can include such things as communication, shipping, and service charges, in addition to the amount owed for securities. n17 The "maximum loan value" is periodically determined by the Federal Reserve Board.

To qualify as a margin security, a security must be registered; as of January 1, 1999, the following securities will qualify: any Nasdaq listed securities; non-equity securities; securities issued by open-end investment companies or unit investment trusts; foreign margin stock; and any debt securities that are convertible to margin securities. n18 A "registered security" is any security registered on a national securities exchange or deemed to be so registered by Section 12(f) of the Act because that security has unlisted trading privileges on a national exchange. n19

Pursuant to Regulation T, a margin call must be satisfied within one payment period after the margin deficiency was created or increased. n20 The additional amount may be satisfied by a transfer from the special memorandum account, deposit of cash, margin securities, or exempted securities, or any combination thereof. n21 The payment period may be extended for one or more limited periods upon a creditor's application to the examining authority prior to the end of a payment period or extension. n22 Extensions will be granted except where the organization or association examining the application believes that the creditor is not acting in good faith, or has not demonstrated circumstances warranting an extension. n23

An extension can only be given in exceptional circumstances and can not last longer than those circumstances require. The New York Stock Exchange has stated it will not grant an extension if the customer has asked for extensions five times within a one year period. n24 If the deposit is not made within the required time, the broker must sell enough of the customer's securities (usually those just purchased) to eliminate any margin deficiency. n25

If credit is initially established with adequate margin, Regulation T does not require additional margin because of a subsequent decrease in the market price of the margin stock or a subsequent change in the margin requirements. n26 However, the rules of the self-regulatory organizations require customers to put up additional collateral under such circumstances, and broker-dealers are also permitted to have their own internal margin maintenance requirements. n27

A customer can withdraw securities or cash from the general account except if additional cash or securities are required to be deposited into the account for a transaction on the same or a previous day or if the withdrawal, together with other transactions, would create or increase a margin deficiency. n28 Margin excess may be withdrawn. Margin excess also may be transferred to the special memorandum account by making a single entry to that account representing a debit to the margin account and a credit to the special memorandum account. n29

Normally, a customer can, on the same day, sell securities and use the margin released to acquire new securities with the same maximum loan value. Such transactions can not violate the margin account requirements of Section 4 of Regulation T because the customer's indebtedness and the loan value of the securities in the account have remained the same for that day. Rule 4(c) gauges the net effect on the customer's account of all transactions on a single day; it does not treat the transactions individually. n30 Thus no new excess indebtedness has been created in the customer's account.

[iii] Special Accounts.

The special accounts authorized by Regulation T cover transactions not falling within the intent of Section 7, such as arbitrage transactions, specialist transactions, transactions in commodities and foreign exchange, and other arrangements involving special circumstances.

The most significant special account is the cash account designed for cash purchases of securities where no credit is to be extended to the customer. n31 If the funds in the account are insufficient to cover a purchase, the customer has a certain number of business days after the purchase, plus delivery time, n32 within which to pay for the security. n33 If the security is not immediately available because it is to be issued later, or distributed later in accordance with a published plan, the period starts to run when the security is made available by the issuer for delivery to purchasers, or when the security is distributed under the plan. n34 If the customer is to pay the broker upon the delivery of the securities, the payment period does not apply. Instead the customer must pay on the earlier of the following two dates: (1) the delivery date of the security or 2) thirty-five calendar days after the date the security is purchased. n35

On application of the creditor, an appropriate committee of either a national securities exchange or a self-regulatory organization may, under exceptional circumstances, extend the applicable payment period. n36 The committee must be satisfied that the application is in good faith and that exceptional circumstances warrant the extension.

If the customer cannot pay within the time allowed, the broker must cancel the transaction and sell the securities. n37 However, the broker has the option to disregard any debt that does not exceed \$1,000. n38 There is authority that holds that if a broker is forced to sell the securities, he may keep any profits he makes if the customer could not have reasonably expected to raise the money needed within the requisite time period. n39

A customer may sell securities from a cash account if he holds such securities in his account. n40 Securities not held in the customer's account may be sold if the broker has a good faith belief that the customer owns the securities and will promptly deposit them in the account. n41 *Naftalin & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* n42 held that the term "promptly" could not be read to require delivery of the securities within any specific time period, n43 but that

if delivery is slow, the broker must "buy-in" the transaction (i.e., cover the customer's short position) if the customer can not reasonably explain the delay. n44 About the same time *Naftalin* was decided, the Commission adopted Rule 15c3-3(m) that requires a broker to buy-in a transaction if for any reason he has not obtained the securities from the customer within ten days of the settlement date. n45 The Commission has suspended this rule with respect to exempted securities (as defined in Section 3(a)(12) of the Exchange Act). n46 A broker can recover from a customer for buying in at a loss, although the broker's damages may be limited if he waits too long to buy into a rising market. n47

"Free riding" is a practice where the customer purchases securities in a cash account, does not immediately pay for them, and sells them within the payment period if their price goes up, using the proceeds to pay the broker for the initial purchase. Thus, the customer can make a profit without using any of his own money. To prevent this, Regulation T provides that if the customer sells a non-exempt security out of his account, or delivers the security to another broker or dealer, or cancels a transaction without having first made full payment for the security, that customer, for the next ninety days, cannot purchase any non-exempt security in his special cash account, unless sufficient funds for the purchase are already in the account. n48 On application of the broker, an appropriate committee of either a national securities exchange or a self-regulatory organization may waive this rule if the committee is satisfied that both creditor and customer are acting in good faith and that circumstances warrant such authorization. n49 Exceptions to the "ninety day rule" are allowed where a customer sells securities without full prior payment, but pays for securities within the time allowed (usually seven days) without withdrawing from the account the proceeds of the sale, and where a customer delivers the purchased security to another broker or dealer for deposit in a cash account in which sufficient funds to pay for the security are held.

The Board strictly interprets this exception to insure that the proceeds of the sale do not pay for the purchase. n50

[iii] Portfolio Margining.

On July 14, 2005 the Commission approved, n51 on a pilot basis expiring July 31, 2007, amendments to NYSE Rule 431 to permit the application of a prescribed risk-based margin requirement, portfolio manager, to certain eligible products (including listed broad-based securities index options, warrants, futures, futures options and related exchange treated funds) as an alternative to strategy-based margin requirements. n52 Subsequently, on July 11, 2006, the Commission approved additional amendments to Rule 431 that: (1) expanded the scope of products eligible for portfolio margining and cross-margining; (2) conform customer disclosure requirements under Rule 726 to comply with this expansion; and (3) modify certain net capital requirements in connection with the maintenance of portfolio margin accounts. n53

Similarly, on February 2, 2006, the Chicago Board of Options Exchange, Incorporated ("CBOE") filed with the Commission a proposed rule change to allow portfolio margining of listed equity options, narrow-based index options and securities futures, as well as certain OTC instruments. n54

Assuming the Commission ultimately gives its approval, the proposed rule change would dramatically reduce collateral requirement on accounts holding equities, options and single stock futures because while today investors must meet Regulation T's collateral requirement of 50% the first day that equities are held in an account, and 25% thereafter maintenance requirements imposed by the SROs, the proposed portfolio margining rule will drop that requirement to a maximum of 15% starting day one.

[b] Regulation U.

In January 1998, the Federal Reserve adopted amendments to Regulation U. n55 The regulation, adopted by the Federal Reserve Board under Section 7(d) of the Exchange Act, imposes limitations on both bank and non-bank lenders that extend credit for the purpose of buying or carrying margin stock. Where a loan is secured directly or indirectly n56 by margin stock the lender may not extend more than 50% of the current market value of the stock. n57 Where a loan made

to purchase or carry margin stock is secured by collateral other than stock, the lender may determine the loan value of the collateral in good faith. n58

Margin stock includes securities registered on a national securities exchange, any listed Nasdaq security, n59 debt securities convertible into margin stock, rights or warrants to acquire margin stock, and certain investment securities. n60 Regulation U does not apply to credit extended on stock for a purpose other than purchasing or carrying margin securities.

When making a loan secured by margin stock in an amount exceeding \$100,000, the lender has the responsibility of determining the purpose of the loan. The lender is entitled to rely in good faith on the "purpose statement," in Form F.R. U-1, which the customer must sign to receive the loan. n61 As under Regulation T, Regulation U restricts the right to withdraw collateral where such withdrawal would cause the credit to exceed, or increase the amount by which the credit exceeds, the maximum loan value of the collateral. n62

There are a number of exceptions to Regulation U. Most allow lenders to extend credit to broker-dealers for a variety of purposes. n63 Also, excepted is credit extended outside the United States, credit extended to any foreign banking institution, and credit extended to any bank. n64 Loan renewals or extensions are not subject to Regulation U. n65

[c] Amendments to Regulation A.

As amended effective January 9, 2003, Regulation A now provides that adjustment credit, previously extended at a below-market rate, be replaced by primary credit, a type of discount window credit which will be available for short terms as a backup liquidity source for depository institutions deemed by the Federal Reserve Bank to be in sound financial condition. Primary credit will be extended at a rate above the federal funds rate, and will be established at least every two weeks by the same procedure used to set the adjustment credit rate. Where institutions fail to qualify for primary credit, a secondary credit program is available.

Regulation A was further amended, effective July 10, 2003, to decrease the primary credit rate at each Federal Reserve Bank. The secondary credit rates at such banks decreased automatically as a result of the action.

[d] Amendments to Regulation B.

In February 2003, the Federal Reserve Board approved amendments to Regulation B. The regulation implements the Equal Credit Opportunity Act which prohibits discrimination by creditors on the basis of an applicant's national origin, marital status, religion, color, sex, race, age, receipt of public assistance benefits, or the exercise of rights under the Consumer Credit Protection Act. n66 As amended, the rule retains prohibitions on inquiries or notations about applicant characteristics for non-mortgage transactions, while creating an exceptions for data collected for the purpose of self-tests. The amendment also provides that creditors must maintain records for prescreened candidates for a period of 25 months. The amendment became effective April 15, 2003, with a mandatory compliance date of April 15, 2004.

[2] Selling New Issues on Credit -- Section 11(d)(1).

Among the problems presented by the activities of securities firms acting sometimes as dealers and sometimes as brokers, is the sale to customers on credit of issues for which the broker-dealers are also acting as underwriters. The possible conflict in such a situation is fairly obvious, and Congress met it by adopting Section 11(d)(1), which makes unlawful the extension or maintenance of credit to a customer on a nonexempt new issue by a broker-dealer who within the past thirty days participated in the distribution of that security. n67 Delayed payment by the customer up to thirty-five days after the purchase because of delayed delivery of the stock is not an extension of credit within Section 11(d)(1).

Rule 11d1-1 states that Section 11(d)(1) does not apply where: (1) the broker-dealer does not sell the security to the customer; (2) the issuer exchanges an old security on which credit was lawfully maintained for a new security; (3) the customer is a broker or dealer or bank; (4) the customer exercises stock purchase rights that he received because he is a shareholder in the issuing company; (5) the distribution is a new issue of an old security where the newly issued shares will make up less than half of all the outstanding securities in that class when the distribution is complete, and the broker-dealer sells the security on a day when he is not participating in the distribution. n68

There are many parallels between life insurance and mutual funds, and there have been some attempts to combine the two in a program for investors. Such efforts, however, create problems under Section 11(d)(1), since sellers of mutual fund shares are constantly engaged in a distribution, and since the proposals for combination have contemplated the funding of life insurance premiums by loans collateralized by the mutual fund shares. n69 It appears, however, that these difficulties can be avoided by careful segregation of functions and accounts to comply with the intent of Congress in enacting Section 11(d)(1). n70

Funding the purchase of life insurance with loans collateralized by the mutual fund shares may violate Regulation T. Consequently, the SEC has adopted Rule 15c2-5 n71 which, while general in terms, was aimed at the insurance premium funding device. n72 The rule allows the use of this device and requires the broker-dealer to disclose in writing to the customer all the terms of such a loan arrangement, all risks involved, and all commissions to be received. The broker-dealer must also become familiar with the customer's financial condition, decide that the transaction is suitable for the customer, and deliver to the customer a statement of the reasons for the decision. Rule 15c2-5 does not apply to a loan made by a broker or dealer in compliance with Regulation T. n73

[3] Disclosure of Credit Terms in Margin Transactions

Rule 10b-16 requires a broker or dealer before opening a general account n74 to disclose the terms under which credit will be extended. In adopting this rule, the Commission stated: n75

The initial disclosure is designed to insure that the investor, before his account is opened, understands the terms and conditions under which credit charges will be made. This will enable him to compare the various credit terms available to him and to understand the methods used in computing the actual credit charges.

Rule 10b-16 requires the following disclosure:

(i) the conditions under which an interest charge will be imposed; (ii) the annual rate or rates of interest that can be imposed; (iii) the method of computing interest; (iv) if rates of interest are subject to change without prior notice, the specific conditions under which they can be changed; (v) the method of determining the debit balance or balances on which interest is to be charged and whether credit is to be given for credit balances in cash accounts; (vi) what other charges resulting from the extension of credit, if any, will be made and under what conditions; and (vii) the nature of any interest or lien retained by the broker or dealer in the security or other property held as collateral and the conditions under which additional collateral can be required. ... n76

Liang v. Dean Witter & Co., Inc. n77 held that if a firm has no internal guidelines for when additional collateral will be required, it need only disclose "that discretion is its sole guide" for margin calls. If such guidelines do exist, they must be disclosed. *Stephens v. Reynolds Securities, Inc.* n78 held that disclosures that the interest rate charged on a customer's debit balance was to be at least 0.5% higher than the broker's call money rate in New York City, and that daily interest would be computed on a 360 day year, were sufficient under Rule 10b-16.

The initial disclosure must be in writing and given or sent at the time the account is opened, except that if the account is

opened by telephone, the required information may be orally communicated to the customer at that time, provided a written statement is sent to the customer immediately thereafter. n79

Rule 10b-16(a)(2) requires a broker to provide a customer using credit with a written statement, at least quarterly, disclosing: (i) the balance at the beginning of the period; the date, amount and a brief description of each credit and debit entered during such period; n80 (ii) the total interest charge for the period during which interest is charged, and the dates on which such period began and ended and the annual rate of interest charged; n81 and (iii) all other charges resulting from the extension of credit in that account.

A broker-dealer is prohibited by Rule 10b-16(b) from changing any terms under which credit charges will be made, unless the customer has been given thirty days written notice of such changes. However, where the change would result in a lower interest charge to the customer, notice of the change may be given within a reasonable time after the effective date of the change.

Courts are split on whether a private right of action exists under Rule 10b-16; such a right has been recognized in several cases. n82 However, other cases have denied that such a cause of action exists. n83

FOOTNOTES:

(n1)Footnote 1. *See Note, Federal Margin Requirements as a Basis for Civil Liability*, 66 *Colum. L. Rev.* 1462, 1462-1463 (1966):

Margin trading--the purchase or short sale of securities with borrowed funds--is usually conducted in one of two ways. Typically, the investor deposits with his broker a percentage of the purchase price--the initial margin--pursuant to an agreement with the broker setting up a margin account. The broker lends the customer the balance, and usually finances this loan by borrowing in turn from a third party while pledging the purchased shares as security. The broker retains the stock as collateral and is given the right to dispose of it if the customer fails to maintain in his account an amount sufficient to assure that his equity in the stock exceeds a defined percentage of the current market value; this mandatory account balance is called the maintenance margin. Alternatively, the investor may borrow directly from a bank or finance company. In this case, no formal margin account need be maintained, although the broker may make the arrangements for the loan. (footnotes omitted)

(n2)Footnote 2. Section 7(c) provides:

It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer--

(A) On any security (other than an exempted security), except as provided in paragraph (2), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System [] shall prescribe under subsections (a) and (b) of this section; and

(B) Without collateral or on any collateral other than securities, except in accordance with such rules and regulations as the Board may prescribe (i) to permit under specified conditions and for a limited period any such member, broker, or dealer to maintain a credit initially extended in conformity with the rules and regulations of the Board; and (ii) to permit the extension or maintenance of credit in cases where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities or of evading or circumventing the provisions of subparagraph (A).

1-3A Federal Securities Exchange Act of 1934 § 3A.02

(n3)Footnote 3. Federal Deposit Insurance Act, Pub. L. No. 91-508, 84 Stat. 1114 (codified as amended at 12 U.S.C. §§ 1829b, 1830, 1831 (2006)).

(n4)Footnote 4. Section 7(f) has had an adverse impact on the development of a private right of action under Section 7. *See* § 3A.03 *infra*.

(n5)Footnote 5. Pub. L. No. 90-437, 82 Stat. 452 (codified as amended at 15 U.S.C. § 78g (2006)).

(n6)Footnote 6. A last version of this list is published at Fed. Banking L. Rep. (CCH) P 69,871.

(n7)Footnote 7. *E.g.*, Reg. T, § 17(a)(1)-(9).

(n8)Footnote 8. Exchange Act, § 7.

(n9)Footnote 9. Three alternative tests are now used: (1) 1,000 active accounts with non broker-dealers; or (2) \$10,000,000 in annual revenues from transactions with such persons; or (3) 10% of annual gross revenues derived from such transactions. Reg. T, § 2; Reg. U, § 2.

(n10)Footnote 10. Reg. U, § 5(c)(10).

(n11)Footnote 11. 12 C.F.R. § 220.

(n12)Footnote 12. The four special accounts are described in Regulation T, Section 8 and include: (1) special memorandum accounts (12 C.F.R. § 220.5), (2) good faith accounts (12 C.F.R. § 220.6), (3) broker-dealer credit accounts (12 C.F.R. § 220.7), and (4) cash accounts (12 C.F.R. § 220.8).

(n13)Footnote 13. Reg. T, § 6(e)(iii)(2).

(n14)Footnote 14. *In re Sutro Bros. & Co.*, 41 S.E.C. 443 (1963) ; Russell L. Irish, Exch. Act Rel. No. 34-7718 (1965).

(n15)Footnote 15. Reg. T, § 3(h).

(n16)Footnote 16. Reg. T, § 4(c)(1).

(n17)Footnote 17. Reg. T, § 4(f)(1).

(n18)Footnote 18. Reg. T, § 2.

(n19)Footnote 19. Reg. T, § 2.

(n20)Footnote 20. Reg. T, § 4(c)(3)(i).

(n21)Footnote 21. Reg. T, § 4(c)(2).

(n22)Footnote 22. Reg. T, § 4(c)(3)(ii).

(n23)Footnote 23. Reg. T, § 4(c)(3)(ii).

(n24)Footnote 24. 151 Sec. Reg. & L.Rep. A-4 (BNA May 10, 1972).

(n25)Footnote 25. Reg. T, § 4(d). No action need be taken by the creditor if the margin deficiency created or increased is \$1,000 or less.

(n26)Footnote 26. Reg. T, § 3(c).

(n27)Footnote 27. NYSE Rule 431(b) addresses the requisite margin requirements for margin accounts. The Rule was amended in 2002 resulting in lower customer maintenance margin requirements for certain non-equity securities and allowing good faith margin treatment for certain non-equity securities held in "exempt accounts. In addition, several broker-dealers have instituted increased margin maintenance requirements for certain volatile technology and internet securities.

(n28)Footnote 28. Reg. T, § 4(e)(1).

(n29)Footnote 29. Reg. T, § 4(e)(2). A special memorandum account may be maintained in conjunction with a margin account. A single entry amount is used to represent a credit to the special memorandum account and a simultaneous debit to the margin account. A transfer between the two accounts is effected by an increase or a reduction in the entry. Likewise, a payment to the customer or a transfer to another of the customer's accounts from the special memorandum account reduces the single entry amount. Reg. T, § 6(a).

(n30)Footnote 30. Reg. T, § 4(c)(1).

(n31)Footnote 31. Reg. T, § 8(a)(1).

(n32)Footnote 32. Reg. T, § 8(b)(3) states:

If any shipment of securities is incidental to consummation of a transaction, a creditor may extend the payment period by the number of days required for shipment, but not more than one additional payment period.

(n33)Footnote 33. Reg. T, § 8(b)(1)(i); 8(b)(4).

(n34)Footnote 34. Reg. T, § 8(b)(1)(i)(B),(C).

(n35)Footnote 35. Reg. T, § 8(b)(2).

(n36)Footnote 36. Reg. T, § 8(d)(1)(i).

(n37)Footnote 37. Reg. T, § 8(b)(4).

(n38)Footnote 38. *Id.*

(n39)Footnote 39. *Surgil v. Kidder, Peabody & Co.*, 69 Misc. 2d 213, 215, 329 N.Y.S. 2d 993, 995 (N.Y. App. Term 1971) .

(n40)Footnote 40. Reg. T, § 8(a)(2)(i).

(n41)Footnote 41. Reg. T, § 8(a)(2)(ii).

(n42)Footnote 42. 469 F.2d 1166 (8th Cir. 1972) .

(n43)Footnote 43. The court specifically rejected the idea that the period allowed for payment in cash account should also apply to the delivery of the securities:

We are persuaded, however, that the 1939 amendment's elimination of the seven-day delivery requirement on the sale side demonstrates an obvious intention to treat sales transactions in special cash accounts differently from purchase transactions. There are, moreover, valid reasons for the different

treatment. In purchase transactions the customer's only obligation is to pay for the securities in cash--the availability of which is generally within the customer's realm of control. Whereas, on the other side of the transaction, because of the mechanics of the securities industry over which the customer ordinarily has no control, he may not be able on all occasions to obtain physical possession of securities which he owns and intends to deliver within a specified period of time, such as seven days. *Naftalin*, 469 F.2d 166 at 1177. (Footnote omitted.)

(n44)Footnote 44. *Naftalin*, 469 F.2d at 1177.

The rejection of a specific delivery date requirement does not, however, mean that Regulation T may be read as sanctioning unnecessary or avoidable delays. Section [8(a)(2)(ii)] places determinative emphasis upon the broker/dealer's good faith, and in the absence of an absolute liquidation requirement we must focus on that good faith as the test of compliance. The good faith of a broker/dealer who has originally executed a sell order in compliance with Regulation T must gradually dissipate as time passes without delivery of the securities. The time comes when the good faith standard of section [8(a)(2)(ii)] requires the broker/dealer to make inquiry concerning the reason for delay and to act accordingly. If, upon inquiry, the broker/dealer ascertains that the slow delivery is unavoidable and out of his customer's control, he may indulge a reasonable delay commensurate with the circumstances without any impairment of good faith. If no credible explanation for the delay is forthcoming, the transaction must be bought-in immediately. (Footnote omitted.)

(n45)Footnote 45. Rule 15c3-3(n) permits an extension of this ten day limit. For further discussion of Rule 15c3-3(m) and a broker's obligation to cover a customer's short position, see § 6.02[3] *infra*.

(n46)Footnote 46. Exch. Act Rel. No. 34-10,093, *Fed. Sec. L. Rep. (CCH) P 79,310* (1973).

(n47)Footnote 47. See § 3A.03[2] *infra*.

(n48)Footnote 48. Reg. T, § 8(c).

(n49)Footnote 49. Reg. T, § 8(d)(iii).

(n50)Footnote 50. Reg. T, § 8(c)(ii). The original broker or dealer may rely on a written statement accepted in good faith from the other broker or dealer that sufficient funds are held in the other cash account. *Id.*

(n51)Footnote 51. See Exch. Rel. No. 34-52031 (July 14, 2005).

(n52)Footnote 52. Prior to these amendments, member organizations were subject exclusively to strategy or position-based margin requirements which apply specific margin percentage requirements in Rule 431 to each security position or strategy, either long or short, held in a customer's account -- irrespective of whether changes in the price of a given security (e.g., an equity option) are proportionate (in percentage terms) with changes in the price of the underlying security (e.g., the equity). When utilizing a portfolio margin methodology offsets are fully realized, whereas under a strategy or position-based methodology, security positions and/or groups of security positions comprising a single strategy are margined independently of each other and offsets between them do not efficiently impact the total margin requirement.

(n53)Footnote 53. See Exch. Rel. No. 34-54125 (July 11, 2006).

(n54)Footnote 54. See Exch. Rel. No. 34-53576 (March 30, 2006). On August 9, 2006, the CBOE filed an amendment to the proposed rule change. See Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change

by the Chicago Board Options Exchange, Incorporated Relating to Customer Portfolio Margining Requirements, available at <http://www.cboe.org/publish/RuleFilingsSEC/SR-CBOE-2006-014.a1.pdf>.

(n55)Footnote 55. *See 63 FR 2806 (Jan. 16, 1998)*. Under the amendments, as of April 1, 1998, Regulation U was extended to cover lenders previously covered under Regulation G. As a result, Regulation G was eliminated. With these amendments, the Federal Reserve eliminated the distinction between bank lenders and non-bank lenders. Previously, Section 8(a) of the Securities Exchange Act of 1934 mandated that distinction. However, the repeal of Section 8(a) allowed for the merging of Regulations G and U.

(n56)Footnote 56. Reg. U, § 2 states: "Indirectly secured."

(1) Includes any arrangement with the customer under which:

(i) The customer's right or ability to sell, pledge, or otherwise dispose of margin stock owned by the customer is in any way restricted while the credit remains outstanding; or

(ii) The exercise of such right is or may be cause for accelerating the maturity of the credit.

(2) Does not include such an arrangement if:

(i) After applying the proceeds of the credit, not more than 25 percent of the value (as determined by any reasonable method) of the assets subject to the arrangement is represented by margin stock;

(ii) It is a lending arrangement that permits accelerating the maturity of the credit as a result of a default or renegotiation of another credit to the customer by another lender that is not an affiliate of the lender;

(iii) The lender holds the margin stock only in the capacity of custodian, depositary, or trustee, or under similar circumstances, and, in good faith, has not relied upon the margin stock as collateral; or

(iv) The lender, in good faith, has not relied upon the margin stock as collateral in extending or maintaining the particular credit.

(n57)Footnote 57. Reg. U, § 7.

(n58)Footnote 58. Reg. U, § 2.

(n59)Footnote 59. Reg. U, § 2.

(n60)Footnote 60. Reg. U, § 2.

(n61)Footnote 61. "Good faith" with respect to: Making a determination or accepting a statement concerning a borrower means that the lender or its duly authorized representative is alert to the circumstances surrounding the credit, and if in possession of information that would cause a prudent person not to make the determination or accept the notice or certification without inquiry, investigates and is satisfied that it is correct.

A broker-dealer who conspires with the customer to file false purpose statements is subject to disciplinary proceedings. *In re Gilbert Parker*, 34 S.E.C. 385, 386 (1952); *Copley & Co.*, Exch. Act Rel. No. 7679 (1965).

(n62)Footnote 62. Reg. U, § 3(f).

(n63)Footnote 63. Reg. U, § 5, which details the types of special purpose credit that allows lenders to extend to

broker-dealers on a good faith basis. They include: hypothecation loans; temporary advances for payment-against-delivery transactions; loans for securities in transit or transfer; intra day loans, to be repaid on the same day; certain arbitrage loans; market maker and specialist loans; underwriter loans; emergency loans; capital contribution loans; and credit to clearing brokers or dealers.

(n64)Footnote 64. Reg. U, § 6(a)-(c).

(n65)Footnote 65. Reg. U, § 3(h); *See Wyshak v. City Nat'l Bank*, 607 F.2d 824, 826 (9th Cir. 1979) .

(n66)Footnote 66. **15 U.S.C. § 1601 et seq.**

(n67)Footnote 67. Section 11(d)(1).

Section 11(d)(1) is not applicable to secondary offerings by insiders who have held the securities for long enough to indicate clearly that there is no connection between the purchase and the sale. *Lubrizol Corp., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) P 78,061* (Div. Tding. & Mkts. 1971).

(n68)Footnote 68. Rule 11d1-1(e) states:

A broker-dealer shall be deemed to be participating in a distribution of a new issue if (1) he owns, directly or indirectly, any undistributed security of such issue, or (2) he is engaged in any stabilizing activities to facilitate a distribution of such issue, or (3) he is a party to any syndicate agreement under which such stabilizing activities are being or may be undertaken, or (4) he is a party to an executory agreement to purchase or distribute such issue.

(n69)Footnote 69. The plan may also involve questions under Regulation T. The plan itself is subject to the registration requirements of the Securities Act of 1933 and may be subject to regulation under the Investment Company Act of 1940. The industry was put on notice in 1962 of the difficulties involved. *See Exch. Act Rel. No. 34-6726, Fed. Sec. L. Rep. (CCH) P 22,833* (Feb. 8, 1962).

(n70)Footnote 70. *See letter of Director of Division of Trading and Exchanges, Fed. Sec. L. Rep. (CCH) P 76,840* (Mar. 5, 1962). This was not reproduced in a release.

(n71)Footnote 71. *17 C.F.R. § 240.15c2-5*.

(n72)Footnote 72. *Exch. Act Rel. Nos. 34-6809* (proposed), *Fed. Sec. L. Rep. (CCH) P 76, 848* (May 22, 1962), 6851 (adopted), *Fed. Sec. L. Rep. (CCH) P 76,852* (July 17, 1962). Special guidelines have been adopted for use in the preparation of registration statements governing the offering of such securities. *See Guide 57* under the Securities Act of 1933.

(n73)Footnote 73. *17 C.F.R. § 240.15c2-5(b)*.

(n74)Footnote 74. *See § 3A.02[1][a][i] supra*

(n75)Footnote 75. *Exch. Act Rel. No. 34-8773 [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 77,765* (1969). This is also the stated purpose of the Truth-in-Lending Act, **15 U.S.C.A. § 1601** , which specifically exempted brokers' margin loans to customers with the expectation that the Commission would act in this area: "In recommending an exemption for stockbroker margin loans in the bill, the committee intends for the SEC to require substantially similar disclosure by regulation as soon as it is possible to issue such regulations." *S. Rep. No. 392, 90th Cong. 1st Sess. 9* (1967).

(n76)Footnote 76. *17 C.F.R. § 240.10b-16(a)(1)*. Further, pursuant to NYSE Rule 726, for those members who

participate in the pilot program for portfolio margining, member organizations must furnish eligible pilot program participants with a special written disclosure statement describing the nature of, and risks associated with, portfolio margining. Eligible participants are required to sign and acknowledge that they have read and understand the disclosure statement and agree to the terms of maintaining a portfolio margin account. See Exch. Rel. No. 34-54125 (July 11, 2006).

(n77)Footnote 77. 540 F.2d 1107, 1112 (D.C. Cir. 1976) .

Note, *SEC Rule 10b-16 and the Regulation of Margin Credit*, 87 Yale L.J. 372 (1977), argues that Rule 10b-16 is inadequate because it does not require specific information about when a discretionary margin call will be made. The article suggests repealing Rule 10b-16, transferring margin credit regulation to the Truth-in-Lending Act, and using Rule 10b-5 as a remedy for abuses in connection with margin transactions.

(n78)Footnote 78. 413 F. Supp. 50, 51 (N.D. Ala. 1976) ; *aff'd by Stephens v. Reynolds Securities, Inc.*, 532 F.2d 1053 (5th Cir. 1976) .

(n79)Footnote 79. 17 C.F.R. § 240.10b-16(a)(1).

(n80)Footnote 80. If interest is charged for a period different from the period covered by the statement, Rule 10b-16(a)(2)(i) requires that the balance as of the last day of the interest period must also be disclosed.

(n81)Footnote 81. If interest is charged separately for separate accounts, then the information required by Rule 10b-16(a)(2)(ii) must be provided separately with respect to all accounts.

(n82)Footnote 82. See *GFL Advantage Fund, Ltd. v. Colkitt*, 272 F.3d 189 (3d Cir. 2001) (recognizing private right of action); *Baden v. Craig-Hallum, Inc.*, 646 F. Supp. 483, 490 (D. Minn. 1986) ; *Finne v. Dain Bosworth Inc.*, 648 F. Supp. 337, 345 (D. Minn. 1986) ; *Greenblatt v. Drexel Burnham Lambert, Inc.*, 763 F.2d 1352 (11th Cir. 1985) ; see also *Liang*, 540 F.2d at 1113 n.25:

It may safely be assumed that noncompliance with Rule 10b-16 provides the basis for a private cause of action. It is already established that a violation of Rule 10b-5, a rule of disclosure analogous to Rule 10b-16, implies a civil remedy. *Supt. of Insurance v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n. 9, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971) . Our recognition here accords with the view that "private enforcement of Commission rules may '[provide] a necessary supplement to Commission action.'" *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730, 95 S.Ct. 1917, 1923, 44 L.Ed.2d 539 (1975) , quoting *J. I. Case Co. v. Borak*, 377 U.S. 426, 432, 84 S.Ct. 1555, 12 L.Ed.2d 423 (1964) .

Still remaining, however, is the determination of whether recovery under Rule 10b-16 requires that the wrongdoer have acted with 'scienter,' *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S.Ct. 1375, 47 L.Ed.2d 668 (1976) ("scienter" a necessary element for damages under Rule 10b-5), or with some lesser degree of error, cf. *Haynes v. Logan Furniture Mart, Inc.*, 503 F.2d 1161 (7th Cir. 1974) (mistake of law not adequate bar to civil liability under Truth in Lending Act). Whatever it determines to be the requisite standard of error for recovery, the trial court, of course, must also find either that the appellants have adequately alleged in their complaint or that the complaint may appropriately be amended to allege it.

See also *Slomiak v. Bear Stearns & Co.*, Fed. Sec. L. Rep. (CCH) P 91,590 (S.D.N.Y. 1984), in which the court held that an implied private right of action exists under Rule 10b-16.

See also *Haynes*, 503 F.2d 1161 , superseded by statute as stated in *Marshall v. Security State Bank*, 121 B.R. 814 (Bankr. C.D. Ill. 1990) . (Rule 10b-16 found to be the securities analogue of the Truth in Lending Act of 1968, Pub. L. 90-321, 82 Stat. 146, 15 U.S.C. §§ 1601 et seq. , requiring adequate disclosure of the costs of credit and containing an express private remedy; an implied private cause of action for damages held to exist under Rule 10b-16 for

noncompliance with the Rule); *Saunders v. Oppenheimer Government Securities, Inc.*, *Fed. Sec. L. Rep. (CCH) P 98,318* (D. Ore. 1981) (court relies on *Haynes* to hold that an implied private right of action exists under Rule 10b-16).

Scienter is not an element of a private right of action under Rule 10b-16. *Id.*

If a broker violates Rule 10b-16, the investor may rescind the sales contract pursuant to Section 29(b), discussed in § 3A.03[2] *infra*. *Id.*

But see Robertson v. Dean Witter Reynolds, Inc., *Fed. Sec. L. Rep. (CCH) P 91,868* (9th Cir. 1984), in which the court acknowledged the existence of a private right of action under Rule 10b-16, but held that scienter is an essential element of such action. The court reasoned that the Commission's authority to issue Rule 10b-16 derived from Section 10(b), not the *Truth in Lending Act*, and the Supreme Court in *Ernst & Ernst v. Hochfelder*, *Fed. Sec. L. Rep. (CCH) 95,479*, 425 U.S. 185, 193, 96 S. Ct. 1375, 1381, 47 L. Ed. 2d 668, 676 (1976), held that proof of scienter was a requirement in proving a violation of that section.

In *Steinberg v. Shearson Hayden Stone, Inc.*, *Fed. Sec. L. Rep. (CCH) 98,868*, 546 F. Supp. 699, 701 (D. Del. 1982), the court held that the existence of an express cause of action under Rule 10b-16 does not preclude an implied right of action under *Rule 10b-5* and allowed a customer's claim against a broker-dealer for fraudulently misstating the credit terms in the broker-dealer's customer margin accounts to be asserted as a *Rule 10b-5* violation.

See also Angelastro v. Prudential Bache Securities, Inc., 575 F. Supp. 270, modified, 764 F.2d 939 (3d Cir. 1985) (violation of Rule 10b-16 provides the basis for a private right of action).

(n83)Footnote 83. *Establissement Tomis v. Shearson Hayden Stone*, 459 F. Supp. 1355, 1361 (S.D.N.Y. 1978) stated: "... Tomis has cited no case (and the court is aware of none) holding that a plaintiff may possess a private right of action for damages under Rule 10b-16. Therefore the first claim will only be treated from a section 10(b) and *Rule 10b-5* standpoint."

See also Furer v. Paine, Webber, Jackson & Curtis, Inc., *Fed. Sec. L. Rep. (CCH) 98,701*, 1982 U.S. Dist. LEXIS 13021 (C.D. Cal. 1982) (no private right of action under Rule 10b-16 since no clear and unambiguous showing that Congress intended the creation of a private remedy).



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Federal Securities Exchange Act of 1934

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CHAPTER 3A Regulation of Credit

1-3A Federal Securities Exchange Act of 1934 § 3A.03

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§ 3A.03 Private Remedies for Violation of Margin Requirements

[1] Damage Actions

Prior to the passage of Section 7(f) in 1970, many cases held that a customer had an implied private right of action if his broker caused him a loss through violation of the margin requirements. n1 In the leading case of *Pearlstein v. Scudder & German*, n2 the Second Circuit held that a customer's private right of action under Section 7 was a necessary and effective way of enforcing the margin requirements, even where the plaintiff was aware of the violation at the time it was committed:

However, our holding does not turn on Pearlstein's subjective knowledge of the law. In our view the danger of permitting a windfall to an unscrupulous investor is outweighed by the salutary policing effect which the threat of private suits for compensatory damages can have upon brokers and dealers above and beyond the threats of governmental action by the Securities and Exchange Commission. n3

Section 7(f) makes it unlawful for a customer to obtain credit in violation of the margin regulations. Regulation X, adopted in 1971, states that a borrower cannot obtain credit from a bank, broker-dealer, or other lender for the purpose of purchasing or carrying securities unless he does so in compliance with the rules contained in Regulations T and U.

The passage of Section 7(f) and the adoption of Regulation X, when considered in light of the *Cort v. Ash* n4 standards for implying a private right of action, has led most courts to conclude that a private right of action under Section 7 no longer exists. n5 The Second Circuit has conceded that its decision in *Pearlstein* may no longer be viable. n6 Perhaps the most detailed judicial consideration of this issue took place in *Stern v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* n7 There, the Fourth Circuit noted that earlier cases considered "establishment of the investor as an intended beneficiary of the statute ... an absolutely essential element in finding any right of action in the investor's favor." n8 Although such cases recognized that the primary purpose of Section 7 was to prevent excessive speculation, they also found an "incidental purpose" of protecting individual investors, thereby making them intended beneficiaries of the statute. Such a purpose could be inferred because the statute applied only to the broker (or other lender) and not the customer. The *Stern* court said: n9

The very fact that the investor was not included in the prohibition was taken as a legislative

expression of the intent of the statute to protect him against the broker. However, this reasoning lost all weight when Section 7(f) was added to the statute. That amendment, with its drastic change in the status of the investor under the statute, was entirely inconsistent with any notion that the statute was intended for the investor's protection. No longer could it be fairly inferred that investor could qualify as a statutory beneficiary of Section 7, entitled to invoke the statute as a basis for a private action in damages in his favor.

The court also noted the Supreme Court's statement in *Piper v. Chris-Craft Industries, Inc.* n10 that a person regulated by a statute "can scarcely lay claim to the status of 'beneficiary' whom Congress considered in need of protection." n11 Thus, Section 7 affords no private action under either the standards of the prior cases allowing a private right of action under Section 7 or under the *Cort v. Ash* requirement that the plaintiff be a member of a class for whose special benefit the statute was enacted.

Another reason offered by *Stern* for denying a private right of action is that such actions may not be necessary to supplement Commission enforcement of the margin rules, because numerous and widespread violations would be needed to contravene the purpose of the statute, i.e. to control national credit policy. Large scale violations could be controlled much better by the Commission than by individual actions. In any event, private actions are a questionable deterrent: "Any deterrent effect of threatened liability on the broker may well be more than offset by the inducement to violations inherent in the prospect of a free ride for the customer who ... is placed in the enviable position of 'heads-I-win tails-you-lose.'" n12

Some cases, however, support a limited private right of action under Section 7. *Palmer v. Thomson & McKinnon Auchincloss, Inc.* n13 held that since Regulation X does not cover investors who make innocent mistakes that are promptly corrected upon their discovery, such investors may sue under Section 7. *Utah State University v. Bear, Sterns & Co.*, criticized this reasoning:

Under Regulation X, the broker is subject to criminal penalties and the customer is not, if the credit is obtained innocently and, if upon learning of the violation, he makes payment. This difference in criminal penalties is no reason for imposing civil liability on the broker. n14

[2] Rescission of Purchases Made in Violation of Section 7

Section 29(b) of the Exchange Act states that every contract made in violation of any provision of the Act, or any rules or regulations thereunder, shall be void. Section 29 states that Section 29(b) does not affect the validity of a loan unless at the time the loan is made, the person making it had actual knowledge that the loan was in violation of the Act or a rule or regulation thereunder.

Some cases have allowed investors to rescind stock purchases under Section 29(b), because the purchases were made with illegal extensions of credit. n15 However, the Supreme Court ruled in *Mills v. Electric Auto Lite Co.* n16 that Section 29(b) does not automatically make a contract void, but makes it voidable at the option of the innocent party. Under Section 7(f) the customer is no longer innocent when he accepts a loan that violates the margin requirement. Thus, those courts unwilling to recognize a damage action under Section 7 will very likely not allow a customer to repudiate a securities purchase made in violation of Section 7. n17 In *Shearson Lehman Bros. Inc. v. M&L Inv.*, n18 the district court held that the client could not recover damages under Regulation T where the client knowingly enjoyed the beneficial use of the illegal extension of credit.

Some customers have attempted to use violation of Regulation T as a defense to contract actions by their brokers. n19 This usually occurs where the customer has effected an undisclosed short sale through the broker, and the broker has been forced to "buy-in" the transaction at a loss when the customer does not deliver the security. Failure to buy-in the transaction once the broker realizes that the customer cannot deliver the security is a violation of Regulation T. n20 The

leading case of *n21* held that if a broker is tardy in buying-in the transaction, his damages will be limited to the difference between the price of the short sale and the price at which the securities could have been bought at the time the buy-in should have been effected.

Rule 15c3-3(m) requires a transaction (other than a bona fide short sale) to be bought-in if delivery of the securities is not made within ten days after the trade. *n22* Extensions of the ten day period are permitted. *n23* *Chicago Corp. v. Jordan* *n24* held that under *Naftalin* and Rule 15c3-3(m), if a broker does not buy-in a transaction within the ten day period (plus any extensions), damages must be based on the market price of the security on the eleventh day (plus any extensions) after the trade.

If a customer makes a purchase from a special cash account, and can not pay for it within the time required (usually seven days), *n25* the broker must promptly sell those securities, and can recover any difference from his customer. *n26* *Chicago Corp. v. Jordan* held that if the broker is late in selling such securities, his damages must be based on the market price of the securities at the time they should have been sold.

FOOTNOTES:

(n1)Footnote 1. *Remar v. Clayton Securities Corp.*, 81 F. Supp. 1014 (D. Mass. 1949) , superseded by statute, 603 F.2d 1073 (4th Cir. 1979) ; *Glickman v. Schweickart & Co.*, 242 F. Supp. 670 (S.D.N.Y. 1965) ; *McCormick v. Esposito*, 500 F.2d 620 (5th Cir. 1974) , cert. denied, 420 U.S. 912 (1975) ; *Spoon v. Walston & Co.*, 478 F.2d 246 (6th Cir. 1973) ; *Landry v. Hemphill & Noyes & Co.*, 473 F.2d 365 (1st Cir.) , cert. denied, 414 U.S. 1002 (1973) . The post-1970 cases cited here involved transactions occurring prior to the passage of Section 7(f).

(n2)Footnote 2. 429 F.2d 1136 (2d Cir. 1970) .

(n3)Footnote 3. *Pearlstein*, 429 F.2d at 1141. (Footnote omitted.)

(n4)Footnote 4. 422 U.S. 66, 95 S. Ct. 2080, 45 L. Ed.2d 26 (1975) . These standards are reprinted at § 5.01 *infra* . In part, they examine whether a private right of action is necessary to further the statutory purpose and whether the statute was enacted for the especial benefit of member's of the plaintiff's class.

Whether *Cort v. Ash* remains viable is the subject of disagreement in the lower courts. See, e.g., *Park Nat'l Bank v. Michael Oil Co.*, 702 F. Supp. 703 (N.D. Ill. 1989) ; *24 Hour Fuel Oil Co. v. Long Island R.R. Co.*, 903 F. Supp. 393 (E.D.N.Y. 1995) ; *Ryan v. Illinois*, 1996 U.S. Dist. LEXIS 5160 (N.D. Ill. Apr. 17, 1996) .

Justices Scalia and O'Connor in their concurrence to *Thompson v. Thompson*, 484 U.S. 174, 189 (1988) , stated that *Touche Ross v. Redington*, 442 U.S. 560 (1979) , "effectively overruled the *Cort v. Ash* analysis," in holding that unless the legislative intent can be inferred from the language of the statute, or some other source, a private remedy will not be implied. Nonetheless, the district court in *24 Hour Fuel Oil* held that the four criteria of *Cort v. Ash* "continue to dictate the manner in which private rights of action are reviewed." *24 Hour Fuel Oil Corp. v. Long Island R.R. Co.*, 903 F. Supp. at 397 .

(n5)Footnote 5. See *Gargallo v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 1992 U.S. App. LEXIS 11386, at *6 (6[th] Cir. May 12, 1992) , cert. denied, 506 U.S. 1008 (1992) ; *Useden v. Acker*, 947 F.2d 1563, 1582 (11[th] Cir. 1991) , cert. denied, 508 U.S. 959 (1993) ; *Utah State Univ. v. Bear, Stearns & Co.*, 549 F.2d 164, 170 (10th Cir.) , cert. denied, 434 U.S. 890 (1977) ; *Birotte v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 468 F. Supp. 1172, 1187 (D.N.J. 1979) ; *Siedman v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 465 F. Supp. 1233, 1239 (S.D.N.Y. 1979) ; *Ettablissement Tomis v. Shearson Hayden Stone, Inc.*, 459 F. Supp. 1355, 1361 (S.D.N.Y. 1978) ; *Gluck v. Frankel*, 440 F. Supp. 1143, 1146 (S.D.N.Y. 1977) ; *Theoharous v. Bache & Co., Inc.*, Fed. Sec. L. Rep. (CCH) P 96,281, at *11 (D. Conn. 1977) . One case allowing a private right of action did so because of precedent rather than the merit of plaintiff's position. See *Nussbacher v. Chase Manhattan Bank (N.A.)*, 444 F. Supp. 973, 980 (S.D.N.Y. 1977) .

(n6)Footnote 6. *Bennett v. U.S. Trust Co.*, 770 F.2d 308, 311 (2d Cir.) , cert. denied, 474 U.S. 1058 (1985) .

(n7)Footnote 7. 603 F.2d 1073 (4th Cir. 1979) .

(n8)Footnote 8. *Stern*, 603 F.2d at 1079.

(n9)Footnote 9. *Stern*, 603 F.2d at 1080-81. Judge Butzner, dissenting from this case, stated:

I think the passage of a § 7(f) in 1970 provides a fair indication of Congress' implicit intention to recognize the legitimacy of private suits. By enacting § 7(f) Congress dealt with the obligation of investors to abide by margin restrictions against a background of case law that for nearly 20 years had established the right of investors to sue their brokers for violation of these restrictions. Nevertheless, Congress did not expressly proscribe private suits by innocent investors when it passed § 7(f). Nor does the legislative history of § 7(f) refer to any intention to prohibit an implied private cause of action on the part of investors. The inference that can be drawn justifiably from such action was recently illustrated in *Cannon v. University of Chicago*, 441 U.S. 677, 99 S. Ct. 1946, 60 L. Ed.2d 560 (1979) . That case raised the question of whether a private cause of action may be implied under Title IX of the Education Amendments of 1972. Pointing to the similarity between Title IX and Title VI of the Civil Rights Act of 1964 and the well recognized implied private remedy under Title VI, Mr. Justice Stevens said:

It is always appropriate to assume that our elected representatives, like other citizens, know the law; in this case, because of their repeated references to Title VI and its modes of enforcement, we are especially justified in presuming both that those representatives were aware of the prior interpretation of Title IV and that that interpretation reflects their intent with respect to Title IX. *Id.* at 1099-1100. (Footnote omitted)

(n10)Footnote 10. 430 U.S. 1, 97 S.Ct. 926, 51 L. Ed. 2d 124 (1977) .

(n11)Footnote 11. *Stern*, 603 F.2d at 1081, quoting 430 U.S. 1, 37, 97 S. Ct. 926, 947, 51 L. Ed.2d 124, 151 (1977) .

(n12)Footnote 12. *Stern*, 603 F.2d at 1092, quoting *Gordon v. duPont Glove Forgan, Inc.*, 487 F.2d 1260, 1263 (5th Cir. 1973) , paraphrasing Judge Friendly's dissent in *Pearlstein v. Scudder & German*, n.2 *supra* at 1148. Judge Butzner's dissent said:

In amici briefs, both the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission, the agencies primarily charged with regulation of the securities market and the nation's resources of credit, have told us that private suits are necessary to effectuate the margin regulations.

Without belaboring this point, it is sufficient to note that no sound reasons have been advanced for doubting this advice. *Id.* at 1100 .

(n13)Footnote 13. 427 F. Supp. 915, 921 (D. Conn. 1977) .

(n14)Footnote 14. 549 F.2d 164, 170 (10th Cir. 1977) . The *Palmer* case was also criticized by *Stern*, n.7 *supra* , for holding that a private right of action was consistent with *Cort v. Ash*, even though it conceded that investor protection was a "byproduct" of the statute's main purpose.

(n15)Footnote 15. *Cooper v. Union Bank*, 354 F. Supp. 669, 682 (C.D. Cal. 1973) rev'd, *Cooper v. Union Bank*, 527 F.2d 762, 766 (9th Cir. 1975) ; *Spoon v. Walston & Co.*, 345 F. Supp. 518, 522 (E.D. Mich. 1972) , aff'd, 478 F.2d 246 (6th Cir. 1973) .

(n16)Footnote 16. 396 U.S. 375, 387 90 S. Ct. 616, 623, 24 L. Ed.2d 593, 603-04 (1970) .

(n17)Footnote 17. See *Bell v. J.D. Winer & Co.*, 392 F. Supp. 646 (S.D.N.Y. 1975) .

(n18)Footnote 18. 776 F.Supp. 1489, 1504 (D. Utah 1991) , aff'd in part and rev'd in part remanded 10 F.3d 1510 (10th Cir. 1993) ; **15 U.S.C. § 1601 et seq.** But see *Golob v. Nauman Vandervoort, Inc.*, 353 F.Supp. 1264 (N.D. Ohio 1972) .

(n19)Footnote 19. See *Shearson, Lehman Bros. Inc. v. M&L Inv.*, 776 F. Supp. 1489 (D. Utah 1991) .

(n20)Footnote 20. See § 3A.02[1][a][ii] *supra*.

(n21)Footnote 21. *Naftalin & Co., Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* 469 F.2d 1166, 1182 (8th Cir. 1972) .

(n22)Footnote 22. See § 3A.02[1][a][ii] *supra*.

(n23)Footnote 23. Rule 15c3-3(n).

(n24)Footnote 24. 96 Misc.2d 1040, 1050 (N.Y. Sup. Ct. 1978) . See also *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Jordan, Fed. Sec. L. Rep. (CCH) P 96,856* (N.Y. Sup. Ct. 1979). One case has held that a customer could not recover the profit his broker made when the broker had to buy-in the customer's transaction. The customer breached his contract with the broker and violated Regulation T by selling securities without informing his broker that he did not own such securities. Thus, the customer could not be granted affirmative relief. *Jeremias v. Shearson Hayden Stone, Inc.*, 420 N.Y.S.2d 881, 882 (N.Y. App. Div. 1979) .

(n25)Footnote 25. See § 3A.02[1][a][ii] *supra*.

(n26)Footnote 26. The broker may also keep any profit he makes from selling out the account. See § 3A.02 *supra*.



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CHAPTER 4 Exchange Act Registration and Reporting Requirements

1-4 Federal Securities Exchange Act of 1934 4.syn

AUTHOR: Brandon C. Parris, Andrew D. Thorpe

§ 4.syn Synopsis to Chapter 4: Exchange Act Registration and Reporting Requirements

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§ 4.01 Registration of Securities Under the Securities Exchange Act of 1934

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[2] Registration of Unlisted Equity Securities -- Section 12(g)

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[iii] Asset Requirements.

[iv] Exemptions.

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FOOTNOTES:

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CHAPTER 4 Exchange Act Registration and Reporting Requirements

1-4 Federal Securities Exchange Act of 1934

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SUMMARY OF THIS CHAPTER

Section 12 of the Exchange Act of 1934, as amended (the "Exchange Act"), calls for registration under the Exchange Act of one or more classes of an issuer's securities which meet the requirements of Section 12(b) or Section 12(g). A nonexempt security cannot be traded on a national securities exchange until it is registered under Section 12(b). If the security meets the listing requirements of the particular exchange, the issuer may register it on the exchange by filing with the Securities and Exchange Commission (the "Commission" or "SEC") and the exchange a registration statement that discloses pertinent information about the issuer and its affairs.

Unless an exemption is available, Section 12(g) requires an issuer to register any class of unlisted or "over-the-counter" equity securities with the Commission if the issuer is engaged in interstate commerce and meets specified asset and stockholder criteria. Section 12(g)(1) permits voluntary registration of any equity security by its issuer.

Upon registration of any class of its securities under Section 12(b) or Section 12(g), the issuer becomes subject to the periodic reporting requirements of the Exchange Act. In the case of a registered class of equity securities, the issuer also becomes subject to the Exchange Act's proxy statement and tender offer rules in addition to the tender offer rules that apply to all securities, and its significant stockholders and insiders also become subject to the beneficial ownership reporting requirements of Section 13(d) of the Exchange Act and the reporting and short-swing liability of Section 16 of the Exchange Act.

Form 10 is the general form for both registration of securities for listing on a national securities exchange under Section 12(b) and registration of unlisted or "over-the-counter" securities under Section 12(g). The form directs the registrant to Regulation S-K and Regulation S-X for the content requirements of the various items of information, documents, and financial statements which are to be included in the registration statement.

Form 8-A is a simplified form for the registration of securities by certain issuers that are already required to file periodic reports under Section 13 or Section 15(d) of the Exchange Act, or that are registering the securities concurrently with an offering of securities registered under the Securities Act of 1933, as amended (the "Securities Act"), including in

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connection with initial public offerings.

A security listed on an exchange may be admitted to unlisted trading privileges on another exchange upon application to the Commission by the other exchange pursuant to Section 12(f).

A security listed on an exchange is subject to suspension or withdrawal. The Commission may suspend or strike the registration of a security on an exchange if after a hearing it finds such action necessary or appropriate for the protection of investors. The issuer may file an application for withdrawal of its security from listing and registration on an exchange in accordance with the rules of the exchange. See § 4.01 *infra*.

Section 13 requires issuers of securities registered under Sections 12(b) and (g) to file periodic and current reports to keep current the information contained in the original Exchange Act registration application or statement. Similar reports are required under Section 15(d) of certain issuers not subject to Section 13 but whose registration statements under the Securities Act have become effective. An issuer complies with the periodic reporting requirements by filing current, quarterly, and annual reports with the Commission. Form 10-K is the general form for filing annual reports under Section 13 or 15(d), except where a specific form is prescribed, and contains a basic information package to investors including audited financial statements of the issuer. Form 10-Q is the form for filing quarterly reports under Section 13 or 15(d) and must be filed for each of the first three fiscal quarters of each fiscal year of the issuer. Current reports are required to be filed on Form 8-K after the occurrence specified events required to be reported. See § 4.02 *infra*.

Regulation S-K contains the disclosure requirements for the majority of documents filed with the Commission under the Securities Act and the Exchange Act. Regulation S-K requires registrants, in the preparation of registration statements, periodic reports, and proxy or information statements, to present all substantive disclosure requirements in accordance with the provisions of the applicable items of the Regulation. Regulation S-K is divided into ten major sections: general, business, securities of the registrant, financial information, management and certain security holders, registration statement and prospectus provisions, exhibits, miscellaneous, list of industry guides, and roll-up transactions. See § 4.03 *infra*.

Rule 3b-6 under the Exchange Act contains a limited safe harbor for forward-looking statements in filings with the Commission and annual reports to stockholders. The Private Securities Litigation Reform Act of 1995 creates a statutory safe harbor for forward-looking statements. The two-pronged safe harbor protects forward-looking written or oral statements from liability if they are identified as forward-looking statements and accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ from those projected. The second prong of the safe harbor protects forward-looking statements if the person or business entity making the statement did not have actual knowledge that it was false or misleading. See § 4.04 *infra*.

All domestic registrants filing reports with the Commission are required to make, with limited exceptions, their Securities Act and Exchange Act filings electronically through the Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system and most filings made by foreign registrants are required to be filed electronically. See § 4.05 *infra*.



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CHAPTER 4 Exchange Act Registration and Reporting Requirements

1-4 Federal Securities Exchange Act of 1934 § 4.01

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§ 4.01 Registration of Securities Under the Securities Exchange Act of 1934

Section 12 of the Exchange Act generally requires registration with the Commission of:

- any security (equity or debt) listed for trading on a national securities exchange, n1 and
- any equity security of an issuer traded in the over-the-counter ("OTC") market if such issuer is engaged in interstate commerce, has total assets in excess of \$1 million, and the class of equity security is held of record by 500 or more persons. n2

Section 12 calls for registration of classes of securities, as opposed to registration of a fixed amount of securities offered to the public, which is required under the Securities Act. Registration, once effective, covers not only all outstanding shares of the class so registered, but additional securities of the same class upon issuance. This contrasts to the approach under the Securities Act in which the registration requirements apply to a discrete number or dollar amount of securities related to a particular transaction or transactions. As opposed to the transaction-oriented focus of registration under the Securities Act, Exchange Act registration begins the process of continuing periodic disclosures of information from the registrant to its stockholders and the securities marketplace.

The registration requirements do not apply to "exempted securities," n3 as defined in Section 3(a)(12), or to other securities exempted by rules and regulations promulgated by the Commission. As in the case of the Securities Act, the terms "security" and "equity security" are broadly defined. n4

The general form for registration on a national securities exchange n5 of any security pursuant to Section 12(b) and of any unlisted equity security pursuant to Section 12(g) is Form 10. n6 If the issuer is already subject to the issuer reporting requirements of Exchange Act Section 13 or 15(d), or is currently registering a class of securities under the Securities Act in connection with the issuer's initial public offering, Form 8-A, n7 a simplified form incorporating much of the required information by reference, may be used.

In January 2006, the SEC approved the registration of The NASDAQ Stock Market LLC as a national securities

exchange. n8 In October 2008, the parent company of the New York Stock Exchange acquired the American Stock Exchange LLC. In connection with the acquisition, the American Stock Exchange was renamed "NYSE Amex."

Registration of a class of securities under either Section 12(b) or 12(g) subjects the issuer to the Section 13 requirement that the issuer file annual, quarterly, and current reports n9 with the Commission and with the securities exchange on which the security is listed. n10 In addition, in the case of a registered equity security, the issuer becomes subject to (1) the proxy solicitation, proxy statement, and information statement requirements of Section 14 n11 and (2) the rules relating to tender offers and "going private" transactions by the issuer and its affiliates. Additionally, upon effectiveness of registration, beneficial owners of five percent or more of a class of registered equity securities become subject to the beneficial ownership disclosure requirements under Section 13(d) of the Exchange Act, n12 and the directors and executive officers of the issuer, and any beneficial owner of more than ten percent of registered equity securities, become subject to the "insider" reporting requirements concerning holdings of, and transactions in, equity securities of the issuer and to civil liability for "short-swing" (less than six months) trading in any of the issuer's equity securities. n13 Exchange Act Release No. 42,054, Fed. Sec. L. Rep. (CCH) P 86,214 (1999).

[1] Registration of Listed Securities--Section 12(b)

A security (other than an exempted security) may not be traded on a national securities exchange unless it has been registered in the manner prescribed by Section 12(b) of the Exchange Act, with certain exceptions concerning unlisted trading privileges. n14 To register a security on a national securities exchange, the issuer must file a registration statement n15 with the exchange and the Commission. The exchange itself will also require the issuer to: submit a listing application containing information beyond that called for in the registration form; n16 enter into a listing agreement under which it agrees to abide by a stated code of conduct; n17 and pay required fees.

Registration under Section 12(b) becomes effective upon receipt by the Commission of certification from the national securities exchange or the filing of the Form 8-A with the Commission, if the class of securities is not being currently registered under the Securities Act, or upon the later of the filing of the Form 8-A with the Commission, receipt by the Commission of certification from the national securities exchange or effectiveness of the Securities Act registration statement relating thereto, if the class of securities is being concurrently registered under the Securities Act. n18

Since an application for registration of a security on an exchange pursuant to Section 12(b) covers the entire class of the security, registration becomes effective as to the shares or amounts then issued and, without further application for registration, upon issuance as to additional shares or amounts then or thereafter authorized. n19 However, if a class of securities is issuable in two or more series with different terms, as is frequently the case with preferred stocks, each series will be regarded as a different class for registration purposes. n20 Notwithstanding the fact that the entire class, including subsequently authorized shares or other units, are deemed registered by single registration under Section 12(b), the exchange itself may require approval of an additional listing application and payment of fees for the additional shares or units. n21

The Commission has eliminated the registration requirement under Section 12(b) of the Exchange Act for American Depositary Receipts ("ADRs"), registered on Form F-6 under the Securities Act. The Section 12(b) registration requirements will continue to apply to the class of securities underlying the ADRs. n22

[2] Registration of Unlisted Equity Securities -- Section 12(g)

Section 12(g)(1) n23 of the Exchange Act generally requires registration by an issuer of any unlisted or "over-the-counter" equity security (other than exempted securities) with the Commission within 120 days after the last day of any fiscal year if:

- the issuer has total assets in excess of \$1 million; n24

- the class of equity security is held of record by 500 or more persons; and
- the issuer is engaged in interstate commerce, or in a business affecting interstate commerce, or if its securities are traded by use of the mails or any means of interstate commerce. It is doubtful that many domestic issuers meeting the total assets and number of stockholders tests of Section 12(g)(1) also would not fall within these jurisdictional grounds. n25

Registration becomes effective sixty days after filing a registration statement with the Commission, or such shorter period as the Commission may determine. n26 A registration statement is not deemed "filed" for the purposes of Section 18 of the Exchange Act (civil liability for false or misleading statements) until it becomes effective. n27

[a] Application of Section 12(g)

[i] Number of Stockholders. The minimum of 500 stockholders set forth in Section 12(g)(1) applies to "a class of equity securities." The term "class" includes all securities of an issuer that are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. n28 An "equity security" is defined so broadly that it includes practically anything except a straight nonconvertible debt security. n29 Since Section 12(g) calls for a registration of classes of equity securities, if an issuer has more than 500 holders of preferred stock, but not more than 500 holders of its common stock, the latter need not be registered.

While the Exchange Act does not define the term "held of record," the Commission, pursuant to the authority given in Section 12(g)(5), has defined the term in Rule 12g5-1 as referring to the persons appearing in the corporate stock books, except that a corporation, partnership, trust, or joint holder is counted as one holder, as is a person holding under slightly different names, but who is obviously only one person. n30 Each outstanding unregistered or bearer certificate is considered as being held by a separate holder unless otherwise proved. The holders of voting trust certificates are considered to be holders of the underlying shares. The issuer may rely upon the certification of an unaffiliated voting trustee as to the number of such holders. Redeemable shares of institutions, such as savings and loan or building and loan, homestead association or cooperative banks, issued as qualifying shares at the time of a loan and to be redeemed on repayment are not counted. Where securities are identified on the company's books as being owned by a person acting as custodian pursuant to a number of separate accounts, the securities will be deemed to be "held of record" by each of the separate accounts. n31 Accordingly, if securities are held in "street name" or in "book-entry" form, the registrant must look through the custodian and count each participant of the custodian (e.g., banks, broker-dealers, and other financial intermediaries) as one holder of record. The registrant does not look through the participants (e.g., the broker-dealer) to the individual investor. There is a catchall provision designed to prevent any circumvention of the Exchange Act which provides that beneficial owners will be considered record owners where the issuers know or have reason to know that the form of their record ownership is being used primarily to circumvent Section 12(g) or 15(d) of the Exchange Act. In addition, where the records of security holders have not been maintained in accordance with accepted practice, any additional person who would be identified as a record owner if the records had been properly maintained is included as an owner of record. This provision is aimed at deterring the formation of trusts, holding companies, subsidiaries and similar entities for the principal purpose of avoiding registration. n32

[ii] Deregistration. Registration of an equity security under Section 12(g) may be terminated within ninety days, or such shorter period as may be determined by the Commission, after the issuer certifies to the Commission on Form 15 that:

- the number of record holders of that class of securities is less than 300; or
- the number of record holders of that class of securities is less than 500 and the total assets of the issuer have not exceeded \$10 million on the last day of each of the issuer's three most recent fiscal years.

n33

The Commission may deny termination if it finds after notice and opportunity for hearing that the facts do not support the certification. n34 The Commission may defer termination of registration pending final determination as to whether the application should be denied. The issuer's duty to file reports due under Section 13(a) is suspended immediately upon filing a Form 15, but if the termination is not approved the issuer must file all reports otherwise due during the suspension within sixty days. n35 Any class of securities for which registration has been terminated will again be subject to registration under Section 12(g) if the requirements for registration are met by the issuer on the last day of any fiscal year.

[iii] Asset Requirements. The Commission has defined the term "total assets" n36 to include the total assets shown on the issuer's balance sheet, or the balance sheet of the issuer and its subsidiaries consolidated, whichever is greater determined in accordance with the Commission's accounting Regulation S-X. n37 If the security is a certificate of deposit, voting trust certificate, or other evidence of interest in a similar trust or agreement, the "total assets" of the issuer of the security held under the trust or agreement are deemed to be the "total assets" of the issuer of the certificate or evidence of interest. n38 Special note should be taken that the statute uses the term "total assets" rather than "net assets," since it is possible that an insolvent company may still be subject to the registration requirements if its total assets exceed the assets threshold.

[iv] Exemptions. Rule 12g-1, adopted by the Commission as part of a classification scheme for exempting small issuers from the reporting requirements of the Exchange Act, n39 exempts an issuer from the registration requirements of Section 12(g) until it has total assets of at least \$10 million on the last day of its most recent fiscal year and, if the issuer is a foreign private issuer, the securities are quoted in an automated interdealer quotation system. As discussed earlier, the effect of Rule 12g-1 is to increase for most issuers the "total assets" test of Section 12(g) from \$1 million to \$10 million.

Section 12(g)(2) exempts from the registration requirements Section 12(g) securities listed and registered on a national securities exchange pursuant to Section 12(b); securities issued by a registered investment company (registered pursuant to Section 8 of the Investment Company Act of 1940); securities (other than nonwithdrawable capital) of savings and loans associations and similar institutions supervised and examined by federal or state authorities; n40 securities of certain nonprofit mutual or cooperative organizations (if certain conditions have been met); n41 securities issued by certain religious and charitable organizations; n42 securities of certain cooperative associations; n43 securities of an insurance company (if certain conditions have been met by the company's domiciliary state); n44 and interests or participations in collective trust funds maintained by banks or separate accounts of insurance companies where the interests or participations are issued for specific purposes. n45 Securities of a foreign private issuer are exempt if the issuer, or a governmental official or agency of the issuer's domicile in which it is organized, furnishes the Commission with information made public under the laws of its domicile, filed with a stock exchange, or distributed to stockholders, along with certain additional information. n46

In addition, the Commission has exempted other securities by Rule 12h-1. n47 The Commission has exercised this power to exempt interests in common trust funds and interests in employee stock purchase, stock bonus, profit sharing, pension, retirement, incentive, thrift, savings, and similar plans. The Commission staff has also issued Rule 12h-1 exemptions or granted no-action letter relief (as opposed to exemptions under Section 12(h)) permitting private companies in limited circumstances to forego Section 12(g) registration of nontransferable options or limited partnership interests and other restricted securities held by more than 500 persons until such time as the issuer otherwise becomes a reporting company under the Exchange Act. The staff of the Commission has indicated that it will not recommend enforcement action in certain limited instances where the number of stockholders exceeds 500 persons solely because of holders of employee stock options which are not exercisable. n48 In addition, the Division of Corporation Finance's Compliance and Disclosure Interpretation 116.01 on Exchange Act Sections provides that stock options will be treated as a separate class of equity securities.

The Commission has also granted subsidiaries relief from complying as separate registrants with the information and reporting requirements of Exchange Act Sections 13 and 15(d) when a subsidiary of a reporting company (a) issues registered debt securities guaranteed by the parent or (b) guarantees registered debt securities issued by the parent. n49

As previously mentioned, a security that normally would have been subject to registration under Section 12(g) is exempt from registration if it is registered on a national securities exchange pursuant to Section 12(b), n50 or if issued by a registered investment company. Such security is deemed registered under Section 12(g) without filing an additional registration statement upon termination of the Section 12(b) registration or termination of registration as an investment company if then held of record by 300 or more persons. n51

Where, for the purpose of effecting a succession by merger, consolidation, exchange of securities, or acquisition of assets, equity securities of an issuer not previously registered under Section 12 are issued to the holders of equity securities of another issuer registered under Section 12(b) or 12(g), the class of equity securities so issued is deemed registered under Section 12(b) or 12(g), as applicable, unless, upon consummation of the succession, the class of equity securities is exempt from such registration (other than by Rule 12g3-2, dealing with certain foreign private issuers), or is held of record by less than 300 persons. n52

Similarly, if the acquired issuer was required to register a class of equity securities under Section 12(g) but has not complied therewith, the duty to register is assumed by the successor, unless, upon consummation of the merger or consolidation, the class of equity securities is exempt from such registration (other than by Rule 12g-3(2)) or is held of record by less than 300 persons. n53

Rule 12g-3 was amended in 1997 to include transactions such as the successor of a non-reporting issuer to more than one reporting issuer, either through consolidation into a new entity or a holding company formation. The securities of such successor issuers are deemed automatically registered under Section 12 of the Exchange Act. n54

If the classes of securities issued by each of the predecessor issuers are registered under the same paragraph of Section 12, the class of securities issued by the successor issuer will be deemed registered under the same paragraph of Section 12. If the classes of securities issued by the predecessor issuers each are registered under different paragraphs of Section 12, then the class of securities issued by the successor issuer will be deemed registered under Section 12(g).

[v] Voluntary Registration. Issuers exempt from Section 12(g) registration requirements, n55 or not otherwise subject to registration, may voluntarily register with the Commission. This alternative is provided for in Section 12(g)(1), that provides in part: "Any issuer may register any class of equity security not required to be registered by filing a registration statement pursuant to the provisions of this paragraph."

The decision of an issuer to voluntarily register an equity security under Section 12 may be motivated by such factors as a desire to facilitate sales, pursuant to Rule 144 under the Securities Act, of privately placed securities or securities sold on behalf of "control persons" of the issuer; or, to make the Exchange Act provisions concerning proxy contests, tender offers, and acquisitions by any person holding more than five percent of the registered class applicable to the security, so that, in the case of an internal conflict, such as a proxy contest, the Commission would regulate the conflict. n56

[vi] Foreign Private Issuers. On March 21, 2007, the SEC adopted amendments to the rules governing when a foreign private issuer n57 may deregister its securities under the Exchange Act. These new rules significantly ease the deregistration process.

Generally, a foreign private issuer becomes subject to SEC registration and reporting under the Exchange Act if the issuer has securities listed on a U.S. national securities exchange, offers securities publicly in the U.S., or has more than a specified number of stockholders in the U.S.

Under the prior Exchange Act rules, terminating Exchange Act registration and associated reporting obligations could be a long and complicated process for a foreign private issuer. A foreign private issuer could exit the Exchange Act reporting regime only when its securities are neither listed on any U.S. national securities exchange nor held by more than 300 U.S. residents. To determine whether 300 U.S. residents are stockholders, the foreign private issuer had to look through the record ownership of institutional and nominee holders on a worldwide basis which was often a difficult and costly proposition. Also, the 300-holder threshold was difficult to avoid in today's global securities markets, even for companies that have little U.S. investor interest relative to their overall stockholder base. Furthermore, under the prior rules a foreign private issuer could only suspend, and not terminate, its Exchange Act reporting obligations.

New Exchange Act Rule 12h-6 now permits foreign private issuers to terminate their reporting obligations regarding a class of equity securities based solely on an U.S. average daily trading volume, or ADTV, test. Alternatively, foreign private issuers may continue to rely on a 300 security holder test that is similar to the test under the prior rules.

A foreign private issuer's equity securities are eligible for deregistration if the ADTV of the securities in the U.S. (including off-exchange trading) represents 5% or less of the ADTV of those securities worldwide during the 12 month period ending within 60 days of an application for deregistration. This new benchmark allows a foreign private issuer to terminate its Exchange Act obligations regardless of the number of U.S. residents holding that security.

In order to take advantage of the new ADTV test, a foreign private issuer must wait 12 months from the date that it has either (i) delisted its securities from a U.S. exchange or (ii) terminated a sponsored American Depositary Receipt ("ADR") facility if, during the 12 months preceding the delisting or facility terminate, its U.S. ADTV exceeds 5% of its worldwide ADTV. The waiting period will not apply to issuers that delisted or terminated their ADR programs within the 12 months preceding the adoption of the rules.

As an alternative to the ADTV benchmark and as long as the issuer meets certain other obligations under Rule 12h-6, a foreign private issuer may terminate its Exchange Act reporting obligations regarding a class of equity securities if it has fewer than 300 record holders on a worldwide basis or who are U.S. residents.

The new rules modify the method for determining the number of U.S. resident security holders by allowing issuers to limit their "look-through" inquiries to brokers, banks and other nominees located in the U.S., the issuer's jurisdiction of organization and the jurisdiction of its primary trading market. If after reasonable diligence, the issuer is unable without unreasonable effort to obtain information about the identity and residence of the underlying security holders, the issuer may assume that the security holders reside in the jurisdiction where the nominees have its principal place of business. Issuers may also rely on good faith on data from third-party providers that specialize in collecting security holder information.

A foreign private issuer intending to deregister and terminate its Exchange Act reporting obligations for equity securities must also meeting the following conditions:

- the issuer must have been a reporting company for at least one year, have filed or submitted all required reports during that year and have filed at least one annual report;
- the securities of the issuer must not have been sold in an offering in the U.S. that is registered under the Securities Act of 1933, as amended, during the preceding 12 months, except for certain types of offerings including offerings pursuant to option plans, selling security holder resales, rights offerings and conversions of outstanding securities;
- the issuer must have maintained a listing for at least a year in a non-U.S. jurisdiction that, either alone or together with one other non-U.S. jurisdiction, constitutes the primary trading market for the

subject class of securities; and

- the issuer makes a public announcement of intention to deregister, and files such announcement with the SEC under cover of Form 6-K or as an exhibit to its deregistration on Form 15F (discussed below), on or prior to the date it files with the SEC to do so.

The new rules also permit a foreign private issuer to terminate its Exchange Act reporting obligations with respect to a class of debt security where:

- the issuer has filed or furnished all required reports under the Exchange Act, including at least one Exchange Act annual report; and
- the debt securities are held of record by either fewer than 300 holders on a worldwide basis or fewer than 300 persons residing in the U.S. (using a counting method similar to the one for equity holders described above).

An issuer that succeeds to Exchange Act requirements as a result of a business combination will be able to use the new rules immediately after succession so long as it meets the foreign listing and quantitative standards of Rule 12h-6 itself, and so long as the acquired company met the one-year reporting requirement. However, if such an issuer effected the business combination through its own U.S.-registered offering, a new one-year reporting period would be triggered, so the issuer would not be able to use the successor provision.

The availability of the exemption from Exchange Act registration and reporting under Rule 12g3-2(b) promulgated under the Exchange Act is significantly extended under the new rules. This exemption allows foreign private issuers, regardless of the number of their U.S. stockholders, to avoid Exchange Act registration so long as they are not listed on a U.S. exchange and provide home-market disclosures to the SEC in English (in certain cases in summary form where the source material is not in English).

The new rules allow immediate and automatic use of 12g3-2(b) after deregistration, so long as the issuer publishes English disclosures required under 12g3-2(b) electronically rather than simply furnishing them to the SEC.

In order to deregister its securities, a foreign private issuer is required to file a Form 15F with the SEC certifying that at the date of filing it meets the conditions for terminating its Exchange Act registration and reporting obligations. Filing of the Form 15F automatically suspends an issuer's reporting obligations regarding the class of security in question. If the SEC does not object within 90 days of the filing of the Form 15F, the suspension becomes a permanent termination. If the SEC were to reject the Form 15F, the issuer would have 60 days to file or submit all reports that would have been required had the Form 15F not been filed. The issuer is under no duty to monitor its eligibility for deregistration during the 90-day waiting period, but if it obtains actual knowledge of information that causes it reasonably to believe it was not eligible for deregistration at the time of filing its Form 15F it must withdraw the Form 15F before effectiveness.

An issuer that deregistered under the prior rules is eligible to use Form 15F to terminate its Exchange Act obligations permanently, so long as it does not have any current Exchange Act registration or reporting requirements and meets the 12-month foreign listing requirement that applies to first-time deregistrants on Form 15F.

[3] Form 10--General Form of Registration Statement Under Exchange Act Section 12(b) or 12(g)

Form 10 is the general form for registering a security under the Exchange Act both in the case of registration for listing on a national securities exchange under Section 12(b) and registration of unlisted equity securities under Section 12(g). n58 Reference must be made to Form 10 itself for the specific information requirements.

Prior to preparation of any registration statement or report under the Exchange Act, the person preparing the document should become familiar with Regulation 12B (Rules 12b-1 through 12b-36), which contains rules governing all registration statements under Section 12 and reports under Sections 13 and 15(d) of the Exchange Act. Careful note should be taken of the definitions in Rule 12b-2, which include such essential terms as "affiliate," "associate," "control," "material," "parent," "subsidiary," "voting securities," and others. In addition, Regulation S-T, which governs the preparation and submission of documents in electronic format, should be consulted. Many of the provisions of Regulation 12B relating to the preparation and submission of documentation in paper format are superseded by the provisions of Regulation S-T concerning documents required to be filed in electronic format. n59

[a] Item 1. Business. Item 1 of Form 10 requires a description of the business of the registrant in accordance with the information required by Item 101 of Regulation S-K. n60

[b] Item 1A. Risk Factors. Item 1A of Form 10 requires, under the caption "Risk Factors," a discussion of risk factors as described in Item 503(c) of Regulation S-K.

[c] Item 2. Financial Information. Item 2 of Form 10 requires the selected financial data, the management's discussion and analysis of the financial condition and results of operations of the registrant, and quantitative and qualitative disclosures about market risk, which are called for by Items 301, 303, and 305 of Regulation S-K. n61

[d] Item 3. Properties. Item 3 of Form 10 requires information relating to properties in accordance with the provisions of Item 102 of Regulation S-K. n62

[e] Item 4. Security Ownership of Certain Beneficial Owners and Management. Item 4 of Form 10 requires the information called for by Item 403 of Regulation S-K, relating to the security ownership of certain beneficial owners and management of the registrant. n63

[f] Item 5. Directors and Executive Officers. Item 5 of Form 10 requires the registrant to describe directors and executive officers and include in the description the information required by Item 401 of Regulation S-K. n64

[g] Item 6. Executive Compensation. Item 6 of Form 10 requires a description of remuneration of directors and officers that includes the information required by Item 402 and paragraph(e)(4) of Item 407 of Regulation S-K. n65

[h] Item 7. Certain Relationships and Related Transactions, and Director Independence. Item 7 of Form 10 requires a description of various kinds of relationships and related transactions with the registrant as specified in Item 404 and matters related to director independence as specified in Item 407(a) of Regulation S-K. n66

[i] Item 8. Legal Proceedings. Item 8 of Form 10 requires a description of legal proceedings that must include the information required by Item 103 of Regulation S-K. n67

[j] Item 9. Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters. Item 9 of Form 10 requires information relating to the market for the registrant's common stock and other related matters as specified in Item 201 of Regulation S-K. n68

[k] Item 10. Recent Sales of Unregistered Securities. Item 10 of Form 10 requires information relating to recent sales of the registrant's securities and use of proceeds from sales of registered securities to be furnished in accordance with Item 701 of Regulation S-K. n69

[l] Item 11. Description of Registrant's Securities to Be Registered. Item 11 of Form 10 requires a description of the registrant's securities to be furnished in accordance with the provisions of Item 202 of Regulation S-K. n70

[m] Item 12. Indemnification of Directors and Officers. Item 12 of Form 10 requires that the information regarding indemnification of directors and officers specified in Item 702 of Regulation S-K be furnished. n71

[n] Item 13. Financial Statements and Supplementary Data. Item 13 of Form 10 requires that the financial statements required by Regulation S-X n72 and the supplementary financial information required by Item 302 of Regulation S-K be furnished. n73

[o] Item 14. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure. Item 14 of Form 10 requires that the information specified in Item 304 of Regulation S-K regarding changes in and disagreements with accountants be furnished. n74

[p] Item 15. Financial Statements and Exhibits. Item 15 of Form 10 requires a separate list of all of the financial statements filed as part of the registration statement and also requires that the exhibits called for by Item 601 of Regulation S-K be provided. n75

[4] Form 8-A--Form for Registration of Certain Classes of Securities Pursuant to Section 12(b) or 12(g)

Form 8-A, a simplified form for registration of any class of securities under Exchange Act Section 12(b) or (g), is available to certain issuers required to file reports pursuant to Sections 13 and 15(d) or pursuant to an order exempting the exchange on which the issuer has securities listed from registration as a national securities exchange. n76 Form 8-A can also be used to list a class of securities that is currently being registered under the Securities Act in connection with an issuer's initial public offering, even though it will not be subject to reporting requirements until after the effectiveness of the Securities Act registration. n77 As opposed to Form 10, the Form 8-A requires only a description of securities being registered and exhibits (either filed or incorporated by reference).

The registrant's name, state of incorporation or organization, IRS employer identification number, and the address of its principal executive offices, including zip code must be stated on the Form 8-A. For securities to be registered under Exchange Act Section 12(b), the registrant must furnish the title of each class of those securities and the name of each exchange on which each class is to be registered. Only the title of each class of securities to be registered under Section 12(g) need be given.

All registration statements made on Form 8-A are automatically effective upon the later of filing the Form 8-A, receipt of certification from the exchange, if applicable, and effectiveness of the relevant Securities Act registration statement, if applicable. n78

As in the case of Form 10, n79 the registrant preparing any registration statement on Form 8-A should become familiar with Regulation 12B (Rules 12b-1 through 12b-36) and Regulation S-T which contain rules governing all registration statements under Section 12 and reports under Sections 13 and 15(d) of the Exchange Act. Careful note should be taken of the definitions of essential terms in Rule 12b-2.

[a] Item 1. Description of the Registrant's Securities to be Registered. The registrant must furnish in the Form 8-A registration statement the information concerning capital stock, debt securities, warrants and rights, other securities, market information for securities other than common equity, and ADRs required by Item 202 of Regulation S-K. n80

If a description of the class of securities comparable to that required by the Form 8-A is contained in any other filing with the Commission, the description may be incorporated by reference to such other filing in response to Item 1. n81 If the securities are to be registered on a national securities exchange and the description has not previously been filed with the exchange, copies of the description should be filed with copies of the application filed with the exchange.

[b] Item 2. Exhibits. There must be set forth a list of all exhibits to the registration statement, including those incorporated by reference. If the securities are to be registered on an exchange on which other securities of the registrant are registered or are to be registered pursuant to Exchange Act Section 12(g), copies of all constituent instruments defining the rights of holders of each class of securities, including any contracts or other documents limiting or qualifying such rights, must be filed as exhibits or incorporated by reference.

[5] Unlisted Trading Privileges

Section 12(f)(1) of the Exchange Act permits any national securities exchange, upon application to and approval by the Commission, to extend unlisted trading privileges n82 to the following securities:

- any securities admitted to unlisted trading on a national securities exchange prior to July 1, 1964;
- any security listed and registered on a national securities exchange (except during a specified period during the initial public offering of such security); and
- any security that is otherwise registered pursuant to this section, or that would be required to be so registered except for the exemption relating to certain investment companies and insurance companies traded over-the-counter and registered under Section 12(g) of the Exchange Act, or that would be required to be so registered except for the exemptions from registration provided in Section 12(g)(2)(B) (security issued by an investment company) and in Section 12(g)(2)(G) (securities of certain insurance companies). n83

An exchange may continue to extend unlisted trading privileges only if the exchange and subject security continue to satisfy the requirements for eligibility. n84

[6] Delisting of Securities Registered under Section 12(b)

A listing of a security on a national securities exchange is subject to suspension or withdrawal by the exchange itself in accordance with its rules n85 or by the Commission, upon application of the issuer or exchange. n86 The exchange is required to notify the Commission of any suspension of trading and any restoration of trading. n87 A suspension does not terminate a registration. n88

An application to strike a security from listing and registration must be made to the Commission by the exchange if:

- the security has been paid off;
- the security is to be paid off and the necessary funds have been made available;
- the security has been superseded by another; or
- all rights pertaining to the security have been extinguished. n89

Primary jurisdiction over delisting procedures is vested in the Commission, from which an appeal lies to the appropriate circuit court of appeals. n90

When a company whose securities are listed and registered on an exchange disseminates false corporate information and files misleading reports, the Commission has grounds for issuing an order granting the exchange the right to strike the securities from listing and registration. n91

An exchange rule may call for delisting when a security is listed on another national securities exchange, and the security may be so delisted when listing and registration have become effective on such other exchange, provided that notice of the action is given to the Commission within three days. n92 Other delistings are made by application of the exchange to the Commission and pursuant to a Commission order, which may be after hearing and on terms designed for investor protection. n93

The issuer may file an application for withdrawal of its security from listing and registration on an exchange in accordance with the rules of the exchange. An application to withdraw listing on an exchange will be effective 10 days after Form 25 is filed with the Commission. An application to deregister a class of securities under Section 12(b) will be effective 90 days, or such shorter period as the Commission may determine, after filing with the Commission. n94 The issuer may not withdraw its registration and listing if the Commission overrules an application for confidential treatment of any material required to be reported. n95

The delisting of a class of securities, with the attendant effect of terminating registration of the securities under Section 12(b), may not deregister the security under other provisions of Section 12. Securities whose registration under Section 12(b) is terminated are deemed to be registered under Section 12(g) unless the securities are held by fewer than 300 holders of record. n96 The 1964 amendments to the Exchange Act, which extended the reporting, proxy, and insider trading provisions of the Exchange Act to unlisted securities, n97 would seem to render more or less academic the procedures for delisting by the issuer, unless the issuer fails to qualify for registration under Section 12(g). There is no longer any particular advantage to be gained in withdrawing the listing as far as the reporting, proxy, and insider trading provisions are concerned.

If the Commission finds that the exchange has complied with the exchange's own rules, n98 then the Commission has no power under Exchange Act Section 12(d) flatly to refuse a delisting application, n99 although it may attach such terms as it considers to be necessary for the protection of investors. n100 If the Commission provides for notices to be sent to stockholders, it may refuse the application if the notice is incomplete or misleading. n101

The Commission is authorized to suspend or strike the registration of a security on an exchange if, after notice and opportunity for hearing, it finds such action to be necessary or appropriate for the protection of investors. n102 Such proceedings have resulted in delisting orders. n103

The Commission is also authorized under Section 12(k) of the Exchange Act summarily to suspend trading in any nonexempt security for a period not exceeding ten business days, if necessary or proper in the public interest and for the protection of investors. The suspension is terminated when adequate information or clarification is filed or published. n104

[7] Reporting Requirements Applicable to Non-Registered Companies Under Section 15(d)

Section 15(d) of the Exchange Act requires each issuer that has filed a registration statement which has become effective under the Securities Act to file with the Commission such supplementary and periodic information, documents and reports as may be required pursuant to Section 13 of the Exchange Act.

Under Section 15(d), an issuer filing a registration statement under the Securities Act is required to file all reports under Section 13(a) for the fiscal year in which the registration statement becomes effective. This reporting obligation continues for subsequent fiscal years unless the issuer's reporting obligations under Section 15(d) are suspended. n105 The duty to file under Section 15(d) is automatically suspended if, and so long as, any class of securities is registered pursuant to Section 12 of the Exchange Act. In addition, Exchange Act Rule 12h-3 permits an immediate suspension of the issuer's filing obligations under Section 15(d) upon filing of a Form 15 n106 if the issuer has filed all reports required under Section 13(a) for the shorter of its most recent three fiscal years and the portion of the current year preceding the filing, or the period since the issuer became subject to such reporting obligation. Securities eligible for this suspension are any class of securities held of record by less than 300 persons or by less than 500 record holders of the securities in question and with total assets of \$10 million or less. n107 Although Rule 12h-3(c) provides that it is unavailable for any class of securities for a fiscal year in which a registration statement covering that class of securities became effective under the Securities Act, the Commission staff has granted a number of exceptions, including in cases of aborted offerings or acquisitions of the issuer. n108

The Rule 12h-3 suspension of the duty to report under Section 15(d) is no longer effective if, on the first day of any fiscal year following such suspension, the issuer ceases to meet the eligibility criteria for suspension described above. In that case, the issuer must resume periodic reporting by filing an annual report on Form 10-K for its preceding fiscal year, not later than 120 days after the end of such fiscal year. n109 Although an issuer subject to Section 15(d) is required to file the same reports under Section 13 as issuers having a class of securities registered under Section 12(b) or Section 12(g) of the Exchange Act, an issuer required to file pursuant to Section 15(d) is not subject to provisions of the Exchange Act that are applicable only to Section 12 registered companies, including the proxy solicitation, beneficial ownership and reporting and tender offer provisions of Sections 13 and 14, and the insider reporting and trading prohibitions of Section 16. n110

FOOTNOTES:

(n1)Footnote 1. Section 12(b).

(n2)Footnote 2. Section 12(g). Although Section 12(g)(1) provides for a total asset threshold of \$1 million, the Commission, through its Rule 12g-1 exemption, has raised the total assets test for most corporations from \$1 million to \$10 million. *See* § 4.01[2][a][iv]. Exchange Act Release No. 37,157, Fed. Sec. L. Rep. (CCH) P 85,801 (1996).

The over-the-counter market is discussed in § 2.01[2] *supra*.

(n3)Footnote 3. "Exempted securities" are listed in Section 3(a)(12) and consist principally of direct obligations of federal, state, and local governments or obligations they have guaranteed and obligations of certain instrumentalities of those governments, interests or participations in a single trust fund or a collective trust fund maintained by a bank exclusively for investment of assets contributed by the bank in designated fiduciary capacities and any security arising out of a contract issued by an insurance company if the interest or participation is issued in connection with a stock bonus, pension, profit-sharing, or annuity plan meeting specified requirements of the Internal Revenue Code of 1986, as amended.

The Commission is given the power to make rules and regulations exempting other securities if such exemptions are consistent with both the public interest and the protection of investors. Section 3(a)(12)(v). The Commission has issued Rules 12a-4 through 12a-7 exempting certain exchange-listed securities from registration under the Exchange Act.

Rule 12a-4 under the Exchange Act, reprinted in the Primary Law Sourcebook, Volume B, Section G, exempts, under certain specified conditions, issued or unissued warrants granted to the holders of a security admitted to dealing on a national securities exchange. Rule 12a-5 temporarily exempts substituted or additional securities, under certain circumstances, whenever the holders of a security admitted to trading on a national securities exchange obtain the right to acquire substituted or additional securities. Rule 12a-6 exempts any underlying security, *i.e.*, one that relates to or is the subject of an option, if the three conditions in Rule 12a-6(b)(1)-(3) are met. Rule 12a-7 exempts the components of certain standardized market baskets, solely for the purpose of inclusion in such basket, if the conditions are met. Section 12(f)(1) concerns the continuation and extension of unlisted trading privileges. *See* § 4.01[5] *infra*. The Rules under the

Exchange Act are reprinted in Primary Law Sourcebook, Volume B, Section G *infra*.

For exemptions from Section 12(g) registration requirements, see § 4.01[2][a][iv] *infra*. Under Rule 3a12-7 any over-the-counter options on government securities traded exclusively otherwise than on a national securities exchange and for which quotations are not disseminated through an automated quotation system are exempt securities pursuant to Section 3(a)(12) of the Exchange Act, provided that the underlying securities represent an obligation equal to or exceeding \$250,000 principal amount. See Exchange Act Release No. 20,625, Fed. Sec. L. Rep. (CCH) P 83,488 (1984).

(n4)Footnote 4. Exchange Act Section 3(a)(10) provides:

The term "security" means any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof) or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

Exchange Act Section 3(a)(11) provides:

The term "equity security" means any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of a similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

Rule 3a11-1 provides:

The term "equity security" is hereby defined to include any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; any security future on any such security; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any put, call, straddle, or other option or privilege of buying such a security from or selling such a security to another without being bound to do so.

(n5)Footnote 5. "National securities exchange" means an exchange registered with the Commission pursuant to Exchange Act Section 6(a). Registration of exchanges as national securities exchanges is discussed in § 2.02 *supra*.

Certain exchanges may be exempted from registration by means of the provisions of Section 5 of the Exchange Act,

which permit exemption by the Commission based upon the limited volume of transactions on the exchange.

(n6)Footnote 6. *See § 4.01[3] infra* for discussion of the information required by Form 10 under the Exchange Act, reprinted in the Primary Law Sourcebook, Volume B, Section H.

(n7)Footnote 7. *See § 4.01[4] infra* for discussion of the information required by Form 8-A.

(n8)Footnote 8. Release No. 34-53128 (January 2006)

(n9)Footnote 9. *See § 4.02 infra*. As result of the adoption of the multijurisdictional disclosure system within Canada, certain Canadian companies may use their home disclosure documents to satisfy the Commission's periodic disclosure requirements and tender offer regulations. Exchange Act Release No. 29,354, Fed. Sec. L. Rep. (CCH) P 84,812 (1991).

(n10)Footnote 10. Many exchanges do not require listed issuers to file reports with the exchanges if they are filed with the Commission and available on EDGAR.

(n11)Footnote 11. *See ch.7 infra*.

(n12)Footnote 12. *See* Exchange Act Release No. 39,538, Fed. Sec. L. Rep. (CCH) P 86,002 (1998).

(n13)Footnote 13. *See ch.8 infra*. Securities registered under Section 12 are also subject to the margin requirements of Section 7 of the Exchange Act. *See ch.3A supra*. Securities of a "foreign private issuer" (as defined in Rule 3b-4(c) under the Exchange Act) are exempted from the Exchange Act's proxy rules and the reporting and short-swing liability provisions of Section 16. *See* Rule 3a12-3.

Rule 3a12-11 exempts debt securities registered under Section 12(b) of the Exchange Act from Section 8(a)'s restrictions on borrowing by broker-dealers and from most of the proxy and information statement rules under Regulation 14A. *See Exchange Act Release No. 34,922, Fed. Sec. L. Rep. (CCH) P 85,450 (1994)*. Prior to Rule 3a12-11, debt securities registered under Section 12(b) were subject to Section 8(a)'s restrictions on borrowing and all of the proxy and information requirements of Section 14. In contrast, debt securities traded in the over-the-counter market are not required to be registered under the Exchange Act and are therefore not subject to the restrictions on borrowing or proxy statement and information statement regulation. Although Rule 3a12-11 has the effect of eliminating most of these distinctions between debt securities listed on a national securities exchange and over-the-counter traded debt securities, exchange listed debt securities remain subject to the antifraud proscriptions of Regulation 14A (Rules 14a-9 and 14c-6) and Regulations 14A's rules governing the transmission to beneficial owners of proxy and consent materials and information statements (Rules 14a-13, 14b-1, 14b-2 and 14c-7).

The Commission has also adopted exemptive rules intended to encourage issuers and bidders to extend tender and exchange offers, rights offerings, and business combinations to the U.S. security holder of foreign private issuers. The exemptions relieve tender offers relating to foreign private issuers from most provisions of the Exchange Act and certain provisions of the Securities Act. Exchange Act Release No. 42,054, Fed. Sec. L. Rep. (CCH) P 86,214 (1999).

(n14)Footnote 14. A security that is listed on an exchange may be admitted to unlisted trading privileges on another exchange upon application to the Commission by the other exchange pursuant to Section 12(f), *see § 4.01[5] infra*. *See also* NYSE Amex Company Guide § 950, regarding the difference between listed and unlisted trading privileges.

Unlisted trading privileges may, however, be sought by a regional exchange in order to permit their members to trade in a security listed on another exchange, such as one of the New York exchanges. Although companies having securities admitted to unlisted trading privileges on the NYSE Amex are not subject to any listing agreements with the NYSE Amex, "the Exchange expects both listed and unlisted companies to adhere to high standards in the conduct of their

businesses and the relations with their stockholders." NYSE Amex Company Guide § 950.

(n15)Footnote 15. The registration statement must include the information concerning the issuer and its controlling or controlled persons specified in Section 12(b)(1), the issuer's articles, bylaws and other documents described in Section 12(b)(2), and the material contracts described in Section 12(b)(3) of the Exchange Act. In connection with Nasdaq's change of status from an automated inter-dealer quotation service to a national securities exchange, effective as of August 1, 2006, all Nasdaq-listed companies that had previously been registered with the SEC under Section 12(g) of the Exchange Act are now automatically registered pursuant to Section 12(b). *See n.x, infra.*

(n16)Footnote 16. In general, a company applying for initial listing on the NYSE Amex, other than member corporations or foreign issuers, must satisfy one of four listing standards or an alternative listing standard to apply for listing.

The four alternative listing standards require a minimum public distribution of 500,000 unaffiliated shares and a minimum of 800 public holders; or a minimum public distribution of 1 million shares, a minimum of 400 public holders; or a minimum public distribution of 500,000 shares, a minimum of 400 public holders, and an average daily volume of 2,000 shares for the six months preceding the date of application as well as:

Alternative One

1. stockholders' equity of at least \$4 million;
2. pretax income of at least \$750,000 in its last fiscal year, or in two of its last three fiscal years; and
3. an aggregate minimum market value for publicly-held shares of \$3 million with a minimum market price of \$3 per share for a reasonable period prior to filing the listing application.

Alternative Two

1. two years of operations;
2. stockholders' equity of at least \$4 million;
3. aggregate market value of publicly held shares of \$15 million; and
4. minimum market price of \$3 per share.

Alternative Three

1. stockholders' equity of at least \$4 million;
2. total value of market capitalization of \$50 million;
3. aggregate market value of publicly held shares of \$15 million; and
4. minimum market price of \$2 per share.

Alternative Four

1. total value of market capitalization of \$75 million; or total assets and total revenue of \$75 million each in its last

fiscal year, or in two if its last three fiscal years;

2. aggregate market value of publicly held shares of \$20 million; and

3. minimum market price of \$3 per share.

Alternative Listing Standards

Certain issuers that do not satisfy any of the above listing standards may be eligible for initial listing pursuant to the appeal procedure, which requires the satisfaction of a minimum numerical Alternative Listings Standard and consideration of the following factors:

1. the nature of the applicant's business and market for its products;

2. the reputation of management;

3. the historical record and pattern of growth; and

4. the financial integrity, demonstrated earning power and future outlook.

Domestic listing requirements on the NYSE call for minimum distribution of a company's shares within the U.S. as well as minimum financial criteria. In general, there are four alternatives for listing on the NYSE:

The four alternative listing standards require a minimum distribution and size criteria of at least 400 U.S. round-lot holders; at least 1,100,000 public shares outstanding; and a market value of public shares of at least \$60 million for IPOs (and \$100 million for other listings). All issuers must have a \$4 stock price at the time of listing.

Financial Criteria

Must meet 1 of the following standards:

Alternative #1 -- Earnings Test

Aggregate pre-tax income for the last 3 years of \$10 million
Minimum in each of the 2 most recent years
of \$2 million
Third year must be positive

OR

Aggregate pre-tax income for the last 3 years of \$12 million
Minimum in the most recent year of \$5 million
Minimum in the next most recent year of \$2 million

Alternative #2a -- Valuation with Cash Flow

Global Market Capitalization of \$500 million
Revenues (most recent 12-month period) of \$100 million
Adjusted Cash Flow:

Aggregate for the last 3 years of \$25 million

All 3 years must be positive

1-4 Federal Securities Exchange Act of 1934 § 4.01

Alternative #2b -- Pure Valuation with Revenues

Global Market Capitalization of \$750 million Revenues (most recent fiscal year) of \$75 million

Alternative #3 -- Affiliated Company

For new entities with a parent or affiliated company listed on the NYSE

Global Market Capitalization of \$500 million Operating History of 12 months Parent or affiliate is a listed company in good standing Company's parent or affiliated company retains control of the entity or is under common control with the entity

Alternative #4 -- Assets and Equity

Global Market Capitalization of \$150 million Total Assets of \$75 million Stockholders' Equity of \$50 million

On January 13, 2006, the SEC approved Nasdaq's application to register The NASDAQ Stock Market as a "national securities exchange" under Section 6 of the 1934 Act. Previously, Nasdaq was considered an automated inter-dealer quotation system of a national securities association registered pursuant to Section 15A of the 1934 Act. In connection with becoming a national securities exchange, Nasdaq changed the names of the NASDAQ National Market to the "NASDAQ Global Market" and the name of the NASDAQ Small Cap Market to the "NASDAQ Capital Market." Nasdaq has also created a new top tier market classification called the "NASDAQ Global Select Market." Nasdaq's transition to a national securities exchange became effective August 1, 2006, and covers both the NASDAQ National Market and the NASDAQ Capital Market.

NASDAQ Global Select Market initial listing requires satisfying the specific financial and liquidity requirements. All listing standards require a high standard of corporate governance, as outlined in the NASDAQ Marketplace Rules. Companies must meet one of three standards of financial requirements.

Standard One

1. Aggregate pre-tax earning in prior three fiscal years of \$11 million, pre-tax earnings in each of the two most recent fiscal years of \$2.2 million and pre-tax earnings in each of the prior three fiscal years at or greater than \$0.

2. Bid price of \$4.00 per share.

3. At least three or four registered and active market makers.

Standard Two

1. Aggregate cash flow in prior three fiscal years of \$27.5 million and cash flow at or greater than \$0 in each of the prior three fiscal years.

2. Average market capitalization of \$550 million over the prior twelve months.

3. Revenue for the previous fiscal year of \$110 million.

4. Bid price of \$4.00 per share.

5. At least three or four registered and active market makers.

Standard Three

1. Average market capitalization of \$850 million over the prior twelve months.
2. Revenue for the previous fiscal year of \$90 million.
3. Bid price of \$4.00 per share.
4. At least three or four registered and active market makers.

New company listings must also satisfy the appropriate liquidity requirements:

Initial public offerings and spin-off companies and affiliated companies (companies affiliated with another company listed on The NASDAQ Global Select Market) are required to have 2,200 beneficial stockholders (450 for affiliated companies); 1.25 million publicly held shares; and either a market value of publicly held shares or a market value of publicly held shares and stockholders' equity of \$70 million. Companies emerging from bankruptcy are required to have 450 beneficial stockholders; 1.25 million publicly held shares; and a market value of publicly held shares at \$110 million or both market value of publicly held shares at \$100 million and stockholders' equity at \$110 million.

NASDAQ Global Market companies must satisfy all requirements of one of three initial listing financial standards. All listing standards require a high standard of corporate governance, as outlined in the NASDAQ Marketplace Rules.

Standard One

1. Stockholders' equity of \$15 million.
2. Income from continuing operations before income tax (in latest fiscal year or in 2 of 3 fiscal years) of \$1 million.
3. 1.1 million publicly held shares.
4. Market value of publicly held shares of \$8 million.
5. Bid price of \$4.00 per share.
6. At least 400 stockholders.
7. At least three registered and active market makers.

Standard Two

1. Stockholders' equity of \$30 million.
2. 1.1 million publicly held shares.
3. Market value of publicly held shares of \$18 million.
4. Bid price of \$4.00 per share.

1-4 Federal Securities Exchange Act of 1934 § 4.01

5. At least 400 stockholders.
6. At least three registered and active market makers.
7. At least two years of operating history.

Standard Three

1. Market value of listed securities of \$75 million; or both \$75 million in total assets and \$75 million in total revenue.
2. 1.1 million publicly held shares.
3. Market value of publicly held shares of \$20 million.
4. Bid price of \$4.00 per share.
5. At least 400 stockholders.
6. At least four registered and active market makers.

NASDAQ Capital Market companies must satisfy the following initial listing requirements (as well as a high standard of corporate governance):

Standard One

1. Stockholders equity of \$5 million and a market value of publicly held shares of \$15 million.
2. 1.0 million publicly held shares.
3. Bid price of \$4 per share.
4. At least 300 stockholders.
5. At least three registered and active market makers.
6. Two years of operating history.

Standard Two

1. Stockholders' equity of \$4 million and a market value of publicly held shares of \$15 million.
2. Market value of listed securities of \$50 million.
3. Minimum bid price of \$4.00 per share.
4. 1.0 million publicly held shares.
5. At least 300 stockholders.
6. At least three registered and active market makers.

Standard Three

1. Stockholders' equity of \$4 million and a market value of publicly held shares of \$5 million.
2. Net income from continuing operations (in the latest fiscal year or in two of the last three fiscal years) of \$750,000.
3. Minimum bid price of \$4.00 per share.
4. 1.0 million publicly held shares.
5. At least 300 stockholders.
6. At least three registered and active market makers.

(n17)Footnote 17. The current forms of listing agreements of the New York Stock Exchange are found in Section 901 of its Listed Company Manual or at its website: <http://www.nyse.com>. The various listing agreements of the NYSE Amex are found in the NYSE Amex Company Guide, Appendix 1 or at its website: <http://www.nyse.com>.

(n18)Footnote 18. Section 12(d); Rules 12d-13 and 12d-14. See *Exchange Act Release No. 38,850, Fed. Sec. L. Rep. (CCH) P 85,953 (1997)*.

(n19)Footnote 19. Rule 12d1-1(a) (2) under the Exchange Act, reprinted in the Primary Law Sourcebook, Volume B, Section G.

(n20)Footnote 20. Rule 12d1-1(d).

(n21)Footnote 21. Rule 12d1-1(c); New York Stock Exchange Listed Company Manual Section 703.00; NYSE Amex Company Guide §§ 301, *et seq.*

(n22)Footnote 22. Exchange Act Release No. 38,850, Fed. Sec. L. Rep. (CCH) P 85,953 (1997).

(n23)Footnote 23. Until 1964, equity securities which were not listed on a national securities exchange were not required to be registered under the Exchange Act. The Securities Acts Amendments of 1964 added Section 12(g) to the Exchange Act, requiring registration of "over-the-counter" equity securities. The Senate Report explained the basis of the provision thus:

There is no convincing reason why the comprehensive scheme of disclosure that affords protection to investors in the exchange markets should not also apply in the over-the-counter market. Nothing in the nature of the securities traded in that market make any less necessary the disclosure of basic information. On the contrary, because the over-the-counter market includes not only securities of widely known and seasoned companies but also those of relatively unknown and insubstantial ones, the need of investors for accurate information is at least as great, if not greater than in the exchange markets. ... Moreover, the disparity between the disclosure requirements of the exchanges and the over-the-counter markets itself stands as an undesirable artificial factor in the allocation of securities between the two markets. ... The public should not be asked to buy and sell in darkness. ...

S. Rep. No. 379, 88th Cong., 1st Sess. 910 (1963) reprinted in the Primary Law Sourcebook, Volume C, Section I. The over-the-counter market is discussed in § 2.04 *supra*.

The Securities Acts Amendments of 1975 amended Section 12(f) of the Exchange Act to permit exchanges to begin

unlisted trading in any securities that are registered under Section 12(g).

(n24)Footnote 24. *See* n.2 *supra*. The Commission, through its Rule 12g-1 exemption, has effectively raised the total assets test to \$10 million for most issuers. *See* § 4.01[2][a][iv] *infra*.

(n25)Footnote 25. The Securities Acts Amendments of 1975 amended the definition of "interstate commerce" in Section 3(a)(17) of the Exchange Act to include intrastate use of any facility of a national securities exchange or of a telephone or other interstate means of communication, or any other interstate instrumentality.

(n26)Footnote 26. Section 12(g)(1) of the Exchange Act, reprinted in the Primary Law Sourcebook, Volume B, Section F. While the Commission has not adopted any similar statement of policy applicable to Section 12(g) companies, it is probable that it would apply the policy (so far as pertinent) set out in Exchange Act Release No. 3,085, *Fed. Sec. L. Rep. (CCH) P 23,081* (1941).

(n27)Footnote 27. Section 12(g)(1).

(n28)Footnote 28. Section 12(g)(5).

(n29)Footnote 29. *See* n.4 *supra* for the broad definitions of "equity security" contained in Exchange Act Section 3(a)(11) and Rule 3a11-1.

(n30)Footnote 30. However, if the corporate stock books show the securities as being held by the same person but in different capacities (*e.g.*, as an individual in one case and as a joint tenant in another), the securities will be deemed to be "held of record" by the number of separate stockholder registrations. *See* *Techne Corporation* (available Sept. 20, 1988).

(n31)Footnote 31. *Id.*

(n32)Footnote 32. Rule 12g5-1 under the Exchange Act, reprinted in the Primary Law Sourcebook, Volume B, Section G. *See also* *Tankersley v. Albright*, 514 F.2d 956 (7th Cir. 1975) .

(n33)Footnote 33. Rule 12g-4. If the issuer has merged into, or consolidated with another issuer or issuers, the form must be filed by the successor issuer. Rule 12g-4(b).

(n34)Footnote 34. Section 12(g)(4).

(n35)Footnote 35. *Id.*, Rule 12g-4.

(n36)Footnote 36. Rule 12g5-2.

(n37)Footnote 37. *Id.* Regulation S-X is codified at 17 C.F.R. Part 210.

(n38)Footnote 38. Rule 12g5-2.

(n39)Footnote 39. *Exchange Act Release No. 18,647, Fed. Sec. L. Rep. (CCH) P 83,204* (1982). *See also* *Exchange Act Release No. 35,895, Fed. Sec. L. Rep. (CCH) P 85,637* (1995).

(n40)Footnote 40. Section 12(g)(2)(C). While banks are not exempt from the securities laws, the enforcement of Sections 12, 13, 14(a), 14(c), 14(d), 14(f), and 16 is vested in the Comptroller of the Currency with respect to national banks, the Federal Reserve Board as to member banks in the Federal Reserve System, and the Federal Deposit Insurance Corporation as to all other insured banks. Section 12(i). Banks that are subject to the Exchange Act's reporting requirements submit their reports to the appropriate banking authority, not the Commission.

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(n41)Footnote 41. Section 12(g)(2)(F). Securities of nonprofit mutual or cooperative organizations are exempted only if they are part of a class issuable only to members who purchase commodities or services from the issuer, the securities are transferable only to a successor in interest or occupancy of premises serviced or to be serviced by the issuer, and no dividends are payable to holders of such securities. *Id.*

(n42)Footnote 42. Section 12(g)(2)(D).

(n43)Footnote 43. Section 12(g)(2)(E).

(n44)Footnote 44. Section 12(g)(2)(G). If an insurance company is subject to Section 15(d), discussed in § 4.02 *infra*, it must file reports required by that section. If it has registered a security pursuant to Section 12(b), it remains subject to Sections 13, 14 and 16.

All fifty states, the District of Columbia, and Puerto Rico have statutes or rules which qualify their insurance companies for exemption, *see 3 Fed. Sec. L. Rep. (CCH) P 23,310*. But *see Reserve Life Insurance Co. v. Provident Life Insurance Co.*, 499 F.2d 715 (8th Cir. 1974), where the court held that the § 12(g)(2) exemption for securities issued by an insurance company did not exempt from registration a voting trust holding an insurance company's stock.

(n45)Footnote 45. Section 12(g)(2)(H).

(n46)Footnote 46. *See* Rule 12g3-2.

(n47)Footnote 47. The Rule 12h-1 exemptions from Exchange Act Section 12(g) were issued pursuant to authority granted to the Commission by Exchange Act Section 12(h): "if the Commission finds... that such action is not inconsistent with the public interest or the protection of investors." *See, e.g.*, Exchange Act Release Nos. 29,124 (1991), 29,020 (1991) and 22,904 (1986); *see also* Superior Services Inc. (available March 18, 1994), Montgomery Watson, Inc. (available Nov. 2, 1995), Convenience Store Investments (available October 17, 1995) and Parsons Brinckerhoff Inc. (available June 21, 1995) (based on representations that holders were officers and employees, with no public investors and adequate disclosure).

(n48)Footnote 48. Millennium Pharmaceuticals, Inc. (available May 21, 1998) and General Roofing Services, Inc. (available Apr. 13, 2000).

(n49)Footnote 49. *See* Rule 3-10 of Regulation S-X, adopted in Exchange Act Release No. 43,124. Fed. Sec. L. Rep. P 86,320 (2000). This rule essentially codifies prior no-action letter relief. *Cf.* Staff Accounting Bulletin No. 53, Topic 1G and H; Communications & Power Industries Holding Company (available March 15, 1996); Geotek Communications, Inc. (available Feb. 22, 1996); Career Horizons, Inc. (available Feb. 15, 1996); Aetna Life and Casualty Company (available March 13, 1995) (preferred securities); WymanGordon Company (available May 28, 1993); and Kendal International, Inc. (available July 30, 1993).

(n50)Footnote 50. Section 12(g)(2)(A).

(n51)Footnote 51. Rule 12g-2. NASDAQ-listed companies are required to file for deregistration using both Form 15 and Form 25 (under which companies listed on national securities exchanges file for deregistration). The deregistration process for NASDAQ-listed companies will be similar to the deregistration procedures currently required of companies listed on other national securities exchanges. Note that because all NASDAQ-listed companies previously were registered under Section 12(g) before they were registered under Section 12(b), their Section 12(g) registration, and possibly reporting obligations under Section 15(d), automatically would revive. The termination of either or both would require filing a Form 15. SEC Release No. 34-54240 (July 2006).

(n52)Footnote 52. Rule 12g-3(a).

(n53)Footnote 53. Rule 12g-3(b). If an issuer fails to register an equity security as required by Section 12, the Commission may, after notice and opportunity for hearing, issue an order requiring compliance. If the issuer fails to obey such an order, the Commission may issue a cease and desist order or apply to a federal district court for an injunction compelling the issuer to comply with the order. Sections 21(d) and (e). The Commission may seek any equitable relief that may be appropriate or necessary for the benefit of investors. Civil and criminal penalties could also be imposed in an appropriate case. Section 21(d)(3), Section 21(d)(5) and Section 32(a).

(n54)Footnote 54. *See e.g.*, First Mutual Savings Bank (available October 8, 1999). Note that the Commission has special rules relating to "back-door" registrations. *See* <http://www.otcbb.com/news/EligibilityRule/8Kreg.stm#SECLetter> (letter of Commission dated April 7, 2000).

(n55)Footnote 55. Section 12(g)(2).

(n56)Footnote 56. A company cannot voluntarily withdraw its registration even though the registration was voluntary. Termination of registration depends upon whether the number of stockholders falls below 300 persons. Section 12(g)(4). *See* § 4.01[2][a][ii] *supra*.

(n57)Footnote 57. A "foreign private issuer" is an issuer incorporated or organized under the laws of a non-U.S. jurisdiction that either (i) has 50% or less of its outstanding voting securities held of record by U.S. residents or (ii) has more than 50% of its outstanding voting securities held by U.S. residents and has (a) a majority of its executive officers or directors be non-U.S. citizens or residents; (b) 50% or more of its assets located outside the U.S. and (c) its business administered principally outside the U.S.

(n58)Footnote 58. Form 10, General Instruction A under the Exchange Act, reprinted in the Primary Law Sourcebook, Volume B, Section H. Issuers already subject to the reporting requirements of Sections 13 or 15(d), including those concurrently effecting initial public offerings, may use Form 8-A, a simplified form incorporating much of the required information by reference. *See* § 4.01[4] *infra*.

The prototype of the issuer required to file Form 10 is one which, over the years, through private or exempt intrastate offerings, employee stock plans, and bequests and inheritance, has accumulated the requisite number of stockholders. In addition, Form 10 would be used for issuers whose Exchange Act reporting obligations formerly were terminated because its stockholders dropped below the 300 minimum level but which later attain a 500 stockholder minimum requiring it again to register under Section 12(g).

See § 4.01[2][a][iii] *supra*. Form 10 would also be used by entities that are spun off to the public without registration under the Securities Act.

Foreign private issuers may use Form 20-F to register their securities under the Exchange Act. Certain Canadian issuers may use Form 40-F to register their securities under the Exchange Act. Form 40-F is used as a wraparound for the filing of home jurisdiction documentation that the issuer has made public, filed with a stock exchange, or distributed to security holders. For purposes of Exchange Act registration, Form 40-F requires the issuer to file that part of its home jurisdiction documentation containing a description of the securities being registered. *Exchange Act Release No. 29354, Fed. Sec. L. Rep. (CCH) P 84,812 (1991)*.

For a discussion of voluntary disclosure of projected financial information in filings with the Commission, *see* § 4.04 *infra*.

(n59)Footnote 59. *See* § 4.05 *infra*.

(n60)Footnote 60. Item 101 of Regulation S-K reprinted in the Primary Law Sourcebook, Volume D, Section K is discussed in § 4.03[2][a] *infra*.

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(n61)Footnote 61. Items 301, 303, and 305 of Regulation S-K are discussed in § 4.03[4] *infra*.

(n62)Footnote 62. Item 102 of Regulation S-K is discussed in § 4.03[2] *infra*.

(n63)Footnote 63. Item 403 of Regulation S-K is discussed in § 4.03[5][c] *infra*. For discussion of the determination of beneficial ownership, see § 7A.02[2] *infra*.

(n64)Footnote 64. Item 401 of Regulation S-K is discussed in § 4.03[5][a] *infra*.

(n65)Footnote 65. Item 402 of Regulation S-K is discussed in § 4.03[5][b] *infra*.

(n66)Footnote 66. Item 404 of Regulation S-K is discussed in § 4.03[5][d] *infra* and Item 407(a) is discussed in § 4.03[5][g] *infra*.

(n67)Footnote 67. Item 103 of Regulation S-K is discussed in § 4.03[2][c] *infra*.

(n68)Footnote 68. Item 201 of Regulation S-K is discussed in § 4.03[3][a] *infra*.

(n69)Footnote 69. Item 701 of Regulation S-K is discussed in § 4.03[8][a] *infra*.

(n70)Footnote 70. Item 202 of Regulation S-K is discussed in § 4.03[3][b] *infra*. Issuers are required to provide disclosure about ADRs in their Form 10. See *Exchange Act Release No. 38,850, Fed. Sec. L. Rep. (CCH) P 85,953* (1997).

(n71)Footnote 71. Item 702 of Regulation S-K is discussed in § 4.03[8][b] *infra*.

(n72)Footnote 72. Regulation S-X is discussed in § 4.01[2][a] *infra*.

(n73)Footnote 73. Item 302 of Regulation S-K is discussed in § 4.03[4][b] *infra*.

(n74)Footnote 74. Item 304 of Regulation S-K is discussed in § 4.03[4][d] *infra*.

(n75)Footnote 75. Item 601 of Regulation S-K is discussed in § 4.03[7][a] *infra*.

(n76)Footnote 76. The Commission's Division of Corporate Finance has stated that it will not recommend enforcement action to the Commission for failure to comply with the registration requirements of Section 12(b) of the Exchange Act if issuers register debt securities listed on the New York Stock Exchange using a modified Form 8-A. New York Stock Exchange (available Aug. 12, 1998). The modified Form 8-A may be used only in connection with a debt security of an issuer that has on-going Exchange Act reporting obligations.

(n77)Footnote 77. General Instruction A(a), Form 8-A. Since most issuers that have a class of equity securities held of record by a sufficient number of persons so as to require registration under § 12(g), or to make listing on an exchange worthwhile, will have at some point filed a registration statement under the Securities Act and, as a result, will be required to file reports under Exchange Act § 15(d), Form 8-A will be available for most registrations under Section 12(b) or 12(g) of the Exchange Act. An issuer required to file an annual report under Section 15(d) of the Exchange Act for its last fiscal year must timely file an annual report for that fiscal year pursuant to that section within the period specified in the appropriate annual report form, even if the registration statement on Form 8-A will become effective before the report is required to be filed. General Instruction A(b), Form 8-A.

(n78)Footnote 78. *Exchange Act Release No. 38,850, Fed. Sec. L. Rep. (CCH) P 85,953* (1997). See also, *Exchange Act Release No. 34,922, Fed. Sec. L. Rep. (CCH) P 85,450* (1994) (making certain debt registrations immediately effective). This release also eliminated the \$250 filing fee under Rule 12b-7 for debt securities.

(n79)Footnote 79. Form 10 under the Exchange Act, reprinted in the Primary Law Sourcebook, Volume B, Section H is discussed in § 4.01[3] *supra*.

(n80)Footnote 80. Item 202 of Regulation S-K, "Description of Registrant's Securities" is discussed in § 4.03[3][b] *infra*.

(n81)Footnote 81. Instruction, Item 1, Form 8-A.

(n82)Footnote 82. For the difference between listed and unlisted trading privileges *see* n.13 *supra*.

Prior to the 1975 Amendments, Section 12(f) of the Exchange Act provided that a national securities exchange might, upon application to and approval by the Commission, extend unlisted trading privileges to any security listed and registered on another national securities exchange. The Securities Acts Amendments of 1975 broadened that provision to encompass securities not listed on any other exchange; other textual changes reflected Congressional concern over the impact of unlisted trading on the development of a national market system and clarified that such applications may not be granted if the effect would be to restrict competition.

43 SEC Ann. Rep. 128129 (1977). (Footnote omitted). *See* S. Rep. No. 9475, 94th Cong. 1st Sess. p. 106 (1975); H. R. Rep. No. 94229, 94th Cong. 1st Sess. p. 95 (1975). The Unlisted Trading Privileges Act authorized the Commission to prescribe additional rules regarding unlisted trading privileges. *See Exchange Act Release No. 35,637, Fed. Sec. L. Rep. (CCH) P 85,615 (1995)*.

For discussion of the Nasdaq Stock Market, *see* § 2.05 *supra*.

(n83)Footnote 83. Section 12(f)(1)(A)(ii). *Exchange Act Release No. 29,285, Fed. Sec. L. Rep. (CCH) P 84,809 (1991)* adopted Rule 12a-7 providing an exemption for securities underlying market baskets from registration under Section 12(a).

Management retains the right under Section 12(f)(4) to petition the Commission to suspend unlisted trading privileges if the Commission finds this "necessary or appropriate in the public interest or for the protection of investors." S. Rep. No. 9475, 9th Cong. 1st Sess. p. 19 (1975).

Exchanges have to wait until before extending unlisted trading privileges to any listed initial public offering until second trading day. The rules also require exchanges to have rules and oversight mechanisms in place to ensure fair and orderly markets and the protection of investors with respect to unlisted trading privileges. *Exchange Act Release No. 35,637, Fed. Sec. L. Rep. (CCH) P 85,615 (1995)*. An exchange may extend unlisted trading privileges to a listed initial public offering security when (1) at least one transaction in the security has been effected on the listing exchange and (2) the transaction has been reported under an effective transaction reporting plan. *Exchange Act Release No. 43,217, Fed. Sec. L. Rep. (CCH) P 86,321 (2000)*.

Section 12(f)(1)(E) prohibits extension of unlisted trading privileges in securities that are registered under Section 12(g) of the Exchange Act (OTC securities), except pursuant to a rule, regulation or order of the Commission approving such extension. The Commission's order approving the ongoing pilot program, including all limitations and conditions therein, is deemed such an order. *Exchange Act Release No. 34,371 (1994); Exchange Act Release No. 35,637, Fed. Sec. L. Rep. (CCH) P 85,615 (1995)*.

(n84)Footnote 84. Section 12(f)(1)(F) of the Exchange Act, reprinted in the Primary Law Sourcebook, Volume B, Section F.

(n85)Footnote 85. The rules to be followed are those in effect at the time the delisting application is filed. The regional exchanges generally have no specific rules, but the New York and NYSE Amex Stock Exchanges and Nasdaq set forth criteria used for delisting by the exchange, *See* New York Stock Exchange Listed Company Manual § 8; NYSE Amex Company Guide §§ 1001-1011; Nasdaq Marketplace Rules 5100 et seq. These criteria may be changed at any time. That such a change may have a retroactive effect on the issuer does not invalidate the change. *Atlas Tack Corp. v. New York Stock Exchange*, 246 F.2d 311 (1st Cir. 1957) .

The New York Stock Exchange will normally give consideration to delisting a security of a company when the number of holders of 100 shares or more (or a unit trading if less than 100 shares) is less than 1,200; when the number of publicly held shares becomes less than 600,000 or their average monthly trading volume is less than 100,000 shares for the most recent twelve months; when the total global market capitalization is less than \$50 million; or when for other reasons the New York Stock Exchange believes that further dealings in the security are not advisable.

Other examples under which suspension or delisting may be considered include situations where liquidation of the company has begun or substantially all of the company's assets have been sold. Delisting of a common stock will also be considered if the issuing company has violated its agreements with the exchange, if a class of nonvoting common stock is created (excluding stock which in the opinion of the exchange entitles it to be regarded as preferred stock), or the company's Exchange Act registration or exemption is no longer effective. Other examples are given. *See* Section 802.00 of the New York Stock Exchange Listed Company Manual.

The New York Stock Exchange provides for delisting of a security following receipt of certified board resolutions approving the removal from listing. New York Stock Exchange Listed Company Manual Section 806.00.

The NYSE Amex also provides for application by a company to remove a security from listing on the NYSE Amex. *See* NYSE Amex Company Guide § 1011.

Rules 5815(a)(2), 5815(d)(2), 5820(e)(6) and 5825(d) provide that Nasdaq will delist an issuer in certain circumstances, following Nasdaq's determination that the issuer no longer meets the requirements for continued listing and after the issuer has received notice of that determination and an opportunity to appeal the determination pursuant to the Rule 5800 Series.

Consistent with Exchange Act Rule 12d2-2, to effect a delisting, Nasdaq will provide public notice of its final determination to remove a security from listing by issuing a press release and posting notice on its web site. This public notice will be disseminated no fewer than 10 days before the delisting becomes effective and will remain posted until the delisting is effective. Following such public notification, Nasdaq will file an application on Form 25 with the Commission to delist the security, and will promptly provide a copy of that Form 25 to the issuer. The Form 25, and the delisting of the security, will become effective 10 days after it is filed pursuant to Exchange Act Rule 12d2-2(d)(1), unless the Commission postpones such delisting pursuant to Rule 12d2-2(d)(3). Nasdaq Marketplace Rule 5830.

(n86)Footnote 86. Section 12(d) reads in part as follows:

A security registered with a national securities exchange may be withdrawn or stricken from listing and registration in accordance with the rules of the exchange and, upon such terms as the Commission may deem necessary to impose for the protection of investors, upon application by the issuer or the exchange to the Commission.

Typical reasons for an exchange application are a consummated exchange, a liquidation, an absence of public interest, the disappearance of substantial value, the failure to maintain a transfer agent or registrar, or the failure to file the requisite reports. 25 SEC Ann. Rep. 68 (1959). The statutory procedures are exclusive and a state court has no

jurisdiction to stay the delisting. *Fifth Avenue Coach Lines, Inc. v. New York Stock Exch.*, 270 N.Y.S.2d 852 (App. Div. 1966) .

The action of an exchange in delisting a stock on the basis of its unacceptably low trading price may not be attacked by a stockholder under the antitrust laws. *Harding v. American Stock Exchange*, 527 F.2d 1366 (5th Cir. 1976) . *Harding* is discussed in connection with the effect of antitrust laws upon collective action by an exchange, see § 2.03[3] *supra*.

Allegations that the exchange has not observed due process requirements with respect to the delisting may be raised in an appeal from the Commission's delisting order under Section 25. *Intercontinental Industries, Inc. v. American Stock Exchange*, 452 F.2d 935 (5th Cir. 1971) , *cert. denied*, 409 U.S. 842 (1972) ; *Harding*, 527 F.2d 1366 .

(n87)Footnote 87. Rule 12d2-1 under the Exchange Act, reprinted in the Primary Law Sourcebook, Volume B, Section G.

(n88)Footnote 88. *Id.*

(n89)Footnote 89. Rule 12d2-2(a). The exchange must file with the Commission an application on Form 25 to withdraw the security from listing and registration within a reasonable time after the exchange finds that any of the conditions exist. *Id.* Form 25 is reprinted in the Primary Law Sourcebook, Vol. B, Section H.

(n90)Footnote 90. See *Winkelman v. New York Stock Exchange*, 445 F.2d 786, 790 (3d Cir. 1971) . Appeal from Commission orders under Section 25 is discussed in § 9.02[2][c] *infra*.

(n91)Footnote 91. See *Intercontinental Industries, Inc. (INI) v. American Stock Exchange*, 452 F.2d 935 (5th Cir. 1971) , *cert. denied*, 409 U.S. 842 (1972) .

(n92)Footnote 92. Rule 12d2-2(b).

(n93)Footnote 93. Rule 12d2-2(c). Such applications may be based on a radical change in the operations of the issuer as the result of which it would no longer qualify for listing. *Fifth Ave. Indus. Corp.*, Exchange Act Release No. 7,977, *Fed. Sec. L. Rep. (CCH) P 23,191 .31* (1966). "However, while delisting may have adverse effects on present investors, such effects are outweighed by the protection afforded future purchasers by removing from Exchange trading securities not possessing the applicable qualifications." *Acme Missiles Constr. Corp.*, Exchange Act Release No. 8,161 p. 4 (1967). See also *Fotochrome Inc.*, Exchange Act Release No. 7,985 (1966); *Magic Marker Corp.*, Exchange Act Release No. 8,163, *Fed. Sec. L. Rep. (CCH) P 23,191 .32* (1967).

"Delisting is designed to protect investors by removing from exchange trading securities which if listed, indicate that they 'meet the qualifications which such listings suggest.' " *The Stephens Co.*, Exchange Act Release No. 8,452, *Fed. Sec. L. Rep. (CCH) P 23,191 .22* at p. 3 (1968). The delisting procedure is not so much for the protection of existing stockholders as it is to avoid the inference that the stock complies with the exchange rules. *Langley Corporation*, Exchange Act Release No. 9,729 at p. 3 (1972); *American Electronics, Inc.*, Exchange Act Release No. 8,244 (1968); *Polorad Electronics Corp.*, Exchange Act Release No. 9,419 (1971).

The establishment of named criteria for delisting under a general statement of policy is not exclusive and other criteria may be used. *American Electronics, Inc. supra*.

The fact that the exchange has not taken similar action against other issuers who are in the same position is no defense. *Fotochrome, Inc.*, Exchange Act Release No. 8,013 (1966); *General Contracting Corp.*, Exchange Act Release No. 8,210, *Fed. Sec. L. Rep. (CCH) P 23,191 .32* (1967); *Lee Motor Prods., Inc.*, Exchange Act Release No. 8,672, *Fed. Sec. L. Rep. (CCH) P 23,191 .44* (1969). When a listing is terminated, the company is required to be eligible for an

original listing in order to be reinstated. *F. L. Jacobs & Co.*, Exchange Act Release No. 8,314, *Fed. Sec. L. Rep. (CCH) P 23,191* .31 (1968).

In the absence of fraud, the decision to delist for failure to have a substantial number of stockholders is a matter within the discretion of the directors. *St. Enterprises, Inc. v. American Export Isbrandtsen Co., Inc.*, *Fed. Sec. L. Rep. (CCH) P 92,711* (1970). *See Shawmut Asso. v. SEC*, 146 F.2d 791 (1st Cir. 1945) . *See also Atlas Tack Corp. v. New York Stock Exchange*, 246 F.2d 311, 315 (1st Cir. 1957) :

Section 12(d) expressly provides that a security registered with a national securities exchange may be stricken from listing and registration in accordance with the rules of the exchange and with such terms as the Commission may deem necessary for the protection of investors, upon application by the exchange to the Commission. Thus, it has been held that, in considering applications to delist under Section 12(d), the Commission has two functions to perform:

(1) To determine whether the rules of the exchange, effective at the time the application is filed, have been complied with; and

(2) To determine what terms, if any, are necessary for the protection of investors.

See The Torrington Company, 19 S.E.C. 39 (1945) ; *Fuller Manufacturing Company*, 14 S.E.C. 895 (1943) ; *The Troxel Manufacturing Company*, 9 S.E.C. 665 (1941) ; *National Union Radio Corporation*, 5 S.E.C. 397 (1939) ; *Application of the New York Stock Exchange, etc.*, 5 S.E.C. 449 (1939) . This has been the consistent administrative construction and is in accord with the normal meaning of the statutory language.

(n94)Footnote 94. Rule 12d2-2(d). The SEC has streamlined the procedures for removing from listing, and withdrawing from registration, securities under Section 12(b) of the Exchange Act. The rules adopted in 2005 require all issuers and national securities exchanges seeking to delist and/or deregister a security in accordance with the rules of any exchange and the SEC to file the amended Form 25 in an electronic format with the SEC on the EDGAR database. The rules also provide that the Form 25 serves as an exchange's notice to the SEC under Section 19(d) of the Exchange Act. Rule 12d2-2(c). Previously the issuer completed a paper filing and the SEC issued an order to remove the security from listing or registration on a national securities exchange. The rule also exempts, on a permanent basis, standardized options and security futures products traded on a national securities exchange from Section 12(d) of the Exchange Act. Release No. 34-52029.

Applications by the issuer for withdrawal are fairly infrequent. The usual reason is inordinate expense. *TechHughes Gold Mines. Ltd.*, 3 S.E.C. 462 (1938) ; *Capitol City Prods. Co.*, 5 S.E.C. 721 (1939) .

(n95)Footnote 95. Rule 24b-2(h), that had allowed such withdrawal, was rescinded in *Exchange Act Release No. 11,774*, *Fed. Sec. L. Rep. (CCH) P 80,319* (1975). A new Rule 24b-2 was promulgated in *Exchange Act Release No. 12,386*, *Fed. Sec. L. Rep. (CCH) P 80,481* (1976). The new rule provides that information will be entitled to confidential treatment only if it is exempt from disclosure under the Commission's rules and regulations adopted under the Freedom of Information Act (17 C.F.R. § 200.80).

(n96)Footnote 96. Rule 12g-2. Rule 12g-2 provides that such registration under Section 12(g) is effective without the filing of an additional Exchange Act registration statement. Notwithstanding that securities deregistered under Section 12(d) of the Exchange Act may be held by fewer than 300 holders of record, the issuer of such securities must file a Form 15 with the Commission to suspend its obligation to file reports under Section 15(d). *See* Rule 12h-3.

(n97)Footnote 97. *See* n.22 *supra*.

(n98)Footnote 98. The question of compliance with exchange rules may have been modified by the amendments to

Section 19 by the Securities Act Amendments of 1975, which grant the Commission unequivocal power over the rules of any self-regulatory organization, including an exchange. Commission oversight powers with respect to exchange rules are discussed in § 2.03[2] *supra*.

(n99)Footnote 99. *Atlas Tack Corp. v. New York Stock Exchange*, 246 F.2d 311, 316 (1st Cir. 1957) :

The Commission having found that the Exchange had complied with its rules, had no power to deny the Exchange's application for delisting under Section 12(d) even "if for some acceptable reason" it believed that trading in Atlas' stock should be continued. *Allen Industries, Inc.*, 2 S.E.C. 14, 17 (1937) . Section 12(d) has been construed, and we believe properly so, as making it mandatory upon the Commission to grant applications for delisting if the rules of the exchange have been followed. *Application of the New York Stock Exchange, etc.*, 4 S.E.C. 723 (1939) . Once the Commission finds the aforementioned compliance its "sole remaining function is to determine whether delisting should be accompanied with any terms necessary for the protection of investors." *Application of the New York Stock Exchange, etc. supra* [5 S.E.C.] at 455 .

See also *Standard Silver-Lead Mining Co.*, 25 S.E.C. 287 (1947) ; *Lincoln Service Corporation*, 15 S.E.C. 17 (1943) ; *National Union Radio Corporation supra*.

See also *Pharmacia & Upjohn, Inc.* (finding that the company had complied with the applicable rules and conditions, the staff would not raise an objection if the company, pursuant to a merger transaction by which its shares were delisted and deregistered, did not file periodic reports pursuant to the Exchange Act). 2000 SEC No-Act. Lexis 634 (available May 10, 2000).

See also *Exchange Buffet Corp. v. S.E.C.*, 244 F.2d 507 (2d Cir. 1957) ; *Texas Hydro- Electric Corp.*, 26 S.E.C. 27 (1947) ; *Allen Indus., Inc.*, 2 S.E.C. 14 (1937) ; *Application of N.Y. Stock Exch.*, 4 S.E.C. 723 (1939) .

(n100)Footnote 100. See *Atlas Tack*, 246 F.2d 311 .

A requirement that the delisting application have the approval of a stated percentage of the outstanding shares is a valid condition. *Shawmut Associates v. S.E.C.*, 146 F.2d 791 (D. Mass. 1947) ; *Suburban Elec. Sec.*, 23 S.E.C. 5 (1946) ; *Torrington Co.*, 19 S.E.C. 39 (1945) . An exchange rule making such a requirement is valid and enforceable. *Fostoria Pressed Steel Corp.*, 8 S.E.C. 476 (1941) .

(n101)Footnote 101. *Capital City Prods. Co.*, 5 S.E.C. 721 (1939) ; *Troxel Mfg. Co.*, 6 S.E.C. 995 (1940) ; *Joslyn Mfg. Co.*, 10 S.E.C. 311 (1941) .

(n102)Footnote 102. Section 12(j) of the Exchange Act, reprinted in the Primary Law Sourcebook, Volume B, Section F, authorizes the Commission to deny, suspend the effective date of, suspend for not more than twelve months, or revoke a security registration for failure to comply with the Exchange Act or the rules and regulations thereunder. Under the provision, when the Commission suspends or revokes the registration of a security, "no broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security the registration of which has been and is suspended or revoked pursuant to the preceding sentence." Section 12(j).

The Commission is also authorized to summarily suspend trading in a security "for a period not exceeding ten business days" by Section 12(k).

No exchange member, broker, or dealer may effect or induce a transaction in a security while trading is suspended or its registration is suspended or revoked pursuant to Section 12(j) or (k).

Suspension or revocation has adverse effects on investors. While they may be used quite effectively to compel issuers to meet their disclosure obligations under the Exchange Act, thereby benefiting investors, they can have severely adverse effects on holders of the securities involved by forcing them to hold what may be a very undesirable investment during the period in which trading is prohibited. The Second Circuit has indicated that a security holder has standing to attack a summary suspension. *See Sloan v. S.E.C.*, 527 F.2d 11 (2d Cir. 1975), *aff'd sub nom. S.E.C. v. Sloan*, 436 U.S. 103, (1978). In affirming, the court voided the Commission's practice of consecutive trading suspensions, holding that the Commission lacked the authority under Section 12(k) of the Exchange Act to indefinitely issue ten-day suspensions of trading in securities based upon a single set of circumstances, even though the Commission periodically redetermined every ten days that suspension of trading in the security in question was required by the public interest and for the protection of investors. The issue of a series of summary suspension orders under Section 12(k) is permissible if each trading suspension order is based upon a separate set of unrelated circumstances.

The prohibition against trading while a suspension is in effect applies to exchange members, brokers, and dealers, but not private persons. *See Douglas R. Graham, Fed. Sec. L. Rep. (CCH) P 80,232* (Div. Mkt. Reg. 1975). Mr. Graham had sold "short" 500 warrants for Equity Funding shares prior to a twenty-five month suspension. He desired to advertise for and purchase 500 warrants to "cover" the short position without using a broker or dealer for the purchase. The staff took a no-action position, but cautioned against involvement of a broker or dealer and pointed out that adequate disclosure must be made to the seller.

(n103)Footnote 103. *See, e.g., Great Sweet Grass Oils, Ltd.*, 37 S.E.C. 683 (1957), *aff'd sub nom. Great Sweet Grass Oils, Ltd., v. SEC*, 256 F.2d 893 (D.C. Cir. 1958); *Cornucopia Gold Mines*, 40 S.E.C. 177 (1960).

(n104)Footnote 104. *See* ch.7 and ch.8 *infra*.

(n105)Footnote 105. *See* Rule 15d-6 under the Exchange Act, reprinted in the Primary Law Sourcebook, Volume B, Section G.

(n106)Footnote 106. In order for the issuer's Section 15(d) obligations to be suspended, the issuer must file a certification on Form 15 with the Commission. *See* Rule 12h-3(a).

(n107)Footnote 107. *Id.* Rule 12h3-1 defines the term "held of record." *See* § 4.01[2][a][i] *supra*.

(n108)Footnote 108. *See, e.g.,* Amgen Boulder Inc. (available March 29, 1995), Vandalia National Corp. (available April 21, 1995), Alta Energy Corp. (available August 1, 1994), Professional Medical Products, Inc. (available June 3, 1994), and Central Point Software, Inc. (available August 7, 1992).

(n109)Footnote 109. *See* Rule 12h-3(e).

(n110)Footnote 110. *See* ch.7 and ch.8 *infra*.



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Federal Securities Exchange Act of 1934

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CHAPTER 4 Exchange Act Registration and Reporting Requirements

1-4 Federal Securities Exchange Act of 1934 § 4.02

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§ 4.02 Periodic and Current Reporting Requirements

On July 30, 2002, President Bush signed into law comprehensive corporate governance and accounting reform legislation known as the Sarbanes-Oxley Act of 2002 n1 (the "Sarbanes-Oxley Act"). The Sarbanes-Oxley Act n2 represents a significant restructuring of the regulatory system governing the capital markets and has broad implications for public companies. n3 More specifically, to improve the delivery and flow of reliable information to investors, the Commission adopted amendments to its rules and forms to accelerate the filing of quarterly and annual reports by issuers deemed "large accelerated filers" and "accelerated filers." n4

As previously discussed, n5 an issuer is required to file a registration statement containing comprehensive, detailed information concerning itself and its securities at the time a class of its securities is registered under Section 12. n6 Thereafter, to keep the registration statement "reasonably current," the initial disclosure must be updated and supplemented by annual, quarterly, and current reports filed by the issuer pursuant to Section 13. n7

Under the Sarbanes-Oxley Act, the Commission is required to review the disclosures (including financial statements) by issuers with securities listed on an exchange or traded on Nasdaq on a "regular and systematic" basis, but in no event less than once every three years. n8 In scheduling these reviews, the Commission is directed to consider, among other factors, (i) issuers that have had material restatements of financial results, (ii) issuers experiencing significant volatility in their stock price, (iii) issuers with the largest market capitalization, (iv) emerging companies with disparities in price to earnings ratios, (v) issuers whose operations significantly affect any material sector of the economy, and (vi) any other factors that the Commission considers relevant. n9

An issuer that is not subject to Section 13, but whose registration statement has become effective under the Securities Act must file essentially the same periodic reports under Section 15(d). If information required to be included in any report is unknown or not reasonably available, the issuer must furnish such information as it can, and show either why the expense of obtaining the information would be unreasonably great or that the sole source of the information is an unaffiliated person who has refused a request to furnish it. n10

One of the primary purposes of the Exchange Act is to insure the timely disclosure of accurate information concerning publicly-held securities. n11 Making available to investors adequate financial and other information about securities in

which they might invest or have invested was determined by the drafters of the Exchange Act to be the best means of enabling them to make intelligent investment decisions and of protecting them against securities fraud. n12

The Sarbanes-Oxley Act requires each issuer to disclose to the public "on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer" as the Commission determines appropriate. n13 In response to these directives, in March 2004, the Commission adopted amendments to Form 8-K that significantly shortened filing deadlines and expanded the disclosure items. n14

Section 13 of the Exchange Act authorizes the Commission to require issuers of securities registered under Section 12 n15 to file current, annual, and quarterly reports with the Commission and, if the security is listed on a national securities exchange, with the exchange. In addition, under Section 15(d) of the Exchange Act issuers whose registration statements have become effective under the Securities Act are required to file essentially the same periodic reports. The rules applicable to filings under Section 15(d) are similar to those that apply to reports of issuers of securities registered pursuant to Section 12. n16 An issuer's duty to file reports under Section 15(d) is suspended while it has a class of securities registered under Section 12. n17

Successors to issuers subject to Section 15(d) assume the predecessor's duty to file reports under that section, unless the successor is exempt or the duty to file has been suspended. n18 An extension of time for filing any report for fifteen days (in the case of annual Forms 10-K and 20-F) and five days (in the case of quarterly or transition reports like Form 10-Q) may be obtained after filing an application on Form 12b-25 in those cases where the registrant cannot timely file the report without unreasonable effort or expense. n19

The reporting requirements of Section 13 are terminated upon termination of the Section 12 registration. The reporting requirements of Section 15(d) are suspended if and so long as a security of the issuer is registered pursuant to Section 12(2) as to any fiscal year (except the fiscal year in which the Securities Act registration statement became effective), if at the beginning of the year, the class of securities to which the registration statement relates is held of record by fewer than 300 persons. n20 The issuer's reporting obligations under Section 15(d) can also be suspended after the second fiscal year following the fiscal year in which the registration statement became effective if, as of the last day of each of the three most recent fiscal years, the issuer had fewer than 500 record holders of such class of securities and not more than \$10 million in total assets.

Reports filed pursuant to Section 13 or 15(d) are subject to the civil liability provisions of Section 18 for false or misleading statements. n21 However, the Commission is authorized by Sections 21(d) and (e) to obtain injunctions prohibiting violations of, or compelling compliance with, the reporting requirements. The Commission has also been granted cease and desist authority and the authority to impose civil penalties for violations of the Exchange Act's reporting requirements or violations of a cease and desist order of the Commission. n22

Section 21(d)(3) of the Exchange Act authorizes the Commission to impose civil penalties for violations of the Exchange Act or any cease and desist order entered by the Commission pursuant to Section 21C. The penalties are tiered as follows: (i) up to \$5,000 per violation for individuals and \$50,000 for corporations and other entities for most violations, (ii) up to \$50,000 for individuals and \$250,000 for corporations and other entities for violations involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, and (iii) up to \$100,000 per violation for individuals and \$500,000 for corporations and other entities for violations involving fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement where such violations, directly or indirectly, resulted in substantial losses or created a significant risk of substantial losses to other persons. n23 In any action or proceeding brought or instituted by the Commission under any provision of the securities laws, the Commission may seek, and any federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors. n24 In the case of a violation of a cease and desist order, each separate violation of such order is a separate offense for Section 21(d)(3) purposes, except that in the case of a continuing failure to comply with the order, each day of the failure to comply is deemed a separate offense. n25 A willful violation may give rise to criminal

prosecution under Section 32. Moreover, the ubiquitous *Rule 10b-5* must not be overlooked. n26

[1] Form 10-K--Annual Report Pursuant to Section 13 or 15(d)

Issuers subject to Section 13 or 15(d) are required to file an annual report on Form 10-K, the applicable form for the vast majority of domestic corporations where none of the special purpose forms is available or required. n27

In 1980, the Commission adopted amendments to Form 10-K and to a number of related rules, regulations, forms, and guides, effective for all filings and reports filed under the Securities and Exchange Acts. n28 These amendments were part of a series of changes and proposals designed to:

- improve disclosures made to investors and other users of financial information;
- reduce some of the burdens of disclosure by eliminating obsolete or duplicative requirements, and by combining informal security holder communications, such as annual reports to security holders, with official Commission filings; and
- facilitate the integration of filings made under the Securities Act and the Exchange Act. n29

The Commission has developed minimum disclosure requirements for the Form 10-K and the annual report to security holders and changed the format and content of both reports to reflect this development. n30 Since the disclosure requirements have common elements, the Commission has made it easier for registrants to voluntarily incorporate material from the annual report to stockholders into the Form 10-K by reference. n31

However, because the Commission believes that the annual report to security holders and the Form 10-K are not necessarily used in an identical manner, the Commission has determined that only portions of the two reports have equivalent disclosure. n32 Disclosure requirements in annual reports to stockholders have been developed in the context of stockholders making voting decisions. The Form 10-K confirms information previously delivered to investors and others making investment decisions about the issuer and, consequently, is more detailed than the annual report to stockholders. n33

The Form 10-K disclosure requirements are based on the Commission's premise that there is a basic information package that most investors expect to be furnished, whether to support the current information requirements of an active trading market or to accompany the registration and sale of newly issued securities under the Securities Act. n34 The essential content of the basic information package includes (1) audited financial statements, (2) a summary of selected financial data appropriate for trend analysis, and (3) a meaningful description of the registrant's business and financial condition. n35

The Form 10-K is designed to segregate the basic information package contained in the Form 10-K from proxy related and supplemental information. The Form 10-K is structured in four parts, to segregate the basic package.

Part I (Items 1-4) contains the detailed disclosure requirements relating to business, properties, legal proceedings, and matters voted upon by security holders. Part II (Items 5-9B) contains market information, selected financial data, management's discussion and analysis of financial condition and results of operations, quantitative and qualitative disclosures about market risk, financial statements and supplementary data, a description of changes in and disagreements with accountants on accounting and financial disclosure, controls and procedures and other information. Part III (Items 10-14) consists of the proxy disclosure information that relates to directors and executive officers, management remuneration, beneficial ownership of securities, related party transactions and principal accountants' fees and services and other information. n36 Part IV (Item 15, signatures and supplemental information) contains

requirements for financial statement schedules and standardized requirements for exhibits. n37

At the registrant's option, the information required by the first two parts (or any portion thereof) of Form 10-K may be supplied by incorporating the information from the registrant's annual report to security holders that is furnished to the Commission pursuant to Rule 14a-3(b), Rule 14c-3(b), or Rule 14c-3(a), or from an annual report to stockholders not furnished to the Commission but containing the information required by Rule 14a-3. However, the material incorporated from the annual report to stockholders to fulfill the requirements of Part I of Form 10-K must contain the information required by Items 1-3 of Part I of Form 10-K to the extent applicable. n38 In addition, if any information required by Part I or II is incorporated by reference into an electronic format document from the annual report to security holders, any such incorporated portion must be filed as an exhibit in electronic format. n39 The information required by Part III of Form 10-K may be supplied by incorporating by reference from the proxy or information statement involving the election of directors, if filed within 120 days of the end of the fiscal year. n40

[a] Filing and Other General Instructions. In 2002, as further modified by rules adopted in 2005, the Commission adopted rule changes that, in phases, shorten the Form 10-K filing deadline from ninety days after an issuer's fiscal year end to sixty days for certain issuers designated as "large accelerated filers" and seventy five days for certain issuers designated as "accelerated filers" as defined in Exchange Act Rule 12b-2. n41 The Commission adopted these rule changes on the belief that the information being supplied in periodic reports filed under the current scheme is often stale and that significant technological advances are increasing investor demand for more timely disclosure and improving registrants' ability to capture, process and disseminate the required information. The new rules also require large accelerated filers and accelerated filers to disclose in their Form 10-K the Internet address of their corporate website and whether they make their periodic and current reports available, free of charge, on their corporate websites as soon as reasonably practicable after such material is filed electronically with the Commission, and if not, the reasons why the issuer does not do so and whether the issuer will provide electronic or paper copies of such reports free of charge upon request. n42

For non-accelerated filers, the instructions to Form 10-K require that it be filed within ninety days n43 after the end of the fiscal year covered by the report, except for schedules required by Article 12 of Regulation S-X which may, at the option of the registrant, be filed as an amendment to the report not later than thirty days after the applicable due date of the report. n44

As with all Commission filings, where the due date is a weekend or holiday, the report must be filed by the end of the next business day. n45

Amendments to Exchange Act filings are designated by adding the letter "A" after the title of the form being amended (e.g., "Form 10-K/A"). n46 An issuer subject to Section 13 must file an annual report with the Commission for each year after the last fiscal year for which financial statements were filed in its Section 12 registration statement. n47 An issuer subject to Section 15(d) must file an annual report for the fiscal year in which the Securities Act registration statement became effective and for each fiscal year thereafter. n48 Pursuant to Rule 15d-2(a), a special financial report is required if the Securities Act registration statement did not contain certified financial statements for the full fiscal year (or the life of the registrant if less than a full fiscal year) preceding the fiscal year in which the registration statement becomes effective. Registrants are permitted to combine and file annual reports to security holders with the required information on Form 10-K. n49

If an issuer subject to Section 13 or 15(d) changes its fiscal year, it must file an interim report. n50 At least one manually signed complete copy of the annual report must be filed with each exchange on which any class of securities of the issuer is registered. n51

Successor issuers are required to file reports upon succession by merger, consolidation, exchange of securities, or acquisition of assets of an issuer required to file, unless the successor is exempt or the duty to file has been suspended.

n52

Sanctions for failure to file an annual report may include a temporary suspension of trading in the nonexempt securities of the issuer. n53

To assure that the most senior officers of public companies are actively involved in the process of preparing periodic reports n54 filed with the Commission and maintain an awareness of their accountability for these reports, the Sarbanes-Oxley Act added two separate certification requirements for periodic reports filed by public companies. n55 Section 906 of the Sarbanes-Oxley Act requires that each periodic report containing financial statements filed with the Commission be accompanied by a certification of the chief executive officer and chief financial officer (or equivalent officers) that the periodic report fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act and that the information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the company. The Section 906 certification requirement carries criminal penalties for "knowingly" or "willfully" making false certifications. n56

The second certification requirement of the Sarbanes-Oxley Act, Section 302, requires the principal executive officer and the principal financial officer to make a more comprehensive certification in each annual or quarterly report filed with the Commission. Such certification must be filed as an exhibit to these reports. n57 Rules 13a-14 and 15d-14 under the Exchange Act require each of these officers to certify that he or she has reviewed the report and, based on the officer's knowledge, the report does not contain any untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report and that the financial statements and other financial information included in the report fairly present n58 in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in the report.

In addition, the officers must make representations regarding the adequacy of the Company's disclosure controls and procedures and their disclosure of deficiencies in internal controls and certain instances of fraud to the audit committee of the board of directors. Finally, the officers must indicate whether there were significant changes in internal controls subsequent to the recent evaluation and any corrective actions.

Rules 13a-15 and 15d-15 also require reporting companies to establish and maintain disclosure controls and procedures and internal control over financial reporting that are adequate to meet the company's reporting obligations under the Exchange Act. These rules are intended to complement existing requirements for reporting companies to establish and maintain systems of internal controls with respect to their financial reporting obligations.

Issuers reporting on Form 10-K should also comply with the provisions of Regulation S-T for documents required to be filed in electronic format. n59 In the limited circumstances involving paper filing, Regulation 12B contains general requirements for such matters as the kind and size of paper to be used, the legibility of the report, the information to be given whenever the title of securities must be stated, and the filing of the report. n60 Particular attention is also directed to Rule 12b-20, which states: "In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."

At least one complete copy must be manually signed by the registrant, and on behalf of the registrant by its principal executive officer or officers, its principal financial officer, its controller or principal accounting officer, and by at least a majority of the board of directors or persons performing similar functions and retained in its files for five years. n61 Duplicated or facsimile signatures will satisfy this requirement so long as the registrant retains the original manually signed document for five years and makes it available to the Commission upon request. n62 For registrants not filing electronically, three complete copies of the report and five additional copies that need not include exhibits must be filed with the Commission. n63 In addition, at least one complete, manually signed copy (including exhibits) must be filed

with each exchange on which any class of securities of the registrant is registered, although NASDAQ and the New York Stock Exchange no longer require copies of documents filed electronically. The transmittal letter for Form 10-K must indicate whether the financial statements in the report to security holders furnished to the Commission reflect a change from the previous year in any accounting principles, practices, or in the method of applying such principles. n64

In completing the Form 10-K, any information required by an item or other requirement with respect to any foreign subsidiary, except for financial statements and other financial schedules, may be omitted to the extent that the required disclosure would be detrimental to the registrant. n65

The registrant may be able to furnish abbreviated narrative disclosure if, on the date of filing its Form 10-K:

- all of the registrant's equity securities are owned, either directly or indirectly, by a single person, which is a reporting company that has filed all the material required to be filed under Section 13, 14 or 15(d), as applicable, and which is named in conjunction with the registrant's description of its business;
- neither the registrant nor its subsidiaries during the preceding thirty-six calendar months and any subsequent period of days has been in material default in the payment of principal, interest, a sinking or purchase fund installment, or any other material default not cured within thirty days with respect to any indebtedness or has been in any material default in the payment of rentals under material long-term leases;
- on the cover page of the Form 10-K the registrant has prominently set forth a statement that it meets the conditions contained in the prior two bullet paragraphs above, and that it is therefore filing the Form 10-K with the reduced disclosure format; and n66
- the registrant is not an asset-backed issuer.

This reduced disclosure format permits the registrant to omit the information called for by Item 6, Selected Financial Data, and Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, if the registrant includes in its Form 10-K a management's narrative analysis of the results of operations that explains the reasons for material changes in the amount of revenue and expense items between the most recent fiscal year presented and the one immediately preceding it. n67 The registrant may also omit the list of subsidiaries exhibit called for by Item 601 of Regulation S-K. n68 Moreover, registrants qualified to file under the reduced disclosure format may omit the items called for by: Item 4, Submission of Matters to a Vote of Security Holders; Item 10, Directors and Executive Officers of the Registrant; Item 11, Executive Compensation; Item 12, Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters; and Item 13, Certain Relationships and Related Transactions. n69 In response to Item 1, Business, the registrant only need furnish a brief description of the business done by the registrant and its subsidiaries during the most recent fiscal year that will, in management's opinion, indicate the general nature and scope of the business of the registrant and its subsidiaries. n70 In response to Item 2, Properties, the registrant only need furnish a brief description of the material properties of the registrant and its subsidiaries that in management's opinion will be necessary to an understanding of the business done by the registrant and its subsidiaries. n71

[b] Facing Sheet. The facing sheet of Form 10-K requires a statement of the fiscal year for which it is being filed, the registrant's Commission file number, and the registrant's name and state of incorporation, address, telephone number and I.R.S. employer identification number. The securities registered under Section 12 of the Exchange Act must also be listed and, if registered pursuant to Section 12(b) of the Securities Act, the name of the securities exchange on which they are registered. The facing page must also indicate (by checking one of two boxes) whether the report is the normal annual report required to be filed under Section 13 or 15(d) or whether the report is a "transition report" relating to a change in the registrant's fiscal year or where a successor to the registrant has a different fiscal year. n72 To facilitate

sales under Rule 144, the registrant must indicate, by checking the appropriate yes/no item, whether it has filed all required reports under Sections 13 and 15(d) of the Exchange Act during the past twelve months and whether it has been subject to those requirements for the past ninety days. If no disclosure is required to be described in the report under Item 405 of Regulation S-K, regarding delinquent Section 16 reports, the registrant is instructed to so indicate by checking the designated box on the facing sheet. n73 The registrant must indicate on the facing sheet whether it is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company as defined in Rule 12b-2 of the Exchange Act. The registrant must also indicate whether it is a "well-known seasoned issuer" as defined by Rule 405 of the Securities Act, n74 and indicate if it is a shell company as defined by Rule 12b-2 of the Exchange Act. Last, the registrant must indicate (by checking one of two boxes) whether it has submitted electronically and posted on its website every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding twelve months. n75

The number of outstanding shares of each class of common stock as of the latest practicable date, and the aggregate market value of the voting stock held by nonaffiliates of the registrant as of the last business day of the registrant's most recently completed second fiscal quarter must also be stated on the facing sheet. n76 Furthermore, if the registrant has been involved in bankruptcy proceedings during the preceding five years, the registrant must indicate whether it has filed all documents and reports required to be filed by Sections 12, 13, or 15(d) of the Exchange Act subsequent to the distribution of securities under a plan confirmed by a court. The registrant is also required to list any annual report to security holders, proxy or information statement, or prospectus filed pursuant to Securities Act Rule 424(b) or (c) that is incorporated by reference and the part of the Form 10-K (e.g., Part I, Part II, etc.) into which the document is incorporated.

[c] Part I--Business, Properties, Legal Proceedings, and Submission of Matters to a Vote of Security Holders.

[i] Item 1. Business. Item 1 of Form 10-K requires a description of the registrant's business in accordance with information required by Item 101 of Regulation S-K (17 C.F.R. Part 229); however, the discussion of the development of the business need only include developments since the beginning of the fiscal year for which the Form 10-K is filed. n77

[ii] Item 1A. Risk Factors. This item requires a description under the heading "Risk Factors" of the risk factors described in Item 503(c) of Regulation S-K that are applicable to the registrant. The discussion of risk factors is to be in plain English in accordance with Rule 421(d) of the Securities Act.

[iii] Item 1B. Unresolved Staff Comments. A registrant that is an accelerated filer, a large accelerated filer n78 or a well-known seasoned issuer n79 must disclose the substance of any comments received from the Commission staff not less than 180 days before the end of the registrant's fiscal year that remain unresolved.

[iv] Item 2. Properties. Item 2 of Form 10-K requires a brief description of properties of the registrant, in accordance with the information required by Item 102 of Regulation S-K. n80

[v] Item 3. Legal Proceedings. This item requires a description of legal proceedings in accordance with the information required by Item 103 of Regulation S-K. n81 Item 3 of Form 10-K also requires that information similar to that required by Item 103 of Regulation S-K be furnished as to any legal proceeding terminated during the fourth quarter of the fiscal year covered by the Form 10-K, including the date of termination and a description of the disposition of the proceeding with respect to the registrant and its subsidiaries. n82

[vi] Item 4. Submission of Matters to a Vote of Security Holders. This item requires that if any matter was submitted during the fourth quarter of the fiscal year covered by the Form 10-K to a vote of security holders, through the solicitation of proxies or otherwise, the following information must be furnished, as applicable:

- (1) the date of the meeting and whether the meeting was an annual or special meeting;
- (2) if the meeting involved the election of directors, the name of each director elected at the meeting and the name of each other director whose term of office as a director continued after the meeting, unless: (a) proxies for the meeting were solicited pursuant to Regulation 14A; there was no solicitation in opposition to the management's nominees as listed in the proxy statement; and all of management's nominees were elected; or (b) the registrant did not solicit proxies and the board of directors as previously reported to the Commission was reelected in its entirety, in which event a statement to that effect is required;
- (3) a brief description of each matter voted upon at the meeting and the number of votes cast for, against or withheld, as well as the number of abstentions and broker nonvotes as to each other matter, including a separate tabulation with respect to each nominee for office; n83
- (4) a description of the terms of any settlement between the registrant and any other participant terminating any solicitation subject to Rule 14a-11, including the cost or anticipated cost to the registrant (this information, however, may be presented by referring to proxy soliciting material containing the information that has been previously furnished to security holders). n84

Corresponding information for any solicitation or other vote of security holders not taken at a meeting must also be furnished.

[d] Part II--Market and Financial Data

[i] Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities. This item requires registrants to furnish the information required by Items 201 and 701 of Regulation S-K as to all equity securities of the registrant sold by the registrant during the period covered by the report that were not registered under the Securities Act. n85 If the Item 701 information has been included in a quarterly report on Form 10-Q, or in a current report on Form 8-K, then the registrant does not need to furnish such information. n86 In addition, if required pursuant to Rule 463 of the Securities Act, the registrant must furnish the information relating to use of proceeds required by Item 701(f) of Registration S-K. n87 The registrant must also furnish the information required by Item 703 of Regulation S-K for any repurchase of its equity securities made in a month within the fourth quarter of the fiscal year covered by the report.

[ii] Item 6. Selected Financial Data. In response to this item, the registrant is required to furnish the financial information called for by Item 301 of Regulation S-K. n88

[iii] Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations. This item requires the registrant to furnish the information required by Item 303 of Regulation S-K. n89

[iv] Item 7A. Quantitative and Qualitative Disclosures About Market Risk. This item requires the registrant to furnish the information required by Item 305 of Regulation S-K. n90

[v] Item 8. Financial Statements and Supplementary Data. This item requires the registrant to file financial statements meeting the requirements of Regulation S-X n91 and the supplementary financial information required by Item 302 of Regulation S-K. n92 In addition, financial statements of the registrant and its subsidiaries consolidated, as required by Rule 14a-3(b) governing the annual report to security holders, are filed in response to Item 8 of Form 10-K.

The General Instructions as to Financial Statements in Article 3 of Regulation S-X require audited balance sheets to be filed with the Form 10-K for the registrant and its subsidiaries on a consolidated basis as of the end of each of the two most recent fiscal years. n93 Consolidated, audited statements of income and changes in financial position must be filed

for the registrant and its subsidiaries with the Form 10-K for each of the three fiscal years preceding the date of the most recent audited balance sheet being filed. n94 The same requirement applies to audited statements of income and changes in financial position of the registrant and its predecessors. n95 If, however, the registrant qualifies as a "smaller reporting company," then pursuant to Article 8 of Regulation S-K, the registrant is required to file an audited balance sheet as of the end of each of the most recent two fiscal years and audited statements of income, cash flows and changes in stockholders' equity for each of the two fiscal years preceding the date of the most recent audited balance sheet. n96

[vi] Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure. This item requires the registrant to furnish the information required by Item 304(b) of Regulation S-K. n97

[vii] Item 9A. Controls and Procedures. Item 9A of Form 10-K requires the registrant to furnish the information required by Items 307 and 308 of Regulation S-K. n98

[viii] Item 9B. Other Information. Item 9B of Form 10-K requires the registrant to disclose any information required to be disclosed in a report on Form 8-K during the fourth quarter of the year covered by the Form 10-K, but not reported, whether or not otherwise required by the Form 10-K. If disclosure of such information is made under Item 9B, the information need not be repeated in a report on Form 8-K which would otherwise be required to be filed with respect to such information or in a subsequent report on Form 10-K. n99

[e] Part III--Traditional Proxy Disclosure Information

[i] Item 10. Directors, Executive Officers and Corporate Governance. Item 10 discloses the description of directors and executive officers of the registrant, details regarding the filing of Forms 3, 4 and 5 and certain corporate governance information, as required under Items 401, 405, 406, and 407(c)(3), (d)(4) and (d)(5) of Regulation S-K. The corporate governance disclosure includes (i) the description of any material changes to the procedures by which security holders recommend nominees; (ii) information regarding the registrant's audit committee and audit committee financial expert; and (iii) details of the registrant's code of ethics, including an explanation for the absence thereof, if applicable. The registrant is permitted to incorporate this information by reference to its proxy statement. n100

[ii] Item 11. Executive Compensation. Item 11 discloses all remuneration of named executive officers as well as certain information regarding the registrant's compensation committee (or equivalent), as required by Item 402 and Item 407(e)(4) and (e)(5) of Regulation S-K. Substantial amendments were made to Item 402 and other executive compensation and related person disclosure rules in 2006. n101 Item 11 now includes a Compensation Discussion and Analysis section that holistically discusses compensation practices. Item 11 also includes, under the caption "Compensation Committee Interlocks and Insider Participation," relevant relationships involving compensation committee members. Under the caption "Compensation Committee Report," the compensation committee (or equivalent) must state whether it has reviewed and discussed the Compensation Discussion and Analysis (as required by Item 402(b) of Regulation S-K) with management and, based upon review and discussions, whether or not the compensation committee recommended to the board of directors that the Compensation Discussion and Analysis be included in the registrant's annual report on Form 10-K. The names of the compensation committee (or equivalent) members must appear below this disclosure. The registrant is permitted to incorporate this information by reference to its proxy statement. n102

[iii] Item 12. Security Ownership of Certain Beneficial Owners and Management. This Item requires the registrant to furnish the information required by Items 201(d) and 403 of Regulation S-K. n103 The registrant is permitted to incorporate this information by reference to its proxy statement. n104

[iv] Item 13. Certain Relationships and Related Transactions, and Director Independence. Item 13 requires the registrant to furnish information regarding related person transactions and director independence, as required by Item 404 and Item 407(a) of Regulation S-K. The registrant is permitted to incorporate this information by reference to its proxy statement. n105

[v] Item 14. Principal Accountant Fees and Services. This Item requires the registrant to furnish the information required by Item 9(e) of Schedule 14A. The registrant is permitted to incorporate this information by reference to its proxy statement. n106 See General Instruction G to Form 10-K. The ability to incorporate by reference is discussed in § 4.02[1] supra.

[f] Part IV -- Item 15. Exhibits and Financial Statement Schedules. All financial statements, the financial statement schedules n107 required to be filed by Item 8 of Form 10-K, n108 and the exhibits required to be filed by Item 601 of Regulation S-K n109 must be listed in response to paragraph (a) of Item 15 of Form 10-K. n110

The exhibits required by Item 601, "Exhibits," of Regulation S-K must be filed in response to paragraph (b) of Item 15. In addition, the list of such exhibits must identify each management contract, compensatory plan, or arrangement required to be filed as an exhibit. n111

Registrants must also file, as financial statements schedules to Form 10-K, the financial statements required by Regulation S-X that are excluded from the annual report to stockholders by Rule 14a-3(b), n112 including separate financial statements of:

- subsidiaries not consolidated and fifty percent or less owned persons;
- affiliates whose securities are pledged as collateral; and
- schedules. n113

[g] Certification Requirements. To assure that the most senior officers of public companies are actively involved in the process of preparing periodic reports n114 filed with the Commission and maintain an awareness of their accountability for these reports, the Sarbanes-Oxley Act added two separate certification requirements for periodic reports filed by public companies. Section 906 of the Sarbanes-Oxley Act requires that each periodic report containing financial statements filed with the Commission be accompanied by a certification of the chief executive officer and chief financial officer (or equivalent officers) that the periodic report fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act and that the information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the company. The Section 906 certification requirement carries criminal penalties for "knowingly" or "willfully" making false certifications. n115

The second certification requirement of the Sarbanes-Oxley Act (the Section 302 Certification) requires the principal executive officer and the principal financial officer to make a more comprehensive certification in n116 each annual or quarterly report filed with the Commission. The Section 302 Certification, which appears as Exhibit 31 of Item 601 of Regulation S-K, requires each of these officers to certify that he or she has reviewed the report and, based on the officer's knowledge, does not contain any untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report and that the financial statements and other financial information included in the report fairly present n117 in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in the report. In addition, the officers must make representations regarding the adequacy of the company's disclosure controls and procedures and its disclosure of deficiencies in internal controls and certain instances of fraud to the audit committee of its board of directors. Finally, the officers must indicate whether there were significant changes in internal controls subsequent to the recent evaluation and any corrective actions.

In connection with its adoption of the rules requiring this certification, the Commission also adopted Rules 13a-15 and 15d-15, which require reporting companies to establish and maintain disclosure controls and procedures and internal control over financial reporting that are adequate to meet the company's reporting obligations under the Exchange Act. These rules are intended to complement existing requirements for reporting companies to establish and maintain

systems of internal controls with respect to their financial reporting obligations.

[h] Supplemental Information by Registrants Subject to Section 15(d). Every registrant that files an annual report on Form 10-K pursuant to Section 15(d), that does not otherwise have securities registered pursuant to Section 12, must furnish to the Commission, at the time of filing its annual report, four copies of:

- any annual report to security holders covering the registrant's last fiscal year; and
- every proxy statement, form of proxy or other proxy soliciting material concerning any annual or other meeting of security holders, that is sent to more than ten of the registrant's security holders. The registrant need not furnish this information, however, to the extent that the information is specifically incorporated into the Form 10-K by reference. n118

If the registrant has not sent an annual report or proxy material to security holders, a statement to that effect must be included under the supplemental information caption. If after the filing of the annual report on the Form 10-K the annual report or proxy material is to be furnished to security holders, the registrant must so state under the supplemental information caption and must furnish copies of that material to the Commission when it is sent to security holders.

The foregoing supplemental material required by the Form 10-K to be furnished to the Commission is not deemed "filed" with the Commission or otherwise subject to the liabilities of Exchange Act Section 18, except to the extent that the registrant specifically incorporates it in its annual report on Form 10-K by reference.

The "Supplemental Information" requirement of Form 10-K was amended as part of the Commission's integrated disclosure amendments to make it clear that all materials furnished to the Commission by incorporation by reference into the Form 10-K need not be supplied again in the Form 10-K. n119

[2] Form 10-Q--Quarterly Report Under Section 13 or 15(d)

Issuers subject to Section 13 or 15(d) of the Exchange Act are, with certain exceptions, required to file a quarterly report on Form 10-Q for each of the first three fiscal quarters of each fiscal year of the issuer, commencing with the first fiscal quarter ending after the relevant registration. n120 For most filers, a report on Form 10-Q must be filed with the Commission within forty-five days after the end of each of the first three fiscal quarters of the year; n121 none is filed for the fourth quarter. n122 The filing deadline is shortened for certain companies from forty-five days after a registrant's quarter end to forty days for certain registrants designated as "large accelerated filers" and "accelerated filers." n123

Form 10-Q n124 is part of the integrated disclosure requirements of the Securities Act and the Exchange Act. Under this integrated disclosure system, registrants may incorporate their informal annual and quarterly reports to stockholders to satisfy the reporting requirements of the Exchange Act to the extent that the informal reports contain the information required to be filed. n125

The structure of Form 10-Q is divided into two parts. Part I requires disclosure of financial statements, management's discussion and analysis of financial condition and results of operations, certain quantitative and qualitative disclosures about market risk, and disclosure controls and procedures. Part II contains six items. However, if substantially the same information has been previously reported n126 by the registrant, an additional report of information on Form 10-Q need not be made. If information called for in Part II has already been disclosed in the financial information provided in Part I, that information need not be presented again in Part II if it is incorporated by reference into Part II by a statement specifically identifying the incorporated information.

[a] General Filing Instructions. Issuers should refer to the provisions of Regulation S-T for documents required

to be filed in electronic format. n127 Issuers reporting on Form 10-Q should also be familiar with Regulation 12B, which contains general requirements for such matters as the kind and size of paper to be used, the legibility of the report, the information to be given whenever the title of securities is required to be stated, and the filing of the report, although many of its provisions are no longer applicable under EDGAR with electronic filer. The definitions contained in Rule 12b-2 n128 should be especially noted. n129

If not filed electronically, pursuant to a hardship exemption from electronic filing, three complete copies of the report, including any financial statements, exhibits or other papers or documents filed as a part of the report, and five additional copies that need not include exhibits, must be filed with the Commission. n130 In addition, at least one completed copy of the report, including any financial statements, exhibits or other papers or documents filed as part of the report, must be filed on each exchange on which any class of securities of the registrant is registered. n131 Forms filed electronically are not required to be separately delivered to The Nasdaq Stock Market or the New York Stock Exchange.

Electronic filers must retain a manually signed original for five years. n132 In addition, the Form 10-Q must be accompanied by the required certifications. n133 For paper filers, at least one of the complete copies that is filed with the Commission and each exchange must be manually signed on the registrant's behalf by a duly authorized officer of the registrant and by the principal financial or chief accounting officer of the registrant. Copies not manually signed must bear typed or printed signatures. Duplicated or facsimile signatures are permitted if the original is retained for five years.

The information contained in Items 1, 2 and 3 of Part I of Form 10-Q, whether included directly on Form 10-Q or incorporated by reference from a report, document, or statement filed as an exhibit to Part I, included in integrated reports to security holders, or contained in a statement regarding computation of per share earnings or a letter regarding a change in accounting principles filed as an exhibit to Part I pursuant to Item 601 of Regulation S-K, n134 is not deemed filed for the purpose of, or subject to the liabilities of Exchange Act Section 18. However, information presented in satisfaction of the requirements of this form other than those of Items 1, 2 and 3 of Part I are deemed filed for the purpose of Section 18 of the Act; except that, where information presented in response to Item 1 or 2 of Part I (or as an exhibit thereto) is also used to satisfy Part II requirements through incorporation by reference, only that portion of Part I (or exhibit thereto) consisting of the information required by Part II is deemed so filed. n135

The registrant may be able to furnish abbreviated narrative disclosure if, on the date of filing its Form 10-Q:

- all of the registrant's equity securities are owned, either directly or indirectly, by a single person that is a reporting company that has filed all the material required to be filed under Section 13, 14, or 15(d), as applicable;
- neither the registrant nor its subsidiaries, during the preceding thirty-six calendar months and any subsequent period of days, has been in material default in the payment of principal, interest, a sinking or purchase fund installment, or any other material default not cured within thirty days with respect to any indebtedness or has been in any material default in the payment of rentals under material long-term leases; and
- on the cover page of the Form 10-Q the registrant prominently sets forth a statement that it meets the conditions set forth above and that it is therefore filing the Form 10-Q with the reduced disclosure format. n136

This reduced disclosure format for certain wholly-owned subsidiaries permits the registrant to omit the information called for by Item 2 of Part I, Management's Discussion and Analysis of Financial Condition and Results of Operations, as long as the registrant includes a management's narrative analysis of the results of operations that explains the reasons for material changes in the amount of revenue and expense items between the most recent fiscal year-to-date period

presented and the corresponding year-to-date period in the preceding fiscal year. n137 The analysis should also include an explanation of any material effect that changes in accounting principles and practices or method of application has on net income as reported. n138

Registrants qualified to file under the reduced disclosure format may also omit the information called for by Item 3 of Part I, Quantitative and Qualitative Disclosures About Market Risk and in Part II, Item 2, Changes in Securities; Item 3, Defaults Upon Senior Securities; and Item 4, Submission of Matters to a Vote of Security Holders. n139

[b] Facing Sheet. The facing sheet of Form 10-Q requires a statement of the quarter for which it is being filed, the registrant's Commission file number, the registrant's name, the address of its principal executive offices, including zip code, and its telephone number, including area code (and its former name, former address, and former fiscal year, if changed since the registrant's last report), I.R.S. employer identification number, and the state or other jurisdiction of organization. The registrant must indicate whether it has or filed all required reports under Section 13 or 15(d) of the Exchange Act during the past twelve months and whether it has been subject to those requirements for the past ninety days. The registrant must also indicate whether it is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company as defined in Rule 12b-2 of the Exchange Act. The registrant must indicate if it is a shell company as defined in Rule 12b-2 of the Exchange Act. If the registrant has been involved in bankruptcy proceedings during the preceding five years, the registrant must indicate whether it has filed all documents and reports required to be filed by Sections 12, 13, or 15(d) of the Exchange Act subsequent to the distribution of securities under a plan confirmed by a court. n140 The facing page must also indicate (by checking one of two boxes) whether the report is the normal quarterly report required to be filed under Section 13 or 15(d) or whether the report is a "transition report" relating to a change in the registrant's fiscal year or where a successor to the registrant has a different fiscal year. n141 The number of outstanding shares of each class of the registrant's common stock as of the latest practicable date must also be stated. n142 Last, the registrant must indicate (by checking one of two boxes) whether it has submitted electronically and posted on its website every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding twelve months. n143

[c] Part I. Financial Information

[i] Item 1. Financial Statements. Item 1 of Form 10-Q requires the registrant to furnish the information required by Rule 10-01 of Regulation S-X. n144 Rule 10-01 of Regulation S-X contains uniform instructions as to the form and content of interim financial statements and the rules governing the periods to be covered by financial statements in Form 10-Q. n145

Under Rule 10-01, interim financial statements need only be provided as to the registrant and its consolidated subsidiaries and may be unaudited. n146 Registrants may presume that users of the interim financial information have read or have access to the audited financial statements for the preceding fiscal year. n147 Thus, footnote disclosure that would substantially duplicate the disclosure contained in the most recent annual report to security holders or latest audited financial statements, e.g., a statement of significant accounting policies and practices, may be omitted. n148 However, events that have occurred subsequent to the end of the most recently completed fiscal year and that have had a material effect on the registrant must be disclosed. n149

In preparing the interim financial statements, summarized income statement information should be given separately as to each subsidiary not consolidated or fifty percent or less owned persons, or as to each group of such subsidiaries or fifty percent or less owned persons for which separate individual or group statements would otherwise be required for annual periods, as long as the unconsolidated subsidiary or person would be required to file quarterly financial information with the Commission if it were a registrant. n150 In addition, the registrant must include the date of any material accounting change and the reason for making it and any material retroactive prior period adjustment made during any period covered by the interim financial statements together with its effect upon net income -- total and per share -- of any prior period included and upon the balance of retained earnings. n151

Rule 10-01(b) also describes the preparation of interim financial statements:

- if the registrant or any of its consolidated subsidiaries entered into a business combination treated for accounting purposes as a pooling of interests;
- where a material business combination accounted for as a purchase has occurred during the current fiscal year; and
- where the registrant has disposed of any significant segment of its business during any of the periods covered by the interim financial statements. n152

Under Rule 10-01(c) the following interim financial statements must be filed on Form 10-Q:

- an interim balance sheet as of the end of the most recent fiscal quarter and a balance sheet as of the end of the preceding fiscal year;
- interim statements of income for the most recent fiscal quarter, for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding periods of the preceding fiscal year; and
- interim statements of cash flows for the period between the end of the preceding fiscal year and the end of the most recent fiscal quarter, and for the corresponding preceding period. n153

The interim financial information included in filings must be reviewed by an independent public accountant and the procedures for conducting such reviews must be in compliance with generally accepted auditing standards. n154

Upon the informal written request of the registrant, the Commission may permit the omission of any interim financial information required or the filing in substitution thereof of appropriate information of corporate character, if permitting such omission is consistent with the protection of investors. n155 The Commission may also require, by informal written notice, the filing of other information in addition to, or in substitution for, the information required. n156

[ii] Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations. This item requires the registrant to furnish the information required by Item 303 of Regulation S-K. n157

[iii] Item 3. Quantitative and Qualitative Disclosures About Market Risk. This item requires the registrant to furnish the information required by Item 305 of Regulation S-K. n158

[iv] Item 4. Controls and Procedures. This item requires the registrant to furnish the information required by Item 307 of Regulation S-K and Item 308(c) of Regulation S-K. n159

[d] Part II--Other Information

[i] Item 1. Legal Proceedings. Item 1 of Form 10-Q, Part I requires registrants to include the information required by Item 103 of Regulation S-K regarding legal proceedings. n160 In addition, similar information must be provided concerning proceedings that have been terminated during the period covered by the report, including the date of termination and a description of the disposition thereof with respect to the registrant and its subsidiaries. A legal proceeding, however, need only be reported on the Form 10-Q filed for the quarter in which it first became a reportable event and in subsequent quarters in which there have been material developments. n161

[ii] Item 1A. Risk Factors. The registrant is required to update the risk factor disclosure made in its Form 10-K, as

required by Item 503(c) of Regulation S-K, to reflect any material changes. Smaller reporting companies are not required to provide the information required by this item. n162

[iii] Item 2. Unregistered Sales of Equity Securities and Use of Proceeds. This item requires a brief statement of the general effect of any material modification of the constituent instruments defining the rights of the holders of any class of registered securities.

Pursuant to Item 2(a), the registrant must provide the information required by Item 701 of Regulation S-K as to all equity securities of the registrant sold by the registrant during the period covered by the report that were not registered under the Securities Act. n163 In addition, Item 2(b) provides that if required pursuant to Rule 463 of the Securities Act, the registrant must furnish the information regarding use of proceeds required by Item 701(f) of Regulation S-K. n164 Under Item 2(c), the registrant must furnish the information required by Item 703 of Regulation S-K for any repurchase made in the quarter covered by the report. Disclosures must be provided covering repurchases made on a monthly basis. For example, if the quarter began on January 16 and ended on April 15, the registrant would include a chart disclosing repurchases for the months from January 16 through February 15, February 16 through March 15, and March 16 through April 15. n165

[iv] Item 3. Defaults Upon Senior Securities. Item 3(a) applies to any material default in payment of principal, interest, a sinking or purchase fund installment, or any other material default not cured within thirty days if the amount of the default exceeds five percent of the total assets of the registrant and its consolidated subsidiaries, in which case the indebtedness must be identified and the nature of the default stated. The amount of the default and the total arrearage on the date the quarterly report is filed must be stated in the case of a default in the payment of principal, interest, or a sinking or purchase fund installment. Item 3(a), however, only refers to events that have become defaults under the governing instruments, *i.e.*, after the expiration of any period of grace and compliance with any notice requirements. n166

Item 3(b) requires disclosure of the title of the class and nature of the arrearage or delinquency if there is a material arrearage in the payment of dividends or any other material delinquency not cured within thirty days with respect to any registered class of preferred stock of the registrant, any class of preferred stock of the registrant that ranks prior to any class of registered securities, or any class of preferred stock of any significant subsidiary of the registrant. In the case of an arrearage in the payment of dividends, the amount and the total arrearage as of the date of filing of the report must be stated.

Item 3 need not be answered, however, concerning any default or arrearage with respect to any class of securities all of which is held by, or for the account of, the registrant or its totally held subsidiaries. n167 Moreover, the information required by Item 3 need not be made if previously disclosed on a report on Form 8-K. n168

[v] Item 4. Submission of Matters to a Vote of Security Holders. This item applies to any matter submitted to a vote of security holders, by proxy or otherwise, and requires the registrant to furnish information as to:

- the date of the meeting and whether it was an annual or special meeting;
- if there was an election of directors at the meeting, the name of (a) each director elected and (b) each other director whose term of office as a director continued after the meeting; n169
- a brief description of each other matter voted upon at the meeting with the number of votes cast for, against, or withheld, as well as the number of abstentions or broker non-votes, as to each matter, including a separate tabulation with respect to each nominee for office; n170 and
- a description of the settlement terms between the registrant and any other participant n171

terminating any solicitation subject to Rule 14a-11, including the anticipated cost to the registrant. n172

[vi] Item 5. Other Information. This item allows the registrant to report, any information required to be disclosed but not previously reported on Form 8-K during the period covered by this Form 10-Q whether or not otherwise called for by Form 10-Q. n173

The registrant must also disclose any material changes to the procedures by which security holders may recommend nominees to the registrant's board of directors, as required by Item 407(c)(3) of Regulation S-K.

[vii] Item 6. Exhibits. This item requires the registrant to furnish the exhibits in accordance with the provisions of Item 601 of Regulation S-K. n174

[3] Form 8-K--Current Report Pursuant to Section 13 or 15(d)

[a] General Filing Instructions n175 With certain exceptions, n176 every issuer subject to Sections 13 and 15(d) of the Exchange Act must file a current report on Form 8-K upon the occurrence of certain events. n177 The Commission substantially amended Form 8-K in 1977. n178 In addition, in 2004 the Commission substantially expanded Form 8-K by adding eight new items to Form 8-K, transferring two items from the periodic reports, expanding disclosures under two existing Form 8-K items, reorganizing the Form 8-K items into topical categories and shortening the Form 8-K filing deadline for most items to four business days. n179 By checking the appropriate box at the front of Form 8-K the registrant may indicate an intention to simultaneously satisfy its filing obligation pursuant to Rule 425 under the Securities Act, n180 Rule 14a-12(b) under the Exchange Act n181 or Rule 14d-2(b) under the Exchange Act. n182 In March 2004, the Commission adopted a limited safe harbor from liability under Section 10(b) of the Exchange Act and *Rule 10b-5* thereunder for failure to timely file reports required by Form 8-K Items 1.01, 1.02, 2.03, 2.04, 2.05, 2.06 and 4.02(a). The safe harbor applies until the filing due date of the registrant's quarterly or annual report for the period in question. Effective November 7, 2006, the Commission made further amendments regarding executive compensation, augmenting disclosure requirements and rearranging disclosure items so that Item 5.02 would encompass all executive compensation disclosure. A plain English requirement was also added. n183 The limited safe harbor for failure to make timely reports was also extended to cover new Item 5.02(e). n184

Unless otherwise specified, a report is to be filed or furnished within four business days after the occurrence of any one or more of the events specified in Sections 1-6 and 9 of Form 8-K. Since reports under Item 8.01 ("Other Events") are optional, there is no specific filing period required. However, registrants furnishing reports under Item 7.01 ("Regulation FD Disclosure") or electing to file a report on Form 8-K under item 8.01 solely to satisfy its obligations under Regulation FD n185 Rules 100 and 101, must furnish such reports in accordance with Regulation FD disclosure requirements. n186 Moreover, if substantially the same information has been previously reported n187 by the registrant, an additional report of the information on Form 8-K need not be made. n188 Copies of documents or instruments required to be filed pursuant to Form 8-K are not required to be filed or furnished as exhibits to the Form 8-K unless specifically required to be filed or furnished by the applicable Item. n189 For reports not filed electronically, a total of eight complete copies of Form 8-K must be filed with the Commission, five of which need not include exhibits. In addition, at least one complete copy must be filed with each exchange on which any class of securities of the registrant is registered. n190 The Nasdaq Stock Market and the New York Stock Exchange do not require copies of reports filed electronically.

[b] Section 1. Registrant's Business and Operations

Item 1.01 Entry into a Material Definitive Agreement. Item 1.01(a) requires the disclosure of the following, where the registrant has entered into a material definitive agreement not in the ordinary course of business of the registrant, n191 or into any amendment of such agreement that is material to the registrant: n192

- the date on which the agreement was entered into or amended, the identity of the parties to the

agreement or amendment and a brief description of any other material relationship between the registrant or its affiliates and any of the parties; and

- a brief description of the terms and conditions of the agreement or amendment that are material to the registrant.

Item 1.02 Termination of a Material Definitive Agreement. Item 1.02(a) requires the disclosure of the following, where a material definitive agreement n193 which was not made in the ordinary course of business of the registrant and to which the registrant is a party is terminated otherwise than by expiration of the agreement on its stated termination date, or as a result of all parties completing their obligations under such agreement, and such termination of the agreement is material to the registrant: n194

- the date of the termination of the material definitive agreement, the identity of the parties to the agreement or amendment and a brief description of any other material relationship between the registrant or its affiliates and any of the parties;
- a brief description of the terms and conditions of the agreement that are material to the registrant;
- a brief description of the material circumstances surrounding the termination; and
- any material early termination penalties incurred by the registrant.

Item 1.03 Bankruptcy or Receivership. n195 Item 1.03(a) requires the disclosure of the following, where a receiver, fiscal agent or similar officer has been appointed for a registrant or its parent, in a proceeding under the Bankruptcy Act or in any other proceeding under state or federal law in which a court or governmental authority has assumed jurisdiction over substantially all of the assets or business of the registrant or its parent, or where existing directors and officers are subject to the supervision and orders of a court or governmental authority:

- the name or other identification of the proceeding;
- the identity of the court or governmental authority;
- the date that jurisdiction was assumed; and
- the identity of the receiver, fiscal agent or similar officer and the date of his or her appointment.

Item 1.03(b) n196 requires the disclosure of the following, where the court or governmental authority holding jurisdiction has entered an order confirming a plan of reorganization, arrangement or liquidation:

- the identity of the court or governmental authority;
- the date that the order confirming the plan was entered by the court or governmental authority;
- a summary of the material features of the plan and pursuant to Item 9.01 ("Financial Statements and Exhibits") a copy of the plan as confirmed;
- the number of shares or other units of the registrant or its parent issued and outstanding, the number reserved for future issuance in respect of claims and interests filed and allowed under the plan, and the aggregate total of such numbers; and

- information as to the assets and liabilities of the registrant or its parent as of the date that the order confirming the plan was entered, or a date as close thereto as practicable.

[c] Section 2. Financial Information

Item 2.01 Completion of Acquisition or Disposition of Assets. n197 Item 2.01 requires the disclosure of the following, where the registrant or any of its majority owned subsidiaries has completed the acquisition or disposition n198 of a significant amount of assets n199 other than in the ordinary course of business:

- the date of the completion of the transaction;
- a brief description of the assets involved;
- the identity of the person(s) from whom the assets were acquired or to whom they were sold and the nature of any other material relationship between the parties or any of the registrant's affiliates, directors, officers or any associate of any such director or officer;
- the nature and amount of the consideration given or received for the assets and, if any material relationship is disclosed, the formula or principle followed in determining the amount of such consideration; and
- if the transaction is an acquisition and if a material relationship exists between the registrant or any of its affiliates and the source(s) of the funds used in the acquisition, disclose, the source(s) of the funds used unless all or any part of the consideration used is a loan made in the ordinary course of a business by a bank as defined by Section 3(a)(6) of the Act, in which case the identity of such bank may be omitted if the registrant has made a confidentiality request n200 and states in the report that the identity of the bank has been omitted and filed separately with the Commission.

Item 2.02 Results of Operations and Financial Condition. The following information must be furnished if the registrant, or any person acting on its behalf, makes any public announcement or release (including updates) disclosing material non-public information regarding the registrant's results of operations or financial condition for a completed quarterly or annual fiscal period: n201

- the date of the announcement or release; and
- a brief identification of the announcement and the text of that announcement or release as an exhibit.

No disclosure is required for oral, telephonic, webcast or broadcast communications (or similar means) if:

- the information is part of a presentation that is complementary to, and initially occurs within 48 hours after, a related, written announcement or release that has been furnished on Form 8-K pursuant to Item 2.02 prior to the presentation;
- the presentation is broadly accessible to the public by dial-in conference call, by webcast, by broadcast or by similar means;
- the financial and other statistical information contained in the presentation is provided on the registrant's website together with any information that would be required under 17 C.F.R. § 244.100 of Regulation G; n202 and

- the presentation was announced by a widely disseminated press release, that included instructions as to when and how to access the presentation and the location on the registrant's web site where the information would be available.

Item 2.03 Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement of a Registrant. n203 The following information must be furnished if the registrant becomes obligated on a direct financial obligation that is material to the registrant: n204

- the date on which the obligation is created and a brief description of the transaction or agreement creating the obligation;
- the amount and terms of the obligation and its payment, the material terms, if any, that may accelerate or increase the obligation and any recourse provisions that would enable the registrant to recover from third parties;
- any other material terms and conditions.

The following information must be furnished if the registrant becomes directly or contingently liable for an obligation that is material to the registrant arising out of an off-balance sheet arrangement:

- the date on which the registrant becomes liable and a brief description of the underlying transaction or agreement;
- the nature and amount of the obligation, including the material terms, if any, whereby it may become a direct obligation, or may be accelerated or increased, and any recourse provisions that would enable the registrant to recover from third parties;
- the maximum potential amount of future payments (undiscounted) that the registrant may be required to make, if different (2.03(b)(3)); n205 and
- any other material terms or conditions.

Item 2.04 Triggering Events That Accelerate or Increase a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement. n206 Item 2.04(a) requires the disclosure of the following, where a triggering event causing the increase or acceleration of a direct financial obligation of the registrant occurs and the consequences are material to the registrant:

- the date of the triggering event and a brief description of the underlying agreement or transaction;
- a brief description of the triggering event;
- the nature and amount of the direct financial obligation, as increased if applicable, and the applicable terms of payment or acceleration; and
- any other material obligation that may arise, increase, be accelerated, or become direct financial obligations as a result of the triggering event or the increase or acceleration of the obligation.

Item 2.04(b) requires the disclosure of the following, where a triggering event causing the increase or acceleration of a direct financial obligation of the registrant under an off-balance sheet arrangement occurs and the consequences are material to the registrant:

- the date of the triggering event and a brief description of the underlying agreement or transaction;
- a brief description of the triggering event;
- the amount of the direct financial obligation, as increased if applicable, and the applicable terms of payment or acceleration; and
- any other material obligation that may arise, increase, be accelerated, or become direct financial obligations as a result of the triggering event or the increase or acceleration of the off-balance sheet obligation or its becoming a direct financial obligation.

Item 2.05 Costs Associated With Exit or Disposal Activities. Item 2.05 requires the disclosure of the following, where the registrant's board of directors, a committee of the board of directors or the officer or officers of the registrant authorized to take such action, commits the registrant to an exit or disposal plan, or otherwise disposes of a long-lived asset or terminates employees under a plan of termination (paragraph 8 of FASB Statement of Financial Accounting Standards No. 146 *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS No. 146)), under which material charges will be incurred under applicable generally accepted accounting principles:

- the date and description of the commitment, including the facts and circumstances leading to the expected action, and the expected completion date;
- for each major type of cost associated with the course of action, an estimate of the total amount or range of amounts expected to be incurred in connection with the action (2.05(b));
- an estimate of the total amount or range of amounts expected to be incurred in connection with the action (2.05(c)); and
- the registrant's estimate of the amount or range of amounts of the charge that will result in future cash expenditures, provided, however, that if the registrant determines that at the time of the filing it is unable in good faith to determine an estimate required by (b), (c) or (d) of Item 2.05, no disclosure of such estimate shall be required; however, the registrant must file an amended report on Form 8-K under Item 2.05 within four business days after it makes a determination of such estimate or range of estimates (2.05(d)).

Item 2.06 Material Impairments. The following information must be furnished if the registrant's board of directors, a committee of the board of directors or the officer or officers of the registrant authorized to take such action, concludes that a material charge for impairment to one or more of its assets, including, without limitation, impairments of securities or goodwill, is required under applicable generally accepted accounting principles: n207

- the date of the conclusion and a description of the impaired asset(s) and the facts and circumstances leading to the conclusions that the charge is required (2.06(a));
- the registrant's estimate of the amount or range of amounts of the impairment charge (2.06(b)); and
- the registrant's estimate of the amount or range of amounts of the impairment charge that will result in future cash expenditures, provided, however, that if the registrant determines that at the time of filing it is unable in good faith to make a determination of an estimate required by paragraphs (b) or (c) of Item 2.06, no disclosure of such estimate is required; however, the registrant must file an amended report on Form 8-K under item 2.06 within four business days after it makes a determination of such estimate(s)

(2.06(c)).

[d] Section 3. Securities and Trading Markets

Item 3.01 Notice of Delisting or Failure To Satisfy a Continued Listing Rule or Standard; Transfer of Listing.

n208 The following information must be furnished if the registrant has received notice from the national securities exchange or national securities association (or a facility thereof) that maintains the principal listing of any class of the registrant's common equity (as defined by 17 C.F.R. § 240.12b-2) that the registrant or such class of the registrant's securities does not satisfy a rule or standard for continued listing on the exchange or association, that the exchange has submitted an application under 17 C.F.R. § 240.12d2-2 to the Commission to delist such class of registrant's securities, or that the association has taken all necessary steps under its rules to delist the security from its automated inter-dealer quotation system (3.01(a)): n209

- the date that the registrant received notice;
- the rule or standard for continued listing on the national securities exchange or association that the registrant fails, or has failed to, satisfy; and
- any action or response that, at the time of filing, the registrant has determined to take in response to the notice.

The following information must be furnished if the registrant has notified the national securities exchange or national securities association (or a facility thereof) that maintains the principal listing for any class of the registrant's common equity (as defined in 17 C.F.R. § 240.12b-2) that the registrant is aware of any material noncompliance with a rule or standard for continued listing on the exchange or association (3.01(b)):

- the date that the registrant provided such notice;
- the applicable rule or standard for continued listing on the exchange or association; and
- any action or response that, at the time of filing, the registrant has determined to take regarding its noncompliance.

If the national securities exchange or national securities association (or a facility thereof) that maintains the principal listing for any class of the registrant's common equity (as defined in 17 C.F.R. § 240.12b-2), in lieu of suspending trading in or delisting such class of registrant's securities, issues a public reprimand letter or similar communication, the registrant must state the date, and summarize the contents of the letter or communication (3.01(c)).

If the registrant's board of directors, a committee of the board of directors or the officer or officers of the registrant authorized to take such action, has taken a definitive action to cause the listing of a class of its common equity to be withdrawn from the national securities exchange or terminated from the automated inter-dealer quotation system of a registered national association, where such exchange or association maintains the principal listing for such class of securities, including by reason of a transfer of the listing or quotation to another securities exchange or quotation system, the registrant must describe the action taken and state the date of the action.

Item 3.02 Unregistered Sales of Equity Securities. If the registrant sells equity securities in a transaction that is not registered under the Securities Act, the registrant must furnish the information set forth in paragraphs (a) and (c) through (e) of Item 701 of Regulation S-K (17 C.F.R. § 229.701(a) and (c) through (e)). n210

Disclosure is not mandatory under Item 3.02 if the equity securities sold, in the aggregate since its last report filed under

Item 3.01 or its last periodic report (whichever is more recent), constitute less than 1% of the number of shares outstanding n211 of the class of equity securities sold. For smaller reporting companies, n212 no report is required if the equity securities sold, in the aggregate since its last report filed under Item 3.01 or its last periodic report (whichever is more recent), constitute less than 5% of the number of shares outstanding of the class of equity securities sold.

Item 3.03 Material Modification to Rights of Security Holders. n213 The following information must be disclosed if the constituent instruments, defining the rights of the holders of any class of registered securities of the registrant have been materially modified:

- the date of the modification;
- the title of the class of securities involved; and
- a brief description of the general effect of such modification upon the rights of holders of such securities.

The following information must be disclosed if the rights evidenced by any class of registered securities have been materially limited or qualified by the issuance or modification of any other class of securities by the registrant:

- the date of the issuance or modification; and
- the general effect of the issuance or modification of such other class of securities upon the rights of the holders of the registered securities.

[e] Section 4. Matters Related to Accountants and Financial Statements

Item 4.01 Changes in Registrant's Certifying Accountant. If an independent accountant who was previously engaged as the principal accountant to audit the registrant's financial statements, or an independent accountant upon whom the principal accountant expressed reliance in its report regarding a significant subsidiary, resigns or indicates that it declines to stand for re-appointment or is dismissed, the registrant must disclose the information required by Regulation S-K n214 under 17 C.F.R. § 229.304(a)(1) and (a)(3).

If a new independent accountant has been engaged as either the principal accountant to audit the registrant's financial statements or as an independent accountant on whom the principal accountant is expected to express reliance in its report regarding a significant subsidiary, the registrant must disclose the information required by Regulation S-K under 17 C.F.R. § 229.304(a)(2). n215

Item 4.02 Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review. Item 4.02(a) requires the disclosure of the following, where the registrant's board of directors, a committee of the board of directors or the officer or officers of the registrant authorized to take such action, concludes that any previously issued financial statements, covering one or more years or interim periods for which the registrant is required to provide financial statements under Regulation S-X (17 C.F.R. part 210), n216 should no longer be relied upon because of an error in such financial statements as addressed in Accounting Principles Board Opinion No. 20, as may be modified, supplemented or succeeded:

- the date of the conclusion regarding the non-reliance and an identification of the financial statements and years or periods covered that should no longer be relied upon;
- a brief description of the facts underlying the conclusion to the extent known to the registrant; and

1-4 Federal Securities Exchange Act of 1934 § 4.02

- a statement of whether the audit committee, or the board of directors in the absence of an audit committee, or authorized officer or officers, discussed with the registrant's independent accountant the matters disclosed in the filing pursuant to Item 4.02(a).

Item 4.02(b) requires the disclosure of the following, where the registrant is advised by, or receives notice from, its independent accountant that disclosure should be made or action should be taken to prevent future reliance on a previously issued audit report or completed interim review related to previously issued financial statements:

- the date on which the registrant was so advised or notified;
- identification of the financial statements that should no longer be relied upon;
- a brief description of the information provided by the accountant; and
- a statement of whether the audit committee, or the board of directors in the absence of an audit committee, or authorized officer or officers, discussed with the registrant's independent accountant the matters disclosed in the filing pursuant to Item 4.02(b).

Item 4.02(c) requires the following actions, where the registrant receives advisement or notice from its independent accountant requiring disclosure under paragraph (b) of Item 4.02:

- provide the independent accountant with a copy of the disclosures it is making in response to this Item 4.02 no later than the day that the disclosures are filed with the Commission;
- request the independent accountant to furnish to the registrant as promptly as possible a letter addressed to the Commission stating whether the independent accountant agrees with the statements made by the registrant in response to this Item 4.02 and, if not, stating the respects in which it does not agree; and
- amend the registrant's previously filed Form 8-K by filing the independent accountant's letter as an exhibit to the filed Form 8-K no later than two business days after the registrant's receipt of the letter.

[f] Section 5. Corporate Governance and Management

Item 5.01 Changes in Control of Registrant. Item 5.01(a) requires the disclosure of the following, where to the knowledge of the registrant's board of directors, a committee of the board of directors or authorized officer or officers of the registrant, a change in control of the registrant has occurred: n217

- the identity of the person(s) who acquired such control;
- the date and a description of the transaction(s) which resulted in the change in control;
- the basis of the control, including the percentage of the voting securities of the registrant now beneficially owned n218 directly or indirectly by the person(s) who acquired control;
- the amount of the consideration used by such person(s);
- the source of the funds used by the person(s), unless all or any part of the consideration used is a loan made in the ordinary course of business by a bank as defined by Section 3(a)(6) of the Act, in which case the identity of such bank may be omitted provided the person who acquired control:

- has made a request for confidentiality pursuant to Section 13(d)(1)(B) of the Act; and
- states in the report that the identity of the bank has been so omitted and filed separately with the Commission.
- the identity of the person(s) from whom control was assumed; and
- any arrangements or understandings among members of both the former and new control groups and their associates with respect to the election of directors or other matters.

Item 5.01(b) requires the registrant to furnish the information required by Item 403(c) of Regulation S-K n219 (17 C.F.R. § 229.403(c)).

Item 5.02 Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers.

n220 Item 5.02(a)(1) requires the disclosure of the following, where, a director has resigned or refuses to stand for re-election to the board of directors since the date of the last annual meeting of the shareholders because of a disagreement with the registrant, known to an executive officer of the registrant, as defined in 17 C.F.R. § 240.3b-7, on any matter relating to the registrant's operations, policies, or practices, or if a director has been removed for cause from the board of directors:

- the date of such resignation, refusal to stand for re-election or removal;
- any positions held by the director on any committee of the board of directors at the time of the director's resignation, refusal to stand for re-election or removal; and
- a brief description of the circumstances representing the disagreement that the registrant believes caused, in whole or in part, the director's resignation, refusal to stand for re-election or removal.

Item 5.02(a)(2) requires that the registrant file a copy of any written correspondence furnished to the registrant by the director concerning the circumstances surrounding his or her resignation, refusal or removal as an exhibit to the report on Form 8-K.

Item 5.02(a)(3) requires that the registrant must also:

- provide the director with a copy of the disclosures it is making in response to Item 5.02 no later than the day the registrant files the disclosures with the Commission;
- provide the director with the opportunity to furnish the registrant as promptly as possible with a letter addressed to the registrant stating whether he or she agrees with the statements made by the registrant in response to Item 5.02 and, if not, stating the respects in which he or she does not agree; and
- file any letter received by the registrant from the director with the Commission as an exhibit by amendment to the previously filed Form 8-K within two business days after receipt by the registrant.

Item 5.02(b) requires that if the registrant's principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or any person performing similar functions, or any other person who is a named executive officer n221 retires, resigns or is terminated from that position, or if a director retires, resigns, is removed, or refuses to stand for re-election (except in circumstances described in Item 5.02(a)), the registrant must disclose the fact that the event has occurred and the date of that event.

Item 5.02(c) requires the disclosure of the following, where the registrant appoints a new principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer or any person performing similar functions: n222

- the name and position of the newly appointed officer and the date of the appointment;
- the information required by Items 401(b),(d), (e) and Item 404(a) of Regulation S-K n223; and
- a brief description of the any material plan, contract or arrangement (whether or not written) to which a covered officer is a party or in which he or she participates that is entered into or material amendment in connection with the triggering event or any grant or award to any such covered person or modification thereto, under any such plan, contract or arrangement in connection with any such event. n224 (5.02(c)(3)).

Item 5.02(d) requires the disclosure of the following, where the registrant elects a new director, except by a vote of security holders at an annual meeting or special meeting convened for such purpose:

- the name of the director and the date of election;
- a brief description of any arrangement or understanding between the director and any other persons, naming such person, pursuant to which such director was selected as a director;
- the committee of the board of directors to which the new director has been, or at the time of this disclosure is expected to be, named (5.02(d)(3));
- the information required by Item 404(a) of Regulation S-K or Item 404(a) of Regulation S-B, as applicable (Item 5.02(d)(4)); n225 and
- a brief description of any material plan, contract or arrangement (whether or not written) to which a covered officer is a party or in which he or she participates that is entered into or material amendment in connection with the triggering event or any grant or award to any such covered person or modification thereto, under any such plan, contract or arrangement in connection with any such event. (Item 5.20(d)(5)). n226

Item 5.02(e) requires disclosure where the registrant enters into, adopts, or otherwise commences a material compensatory plan, contract or arrangement (whether or not written), as to which the registrant's principal executive officer, principal financial officer, or a named executive officer participates or is a party. If there is a material amendment or modification, or a material grant or award under any such plan, contract or arrangement to any such person is made or materially modified, then the registrant must provide a brief description of the terms and conditions of the plan, contract or arrangement and the amounts payable to the officer thereunder. n227

Item 5.02(f) requires updated disclosure of the total compensation figure of a named executive officer to reflect recently available figures regarding salary or bonus payments. n228

Item 5.03 Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year. n229 If a registrant with a class of equity securities registered under Section 12 of the Exchange Act n230 amends its articles of incorporation or bylaws and a proposal for the amendment was not disclosed in a proxy statement or information statement filed by the registrant, the registrant must disclose the following information: n231

- the effective date of the amendment; and
- a description of the provision adopted or changed by amendment and, if applicable, the previous provision.

Item 5.03(b) requires that if a registrant determines to change the fiscal year from that used in its most recent filing with the Commission other than by means of a submission to a vote of security holders through the solicitation of proxies or otherwise, or an amendment to its articles of incorporation or bylaws, the following information must be disclosed:

- the date of such determination;
- the date of the new fiscal year end; and
- the form (e.g., Form 10-K or Form 10-Q) on which the report covering the transition period will be filed. n232.

Item 5.04 Temporary Suspension of Trading Under Registrant's Employee Benefit Plan. Under 5.04(a), no later than the fourth business day after which the registrant receives the notice required by section 101(i)(2)(E) of the Employment Retirement Income Security Act of 1974 n233, or, if such notice is not received by the registrant, on the same date by which the registrant transmits a timely notice to an affected officer or director within the time period prescribed by Rule 104(b)(2)(i)(B) or 104(b)(2)(ii) of Regulation BTR (*17 C.F.R. § 245.104(b)(2)(i)(B)* or *17 C.F.R. § 245.104(b)(2)(ii)*), the registrant must provide the information specified in Rule 104(b) (*17 C.F.R. § 245.104(b)*) and the date the registrant received the notice required by section 101(i)(2)(E) of the Employment Retirement Income Security Act of 1974 (*29 U.S.C. § 1021(i)(2)(E)*), if applicable.

Under 5.04(b), on the same date by which the registrant transmits a timely updated notice to an affected officer or director, as required by the time period under Rule 104(b)(2)(iii) of Regulation BTR (*17 C.F.R. § 245.104(b)(2)(iii)*), the registrant must provide the information specified in Rule 104(b)(3)(iii) (*17 C.F.R. § 245.104(b)(2)(iii)*).

Item 5.05 Amendments to the Registrant's Code of Ethics, or Waiver of Provision of the Code of Ethics. Item 5.05 requires that the registrant briefly describe the date and nature of any amendments made to, or waivers n234 granted from, its code of ethics n235 that apply to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. n236 The disclosure must briefly describe the date and nature of the amendment or waiver, and in the case of a waiver, the name of the person to whom the waiver was granted and the date of the waiver. n237

The registrant need not provide any information pursuant to Item 5.05 if it discloses the required information on its Internet website within four business days following the date of the amendment or waiver and the registrant has disclosed in its most recently filed annual report its Internet address and intention to provide disclosure in this manner. n238 Such information must remain on the website for at least a 12-month period and must be retained by the registrant for a period of not less than five years.

[g] Section 6. Asset-Backed Securities n239

Item 6.01 ABS Informational and Computational Material. The registrant must report under this Item any ABS informational and computation material n240 filed in, or as an exhibit to, the report.

Item 6.02 Change of Servicer or Trustee. If a servicer contemplated by Item 1108(a)(2) or (3) of Regulation AB (*17 CFR 229.1108(a)(2)*) n241 or a trustee has resigned or been removed, replaced, substituted or appointed, Item 6.02 instructs as to various required disclosures.

Item 6.03 Change in Credit Enhancement or Other External Support. The loss of an existing enhancement or support, except where the termination occurs through expiration of, or fulfillment of all obligations under, the contract requires certain disclosures, including a description of the termination, the circumstances surrounding the termination and any penalties must be described. Certain disclosures are also required under this section for the addition of or material changes to an enhancement or support.

Item 6.04 Failure to Make a Required Distribution. If a required distribution to holders of the asset-backed securities is not made as of the required distribution date under the transaction documents, and such failure is material, the registrant must identify the failure and state the nature of the failure to make the timely distribution.

Item 6.05. Securities Act Updating Disclosure. Regarding an offering of asset-backed securities registered on Form S-3, if any material pool characteristic of the actual asset pool differs by more than 5% from the asset pool described in the prospectus, then disclosures as to the actual asset pool are required under this section.

[h] Section 7. Regulation FD

Item 7.01 Regulation FD Disclosure. Pursuant to Regulation FD, Item 7.01 allows the registrant to use Form 8-K to publicly disclose information required under Regulation FD Rules 100 and 101.

In its release adopting Regulation FD, the Commission included a non-exhaustive list of some types of information or events that should be reviewed carefully to determine whether they are material: (1) earnings information; (2) mergers, acquisitions, tender offers, joint ventures, or changes in assets; (3) new products or discoveries, or developments regarding customers or suppliers (*e.g.*, the acquisition or loss of a contract); (4) changes in control or in management; (5) changes in auditors or auditor notification that the issuer may no longer rely on an auditor's audit report; (6) events regarding the issuer's securities—such as defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to the rights of security holders, public or private sales of additional securities; and (7) bankruptcies or receiverships. The Commission did not imply that each of these items is *per se* material. The information and events on this list still require determinations as to their materiality, although some determinations will be reached more easily than others. For example, some new products or contracts may clearly be material to a particular company, but that does not mean that every product development or contract will be material. n242. In July 2002, the Sarbanes-Oxley Act of 2002 added Section 13(1) to the Exchange Act, requiring public companies to disclose material information as determined by Commission regulation, "to the public on a rapid and current basis."

If the registrant chooses to make the disclosure under Item 7.01, such information will not be deemed filed for purposes of Section 18 of the Exchange Act or otherwise subject to the liabilities of that section, except if the registrant specifically states that the information is to be considered filed under the Exchange Act or incorporates it by reference into a filing under the Securities Act or the Exchange Act. A registrant may choose to make the Form 8-K Regulation FD disclosure under Item 8.01 of the Form 8-K, in which case the disclosure is deemed to be filed under the Exchange Act. n243

[i] Section 8. Other Events

Item 8.01 Other Events. The registrant may report any events that the registrant deems of importance to security holders n244 and with respect to which information is not otherwise called for on Form 8-K. The registrant, may at its option, report under Item 8.01, as opposed to Item 7.01, any previous nonpublic material information that the registrant desires to disclose in the Form 8-K to satisfy the public disclosure requirements of Regulation FD n245. The Commission advises registrants, when considering reporting on Form 8-K, particularly of other events of material importance pursuant to Item 7.01 and Item 8.01, to have due regard for the accuracy, completeness, and currency of the

information, in registration statements filed under the Securities Act which incorporate by reference information in reports filed pursuant to the Exchange Act, including reports on the Form 8-K. n246

[j] Section 9. Financial Statements and Exhibits

Item 9.01 Financial Statements and Exhibits. n247 Item 9.01(a) requires the filing of financial statements of businesses acquired that are required to be described in answer to Item 2.01. n248

The registrant may file Form 8-K without audited financial statements for acquired businesses, if the registrant files the omitted statements within seventy-one calendar days after the date that the initial report on Form 8-K must be filed. n249

The registrant may, at its option, include unaudited financial statements in its initial report. n250 During the period after a registrant has reported a business combination pursuant to Item 2.01 until the date on which the financial statements specified in Item 9.01 must be filed, registrants are deemed current in their reporting obligations, but registration statements and post-effective amendments to registration statements under the Securities Act will not be declared effective unless financial statements meeting the requirements of Rule 3-05 of Regulation S-X are provided. In addition, offerings shall not be made pursuant to effective registration statements or pursuant to Rules 505 and 506 of Regulation D, where any purchasers are not accredited investors, until the audited financial statements are filed. Provided, however, that the following offerings or sales of securities may proceed notwithstanding that financial statements of the acquired business have not been filed: offerings or sales of securities upon the conversion of outstanding convertible securities or upon the exercise of outstanding warrants or rights; dividend or interest investment plans; employee benefit plans; transactions involving secondary offerings; or sales of securities pursuant to Rule 144. n251

Item 9.01(b) requires the registrant to provide pro forma financial information for any transaction required to be described in answer to Item 2.01. The information provided must meet the requirements of Article 11 of Regulation S-X or Rule 8-05 of Regulation S-X for smaller reporting companies. n252

The exhibits shall be deemed to be filed or furnished depending on the relevant item requiring such exhibit, in accordance with the provisions of Item 601 of Regulation S-K and Instruction B(2) of Form 8-K. n253

[4] Interactive Date For Financial Reporting

In January 2009, the Commission adopted regulations that require companies to provide their financial statements in interactive data format using eXtensible Business Reporting Language (XBRL) by submitting them to the Commission and posting them on their corporate web sites. n254 The regulations amended Item 601(b)(101) of Regulation S-K (i.e., the form exhibit requirements), Rules 405 and 406T of Regulation S-T and the EDGAR Filer Manual. n255

The disclosure in interactive data format will be in addition to, rather than instead of, disclosure in the traditional electronic filing formats. Financial statements will continue to be required to be submitted to the Commission in traditional format under existing requirements. n256 The Commission's primary purpose of the amendments is to make financial information easier for investors to analyze and to assist companies in automating regulatory filings and business information processing. n257

Companies, other than investment companies, will become subject to the interactive data requirements in three groups. Smaller reporting companies will be in the last group. n258

The phase-in schedule of the interactive data requirements will apply to three groups of companies, as follows: n259

Year 1 --

1-4 Federal Securities Exchange Act of 1934 § 4.02

- Domestic and foreign companies that are large accelerated filers under Exchange Act Rule 12b-2, use U.S. Generally Accepted Accounting Principles (U.S. GAAP) and have non-affiliate held equity securities valued at more than \$5 billion (about 500 companies).

- Requirements begin for the first quarterly report on Form 10-Q or annual report on Form 20-F or 40-F, as applicable, that contains financial statements for a period ending on or after June 15, 2009.

Year 2 --

- All other domestic and foreign companies that are large accelerated filers and use U.S. GAAP.

- Requirements begin for the first quarterly report on Form 10-Q or annual report on Form 20-F or 40-F, as applicable, that contains financial statements for a period ending on or after June 15, 2010.

Year 3 --

- All other domestic and foreign companies that use U.S. GAAP and foreign companies that use International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS/IASB).

- Requirements begin for the first quarterly report on Form 10-Q or annual report on Form 20-F or 40-F, as applicable, that contains financial statements for a period ending on or after June 15, 2011.

A company will be required to tag the face of its financial statements in its initial year of interactive data reporting. A company also will be required to tag its financial statement footnotes and financial statement schedules in its initial year, but only as blocks of text. After the first year of such tagging, a company also will be required to tag the detailed quantitative disclosures within the footnotes and schedules. Following Year 3 of the phase-in period for the interactive data requirements, new public companies will become subject to the interactive data requirements for the first quarterly report on Form 10-Q or annual report on Form 20-F or 40-F, as applicable, due after they become public companies.

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FOOTNOTES:

(n1)Footnote 1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 2002 (H.R. 3763).

(n2)Footnote 2. The provisions of the Sarbanes-Oxley Act revise corporate governance standards, bolster disclosure and reporting requirements, create new federal crimes related to securities fraud, set up a new public auditor oversight board, and increase the criminal penalties for securities law violations.

(n3)Footnote 3. The Sarbanes-Oxley Act covers not only U.S. public companies, but also foreign companies that file or are required to file periodic reports under the Exchange Act. In addition, many provisions of the new law apply to

any company that has filed a registration statement under the Securities Act that has not yet become effective and has not been withdrawn. Sarbanes-Oxley Act § 2(a)(7).

(n4)Footnote 4. Rule 12b-2 defines both the "large accelerated filer" and the "accelerated filer" as an issuer meeting the following criteria as of the end of its fiscal year:

- it has been subject to the requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least twelve calendar months;
- it has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and
- it is not eligible to use the requirements for smaller reporting companies for its annual and quarterly reports.

The "large accelerated filer" has an aggregate worldwide market value of voting and non-voting common equity held by non-affiliates of the issuer of \$700 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter and the "accelerated filer" has a public float of \$75 million or more, but less than \$700 million. Rule 12b-2.

(n5)Footnote 5. *See § 4.01[1], [3] supra.*

(n6)Footnote 6. *See § 4.01[7] supra.*

(n7)Footnote 7. Certain Canadian issuers may comply with such reporting obligations by filing their home jurisdiction disclosure documents. Rule 12g3-2(b), Exchange Act Release No 29,354 *Fed. Sec. L. Rep. (CCH) P 84,812* (1991).

(n8)Footnote 8. Sarbanes-Oxley Act § 408(a) and (c).

(n9)Footnote 9. Sarbanes-Oxley Act § 408(b).

(n10)Footnote 10. Rule 12b-21.

(n11)Footnote 11. *See the House Report, H.R. Rep. No. 1383, 73d Cong. 2d Sess. (1934), reprinted in the Primary Law Sourcebook, Volume C, Section I.*

No investor, no speculator, can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. Delayed, inaccurate, and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculate on inside information. Despite the tug of conflicting interests and the influence of powerful groups, responsible officials of the leading exchanges have unqualifiedly recognized, in theory at least, the vital importance of true and accurate corporate reporting as an essential cog in the proper functioning of the public exchanges. Their efforts to

bring about more adequate and prompt publicity have been handicapped by the lack of legal power and by the failure of certain banking and business groups to appreciate that a business that gathers its capital from the investing public has not the same right to secrecy as a small privately owned and managed business. It is only a few decades since men believed that the disclosure of a balance sheet was a disclosure of a trade secret. Today few people would admit the right of any company to solicit public funds without the disclosure of a balance sheet.

The Exchange Act's disclosure requirements were imposed in light of the information concerning abuses developed by the "Pecora Committee," a subcommittee of the Senate Committee on Banking and Currency that was appropriately named after its able general counsel, Ferdinand Pecora, Esq. The Committee Report summarizing its investigation stressed the importance of timely accurate disclosure by publicly held issuers:

Responsible officials of the leading exchanges have unqualifiedly recognized in public utterances the vital importance of furnishing to the public complete, accurate, and current information regarding the financial condition of corporations with securities listed on the exchanges. The Securities Exchange Act of 1934 supplements the Securities Act of 1933, which requires information to be filed only as to the situation existing at the time the security is issued. Under the Securities Exchange Act of 1934, it is made unlawful for a member, broker, or dealer to effect any transaction in any security on a national securities exchange unless a registration is effective as to such security in accordance with the provisions of the act. The security may be registered on a national securities exchange only after the issuer has filed an application with the Securities and Exchange Commission together with such information in such detail as the Commission may by rules and regulations require as necessary or appropriate in the public interest or for the protection of investors. It is anticipated that the information filed by a corporation as a condition precedent to registration will be so complete as to present to the stockholder, or the prospective stockholder, a picture of the corporation's financial condition which will enable him intelligently to evaluate its securities.

S. Rep. No. 1455, 73d Cong. 2d Sess. (1934).

(n12)Footnote 12. See Report of Special Study of Security Markets by the Securities and Exchange Commission, House Document No. 95, 88th Cong. 1st Sess., Part 3, p. 1 (1963).

(n13)Footnote 13. Sarbanes-Oxley Act § 409, Section 13(1).

(n14)Footnote 14. See Exchange Act Release No. 49424 (2004).

(n15)Footnote 15. Registration pursuant to Section 12 is discussed in § 4.01 *supra*.

(n16)Footnote 16. See § 4.01[7] *supra*. Compare Rules 15d-1, 15d-11 and 15d-13 with Rules 13a-1, 13a-11 and 13a-13.

(n17)Footnote 17. A Section 15(d) company whose number of record stockholders falls to fewer than 300 must file with the SEC a notice on Form 15 in order to take advantage of the reporting suspension provision of Section 15(d). See Rule 15d-6 and discussion at § 4.01[7] *supra*. Section 12(g) registration requirements are discussed in § 4.01[2] *supra*.

(n18)Footnote 18. Rule 15d-5. Copies of all reports filed with the Commission are available for viewing and inspection at the Commission's Public Reference Room in Washington, D.C., and reproductions may be made. See 17 C.F.R. § 200.80. Documents can also be accessed on the Commission's site located at <http://www.sec.gov>.

Rule 15d-5 provides that an issuer deemed to be a successor issuer under Rule 15d-5(a) should file reports on the

same forms as the predecessor issuer except that:

- (1) an issuer that is not a foreign issuer is ineligible to file Form 20-F; and
- (2) a foreign private issuer is eligible to file Form 20-F. Rule 15d-5(b)(1) and (2).

(n19)Footnote 19. Rule 12b-25. Under 12b-25 the registrant, no later than one business day after the end of the specified period when the report is due, must file with the Commission a notification on Form 12b-25 that identifies the report or portion thereof that will be delayed and gives reasons for the filing delay. General Instruction A, Form 10-K. Form 12b-25, as a disclosure document, will be placed in the public files. The procedure requires only notification and does not necessitate any responsive staff action. However, with the increased number of Form 12b-25 filings as issuers tried to achieve compliance with new requirements following the adoption of the Sarbanes-Oxley Act, the SEC staff has similarly incurred its oversight of these filings.

Under Rule 12b-25, an annual or quarterly report, or portion thereof, that is filed on or before the fifteenth or fifth day, respectively, after the prescribed due date, will be deemed to have been filed timely if the issuer: (1) indicates that the reasons causing the inability to file timely could not have been eliminated without unreasonable effort or expense; (2) makes an undertaking in Form 12b-25 that the annual or quarterly report or portion thereof will be filed no later than the fifteenth or fifth calendar day, respectively, following the prescribed due date; (3) attaches an exhibit to Form 12b-25 containing a statement from any person other than the registrant (e.g., the independent auditor), whose inability to furnish any required opinion, report, or certification was the reason the annual or quarterly report could not be timely filed without unreasonable effort or expense; and (4) files the annual or quarterly report within the represented time period. *Id.*

If only a portion of a report is filed late, the registrant must indicate which items are omitted on the cover page of that portion of the report that is timely filed. When the missing items are filed, the registrant must file an amendment and must include the following statement: "The following items were the subject of a Form 12b-25 and are included herein:" The statement must then list the late-filed items submitted with the amendment.

If a report is required to be filed in electronic format and the sole reason the registrant is unable to file a report within the prescribed time period is difficulties with electronic filing, the provisions of Rule 12b-25 will not apply and the registrant should refer to the applicable rules under Regulation S-T. *See § 4.05 infra.*

(n20)Footnote 20. Section 15(d). Notice that the number of record holders is fewer than 300 persons must be given to the Commission on Form 15. Rule 15d-6.

(n21)Footnote 21. Section 18(a), discussed in § 5.03[2] *infra*, is the exclusive remedy for alleged violations of Section 13(a). Therefore, no implied private right of action exists under Section 13(a). *In re Penn Central Securities Litigation*, 494 F.2d 528 (3d Cir. 1974) ; *Phillips v. TPC Communications, Inc.*, 532 F. Supp. 696 (W.D. Pa. 1982) . However, the presence of a Section 18 remedy does not preclude implied remedies under Section 10(b) or Section 14. *See e.g.*, *Ross v. A.H. Robins Co., Ins.*, 607 F.2d 545 (2d Cir. 1979) , *cert. denied*, 446 U.S. 946 (1980) and *Gould v. American Hawaiian Steamship Co.*, 351 F.Supp. 853 (D. Del 1972) .

(n22)Footnote 22. The Securities Law Enforcement Remedies and Penny Stock Reform Act of 1990 (the "Remedies Act"), Pub. L. No. 89110, Fed. Sec. L. Rep. (CCH) No. 1416, Part II (October 10, 1990) among other things added Section 21C to the Exchange Act. Section 21C(a) gives the Commission permanent cease and desist authority to address past, current, or threatened violations of the Exchange Act or any rules or regulations promulgated thereunder. In such cease and desist proceedings, the Commission is permitted to order that a respondent cease and desist from violations of the Exchange Act and to cause the respondent to take affirmative steps to comply or effect compliance with the applicable Exchange Act provisions, including steps to ensure future compliance under Section 21C(c). The Commission also is empowered to issue temporary cease and desist orders whenever it determines that the alleged

violation or threatened violation which is the subject of a permanent cease and desist proceeding under Section 21C(a) presents a danger of dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest. In addition, in any cease-and-desist proceeding, the Commission has the authority under Section 21C(e) to enter an order requiring an accounting and disgorgement and to prohibit persons from serving as officers or directors under Section 21(C)(f).

(n23)Footnote 23. Section 21(d)(3)(B).

(n24)Footnote 24. Section 21(d)(5).

(n25)Footnote 25. Section 21(d)(3)(D).

(n26)Footnote 26. *See § 5.04 infra*. Under Section 21(d)(2) of the Exchange Act, which was also added by the Remedies Act, a court is empowered, in any civil injunctive actions brought under Section 21(d)(1), to bar an individual who has violated Section 10(b) of the Exchange Act or any of the rules or regulations thereunder (including *Rule 10b-5*) from acting as an officer or director of any company that is required to file reports under Section 15(d) or has a class of securities registered pursuant to Section 12 of the Exchange Act if the individual's conduct demonstrates unfitness to serve as an officer or director of such issuer.

(n27)Footnote 27. Special purpose forms for annual reports are: Form 11-K for employee stock purchase, savings, and similar plan interests in which securities are registered under the Securities Act; Form 18-K for foreign governments and their political subdivisions; and Form 20-F for foreign private issuers. Form 40-F is available to certain Canadian issuers under the multi-jurisdictional disclosure system with Canada adopted by the Commission in 1991. *See also* General Instruction A, Form 10-K.

(n28)Footnote 28. *Exchange Act Release No. 17,114, Fed. Sec. L. Rep. (CCH) P 72,301 (1980)*.

(n29)Footnote 29. *Id.* Concurrent with the adoption of amendments to Form 10-K, the Commission issued three other releases adopting changes related to: uniform financial statement instructions required for certain forms and reports pursuant to the Securities Act and Exchange Act, *see § 4.02[2][a] infra*; Regulation S-X (17 C.F.R. Part 210) designed to achieve uniformity, to the extent possible, between the requirements of generally accepted accounting principles and those of Regulation S-X, *see § 4A.01[3][a][i] infra*; and a simplified Form S-15, since rescinded and supplemented with Form S-4, for the registration of securities under the Securities Act issued in certain merger and reorganization transactions.

These revisions were prompted by the work of the Advisory Committee on Corporate Disclosure which had recommended a comprehensive revision of the disclosure requirement under the Securities Act and Exchange Act to achieve a simplified and uniform disclosure system. *Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission* 481 (November 3, 1977), 95th Cong. 1st Sess., Committee Print No. 9529 House Committee on Interstate and Foreign Commerce.

(n30)Footnote 30. *Exchange Act Release No. 17,114, Fed. Sec. L. Rep. (CCH) P 72,301 (1980)*.

(n31)Footnote 31. *Id.* *See* General Instruction G(2), Form 10-K.

(n32)Footnote 32. The principal effort in the case of the annual report to stockholders has been to standardize disclosure items to make them consistent with similar requirements in Commission filings, especially to provide uniformity in form, content, and timing of financial disclosure in the stockholders' report. *Exchange Act Release No. 17,114, Fed. Sec. L. Rep. (CCH) § 72,301 (1980)*.

(n33)Footnote 33. *Id.* The most frequent users of the annual report on Form 10-K have been institutional investors, professional security analysts, and individual investors.

(n34)Footnote 34. *Id.*

(n35)Footnote 35. *Id.*

(n36)Footnote 36. Items 5, 9 and 15 were effective August 23, 2004.

(n37)Footnote 37. *Exchange Act Release No. 17,095, Fed. Sec. L. Rep. (CCH) P 82,642* (1970), in which the Commission standardized its requirements on the filing of exhibits by deleting certain exhibits and by revising and making uniform other exhibit requirements. These exhibit requirements have been adopted in Item 601 of Regulation S-K, reprinted in the Primary Law sourcebook, Volume D, Section K *see* § 4.03[7] *infra.*, and were amended in *Exchange Act Release No. 18,524, Fed. Sec. L. Rep. (CCH) P 72,328* (1982).

(n38)Footnote 38. *See* Note, General Instruction G(2), Form 10-K. For discussion of Rule 14a-3(b), *see* § 7.03 *infra.*

(n39)Footnote 39. *Id. See also* § 4.05 *supra.*

(n40)Footnote 40. *Exchange Act Release No. 17,114, Fed. Sec. L. Rep. (CCH) P 72,301* (1980); General Instruction G(3), Form 10-K. If the proxy or information statement is not filed within 120 days after the end of the fiscal year covered by the Form 10-K, then Items 10-13 (Part III) must be filed as part of the Form 10-K or as an amendment to the Form 10-K not later than the end of the 120 day period. General Instruction G(3), Form 10-K.

(n41)Footnote 41. General Instruction A, Form 10-K and Exchange Act Rules 13a-10 and 15d-10. The accelerated filing deadlines were amended and the category of large accelerated filer was created. The "large accelerated filer" will have a deadline for filing Form 10-K annual reports of sixty days, beginning with the annual report filed for its first fiscal year ending on or after December 15, 2006. With the creation of the "large accelerated filer" category, "accelerated filers" were carved out of the sixty day deadline and the deadline for filing Form 10-K annual reports for "accelerated filers" is scheduled for no further reduction than to the seventy-five day annual report deadline.

(n42)Footnote 42. The requirement for disclosure regarding website posting of Commission reports was effective beginning with fiscal years ending on or after December 15, 2002.

(n43)Footnote 43. Any company with voting or non-voting common securities listed on the New York Stock Exchange that is required to file with the SEC an annual report that includes audited financial statements is required to simultaneously make such annual report available to stockholders of such securities on or through the company's website. Listed Company Manual § 203.01. Since all listed companies are required to file their periodic and current reports, as well as other materials, through the SEC's Electronic Data Gathering Analysis and Retrieval (EDGAR) system, the New York Stock Exchange does not require a listed company to file hard copies of most SEC filing with the New York Stock Exchange.

(n44)Footnote 44. General Instruction A, Form 10-K. If a company does not timely file its Form 10-K, notice will be given by the New York Stock Exchange to (i) contact the exchange and explain the delay; and (ii) issue a press release disclosing the reason and status of the delay as well as giving the anticipated filing date, if known. Listed Company Manual § 203.01.

(n45)Footnote 45. Exchange Act Rule 0-3(a).

(n46)Footnote 46. *Exchange Act Release No. 31,905, Fed. Sec. L. Rep. (CCH) P 85,111* (1993).

(n47)Footnote 47. Rule 13a-1. Registration pursuant to Section 12 is discussed in § 4.01 *supra.*

(n48)Footnote 48. Rule 15d-1 under the Exchange Act, reprinted in the Primary Law Sourcebook, Volume B, Section G. *See* § 4.01[7] *supra.*

(n49)Footnote 49. General Instruction H, Form 10-K. Combined documents must contain full and complete answers to all Form 10-K items, the cover page, and the required signatures. Any such portions filed on behalf of electronic filers must be made in electronic format. *Id.*

(n50)Footnote 50. Rules 13a-10, 15d-10. In 1989, the Commission adopted significant changes in the Exchange Act reporting requirements when an issuer changes its fiscal year, or where a successor to an issuer has a different fiscal year than the issuer. Transition reports on either Form 10-K or Form 10-Q are required to be filed for interim periods between the end of an old fiscal year and the opening date of a new one. *Exchange Act Release No. 26,589, Fed. Sec. L. Rep. (CCH) P 72,435* (1989). Issuers must file a transition report on the annual reporting form, usually Form 10-K, including audited financial statements, for transition periods of six or more months. For a transition period shorter than six months, issuers have the option of filing a transition report on either Form 10-Q, including unaudited financial statements, or Form 10-K, including audited financial statements. Information for a transition period of one month or less may be included in the issuer's report on Form 10-Q for the first quarter of the newly adopted fiscal year that ends after the date on which the issuer determined to change its fiscal year, if separate audited statements of income and cash flows covering the transition period are filed with the first annual report for the newly adopted fiscal year. If the issuer's next report is the first annual report for the newly adopted fiscal year, instead of a quarterly report, a transition period of one month or less may be covered in that annual report. *Id.*

A number of issues related to transition reports are discussed in the Commission's "Compliance and Disclosure Interpretations," which is compiled and regularly updated by The Office of Chief Counsel and available on the Commission's website at <http://www.sec.gov>.

For non-accelerated filers, the filing period for transition reports on Form 10-K is ninety days after the close of the transition period or the date of the determination to change the fiscal year, whichever is later, and for transition reports on Form 10-Q, forty-five days after the later of those two events. *Id.* The timeframe for filing transition reports for accelerated filers has been reduced to conform to the periodic reporting timeframe for accelerated filers. Exchange Act Rules 13a-10 and 15d-10.

Issuers have the option of filing quarterly reports for the transition period on the basis of either the old or new fiscal year. Also, issuers, in most cases, will continue to be required to file a quarterly report for any quarter of the old fiscal year that ended before the date of the issuer's determination to change its year end. The requirement to file quarterly reports on the new basis begins with the first quarter in the new fiscal year that ends after the issuer determined to change its year end.

(n51)Footnote 51. General Instruction D(1), Form 10-K. For discussion of Rule 14a-3(b), see § 7.03 *infra*. NASDAQ and the New York Stock Exchange no longer require copies of reports filed electronically via EDGAR.

(n52)Footnote 52. Rules 12g-3, 15d-5. Rule 12g-3 clarifies the application of the periodic reporting requirements to issuers that acquire reporting issuers by the issuance of securities. See § 4.01[2] *supra*, and Rule 15d-5 clarifies when an issuer deemed to be a successor issuer should file reports on the same form as the predecessor issuer. Under Rules 13a-10 and 15d-10 transition reporting is required for successor issuers which have a different fiscal year end from that of the predecessor issuer. Successor issuers are required to file a transition report concerning the predecessor issuer for any transition period between the close of the fiscal year covered by the last annual report of the predecessor issuer and the date of succession. For a transition period of six or more months, the successor issuer must file the transition report on Form 10-K, including audited financial statements. For a transition period of less than six months, the successor issuer may opt instead to file the transition report on Form 10-Q, including unaudited financial statements. Where the transition period is one month or less, the successor issuer need not file a separate transition report, provided that the required information for the transition period is contained in a subsequent quarterly report, or, if the next report is an annual report, in that annual report.

(n53)Footnote 53. Summary suspension of trading pursuant to Section 12(k) is discussed in § 4.01[6] *supra*.

1-4 Federal Securities Exchange Act of 1934 § 4.02

(n54)Footnote 54. The certification requirement applies to annual reports on Forms 10-K, 10-KSB, 20-F and 40-F; quarterly reports on Forms 10-Q and 10-QSB; and any amendments to those forms.

(n55)Footnote 55. Issuers must provide the certifications mandated by the Sarbanes-Oxley Act as exhibits to their filings on Forms 10-Q and 10-K. *See* Exchange Act Release No. 47,986 (2003). Item 601 of Regulation S-K provides that the Section 302 Certification is Exhibit 31 and the Section 906 Certification is Exhibit 32.

(n56)Footnote 56. An officer who files a certification to the Commission knowing that the report does not comply with the Section 906 requirements is subject to a fine of up to \$1 million or imprisonment for up to ten years, or both. A "willful" violation is punishable by a fine of up to \$5 million or up to twenty years in prison, or both. Sarbanes-Oxley Act § 906(c). While there is no penalty specified for a failure to provide the Section 906 certification, it seems clear that the officers could be subjected to civil and criminal liability under the Exchange Act, particularly given that Section 3(a) of the Sarbanes-Oxley Act provides that a violation of the Sarbanes-Oxley Act or any rule or regulation thereunder will be treated as a violation of the Exchange Act.

(n57)Footnote 57. *See* Sarbanes-Oxley Act § 302. On August 27, 2002, the Commission adopted rules implementing the Section 302 certification.

(n58)Footnote 58. In the Commission's view:

A "fair presentation" of an issuer's financial condition, results of operations and cash flows encompasses the selection of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations and cash flows.

(n59)Footnote 59. *See* § 4.05 *infra*.

(n60)Footnote 60. General Instruction B(2), Form 10-K.

(n61)Footnote 61. The requirement that a majority of the registrant's directors sign the annual report on Form 10-K was adopted in 1980. *Exchange Act Release No. 17,114, Fed. Sec. L. Rep. (CCH) P 72,301* (1980). The directors' signature requirement was added to the Form 10-K to focus the attention of directors on Exchange Act filings (just as the Commission's Division of Corporation Finance was shifting its focus to periodic disclosure under the Exchange Act). *Id.* The Commission anticipated that requiring a majority of the directors to sign the Form 10-K would encourage directors to devote the necessary attention to reviewing the Form 10-K and to seek the involvement of other professionals to the degree necessary to satisfy the directors. *Id.* The directors' signature requirement reflects the Commission's belief that the added involvement of the directors in the annual report on Form 10-K is vital to disclosure under the federal securities laws and outweighs any potential legal liability caused by the added signature requirement. *Id.* For a discussion of the level of oversight expected by the Commission, see *In the Matter of W.R. Grace & Co.*, Exchange Act Release Nos. 39,156 and 39,157, *Fed. Sec. L. Rep. (CCH) P 85,963* (1997). A person who signs a filing has made a "statement" of the information contained therein for purposes of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. *Howard v. Everex Systems, Inc.*, 228 F.3d 1057 (9th Cir. 2000).

(n62)Footnote 62. *See* Rule 12b-11(d) which provides that:

Duplicated or facsimile versions of manual signatures of persons required to sign any registration statement pursuant to Sections 12(b) and 12(g) of the [Exchange] Act, any report or schedule filed pursuant to Sections 13 or 15(d) of the [Exchange] Act, or any amendment or exhibit to such registration statement, report or schedule, that are filed or submitted to the Commission under the [Exchange] Act, shall be considered manual signatures for the purposes of the [Exchange] Act and rules and regulations

thereunder; provided that, the original signed document is retained by the files for a period of five years and, upon request, the filer furnishes to the Commission or the staff the original manually-signed document.

(n63)Footnote 63. General Instruction D, Form 10-K.

(n64)Footnote 64. General Instruction D(3), Form 10-K. This requirement was previously under the Instructions for the annual report to stockholders furnished to the *Commission. Exchange Act Release No. 31,905, Fed. Sec. L. Rep. (CCH) P 85,111* (1993).

(n65)Footnote 65. General Instruction E, Form 10-K. If information is omitted, a statement to that effect must be made and the names of the subsidiaries involved must be furnished separately to the Commission. The Commission may, in its discretion, require justification that the required disclosure would be detrimental. *Id.*

(n66)Footnote 66. General Instruction I(1), Form 10-K. The Commission has granted no-action relief to a non wholly-owned subsidiary in certain cases. *See American Standard* (available March 23, 1995).

(n67)Footnote 67. *Id.*, General Instruction I(2)(a). The registrant, in explaining the material changes as part of the management's narrative analysis, should include changes in the various elements that determine revenue and expense levels such as unit sales volume, prices charged and paid, production levels, production cost variances, labor costs, and discretionary spending programs. The analysis should also include an explanation of the effect of any changes in accounting principles or practices, or method of application that have a material effect on net income as reported. *Id.*

(n68)Footnote 68. *Id.*, General Instruction I(2)(b).

(n69)Footnote 69. *Id.*, General Instruction I(2)(c).

(n70)Footnote 70. *Id.*, General Instruction I(2)(d).

(n71)Footnote 71. *Id.*

(n72)Footnote 72. For a discussion of the transition period reporting requirements applicable to Form 10-K and Form 10-Q filings, *see* § 4.02[1][a] *supra*.

(n73)Footnote 73. *Exchange Act Release No. 28,869, Fed. Sec. L. Rep. (CCH) P 84,709* (1991). This is intended to facilitate form processing and review. Failure to provide such indication will not create liability for violation of federal securities laws. Instruction to Item 10, Form 10-K.

(n74)Footnote 74. Rule 405 defines a well-known seasoned issuer as an issuer that meets all of the registrant requirements of General Instructions I.A. on Form S-3 or Form F-3 and (i) that, within 60 days of the determination date, has a public float of \$700 million or more; or (ii) that, within 60 days of the determination date, has issued at least \$1 billion aggregate principal amount of non-convertible securities, other than common equity, in primary offerings for cash in the last three years and will register only non-convertible securities, other than common equity, and full and unconditional guarantees, other than common equity. The definition of a well-known seasoned issuer also includes issuers that meet the Form S-3 and Form F-3 registrant requirements and are a majority-owned subsidiary of a parent that is a well-known seasoned issuer and the parent provides a full and unconditional guarantee of the payment obligations on the subsidiary's securities and the securities are (or are guarantees of) non-convertible securities, other than common equity. The securities of the subsidiary are guarantees of non-convertible securities, other than common equity, of the parent being registered or are non-convertible securities, other than common equity, of another majority-owned subsidiary being registered where there is a full and unconditional guarantee of such non-convertible securities by the parent.

The determination date is the latest of (a) the time of filing of its most recent shelf registration statement; or (b) its most recent amendment to a shelf registration; or (c) if the issuer has not filed a shelf registration statement or amendment thereto for the purposes of complying with Section 10(a)(3) of the Securities Act for sixteen months, the time of filing of the issuer's most recent annual report on Form 10-K or Form 20-F.

(n75)Footnote 75. See Form 10-K. In its Compliance and Disclosure Interpretations, the Commission Staff confirmed that until an issuer is required to submit Interactive Data Files, it should leave the boxes on the Form 10-K and Form 10-Q unchecked. For a discussion regarding the requirements and the applicable phase-in periods for Interactive Data files see § 4.02[4] *infra*.

(n76)Footnote 76. Although the Division of Corporation Finance does not expect the requirement that a registrant state the aggregate market value of voting stock held by nonaffiliates to be unduly burdensome, if the determination of affiliate status cannot be made without incurring inordinate time and expense, a registrant may fulfill the requirement by indicating that the amount has been calculated based on certain assumptions, which should be set forth in the Form 10-K. See Note to instructions to cover page of Form 10-K.

(n77)Footnote 77. Item 101 of Regulation S-K, reprinted in the Primary Law Sourcebook, Volume D, Section K is discussed in § 4.03[2][a] *infra*.

(n78)Footnote 78. Accelerated filer and large accelerated filer are defined in Rule 12b-2 of the Exchange Act and discussed in § 4.02[1][a] *supra*.

(n79)Footnote 79. Well-known seasoned issuer is defined in Rule 405 of the Securities Act. See § 4.02[1][a] *supra*.

(n80)Footnote 80. Item 102 of Regulation S-K is discussed in § 4.03[2][b] *infra*.

(n81)Footnote 81. Item 103 of Regulation S-K is discussed in § 4.03[2][c] *infra*.

(n82)Footnote 82. Item 3(b), Form 10-K.

(n83)Footnote 83. If, however, the registrant has published a report containing all the information required by Item 4 of Form 10-K, the Item may be answered by a reference to the information contained in the report. Instruction 6 to Item 4, Form 10-K. Regulation 14A is discussed in § 7.01[4] *infra*.

(n84)Footnote 84. *Exchange Act Release No. 31,326, Fed. Sec. L. Rep. (CCH) P 85,051 (1992)*.

(n85)Footnote 85. Disclosure of information relating to unregistered sales made in reliance on Regulation S must be furnished under Item 5 as of January 1, 1999. *Exchange Act Release No. 39,668, Fed. Sec. L. Rep. (CCH) P 86,006 (1998)*.

(n86)Footnote 86. *Exchange Act Release No. 39,668, Fed. Sec. L. Rep. (CCH) P 86,006 (1998)*.

(n87)Footnote 87. *Exchange Act Release No. 38,850, Fed. Sec. L. Rep. (CCH) P 85,953 (1997)*.

(n88)Footnote 88. Item 301 of Regulation S-K is discussed in § 4.03[4][a] *infra*.

(n89)Footnote 89. Item 303 of Regulation S-K is discussed in § 4.03[4][c] *infra*.

(n90)Footnote 90. Item 305 of Regulation S-K is discussed in § 4.03[4][e] *infra*. This disclosure was added in 1997. *Exchange Act Release No. 38,223, Fed. Sec. L. Rep. (CCH) P 72,448 (1997)*.

(n91)Footnote 91. For discussion of Regulation S-X, *see* § 4A.01[2][a] *infra*.

(n92)Footnote 92. Item 302 of Regulation S-K is discussed in § 4.03[4][b] *infra*. Item 8 of Form 10-K was amended, effective September 30, 1982, to provide that the registrant furnish financial statements meeting the requirements of Regulation S-X, except for Rule 3-05 and Article 11.

(n93)Footnote 93. Rule 301, Regulation S-X.

(n94)Footnote 94. Rule 302, Regulation S-X.

(n95)Footnote 95. *Id.*

(n96)Footnote 96. Article 8 of Regulation S-X. Article 8 of Regulation S-X replaces Item 310 of Regulation S-B for a smaller reporting company's financial statement requirements. Smaller reporting companies are discussed in § 4.03[12] *infra*.

(n97)Footnote 97. Item 304 of Regulation S-K is discussed in § 4.03[4][d] *infra*.

(n98)Footnote 98. Items 307 and 308 of Regulation S-K are discussed in § 4.03[4][g] and § 4.03[4][h] *infra*. If the registrant is neither a large accelerated file nor an accelerated filer, then pursuant to Item 9A(T) of Form 10-K, the registrant is required to furnish the information required by Items 307 and 308T of Regulation S-K for annual reports filed for fiscal years ending on or after December 15, 2007 but before December 15, 2009. Item 9A(T) of Form 10-K is scheduled to expire on June 30, 2010.

(n99)Footnote 99. *See* Exchange Act Release No. 49424 (2004).

(n100)Footnote 100. *See* General Instruction G to Form 10-K. The ability to incorporate by reference is discussed in § 4.02[1] *infra*.

(n101)Footnote 101. *See* SEC Release 33-8732A; 34-54302A; IC-27444A; August 29, 2006.

On January 27, 2006, the Commission proposed revisions to the rules governing disclosure of executive compensation, director compensation, related party transactions, director independence and other corporate governance matters, current reporting regarding compensation arrangements and beneficial ownership. *Release No. 33-8566 (Jan. 27, 2006) [71 FR 6542]*. The final rules were released August 29, 2006, with an effective date of November 7, 2006. Companies were required to comply with the disclosure requirements in Forms 8-K for triggering events that occur on or after November 7, 2006, and in Forms 10-K and 10-KSB for fiscal years ending on or after December 15, 2006. Compliance is required for any proxy or information statement filed on or after December 15, 2006, where the filing is required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006.

The amendments to the compensation disclosure rules are intended to provide investors with a "clearer and more complete picture of compensation" to principal executive officers, principal financial officers, the other highest paid executive officers and directors. Exchange Act Release No. 54302A (2006). The final rules also affect disclosure regarding related party transactions, director independence and board committee functions.

Compensation disclosure begins with a narrative providing a general overview, the Compensation Discussion and Analysis, similar to MD&A, discussing the material factors underlying compensation policies and decisions reflected in the data presented in the tables. This includes a separate report of the compensation committee, similar to the report required of the audit committee, which is considered furnished and not filed. Following the Compensation Discussion and Analysis, the executive compensation disclosure is divided into three broad categories: (1) compensation with respect to the last fiscal year (and the two preceding fiscal years); (2) holdings of equity-related interests that relate to compensation or are potential sources of future gains; and (3) retirement and other post-employment compensation. The

new rules also require a director compensation table similar to the amended Summary Compensation Table.

(n102)Footnote 102. See General Instruction G to Form 10-K. The ability to incorporate by reference is discussed in § 4.02[1] *supra*.

(n103)Footnote 103. Item 201 of Regulation S-K is discussed in § 4.03[3][a] *infra*. Item 403 of Regulation S-K is discussed in § 4.03[5][c] *infra*.

(n104)Footnote 104. See General Instruction G to Form 10-K. The ability to incorporate by reference is discussed in § 4.02[1] *supra*.

(n105)Footnote 105. See General Instruction G to Form 10-K. The ability to incorporate by reference is discussed in § 4.02[1] *supra*.

(n106)Footnote 106. See General Instruction G to Form 10-K. The ability to incorporate by reference is discussed in § 4.02[1] *supra*.

(n107)Footnote 107. The financial statements and schedules that are filed in Part IV of the Form 10-K but are not required in the annual report to security holders pursuant to Rule 14a-3 or 14c-3 are labeled "financial statement schedules."

The reason for the term "financial statement schedules" is to distinguish such documents from the other exhibits filed as part of Form 10-K for purposes of Form 10-K mailings to security holders and for microfiche processing, among others. For example, security holders requesting a copy of the Form 10-K from the registrant will receive, at no charge, copies of the financial statement schedules but will not receive copies of any exhibits.

Exchange Act Release No. 17,114, Fed. Sec. L. Rep. (CCH) P 72,301 (1980).

(n108)Footnote 108. For a discussion of Item 8 of Form 10-K, see § 4.02[1][d][v] *supra*.

(n109)Footnote 109. For a discussion of Item 601 of Regulation S-K, see § 4.03[7] *infra*.

(n110)Footnote 110. The list in response to paragraph (a) of Item 15 must contain the incorporation by reference of any financial statement, financial statement schedule, or exhibit. A financial statement schedule constitutes an "exhibit" for purposes of all rules concerning incorporation by reference. See Rule 12b-23; Item 15(a)(3), Form 10-K, reprinted in the Primary Law Sourcebook, Volume B, Section H.

(n111)Footnote 111. *Exchange Act Release No. 31,327, Fed. Sec. L. Rep. (CCH) P 85,056 (1992).* See Item 14(a)(3).

(n112)Footnote 112. See Rule 14a-3(b).

(n113)Footnote 113. Item 15(d), Form 10-K.

(n114)Footnote 114. The certification requirement applies to annual reports on Forms 10-K, 20-F and 40-F; quarterly reports on Form 10-Q; and any amendments to, and transition reports on, any of the foregoing reports.

(n115)Footnote 115. An officer who files a certification knowing that the report does not comply with the Section 906 requirements is subject to a fine of up to \$1 million or imprisonment for up to ten years, or both. A "willful" violation is punishable by a fine of up to \$5 million or up to twenty years in prison, or both. Sarbanes-Oxley Act § 906(c). While there is no penalty specified for a failure to provide the Section 906 certification, it seems clear that the

officers could be subjected to civil and criminal liability under the Exchange Act, particularly given that Section 3(b) of the Sarbanes-Oxley Act provides that a violation of the Sarbanes-Oxley Act or any rule or regulation thereunder will be treated as a violation of the Exchange Act.

(n116)Footnote 116. See Sarbanes-Oxley Act § 302. On August 27, 2002, the Commission adopted rules implementing the Section 302 Certification.

(n117)Footnote 117. In the Commission's view:

A "fair presentation" of an issuer's financial condition, results of operations and cash flows encompasses the selection of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations and cash flows.

(n118)Footnote 118. If the information is specifically incorporated into the Form 10-K by reference, copies of the specific materials must be filed as an exhibit and are deemed to be filed with the Commission. Rule 12b-23(b).

(n119)Footnote 119. *Exchange Act Release No. 17,114, Fed. Sec. L. Rep. (CCH) P 72,301* (1980).

(n120)Footnote 120. Rules 13a-13 and 15d-13. Issuers with securities registered under Section 12 that file annual reports on Form 10-K are required to file their quarterly reports on Form 10-Q. The exceptions are investment companies and foreign issuers required to file reports on Form 6-K by Rule 13a-16 or 15d-16. In addition, Part I of Form 10-Q need not be filed by life insurance companies and holding companies having only life insurance subsidiaries, mutual life insurance companies, and mining companies engaged primarily in the exploration or development (but not the production) of mineral deposits other than oil, gas, or coal. Rules 13a-13(b) and 15d-13(b).

(n121)Footnote 121. General Instruction A, Form 10-Q.

(n122)Footnote 122. Under Rule 12b-25, a registrant is required to notify the Commission on Form 12b-25 if the registrant is unable to file timely all or any portion of an annual report on Form 10-K, 20-F, or 11-K or a quarterly report on Form 10-Q. See n.46 *supra*, for a discussion of Rule 12b-25's requirements and procedure.

If a report is required to be filed in electronic format and the sole reason the registrant is unable to file a report within the prescribed time period is difficulties with electronic filing, the provisions of Rule 12b-25 will not apply and the registrant should refer to the applicable rules under Regulation S-T.

(n123)Footnote 123. Changes to the Form 10-Q deadlines originally followed a phase-in period that would ultimately have required accelerated filers (and probably large accelerated filers, that category not yet created at the time of the original deadline adjustments) to step-down their deadlines to thirty-five days after the end of the first three fiscal quarters. The Commission amended the deadline so that it would not be less than forty days.

(n124)Footnote 124. The Commission deleted from Form 10-Q items that required disclosure of changes in security for registered securities; increases in amount outstanding of securities or indebtedness; and decreases in amount outstanding of securities or indebtedness, in the belief that those items would be contained in footnotes to the registrant's financial statements to the extent that the information is significant. *Exchange Act Release No. 17,524, Fed. Sec. L. Rep. (CCH) P 72,308* (1981).

(n125)Footnote 125. *Exchange Act Release No. 17,524, Fed. Sec. L. Rep. (CCH) P 72,308* (1981). The Commission encourages companies to publish readable and understandable reports to stockholders and believes that by so doing companies can reduce their reporting burdens by taking advantage of the opportunity to incorporate by

reference from their informal reports in partial or full satisfaction of their quarterly reporting obligations. *Id.* See General Instruction D, Form 10-Q.

(n126)Footnote 126. The term "previously reported" is defined in Rule 12b-2:

The terms "previously filed" and "previously reported" mean previously filed with, or reported in, a statement under Section 12, a report under Section 13 or 15(d), a definitive proxy statement or information statement under Section 14 of the Act, or a registration statement under the Securities Act of 1933; *provided, that information contained in any such document shall be deemed to have been previously filed with, or reported to, an exchange only if such document is filed with such exchange.*

It should be noted, however, that if any information is incorporated by reference into an electronic format document, any portion so incorporated shall be filed as an exhibit in electronic format.

General Instruction D(3), Form 10-Q.

(n127)Footnote 127. See § 4.05 *infra*.

(n128)Footnote 128. 17 C.F.R. § 240.12b-2.

(n129)Footnote 129. General Instruction B, Form 10-Q.

(n130)Footnote 130. General Instruction G, Form 10-Q.

(n131)Footnote 131. *Id.*

(n132)Footnote 132. Rule 12b-11 under the Exchange Act, reprinted in the Primary Law Sourcebook, Volume B, Section G, will permit the use of duplicated or facsimile signatures. *Id.* See n.63 *supra*. If the principal financial officer or chief accounting officer is also duly authorized to sign on behalf of the registrant, one signature is permissible as long as the dual responsibilities of the person so signing are clearly indicated. General Instruction G, Form 10-Q.

(n133)Footnote 133. For a discussion of the required certifications, see § 4.02[1][g] *supra*.

(n134)Footnote 134. See § 4.03[7] *infra*.

(n135)Footnote 135. General Instruction F(1), Form 10-Q.

(n136)Footnote 136. General Instruction H(1), Form 10-Q.

(n137)Footnote 137. General Instruction H(2)(a), Form 10-Q. Explanations of material changes should include changes in those elements that determine revenue and expense levels, e.g., unit sales volume, prices charged and paid, production levels, production cost variances, labor costs, and discretionary spending programs. *Id.*

(n138)Footnote 138. *Id.*

(n139)Footnote 139. General Instruction H(2)(b) and (c), Form 10-Q.

(n140)Footnote 140. The Form 10-Q facing sheet is similar to that of the Form 10-K. See § 4.02[1][b] *supra*.

(n141)Footnote 141. For a discussions of the transition period reporting requirements applicable to Form 10-K and Form 10-Q filings; see n.51 *supra*.

(n142)Footnote 142. This requirement is applicable only to corporate issuers. *Exchange Act Release No. 12,521,*

Fed. Sec. L. Rep. (CCH) P 80,601 (1976), as amended by *Exchange Act Release No. 17,524, Fed. Sec. L. Rep. (CCH) P 72,308* (1981).

(n143)Footnote 143. See Form 10-Q. In its Compliance and Disclosure Interpretations, the Commission Staff confirmed that until an issuer is required to submit Interactive Data Files, it should leave the boxes on the Form 10-K and Form 10-Q unchecked. For a discussion regarding the requirements and the applicable phase-in periods for Interactive Data files see § 4.02[4] *infra*.

(n144)Footnote 144. 17 C.F.R. § 210.1001.

(n145)Footnote 145. *Exchange Act Release No. 17,524, Fed. Sec. L. Rep. (CCH) P 72,308* (1981).

(n146)Footnote 146. Rule 10-01(a)(1), Regulation S-X.

Interim balance sheets should include only major captions (i.e., numbered captions) prescribed by Regulation S-X, with the exception of inventories. If any major balance sheet caption is less than ten percent of total assets and the amount in the caption has not increased or decreased by more than twenty-five percent since the end of the preceding fiscal year, the caption may be combined with others. Rule 10-01(a)(2), Regulation S-X.

Interim statements of income should also include major captions prescribed by Regulation S-X. If any major income statement caption is less than fifteen percent of average net income for the most recent three fiscal years and the amount in the caption has not increased or decreased by more than twenty percent as compared to the corresponding interim period of the preceding fiscal year, the caption may be combined with others. Rule 10-01(a)(3), Regulation S-X.

(n147)Footnote 147. Rule 10-01(a)(5), Regulation S-X.

(n148)Footnote 148. *Id.*

(n149)Footnote 149. *Id.*

(n150)Footnote 150. Rule 10-01(b)(1), Regulation S-X.

(n151)Footnote 151. *Id.*, Rule 10-01(b)(6) and (7).

(n152)Footnote 152. *Id.*, Rule 10-01(b)(3), (4) and (5).

(n153)Footnote 153. Rule 10-01(c)(1), (2) and (3). *Exchange Act Release No. 26,556, Fed. Sec. L. Rep. (CCH) P 84,354* (1989). In lieu of the year-to-date statements specified in Rule 10-01(c)(2) and (3), registrants engaged in seasonal production and sale of a single crop agricultural commodity may provide interim statements of income and changes in financial position for the twelve month period ended during the most recent fiscal quarter and for the corresponding preceding period. *Id.*, Rule 10-01(c)(4). An interim balance sheet as of the end of the corresponding fiscal quarter of the preceding fiscal year need not be provided unless necessary for an understanding of the impact of seasonal fluctuations on the registrant's financial condition. Rule 10-01(c)(1).

(n154)Footnote 154. Rule 10-01(d), Regulation S-X.

(n155)Footnote 155. Rule 10-01(e), Regulation S-X.

(n156)Footnote 156. *Id.*

(n157)Footnote 157. Item 303 of Regulation S-K reprinted in the Primary Law Sourcebook, Volume D, Section K, is discussed in § 4.03[4][c] *infra*.

(n158)Footnote 158. Item 305 of Regulation S-K is discussed in § 4.03[4][e] *infra*.

(n159)Footnote 159. Item 307 of Regulation S-K is discussed in § 4.03[4][g] *infra*.

If the registrant is neither a large accelerated filer nor an accelerated filer, then pursuant to Item 4T of Form 10-Q, the registrant is required to furnish the information required by Items 307 and 308T(b) of Regulation S-K with respect to a quarterly period that the registrant is required to file for a fiscal year ending on or after December 15, 2007, but before December 15, 2009. Item 4T of Form 10-Q is scheduled to expire on June 30, 2010.

(n160)Footnote 160. Item 103 of Regulation S-K is discussed in § 4.03[2][c] *infra*.

(n161)Footnote 161. Instruction, Item 1, Form 10-Q. The Instruction also requires that subsequent Form 10-Q filings in the same fiscal year in which a legal proceeding or a material development is reported should reference any previous reports in that year. *Id.* Note that if substantially the same information has been previously reported by the registrant, duplicative reporting on such information in the Form 10-Q need not be made.

(n162)Footnote 162. See Item 1A of Form 10-Q.

(n163)Footnote 163. *Exchange Act Release No. 37,801, Fed. Sec. L. Rep. (CCH) P 85,852 (1996)*. Information relating to unregistered sales made in reliance on Regulation S must be furnished under Item 2(c). *Exchange Act Release No. 39,668, Fed. Sec. L. Rep. (CCH) P 86,006 (1998)*. If the Item 701 information has been included in a Current Report on Form 8-K, however, it need not be furnished. See SEC Release No. 33-8400.

(n164)Footnote 164. *Exchange Act Release No. 38,850, Fed. Sec. L. Rep. (CCH) P 85,953 (1997)*.

(n165)Footnote 165. *Exchange Act Release No. 34-48766 (2003)*.

(n166)Footnote 166. Instruction, Item 3(a), Form 10-Q.

(n167)Footnote 167. Instruction, Item 3(b), Form 10-Q.

(n168)Footnote 168. *17 C.F.R. § 249.308*. The Commission amended Item 3, effective August 23, 2004, to include this instruction under Item 3(a). *Securities Act Release No. 33-8400 (2004)*.

(n169)Footnote 169. This information need not be provided if (a) proxies for the meeting were solicited pursuant to Regulation 14, (b) there was no solicitation in opposition to the management's nominees as listed in the proxy statements, and (c) all the nominees were elected. If the registrant did not solicit proxies and the board of directors as previously reported to the Commission was re-elected in its entirety, a statement to that effect is all that is required in response to this paragraph. Instruction 3, Item 4, Form 10-Q.

(n170)Footnote 170. See *Exchange Act Release No. 31,326, Fed. Sec. L. Rep. (CCH) P 85,051 (1992)*.

(n171)Footnote 171. "Participant" is defined in Rule 14a-11(b), see § 7.08 [1][b] *infra*.

(n172)Footnote 172. If the registrant has furnished to its security holders proxy soliciting material containing the information required by this paragraph, the information in that material may be incorporated by reference in response to this paragraph. Instruction 5, Item 4, Form 10-Q. Proxy contests subject to Rule 14a-11 of Regulation 14A are discussed in § 7.08[1] *infra*.

(n173)Footnote 173. For discussion of current reports on Form 8-K, see § 4.02[3] *infra*. If the registrant discloses information under Item 5, it need not be repeated in a report on Form 8-K that would otherwise be required to be filed concerning that information or in a subsequent report on Form 10-Q.

(n174)Footnote 174. The exhibit requirements for Form 10-Q are discussed in § 4.03[7][c] *infra*.

(n175)Footnote 175. In December 2004, the reporting requirements were amended in order to establish a separate framework for the registration and reporting of asset-backed securities due to the differences between asset-backed securities and other securities. Among the amendments is General Instruction G in the General Filing Instructions:

The following applies to registrants that are asset-backed issuers. Terms used in this General Instruction G have the same meaning as in Item 1101 of Regulation AB (17 C.F.R. § 229.1101). 1. *Reportable Events That May Be Omitted*. The registrant need not file a report on this Form upon the occurrence of any one or more of the events specified in the following: (a) Item 2.01, Completion of Acquisition or Disposition of Assets; (b) Item 2.02, Results of Operations and Financial Condition; (c) Item 2.03, Creation of a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement of a Registrant; (d) Item 2.05, Costs Associated with Exit or Disposal Activities; (e) Item 2.06, Material Impairments; (f) Item 3.01, Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing; (g) Item 3.02, Unregistered Sales of Equity Securities; (h) Item 4.01, changes in Registrants Certifying Accountant; (i) Item 4.02, Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review; (j) Item 5.01, Changes in Control of Registrant; (k) Item 5.02, Departure of Directors or Principal Officers; Election of Directors; Appointment of Principal Officers; (l) Item 5.04, Temporary Suspension of Trading Under Registrant's Employee Benefit Plans; and (m) Item 5.05, Amendments to the Registrant's Code of Ethics, or Waiver of a Provision of the Code of Ethics. 2. *Additional Disclosure for the Form 8-K Cover Page*. Immediately after the name of the issuing entity on the cover page of the Form 8-K, as separate line items, identify the exact name of the depositor as specified in its charter and the exact name of the sponsor as specified in its charter. 3. *Signatures*. The Form 8-K must be signed by the depositor. In the alternative, the Form 8-K may be signed on behalf of the issuing entity by a duly authorized representative of the servicer. If multiple servicers are involved in servicing the pool assets, a duly authorized representative of the master servicer (or entity performing the equivalent functions) must sign if a representative of the servicer is to sign the report on behalf of the issuing entity.

(n176)Footnote 176. Foreign governments, foreign private issuers required to report on Form 6-K, issuers of ADRs for securities of any foreign issuer, and registered investment companies required to file quarterly reports pursuant to Rule 30b-11 of the Investment Company Act of 1940 do not report on Form 8-K. Rules 13a-11, 15d-11.

(n177)Footnote 177. General Instruction A, Form 8-K.

(n178)Footnote 178. The Commission, as part of its integrated disclosure program, adopted amendments to Form 8-K, for current reports, to ensure that:

- (1) the provisions of Form 8-K are consistent with revised provisions of Forms 10-K and 10-Q; and
- (2) Form 8-K complements other Exchange Act reporting requirements by helping to keep corporate information and documents filed with the Commission reasonably current through prompt and accurate disclosure of material corporate developments to security holders and the investing public.

Exchange Act Release No. 18,524, Fed. Sec. L. Rep. (CCH) P 72,328 (1982).

(n179)Footnote 179. By adopting these amendments, the Commission intended to benefit markets by increasing the number of unquestionably or presumptively material events that must be disclosed. The Commission also intended to benefit investors by providing better and more timely disclosure of important corporate events. The Commission noted that, the amendments were adopted to further the goals of Section 409 of the Sarbanes-Oxley Act.

(n180)Footnote 180. *17 C.F.R. § 230.425.*

(n181)Footnote 181. *17 C.F.R. § 240.14a-12(b).*

(n182)Footnote 182. *17 C.F.R. § 240.14d-2(b).*

Form 8-K may be used by a registrant to satisfy its filing obligations pursuant to Rule 425, Rule 14a-12(b) or Rule 14d-2(b) provided that the Form 8-K filing satisfies all the substantive requirements of those rules (other than the Rule 425(c) requirement to include certain specified information in any prospectus filed pursuant to such rule). A registrant is not required to check the box in connection with Rule 14a-12(b) or Rule 14d-2(b) if the communication is filed pursuant to Rule 425. Communications filed pursuant to Rule 425 are deemed filed under the other applicable sections. General Instructions A(2), Form 8-K.

(n183)Footnote 183. Release No. 34-5430A.

(n184)Footnote 184. General Instruction D to Form 8-K, which permits a registrant to file a single Form 8-K to satisfy one or more disclosure items, was amended to allow omission of the Item 1.01 heading in a Form 8-K that also discloses any other item, so long as the substantive disclosure required by Item 1.01 is included in the Form 8-K.

(n185)Footnote 185. Regulation FD provides that when a registrant, or a person acting on its behalf, selectively discloses material, nonpublic information to securities market professionals or holders of the registrant's securities where it is reasonably foreseeable that the holders will trade on the basis of the information, then the issuer must make public disclosure of the information simultaneously, in the case of an intentional disclosure, or promptly thereafter in the case of an unintentional disclosure. Acceptable methods of public disclosure include press releases distributed through a widely circulated news or wire service, or announcements made through press conferences or conference calls that interested members of the public may attend or listen to either in person, by telephonic transmission, or by other electronic transmission. *Exchange Act Release No. 43,154, Fed. Sec. L. Rep. (CCH) P 86,319 (2000)*. Companies should note that the applicable exchange may nonetheless require disclosure of material information in a press release.

(n186)Footnote 186. General Instruction B(1), Form 8-K.

(n187)Footnote 187. The term "previously reported" is defined in Rule 12b-2.

(n188)Footnote 188. General Instruction B(3), Form 8-K.

(n189)Footnote 189. This instruction does not affect the requirement to otherwise file such documents or instruments, including as exhibits to registration statements and periodic reports pursuant to Item 601 of Regulation S-K or Item 601 of Regulation S-B. General Instructions, B(4), Form 8-K. Item 601 of Regulation S-K is discussed at § 4.03[7][a] *infra*.

(n190)Footnote 190. General Instruction E, Form 8-K. Electronic filers must retain a manually signed original for five years.

(n191)Footnote 191. A material definitive agreement is defined as an agreement that provides for obligations that are material to and enforceable against the registrant, or rights that are material to the registrant and enforceable by the registrant against one or more other parties to the agreement. Item 1.01(b), Form 8-K. An agreement is deemed to be not made in the ordinary course of business even if the agreement is such as ordinarily accompanies the kind of business conducted by the registrant if it involves the subject matter identified in Item 601(b)(10)(ii)(A)-(D) of Regulation S-K (*17 C.F.R. § 229.601(b)(10)(ii)(A)-(D)*). Instruction 1, Item 1.01, Form 8-K. The last line of Instruction 1 to Item 1.01 was deleted and replaced with a sentence specifying that agreements involving the subject matter identified in Item 601(b)(10)(iii)(A) and (B) of Regulation S-K need not be disclosed under amended Item 1.01. This change also applies to the disclosure of terminations of material definitive agreements under Item 1.02 of Form 8-K, which references the

definition of "material definitive agreements" under Item 1.01 of Form 8-K. These changes occurred under the executive compensation rules promulgated in 2006, for the primary purpose of affording Form 8-K disclosure of executive compensation. Instead of being required to be disclosed based on the general requirements with regard to material definitive agreements in Item 1.01 and Item 1.02 of Form 8-K, employment compensation arrangements are covered under Item 5.02 of Form 8-K. Release No. 34-54302A.

Effective April 2006, the Commission admitted amendments to Form 8-K requiring the surviving entity in a transaction where a shell company ceases being a shell company to make a more specific and detailed filing upon assumptions of such a transaction that is required to be reported on that form. In most cases, this will occur when the shell company acquires or is acquired by an operating business. It could also occur when the shell company acquires more than nominal assets (other than cash or cash equivalents). SEC Release 33-8587.

(n192)Footnote 192. A registrant must also provide disclosure if the registrant succeeds as a party to the agreement or amendment to the agreement by assumption or assignment (other than in connection with a merger or acquisition or similar transaction). Instruction 2, Item 1.01, Form 8-K. As amended in December 2004, with respect to asset-backed securities, as defined in Item 1101 of Regulation AB (17 C.F.R. § 229.1101), disclosure is required under this Item 1.01 regarding the entry into or an amendment to a definitive agreement that is material to the asset-backed securities transaction, even if the registrant is not a party to such agreement (e.g., a servicing agreement with a servicer contemplated by Item 1108(a)(3) of Regulation AB (17 C.F.R. § 229.1108(a)(3))).

(n193)Footnote 193. A material definitive agreement carries the same meaning as in Item 1.01.

(n194)Footnote 194. No disclosure is required solely by reason of Item 1.02 if the registrant believes in good faith that the material definitive agreement has not been terminated, unless the registrant has received notice of termination pursuant to the terms of the agreement. Instruction 2, Item 1.02, Form 8-K. As amended in December 2004, with respect to asset-backed securities, as defined in Item 1101 of Regulation AB (17 C.F.R. § 229.1101), disclosure is required under this Item 1.02 regarding the termination of a definitive agreement that is material to the asset-backed securities transaction (otherwise than by expiration of the agreement on its stated termination date or as a result of all parties completing their obligations under such agreement), even if the registrant is not a party to such agreement (e.g., a servicing agreement with a servicer contemplated by Item 1108(a)(3) of Regulation AB (17 C.F.R. § 229.1108(a)(3))).

(n195)Footnote 195. As amended in December 2004, with respect to asset-backed securities, disclosure also is required under Item 1.03 if the depositor (or servicer if the servicer signs the report on Form 10-K (17 CFR 249.310) of the issuing entity) becomes aware of any instances described in Item 1.03 with respect to the sponsor, depositor, servicer contemplated by Item 1108(a)(3) of Regulation AB (17 CFR 229.1108(a)), trustee, significant obligor, enhancement or support provider contemplated by Items 1114(b) or 1115 of Regulation AB (17 CFR 229.1114(b) or 229.1115) or other material party contemplated by Item 1101(d)(1) of Regulation AB (17 CFR 1101(d)(1)).

(n196)Footnote 196. Item 1.03(b) was added in *Exchange Act Release No. 14,618, Fed. Sec. L. Rep. (CCH) P 81,549* (1978). Prior to that amendment, Item 1.03 required only that information about such bankruptcy proceedings be filed with the Commission when the proceedings were commenced. In the Commission's view, information about bankruptcy should also be reported after the proceedings have been completed.

(n197)Footnote 197. In 2005, the Form 8-K rules were amended with respect to reporting qualifications for shell companies. The amendments trigger a heightened degree of disclosure (requiring the same type of information that would be required if the registrant were filing a general form for registration of securities under the Exchange Act) for shell companies where an event occurs that terminates the shell company status. For Item 2.01, this also includes giving information reflecting the registrant and its securities upon consummation of the transaction.

(n198)Footnote 198. Acquisitions include every purchase, acquisition by lease, exchange, merger, consolidation, succession or other acquisition, except that the construction or development of property by or for the registrant or the

acquisition of materials for such purchase are not included. Dispositions include every sale, disposition by lease, exchange, merger, consolidation, mortgage, assignment or hypothecation of assets, abandonment, destruction, or other dispositions. Instruction 2, Item 2.01, Form 8-K.

(n199)Footnote 199. An amount of assets is considered significant if the registrant's and its other subsidiaries' equity in the net book value of such assets or the amount paid or received for the assets upon such acquisition or disposition exceed 10% of the total assets of the registrant and its consolidated subsidiaries, or if the transaction involved a business (see 17 C.F.R. § 210.11-01(d)) that is significant (see 17 C.F.R. § 210.11-01(b)). Acquisitions of individually insignificant businesses are not required to be reported unless they are related (see 17 C.F.R. § 210.3-05(a)(3)) and are significant in the aggregate. Instruction 4, Item 2.01, Form 8-K.

(n200)Footnote 200. Pursuant to Section 13(d)(1)(B) of the Act

(n201)Footnote 201. The requirements (e)(1)(i) of Item 10 of Regulation S-K (17 C.F.R. § 229.10(e)(1)(i)), or, if applicable, (h)(1)(i) of Item 10 of Regulation S-B (17 C.F.R. § 228.10(h)(1)(i)) apply to Item 2.02 disclosures. Instruction 2, Item 2.02, Form 8-K. Item 2.02 does not apply to disclosures made in quarterly reports on Form 10-Q or annual reports on Form 10-K. Instruction 4, Item 2.02, Form 8-K. Additionally, Nasdaq-listed companies providing earnings or other material financial "guidance" in quarterly conference calls or webcasts must comply with Nasdaq Marketplace Rule 5250(b)(1), which require that such "guidance" be provided to the public through any Regulation FD complaint method. Any material information that would reasonably be expected to affect the value of a company's securities or influence an investors' decision, or any other event that requires the filing of a current report with the SEC should be provided to NASDAQ at least ten minutes before its public dissemination. See NASDAQ Regulatory Requirements, August 2006.

(n202)Footnote 202. Regulation G applies whenever a registrant publicly discloses or releases material information that includes financial information that is prepared other than in accordance with generally accepted accounting principles ("GAAP"). Exchange Act Release No. 47,226 (2003). For a discussion of Regulation G, see § 4.03 *infra*.

(n203)Footnote 203. Under Item 2.03, direct financial obligation means the following: 1) a long-term debt obligation, as defined in 303(a)(5)(ii)(A) of Regulation S-K; 2) a capital lease obligation, as defined in 303(a)(5)(ii)(B) of Regulation S-K; 3) an operating lease obligation, as defined in 303(a)(5)(ii)(C) of Regulation S-K; or 4) a short-term debt obligation that arises other than in the ordinary course of business. Item 2.03(c), Form 8-K. Under 2.03, off-balance sheet arrangement has the meaning set forth in 303(a)(4)(ii) of Regulation S-K. Item 2.03(d), Form 8-K. Under 2.03, short-term debt obligation means a payment obligation under a borrowing arrangement scheduled to mature within one year, or, if applicable, within a registrant's operating cycle that is longer than one year. Item 2.03(e), Form 8-K.

(n204)Footnote 204. If the obligation is a security, or a term of a security, that has been or will be sold pursuant to an effective registration statement of the registrant, 8-K disclosure is not required for this obligation, if the prospectus relating to the sale contains the information required by Item 2.03 and is filed according to Securities Act Rule 424. Instruction 5, Item 2.03, Form 8-K.

(n205)Footnote 205. Under 2.03(b)(3), the maximum amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered by the registrant under recourse or collateralization provision in any guarantee agreement, transaction or arrangement. Instruction 4, Item 2.03, Form 8-K.

(n206)Footnote 206. Under Item 2.04, direct financial obligation has the meaning provided in 2.03, but also include an obligation arising out of an off-balance sheet arrangement that is accrued under FASB Statement of Financial Accounting Standards No. 5 *Accounting for Contingencies* (SFAS No. 5) as a probable loss contingency. Item 2.04(c), Form 8-K. Under 2.04, off-balance sheet arrangement has the meaning provided in Item 2.03. Item 2.04(d), Form 8-K. Under 2.04, a triggering event is an event, including default or acceleration or similar event, as a result of which a direct

financial obligation or an obligation under an off-balance sheet arrangement is increased or becomes accelerated or as a result of which a contingent obligation of the registrant arising out of an off-balance sheet arrangement becomes a direct financial obligation of the registrant. Item 2.04(e), Form 8-K. No disclosure is required under Item 2.04 if the registrant believes in good faith that no triggering event has occurred, unless the registrant has received a notice of the occurrence of a triggering event pursuant to the terms of the agreement, transaction or arrangement and the satisfaction of all conditions to such occurrence, except the passage of time. Instruction 3, Item 2.04, Form 8-K. In December 2004, the Commission amended Item 2.04 by adding the following instruction: "With respect to asset-backed securities, as defined in 17 C.F.R. § 229.1101, disclosure also is required under this Item 2.04 if an early amortization, performance trigger or other event, including an event of default, has occurred under the transaction agreements for the asset-backed securities that would materially alter the payment priority or distribution of cash flows regarding the asset-backed securities or the amortization schedule for the asset-backed securities. In providing the disclosure required by this Item, identify the changes to the payment priorities, flow of funds or asset-backed securities as a result. Disclosure is required under this Item whether or not the registrant is a party to the transaction agreement that results in the occurrence identified."

(n207)Footnote 207. No filing is required under Item 2.06 if the conclusion is made in connection with the preparation, review or audit of financial statements required to be included in the next periodic report due under the Exchange Act, the periodic report is filed on a timely basis and such conclusion is disclosed in the report. Instruction, Item 2.06, Form 8-K.

(n208)Footnote 208. Disclosure under Item 3.01(a) and 3.01(b) is required for failure to satisfy a rule or standard for continued listing (as applicable to 3.01) even if the registrant has the benefit of a grace period during which it may cure the deficiency that triggers the disclosure requirement. Instruction 2, Item 3.01, Form 8-K. Disclosure under 3.01(a), 3.01(b), and 3.01(c) is not mandatory for notices or other communications subsequent to an initial notice that the registrant does not comply with the same rule or standard. Instruction 3, Item 3.01, Form 8-K. Registrants whose securities are quoted exclusively on automated inter-deal quotation systems are not subject to Item 3.01. Instruction 4, Item 3.01, Form 8-K.

(n209)Footnote 209. The registrant is not required to disclose any information pursuant to 3.01(a) where the delisting is a result of one of the following: 1) the entire class of the security has been called for redemption, maturity or retirement; appropriate notice thereof has been given; if required, funds sufficient for the payment of all such securities have been deposited with an agency authorized to make such payments; and such funds have been made available to security holders; 2) the entire class of the security has been redeemed or paid at maturity or retirement; 3) the instruments representing the entire class of securities have come to evidence, by operation of law or otherwise, other securities in substitution thereof and represent no other right, except, if true, the right to receive an immediate cash payment; or 4) all rights pertaining to the entire class of the security have been extinguished, provided, however, that where such an event occurs as the result of an order of a court or governmental authority, the order is final, all applicable appeal periods have expired and no appeals are pending. Instruction 1, Item 3.01, Form 8-K.

(n210)Footnote 210. The registrant has no obligation to disclose information under Item 3.02 until the registrant enters into an agreement enforceable against the registrant, whether or not subject to conditions, under which the equity securities are to be sold. Absent such an agreement, the registrant must provide disclosure within four business days after the occurrence of the closing or settlement of the transaction or arrangement under which the equity securities are to be sold.

(n211)Footnote 211. Number of shares outstanding refers to the actual number of shares of equity securities of the class outstanding and does not include outstanding securities convertible into or exchangeable for such equity securities. Instruction 1, Item 3.02, Form 8-K.

(n212)Footnote 212. A smaller reporting company is defined under Item 10(4)(1) of Regulation S-K. Instruction 2, Item 3.02, Form 8-K. Smaller reporting companies are discussed in § 4.03[12] *infra*.

(n213)Footnote 213. Working capital restrictions and other limitations upon the payment of dividends must be reported pursuant to this Item 3.03. Instruction, Item 3.03, Form 8-K.

(n214)Footnote 214. Item 304 of Regulation S-K is discussed in § 4.03[4][d] *infra*.

(n215)Footnote 215. The resignation or dismissal of an independent accountant, or its refusal to stand for re-appointment, is a reportable event separate from the engagement of a new independent accountant. On some occasions, two reports on Form 8-K are required for a single change in accountants, the first on the resignation (or refusal to stand for re-appointment) or dismissal of the former accountant and the second when the new accountant is engaged. Information required in the second Form 8-K in such situations need not be provided to the extent that it has been reported previously in the first Form 8-K. Instruction, Item 4.01, Form 8-K.

(n216)Footnote 216. Regulation G is discussed in § 4A.01[2][a] *infra*.

(n217)Footnote 217. In 2005, the Form 8-K rules were amended regarding reporting qualifications for shell companies. The amendments trigger a heightened degree of disclosure (requiring the same type of information that would be required if the registrant were filing a general registration form under the Exchange Act) for shell companies where an event occurs that terminates the shell company status. For Item 2.01, this also includes giving information reflecting the registrant and its securities upon consummation of the transaction.

(n218)Footnote 218. The determination of beneficial ownership pursuant to Exchange Act Sections 13(d) and 13(g), and the rules adopted thereunder, is discussed in § 7A.02 *infra*.

(n219)Footnote 219. Item 403(c) of Regulation S-K is discussed in § 4.03[5][c] *infra*. Note that Item 6(c) of Schedule 14A, containing the disclosure requirements governing proxy statements, requires the information called for by Item 403(c) of Regulation S-K to be reported in the proxy statement to the extent known by the person on whose behalf the proxy solicitation is being made.

(n220)Footnote 220. See *Exchange Act Release No. 15,384, Fed. Sec. L. Rep. (CCH) P 81,766* (1978). See SEC Release No. 33-8400 (2004). The disclosure requirements of Item 5.02 do not apply to a registrant that is a wholly-owned subsidiary of an issuer with a class of securities registered under Section 12 of the Exchange Act (15 U.S.C. § 78 l), or that is required to file reports under Section 15(d) of the Exchange Act (15 U.S.C. § 780(d). Instruction 1, Item 5.02, Form 8-K.

The new executive compensation rules adopted in 2006 make significant changes to Item 5.02. The changes modify the overall requirements for disclosure of employment compensation arrangements on Form 8-K and locate all such disclosure under Item 5.02. While Item 5.02 previously contained some executive compensation disclosure, the amendments require description of employment compensation arrangements involving "named executive officers" that were previously disclosed under Item 1.01. A new Instruction to Item 5.02 defines "named executive officer" for the purposes of Item 5.02 as the persons for whom disclosure was required in the most recent filing with the Commission that required disclosure under Item 402(c) of Regulation S-K or Item 402(b) of Regulation S-B, as applicable. A new Instruction to Item 5.02 excludes disclosure of plans, contracts, and arrangements to the extent they do not discriminate in scope, terms or operation, in favor of executive officers or directors of the registrant and are available generally to all salaried employees.

The increased disclosure, with a brief description of the specified matter, includes:

- information regarding retirement, resignation or termination for all named executive officers, whether or not included in the list specified in Item 5.02 prior to the amendments;
- expanding 5.02 disclosure beyond employment agreements to include a brief description of any

material plan, contract or agreement to which a covered officer or director is a party or in which he or she participates that is entered into or materially amended in connection with any of the triggering events specified in Item 5.02(c) and (d), or any grant or award to any such covered person, or modification thereto, under any such plan, contract or arrangement in connection with any such event;

- a brief description of any material new compensatory plan, contract or arrangement, or new grant or award thereunder (whether or not written), and any material amendment to any compensatory plan, contract or arrangement (or any modification to a grant or award thereunder), whether or not such occurrence is in connection with a triggering event specified in Item 5.02; provided, however, that grants, awards or modifications do not require disclosure if they are inconsistent with the terms of previously disclosed plans or arrangements and they are disclosed the next time the company is required to provide new disclosure under Item 402 of Regulation S-K; and

- salary or bonus information for the most recent fiscal year that was not available at the latest practicable date in connection with disclosure under Item 402 of Regulation S-K. This disclosure will also require a new total compensation recalculation to reflect the new salary or bonus information.

(n221)Footnote 221. Instruction 4 was added to Item 5.02 of Form 8-K as part of the executive compensation disclosure amendments in 2006, and defines "named executive officer" as those executive officers for whom disclosure was required in the registrant's most recent filing with the Commission under the Securities Act or Exchange Act that required disclosure pursuant to Item 402(c) of Regulation S-K. Release No. 34- 54302A.

(n222)Footnote 222. If the registrant intends to make a public announcement of the appointment other than by means of a report on Form 8-K, the registrant may delay filing the Form 8-K containing the disclosures required by this Item 5.02(c) until the day on which the registrant otherwise makes public announcement of the appointment of such officer. Instruction, Item 5.02(c), Form 8-K.

(n223)Footnote 223. 17 C.F.R. § 229.401(b),(d), (e) and 229.404(a), or in the case of a small business issuer, 17 C.F.R. § 228.401(a)(4), (a)(5), (c) and 228.404(a) and (b)

(n224)Footnote 224. Item 5.02(c)(3) was amended in 2006 to expand the disclosure of employment compensation arrangements, effective as to triggering events on or after November 7, 2006. Release No. 34-54302A. The instruction to 5.02(c) provides that if the registrant intends to make a public announcement of the appointment other than by means of a report on Form 8-K, the registrant may delay filing the Form 8-K containing the 5.02(c) disclosure until the day on which the registrant otherwise makes public announcement of such officer.

(n225)Footnote 225. 17 C.F.R. § 229.404(a) or 228.404(a), respectively. To the extent that any information required in Item 5.02(c)(3), 5.02(d)(3) or Item 5.02(d)(4) is not determined or is unavailable at the time of the required filing, the registrant must include a statement to this effect in the filing and then must file an amendment to its Form 8-K filing containing such information within four business days after the information is determined or becomes available. Instruction 2, Item 5.02, Form 8-K.

(n226)Footnote 226. Item 5.02(d)(5) was added in 2006 as part of the effort to move all executive compensation disclosure to Section 5.02. Release No. 34-54302A.

(n227)Footnote 227. Item 5.02(e) was added in 2006 as part of the effort to move all executive compensation disclosure to Section 5.02. Instructions to paragraph (e) were also added to (i) require disclosure under Item 5.02(e) regardless of whether the specified event is in connection with events otherwise triggering disclosure pursuant to Item 5.02; and (ii) clarify that grants or awards that are materially consistent with the previously disclosed terms of the plan, contract or arrangement need not be disclosed under Item 5.02(e), provided that the registrant has previously disclosed

such terms and the grant, award or modification is disclosed when Item 402 of Regulation S-K requires such disclosure. Instruction 3 to Item 5.02 was added to exclude the disclosure of plans, contracts or arrangements to the extent they do not discriminate in scope, terms or operation, in favor of executive officers or directors of the registrant and that are available generally to all salaried employees. Release No. 34-54302A.

(n228)Footnote 228. Item 5.02(f) was added in 2006, under the executive compensation disclosure amendments as part of the effort to move all executive compensation disclosure to Section 5.02. Release No. 34-54302A. If the salary or bonus of a named executive officer is omitted from the Summary Compensation Table as specified in Instruction 1 to Item 402(c)(2)(iii) and (iv) of Regulation S-K because the figure cannot be calculated as of the most recent practicable data, disclosure is appropriate under this Item 5.02(f) when there is a payment, grant, award, decision or other occurrence as a result of which such amounts become calculable in whole or in part.

(n229)Footnote 229. Refer to Item 601(b)(3) of regulation S-K regarding the filing of exhibits to this Item 5.03. Instruction, Item 5.03, Form 8-K. Item 601 of Regulation S-K is discussed at § 4.03[7][a] *infra*. In December 2006, the Commission amended Item 5.03 by adding the following instruction: "With respect to asset-backed securities, as defined in 17 C.F.R. § 229.1101, disclosure is required under this Item 5.03 regarding any amendment to the governing documents of the issuing entity, regardless of whether the class of asset-backed securities is reporting under Section 13 or 15(d) of the Exchange Act."

(n230)Footnote 230. 15 U.S.C. § 78l

(n231)Footnote 231. Item 5.03(a), Form 8-K.

(n232)Footnote 232. If the registrant decides later to file the report covering the transition period on a form different from the form specified in the Form 8-K, the registrant should file an amended Form 8-K stating the change. *Exchange Act Release No. 26,589, Fed. Sec. L. Rep. (CCH) P 72,435 (1989). See § 4.02[1][a], supra*, for a discussion of the reporting requirements applicable to a change in fiscal year. *See Exchange Act Release No. 46,084 (2002) for proposed changes to this Item.*

(n233)Footnote 233. 29 U.S.C. § 1021(i)(2)(E).

(n234)Footnote 234. The term "waiver" means the approval by the registrant of a material departure from a provision of the code of ethics, and the term "implicit waiver" means the registrant's failure to take action within a reasonable period of time regarding a material departure from a provision of the code of ethics that has been made known to an executive officer, as defined in Rule 3b-7 of the Exchange Act. Instruction 2, Item 10. Exchange Act Release No. 47,235 (2003).

(n235)Footnote 235. Item 5.05(a). For a detailed discussion of Item 406 of Regulation S-K and the definition of "code of ethics," *see § 4.03[5][f] infra*.

(n236)Footnote 236. Item 5.05, Form 8-K. Only amendments or waivers relating to the specified officers must be disclosed. Instruction 1, Item 5.05, Form 8-K.

(n237)Footnote 237. Item 5.05(b), Form 8-K.

(n238)Footnote 238. Item 5.05(c), Form 8-K.

(n239)Footnote 239. Asset-backed security, or ABS, generally means a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period, plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to the security holders. The Commission adopted final rules regarding the regulation, disclosure and reporting requirements for an ABS. According to the adopting release in December 2004, the

Commission felt that an ABS required more disclosure as to servicing, transaction structure, characteristics and quality of the asset pool.

(n240)Footnote 240. ABS information and computational material means a written communication consisting solely of one or some combination of the following: (i) factual information regarding the asset-backed securities being offered and the structure and basic parameters of the securities, and descriptive information relating to each class; (ii) factual information regarding the pool assets underlying the asset-backed securities, including the factual information concerning the parameters of the asset pool appropriate to the nature of the underlying assets, such as the type of assets comprising the pool and the programs under which the loans were originated; (iii) identification of key parties to the transaction, such as services, trustees, depositors, sponsors, originators and providers of credit enhancement or other support, including a brief description of each party's roles, responsibilities, background and experiences; (iv) static pool data, as referenced in Item 1105 of Regulation AB (for amortizing asset pools), such as for the sponsor's and/or servicer's portfolio, prior transactions or the asset pool itself; (v) statistical information displaying for a particular class of asset-backed securities the yield, average life, expected maturity, interest rate sensitivity, cash flow characteristics, total rate of return, option adjusted spread or other financial or statistical information relating to the class or classes under specified prepayment, interest rate, loss or other hypothetical scenarios; (vi) the names of the underwriters participating in the offering of the securities, and other additional roles, if any, within the underwriting syndicate; (vii) the anticipated schedule for the offering (including the approximate date upon which the proposed sale to the public will begin) and a description of marketing events (including the dates, times, locations, and procedures for attending or otherwise accessing them); and (viii) a description of the procedures by which the underwriters will conduct the offering and the procedures for transactions in connection with the offering with an underwriter or participating dealer.

(n241)Footnote 241. Regulation AB is the source of various disclosure items and requirements for asset-backed securities filings under the Securities Act and Exchange Act. Item 1100(a).

(n242)Footnote 242. See *Exchange Act Release No. 43,154, Fed. Sec. L. Rep. (CCH) P 86,319* (2000).

(n243)Footnote 243. General Instructions, Form 8-K. See also, *Exchange Act Release No. 43,154, Fed. Sec. L. Rep. (CCH) P 86,319* (2000). An issuer can use other Exchange Act filings, such as a Form 10-Q, to make requisite public disclosure of information. See *Telephone Interpretations Manual No. 5* (October 2000).

(n244)Footnote 244. Item 8.01 of Form 8-K was amended to permit a registrant to include in Form 8-K any other information that the registrant deems of importance to security holders. Prior to the amendment, Item 8.01 required inclusion of information of "material" importance to security holders. *Exchange Act Release No. 18,524, Fed. Sec. L. Rep. (CCH) P 72,378* (1982).

(n245)Footnote 245. General Instruction B(1), Form 8-K

(n246)Footnote 246. General Instruction B(5), Form 8-K

(n247)Footnote 247. In June 2004, the Commission amended Item 9.01 to require a registrant that was a shell company immediately before a transaction required to be described in Item 2.01 or Item 5.01 of this form to file the financial statements required by those items in the initial report."

(n248)Footnote 248. Item 9.01(a)(1), Form 8-K. The examination, form, and content of the financial statements filed as part of the current report on Form 8-K is governed by Regulation S-X, discussed in § 4A.01[2][a] *infra*; however, no supporting schedules need be filed. Item 9.01(a)(2), Form 8-K. The financial statements must cover the time periods described in Rule 3-05(b) of Regulation S-X. Item 9.01(a)(1), Form 8-K. The financial statements must be accompanied by a manually signed accountant's report pursuant to Rule 2-02 of Regulation S-X. Item 9.01(a)(2), Form 8-K. Where one or more real estate properties are acquired, the registrant must file the financial statements and additional information specified by Rule 314 of Regulation S-X. Item 9.01(a)(3), Form 8-K.

(n249)Footnote 249. Item 9.01(a)(4), Form 8-K. *See Exchange Act Release No. 37,802, Fed. Sec. L. Rep. (CCH) P85,851 (1996).*

(n250)Footnote 250. *Exchange Act Release No. 35,113, Fed. Sec. L. Rep. (CCH) P 85,475 (1995).*

(n251)Footnote 251. Instruction 2, Item 9.01. *Exchange Act Release No. 35,897, Fed Sec. L. Rep. (CCH) P 85,640 (1995)*, allowing registrations and sales if financials are not readily available.

(n252)Footnote 252. The Item 9.01(a)(4) provision concerning the delayed filing of financial statements also applies to the filing of pro forma financial information. Item 9.01(b)(2), Form 8-K.

(n253)Footnote 253. Item 601 of Regulation S-K is discussed at § 4.03[7][a] *infra*. General Instruction F, "Incorporation by Reference," to Form 8-K permits registrants to incorporate by reference, rather than restate in the current report on Form 8-K, press releases or other communications to stockholders containing the required information, provided copies of the press releases or other documents are filed as exhibits to the Form 8-K.

(n254)Footnote 254. *See Securities Act Release No. 33-9002 (Exchange Act Release 34-59324) and the Commission's Small Business Compliance Guide -- Interactive Data for Financial Reporting.*

(n255)Footnote 255. *Id.*

(n256)Footnote 256. *Id.*

(n257)Footnote 257. *Id.*

(n258)Footnote 258. *Id.*

(n259)Footnote 259. *Id.*

(n260)Footnote 260. *Id.*



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Federal Securities Exchange Act of 1934

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CHAPTER 4 Exchange Act Registration and Reporting Requirements

1-4 Federal Securities Exchange Act of 1934 § 4.03

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§ 4.03 Integrated Disclosure--Regulation S-K

Regulation S-K was adopted in 1977 to increase the uniformity and integration of disclosure called for by the registration, reporting, and proxy solicitation requirements of the Securities Act and the Exchange Act. n1 Prior to the adoption of Regulation S-K, the Commission's forms and regulations contained separate disclosure requirements for each type of filing under both the Securities Act and the Exchange Act. Since its adoption, the Regulation has evolved into a centralized source of all disclosure requirements for periodic reports, proxy solicitations, and registration statements. n2

Regulation S-K is divided into eleven sections: (1) General; (2) Business; (3) Securities of the Registrant; (4) Financial Information; (5) Management and Certain Security Holders; (6) Registration Statement and Prospectus Provisions; (7) Exhibits; (8) Miscellaneous; (9) List of Industry Guides; (10) Roll-up Transactions; and (11) Disclosure by Registrants Engaged in Oil and Gas-Producing Activities. n3

[1] General

The first section of Regulation S-K, "General," contains six parts: "Application of Regulation S-K," "Commission Policy on Projections," "Commission Policy on Security Ratings," "Incorporating by Reference," "Use of Non-GAAP Financial Measures in Commission Filings," and "smaller reporting companies."

[a] Application of Regulation S-K. This part provides that Regulation S-K is applicable to registration statements under the Securities Act, registration statements, annual or other reports under the Exchange Act, annual reports to security holders and proxy and information statements, and any other documents required to be filed under the Exchange Act, to the extent provided in the forms and rules under the Securities Act and the Exchange Act.

[b] Commission Policy on Projections. This part contains the Commission's policy on disclosure of projections, which encourages the use in those documents specified in Rule 175 under the Securities Act and Rule 3b-6 under the Exchange Act n4 of management's good faith projections of future economic performance that have a reasonable basis and are presented in an appropriate format. The part provides that a history of operations, experience in projecting, or an outside review, among other things, may provide a reasonable basis for projections. The part also provides that in determining the appropriate format for projections, consideration must be given to, among other things, the financial

items to be projected, the period to be covered, and the manner of presentation to be used. Projections should be accompanied by disclosures that provide investors with an understanding of the basis for and the limitations of the projections, including the assumptions that, in management's opinion, are most significant to the projections or are the key factors upon which the financial results of the enterprise depend. Consideration should also be given to disclosures concerning the accuracy or inaccuracy of previous projections; and the discontinuance or resumption of providing projections should have a reasonable basis.

[c] Commission Policy on Security Ratings. This part contains the Commission's policy on disclosure of security ratings, which permits registrants to disclose, on a voluntary basis, ratings assigned by:

- rating organizations to classes of debt securities, convertible debt securities, and preferred stock in registration statements and periodic reports; and
- nationally recognized statistical rating organizations ("NRSROs") in certain communications deemed not to be a prospectus, i.e., "tombstone advertisements."

The Commission's view is that if a registrant includes a security rating in a registration statement or periodic report filed with the Commission, the registrant should also consider including: any other rating intended for public dissemination assigned to the class of securities by a NRSRO that is available on the date of the initial filing of the document and that is materially different from any rating disclosed; and the name of each rating organization whose rating is disclosed, each such rating organization's description of the category in which it rated the class of securities, the relative rank of each rating within the assigning rating organization's overall classification system, and certain disclaimers concerning the rating. Certain written consents must be included with the ratings.

Registrants should consider disclosing in an amendment or an additional filing with the Commission any material change in a security rating included in a registration statement or report. If there is a material change in the rating assigned by any NRSRO to any class of securities of a registrant subject to the reporting requirements of Section 13(a) or 15(d), the registrant should consider filing a Form 8-K or another appropriate report disclosing the rating change.

[d] Incorporation by Reference. This part contains the Commission's policy that where rules, regulations, or instructions to forms permit it, a document previously filed with the Commission may be incorporated by reference to the specific document and to the prior filing or submission in which such document was physically filed or submitted. In addition, registrants or issuers, unless expressly required, may not reference any document that incorporates another document by reference if the pertinent portion of the document containing the information or financial statements to be incorporated by reference includes an incorporation by reference to another document. This part also indicates that no document on file with the Commission for more than five years may be incorporated by reference except: (1) documents contained in registration statements as long as the registrant has a reporting requirement with the Commission; or (2) documents that the registrant specifically identifies by physical location or by Commission file number, provided such materials have not been disposed of by the Commission pursuant to its Records Control Schedule.

[e] Use of Non-GAAP Financial Measures in Commission Filings. n5 Subject to certain exceptions, whenever a registrant includes one or more non-GAAP financial measures in a filing with the Commission, this part requires the registrant to include the following in the filing:

- a presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with GAAP;
- a reconciliation (by schedule or other clearly understandable method), which shall be quantitative for historical non-GAAP measures presented, and quantitative, to the extent available without unreasonable

efforts, for forward-looking information, of the differences between the non-GAAP financial measure disclosed or released with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP;

- a statement disclosing the reasons why the registrant's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations; and

- to the extent material and not already disclosed, a statement disclosing the additional purposes, if any, for which the registrant's management uses the non-GAAP financial measure. n6

Further, a registrant must not:

- exclude charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP liquidity measures, other than the measures earnings before interest and taxes (EBIT) and earnings before interest, taxes, depreciation, and amortization (EBITDA);

- adjust a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years or there was a similar charge or gain within the prior two years;

- present non-GAAP financial measures on the face of the registrant's financial statements prepared in accordance with GAAP or in the accompanying notes;

- present non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; or

- use titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures. n7

For purposes of this part, a non-GAAP financial measure is a numerical measure of a registrant's historical or future financial performance, financial position or cash flows that:

- excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements) of the issuer; or

- includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable GAAP measure so calculated and presented. n8

[f] Smaller Reporting Companies. n9

The requirements of Regulation S-K apply to smaller reporting companies. A smaller reporting company may comply with either the requirements applicable to smaller reporting companies or the requirements applicable to other companies for each item of Regulation S-K, unless the requirements for smaller reporting companies specify that smaller reporting companies must comply with the smaller reporting company requirements. The items of Regulation S-K that contain requirements that are different for smaller reporting companies than the requirements applicable to other companies include:

Item 101	Description of business
Item 201	Market price of and dividends on registrant's common equity and related stockholder matters
Item 301	Selected financial data
Item 302	Supplementary financial information
Item 303	Management's discussion and analysis of financial condition and results of operations
Item 305	Quantitative and qualitative disclosures about market risk
Item 402	Executive compensation
Item 404	Transactions with related persons, promoters and certain control persons
Item 407	Corporate governance
Item 503	Prospectus summary, risk factors, and ratio of earnings to fixed charges
Item 504	Use of proceeds
Item 601	Exhibits

[2] Business

The second section of Regulation S-K, "Business," contains three items: "Description of Business," "Description of Property," and "Legal Proceedings."

[a] Item 101. Description of Business.

Item 101 of Regulation S-K, "Description of Business," contains eight pertinent parts: "General Development of Business," "Financial Information About Segments," "Narrative Description of Business," "Financial Information About Geographic Areas," "Available Information," "Reports to Security Holders," "Enforceability of Civil Liabilities Against Foreign Persons," and "Smaller Reporting Companies." The Commission may permit, upon the written request of the registrant and if consistent with the protection of investors, the omission of, or the substitution of comparable information for, any information required by Item 101. n10

[i] General Development of Business. Part (a) of Item 101, "General Development of Business," requires a description of the general development of the business of the registrant, its subsidiaries, and any predecessors during the prior five fiscal years, or such shorter period as the registrant has been engaged in business. Earlier periods should be disclosed if material to an understanding of the general development of the business. The description of developments should include the following information:

- the year in which the registrant was organized and the registrant's form of organization;
- the nature and results of any bankruptcy, receivership, or similar legal proceedings involving the registrant or any of its significant subsidiaries;
- the nature and results of any material reclassification, merger, or consolidation of the registrant or any of its significant subsidiaries;
- the acquisition or disposition of any material amount of assets not in the ordinary course of business; and
- any material changes in the mode of conducting the business. n11

Registrants filing a Registration Statement on Form S-1 under the Securities Act or on Form 10 under the Exchange Act, n12 that are not subject to the reporting requirements of Section 13(a) or Section 15(d) n13 of the Exchange Act immediately prior to the filing and that (including predecessors) have not had operating revenues for each of the last three fiscal years, must also describe their future plan of operation. n14

[ii] Financial Information About Segments. Part (b) of Item 101, "Financial Information About Segments," requires the registrant to report for each segment, as defined by generally accepted accounting principles, revenues from external customers, a measure of profit or loss, and total assets n15 for the last three fiscal years or for each fiscal year the registrant has been engaged in business, whichever period is shorter. In lieu of presenting duplicate information about its operating segments, n16 a registrant may reference its financial statements. n17

[iii] Narrative Description of Business. Part (c) of Item 101, "Narrative Description of Business," requires a description of the business done and intended to be done by the registrant and its subsidiaries focusing on the registrant's dominant segment or each of the reportable segments about which financial information is presented in the financial statements. The following information, to the extent material to an understanding of the registrant's business as a whole, n18 must be presented for each segment:

- the principal products produced and services rendered by the registrant in the segment and the principal markets for, and methods of distribution of, the segment's principal products and services, plus quantification of the amount or percentage of the total revenue contributed by any significant class of similar products or services accounting for ten percent or more of consolidated annual revenue for the last three fiscal years or fifteen percent or more of consolidated revenue if total revenue did not exceed \$50,000,000 during any of such fiscal years;
- the status of any material new product or segment, if the registrant has made available public information about it;
- the sources and availability of raw materials;
- the importance to the segment and the duration and effect of all patents, trademarks, licenses, franchises, and concessions held;
- the extent to which the business of the segment is or may be seasonal;
- the practices of the registrant and the industry relating to working capital items;
- the dependence of the segment upon a single or a few customers, the loss of any one or more of which would have a material adverse effect on the segment; n19
- the dollar amount of backlog orders believed to be firm as of a recent date and as of a comparable date in the preceding fiscal year, together with an indication of the portion thereof not reasonably expected to be filled within the current fiscal year, and seasonal or other material aspects of the backlog; n20
- any material portion of the business subject to renegotiation of profits or termination of contracts at the election of the government; and
- competitive conditions in the business including, where material, the identity of particular markets where the registrant competes and estimates of the number of competitors and registrant's competitive position; consideration must also be given to the principal products or services of the segment, if any.

n21

Registrants must also disclose the following information with respect to the registrant's business in general and, if material, must identify the segments to which the information is significant. Registrants must disclose, if the amount is material, the estimated amount spent during each of the last three fiscal years on company-sponsored research and development activities, determined in accordance with generally accepted accounting principles, and, if material, the estimated amount spent in each of such years on customer-sponsored research activities. In addition, the registrant must disclose the material effects of compliance with federal, state, and local environmental protection laws upon the capital expenditures, earnings, and competitive position of the registrant and its subsidiaries, as well as any material capital expenditures for environmental control facilities for the remainder of its current year and its succeeding fiscal year and for such further periods as the registrant may deem material. Finally, the number of persons employed by the registrant must be disclosed. n22

[iv] Financial Information About Geographic Areas. Part (d) of Item 101, "Financial Information About Geographic Areas," requires that the registrant disclose for each of its last three fiscal years, or for each fiscal year the registrant has been engaged in business, whichever period is shorter, revenues from external customers deriving from: the registrant's country of domicile; all foreign countries in total from which the registrant derives revenues; and any individual foreign country if material. In addition, a registrant must disclose the basis for attributing revenues from external customers to individual countries. n23 The registrant must also disclose long-lived assets, other than financial instruments, long-term customer relationships of a financial institution, mortgage and other servicing rights, deferred policy acquisition costs, and deferred tax assets located in: the registrant's country of domicile; all foreign countries in which it holds assets; and any individual foreign country if material. As with Item 101(b), n24 Item 101(d) permits cross-reference to and from the registrant's financial statements under certain circumstances. Restatement of prior period information is required in certain cases.

[v] Available Information. Part (e) of Item 101, "Available Information" requires that certain registrants meeting the definition of "accelerated filer" or "large accelerated filer" n25 disclose their Internet address in Form 10-K, if they have an Internet address, and indicate whether they make available, free of charge or through such Internet website, annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished to the Commission. If such accelerated filers do not make such filings available in this manner, they must disclose the reasons for not doing so and whether they will voluntarily provide electronic or paper copies of their filings free of charge upon request. n26 Additionally, pursuant to part (e) of Item 101, a registrant must disclose the following information in any registration statement it files with the Commission: (1) whether it files reports with the Commission, and, if it is a reporting company, the reports and other information it files with the Commission; and (2) that the public may read and copy any materials the registrant files with the Commission at its Public Reading Room, and, if the registrant is an electronic filer, on the Commission's website. n27

[vi] Reports to Security Holders.

Part (f) of Item 101, "Reports to Security Holders," requires registrants to disclose in any registration statement filed under the Securities Act (i) a brief description of the nature and frequency of reports that the registrant will give to security holders if the Commission's proxy rules or regulations, or stock exchange requirements, do not require the registrant to send an annual report to security holders or to holders of American depository receipts, and (ii) whether the reports that the registrant give will contain financial information that has been examined and reported on, with an opinion expressed "by" an independent public or certified public accountant. For registrants that are foreign private issuers, the registrant must state whether the report will include a reconciliation of financial information with United States generally accepted accounting principles if the report contains financial information that was not prepared in accordance with United States generally accepted accounting principles. n28

[vii] Enforceability of Civil Liabilities Against Foreign Persons.

Part (g) of Item 101, "Enforceability of Civil Liabilities Against Foreign Persons," requires registrants that are foreign private issuers filing registration statements under the Securities Act to make certain disclosures regarding an investor's ability to bring actions under the civil liability provisions of the United States federal securities laws against the registrant, its officers, directors and underwriters. n29

[viii] Smaller Reporting Companies. n30

Part (h) of Item 101, "Smaller Reporting Companies," provides that a registrant that meets the definition of smaller reporting company can satisfy its disclosure obligations under Item 101 of Regulation S-K by describing the development of its business during the last three years. If the smaller reporting company has not been in business for three years, then it can give the same information for predecessor(s) of the smaller reporting company if there are any. This business development description should include:

- Form and year of organization.
- Any bankruptcy, receivership or similar proceeding.
- Any material reclassification, merger, consolidation, or purchase or sale of a significant amount of assets not in the ordinary course of business.
- Business of the smaller reporting company (in response to the specific items addressed in 101(h) of Regulation S-K).

[b] Item 102. Description of Property. Item 102 of Regulation S-K, "Description of Property," requires a brief description of the location and general character of the principal plants, mines, and other materially important physical properties of the registrant and its subsidiaries, with identification of the segments that use the properties described. n31 Item 102 also requires the registrant to state whether any of the described properties is not held in fee or is held subject to any major encumbrance, and, if so, to briefly describe how the property is held. In addition, Item 102 provides specific disclosure requirements for certain extractive enterprises n32 and reserve estimates. n33 In connection with the oil and gas modernization amendments that are effective January 1, 2010, registrants who are engaged in oil and gas producing activities or significant mining operating will be required to provide additional disclosures called for by the relevant Industry Guide applicable to the registrant's business. n34

[c] Item 103. Legal Proceedings. Item 103 of Regulation S-K, "Legal Proceedings," requires a brief description of any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. A pending legal proceeding need not be described if: the business ordinarily results in actions for negligence or other claims and the proceeding does not depart from the normal kind of those actions; n35 or the proceeding involves primarily a claim for damages and the amount involved, exclusive of interest and costs, does not exceed ten percent of the current assets of the registrant and its subsidiaries on a consolidated basis. n36

Notwithstanding the foregoing, the following legal proceedings must be described:

- any material bankruptcy, receivership, or similar proceeding with respect to the registrant or any of its significant subsidiaries; n37
- any material proceeding to which any director, officer, or affiliate of the registrant, more than five percent beneficial owner or owner of record of a class of voting securities of the registrant, or an associate of any of those persons, is an adverse party or has a material interest adverse to the registrant or any of its subsidiaries; n38 and

■ any administrative or judicial proceeding (including proceedings which present in large degree the same issues) arising under any federal, state, or local provisions regulating the discharge of materials into the environment or primarily for the purpose of protecting the environment if: (a) the proceeding is material to the business or financial condition of the registrant; (b) the proceeding involves primarily a claim for damages, or involves potential monetary sanctions, capital expenditures, deferred charges, or charges to income of an amount, exclusive of interest and costs, exceeding ten percent of the current assets of the registrant and its subsidiaries on a consolidated basis; or (c) a governmental authority is a party to the proceeding and the proceeding involves potential mandatory sanctions, n39 unless the registrant reasonably believes that the proceeding will result in no monetary sanctions, or in monetary sanctions of less than \$100,000, exclusive of interest and costs. n40

If a material legal proceeding is pending, or is known to be contemplated by governmental authorities, the registrant should include the following or similar information:

- the court or agency in which the proceeding is pending;
- the date the proceeding was instituted;
- the principal parties to the proceeding;
- a description of the factual basis alleged to underlie the proceeding; and
- the relief sought.

[3] Securities of the Registrant

The third section of Regulation S-K, "Securities of the Registrant," contains two items: "Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters" and "Description of Registrant's Securities."

[a] Item 201. Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters.

Item 201 of Regulation S-K, "Market Price and Dividends on the Registrant's Common Equity and Related Stockholder Matters," contains five parts: "Market Information," "Holders," "Dividends," "Securities Authorized for Issuance under Equity Compensation Plans," and "Performance Graph."

[i] Market Information. Part (a) of Item 201, "Market Information," requires the registrant to identify the principal U.S. market(s) in which each class of the registrant's common equity is being traded. n41 If the principal U.S. market for the registrant's common equity is an exchange, the registrant must state the high and low sales prices for the equity for each full quarterly period within the two most recent fiscal years and any subsequent interim period for which financial statements are included, or are required to be included by Article 3 of Regulation S-X or Article 8 in the case of smaller reporting companies, n42 as reported in the consolidated transaction reporting system, or if not reported in that system, as reported on the principal exchange market for the equity. n43 If the principal U.S. market for the registrant's common equity is not an exchange, the registrant must state the range of high and low bid information for the same periods, as regularly quoted on the automated quotation system of a registered securities association, or if not quoted on a quotation system, the range of quotations as reported, with the source of the quotations indicated. n44

If there is no established public trading market n45 for a class of the registrant's common equity, a statement to that effect must be furnished n46 and reference to bid quotations must be qualified by appropriate explanation. n47 In

addition, if market information is being presented in a registration statement on Form S-1 under the Securities Act, or on Form 10 under the Exchange Act relating to a class of common equity for which at the time of filing there is no established United States public trading market, the registrant must indicate the amount of common equity that:

- is subject to outstanding options or warrants to purchase, or securities convertible into, the registrant's common equity;
- could be sold under Securities Act Rule 144 n48 or that the registrant has agreed to register under the Securities Act for sale by security holders; or
- is being publicly offered (or has been publicly proposed to be offered), unless it is offered pursuant to an employee benefit or dividend reinvestment plan, the offering of which could have a material effect on the market price of the registrant's common equity. n49

If the market information required by Item 201 is presented in a registration statement or a proxy or information statement, the registrant must also include price information as of the latest practicable date, and if the securities are to be issued in connection with an acquisition, business combination, or other reorganization, as of the date immediately prior to the public announcement of the transaction. n50

Foreign registrants must also identify the principal established foreign public trading market, if any, for their common equity n51 and provide market price information comparable, to the extent practicable, to that required for the principal U.S. market. n52 Such price information may be stated in the currency in which it is quoted, or may be translated into U.S. currency at the exchange rate in effect on the date such information was reported on the foreign exchange. If the primary U.S. market for the registrant's common equity trades using American Depositary Receipts, the U.S. prices shall be disclosed on that basis. n53

[iii] Holders. Part (b) of Item 201, "Holders," requires the registrant to disclose the approximate number of holders of each class of the registrant's common equity as of the latest practicable date. n54 If this information is presented in a registration statement or a proxy or information statement relating to an acquisition, business combination, or other reorganization, the registrant must indicate the effect of the transaction on the amount and percentage of present holdings of the registrant's common equity beneficially owned by the following persons:

- any person who is known to the registrant to be the beneficial owner of more than five percent of any class of the registrant's common equity;
- each director and nominee; and
- all directors and officers as a group. n55

The effect of the transaction on the registrant's present commitments to these persons with respect to the issuance of shares of any class of the registrant's common equity must also be indicated. n56

[iii] Dividends. Part (c) of Item 201, "Dividends," requires the registrant to state the frequency and amount of any cash dividends declared on each class of its common equity for the two most recent fiscal years and any subsequent interim period for which financial statements are required to be presented by Article 3 of Regulation S-X. n57 Restrictions on the ability of the registrant to pay dividends currently or in the future, or on the ability of the registrant's subsidiaries to transfer cash dividends, loans, or advances to the registrant, must be described briefly. n58 If the registrant has a record of not paying cash dividends although its earnings indicate that it has the ability to do so, the registrant is encouraged to consider the question of its intention to pay cash dividends in the foreseeable future, and if no such intention to pay cash dividends exists, to state that fact. n59 Registrants that have a history of paying cash

dividends are encouraged to indicate whether they expect comparable cash dividends to be paid in the future, and, if not, the nature of the expected change in the amount or rate of payment. n60

[iv] Securities Authorized for Issuance Under Equity Compensation Plans. Part (d) of Item 201, "Securities Authorized for Issuance Under Equity Compensation Plans," requires the inclusion, in tabular form, of information concerning compensation plans, including individual compensation arrangements, under which the registrant's equity securities are authorized for issuance. The table must distinguish between (i) compensation plans previously approved by security holders and (ii) compensation plans not previously approved by security holders and within these two categories must depict: (a) the number of securities to be issued upon the exercise of outstanding options, warrants, and rights; (b) the weighted-average exercise price of the outstanding options, warrants, and rights disclosed pursuant to (a); and (c) other than securities to be issued upon the exercise of the outstanding options, warrants, and rights disclosed pursuant to (a). n61 In addition, for each compensation plan under which the registrant's equity securities are authorized for issuance that was adopted without the approval of security holders, the registrant must also briefly describe, in narrative form, the material features of such plan. n62

[v] Performance Graph. Item 201(e) requires registrants to provide a line graph comparing, over a minimum period of five consecutive years through and including the company's last full fiscal year, n63 the yearly percentage change in the registrant's cumulative total stockholder return n64 against that of a broad equity market index assuming reinvestment of dividends. This index includes companies whose equity securities are traded on the same exchange, or one of a comparable market capitalization such as the S&P 500 Stock Index, n65 and that of either a published industry or line-of-business index n66 or a company-constructed peer group or similar market capitalization group index. n67 Companies will be expected to use the same index from year to year unless a narrative discussion is provided explaining the reasons for change in indices and comparing return on equity on both the old and the new index for the graph. n68 If the registrant uses a peer issuer comparison or comparison with issuers with similar market capitalizations, the identity of those issuers must be disclosed and the return of each component issuer of the group must be weighted according to the respective issuer's stock market capitalization at the beginning of each period for which a return is indicated. n69

Registrants may include comparisons using performance measures in addition to total return, such as return on average common stockholders' equity, so long as the compensation committee discusses the link between that measure and the level of executive compensation in the statement under Item 402(k). n70 Electronic filers subject to this requirement are required to describe the omitted performance graph by presenting the graph's data points in tabular form. n71

Registrants that qualify as smaller reporting companies are not required to provide the information required by Item 201(e) of Regulation S-K. n72

[b] Item 202. Description of Registrant's Securities.

Item 202 of Regulation S-K, "Description of Registrant's Securities," contains six parts: "Capital Stock," "Debt Securities," "Warrants and Rights," "Other Securities," "Market Information for Securities Other than Common Equity," and "American Depositary Receipts." If the securities being described pursuant to Item 202 have been accepted for listing on an exchange, the registrant may identify the exchange. n73 Foreign registrants must provide information in addition to the information required of domestic registrants in the description of securities. n74

[i] Capital Stock. Part (a) of Item 202, "Capital Stock," requires that if capital stock is to be registered, the registrant must state the title of the class n75 and, to the extent relevant, briefly outline:

- dividend rights;
- terms of conversion;
- sinking fund provisions;

1-4 Federal Securities Exchange Act of 1934 § 4.03

- redemption provisions; n76
- voting rights, including any provisions specifying the vote required by security holders to take action;
- any classification of the board of directors, and the impact of such classification where cumulative voting is permitted or required;
- liquidation rights;
- preemption rights;
- liability to further calls or to assessments by the registrant and for liabilities of the registrant imposed on the registrant's stockholders under state statutes, e.g., to laborers, servants, or employees of the registrant, unless that information is immaterial because the financial resources of the registrant or other factors make it improbable that liability under the state statutes would be imposed;
- any restriction on alienability of the securities to be registered; and
- any provision discriminating against any existing or prospective holder of the securities as a result of such security holder owning a substantial amount of securities. n77 The registrant must also indicate and briefly explain:
 - if the rights of holders of capital stock may be modified other than by a vote of at least a majority of the outstanding shares voting as a class; n78
 - if preferred stock is to be registered, any restriction on the repurchase or redemption of shares by the registrant while there is any arrearage in the payment of dividends or sinking fund installments; n79 and
 - any provision of its charter or bylaws that would have the effect of delaying, deferring, or preventing a change in control of the registrant and that would operate only with respect to an extraordinary corporate transaction involving the registrant or any of its subsidiaries, such as a merger, reorganization, tender offer, sale or transfer of substantially all the registrant's or subsidiary's assets, or liquidation, unless the provision was required by law or imposed by governmental or judicial authority. n80

If the rights evidenced by, or amounts payable with respect to, the capital stock to be registered may be materially limited or qualified by the rights of any other authorized class of securities, the registrant must include information about the other class (unless that class is to be retired and steps have been taken to ensure that the retirement will be completed prior to or upon delivery of the capital stock) that will enable investors to understand the limitations or qualifications. n81

[ii] Debt Securities. Part (b) of Item 202, "Debt Securities," requires that if debt securities are to be registered, n82 the registrant must state:

- the title of the securities; n83
- the principal amount being offered; and

- if a series, the total amount authorized and the total amount outstanding as of the most recent practicable date.

To the extent relevant, the registrant must also briefly outline:

- provisions relating to maturity, interest, conversion, redemption, amortization, sinking fund, or retirement; n84
- provisions relating to the kind and priority of any lien securing the securities, and an identification of the principal properties subject to the lien;
- provisions relating to the subordination of the rights of holders of the securities to other security holders or creditors of the registrant and, if the debt securities being offered are designated subordinated, the amount as of the most recent practicable date of senior indebtedness outstanding and any limitation on the issuance of additional senior indebtedness or that there is no such limitation;
- provisions restricting the declaration of dividends or requiring the maintenance of any asset ratio or the creation or maintenance of reserves;
- restrictions on the incurrence of additional debt or the issuance of additional securities; n85
- the general type of event constituting a default and whether any periodic evidence must be furnished as to the absence of default or as to compliance with the terms of the indenture; and
- provisions relating to modification of the terms of the security or the rights of security holders.

In addition, if the rights evidenced by the securities to be registered may be materially limited or qualified by the rights of any other authorized class of securities, information about the other class (to the extent not otherwise disclosed pursuant to Item 202) sufficient to enable investors to understand the rights evidenced by the securities must be disclosed. However, no other information need be given where the other class is to be retired and steps have been taken to ensure that the retirement will be completed prior to or upon delivery of the debt securities. If the securities are to be offered at an "original issue discount," as defined in paragraph (a) of *Section 1273 of the Internal Revenue Code*, n86 or if the securities are to be sold in a package with other securities and the allocation of the offering price between the two securities may have the effect of offering the securities at an "original issue discount," the tax effects under *Sections 1271-1278 of the Internal Revenue Code* must be disclosed.

Finally, information relating to the trustee must be disclosed, including:

- the name of the trustee;
- the nature of any material relationship between the trustee and the registrant or its affiliates;
- the percentage of the class of securities necessary to require the trustee to take action; and
- what indemnification the trustee may require before proceeding to enforce the lien. n87

[iii] Warrants and Rights. Part (c) of Item 202, "Warrants and Rights," requires that if the securities described are to be issued pursuant to warrants or rights, the registrant must state:

- the amount of securities called for by the warrants or rights;
- the period during which and the price at which the warrants or rights are exercisable;
- the amount of warrants or rights outstanding;
- provisions for changes to or adjustments in the exercise price of the warrants or rights; and
- any other material terms of the warrants or rights. n88

[iv] Other Securities. Part (d) of Item 202, "Other Securities," requires that the registrant provide a comparable description to that required when capital stock, debt securities, or warrants or rights are registered if securities other than those securities are registered.

[v] Market Information for Securities Other Than Common Equity. Part (e) of Item 202, "Market Information for Securities Other Than Common Equity," requires that if securities other than common equity are to be registered and there is an established public trading market for the securities, n89 the registrant must provide market information for those securities comparable to the information required by Item 201(a) of Regulation S-K. n90

[vi] American Depositary Receipts. Part (f) of Item 202, "American Depositary Receipts," requires that if Depositary Shares represented by American Depositary Receipts are being registered, the registrant must state:

- the name of the depositary and the address of its principal executive office;
- the title of the American Depositary Receipts, an identification of the deposited security, and a brief description of the terms of deposit; n91 and
- a description of all fees and charges n92 that may be imposed directly or indirectly against the holder of the American Depositary Receipts, including the type of service for which the fee or charge is incurred, the amount, and to whom paid.

[4] Financial Information

The fourth section of Regulation S-K, "Financial Information," contains seven permanent items: "Selected Financial Data," "Supplementary Financial Information," "Management's Discussion and Analysis of Financial Condition and Results of Operations," and "Changes in and Disagreements with Accountants on Accounting and Financial Disclosure," "Quantitative Disclosures About Market Risk," "Controls and Procedures," and "Internal Control Over Financial Reporting."

[a] Item 301. Selected Financial Data. Item 301 of Regulation S-K, "Selected Financial Data," requires that the registrant furnish selected financial data in comparative columnar form for the registrant and its consolidated subsidiaries. n93 The required data must be furnished for each of the registrant's last five fiscal years or for the life of the registrant and its predecessors, if less, n94 and for additional fiscal years necessary to keep the information provided from being misleading, n95 including as appropriate:

- net sales or operating revenues;
- income or loss from continuing operations;
- income or loss from continuing operations per common share;

- total assets;
- long-term obligations and redeemable preferred stock; n96
- cash dividends declared per common share; and
- additional information, at the option of the registrant, that the registrant believes would enhance an understanding of, and would highlight other trends in, the registrant's financial condition and results of operations. n97

Registrants should also describe, or cross-reference to a discussion of, factors that materially affect the comparability of the selected financial data, e.g., accounting changes, business combinations, dispositions of business operations, and any material uncertainties that may cause the selected financial data not to be indicative of the registrant's future financial condition or results of operations. n98 Foreign registrants must provide information in addition to the information required of domestic registrants in the presentation of selected financial data. n99

Registrants that qualify as smaller reporting companies are not required to provide the information required by Item 301 of Regulation S-K. n100

[b] Item 302. Supplementary Financial Information.

Item 302 of Regulation S-K, "Supplementary Financial Information," contains two parts: "Selected Quarterly Financial Data" and "Information About Oil and Gas Producing Activities."

[i] Selected Quarterly Financial Data. Part (a) of Item 302, "Selected Quarterly Financial Data," sets forth requirements for registrants, except for foreign private registrants that have securities registered pursuant to Section 12(b) (other than mutual life insurance companies) or 12(g) of the Exchange Act. n101

If a registrant meets the above condition, Item 302(a) requires the inclusion of information that discloses:

- net sales;
- gross profit;
- income or loss, in each case before extraordinary items and cumulative effect of a change in accounting;
- per share data based upon income or loss; and
- net income or loss for each full quarter within the two most recent fiscal years and any subsequent interim period for which financial statements are included or are required to be included under Article 3 of Regulation S-X. n102

In addition, information must be included that reconciles the data required by Item 302(a) if that data differs from amounts previously reported on Form 10-Q for any quarter and describes the reason for the difference, e.g., a pooling of interests occurred or an error was corrected. n103 Also, information must be provided that describes the effect of any disposal of segments of a business and extraordinary, unusual, or infrequently occurring items recognized in each fiscal quarter within the two most recent years and for any subsequent interim period for which financial statements are included or are required to be included by Article 3 of Regulation S-X, as well as the aggregate effect and the nature of any year-end or other adjustments material to the results of that quarter. n104

Finally, if the financial statements to which the quarterly data relates have been reported on by an accountant, the quarterly data must be presented by the reporting accountant in accordance with appropriate professional standards and procedures.

Registrants that qualify as smaller reporting companies are not required to provide the information required by Item 302 of Regulation S-K. n105

[ii] Information About Oil and Gas Producing Activities. Paragraph (b) of Item 302, "Information About Oil and Gas Producing Activities," requires registrants engaged in significant oil and gas producing activities to present information about those activities in accordance with Statement of Financial Accounting Standards provisions.

[c] Item 303. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Item 303 of Regulation S-K, "Management's Discussion and Analysis of Financial Condition and Results of Operations," contains three parts: "Full fiscal years," "Interim periods," n106 and "Safe Harbor." In December 2003, the Commission staff published interpretive guidance n107 on how public companies can improve their Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") in their upcoming quarterly and annual reports. The staff's general dissatisfaction with the quality of MD&A disclosure prompted the release. The staff had publicly complained that MD&A disclosure have become too boilerplate and repetitive and only parrot the presentation of information in a company's financial statements. The staff's guidance does not amend the current disclosure requirements of MD&A or its past guidance, but highlights areas of MD&A that need improvement.

The release does not contain specific guidance. It broadly focuses on:

- the overall presentation of MD[A]
- the focus and content of MD[A]
- liquidity and capital resources; and
- critical accounting estimates.

The release recommends that companies include an introductory section to their MD&A. The introduction would highlight the most important developments of the period being reported without being repetitive of or summarizing the ensuing discussion. In past public statements, the staff has suggested that such an introduction be similar to management's letter to shareholders appearing in a company's annual report to shareholders. According to the staff, a "good introduction or overview" would be written in Plain English from the CEO's perspective, focusing on topics "that keep him or her up at night." Such topics could include:

- economic or industry-wide factors relevant to the company;
- how the company earns revenues and income and generates cash;
- the company's lines of business, locations of operations and principal products and services without being repetitive of the Description of Business section; and
- the material opportunities, challenges and risks that management are most focused on for the short and long term, as well as actions that they are taking to address these opportunities, challenges and risks.

Rather than present financial information from the current period and comparable past periods in a line-by-line narrative format, the staff suggests using tabular presentations to present the information. The accompanying narrative could then be used to discuss and analyze known changes, events, trends and uncertainties.

Currently, most companies divide their MD&A discussions under at least two headings, Results of Operations and Liquidity and Capital Resources. The staff encourages companies to use additional headings to assist readers in following "the flow of MD&A."

The release encourages companies to provide more nonfinancial information when such information is used by management to evaluate the company's business. Depending on the circumstances, microeconomic information, such as sales information measured in units or volume or business strategy, may be integral to a company's business. The release reaffirms the staff's position that any analysis of whether non-GAAP financial information is appropriately presented is separate from the consideration of whether MD&A should address "key performance indicators" of a company. The implicit message from the staff is that when non-GAAP financial information is publicly disclosed to analysts and in press conferences, management must evaluate why this information is being released and whether MD&A requires similar disclosure.

The staff is encouraging companies to trim their MD&A. Companies should evaluate whether information already disclosed in prior periods continues to be material for a current period. Though MD&A still requires a comparison of material financial information from a current period against a past comparable period, the staff recommends that companies focus on whether the financial information should be discussed in the first place. The staff recognizes that different quantitative and qualitative information may be material for a company's quarterly and annual MD&A disclosures.

The release reaffirms the staff's past position that, as a general rule, forward-looking information is optional disclosure. However, the staff also reaffirms that disclosure of a known trend, demand, commitment, event or uncertainty is required unless a company is able to conclude either that the trend, uncertainty or other event is not reasonably likely to occur, or that a material effect on the company's liquidity, capital resources or results of operations is not likely to occur.

Companies are required to evaluate their ability to meet upcoming cash requirements over both the short and long term. Routinely, companies have recited how they have spent cash during the period and have represented that "existing capital resources are adequate to meet the company's short and long term needs" or "for the foreseeable future." The release indicates that these types of disclosures are insufficient unless additional more detailed information about known material trends or uncertainties related to cash flow, capital resources, capital requirement or liquidity is not known. The staff intends to use a company's tabular disclosure of its contractual obligations as one means of evaluating the adequacy of a MD&A description of a company's future cash requirements and capital resources. The release clarifies that under the current requirements, companies should consider disclosing accounting estimates or assumptions where:

- the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and
- the impact of the estimates and assumptions on financial condition or operating performance is material.

Such disclosures should supplement, not duplicate, the description of accounting policies required in the notes to the financial statements. The accounting policy note to the financial statements generally describes the method used to apply an accounting principle while the MD&A disclosure should present a company's analysis of the uncertainties

involved in applying a principle at the current time or the variability that is reasonably likely to result from its application over time.

[i] Full Fiscal Years.

Paragraph (a) of Item 303, "Full Fiscal Years," requires the registrant to discuss and analyze its (and that of its consolidated subsidiaries) financial condition, n108 changes in financial condition, and results of operations, as based on the financial statements and any other statistical data that the registrant believes will enhance a reader's understanding of those factors. n109 The purpose of the discussion and analysis is to provide information relevant to an assessment of financial condition and results of operations of the registrant as determined by evaluating the amounts and certainty of cash flows from operations and outside sources. n110 The registrant should specifically focus on material events and uncertainties that would cause reported financial information not to be necessarily indicative of future financial condition or operating results, e.g., matters that have not had an effect on operations in the past but may in the future, or matters that have had an impact on reported operations but are not expected to have such an impact in the future. n111

If, in the registrant's judgment, a discussion of segment information or of other subdivisions of the registrant's business would be appropriate to an understanding of the business, the discussion should also focus on each relevant, reportable segment or other subdivision of the business and on the registrant as a whole. n112 The discussion of financial condition and results of operations should generally cover the three-year period of the financial statements and should use year-to-year comparisons or any other formats that in the registrant's judgment enhance a reader's understanding of those factors. n113

The registrant should provide the following information pursuant to Item 303(a).

[A] Liquidity. n114 The registrant must identify any known trends or demands, commitments, events, or uncertainties reasonably likely to result in a material increase or decrease in the registrant's liquidity. n115 The course of action that the registrant has taken or proposes to take to remedy any material deficiency in liquidity must be identified. n116 In addition, the registrant must identify and separately describe internal and external sources of liquidity and must briefly discuss any material unused sources of liquid assets. n117

[B] Capital Resources. n118 The registrant is required to describe its material commitments for capital expenditures as of the end of the latest fiscal period, the general purpose of those commitments, and the anticipated source of funds to meet those commitments. n119 The registrant is also required to describe any material trends in its capital resources and any expected material changes in the mix and relative cost of those resources. The discussion of capital resources should include consideration of changes between equity, debt, and any off-balance sheet financing arrangements. n120

[C] Results of Operations. The registrant is required to describe:

- any unusual or infrequent events or transactions or any significant economic changes that materially affected reported income from continuing operations and the extent to which reported income was affected;
- any significant components of revenues or expenses that in the registrant's judgment should be described to understand its results of operations;
- any known trends or uncertainties that have had or that the registrant reasonably expects will have a material effect on net sales or revenues or income from continuing operations; n121 and
- any known event that will cause a material change in the relationship between costs and revenues,

e.g., future increases in costs of labor or material.

In addition, the registrant must describe, in narrative discussion, the extent to which any material increases in net sales or revenues disclosed in the financial statements are attributable to increases in prices, increases in the volume or amount of goods or services being sold, or the introduction of new products or services.

The registrant is also required to describe the effect of inflation and changing prices on the registrant's net sales and revenues and on income from continuing operations, either for the three most recent fiscal years or the fiscal years in which the registrant has been engaged in business, whichever is shortest. n122

In addition, the registrant should provide any other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition, and results of operations. n123 Registrants are encouraged to supply forward-looking information. n124

[D] Off-Balance Sheet Arrangements. n125 Part (a)(4) of Item 303, "Off-Balance Sheet Arrangements," n126 requires registrants to discuss, in a separately-captioned section, the registrant's off-balance sheet arrangements that have or are reasonably likely to have a material current or future effect on the registrant's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources. n127 The discussion must include the following items to the extent necessary to an understanding of such arrangements and their effect, and must also include other information that the registrant believes is necessary for such an understanding:

- the nature and business purpose to the registrant of such off-balance sheet arrangements;
- the importance to the registrant of such off-balance sheet arrangements with respect to its liquidity, capital resources, market risk support, credit risk support or other benefits;
- the amounts of revenue, expenses and cash flows of the registrant arising from such arrangements; the nature and amounts of any interests retained, securities issued and other indebtedness incurred by the registrant in connection with such arrangements; and the nature and amounts of any other obligations or liabilities (including contingent obligations or liabilities) of the registrant arising from such arrangements that are or are reasonably likely to become material and the triggering events or circumstances that could cause them to arise; and
- any known event, demand, commitment, trend or uncertainty that will result in or is reasonably likely to result in the termination, or material reduction in availability to the registrant, of its off-balance sheet arrangements that provide material benefits to it, and the course of action that the registrant has taken or proposes to take in response to any such circumstances. n128

The instructions to part (a)(4) of Item 303 clarify several ambiguities, including:

- No obligation to make disclosure under part (a)(4) arises with respect to an off-balance sheet arrangement until a definitive agreement that is unconditionally binding or subject only to customary closing conditions exists or, if there is no such agreement, when settlement of the transaction occurs. n129
- Registrants should aggregate off-balance sheet arrangements in groups or categories that provide material information in an efficient and understandable manner and should avoid repetition and disclosure of immaterial information. Effects that are common or similar with respect to a number of off-balance sheet arrangements must be analyzed in the aggregate to the extent the aggregation increases understanding. Distinctions in arrangements and their effects must be discussed to the extent the

information is material, but the discussion should avoid repetition and disclosure of immaterial information. n130

- Contingent liabilities arising out of litigation, arbitration or regulatory actions are not considered to be off-balance sheet arrangements under part (a)(4). n131

- Generally, the disclosure required by part (a)(4) must cover the most recent fiscal year. However, the discussion should address changes from the previous year if such discussion is necessary to an understanding of the disclosure. n132

- In satisfying the requirements of part (a)(4), the discussion of off-balance sheet arrangements need not repeat information provided in the footnotes to the financial statements, provided that such discussion clearly cross-references to specific information in the relevant footnotes and integrates the substance of the footnotes into such discussion in a manner designed to inform readers of the significance of the information that is not included within the body of such discussion. n133

[E] Tabular Disclosure of Contractual Obligations. Part (a)(5) of Item 303, "Tabular Disclosure of Contractual Obligations," requires the registrant to provide, in a tabular format, certain information as of the latest fiscal year-end balance sheet date with respect to the registrant's known contractual obligations. n134 The categories of contractual obligations of which the registrant must provide information include: "long-term debt obligations," "capital lease obligations," "operating lease obligations," "purchase obligations," and "other long-term liabilities reflected on the registrant's balance sheet under GAAP." n135 Definitions of the foregoing terms are provided in paragraph (ii) of part (a)(5). n136

The registrant must provide amounts, aggregated by type of contractual obligation, in its tabular disclosure. n137 The registrant may disaggregate the specified categories of contractual obligations using other categories suitable to its business, but the presentation must include all of the registrant's obligations that fall within the specified categories. A table covering at least the following periods must be included: less than one year, from one to three years, from three to five years, and more than five years. n138 Additionally, the tabular presentation may be accompanied by footnotes to describe provisions that create, increase or accelerate obligations, or other pertinent data to the extent necessary for an understanding of the timing and amount of the registrant's specified contractual obligations. n139

Finally, the registrant is not required to include the table required by part (a)(5) of Item 303 for interim periods. n140 Instead, the registrant should disclose material changes outside the ordinary course of business in the specified contractual obligations during the interim period. n141

[ii] Interim Periods. Part (b) of Item 303, "Interim Periods," requires the registrant to provide a management's discussion and analysis of financial condition and results of operations, including the same information as required under Item 303(a) (with the exception of the effect of inflation and changing prices on operations), if interim period financial statements are included or are required to be included by Regulation S-X in order to enable the reader to assess material changes in financial condition and results of operations by a comparison of the financial statements provided for full fiscal years with those provided for any subsequent interim periods. n142

The registrant is required to discuss any material changes in its financial condition, including any seasonal aspects of its business that may have had a material effect upon its financial condition, n143 from the end of the preceding fiscal year to the date of the most recent interim balance sheet provided. n144 If the interim financial statements include an interim balance sheet as of the corresponding interim date of the preceding fiscal year, any material changes in financial condition from that date to the date of the most recent interim balance sheet provided should also be discussed. n145 If discussions of changes in financial condition from both the end and the corresponding interim date of the preceding fiscal year are required, the discussions may be combined. n146

The registrant is also required to discuss any material changes in its results of operations, including any significant elements of the registrant's income or loss from continuing operations that do not arise or are not necessarily representative of the registrant's ongoing business, n147 and the seasonal aspects of the registrant's business that have a material effect upon its results of operations n148 for the most recent year-to-date period for which an income statement is provided and the corresponding year-to-date period of the preceding fiscal year. n149

If the registrant is required to provide, or has provided, an income statement for the most recent fiscal quarter, the discussion should also cover material changes in results of operations for that fiscal quarter and the corresponding fiscal quarter in the preceding fiscal year. n150 In addition, if the registrant has provided an income statement for the twelve-month period ended as of the date of the most recent interim balance sheet provided, the discussion should cover material changes for that twelve-month period and the twelve-month period ended as of the corresponding interim balance sheet date of the preceding fiscal year. n151 Any forward-looking information supplied is expressly covered by the safe harbor rule for projections. n152

[iii] Safe Harbor. Part (c) of Item 303 provides a safe harbor for forward-looking statements provided pursuant to parts (a)(4) and (5) of Item 303 in certain circumstances. n153 The safe harbors found in Section 27A of the Securities Act and Section 21E of the Exchange Act apply to forward-looking information provided pursuant to parts (a)(4) and (5) of Item 303 if the disclosure is made by: an issuer; a person acting on behalf of an issuer; an outside reviewer retained by an issuer making a statement on behalf of the issuer; or an underwriter, with respect to information provided by an issuer or information derived from information provided by an issuer. n154

For the purposes of Item 303, part (c):

- all information required by parts (a)(4) and (5) is deemed to be a forward-looking statement, as that term is defined in the safe harbors found in Section 27A of the Securities Act and Section 21E of the Exchange Act, except for historical facts; and
- with respect to part (a)(4), the meaningful cautionary statements element of the safe harbors found in Section 27A of the Securities Act and Section 21E of the Exchange Act are satisfied if a registrant satisfies all requirements of part (a)(4) of Item 303. n155

[d] Item 304. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure. Item 304 of Regulation S-K, "Changes in and Disagreements with Accountants on Accounting and Financial Disclosure," requires that if, during the registrant's two most recent fiscal years or any subsequent interim period, an independent accountant who was previously engaged as the principal accountant to audit the registrant's financial statements, or an independent accountant who was previously engaged to audit a significant subsidiary and on whom the principal accountant expressed reliance in its report, either resigned, indicated an intention not to stand for reelection after completion of the current audit, or was dismissed, the registrant must provide information with respect to:

- whether the former accountant resigned, declined to stand for reelection, or was dismissed and the date of whichever of the foregoing events is applicable;
- whether the principal accountant's report on the financial statements for either of the past two years contained an adverse opinion, a disclaimer of opinion, or was modified or qualified as to uncertainty, audit scope, or accounting principles and the nature of any such adverse opinion, disclaimer of opinion, modification, or qualification;
- whether the decision to change accountants was recommended or approved by any audit or similar committee of the board of directors where the registrant has such a committee or, where the registrant

has no such committee, whether the decision was recommended or approved by the board of directors; and

- whether, during the registrant's two most recent fiscal years and any subsequent interim period preceding such resignation, declination, or dismissal, there were any disagreements with the former accountant on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreement(s), if not resolved to the satisfaction of the former accountant, would have caused the accountant to make a reference to the subject matter of the disagreement(s) in connection with the financial report. n156

The registrant must also provide all of the information required by the last bullet point above where any of the following kinds of advice were given to the registrant by the former accountant within the registrant's two most recent fiscal years and any subsequent interim period which preceded the former accountant's resignation, declination to stand for reelection, or dismissal ("reportable events"):

- advice that the internal controls necessary for the registrant to develop reliable financial statements do not exist;
 - advice that information has come to the accountant's attention that has led the accountant to conclude that it can no longer rely on management's representations or that it is unwilling to continue to be associated with the financial statements prepared by management;
 - advice, relating to the need to expand significantly the scope of the audit, not acted upon because of the accountant's resignation or dismissal or for any other reason, or advice that information has come to the attention of the accountant during the two preceding fiscal years and any subsequent interim period which, although not further investigated due to the accountant's resignation or dismissal or for any other reason, could, if further investigated:
 - materially impact the fairness or reliability of either a previously issued audit report or the underlying financial statements, or the financial statements issued or to be issued covering the fiscal period(s) subsequent to the date of the most recent financial statements covered by an audit report (including information that may prevent the accountant from rendering an unqualified audit report on those financial statements); or
 - cause the accountant to be unwilling to rely on management's representations or be associated with the registrant's financial statements; or
 - that information has come to the accountant's attention that creates an issue that was not resolved to the accountant's satisfaction prior to the accountant's resignation, dismissal, or declination to stand for reelection, and the accountant has concluded that the information materially impacts the fairness or reliability of either:
 - a previously issued audit report or the underlying financial statements; or
 - the financial statements issued or to be issued covering the fiscal period(s) subsequent to the date of the most recent financial statements covered by an audit report (including information that, unless resolved to the accountant's satisfaction, would prevent the accountant from rendering an unqualified audit report on the subject financial statements).
- n157

If, during the registrant's two most recent fiscal years or any subsequent interim period, a new independent accountant has been engaged as either the principal accountant to audit the registrant's financial statements, or as an independent accountant to audit a significant subsidiary and on whom the principal accountant is expected to express reliance in its report, the registrant shall identify the newly engaged accountant and indicate the date of engagement. If, during the same time period, the registrant or someone on the registrant's behalf consulted the newly engaged accountant regarding the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion that might be rendered on the registrant's financial statements and there was provided to the registrant by such newly engaged accountant either a written report or oral advice which the new accountant concluded was an important factor considered by the registrant in reaching a decision as to the accounting, auditing or financial reporting issue, or any matter that was either the subject of a "disagreement" as defined in Item 304(a)(1)(iv) and the related instructions to Item 304 or a "reportable event" as described in Item 304(a)(1)(v), then the registrant must:

- so state and identify the issues that were the subject of the consultations;
- briefly describe the views of the newly engaged accountant as expressed orally or in writing to the registrant on each such issue and, if written views were received by the registrant, file them as an exhibit to the subject report or registration statement;
- state whether the former accountant was consulted by the registrant regarding any such issues, and, if so, provide a summary of the former accountant's views; and
- request the newly engaged accountant to review the disclosure required by Item 304(a) before it is filed with the Commission.

The registrant must provide the new accountant the opportunity to furnish the registrant with a letter addressed to the Commission containing any new information, clarification of the registrant's expression of its views, or the respects in which the new accountant does not agree with the statements made by the registrant, and file any such letter as an exhibit to the report or registration statement containing the disclosure required by Item 304. n158

The registrant must request that the former accountant furnish the registrant with a letter addressed to the Commission stating whether the accountant agrees with the statements made by the registrant in response to Item 304(a) and, if not, stating the respects in which it does not agree. The registrant must file the former accountant's letter as an exhibit to the report or registration statement containing the disclosure. If the former accountant's letter is not available at the time of filing, it must be filed by amendment promptly thereafter. n159

If, in connection with a change in accountants subject to Item 304(a), there was any "disagreement" of the type described in paragraph (a)(1)(iv) or any "reportable event" as described in paragraph (a)(1)(v) of Item 304 and, during the fiscal year in which the change of accountants took place or during the subsequent fiscal year, there have been transactions or events similar to those which involved the disagreement or reportable event, and such transactions or events were material and were accounted for or disclosed in a manner different from that which the former accountants apparently would have concluded was required, then the registrant must state the existence and nature of the disagreement or reportable event and the effect on the financial statements if the method had been followed which the former accountants apparently would have concluded was required. n160

[e] Item 305. Quantitative and Qualitative Disclosures About Market Risk. Item 305 of Regulation S-K, "Quantitative and Qualitative Disclosure About Market Risk," requires registrants to provide, in their reporting currency, quantitative information about market risk as of the end of the latest fiscal year in accordance with one of three disclosure alternatives. The three disclosure alternatives are: (1) tabular presentation of information related to market risk sensitive instruments and contract terms; (2) sensitivity analysis disclosures that express the potential loss in future earnings, fair values, or cash flows of market risk sensitive instruments resulting from one or more selected

hypothetical changes in interest rates, foreign currency exchange rates, commodity prices, and other relevant market rates or prices over a selected period of time; or (3) value at risk disclosures that express the potential loss in future earnings, fair values or cash flows of market risk sensitive instruments over a selected period of time, with a selected likelihood of occurrence, from changes in interest rates, foreign currency exchange rates, commodity prices, and other relevant market rates or prices. n161 In preparing this quantitative information, registrants must categorize market risk sensitive instruments into instruments entered into for trading purposes and those entered into for other purposes. Within both such portfolios, separate quantitative information is to be presented for each market risk category (i.e., interest rate risk, foreign currency exchange rate risk, commodity price risk, and other relevant market risks, such as equity price risk). n162 Registrants are required to describe, to the extent material, certain qualitative information about market risk including: (1) the registrant's primary market risk exposures; n163 (2) how these exposures are managed, including a discussion of the objectives, general strategies, and instruments, if any, needed to manage those exposures; and (3) changes in either the registrant's primary market risk exposures or how those exposures are managed, when compared to what was in effect during the most recently completed fiscal year and what is known or expected to be in effect in future reporting periods. n164 Registrants should describe primary market risk exposures that exist as of the end of the latest fiscal year, and how those exposures are managed. n165 If interim period financial statements are included or are required to be included by Article 3 of Regulation S-K, discussion and analysis is required to enable the public to assess the sources and effects of material changes in information that would be provided under Items 305 of Regulation S-K from the end of the preceding fiscal year to the date of the most recent interim balance sheet. The safe harbor provided in Section 27A of the Securities Act and Section 21E of the Exchange Act apply to information provided under Items 305(a), (b), and (c). n166 The required quantitative and qualitative information should be disclosed outside the financial statements and related notes thereto. n167

[f] Item 307. Disclosure Controls and Procedures. Item 307 of Regulation S-K, "Disclosure Controls and Procedures," requires a registrant to disclose the conclusions of its principal executive and principal financial officers, or persons performing similar functions, regarding the effectiveness of the registrant's disclosure controls and procedures as of the end of the period covered by the report. n168 Their conclusions must be based on the evaluation of those controls and procedures required by Rules 13a-15(b) or 15d-15(b) under the Exchange Act. n169 For the purposes of Item 307 disclosure, the term "disclosure controls and procedures" is defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act, which state that the term means "controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the [Exchange] Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms." n170

[g] Item 308. Internal Control Over Financial Reporting. n171 Part (a) of Item 308, entitled "Management's annual report on internal control over financial reporting," requires the registrant to provide a report of its management on the registrant's internal control over financial reporting that contains:

- a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the registrant;
- a statement identifying the framework used by management to evaluate the effectiveness of the registrant's internal control over financial reporting, as required by Rules 13a-15 or 15d-15 under the Exchange Act;
- management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year, including a statement as to whether or not the registrant's internal control over financial reporting is effective; n172 and
- a statement that the registered public accounting firm that audited the registrant's financial statements included in the annual report containing the disclosure required by Item 308 has issued an attestation

report on management's assessment of the registrant's internal control over financial reporting. n173

Part (b) of Item 308 requires the registrant to provide in its annual report the aforementioned registered public accounting firm's attestation report on the registrant's internal control over financial reporting, n174 while part (c) of Item 308 requires the registrant to disclose any changes in its internal control over financial reporting identified in connection with management's evaluation that occurred during the registrant's last fiscal quarter and that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

[5] Management and Certain Security Holders

The fifth section of Regulation S-K contains seven items: "Directors, Executive Officers, Promoters and Control Persons," "Executive Compensation," "Security Ownership of Certain Beneficial Owners and Management," "Certain Relationships and Related Transactions," "Compliance with Section 16(a) of the Exchange Act," "Code of Ethics," and "Corporate Governance."

[a] Item 401. Directors Executive Officers, Promoters, and Control Persons.

Item 401 of Regulation S-K, "Directors, Executive Officers, Promoters and Control Persons," contains seven parts: "Identification of Directors," "Identification of Executive Officers," "Identification of Certain Significant Employees," "Family Relationships," "Business Experience," "Involvement in Certain Legal Proceedings," and "Promoters and Control Persons." Item 401 of Regulation S-K was amended, effective November 7, 2006, as part of the amendments to the executive compensation and related person disclosure rules. Item 401(h), (i) and (j) were removed. The disclosure requirements covered by these sections have been modified and moved to the new Item 407 of Regulation S-K. n175

[i] Identification of Directors. Part (a) of Item 401, "Identification of Directors," requires the registrant to list the names and ages of all directors of the registrant, and all persons nominated or chosen to become directors, n176 and to disclose as to each such individual:

- all positions and offices held with the registrant;
- his or her term of office as director and any periods during which the individual served as such; and
- any arrangement or understanding between the individual and any other persons, naming those persons, pursuant to which he or she was or is to be selected as a director or nominee. n177

The registrant, however, is not required to provide this information in a proxy or information statement for any director whose term of office as a director will not continue after the meeting to which the statement relates. n178

[ii] Identification of Executive Officers. Part (b) of Item 401, "Identification of Executive Officers," requires the registrant to disclose the same information concerning its executive officers n179 as is required concerning directors. n180

[iii] Identification of Certain Significant Employees. Part (c) of Item 401, "Identification of Certain Significant Employees," requires that, if the registrant employs persons such as production managers, sales managers, or research scientists who are not executive officers but who make or are expected to make significant contributions to the business of the registrant, those persons must be identified and their backgrounds disclosed to the same extent as for executive officers. This information, however, is not required if the registrant, immediately prior to the filing of the document in which the information was to be presented, was subject to the reporting requirements of Sections 13(a) or 15(d) or an insurance company whose securities are exempt from the reporting requirements of Section 13(a) by Section 12(g)(2)(G). n181

[iv] Family Relationships. Part (d) of Item 401, "Family Relationships," requires the registrant to state the nature of any family relationship n182 between any director, executive officer, or person nominated or chosen by the registrant to become a director or executive officer.

[v] Business Experience. Part (e) of Item 401, "Business Experience," requires the registrant to provide a brief account of the business experience during the past five years of each person identified by the registrant as a director, executive officer, each person chosen or nominated to become a director or executive officer, and each significant employee identified in response to Item 401(c), including principal occupations and employment and the name and principal business of the organization in which the occupation or employment was carried on. n183 If any person identified by the registrant as an executive officer or significant employee has been employed by the registrant or any of the registrant's subsidiaries for less than five years, the registrant must also include a brief explanation of the nature of the responsibility undertaken by the person in principal occupations and employment in the past five years. n184 Directorships held by each director or person nominated or chosen to become a director in a company:

- with a class of securities registered under Section 12;
- subject to the reporting requirements of Section 15(d); or
- registered as an investment company under the Investment Company Act of 1940;

must be indicated, and the company in which the directorship was held must be named. n185

[vi] Involvement in Certain Legal Proceedings. Part (f) of Item 401, "Involvement in Certain Legal Proceedings," requires the registrant to describe any of the following legal proceedings that occurred during the past five years n186 and that are material n187 to an evaluation of the ability or integrity of a person who is a director, director-nominee, or executive officer of the registrant. First, the registrant must describe any petition under bankruptcy or insolvency laws that was filed by or against, or the appointment of a receiver or similar officer by a court for, the business or property of the person, any partnership in which the person was a general partner at or within two years before the time of the filing, or any corporation or business association of which the person was an executive officer at or within two years before the time of the filing. n188

The registrant must also describe any criminal proceeding in which the person was convicted, or any pending criminal proceeding of which the person is a named subject, excluding traffic violations and other minor offenses. n189 Any order, judgment, or decree must be described that has not been subsequently reversed, suspended, or vacated, of which the person was the subject, permanently or temporarily enjoining the person from, or otherwise limiting, the following activities:

- acting as a futures commission merchant, introducing broker, commodity trading advisor, commodity pool operator, floor broker, leverage transaction merchant, any other person regulated by the Commodity Futures Trading Commission, or an associated person of any of the foregoing, or as an investment adviser, underwriter, broker or dealer in securities, or as an affiliated person, director, or employee of any investment company, bank, savings and loan association or insurance company, or engaging in or continuing any conduct or practice in connection with such activity;
- engaging in any type of business practice; or
- engaging in any activity in connection with the purchase or sale of any security or commodity or in connection with any violation of federal or state securities laws or federal commodities laws. n190

Any order, judgment, or decree, not subsequently reversed, suspended or vacated, of any federal or state authority, of

which the person was the subject, barring, suspending, or otherwise limiting for more than sixty days the right of the person to engage in any activity described in the first bulleted paragraph above or to be associated with persons engaged in any such activity must be described. n191 The registrant must also describe any finding by a court of competent jurisdiction in a civil action or by the Commission that the person violated any federal or state securities law. n192 Finally, the registrant must describe any findings by a court of competent jurisdiction in a civil action or by the Commodities Futures Trading Commission that the person violated any federal commodity law, and the judgment in such civil action or finding by the Commodity Futures Trading Commission has not been subsequently reversed, suspended, or vacated. n193

[vii] Promoters and Control Persons. Part (g) of Item 401, "Promoters and Control Persons," requires registrants that have not been subject to the reporting requirements of Section 13(a) or 15(d) for the twelve months immediately prior to the filing and that were organized within the last five years to describe with respect to promoters and control persons any of the events detailed above that are material to a voting or investment decision and that occurred during the past five years. n194

[b] Item 402. Executive Compensation. n195

Item 402 of Regulation S-K, "Executive Compensation," contains eleven parts: "General," "Compensation Discussion and Analysis," "Summary Compensation Table," "Grants of Plan-Based Awards Table," "Narrative Disclosure to Summary Compensation Table and Grants of Plan-Based Awards Table," "Outstanding Equity Awards at Fiscal Year-End Table," "Option Exercises and Stock Vested Table," "Pension Benefits," "Nonqualified Defined Contribution and Other Nonqualified Deferred Compensation Plans," "Potential Payments Upon Termination or Change-in-Control," and "Compensation of Directors." n196

[i] General.

Part (a) of Item 402, "General," describes the treatment of certain issuers and defines the compensation and persons covered by Item 402.

[A] Specific Issuers. Foreign private issuers are deemed to comply with Item 402 by providing certain limited information. n197

[B] Compensation Covered. Item 402(a)(2) requires clear, concise, and understandable disclosure of all plan and non-plan compensation awarded to, earned by, or paid to the individual for all services rendered in all capacities to the registrant and its subsidiaries, unless otherwise specified. All such compensation must be reported pursuant to Item 402, even if also called for by another requirement, including transactions between the registrant and a third party where the primary purpose of the transaction is to furnish compensation to an individual. n198 Amounts reported as compensation for one fiscal year may be required to be reported in a different manner pursuant to this item.

[C] Persons Covered. Item 402 requires disclosure for each of the following persons (the "named executive officers"): the Commission has solicited comments regarding a proposed disclosure requirement pursuant to which the total compensation and job description of up to an additional three most highly compensated employees who are not executive officers or directors but who earn more than the named executive officers would be required. The proposal may be modified to apply only to large accelerated filers who would disclose the total compensation for the most recent fiscal year and a description of the job position for each of their three most highly compensated employees whose total compensation is greater than any of the named executive officers, whether or not such persons are executive officers. Under this approach, employees who have no responsibility for significant policy decisions within either the company, a significant subsidiary or a principal business unit, division, or function, would be excluded from the determination of the three most highly compensated employees and no disclosure regarding them would be required. n199

- all individuals serving as the registrant's principal executive officer or acting in a similar capacity

during the last completed fiscal year (the "CEO"), n200 regardless of compensation level;

- All individuals serving as the registrant's principal financial officer or acting in a similar capacity during the last completed fiscal year ("PFO"), regardless of compensation level;
- the registrant's three most highly compensated executive officers n201 other than the PEO and PFO who were serving as executive officers at the end of the last completed fiscal year and whose total annual salary and bonuses exceed \$100,000; and
- up to two additional individuals for whom disclosure would have been provided pursuant to the above, but for the fact that the individual was not serving as an executive officer of the registrant at the end of the last completed fiscal year. n202

It may be appropriate in limited circumstances for a registrant not to include in the disclosure an individual, other than the PEO and PFO, who is one of the registrant's most highly compensated executive officers due to payment of amounts of cash compensation relating to overseas assignments that may be attributed predominately to such assignments. n203 Item 402 disclosure includes transactions between the registrant and a third party where the primary purpose of the transaction is to furnish compensation to a named executive officer.

[D] Omission of Tables or Columns. Tables and columns may be omitted if there has been no compensation awarded to, earned by, or paid to any of the named executive officers or directors required to be reported in such table or column. n204

[E] Definitions. Item 402(a)(6) provides the following definition of terms used in the remainder of the item. The term "stock appreciation rights" ("SARs") refers to SARs payable in cash or stock, including SARs payable in cash or stock at the election of the registrant or a named executive officer. The term "plan" includes, but is not limited to, the following: any plan, contract, authorization, or arrangement, whether or not set forth in any formal document pursuant to which cash, securities, similar instruments, or any other property may be received. n205 A plan may be applicable to one person. The term "long-term incentive plan" means any plan providing compensation intended to serve as incentive for performance to occur over a specified period, whether such performance is measured by reference to financial performance of the registrant or an affiliate, the registrant's stock price, or any other measure. The term "equity incentive plan" is an incentive plan or portion of an incentive plan under which awards are granted that fall within the scope of Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, as modified or supplemented ("FAS 123R"). A "non-equity incentive plan" is an incentive plan or portion of an incentive plan that is not an equity incentive plan. The term "incentive plan award" means an award provided under an incentive plan. The terms "date of grant" or "grant date" refer to the grant date determined for financial statement reporting purposes pursuant to FAS 123R. "Closing market price" is defined as the price at which the registrant's security was last sold in the principal United States market for such security as of the date for which the closing market price is determined.

[ii] Compensation Discussion and Analysis. n206 Under Item 402(b), companies are to provide a discussion of all material elements of the compensation of the named executive officers. The discussion must describe the following:

- the objectives of the registrant's compensation programs;
- what the compensation program is designed to reward;
- each element of compensation;
- why the registrant chooses to pay each element;

1-4 Federal Securities Exchange Act of 1934 § 4.03

- how the registrant determined the amount (and, where applicable, the formula) for each element to pay; and
- how each compensation element and the registrant's decisions regarding that element fit into the registrant's overall compensation objectives and affect decisions regarding other elements.

The material information to be disclosed in the Compensation Discussion and Analysis section will vary depending upon the facts and circumstances. For that reason, Item 402(b) provides the following as examples of the type of information discussed:

- the policies for allocating between long-term and currently paid out compensation;
- the policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation;
- for long-term compensation, the basis for allocating compensation to each different form of award (such as relationship of award to the achievement of the registrant's long-term goals, management's exposure to downside equity performance risk, correlation between cost to registrant and expected benefit to the registrant);
- how the determination is made as to when awards are granted, including awards of equity-based compensation such as options;
- what specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions;
- how specific forms of compensation are structured and implemented to reflect these items of the registrant's performance, including whether discretion can be or has been exercised (either to award compensation absent attainment of the relevant performance goal(s) or to reduce or increase the size of the award or payout), identifying any particular exercise of discretion, and stating whether it applied to one or more specified named executive officers or to all compensation subject to the relevant performance goal(s);
- how specific forms of compensation are structured and implemented to reflect the named executive officer's individual performance and/or individual contribution to these items of the registrant's performance, describing the elements of individual performance and/or contribution that are taken into account;
- registrant policies and decisions regarding the adjustment or recovery of awards or payments if the relevant registrant performance measures upon which they are based are restated or otherwise adjusted in a manner that would reduce the size of an award or payment; n207
- the factors considered in decisions to increase or decrease compensation materially;
- how compensation or amounts realizable from prior compensation are considered in setting other elements of compensation (*e.g.*, how gains from prior option or stock awards are considered in setting retirement benefits);
- with respect to any contract, agreement, plan or arrangement, whether written or unwritten, that

provides for payment(s) at, following, or in connection with any termination or change-in-control, the basis for selecting particular events as triggering payment (e.g., the rationale for providing a single trigger for payment in the event of a change-in-control);

- the impact of the accounting and tax treatments of the particular form of compensation;
- the registrant's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership), and any registrant policies regarding hedging the economic risk of such ownership;
- whether the registrant engaged in any benchmarking of total compensation, or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies); and
- the role of executive officers in determining executive compensation.

[iii] Summary Compensation Table.

Under Item 402(c), companies are required to present a tabular summary of compensation paid to the named executive officers for each of the company's previous fiscal years. The three-year period covered by the Summary Compensation Table is intended to enable stockholders to discern trends in executive compensation and compare their own company's compensation practice with that of other companies. n208 The general instruction to Item 402(b) also provides, however, that if a company was not an Exchange Act reporting company during the entire three-year period, no information need be provided in the Summary Compensation Table for any year, other than the most recently completed fiscal year, during which the company was not an Exchange Act reporting company. However, the registrant will be required to provide information for any such year if that information previously was required to be provided in response to a Commission filing requirement. Disclosure of all forms of executive compensation is required.

The Summary Compensation Table includes disclosure of the following compensation components.

[A] Base Salary and Bonus. Both the base salary and bonus salary figures in the Summary Compensation Table columns should be a dollar value of all cash and non-cash salary and bonus earned, in its respective column, by the named executive officer n209 for the fiscal year. Any amounts deferred shall be included in the appropriate column for the fiscal year in which earned. n210 If the amount of salary or bonus earned in a given fiscal year is not calculable through the latest practicable date, a footnote should so disclose and provide the date at which the amount of salary or bonus is expected to be determined. That updated disclosure of salary or bonus must then be reported under Item 5.02(f) of Current Report Form 8-K. Registrants need not include in the salary column or bonus column any amount of salary or bonus forgone at the election of the named executive officer. n211

[B] Stock Awards. The aggregate grant date fair value for stock awards is to be reported in column (e). A footnote should disclose all assumptions made in the valuation by reference to a discussion of those assumptions in the registrant's financial statements, footnotes to the financial statements, or discussion in the Management's Discussion and Analysis section. n212

[C] Option Awards. The aggregate grant date fair value for award of options, with or without tandem SARs (including awards that subsequently have been transferred) is to be reported in column (f). The incremental fair value produced by any material modification during the last completed fiscal period to past option or SAR awards must be reported as awards in column (f). n213

[D] Non-equity Incentive Plan. The dollar value of all earnings for services performed during the fiscal year pursuant to awards under non-equity plans n214 and all earnings on any outstanding awards are to be reported in

column (g). If the relevant performance measure is satisfied during the fiscal year, even if the earnings are not payable until a later date and even if the earnings are for a single year in a plan with a multi-year performance measure, the earnings are reported for that fiscal year. n215 The timing of payments of earnings in this column must be disclosed in a footnote.

[E] Change in Pension Value and Nonqualified Deferred Compensation Earnings. The aggregate change in the actuarial present value of the named executive officer's accumulated benefit under all defined benefit and actuarial pension plans (including supplemental plans) is to be reported in column (h). If present value is negative, it should be disclosed in footnote but should not be represented in the column. In addition, the above-market or preferential earnings on compensation that is deferred on a basis that is not tax-qualified, including earnings on nonqualified defined contribution plans are reported here. The source of the amounts reported in column (h) are to be identified by footnote.

[F] All Other Compensation. All other compensation for the covered fiscal year that the registrant could not properly report in any other column of the Summary Compensation Table, regardless of the amount, is to be disclosed in column (i). Such compensation reported must include, but is not limited to:

- perquisites and other personal benefits, or property, unless the aggregate amount is less than \$10,000;
- all "gross-ups" or other amounts reimbursed for the payment of taxes; n216
- the compensation cost (as computed in accordance with FAS 123R) of any security of the registrant or its subsidiaries purchased from the registrant or its subsidiaries at a discount from the market price at the date of purchase, unless that discount is generally available to either all security holders or to all salaried employees;
- amounts paid or accrued n217 in connection with termination, including retirement, resignation, severance or constructive termination (including a change in responsibilities);
- amounts paid or accrued n218 in connection with a change in control; n219
- registrant contributions or allocations to a vested and unvested defined contribution plan;
- the dollar value of insurance premiums paid by, or on behalf of, the registrant with respect to life insurance for the benefit of the named executive officer; and
- the dollar value of any dividends or other earnings paid on stock or option awards, when those amounts were not factored into the grant date fair value required to be reported pursuant to columns (e) or (f).

All items reported for a named executive officer under this column (i) that exceed \$10,000 must be identified and quantified in a footnote. n220 When the total value of all perquisites and personal benefits equals or is greater than \$10,000 for any named executive officer, then each perquisite or personal benefit, regardless of its amount, must be identified by type. Any perquisite and personal benefit reported under this column that exceeds \$25,000 or 10% of the total amount of perquisites and personal benefits for that officer must be quantified and disclosed in a footnote. n221

[G] Total Compensation. The dollar value of total compensation for the covered fiscal year is reported in column (j). With respect to each named executive officer, disclose the sum of all amounts reported in columns (c) through (i).

[iv] Grants of Plan-Based Awards Table. For the PEO and PFO and each named officer, the table required under Item 402(d) should disclose certain information concerning each grant n222 of an award made in the last completed

fiscal year under any plan, including awards that have subsequently been transferred. For incentive plan awards, the table requires giving the range of payout (in dollar value for non-equity plans n223 and the number of shares of stock, or the number of shares underlying options to be paid out or vested for equity plans). The table allots columns for the threshold, n224 target n225 and maximum payouts. For all other awards, the number of shares of stock or securities underlying options and the per-share exercise or base price of options granted in a fiscal year are reported in the table. If the exercise or base price is less than the closing market price of the underlying security on the date of the grant, a separate, adjoining column showing the closing market price on the date of the grant is to be added after column (k). The dollar amount of consideration, if any, paid by the executive officer for the awards should be disclosed with an appropriate footnote. n226

[v] Narrative Disclosure to Summary Compensation Table and Grants of Plan-Based Awards Table. Any material facts necessary to understanding the information disclosed in the Summary Compensation Table and the Grants of Plan-Based Awards table should be provided in a narrative description. These material facts include the terms of the named executive officer's employment agreement (written or unwritten), a description of the repricing or material modification of any outstanding option or equity-based award, n227 the material terms n228 of any award reported in the Grants of Plan-Based Awards Table and an explanation of the amount of salary and bonus in proportion to total compensation.

[vi] Outstanding Equity Awards at Fiscal Year-End Table. This table provides details regarding unexercised options, stocks that have not vested and equity incentive plan awards for named executive officers as of the end of the registrant's last completed fiscal year. The awards are delineated on an award-by-award basis, although awards with the same expiration date and exercise and/or base price may be aggregated. n229

[vii] Options Exercises and Stock Vested Table. This table provides details, including the aggregate dollar value realized, n230 regarding each exercise of stock options, SARs and similar instruments, and each vesting of stock, including restricted stock, restricted stock units and similar instruments, during the last completed fiscal year for each of the named executive officers on an aggregated basis.

[viii] Pension Benefit Tables. This table provides details regarding each plan that provides for payments or other benefits at, following, or in connection with retirement. The table includes the number of years of service, n231 the actuarial present value of the named executive officer's accumulated benefit under the plan and the dollar amounts of any payments and benefits paid to the named executive officer during the registrant's last completed fiscal year. n232

A narrative description of any material factors necessary to understanding each plan covered should included with the table. Material factors include:

- the material terms and conditions of payments and benefits available under the plan, including the plan's normal retirement payment and benefit formula and eligibility standards, and the effect of the form of benefit elected on the amount of annual benefits; n233
- whether a named executive officer is currently eligible for early retirement and what the early retirement payment and benefit formula and eligibility standards are;
- the specific elements of compensation included in applying the payment and benefit formula;
- the different purposes of each plan where the named executive officer participates in multiple plans; and
- registrant's policies regarding matters such as granting extra years of credited service.

[ix] Nonqualified Deferred Compensation Table. This table provides details regarding each defined contribution

or other plan that provides for the deferral of compensation on a basis that is not tax-qualified. The table includes, for the registrant's last fiscal year, the dollar amount of aggregate executive contributions and aggregate registrant contributions, the dollar amount of aggregate interest and other earnings accrued, the aggregate dollar amount of all withdrawals by and distributions to the executive, and the total balance of the executive's account. n234

A narrative description of any material factors necessary to understanding each plan covered should be included with the table. Material factors include:

- the types of compensation permitted to be deferred, and any limitations on deferral;
- the measures for calculating interest or other plan earnings (including whether such measure(s) are selected by the executive or the registrant and the frequency and manner in which such selections may be changed), quantifying interest rates and other earnings measures applicable during the registrant's last fiscal year; and
- material terms with respect to payouts, withdrawals and other distributions.

[x] Potential Payment Upon Termination or Change-in-Control. Any arrangement that provides for payments to named executive officers n235 following termination or change-of-control, unless it is non-discriminatory, n236 is to be described in detail. n237 The registrant must provide quantitative disclosure as if the triggering event took place on the last business day of the registrant's last completed fiscal year and the price per share of the registrant's securities were the closing market price as of that date. n238 The specific circumstances that trigger payments or other provisions should be described, including perquisites n239 and health care benefits.

[xi] Director Compensation Table. This table provides details and dollar amounts regarding the compensation of each director n240 for the registrant's last completed fiscal year. The information to be disclosed includes:

- the aggregate dollar amount of all fees earned or paid in cash for services (including retainer fees, committee and/or chairmanship fees and meeting fees); n241
- the aggregate grant date fair value for stock and stock option n242 awards;
- the dollar value of all earnings for services performed during the fiscal year pursuant to non-equity incentive plans and all earnings on outstanding awards;
- the sum of the amounts (i) the aggregate change in the actuarial present value of the director's accumulated benefit under all defined and actuarial pension plans (including supplemental plans) n243 and (ii) the above-market or preferential earnings on compensation that is deferred on a basis that is not tax-qualified, including such earnings on nonqualified defined contribution plans;
- all other compensation for the covered fiscal year; and n244
- the dollar value of total compensation for each director (the sum of all amounts reported in the columns).

Any item reported for a director under the "All Other Compensation" column that is not a perquisite or personal benefit and exceeds \$10,000 in value must be identified and quantified in a footnote to the "All Other Compensation" column. Any amounts deferred, whether pursuant to a plan established under *section 401(k) of the Internal Revenue Code*, or otherwise, are to be included in the appropriate column for the fiscal year in which earned. n245 If the amount of salary or bonus earned in a given fiscal year is not calculable through the latest practicable date, a footnote should so disclose.

When the amount of salary or bonus is later determined, it must then be disclosed in a Current Report filed on Form 8-K. n246

A narrative description of any material factors necessary to understanding the director compensation disclosed in the table. Material factors include:

- a description of the standard compensation arrangements (such as fees for retainer, committee service, service as chairman of the board or a committee, and meeting attendance); and
- whether any director has a different compensation arrangement, identifying that director and describing the terms of that arrangement.

Registrants that qualify as smaller reporting companies provide generally similar executive compensation information, but may omit a Compensation Discussion & Analysis and only must cover two fiscal years in the Summary Compensation Table. n247

[c] Item 403. Security Ownership of Certain Beneficial Owners and Management.

Item 403 of Regulation S-K, "Security Ownership of Certain Beneficial Owners and Management," contains three parts: "Security Ownership of Certain Beneficial Owners," "Security Ownership of Management," and "Changes in Control."

[i] Security Ownership of Certain Beneficial Owners. Part (a) of Item 403, "Security Ownership of Certain Beneficial Owners," requires the registrant to provide information, in tabular form as of the most recent practicable date, for any person n248 known to the registrant n249 to be the beneficial owner of more than five percent of any class of the registrant's voting securities, including the title of the class of voting securities for which the information is being provided, and the name and address n250 of each person for whom information is required to be presented. In addition, disclosure must be provided of the amount and nature of beneficial ownership n251 of each person listed, including disclosure, by footnote or otherwise, of the amount known to the registrant to be shares for which each person has the right to acquire beneficial ownership and, by additional subcolumns or other appropriate explanation necessary, to reflect amounts as to which each person has:

- sole voting power;
- shared voting power;
- sole investment power;
- shared investment power; and
- the percentage of the class of voting securities owned by each person. n252

If any person named pursuant to Item 403(a) holds more than five percent of any class of the registrant's voting securities under a voting trust or similar agreement, the registrant must also state:

- the title of the securities;
- the amount of securities held or to be held pursuant to the agreement, if not clear from the above table;
- the duration of the agreement;

- the names and addresses of the voting trustees; and
- the voting rights and other powers of the voting trustees under the agreement. n253

[ii] Security Ownership of Management. Part (b) of Item 403, "Security Ownership of Management," requires the registrant to provide as of the most recent practicable date, the tabular information required by Item 403(a), with the exception of addresses of the persons for whom information is presented, as to each class of the equity securities of the registrant or any of its parents or subsidiaries including directors' qualifying shares, beneficially owned n254 by (and the percent of class so owned) all: directors and nominees, naming them; named executive officers; and directors and officers as a group, without naming them. n255

[iii] Changes in Control. Part (c) of Item 403, "Changes in Control," requires the registrant to describe any arrangements known to it (including any pledge by any person of securities of the registrant or any of its parents), the operation of which may at a subsequent date result in a change in control of the registrant. n256

[d] Item 404.

Item 404 of Regulation S-K, Transactions with Related Persons, Promoters and Certain Control Persons contains three parts: "Review, Approval or Satisfaction of Transactions with Related Persons" n257

[i] Transactions with Related Persons. Part (a) of Item 404, requires the registrant to briefly describe any transactions or series of similar transactions since the beginning of the registrant's last fiscal year or any currently proposed transactions in which the amount involved exceeds \$120,000 to which the registrant was or is to be a participant and in which any related person had or is to have a direct or indirect n258 material n259 interest.

A related person includes:

- any person who was in any of the following categories at any time since the beginning of the registrant's last fiscal year, including persons involved in any currently proposed transactions, for which disclosure under Item 404(a) is required:
 - any director or executive officer of the registrant
 - any nominee for director, when the information under this Item is being presented in a proxy or information statement relating to the election of that nominee for director; or
 - any immediate family member n260 of a director or executive officer of the registrant, or of any nominee for director when the information called for by Item 404(a) is being presented in a proxy or information statement relating to the election of that nominee for director; and
- any person who was in any of the following categories when a transaction in which such person had a direct or indirect material interest occurred or existed:
 - a security holder covered by Item 403(a); or
 - an immediate family member n261 of any such security holder

The following information regarding the transaction must be disclosed:

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- the name of the related person and the basis on which they are a related person;
- the related person's interest in the transaction with the registrant, including position(s) or relationship(s) with, or ownership in, a firm, corporation, or other entity that is a party to, or has an interest in, the transaction;
- the approximate dollar value of the amount involved n262 in the transaction;
- the approximate dollar value of the amount of the related person's interest in the transaction, which shall be computed without regard to the amount of profit or loss;
- in the case of indebtedness, n263 disclosure of the amount involved in the transaction shall include the largest aggregate amount of principal outstanding as of the latest practicable date, the amount of principal paid during the periods for which disclosure is provided, the amount of interest paid during the period for which disclosure is provided, and the rate or amount of interest payable on the indebtedness; and n264
- any other information regarding the transaction or the related person in the context of the transaction that is material to investors in light of the circumstances of the particular transaction.

The registrant need not provide information concerning a transaction if:

- in the case of indebtedness, the transaction involves a related person who is a security holder covered by Item 403(a) or any immediate family member of such security holder; n265
- disclosure of an employment relationship or transaction involving an executive officer and any related compensation and the compensation is reported pursuant to Item 402 or Regulation S-K; n266
- the interest arises solely from such person's position as a limited partner in a partnership in which the related person has an interest of less than ten percent, and the person is not a general partner of and does not hold another position in the partnership;
- the interest of the person arises solely from the (i) ownership, individually and in the aggregate, of less than ten percent of any class of equity securities of another person (other than a partnership) which is a party to the transaction (ii) the person's position as director of the other corporation or organization or (iii) both n267
- the rates or charges for the transaction are determined by competitive bids;
- the transaction involves the rendering of services as a common or contract carrier or public utility at rates or charges fixed in conformity with law or governmental authority;
- the transaction involves services as a bank depository of funds, transfer agent, registrar, trustee under a trust indenture, or similar services; or
- the interest of the person arises solely from the ownership of the registrant's securities and the person receives no extra or special benefit not shared on a pro rata basis. n268

[ii] Review, Approval or Ratification of Transactions With Related Persons. n269 Part (b) of Item 404, "Review, Approval or Ratification of Transactions With Related Persons," requires the registrant to provide detail as to

the process of review, approval or ratification of any transaction with related persons (transactions required to be reported under paragraph (a) of Item 404). Item 404(b) does not set a formula for disclosure but does provide examples of what might be relevant features of the policies and procedures, including (i) the types of transactions that are covered; (ii) the standards applied; (iii) the persons responsible for application; and (iv) a statement regarding the written or other evidence of such policies and procedures.

Under this paragraph (b), the registrant should also identify any transaction required to be reported under paragraph (b) of Item 404 since the beginning of the registrant's last fiscal year where such policies and procedures did not require review, approval or ratification or where such policies and procedures were not followed. n270

[iii] Promoters and Certain Control Persons. n271 Part (c) of Item 404, "*Promoters and Certain Control Persons*," requires registrants filing a registration statement on Securities Act Form S-1 or Exchange Act Form 10 that had a promoter at any time during the last five years to state the names of the promoters and the nature and amount of anything of value received or to be received by each promoter directly or indirectly from the registrant, including money, property, contracts, options or rights of any kind. The nature and amount of assets, services, or other consideration received or to be received by the registrant from each promoter must be described. As to any assets acquired or to be acquired by the registrant from the promoter, the amount at which the assets were acquired or are to be acquired, the principle persons determining the value of the assets and their relationship, if any, with the registrant or any promoter must be described. If the assets were acquired by the promoter within two years before their transfer to the registrant, the cost of the assets to the promoter must be stated.

Where the registrant is a shell company, the above disclosures regarding promoters must also be given as to any person who has, or any person that is part of a group that has, acquired control of the registrant. n272

Registrants that qualify as smaller reporting companies are not required to provide all of the information required by Item 404 of Regulation S-K. n273

[e] Item 405. Compliance with Section 16(a) of the Exchange Act. Item 405 of Regulation S-K requires registrants to provide information concerning noncompliance by its insiders with the reporting requirements of Section 16(a) of the Exchange Act. n274 Part (a) of Item 405 provides that, under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" and based solely upon a review of Forms 3 and 4 and amendments thereto furnished to the registrant pursuant to Exchange Act Rule 16a-3(e) during its most recent fiscal year and Forms 5 and amendments thereto furnished to the registrant with respect to its most recent fiscal year, and certain written representations, n275 the registrant n276 must identify each person who, at any time during the fiscal year, was a "reporting person" that failed to file on a timely basis, as disclosed in the Forms referred to above, reports required by Exchange Act Section 16(a) during the most recent fiscal year or prior fiscal years. n277 A reporting person is defined as:

- a director, officer, beneficial owner of more than ten percent of any class of equity securities of the registrant pursuant to Exchange Act Section 12; or
- any other person subject to Exchange Act Section 16 with respect to the registrant because of the requirements of Section 30 of the Investment Company Act or Section 17 of the Public Utility Holding Company Act.

For each such person, the registrant must set forth the number of late reports, the number of transactions that were not reported on a timely basis, and any known failure to file a required Form. A known failure includes a failure to file a Form 3, which is required of all reporting persons, and a failure to file a Form 5 in the absence of a written representation that no form is required. n278 If the registrant receives a written representation from the reporting person that no Form 5 is required, and maintains the representation for two years, making a copy available to the Commission

upon request, the registrant need not identify such reporting person as having failed to file a Form 5 with respect to the fiscal year. n279

[f] Item 406. Code of Ethics. Item 406 requires a registrant to disclose whether it has adopted a code of ethics n280 that applies to its principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. n281 If the registrant has not adopted such a code of ethics, it must explain why it has not done so. n282

Additionally, a registrant must:

- file a copy of its code of ethics as an exhibit to its annual report;
- post the text of its code of ethics on its Internet website and disclose, in its annual report, its Internet address and the fact that it has posted its code of ethics on its website; or
- undertake in its annual report to provide to any person, without charge and upon request, a copy of its code of ethics and explain the manner in which such request may be made. n283

Finally, if a registrant intends to satisfy the disclosure requirement under Item 5.05 of Form 8-K Form 8-K (regarding an amendment to, or a waiver from, a provision of its code of ethics) by posting such information on its Internet website, the registrant must disclose its Internet address and its intention to amend or grant a waiver from its code of ethics. n284

[g] Item 407. Corporate Governance. n285 Item 407(a) requires the registrant to identify each director n286 and director nominee that is independent, as defined in this Item 407. The registrant must also disclose the definition of independence used for determining the independence of directors and director nominees and members of specific committees of the board of directors.

When the registrant determines independence of directors and director nominees, the registrant must apply certain applicable independence standards. If the registrant is a listed issuer whose securities are listed on a national securities exchange or an inter-dealer quotation system, and the registrant adopted standards specifically to comply with corporate governance requirements, n287 then the following independence standards apply:

- in determining if a director or director nominee is independent, the applicable definition of independence would be the registrant's definition of independence that it uses for determining if a majority of the board of directors is independent in compliance with the listing standards applicable to the registrant; n288
- in determining whether the members of a committee of the board of directors are independent, the applicable independence standards would be the standards used by the registrant in determining if the members of that specific committee are independent in compliance with the listing standards applicable to the registrant; and
- if the registrant does not have independence standards for a committee, the applicable standard would be the independence standards for that specific committee that the registrant uses in determining if the directors are independent in compliance with the listing standards applicable to the registrant.

If the registrant is not a listed issuer, the registrant is to use the definition of independence of a national securities exchange or an inter-dealer quotation system which has requirements that a majority of the board of directors be independent. n289 The registrant must state which definition is used and must use the same definition with respect to all

directors and director nominees. When determining independence standards for a specific committee, if the chosen source of independence definition has standards for a specific committee, the registrant must use those committee specific standards.

If the registrant has adopted its own definitions for determining independence, the registrant must disclose whether those policies are available to security holders via the registrant's website and give the website address, or include the policies in an appendix to the registrant's proxy statement or information statement that is provided to security holders at least once every three fiscal years (or when the policies have been materially amended as of the beginning of the registrant's last fiscal year). n290

For each director and director nominee that is identified as independent, the registrant must fully describe, in such detail as is necessary, n291 by specific category or type, any transaction, relationship or arrangement not disclosed pursuant to Item 404(a) (regarding transactions with related persons) that was considered by the board of directors under the applicable independence definitions in determining that the director is independent.

Board Meetings and Committees; Annual Meeting Attendance. Item 407(b) requires the registrant to disclose the total number of board meetings held during the last full fiscal year and provide information regarding director attendance. The registrant should also disclose the attendance policies for attendance at annual meetings and state the number of board members who attended the prior year's annual meetings. n292 The registrant must provide details regarding its audit, nominating and compensation committees, including whether they have standing committees, the identity of each committee member, the number of meetings held by each committee during the last fiscal year and the functions performed by each committee.

Nominating Committee. n293 If the registrant does not have a standing nominating committee, it must provide the basis for determining that the absence of a standing committee is appropriate. The registrant should also identify each director who participates in the consideration of director nominees. The following information should be disclosed regarding the director nomination process:

- disclosure of, or absence of, a nominating committee charter;
- description of the policy for consideration of director nominees recommended by security holders, including a statement as to whether the committee will consider director candidates recommended by security holders;
- if there is no policy governing the consideration of director nominees recommended by security holders, there must be a statement as to that fact and the basis for the view of the board of directors that it is appropriate for the registrant not to have such a policy;
- description of the procedures to be followed by security holders submitting director nominee recommendations (if the nominating committee will consider director candidates recommended by security holders) as well as description of any material changes to the procedures; n294
- description of specific minimum qualifications, as well as any specific qualities or skills, that the nominating committee believes must be met by a candidate that committee has recommended;
- description of the process for identifying and evaluating director nominees, including whether the processes are different depending on the source of the nominee;
- the source of the nomination for a nominee submitted on the proxy statement; n295

- disclosure of the function performed any an third party that receives fees from the registrant to identify or evaluate or assist in identifying or evaluating potential nominees; and
- identify and provide certain information for director nominees submitted by a security holder, or a group thereof, that beneficially owns more than 5% of the registrant's voting common stock for at least one year as of the date the recommendation was made. n296

Audit Committee. The registrant must state whether or not the audit committee has a charter. If the registrant is a listed issuer with a director appointed to the audit committee that is not independent (in accordance with the listing standards applicable to the issuer, including as a result or exception or limited or similar circumstances), disclosure as to the nature of the relationship that makes the individual not independent and the reasons for the board of directors' determination must be given.

If the registrant is a listed issuer filing either an annual report on Form 10-K or 10-KSB, or a proxy statement or information statement pursuant to the Exchange Act if action is to be taken with respect to the election of directors and the registrant is not relying upon exemptions to the reporting requirements of Item 407, n297 then the registrant must state whether or not it has a separately-designated standing audit committee established in accordance with the Exchange Act or a committee performing similar functions. If there is a standing audit committee, each member (including where entire board composes the audit committee) must be identified. The registrant must disclose the information required by Rule 10A-3(d) of the Exchange Act if relying upon an exemption from the listing standards for audit committees.

Audit Committee Report. n298 Item 407(d)(3) requires a registrant's audit committee to state whether it has:

- reviewed and discussed the audited financial statements with management;
- discussed with the registrant's independent auditors the matters required to be discussed by Auditing Standards No. 61, as amended (AICPA, *Professional Standards*, Vol. 1, AU section 380) as adopted by the Public Company Accounting Oversight Board in Rule 3200T;
- received the written disclosures and the letter from the registrant's independent accountants required by applicable requirements of the Public Company Accounting Oversight Board regarding the independent accountant's communications with the audit committee concerning independence and has discussed with the independent accountant the independent accountant's independence; and
- based on the review and discussions referred to in the preceding points, whether the audit committee recommends to the registrant's Board of Directors that the audited financial statements be included in the registrant's Annual Report on Form 10-K for the last fiscal year for the filing with the Commission. The name of each member of the registrant's audit committee (or, in the absence of an audit committee, the board committee performing equivalent functions or the entire board of directors) must appear below the audit committee report. n299

Audit Committee Financial Expert. The registrant must disclose if, in the board's determination, the registrant has, or does not have, a financial expert. n300 If the registrant has a financial expert, it should also be disclosed whether he or she is independent, n301 as defined in the listing standards applicable to the listed issuer. If the registrant does not have a financial expert, the registrant must disclose this and provide an explanation. An audit committee financial expert must have the following attributes:

- an understanding of generally accepted accounting principles and financial statements;

1-4 Federal Securities Exchange Act of 1934 § 4.03

- the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal control over financial reporting; and
- an understanding of audit committee functions.

Further, the audit committee expert is to have required such attributes through:

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
- experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- other relevant experience. n302

Item 407 provides a safe harbor for the audit committee financial expert from the imposition of any extra duties, obligations and liabilities that could arguably accompany such title. The audit committee financial expert does not bear any special duties, obligations or liabilities that are greater than those imposed through membership on the audit committee and the board of directors. The audit committee financial expert is not deemed an *expert* for any purpose, including without limitation for purposes of Section 11 of the Securities Act, as a result of being designated or identified as an audit committee financial expert pursuant to Item 407. The designation or identification of a person as an audit committee financial expert also does not affect the duties, obligations or liabilities of any other member of the audit committee or board of directors.

Compensation Committee. If the registrant does not have a standing compensation committee, there should be a statement disclosing this fact, including the basis for the view of the board of directors that it is appropriate for the registrant not to have such a committee. The registrant must then identify each director who participates in the consideration of executive officer and director compensation.

The registrant must provide a narrative description of the registrant's processes and procedures for the consideration and determination of executive and director compensation, including:

- the scope of authority of the compensation committee (or persons performing the equivalent functions);
- the extent to which the compensation committee (or persons performing the equivalent functions) may delegate any authority that is within the scope of the compensation committee's authority and to whom;

- any role of executive officers in determining or recommending the amount or form of executive and director compensation; and
- any role of compensation consultants in determining or recommending the amount or form of executive and director compensation, identifying such consultants, stating whether such consultants are engaged director by the compensation committee (or persons performing the equivalent functions) or any other person, describing the nature and scope of their assignment, and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement.

Compensation Committee Interlocks and Insider Participation. Under the caption "Compensation Committee Interlocks and Insider Participation," the registrant is to provide certain details regarding the members of the compensation committee, or those performing similar function. If the registrant has a compensation committee, the registrant should identify each member of the compensation committee that served on the registrant's board of directors (or board committee performing equivalent functions) during the last completed fiscal year and indicate each member who was, during any part of the fiscal year, an officer or employee of the registrant, was formerly an officer of the registrant, or had a relationship requiring disclosure under Item 404 (transactions with related persons, promoters and certain control persons). n303

If the registrant does not have a compensation committee (or other board committee performing equivalent functions), the registrant is to identify each officer and employee of the registrant, and any former officer of the registrant, who, during the last completed fiscal year, participated in deliberations of the registrant's board of directors concerning executive officer compensation. The registrant must then describe any reciprocal relationship between two entities whereby executive officers serve on the other entity's compensation committee or board of directors.

Compensation Committee Report. n304 Under the caption "Compensation Committee Report," the compensation committee (or other board committee performing equivalent functions, or, in the absence of such committee, the entire board of directors) must state:

- whether the compensation committee has reviewed and discussed the Compensation Discussion and Analysis required by Item 402(b) with management;
- based on such review, whether the compensation committee recommends to the board of directors that the Compensation Discussion and Analysis be included in the registrant's annual report on Form 10-K, proxy statement on Schedule 14A or information statement on Schedule 14C; and
- the name of each member of the registrant's compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors).

Stockholder Communications. The registrant must state whether or not it has a process for facilitating security holder communication n305 with board of directors. If the registrant has such a process for security holders to send communications to the board of directors, the registrant must describe the process (the manner in which to send communications to the board and/or specified individual directors, or the registrant's process for determining which communications will be relayed to the board, if all such communications are not sent directly to the board and such process for relaying communications has not been approved by a majority of the independent directors of the board). n306 This may also be satisfied by directing the security holder to the registrant's website where the description of such process can be found. n307 If the registrant does not have such a process, the registrant must state the basis for the view of the board of directors that it is appropriate for the registrant not to have such a process.

Committee Charters. The registrant must state whether or not it has nominating, audit and compensation committee

charters. If so, a current copy of the charters must be available at the registrant's website, with statements indicating where the charters can be found, or must be included as an appendix to the registrant's proxy or information statement that is provided to security holders at least once every three fiscal years, or upon material amendment. n308 For years where the charters are not included as an appendix to the proxy or information statement, the registrant must identify which of the prior fiscal years the charter was so included.

Registrants that qualify as smaller reporting companies are not required to provide all of the information required by Item 407 of Regulation S-K. n309

[6] Registration Statement and Prospectus Provisions

The sixth section of Regulation S-K contains twelve items that set forth specific content requirements applicable only to Securities Act registration statements and the legends and undertakings thereunder.

[7] Exhibits

The seventh section of Regulation S-K covers "Exhibits" to filings under the Securities Act and Exchange Act. Item 601 of Regulation S-K, "Exhibits," provides an exhibit table listing the exhibits that must be filed as part of certain Securities Act and Exchange Act registration statements and reports. A registrant is also permitted to file any additional exhibits that it may wish to file. n310 The filing of exhibits pursuant to Item 601 is subject to Rule 12b-32 which permits incorporation of exhibits by reference n311 and to Regulation S-T under the Exchange Act as to electronic filers. n312

Copies of each required exhibit, rather than originals, need only be filed unless otherwise specifically noted. n313 Each registration statement or report is required to contain an exhibit index, immediately preceding the exhibits filed, indicating the page number where each exhibit can be found or that the exhibit has been incorporated by reference. n314 Each exhibit must be listed in the exhibit index according to the number assigned to it in the exhibit table in Item 601(b) of Regulation S-K. When applicable, the first page of a manually signed registration statement must list the page in the filing where the exhibit index is located.

[a] Form 10 Exhibits. The following exhibits must be filed as part of Form 10:

- (2) n315 each material plan of acquisition, disposition, reorganization, readjustment, succession, liquidation, or arrangement and any amendments to the plan described in the registration statement or report; n316
- (3) the articles of incorporation and bylaws of the registrant, or corresponding instruments, and any amendments to the articles or bylaws; n317
- (4) instruments defining the rights of security holders, n318 including indentures; n319
- (9) each voting trust agreement and any amendments to the agreement; n320
- (10) material contracts; n321
- (11) a statement setting forth in reasonable detail the computation of per share earnings (on both primary and fully diluted bases); n322
- (12) a statement setting forth in reasonable detail the computation of any ratio of earnings to fixed charges, any ratio of earnings to combined fixed charges and preferred stock dividends, or any other

ratios that appear in the registration statement; n323

- (16) a letter relating to a change in the certifying accountant; n324
- (21) a list of all subsidiaries of the registrant, the jurisdiction of incorporation or organization of each, and the names under which each does business; n325
- (24) if any name is signed to the registration statement pursuant to a power of attorney, manually signed copies of the power of attorney, or if the name of any officer signing on behalf of the registrant is signed pursuant to a power of attorney, certified copies of a resolution of the registrant's board of directors authorizing that signature; n326
- (99) additional exhibits; n327 and
- (100) XBRL-related documents. n328

[b] Form 8-K Exhibits. The following exhibits must be filed as part of Form 8-K, if relevant to the particular report:

- (1) each underwriting contract or agreement (or the proposed forms if the terms of the contract or agreement have not been determined) with a principal underwriter pursuant to which the securities being registered are to be distributed, or, if the terms of such documents have not been determined, the proposed forms thereof; n329
- (2) each material plan of acquisition, disposition, reorganization, readjustment, succession, liquidation, or arrangement and any amendments thereto described in the registration statement or report; n330
- (3) the text of any amendment to the articles of incorporation or bylaws, or corresponding instruments, of the registrant; and n331
- (4) instruments defining the rights of security holders, including indentures; n332
- (7) correspondence from an independent accountant regarding non-reliance on a previously issued audit report or completed interim review. n333
- (14) the registrant's code of ethics, if applicable; n334
- (16) a letter relating to the change in certifying accountant; n335
- (17) any letter from a former director that sets forth a description of a disagreement with the registrant that led to the director's resignation or refusal to stand for reelection which requests that the matter be disclosed; n336
- (20) a document or statement furnished to security holders containing information meeting some or all the requirements of Form 8-K, if furnished within the period prescribed for the filing of the report; n337
- (23) where the filing of written consents of experts and counsel (dated and manually signed) as to material incorporated by reference in a previously filed Securities Act registration statement is requested,

such consents may be filed as an exhibit to the material incorporated by reference; n338

- (24) if any name is signed to the report pursuant to a power of attorney, manually signed copies of the power of attorney, or if the name of any officer signing on behalf of the registrant is signed pursuant to a power of attorney, certified copies of a resolution of the registrant's board of directors authorizing that signature; n339 and

- (99) additional exhibits; and n340

- (100) XBRL-related documents may be submitted in electronic format as an exhibit to a Form 8-K that references the filing (or amendment thereto) to which the XBRL-documents relate (if the Form 8-K is submitted no earlier than the date of that filing). n341

[c] Form 10-Q Exhibits. The following exhibits must be filed as part of Form 10-Q:

- (2) each material plan of acquisition, disposition, reorganization, readjustment, succession, liquidation, or arrangement and any amendments thereto described in the report; n342

- (3) the articles of incorporation and bylaws of the registrant, or corresponding instruments, and any amendments to the articles or bylaws; n343

- (4) instruments defining the rights of security holders, including indentures; n344

- (10) material contracts; n345

- (11) a statement setting forth in reasonable detail the computation of per share earnings (on both primary and fully diluted bases); n346

- (15) a letter, if applicable, from the independent accountant acknowledging awareness of the use in a registration statement of a report on unaudited interim financial information that is not considered a part of a registration statement or report prepared or certified by an accountant; n347

- (18) a letter from the registrant's independent accountant indicating whether any change in accounting principles or practices followed by the registrant, or any change in the method of applying any accounting principles or practices, that affected the financial statements filed in the report or that is reasonably certain to affect the financial statements of future fiscal years, is to an alternative accounting principle or practice which in the accountant's judgment is preferable under the circumstances; n348

- (19) a document or statement furnished to security holders containing information meeting some or all the requirements of Part I of Form 10-Q, incorporated by reference into Form 10-Q, if furnished within the period prescribed for the filing of the report; n349

- (22) published reports regarding matters submitted to a vote of security holders incorporated by reference in Form 10-Q n350 that are required to be filed as exhibits by Rule 12b-23(a)(3); n351

- (23) where the filing of written consents of experts and counsel (dated and manually signed) as to material incorporated by reference in a previously filed Securities Act registration statement is required, such consents may be filed as an exhibit to the material incorporated by reference; n352

- (24) if any name is signed to the report pursuant to a power of attorney, manually signed copies of

the power of attorney, or if the name of any officer signing on behalf of the registrant is signed pursuant to a power of attorney, certified copies of a resolution of the registrant's board of directors authorizing that signature; n353

- (31) the certifications required by Rules 13a-14(a) or 15d-14(a) of the Exchange Act adopted pursuant to Section 302 of the Sarbanes-Oxley Act, exactly as set forth in Item 601(b)(31); n354

- (32) the certifications required by Rules 13a-14(b) or 15d-14(b) of the Exchange Act and *18 U.S.C. § 1350* adopted pursuant to Section 906 of the Sarbanes-Oxley Act; n355

- (99) any additional exhibits which the registrant may wish to file; however, if pursuant to Section 11(a) of the Securities Act, an issuer makes available to its security holders generally an earnings statement covering a period of at least twelve months beginning after the effective date of a registration statement (other than through the issuer's Exchange Act reports contemplated by Rule 158 of the Securities Act), it must be filed as an exhibit to the next periodic report required by Section 13 or 15(d) of the Exchange Act covering the period when the earnings statement is released; n356

- (100) XBRL-related documents may be submitted in electronic format as an exhibit to the filing (or amendment thereto) to which they relate; and n357

- (101) Interactive Data File. n358

[d] Form 10-K Exhibits. The following exhibits must be filed as part of Form 10-K:

- (2) each material plan of acquisition, disposition, reorganization, readjustment, succession, liquidation, or arrangement and any amendments to the plan described in the report; n359

- (3) the articles of incorporation and bylaws of the registrant, or corresponding instruments, and any amendments to the articles or bylaws; n360

- (4) instruments defining the rights of security holders, including indentures; n361

- (9) each voting trust agreement and any amendments thereto; n362

- (10) material contracts; n363

- (11) a statement setting forth in reasonable detail the computation of per-share earnings (on both primary and fully diluted bases); n364

- (12) a statement setting forth in reasonable detail the computation of any ratio of earnings to fixed charges, any ratio of earnings to combined fixed charges and preferred stock dividends, or any other ratios that appear in the report; n365

- (13) the annual report to security holders for the last fiscal year, and the quarterly report to security holders if all or a portion of the quarterly report is incorporated by reference in the report; n366

- (14) the registrant's code of ethics, if applicable; n367

- (16) a letter relating to a change in the certifying accountant; n368

- (18) a letter from the registrant's independent accountant indicating whether any change in accounting principles or practices followed by the registrant, or any change in the method of applying any accounting principles or practices, that affected the financial statements of future fiscal years, is to an alternative accounting principle or practice which in the accountant's judgment is preferable under the circumstances; n369
- (21) a list of all subsidiaries of the registrant, the jurisdiction of incorporation or organization of each, and the names under which each does business; n370
- (22) published reports regarding matters submitted to a vote of security holders incorporated by reference in Form 10-K n371 that are required to be filed as exhibits by Rule 12b-23(a)(3); n372
- (23) where the filing of written consents of experts and counsel (dated and manually signed) as to material incorporated by reference in a previously filed Securities Act registration statement is required, such consents may be filed as an exhibit to the material incorporated by reference; n373
- (24) if any name is signed to the report pursuant to a power of attorney, manually signed copies of the power of attorney, or if the name of any officer signing on behalf of the registrant is signed pursuant to a power of attorney, certified copies of a resolution of the registrant's board of directors authorizing that signature; n374
- (31) the certifications required by Rules 13a-14(a) or 15d-14(a) of the Exchange Act adopted pursuant to Section 302 of the Sarbanes-Oxley Act, exactly as set forth in Item 601(b)(31); n375
- (32) the certifications required by Rules 13a-14(b) or 15d-14(b) of the Exchange Act and 18 U.S.C. § 1350 adopted pursuant to Section 906 of the Sarbanes-Oxley Act; n376
- (33) the report on assessment of compliance with servicing criteria for asset-backed securities; n377
- (34) the attestation report on assessment of compliance with servicing criteria for asset-backed securities; n378
- (35) servicer compliance statement; n379
- (99) any additional exhibits which the registrant may wish to file; however, if pursuant to Section 11(a) of the Securities Act, an issuer makes available to its security holders generally an earnings statement covering a period of at least twelve months beginning after the effective date of a registration statement (other than through the issuer's Exchange Act reports contemplated by Rule 158 of the Securities Act), it must be filed as an exhibit to the next periodic report required by Section 13 or 15(d) of the Exchange Act covering the period when the earnings statement is released; and n380
- (100) XBRL-related documents may be submitted in electronic format as an exhibit to the filing (or amendment thereto) to which they relate; and n381
- (101) Interactive Data File. n382

[8] Miscellaneous

The eighth section of Regulation S-K contains two items: "Recent Sales of Unregistered Securities; Use of Proceeds from Unregistered Securities" and "Indemnification of Directors and Officers."

[a] Item 701. Recent Sales of Unregistered Securities; Use of Proceeds from Registered Securities. Item 701 of Regulation S-K, "Recent Sales of Unregistered Securities; Use of Proceeds from Registered Securities," requires the registrant to furnish the following information as to all securities of the registrant sold by the registrant within the last three years, or in the case of Exchange Act reports, within the applicable reporting period, that were not registered under the Securities Act: n383

- the date of sale and the title and amount of securities sold;
- the names of any principal underwriters;
- if the securities were not publicly offered, the names of the persons or the identity of the class of persons to whom the securities were sold;
- if the securities were sold for cash, the aggregate offering price and the aggregate underwriting discounts or commissions;
- if the securities were not sold for cash, the nature of the transaction and the nature and aggregate amount of consideration received; and
- the exemption from registration claimed and the facts relied upon to make the exemption available; and in the case of convertible or exchangeable securities, warrants, and options, the terms of conversion or exercise. n384

Following the effective date of the first registration statement filed under the Securities Act by an issuer, the issuer or successor issuer must report the use of proceeds in its first periodic report filed pursuant to Section 13(a) and 15(d) of the Exchange Act, and thereafter on each of its subsequent periodic reports through the later of disclosure of the application of all the offering proceeds or termination of the offering. In disclosing the use of proceeds in the first periodic report filed pursuant to the Exchange Act, the issuer (or any successor issuer) must include the following information:

- the effective date of the Securities Act registration statement for which the use of proceeds information is being disclosed and the Commission file number assigned to the registration statement;
- if the offering has commenced, the offering date, and if the offering has not commenced, an explanation of why it has not;
- if the offering terminated before any securities were sold, an explanation for such termination;
- if the offering did not terminate before any securities were sold:
 - whether the offering has terminated and, if so, whether it terminated before the sale of all securities registered;
 - the names of any managing underwriter;
 - the title of each class of securities registered and where a class of convertible securities is being registered, the title of any class of securities into which such securities may be converted; and
 - for each class of securities (other than a class of securities into which a class of

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convertible securities registered may be converted without additional payment to the issuer) the following information, provided for both the account of the issuer and the accounts of any selling security-holder: the amount registered; the aggregate price of the offering amount registered; the amount sold; and the aggregate offering price of the amount sold to date;

- from the effective date of the Securities Act registration statement to the ending date of the reporting period, the amount of expenses incurred for the issuer's account in connection with the issuance and distribution of the securities registered for underwriting discount and commission, finders' fees, expenses paid to or for underwriters, other expenses, and total expenses. The issuer must indicate if a reasonable estimate for the amount of expenses incurred is provided instead of the actual amount of expenses.

Indicate whether such payments were:

- direct or indirect payments to directors, officers, general partners of the issuers or their associates; to persons owning ten percent or more of any class of equity securities of the issuer; and to affiliates of the issuer; or

- direct or indirect payments to others;

- the net offering proceeds to the issuer after deducting the total expenses;

- from the effective date of the Securities Act registration statement to the ending date of the reporting period, the amount of net offering proceeds to the issuer and for construction of plant, buildings, and facilities, purchase and installation of machinery and equipment; purchases of real estate; acquisition of other businesses; repayment of indebtedness; working capital; temporary investment (which should be specified); and any other purposes for which at least five percent of the issuer's total offering proceeds or \$100,000 (whichever is less) has been used (which should be specified). Indicate if a reasonable estimate for the amount of net offering proceeds applied is provided instead of the actual amount of net offering proceeds and indicate whether such payments were:

- direct or indirect payments to directors, officers, general partners of the issuer or their associates; to persons owning ten percent or more of any class of equity securities of the issuer; and the affiliates of the issuer; or

- direct or indirect payments to others; and

- if the use of proceeds above represents a material change in the use of proceeds from that described in the prospectus, the issuer should briefly describe the material change. n385

Item 701 of Regulation S-K applies to sales of new issues; sales of reacquired securities; securities issued in exchange for property, services, or other securities; and new securities resulting from the modification of outstanding securities.

n386 The Commission has determined that timely disclosure of unregistered sales of equity securities is of interest to the market, particularly with respect to sales made in reliance upon Regulation S, the safe harbor for offshore sales, and Section 4(2), the private placement exemption. Thus, disclosure of this information is now required in annual and quarterly Exchange Act Reports. n387 Item 701 of Regulation S-K enhances the exposure to liability under the Securities Act if the registrant has sold unregistered securities for which no exemption was available. The Commission may take the position that this contingent liability must be reflected in the registrant's financial statements.

[b] Item 702. Indemnification of Directors and Officers. Item 702 of Regulation S-K, "Indemnification of Directors and Officers," requires the registrant to state the general effect of any statute, charter provision, bylaw,

contract, or other arrangement under which any person is insured or indemnified against liabilities incurred in his capacity as a director, officer, or controlling person of the registrant.

[c] Item 703. Purchases of Equity Securities by the Issuer and Affiliated Purchasers. Item 703 of Regulation S-K requires the registrant to disclose, in the tabular format set forth in Item 703, certain information with respect to any purchase made by or on behalf of the registrant or any "affiliated purchaser" (as defined in Rule 10b-18(a)(3) of the Exchange Act) of shares or other units of any class of the registrant's equity securities that is registered pursuant to Section 12 of the Exchange Act. n388 The table must include the following information for each class or series of securities for each month included in the period covered by the report (or in each month in the registrant's fourth quarter if the disclosure is contained in an annual report n389):

- the total number of shares or units purchased; n390
- the average price paid per share or unit;
- the total number of shares or units purchased as part of publicly-announced repurchase plans or programs (in the aggregate); and
- the maximum number (or approximate dollar value) of shares or units that may yet be purchased under the plans or programs (in the aggregate). n391

The registrant must also disclose, by footnote to the table: (a) the date each plan or program was announced; (b) the dollar amount (or share or unit amount) approved; (c) the expiration date (if any) of each plan or program; (d) each plan or program that has expired during the period covered by the table; and (e) each plan or program the registrant has determined to terminate prior to expiration, or under which the issuer does not intend to make further purchases. n392 Issuers should note that this may include certain stock options exercise transactions.

[9] List of Industry Guides

The ninth section of Regulation S-K contains two items: "Securities Act Industry Guides" (applicable to Securities Act filings) and "Exchange Act Industry Guides."

Item 802 of Regulation S-K, "Exchange Act Industry Guides," lists the following guides for disclosure under the Exchange Act: n393

- Guide 2, "Disclosure of oil and gas operations"
- Guide 3, "Statistical disclosure by bank holding companies"
- Guide 4, "Disclosures concerning unpaid claims and claim adjustment expenses of property-casualty underwriters" and
- Guide 7, "Description of property by issuers engaged or to be engaged in significant mining operations."

[10] Roll-up Transactions

The tenth section of Regulation S-K contains fifteen items that set forth specific content requirements applicable only to transactions involving roll-ups of limited partnerships or similar entities. n394

[11] Disclosure by Registrants Engaged in Oil and Gas Producing Activities.

The eleventh section of Regulation S-K contains eight items that set forth specific content requirements applicable only to registrants engaged in oil and gas producing activities. This section of Regulation S-K is not effective until January 1, 2010. n395

[12] Small Businesses

Effective February 4, 2008, the Commission adopted rules significantly revising its regulations regarding small business issuers. n396 The revised rules eliminated the definition of "small business issuer" and created a new category of issuer called a "a smaller reporting company". n397 The revised rules also eliminated Regulation S-B and the related forms in favor of a new system of scaled disclosure for reporting, registration and proxy solicitation filings under the Securities Act and the Exchange Act. n398

[a] Definition. A "a smaller reporting company" is an entity:

- with an aggregate market value of common equity held by nonaffiliates ("public float") of less than \$75 million, or, if unable to calculate its public float, has annual revenue of \$50 million or less;
- that is not an investment or asset-backed company; and
- that is not a majority-owned subsidiary of a non -"smaller reporting company."

In order to qualify as a "smaller reporting company," a reporting company must meet both the public float tests as of the last business day of its most recently completed second fiscal quarter, or if applicable, the revenue test during its most recently completed fiscal year for which audited financial statements are available. n399 The Commission's rules governing smaller reporting companies allow such companies to move in and out of the scaled disclosure system, based upon changes in the smaller reporting company's market capitalization over time. A smaller reporting company is required to exit the scaled disclosure system in the fiscal year after its individual public float rises above \$75 million as of the last business day of its second fiscal quarter. A former smaller reporting company that chooses to re-enter the scaled disclosure system may only do so if its public float was less than \$50 million as of the last business day of its second fiscal quarter, and would be able to use scaled disclosure in the next fiscal year after that determination, beginning with its initial Form 10-Q of that year. n400

[b] Scaled Disclosure. The Commission's smaller reporting company rules integrate individual Regulation S-B disclosure items (other than Item 310) into Regulation S-K. These rules allow each smaller reporting company to select on an item-by-item, or "a la carte" basis, whether it will comply with the new scaled disclosure requirements in Regulation S-K for smaller reporting companies, or whether it will comply with the more rigorous disclosure requirements in Regulation S-K that apply to other companies n401 A smaller reporting company may comply with either the requirements applicable to smaller reporting companies or the requirements applicable to other companies for each item of Regulation S-K, unless the requirements for smaller reporting companies specify that smaller reporting companies must comply with the smaller reporting company requirements. The items of Regulation S-K that contain requirements that are different for smaller reporting companies than the requirements applicable to other companies include: n402

Item 101	Description of business
Item 201	Market price of and dividends on registrant's common equity and related stockholder matters
Item 301	Selected financial data
Item 302	Supplementary financial information
Item 303	Management's discussion and analysis of financial condition and results of operations

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Item 305	Quantitative and qualitative disclosures about market risk
Item 402	Executive compensation
Item 404	Transactions with related persons, promoters and certain control persons
Item 407	Corporate governance
Item 503	Prospectus summary, risk factors, and ratio of earnings to fixed charges
Item 504	Use of proceeds
Item 601	Exhibits

The Commission also moved the scaled financial statement requirements in Item 310 of Regulation S-B into new Article 8 of Regulation S-X, and amended the requirements to provide a scaled disclosure option for smaller reporting companies, requiring two years of balance sheet data instead of one year. n403

[13] Plain English

The Commission has adopted "the plain English rule," which requires issuers to write substantially all of the prospectuses and proxy statements in plain English. Specifically, in these sections issuers must use: short sentences; definite, concrete, everyday language; active voice; tabular presentation of complex information; no legal or business jargon; and no multiple negatives. The Commission has stated that it believes that preparing documents in plain English increases investors' understanding and helps them make informal investment decisions. Thus, registrants should consider applying similar principles in Exchange Act reports.

FOOTNOTES:

(n1)Footnote 1. *Exchange Act Release No. 14,306, Fed. Sec. L. Rep. (CCH) P 72,258* (1977), in which the Commission announced the adoption of Item 1 "Description of Business" and Item 2 "Description of Property" of Regulation S-K, reprinted in the Primary Law Sourcebook, Volume D, Section K. Regulation S-K, codified at 17 C.F.R. § 229, is reprinted in the Primary Law Sourcebook, Vol. D, Section K.

(n2)Footnote 2. *Exchange Act Release No. 18,524, Fed. Sec. L. Rep. (CCH) P 956* (1982); cf., *Exchange Act Release No. 18,008, Fed. Sec. L. Rep. (CCH) P 966*, Part I (1981). For a discussion of the disclosure obligation of a smaller reporting company generally, see § 4.03[12] *infra*.

(n3)Footnote 3. Effective January 1, 2010, Subpart 1200 to Regulation S-K was added (including Items 1201-1208) as part of the modernization of oil and gas reporting.

(n4)Footnote 4. Section 21E of the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section F, the statutory safe harbor for forward-looking statements, is discussed in § 4.04 *infra*.

(n5)Footnote 5. In accordance with § 401 of the Sarbanes-Oxley Act, the Commission amended the prior set of rules governing the use of non-GAAP financial measures in Commission filings in January 2003. See *Exchange Act Release No. 47,226* (2003). These amended rules contain more detailed and stringent requirements regarding use of non-GAAP financial measures than Regulation G. Under Regulation G, when the registrant discloses or releases publicly any material non-public information that includes a non-GAAP financial measure, the registrant must include,

in the same disclosure or release, (1) a presentation of the most directly comparable GAAP financial measure and (2) a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure. The reconciliation (through a schedule or other detailed presentation) must be quantitative for historic measures and, to the extent available without unreasonable efforts, for prospective measures. If the prospective GAAP financial measure is not accessible, the registrant must identify the unavailable information and disclose its probable significance. Regulation G also provides that a non-GAAP financial measure, taken together with the accompanying information, may not misstate a material fact or omit to state a material fact necessary to make the presentation of the non-GAAP financial measure not misleading, in light of the circumstances under which it is presented. See Exchange Act Release No. 47,226 (2003).

(n6)Footnote 6. Item 10(e)(1)(i), Regulation S-K.

(n7)Footnote 7. Item 10(e)(1)(ii), Regulation S-K.

(n8)Footnote 8. Item 10(e)(2), Regulation S-K.

(n9)Footnote 9. Item 10(f), Regulation S-K. For additional information on smaller reporting companies, *see* § 4.03[12] *infra*.

(n10)Footnote 10. Instruction 3 to Item 101, Regulation S-K.

(n11)Footnote 11. Item 101(a)(1), Regulation S-K.

(n12)Footnote 12. Exchange Act Form 10 under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section H, is discussed in § 4.01[3] *supra*.

(n13)Footnote 13. The reporting requirements of Exchange Act Sections 13(a) and 15(d) are discussed in the introductory paragraphs of § 4.02 *supra*.

(n14)Footnote 14. Item 101(a)(2), Regulation S-K. The description of a future plan of operation should include information as to material product research and development to be performed, anticipated material acquisitions of plants and equipment, and anticipated material changes in number of employees, as well as a statement indicating the registrant's opinion as to the period of time that the proceeds of the offering will satisfy cash requirements and whether it will be necessary in the next six months to raise additional funds. *Id.*

(n15)Footnote 15. SFAS No. 131 does not define segment profit, loss or assets. *Exchange Act Release No. 40,884, Fed. Sec. L. Rep. (CCH) P 86,102* (1999). In determining whether information about segments is required for a particular year, the registrant should look to interperiod comparability. Interperiod comparability would require a registrant to report segment information in the current period if a segment has been significant in the immediately preceding period and the registrant expects it to be significant in the future. Regulation S-K, Instruction 2 to Item 101.

(n16)Footnote 16. An operating segment is a component of a business that engages in activities from which it may earn revenues and incur expenses, for which discrete financial information is available that management regularly evaluates in deciding how to allocate resources and assess performance. *Id.* Release No. 40,884.

(n17)Footnote 17. Conversely, to the extent the information provided pursuant to Item 101(b) complies with generally accepted accounting principles, the registrant may include in its financial statements a cross reference to Item 101(b). Item 101(b), Regulation S-K.

(n18)Footnote 18. In determining what information about the segments is material to an understanding of the registrant's business taken as a whole and is therefore required to be disclosed, the registrant should take into account:

(1) the significance of the matter to the registrant, e.g., whether a matter with a relatively minor effect on the registrant's business is represented by management to be important to the registrant's future profitability;

(2) the pervasiveness of the matter, e.g., whether it affects numerous items in the segment information; and

(3) the impact of the matter, e.g., whether it distorts trends reflected in the segment information.

Situations may arise when information should be disclosed about a segment, although the information in quantitative terms may not appear significant to the registrant's business taken as a whole. Instruction 1 to Item 101, Regulation S-K.

(n19)Footnote 19. The name of any customer and its relationship, if any, with the registrant or its subsidiaries must be disclosed if sales to the customer are equal to ten percent or more of the registrant's consolidated revenue and loss of the customer would have a material adverse effect on the registrant and its subsidiaries taken as a whole. Item 101(c)(1)(vii), Regulation S-K.

(n20)Footnote 20. "Firm orders" may include government orders that are firm but not funded and contracts awarded but not yet signed, provided an appropriate explanatory statement is included. Item 101(c)(1)(viii), Regulation S-K.

(n21)Footnote 21. Item 101(c)(1)(i)(x), Regulation S-K.

(n22)Footnote 22. Item 101(c)(1)(xi)(xiii), Regulation S-K.

(n23)Footnote 23. *Exchange Act Release No. 40,884, Fed. Sec. L. Rep. (CCH) P 86,102 (1999).*

(n24)Footnote 24. If providing the geographic information is impractical, the registrant must disclose that fact. It should also describe any risks attendant to the foreign operations and any dependence of one or more of its segments on such foreign operations. Item 101(d)(ii), Regulation S-K. See n.11 *supra* for discussion of Item 101(b) of Regulation S-K.

(n25)Footnote 25. See the definition of "accelerated filer" and "large accelerated filer" in § 4.02 *supra*.

(n26)Footnote 26. Paragraph (e)(3) and Paragraph (e)(4), Item 101, Regulation S-K.

(n27)Footnote 27. Items 101(e)(1) and (2), Regulation S-K.

(n28)Footnote 28. Item 101(f), Regulation S-K.

(n29)Footnote 29. Item 101(g), Regulation S-K.

(n30)Footnote 30. Item 101(h), Regulation S-K. For additional information regarding smaller reporting companies, see § 4.03[12] *infra*.

(n31)Footnote 31. The information disclosed must inform investors as to the suitability, adequacy, productive capacity, and extent of utilization of the facilities by the registrant. Instruction 1 to Item 102, Regulation S-K. In determining whether properties should be described, the registrant should consider the factors listed in Instruction 1 to Item 101, Regulation S-K. See n.12 *supra*. Instruction 2 to Item 102, Regulation S-K.

(n32)Footnote 32. See Instruction 3 to Item 102, Regulation S-K. Effective January 1, 2010, this instruction was amended as part of the modernization of oil and gas reporting.

(n33)Footnote 33. See Instructions 4 and 5 to Item 102, Regulation S-K. Effective January 1, 2010, this instruction was amended as part of the modernization of oil and gas reporting.

(n34)Footnote 34. See Instructions 7 and 8 to Item 102, Regulation S-K.

(n35)Footnote 35. Instruction 1 to Item 103, Regulation S-K.

(n36)Footnote 36. Instruction 2 to Item 103, Regulation S-K. If, however, the proceeding involves to a large degree the same issues as other proceedings pending or *known to be contemplated*, the amount involved in such other proceedings must be included in determining the percentage of current assets to which the claim relates. *Id.*

(n37)Footnote 37. Instruction 3 to Item 103, Regulation S-K.

(n38)Footnote 38. Instruction 4 to Item 103, Regulation S-K.

(n39)Footnote 39. Permit proceedings and requests for variances or waivers are not required to be disclosed under this provision. *Exchange Act Release No. 18,524, Fed. Sec. L. Rep. (CCH) P 956 (1982).*

(n40)Footnote 40. Instruction 5 to Item 103, Regulation S-K. Proceedings similar in nature may be grouped and described generically. *Id.* This provision, however, does not require that the potential fines in similar proceedings be aggregated to determine whether the \$100,000 threshold has been met. *Exchange Act Release No. 18,524, Fed. Sec. L. Rep. (CCH) P 956 (1982).* Compare Instruction 2 to Item 103 at n. 25 *supra*.

(n41)Footnote 41. Item 201(a)(1)(i), Regulation S-K. Market information for a registrant's noncommon equity is required under Item 202(e) of Regulation S-K, discussed in § 4.03[3][b][v] *infra*.

(n42)Footnote 42. Article 3 of Regulation S-X is discussed in § 4A.01[3][a][i] *infra*.

(n43)Footnote 43. Item 201(a)(1)(ii), Regulation S-K. If the registrant's common equity is listed for trading on more than one exchange, the registrant must indicate each of those exchanges. However, the registrant need only report one set of price quotations, either:

(1) the prices reported in the consolidated trading system, if available; or

(2) if the prices are not reported in the consolidated trading system, the prices on the most significant exchange, in terms of volume of trading, Instruction 1 to Item 201, Regulation S-K.

Market prices must be adjusted to give retroactive effect to material changes resulting from stock dividends, stock splits, and reverse stock splits. *Id.*, Instruction 2.

(n44)Footnote 44. Item 201(a)(1)(iii), Regulation S-K. The registrant must also indicate, as applicable, that such over-the-counter market quotations reflect inter-dealer prices, without retail markup, markdown, or commission, and may not necessarily represent actual transactions. *Id.*

(n45)Footnote 45. The existence of limited or sporadic quotations does not of itself constitute an established public trading market. Item 201(a)(1)(i), Regulation S-K.

(n46)Footnote 46. *Id.*

(n47)Footnote 47. Item 201(a)(1)(iii), Regulation S-K.

(n48)Footnote 48. Securities Act Rule 144, which sets forth conditions governing certain resales of "restricted" and "control" securities, is discussed in *Federal Securities Act of 1933*, ch.6 (Matthew Bender).

(n49)Footnote 49. Item 201(a)(2), Regulation S-K.

(n50)Footnote 50. *Id.*, Item 201(a)(1)(v).

(n51)Footnote 51. *Id.*, Item 201(a)(1)(i).

(n52)Footnote 52. *Id.*, Item 201(a)(1)(iv). Foreign registrants must also briefly describe: (1) government laws, decrees, or regulations in the registrant's country of organization that restrict the export or import of capital; and (2) taxes to which U.S. common equity holders are subject under the laws and regulations of the registrant's country of organization, including pertinent provisions of any reciprocal tax treaty between such foreign country and the United States or that there is no such treaty. Instruction 4 to Item 201, Regulation S-K.

(n53)Footnote 53. *Id.*, Item 201(a)(1)(iv).

(n54)Footnote 54. Item 201(b)(1), Regulation S-K. The number of security holders may be based upon the number of record holders or also may include individual participants in security position listings; the method of computation chosen must be indicated. Instruction 3 to Item 201, Regulation S-K. Rule 17Ad-8 defines a "securities position listing" to mean, as to the securities of any issuer held by a registered clearing agency in the name of the clearing agency or its nominee, a list of those participants in the clearing agency on whose behalf the clearing agency holds the issuer's securities and of the participants' respective positions in those securities as of a specified date.

(n55)Footnote 55. Item 201(b)(2), Regulation S-K. "Beneficial ownership" is discussed in § 7A.02[2] *infra*.

(n56)Footnote 56. Item 201(b)(2), Regulation S-K.

(n57)Footnote 57. Item 201(c)(1), Regulation S-K. Dividends reported must be adjusted to give retroactive effect to material changes resulting from stock dividends, stock splits, and reverse stock splits. Instruction 2 to Item 201, Regulation S-K. Foreign registrants must also briefly describe governmental laws, decrees, or regulations in the registrant's country of organization that effect the remittance of dividends or other payments to nonresident holders of the registrant's common equity. Instruction 4 to Item 201, Regulation S-K.

(n58)Footnote 58. Item 201(c)(1), Regulation S-K. This information may be provided by cross-referencing to:

(1) the discussion of dividend restrictions pursuant to Item 303 of Regulation S-K, discussed in § 4.03[4][c] *infra*; and,

(2) the description of the restrictions in the financial statements.

Id.

(n59)Footnote 59. Item 201(c)(2), Regulation S-K.

(n60)Footnote 60. *Id.*

(n61)Footnote 61. The Commission implemented Item 201(d) in order to enhance disclosure of the number of outstanding options, warrants, and rights granted by registrants to participants in equity compensation plans, as well as the number of securities remaining available for future issuance under these plans. *Exchange Act Release No. 45,189, Fed. Sec. L. Rep. (CCH) P 86,611* (2002). Disclosure should be provided with respect to any compensation plan and individual compensation arrangement of the registrant (or parent, subsidiary, or affiliate of the registrant) under which equity securities of the registrant are authorized for issuance to employees or non-employees (such as directors, consultants, advisors, vendors, customers, suppliers, or lenders) in exchange for consideration in the form of goods or services as described in Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, or any successor standard. Instruction 1 to Paragraph (d), Item 201, Regulation S-K.

No disclosure need be made by the registrant with respect to:

- (1) any plan, contract or arrangement for the issuance of warrants or rights to all security holders of the registrant as such on a pro rata basis (such as a stock rights offering); or
- (2) any employee benefit plan that is intended to meet the qualification requirements of *Section 401(a) of the Internal Revenue Code (26 U.S.C. § 401(a))*. *Id.*

If more than one class of equity security is issued under its equity compensation plans, a registrant should aggregate plan information for each class of security. A registrant may aggregate information regarding individual compensation arrangements with the plan information required in this table. Instructions 3 and 4 to Paragraph (d), Item 201, Regulation S-K.

A registrant may aggregate information regarding a compensation plan assumed in connection with a merger, consolidation, or other acquisition transaction pursuant to which the registrant may make subsequent grants or awards of its equity securities with the plan information required for this table. A registrant should disclose on an aggregated basis in a footnote to the table the number of securities to be issued upon the exercise of outstanding options, warrants, and rights and the weighted- average exercise price of such outstanding options, warrants, and rights, with respect to any individual options, warrants, or rights assumed in connection with a merger, consolidation, or other acquisition transaction. Instruction 5 to Paragraph (d), Item 201, Regulation S-K.

To the extent that the number of securities remaining available for future issuance disclosed in the table includes securities available for future issuance under any compensation plan or individual compensation arrangement other than upon the exercise of an option, warrant, or right, the registrant should disclose the number of securities and type of plan separately for each such plan in a footnote to the table. Instruction 6 to Paragraph (d), Item 201, Regulation S-K.

If the description of an equity compensation plan set forth in a registrant's financial statements describes the material features of a compensation plan under which the registrant's equity securities are authorized for issuance that was adopted without the approval of security holders, a cross-reference to such description will satisfy the requirements of this Item. Instruction 7 to Paragraph (d), Item 201, Regulation S-K.

If an equity compensation plan contains a formula for calculating the number of securities available for issuance under the plan, including, without limitation, a formula that automatically increases the number of securities available for issuance by a percentage of the number of outstanding securities of the registrant, a description of this formula must be disclosed in a footnote to the table. Instruction 8 to Paragraph (d), Item 201, Regulation S-K.

(n62)Footnote 62. Paragraph (d)(3), Item 201, Regulation S-K.

(n63)Footnote 63. The measurement period begins at the market close of the last trading day before the beginning of the registrant's fifth preceding fiscal year, through and including the end of the last completed fiscal year, or such shorter period during which the registrant has had securities registered under the Exchange Act. Item 201(e)(2), Regulation S-K.

(n64)Footnote 64. Total stockholder return is measured by dividing the sum of the cumulative amount of dividends for the measurement period assuming dividend reinvestment, and the difference between the registrant's share price at the end and beginning of the measurement period by the share price at the beginning of the measurement period. Item 201(e)(1), Regulation S-K.

(n65)Footnote 65. Use of the Standard & Poor's 500 Stock Index is required for entities within such index. Item

201(e)(1)(i), Regulation S-K.

(n66)Footnote 66. A published industry or line-of-business index includes any index that is prepared by a party other than the registrant or an affiliate and is accessible to securities holders, or an index prepared by the registrant if such index is widely recognized and used. Item 201(e)(3), Regulation S-K.

(n67)Footnote 67. An issuer may use a similar market capitalization index only if it does not use a published industry or line-of-business index and does not believe it can reasonably identify a peer group. If the registrant uses this alternative, the graph must be accompanied by a statement of the reasons for this selection. Item 201(4), Regulation S-K. The information required in the performance graph shall not be deemed "soliciting material," or to be "filed" with the Commission. Instruction 8 to Item 201(e), Regulation S-K.

(n68)Footnote 68. Item 201(e)(4), Regulation S-K.

(n69)Footnote 69. Instruction 5 to Item 201(e), *Regulation S-K. Exchange Act Release No. 33,229, Fed. Sec. L. Rep. (CCH) P 85,259 (1993); Exchange Act Release No. 31,420, Fed. Sec. L. Rep. (CCH) P 85,061 (1992).*

(n70)Footnote 70. Instruction 4 to Item 201(e), Regulation S-K.

(n71)Footnote 71. *Exchange Act Release No. 34,332, Fed. Sec. L. Rep. (CCH) P 85,402 (1994); Exchange Act Release No. 35,133, Fed. Sec. L. Rep. (CCH) P 85,476 (1994) and Exchange Act Release No. 38,798, Fed. Sec. L. Rep. (CCH) P 85,947 (1997).*

(n72)Footnote 72. Instruction 6 to Item 201(e), Regulation S-K. For additional information regarding smaller reporting companies, see § 4.03[12] *infra*.

(n73)Footnote 73. Note to Item 202, Regulation S-K. The document should not, however, convey the impression that the registrant may apply successfully for listing of the securities on an exchange or that, in the case of an underwritten offering, the underwriters may request the registrant to apply for such listing, unless there is a reasonable assurance that the securities to be offered will be acceptable to a securities exchange for listing. *Id.*

(n74)Footnote 74. Foreign registrants must provide, to the extent not otherwise provided, a brief description of:

(1) limitations, if any, on the right of nonresident or foreign owners of the securities to hold or vote the securities which are imposed by foreign law or by the charter or other constituent document of the registrant or if no such limitations are applicable;

(2) governmental laws, decrees, or regulations in the country in which the registrant is organized that affect the remittance of dividends, interest, and other payments to nonresident holders of the securities;

(3) taxes to which U.S. security holders are subject under the laws and regulations of the country in which the registrant is organized; and

(4) pertinent provisions of any reciprocal tax treaty between the country in which the registrant is organized and the United States, or if no such treaty exists. Instruction 2 to Item 202, Regulation S-K.

(n75)Footnote 75. In addition to stating the title of the class of securities, the registrant must also provide information that indicates the type and character of the securities to the extent not disclosed pursuant to Item 201, including:

(1) in the case of shares:

- (a) the par or stated value of the shares, if any;
- (b) the rate of dividends, if fixed;
- (c) whether dividends are cumulative or noncumulative;
- (d) an indication of preference, if any; and
- (e) whether the shares are convertible or redeemable; and

(2) in the case of other kinds of securities, appropriate information of comparable character. Instructions 1A and 1C to Item 202, Regulation S-K.

(n76)Footnote 76. Where convertible securities or stock purchase warrants that are subject to redemption or call are being registered, the description of the conversion terms of the securities or material terms of the warrant must disclose:

(1) whether the right to convert the securities will be forfeited unless the right is exercised before the date specified in a notice of redemption or call;

(2) the expiration or termination dates of the warrants;

(3) the kinds, frequency, and timing of the notice of redemption or call, including the cities or newspapers in which notice will be published; and

(4) in the case of bearer securities, that investors are responsible for making arrangements to prevent loss of the right to convert or purchase in the event of redemption or call, e.g., by reading the newspapers in which the notice of redemption may be published. Instruction 4 to Item 202, Regulation S-K.

(n77)Footnote 77. Item 202(a)(1), Regulation S-K.

(n78)Footnote 78. *Id.*, Item 202(a)(2).

(n79)Footnote 79. *Id.*, Item 202(a)(3).

(n80)Footnote 80. *Id.*, Item 202(a)(5). This information may be supplied by cross-reference to a description in another part of the document. *Id.*

(n81)Footnote 81. Item 202(a)(4), Regulation S-K, reprinted in the Primary Law Sourcebook, Volume D, Section K.

(n82)Footnote 82. For the purposes of Item 202, debt securities that differ from one another only as to interest rate or maturity are considered to be securities of the same class. Item 202(b), Regulation S-K.

(n83)Footnote 83. In addition to stating the title of the debt securities, the registrant must also provide information that indicates the type and character of the debt securities, including:

(1) the rate of interest;

(2) the date of maturity, or if the issue matures serially, a brief indication of the serial maturities, e.g., "maturing serially from 2015 to 2015;"

(3) whether the payment of interest or principal is contingent and a description of any contingency;

(4) the priority of the issue; and

(5) whether the debt securities are convertible or callable. Instruction 1B to Item 202, Regulation S-K.

(n84)Footnote 84. The registrant must also provide certain information with respect to the conversion terms of convertible debt securities subject to redemption.

(n85)Footnote 85. In the case of secured debt, whether the securities being registered are to be issued on the basis of unbonded bondable property, the deposit of cash, or otherwise; as of the most recent practicable date, the approximate amount of unbonded bondable property available as a basis for the issuance of bonds; provisions permitting the withdrawal of cash deposited as a basis for the issuance of bonds; and provisions permitting the release or substitution of assets securing the issue; provided, however, that provisions permitting the release of assets upon the deposit of equivalent funds or the pledge of equivalent property, the release of property no longer required in the business, obsolete property, or property taken by eminent domain or the application of insurance moneys, and other similar provisions need not be described. Item 202(b)(5), Regulation S-K.

(n86)Footnote 86. 26 U.S.C. § 1273. *Section 1273(2) of the Internal Revenue Code* defines the term "original issue discount" to mean the excess, if any, of the stated redemption price over the issue price.

(n87)Footnote 87. Item 202(b)(1)(10), Regulation S-K.

(n88)Footnote 88. Item 202(c)(1)(5), Regulation S-K. The description of the material terms of stock purchase warrants or convertible securities must disclose:

(1) whether the right to purchase the securities will be forfeited unless the right is exercised before the date specified in a notice of call;

(2) the expiration or termination date of the warrants;

(3) the kinds, frequency, and timing of the notice of call, including the cities or newspapers in which the notice will be published; and

(4) in the case of bearer securities, that investors are responsible for making arrangements to prevent loss of the right to purchase in the event of call, e.g., by reading the newspapers in which the notice of call may be published. Instruction 4 to Item 202, Regulation S-K.

(n89)Footnote 89. The term "established public trading market" in Item 202(e) is used as in Item 201 of Regulation S-K, *see* § 4.03[3][a][i] *supra*.

(n90)Footnote 90. Item 201(a) of Regulation S-K, which requires market information for a registrant's common equity, is discussed in § 4.03[3][a][i] *supra*.

(n91)Footnote 91. The description of the terms of deposit must include the provisions, if any, with respect to:

(1) the amount of deposited securities represented by one unit of American Depositary Receipts;

(2) the procedure for voting, if any, the deposited securities;

- (3) the collection and distribution of dividends;
- (4) the transmission of notices, reports, and proxy soliciting material;
- (5) the sale or exercise of rights;
- (6) the deposit or sale of securities resulting from dividends, splits, or plans of reorganization;
- (7) amendment, extension, or termination of the deposit;
- (8) rights of holders of receipts to inspect the transfer books of the depositary and the list of holders of receipts;
- (9) restrictions upon the right to deposit or withdraw the underlying securities; and
- (10) limitations upon the liability of the depositary. Item 202(f)(2), Regulation S-K.

(n92)Footnote 92. Information is to be provided concerning any fees and charges relating to:

- (1) the deposit or substitution of the underlying securities;
- (2) receipt and distribution of dividends;
- (3) the sale or exercise of rights;
- (4) the withdrawal of the underlying security; and
- (5) the transferring, splitting, or grouping of receipts.

Information concerning the right to collect the fees and charges against dividends received and deposited securities must also be included. Instruction 5 to Item 202, Regulation S-K.

(n93)Footnote 93. Instruction 3 to Item 301, Regulation S-K.

(n94)Footnote 94. Item 301(a), Regulation S-K.

(n95)Footnote 95. Item 301(b), Regulation S-K.

(n96)Footnote 96. Information relating to long-term debt, capital leases, and redeemable preferred stock as defined in Rule 5-02.28(a) of Regulation S-X must be included. Instruction 2 to Item 301, Regulation S-K.

(n97)Footnote 97. Instruction 2 to Item 301, Regulation S-K. The purpose of the presentation of the selected financial data is to highlight significant trends in a registrant's financial condition and results of operations. Instruction 1 to Item 301, Regulation S-K.

(n98)Footnote 98. Instruction 2 to Item 301, Regulation S-K. Registrants should consider updating the selected financial data for interim periods if interim financial statements are included or are required to be included under Article 3 of Regulation S-X, to reflect any material change in trends. Instruction 4 to Item 301, Regulation S-K.

(n99)Footnote 99. The Commission revised the definition of "foreign private issuer" to give clearer guidance on how foreign companies should determine whether their shareholders are U.S. residents. Effective September 30, 2000, the Commission adopted revised disclosure requirements for foreign private issuers to conform to the international

disclosure standards endorsed by the International Organization of Securities Commissions in September 1998. The international disclosure standards replace most of the non-financial statement disclosure requirements of Form 20-F, the basic disclosure document for private issuers. *Exchange Act Release No. 41,936, Fed. Sec. L. Rep. (CCH) P 86,208 (1999-2000)*.

A foreign private issuer is required to disclose the following in all filings containing financial statements:

- (1) in the forepart of the document and as of the latest practicable date, the exchange rate into U.S. currency of the foreign currency in which the financial statements are presented;
- (2) a history of exchange rates for the five most recent years and any subsequent interim period included in the financial statements, setting forth the rate for period end, the average rates, and the range of high and low rates for each year; and
- (3) if equity securities are being registered, a five year summary of dividends per share stated in both the currency in which the financial statements are presented and U.S. currency based on the exchange rates at each respective payment date.

A foreign private issuer must present the selected financial data in the same currency as its financial statements and may present the data on the basis of the accounting principles used in the primary financial statements. However, the issuer must also present the data on the basis of any reconciliation of the data to United States generally accepted accounting principles ("GAAP") and Regulation S-X made under Rule 4-01(a)(2) of Regulation S-X. Instructions 5 and 6 to Item 301, Regulation S-K. The Commission has adopted amendments to Regulation S-X and Form 20-F to facilitate registration and reporting by foreign private issuers. The amendments allow foreign issuers flexibility in the selection of the reporting currency used in filings with the Commission and streamlined financial statement reconciliation requirements for foreign private issuers with operations in countries with hyperinflationary economies. *Exchange Act Release No. 35,093 (1994)*. See also *Exchange Act Release No. 32,531, Fed. Sec. L. Rep. (CCH) P 85,207 (1993)*, amending Form 40-F in order to continue the requirement that financial statements presented in filings on such forms include a reconciliation to U.S. GAAP.

(n100)Footnote 100. Item 301(c) of Regulation S K.

(n101)Footnote 101. Item 302(a)(5), Regulation S-K. Registration of securities under Section 12(b) is discussed in § 4.01[1] *supra*.

(n102)Footnote 102. *Id.*, Item 302(a)(1).

(n103)Footnote 103. *Id.*, Item 302(a)(2).

(n104)Footnote 104. *Id.*, Item 302(a)(3).

(n105)Footnote 105. Item 302(c) of Regulation S K.

(n106)Footnote 106. In *Exchange Act Release No. 26,831, Fed. Sec. L. Rep. (CCH) P 72,436 (1989)* ("1989 MD&A Release"), the Commission set out its views regarding several disclosure matters that should be considered by registrants in preparing their MD&As. According to the Commission, the MD&A requirements are intended to provide, in one section of a registrant's filing, material historical and prospective textual disclosure that enables investors and other users to assess the financial condition and results of operations of the registrant, with particular emphasis on the registrant's prospects for the future.

The 1989 MD&A Release gives interpretive guidance on the following matters among others: Prospective

Information; Liquidity-Capital Resources; Material Changes; Interim Period Reporting; Segment Analysis; Participation in High Yield Financings, Highly Leveraged Transactions, or Non-Investment Grade Loans and Investments; and Preliminary Merger Negotiations. The MD&A Release was based on a systematic study, commenced in early 1988, in which the Commission reviewed the 1989 MD&A reporting of numerous registrants in at least two dozen industries and contains numerous illustrative examples.

Enforcement releases also provide useful illustrations of the Commission's interpretation of the MD&A disclosure requirements. In particular, *Exchange Act Release No. 30,532, Fed. Sec. L. Rep. (CCH) P 73,830* (1992), describes the Commission's application of Item 303 with regard to Caterpillar Inc.'s failure to disclose information about the 1989 earnings of Caterpillar Brazil, S.A. ("CBSA"), its wholly owned Brazilian subsidiary, and uncertainties about CBSA's 1990 earnings. In the release, the Commission noted that Caterpillar's financial results were consolidated and the impact of CBSA's operations in Caterpillar's overall results were not apparent from the face of the financial statements, but even if apparent it would not have obviated the requirement that CBSA's operations be discussed in the MD&A disclosure. The Commission reviewed the 1989 Form 10-K and 1990 first quarter Form 10-Q and found that neither indicated the extent to which CBSA had affected Caterpillar's bottom line in 1989, nor did they indicate that any decline in CBSA's future results could have a material adverse effect on Caterpillar's bottom line in 1990. In fact, nothing in the MD&A section of the 1989 Form 10-K suggested the disproportionate impact of CBSA's profits on Caterpillar's 1989 overall profitability, and neither the 1989 Form 10-K nor the 1990 first quarter Form 10-Q adequately mentioned management's uncertainty about CBSA's 1990 performance. The Commission found that "Caterpillar's failure to include required information about CBSA in the MD&A left investors with an incomplete picture of Caterpillar's financial condition and results of operations and denied them the opportunity to see the Company "through the eyes of management." *Id.* The Commission held that "by failing (i) in its Annual Report on Form 10-K for the year ended December 31, 1989 to provide an adequate discussion and analysis of the impact on CBSA in its 1989 results of operations as contained in its financial statement, and (ii) to adequately disclose in its 1989 Form 10-K and in its Quarterly Report on Form 10-Q for the first quarter of 1990 known uncertainties reasonably likely to have a material effect on Caterpillar's future results of operations, due to CBSA's questionable ability to repeat its 1989 performance, Caterpillar violated Section 13(a) of the Exchange Act..." *Id.*

In January 2002, the Commission issued a statement in which it made several suggestions for improving the quality of MD&A disclosures, including: (1) more detailed liquidity resource disclosures; (2) more clear descriptions of off-balance sheet arrangements; (3) a schedule of future obligations and commitments; (4) disclosures of valuation of trading activities involving commodities contracts; and (5) more detailed disclosures about transactions with related parties. *Exchange Act Release No. 45,321, Fed. Sec. L. Rep. (CCH) § 86,617* (2002).

In May 2002, the Commission proposed amendments to MD&A requirements that would require registrants to disclose their "critical accounting policies." *Exchange Act Release No. 45,907, Fed. Sec. L. Rep. (CCH) § 86,638* (2002). The proposals would require disclosure of the critical accounting estimates made by registrants in applying their accounting policies as well as the initial adoption of new accounting policies that would have a material impact on the registrant's financial condition, changes in financial condition, and results of operations.

In December 2003, the Commission published additional interpretive guidance regarding MD&A. The guidance was intended to elicit more meaningful disclosure in MD&A with respect to several areas, including the overall presentation and focus of MD&A, with general emphasis on the discussion and analysis of known trends, demands, commitments, events and uncertainties, and specific guidance on disclosures about liquidity, capital resources and critical accounting estimates. *Exchange Act Release No. 48960* (2003).

(n107)Footnote 107. Securities Act Release No. 33-8350.

(n108)Footnote 108. Instruction 10 to Item 303(a), Regulation S-K directs that information be given with respect to the registrant and its consolidated subsidiaries.

(n109)Footnote 109. *Id.*, Instruction 1 to Item 303(a).

(n110)Footnote 110. *Id.*, Instruction 2 to Item 303(a).

(n111)Footnote 111. Instruction 3 to Item 303(a), Regulation S-K. For a discussion of the Commission's position on forward-looking statements, see § 4.04 *infra* and *Exchange Act Release No. 34,831, Fed. Sec. L. Rep. (CCH) P 85,436* (1994).

(n112)Footnote 112. Item 303(a), Regulation S-K.

(n113)Footnote 113. *Id.* Instruction 1 to Item 303(a), Regulation S-K. If, however, trend information is relevant, the registrant may be required to refer to the five year selected financial data presented pursuant to Item 301 of Regulation S-K discussed in § 4.03[4][a] *supra*.

(n114)Footnote 114. "Liquidity" is defined for the purposes of Item 303 as the ability of an enterprise to generate adequate amounts of cash to meet the enterprise's need for cash. Instruction 5 to Item 303(a), Regulation S-K. The discussion of liquidity may be combined with that of capital resources whenever the two topics are interrelated. Item 303(a), Regulation S-K.

(n115)Footnote 115. Item 303(a)(1), Regulation S-K. Liquidity should be discussed on both a long-term and short-term basis and in the context of the registrant's own business. Instruction 5 to Item 303(a), Regulation S-K. The registrant should also indicate those balance sheet conditions or income or cash flow items that it believes may be indicators of its liquidity condition. *Id.* The Commission will bring enforcement actions against registrants who fail to timely and fully disclose known trends, demands, commitments, or events materially affecting the registrant's liquidity. *See America West Airlines, Inc.*, Exchange Act Release No. 34,047, Sec. L. Rep. (CCH) P 74,022 (1994) (failure to disclose adverse impact on liquidity of decreased passenger traffic, increased fuel costs and inability to obtain long-term financing) and *Salant Corporation and Martin Tynan*, Exchange Act Release No. 34,046, Sec. L. Rep. (CCH) P 74,021 (1994) (failure to disclose impact on liquidity of excess inventory, operating losses, delays in payments to vendors, and renegotiations of bank financing arrangements). *See also*, *Gordon N. Oates and Ronald P. Freres*, Exchange Act Release No. 35,882, Sec. L. Rep. (CCH) P 74,245 (1995).

The Commission has increased its focus on MD&A disclosures concerning the risks to a registrant of derivative activities, including interest rate swaps, commodity derivatives and foreign currency contracts. *See, e.g.*, *Gibson Greetings, Inc.*, Exchange Act Release No. 36,357 (1995).

(n116)Footnote 116. Item 303(a)(1), Regulation S-K.

(n117)Footnote 117. *Id.* If the financial statements are required to disclose restrictions on the ability of subsidiaries, consolidated or unconsolidated, to transfer cash dividends, loans, or advances to the registrant, pursuant to Rule 408(e)(3) under Regulation S-X, the registrant must also discuss the nature and extent of the restrictions and the effect the restrictions have had and are expected to have on the ability of the parent company to meet its cash obligations. Instruction 6 to Item 303(a), Regulation S-K.

(n118)Footnote 118. The discussion of capital resources may be combined with that of liquidity whenever the two topics are interrelated. Item 303(a), Regulation S-K.

(n119)Footnote 119. Item 303(a)(2), Regulation S-K.

(n120)Footnote 120. *Id.*

(n121)Footnote 121. The 1989 MD&A Release indicates that, if management knows of a trend, demand, commitment, event, or uncertainty, it must make the following assessments:

(1) Is the known trend, demand, commitment, event, or uncertainty likely to come to fruition? If management concludes that it is not, no disclosure is required.

(2) If management is not able to make the determination in (1), it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty on the assumption that it will come to fruition. Disclosure is then required unless management determines that it is not reasonably likely to have a material effect on the registrant's financial condition or results of operations.

In addition to the Caterpillar release, a number of enforcement actions have been brought by the Commission based on the failure of the registrant to adequately discuss a known trend, demand, commitment, event or uncertainty in its MD&A. See Bank of Boston Corporation, Exchange Act Release No. 33,454 (1994) (failure to disclose deterioration in bank's domestic real estate loan portfolio) and Shared Medical Systems, Inc., Exchange Act Release No. 33,632 (1994) (failure to discuss known trend of decreased sales activity and the registrant's expectation that the trend would have a national unfavorable impact on net sales, revenues and earnings during the year).

(n122)Footnote 122. Item 303(a)(3), Regulation S-K reprinted in the Primary Law Sourcebook, Volume D, Section K. Registrants are only required to discuss the effects of inflation and other changes in prices when considered material. The discussion may be made in any appropriate manner. All that is required is a brief textual presentation of management's views. Specific numerical data need not be presented, except as required by Rule 3-20(c) of Regulation S-X. However, registrants may elect to voluntarily disclose supplemental information on the effects of changing prices either as provided for in SFAS No. 89 (as modified in certain limited respects by SFAS No. 96) or through other supplemental disclosures. The Commission encourages experimentation with such disclosures in order to provide meaningful presentation in financial statements of the impact of price changes. Instruction 8 to Item 303(a), Regulation S-K.

Registrants that elect to disclose supplementary information on the effects of changing prices as specified by SFAS No. 89 (as modified in certain limited respects by SFAS No. 96) may combine those explanations with the discussion and analysis required by Item 303(a) of Regulation S-K or may supply information separately with appropriate cross reference. Instruction 9 to Item 303(a), Regulation S-K.

(n123)Footnote 123. Item 303(a), Regulation S-K. The 1989 MD&A Release contains some examples of this type of disclosure, including:

- (1) a known trend in the form of an expected further decline in unit sales of products;
- (2) planned capital expenditures and related financial sources necessary to maintain sales growth;
- (3) the likely effect of a known event in the form of completion of an important contract;
- (4) uncertainty created by implementation of recent legislation;
- (5) violation of covenants of loan agreements and more stringent payment terms imposed by vendors;
- (6) an analysis of a material increase in revenues and the effects of offsetting developments, including depressed economic conditions in the product market;
- (7) the likelihood of a material future effect on financial condition or results of operations as a result of the loss of a major customer;

(8) segment disclosure where the amount contributed to operating income by segments was disproportionate to their revenues;

(9) participation as a lender in highly leveraged transactions;

(10) portfolio investments in noninvestment grade debt securities; and

(11) a financial institution's dependence on federal assistance and the material adverse effect on future operations of the expiration of a put option for problem assets.

Foreign private registrants should also briefly discuss any pertinent governmental economic, fiscal, monetary, or political policies or factors that have materially affected or could materially affect, directly or indirectly, their operations or investments by U.S. nationals. Instruction 11 to Item 303(a), Regulation S-K.

Where the registrant is a foreign private issuer, the discussion required by Item 303(a) should focus on the primary financial statements presented in the statement or report, but there should be reference to the reconciliation to U.S. GAAP and a discussion of any aspects of the differences between foreign and U.S. GAAP that are not discussed in the reconciliation and that the registrant believes must be understood in order to understand the financial statements as a whole. Instruction 12 to Item 303(a), Regulation S-K.

(n124)Footnote 124. Such information is expressly covered by the safe-harbor rules for projections. *See Section 4.04 infra*. As noted above, Item 303 *requires* forward-looking information in a number of areas. *See* Regulation S-K, Items 303(a)(1), 303(a)(2)(ii), and 303(a)(3)(ii).

(n125)Footnote 125. In accordance with the Sarbanes-Oxley Act, the Commission clarified disclosures regarding off-balance sheet arrangements in Management's Discussion and Analysis. Exchange Act Release No. 47,264 (2003).

(n126)Footnote 126. As used in part (a)(4) of Item 303, the term "off-balance sheet arrangement" means any transaction, agreement or other contractual arrangement to which an entity unconsolidated with the registrant is a party, under which the registrant has:

- any obligation under a guarantee contract that has any of the characteristics identified in paragraph 3 of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (November 2002) ("FIN 45"), as may be modified or supplemented, and that is not excluded from the initial recognition and measurement provisions of FIN 45 pursuant to paragraphs 6 or 7 of that Interpretation;
- a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to such entity for such assets;
- any obligation, including a contingent obligation, under a contract that would be accounted for as a derivative instrument, except that it is both indexed to the registrant's own stock and classified in stockholders' equity in the registrant's statement of financial position, and therefore excluded from the scope of FASB Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (June 1998), pursuant to paragraph 11(a) of that Statement, as may be modified or supplemented; or
- any obligation, including a contingent obligation, arising out of a variable interest (as referenced in FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (January 2003), as may be modified or supplemented) in an unconsolidated entity that is held by, and material to, the registrant,

where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with, the registrant.

Item 303(a)(4)(ii), Regulation S-K.

(n127)Footnote 127. Item 303(a)(4)(i), Regulation S-K.

(n128)Footnote 128. *Id.*

(n129)Footnote 129. Instruction 1 to Item 303(a)(4), Regulation S-K.

(n130)Footnote 130. Instruction 2 to Item 303(a)(4), Regulation S-K.

(n131)Footnote 131. Instruction 3 to Item 303(a)(4), Regulation S-K.

(n132)Footnote 132. Instruction 4 to Item 303(a)(4), Regulation S-K.

(n133)Footnote 133. Instruction 5 to Item 303(a)(4), Regulation S-K.

(n134)Footnote 134. Exchange Act Release No. 47,264 (2003). Item 303(a)(5)(i), Regulation S-K.

(n135)Footnote 135. *Id.*

(n136)Footnote 136. Item 303(a)(5)(ii), Regulation S-K.

(n137)Footnote 137. Item 303(a)(5)(i), Regulation S-K.

(n138)Footnote 138. *Id.*

(n139)Footnote 139. *Id.*

(n140)Footnote 140. Instruction 7 to Item 303(b), Regulation S-K.

(n141)Footnote 141. *Id.*

(n142)Footnote 142. In preparing the interim period discussion, the registrant may presume that users of the interim period financial information have access to the discussion of full fiscal year financial information required by Item 303(a) of Regulation S-K, discussed in § 4.03[4][c][i] *supra*. Instruction 2 to Item 303(b), Regulation S-K. If interim financial statements are presented together with financial statements for full fiscal years, the required discussions of those financial statements under Item 303 of Regulation S-K may be combined. Instruction 1 to Item 303(b), Regulation S-K.

(n143)Footnote 143. Instruction 5 to Item 303(b), Regulation S-K.

(n144)Footnote 144. Item 303(b)(1), Regulation S-K.

(n145)Footnote 145. *Id.*

(n146)Footnote 146. *Id.*

(n147)Footnote 147. Instruction 4 to Item 303(b), Regulation S-K.

(n148)Footnote 148. *Id.*, Instruction 5.

(n149)Footnote 149. Item 303(b)(2), Regulation S-K.

(n150)Footnote 150. *Id.*

(n151)Footnote 151. *Id.* If, however, the registrant is engaged primarily in the distribution of electrical, gas, water, or telephone service and pursuant to Rule 303 of Regulation S-X provides a statement of income for the twelve-month period ended as of the date of the most recent interim balance sheet in lieu of the interim income statements otherwise required, the discussion of material changes in results of operations in that twelve-month period will be with respect to the preceding fiscal year rather than the corresponding preceding period. *Id.*

(n152)Footnote 152. Instruction 6 to Item 303(b), Regulation S-K; see Exchange Act Release No. 47,264 (2003). *See also* § 4.02[2] *infra*.

(n153)Footnote 153. Exchange Act Release No. 47,264 (2003). Item 303(c)(1), Regulation S-K.

(n154)Footnote 154. *Id.*

(n155)Footnote 155. Item 303(c)(2), Regulation S-K.

(n156)Footnote 156. Item 304(a)(1)(i)(iv), Regulation S-K. In the event that there has been a disagreement of the kind referred to in the forth bullet point above, the registrant must:

- (1) describe each such disagreement;
- (2) state whether any audit or similar committee of the board of directors, or the board of directors, discussed the subject matter of any such disagreements with the former accountant; and
- (3) state whether the registrant has authorized the former accountant to respond fully to the inquiries of the successor accountant concerning the subject matter of any of such disagreements and, if not, the nature of and reason for any limitation on such authorization. Item 304(a)(1)(iv), Regulation S-K.

Disagreements required to be reported in response to Item 304(a)(1)(iv) of Regulation S-K include both those resolved to the former accountant's satisfaction and those not so resolved and mean those that occur at the decision-making level, i.e., between personnel of the registrant responsible for presentation of the financial statements and personnel of the accounting firm responsible for rendering the report. *Id.*

The term "disagreement" as used in Item 304 of Regulation S-K is to be interpreted broadly so as to include any difference of opinion concerning any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure which, if not resolved to the satisfaction of the former accountant, would have caused such accountant to make reference to the subject matter of the disagreement in connection with the report. Accordingly, a mere difference of opinion triggers disclosure, not only an argument or formal disagreement. Instruction 4 to Item 304, Regulation S-K. Disclosure is not required, however, of initial differences of opinion based on incomplete facts or preliminary information, which were later resolved to the former accountant's satisfaction by obtaining additional relevant facts or information, provided that the registrant and the accountant did not continue to have a difference of opinion with respect to the matter resolved. *Id.* In determining whether any "disagreement" or "reportable event" (as those terms are used in Item 304(a)(1)(iv) and (v)) has occurred, an oral communication from the engagement partner or another person responsible for rendering the accounting firm's opinion (including their designee) will generally suffice as an indication that the accountant has advised the registrant of a "reportable event" or that there has been a "disagreement" at the "decision-making level" as those terms are used in Item 304. Instruction 5 to Item 304, Regulation S-K.

(n157)Footnote 157. Item 304(a)(1)(v)(A)-(D), Regulation S-K.

(n158)Footnote 158. Item 304(a)(2)(A)(D), Regulation S-K.

(n159)Footnote 159. Item 304(a)(3), Regulation S-K. The disclosure called for by Item 304(a) of Regulation S-K need not be provided if it has previously been reported in or filed with a statement under Section 12, a report under Section 13 or 15(d), or a definitive proxy or information statement under Section 14 of the Exchange Act, or a registration statement under the Securities Act. The disclosure must be provided, however, notwithstanding prior disclosure, if required pursuant to Item 9 of Schedule 14A. Instruction 1 to Item 304, Regulation S-K.

When disclosure is required by paragraph (a) of Item 304 of Regulation S-K in an annual report to security holders pursuant to Rule 14a-3 or Rule 14c-3 or in a proxy or information statement filed pursuant to the requirements of Schedule 14A or 14C, all under the Exchange Act, then instead of the letters from the newly engaged accountant and the former accountant which are required by paragraphs (a)(2)(D) and (a)(3) of Item 304, the registrant must furnish, prior to filing with or furnishing such material to the Commission, the disclosure required by paragraph (a) of Item 304 to any former accountant engaged by the registrant during the two preceding fiscal years and any subsequent interim period as well as to the newly engaged accountant. If any such accountant believes that the statements made by the registrant in response to the provisions of paragraph (a) of Item 304 are incorrect or incomplete, it may present its views in a brief statement, ordinarily not expected to exceed 200 words, to be included in the annual report or proxy or information statement. The accountant's statement must be submitted to the registrant within ten business days of the date that the accountant receives the registrant's disclosure. Instruction 2 to Item 304, Regulation S-K.

Unless the written views of the newly engaged accountant required to be filed as an exhibit by paragraph (a)(2)(B) of Item 304 have been previously filed with the Commission, the registrant must file a Form 8-K concurrently with the annual report or proxy or information statement for the purpose of filing such written views as an exhibit to the Form 8-K. *Id.*

The information required by Item 304(a) need not be provided for a company being acquired by the registrant if the acquired company is not subject to the filing requirements of either Section 13(a) or 15(d) of the Exchange Act, or, because of Section 12(i) of the Exchange Act, has not filed an annual report to security holders pursuant to Rule 14a-3 or Rule 14c-3 for its latest fiscal year. Instruction 3 to Item 304, Regulation S-K.

(n160)Footnote 160. Item 304(b), Regulation S-K. These disclosures need not be made if the method asserted by the former accountants ceases to be generally accepted because of authoritative standards or interpretations subsequently issued. *Id.* The disclosure called for by paragraph (b) of Item 304 must be furnished, where required, notwithstanding any prior disclosure about accountant changes or disagreements. Instruction 1 to Item 304, Regulation S-K.

(n161)Footnote 161. Item 305(a), Regulation S-K. Registrants may use different formats for each portfolio or risk exposure category.

(n162)Footnote 162. Item 305(a)(1), of Regulation S-K.

(n163)Footnote 163. Primary market risk exposures means the following categories of market risk: interest rate risk, foreign currency exchange rate risk, commodity price risk, and other relevant market rate or price risks; and within each of these categories, the particular markets that present the primary risk of loss to the registrant. Instruction 1 to Item 305(b), Regulation S-K.

(n164)Footnote 164. Item 305(b)(1), Regulation S-K. Qualitative information for instruments entered into for trading purposes and those entered into for other purposes are to be presented separately. Item 305(b)(2), Regulation S-K.

(n165)Footnote 165. Instruction to Item 305(b), Regulation S-K.

(n166)Footnote 166. Item 305(d), Regulation S-K.

(n167)Footnote 167. *Exchange Act Release No. 38,223, Fed. Sec. L. Rep. (CCH) P 74,389 (1997)*. A number of answers regarding Item 305 disclosure requirements can be found in the Commissioner's July 31, 1997 "Questions and Answers About the New Market Risk Disclosure Rules," available on the Commission's website at <http://www.sec.gov>. In this Question and Answer release, the Commission notes that a separate section for this disclosure is not necessary, although it is usually most appropriate to present the responsive information in a single location outside of MD&A. Management may elect to integrate the disclosures with MD&A and the description of business section of filings. Duplicative information need not be presented, but cross-references may be necessary to make a particular disclosure complete. However, the safe harbor does not apply to market risk information included in the financial statements and the related notes. *Id.*, Question No. 73.

(n168)Footnote 168. Item 307, Regulation S-K.

(n169)Footnote 169. Item 307, Regulation S-K.

(n170)Footnote 170. Exchange Act Rules 13a-15(e) and 15d-15(e).

(n171)Footnote 171. The disclosure requirements of Item 308 of Regulation S-K became effective for accelerated filers (as defined in Rule 12b-2 under the Exchange Act) as of the end of the first fiscal year ending on or after November 15, 2004, for the annual report for that fiscal year. For a company that was not an accelerated filer, compliance with the disclosure requirements became effective for the annual report for the first fiscal year ending on or after December 15, 2009.

(n172)Footnote 172. Instruction 1 to Item 308 states that a registrant need not comply with paragraphs (a) and (b) until it either was required to file an annual report under the Exchange Act for the prior fiscal year, or filed an annual report for the prior fiscal year. Thus, IPOs enjoy a one-year grace period, while voluntary filers do not escape the Item 308 requirements if they filed an annual report for the prior year. Instruction 2 to Item 308 states that the registrant must maintain evidence, including documentation, to provide reasonable support for management's assessment of the effectiveness of the registrant's internal control over financial reporting.

(n173)Footnote 173. Item 308(a), Regulation S-K.

(n174)Footnote 174. Item 308(b), Regulation S-K.

(n175)Footnote 175. Exchange Act Release No. 54,302A (2006).

(n176)Footnote 176. The registrant, however, is not permitted to list any person chosen to become a director who has not consented to act as such. Instruction 2 to Item 401(a), Regulation S-K.

(n177)Footnote 177. The registrant is not required to include arrangements or understandings with directors or officers of the registrant acting solely in their capacities as directors or officers. Instruction 1 to Item 401(a), Regulation S-K.

(n178)Footnote 178. *Id.*, Instruction 3. If the information required by Item 401(a) is presented in a proxy statement concerning the election of directors, the statement must include the following:

(1) if fewer nominees are named than the number fixed by the registrant's governing instruments, the reasons for this procedure and a statement that the proxies cannot be voted for a greater number of persons than the nominees named; and

(2) if the proxy solicitation is made by persons other than management, information must be given as to nominees of the persons making the solicitation. Instructions 4 and 5 to Item 401(a), Regulation S-K.

(n179)Footnote 179. The term "executive officer" is defined in Rule 3b-7 to mean:

- (1) a president;
- (2) a vice president in charge of a principal business unit, division, or function (e.g., sales, administration, finance); or
- (3) any person performing similar policy-making functions for the issuer.

Rule 3b-7 under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G, also provides that executive officers of subsidiaries may be deemed executive officers of the registrant if they perform policy-making functions for the registrant.

(n180)Footnote 180. The 401(b) information concerning executive officers, however, need not be furnished in proxy or information statements if the information is included in Part I of the registrant's annual report on Form 10-K under a separate item captioned "Executive Officers of the Registrant." Instruction 3 to Item 401(b), Regulation S-K.

(n181)Footnote 181. Item 401(c), Regulation S-K. *See § 4.01[2][a][iv]* and n.47 *supra*.

(n182)Footnote 182. "Family relationship" is defined as any relationship by blood, marriage, or adoption not more remote than first cousin. Instruction to Item 401(d), Regulation S-K.

(n183)Footnote 183. Item 401(e)(1), Regulation S-K. Registrants, in identifying any corporations or other organizations by which the enumerated persons have been employed in the past five years, must indicate whether that corporation or organization is a parent, subsidiary, or other affiliate of the registrant. *Id.*

(n184)Footnote 184. *Id.*, Item 401(e)(1). The explanation required relates to level of professional competence and may include information as to the size of the operation supervised. *Id.*

(n185)Footnote 185. *Id.*, Item 401(e)(2).

(n186)Footnote 186. For purposes of determining this five year period, the date of the reportable proceeding is deemed to be:

- (1) for bankruptcy proceedings, the date
 - (a) of filing for uncontested petitions, or
 - (b) upon which approval of a contested petition became final; and

- (2) for other proceedings, the date

- (a) the final order, judgment, or decree was entered, or
 - (b) upon which any rights of appeal from preliminary orders, judgments, or decrees have lapsed.
- Instruction 1 to Item 401(f), Regulation S-K.

(n187)Footnote 187. If a registrant omits a legal proceeding because it is not deemed material, it may furnish to

the Commission at the time of filing as supplemental information not part of the statement or report to which the omission relates, a description of the proceedings and the reasons for the omission. Instruction 2 to Item 401(f), Regulation S-K.

(n188)Footnote 188. Item 401(f)(1), Regulation S-K.

(n189)Footnote 189. Item 401(f)(2).

(n190)Footnote 190. Item 401(f)(3).

(n191)Footnote 191. Item 401(f)(4).

(n192)Footnote 192. Item 401(f)(5).

(n193)Footnote 193. Item 401(f)(6). The registrant may also explain any mitigating circumstances associated with the legal proceedings. Instruction 3 to Item 401(f), Regulation S-K. The registrant is not required to provide information concerning involvement in legal proceedings in a proxy or information statement for a director whose term of office as a director will not continue after the meeting to which the statement relates. *Id.*, Instruction 4.

(n194)Footnote 194. Item 401(g)(1)(2), Regulation S-K. Paragraph (g) does not apply to a subsidiary of a registrant that has been reporting pursuant to Section 13(a) or 15(d) for the twelve months prior to the filing. Instruction 2 to Item 401(g), Regulation S-K. Instructions 1 to 3 of Item 401(f) also apply to Item 401(g). *See nn. 135, 136 and 142 supra*. The proposed amendment of Item 401(f) would delete Item 401(g). *Exchange Act Release No. 34,923, Fed. Sec. L. Rep. (CCH) P 85,452 (1994)*.

(n195)Footnote 195. Item 402 was amended, effective November 7, 2006, as part of the amendments to the executive compensation and related person disclosure rules.

There is a transition period for a phased-in implementation of the amended Summary Compensation Table and amended Item 404(a) disclosure over a three-year period for Regulation S-K companies. During this phase-in period, companies will not be required to present prior years' compensation disclosure or Item 404(a) disclosure under the former rules.

(n196)Footnote 196. The Commission has issued transition questions and answers related to executive compensation and related person disclosure. See <http://www.sec.gov/divisions/corpfin/faqs/execcompqa.pdf>.

(n197)Footnote 197. Item 402(a)(1), Regulation S-K.

(n198)Footnote 198. Item 402(a)(2), Regulation S-K. *Id.* No item reported as compensation for one fiscal year need be reported as compensation for a subsequent fiscal year. *Id.*

(n199)Footnote 199. Exchange Act Release No. 54,302A; IC-27444A (August 29, 2006).

(n200)Footnote 200. If the CEO served in that capacity during part of a fiscal year, information should be provided as to all compensation for the full fiscal year. Item 402(a)(4), Regulation S-K.

(n201)Footnote 201. The determination as to which executive officers are most highly compensated is made by reference to total compensation for the last completed fiscal year as shown on the Summary Compensation Table, reduced by the amount required to be disclosed pursuant to paragraph (c)(2)(viii), provided, however, that no disclosure need be provided for any executive officer, other than a PEO and PFO, whose total compensation, as so reduced, does not exceed \$100,000. Instruction 1 to Item 402(a)(3), Regulation S-K. It may be appropriate in certain circumstances for a registrant to include an executive officer of a subsidiary in the disclosure required by this Item. Instruction 2 to Item 402(a)(3), Regulation S-K. If a named executive officer served as an executive officer of the registrant (whether or not

in the same position) during any part of a fiscal year, information must be provided as to all compensation of that individual for the full fiscal year. Item 402(a)(4), Regulation S-K.

(n202)Footnote 202. Item 402(a)(3), *Regulation S-K. Exchange Act Release No. 31,327, Fed. Sec. L. Rep. (CCH) P 85,056 (1992)*. Based on the Commission's review of the disclosure provided in filings during the first proxy season after the executive compensation disclosure was revised in 1992, the Commission proposed certain modifications to such disclosures, including modification of the named executive officers to include certain former executive officers. *Exchange Act Release No. 32,723, Fed. Sec. L. Rep. (CCH) P 85,209 (1993)* and *Exchange Act Release No. 33,229, Fed. Sec. L. Rep. (CCH) P 85,259 (1993)*.

(n203)Footnote 203. Instruction 3 to Item 402(a)(3), Regulation S-K.

(n204)Footnote 204. Item 402(a)(5), Regulation S-K. However, the Commission has stated that to promote intercompany comparability and comprehensible disclosure, the rules require, with few exceptions, strict adherence to the specified tabular formats. *Exchange Act Release No. 32,723, Fed. Sec. L. Rep. (CCH) P 85,209 (1993)*.

(n205)Footnote 205. A plan may include a compensatory contract or arrangement for a single individual. Registrants may omit information regarding group life, health, hospitalization, medical reimbursement, or relocation plans that do not discriminate in scope, terms or operation in favor of executive officers or directors of the registrant and that are available generally to all salaried employees. Item 402(a)(7)(ii), Regulation S-K.

(n206)Footnote 206. This section was added pursuant to the executive compensation and related person disclosure rules in 2006.

(n207)Footnote 207. Registrants are not required to disclose target levels with respect to specific quantitative or qualitative performance-related factors considered by the compensation committee or the board of directors, or any other factors or criteria involving confidential trade secrets or confidential commercial or financial information, the disclosure of which would result in competitive harm for the registrant. However, the registrant should discuss the level of difficulty or changes of attainment for the undisclosed target levels or other factors. Instruction 4 to Item 402(b), Regulation S-K.

(n208)Footnote 208. Cf. *Exchange Act Release No. 31,327, Fed. Sec. L. Rep. (CCH) P 85,056 (1992)*.

(n209)Footnote 209. If the named executive officer is also a director who receives compensation for services as a director, the registrant must reflect that compensation in the Summary Compensation Table and provide a footnote identifying and itemizing such compensation and amounts. The categories in the Director Compensation Table required pursuant to Item 402(k) should be used. Instruction 3 to Item 402(c), Regulation S-K.

(n210)Footnote 210. Amounts deferred, whether pursuant to a plan established under *section 401(k) of the Internal Revenue Code*, or otherwise, are to be included in the Summary Compensation Table. Instruction 4 to Item 402(c), Regulation S-K.

(n211)Footnote 211. Where the named executive officer forgoes salary or bonus compensation pursuant to a registrant's program under which stock, equity-based or other forms of non-cash compensation may be received, that non-cash compensation is disclosed in the appropriate column of the Summary Compensation Table corresponding to that fiscal year. Stock awards are reported in column (e); option awards are reported in column (f); and all other compensation is reported in column (i). Grants pursuant to a non-equity incentive plan are not reported under the Summary Compensation Table (and are reported in the Grants of Plan-Based Awards Table required by Item 402(d)) but are mentioned in a footnote to the bonus or salary column. Instruction 2 to Item 402(c)(2)(iii) and (iv), Regulation S-K.

(n212)Footnote 212. Instruction 1 to Item 402(c)(2)(v) and (vi), Regulation S-K.

(n213)Footnote 213. Instruction 2 to Item 402(c)(2)(v) and (vi), Regulation S-K.

(n214)Footnote 214. A non-equity incentive plan is an incentive plan or portion of an incentive plan that is not an equity incentive plan. Item 402(a)(6)(iii), Regulation S-K.

(n215)Footnote 215. The earnings are not reportable again in the fiscal year when the amounts are paid to the named executive officer. Instructions to Item 402(c)(2)(vii), Regulation S-K.

(n216)Footnote 216. Tax reimbursements for perquisites or other personal benefits would be disclosed here. Instruction 4 to Item 402(c)(2)(ix), Regulation S-K.

(n217)Footnote 217. For the purposes of this disclosure, accrued amount is an amount for which payment has become due.

(n218)Footnote 218. Id.

(n219)Footnote 219. Benefits paid pursuant to defined benefit and actuarial plans would be reported only if accelerated pursuant to a change in control. Instruction 2 to Item 402(c)(2)(ix), Regulation S-K.

(n220)Footnote 220. Instruction 3 to Item 402(c)(2)(ix), Regulation S-K.

(n221)Footnote 221. Perquisites and other personal benefits are valued on the basis of the aggregate incremental cost to the registrant. Where there is footnote qualification, the footnote must describe the methodology for computing the aggregate incremental cost. Even if the perquisite or personal benefit does not exceed \$10,000, some disclosure may be required in column (i) if the registrant reimbursed taxes owed with respect to the perquisite or personal benefit. Instruction 4 to Item 402(c)(2)(ix), Regulation S-K.

(n222)Footnote 222. Each grant of an award made during a fiscal year is disclosed on a separate line. If the grants were made to a named executive officer under more than one plan, registrants must identify the particular plan under which each grant was made. Instruction 1 to Item 402(d), Regulation S-K. A tandem grant of two instruments, only one of which is granted under an incentive plan, need only be reported as applicable in this column. The tandem feature should be noted by a footnote or in the accompanying textual narrative. Instruction 4 to Item 402(d), Regulation S-K.

(n223)Footnote 223. If non-equity incentive awards are denominated in units or other rights, a separate, adjoining column between columns (b) (grant date) and (c) (threshold) is added quantifying the unit or other rights awarded. Instruction 6 to Item 402(d), Regulation S-K.

(n224)Footnote 224. Threshold refers to the minimum amount payable for a certain level of performance under an incentive plan. Instruction 2 to Item 402(d), Regulation S-K.

(n225)Footnote 225. If the incentive plan only provides for a single estimated payout, that amount is reported as the target. If the target is not determinable, a representative amount based on the previous fiscal year's performance is required. Instruction 2 to Item 402(d), Regulation S-K.

(n226)Footnote 226. Instruction 5 to Item 402(d), Regulation S-K.

(n227)Footnote 227. Material modification would include extension of exercise periods, a change of vesting or forfeiture conditions, the change or elimination of applicable performance criteria, or the change in the bases upon which returns are determined. Item 402(e) of Regulation S-K. However, re-pricing that occurs through a pre-existing formula or mechanism in the plan or award that results in the periodic adjustment of the option or SAR exercise or base price, an anti-dilution provision, or a recapitalization or similar transaction equally affecting all holders of the class of securities underlying the options or SARs would not need to be reported here. Instruction 1 to Item 402(e), Regulation S-K.

(n228)Footnote 228. Registrants are not required to disclose target levels with respect to specific quantitative or performance-related factors considered by the compensation committee or the board of directors where such disclosure would result in disclosure of confidential trade secrets or confidential commercial or financial information that would cause competitive harm to the registrant. The registrant does not need to seek confidential treatment of this information. The registrant should discuss how difficult it will be for the executive or how likely it will be for the executive to achieve the undisclosed target levels or other factors. Further, disclosure of target levels that are non-GAAP financial measures will not be subject to Regulation G and Item 10(e) of Regulation S-K; but the registrant must disclose how the number is calculated from the registrant's audited financial statements. Instruction 2 to Item 402(e)(1), Regulation S-K.

(n229)Footnote 229. Instruction 4 to Item 402(f), Regulation S-K.

(n230)Footnote 230. The dollar amount realized upon exercise is the difference between the market price of the underlying securities at exercise and the exercise or base price of the options. The value of any related payment or other consideration provided by the registrant to or on behalf of a named executive officer, whether in payment of the exercise price or related taxes is not to be included here, as it is reported in the Summary Compensation Table. Instruction to Item 402(g)(2), Regulation S-K.

(n231)Footnote 231. If the named executive officer's number of years of credited service with respect to any plans disclosed in this table is different from the named executive officer's number of actual years of service with the registrant, it must be disclosed in a footnote quantifying the differences and any resulting benefit augmentation. Instruction 4 to Item 402(h)(2), Regulation S-K.

(n232)Footnote 232. Disclosure applies to each plan that provides for specified payments and benefits, or payments and benefits that will be provided primarily following retirement, including but not limited to tax-qualified defined benefit plans and supplemental executive retirement plans, but excluding tax-qualified defined contribution plans and nonqualified defined contribution plans. Each plan is to be disclosed in a separate row. Instruction 1 to Item 402(h)(2), Regulation S-K.

(n233)Footnote 233. Normal retirement means retirement at the normal retirement age as defined in the plan, or if not so defined, the earliest time at which a participant may retire under the plan without any benefit reduction due to age. Item 402(h)(3)(i), Regulation S-K.

(n234)Footnote 234. A footnote should describe the extent to which amounts reported in the contributions and earnings columns are reported as compensation in the last completed fiscal year, and previous years, in the registrant's Summary Compensation Table. Instruction to Item 402(i)(2).

(n235)Footnote 235. Where a triggering event has actually occurred for a named executive officer and that individual was not serving as a named executive officer of the registrant at the end of the last completed fiscal year, the disclosure for that named executive officer required involves only that triggering event. Instruction 4 to Item 402(j), Regulation S-K.

(n236)Footnote 236. Instruction 5 to Item 402(j), Regulation S-K.

(n237)Footnote 237. If the relevant information regarding termination and change-in-control has been disclosed pursuant to paragraph (h) or (i) of Item 402, reference may be made to that disclosure. If any payment or benefit would be enhanced or its vesting or other provisions accelerated in connection with any triggering event, such enhancement or acceleration would be disclosed under this paragraph. Instruction 3 to Item 402(j), Regulation S-K.

(n238)Footnote 238. Where uncertainty exists as to the provision of payments and benefits or the amounts involved, the registrant should make reasonable estimates. Instruction 1 to Item 402(j), Regulation S-K.

(n239)Footnote 239. Perquisites and other personal benefits or property with an aggregate value less than \$10,000

may be excluded in accordance with Instruction 4 to Item 402(c)(2)(ix) of Regulation S-K. Instruction 2 to Item 402(j), Regulation S-K.

(n240)Footnote 240. Two or more directors may be grouped in a single row in the table if all elements of their compensation are identical. The names of the directors for whom disclosure is presented on a group basis should be clear from the table. Instruction to Item 402(K)(2), Regulation S-K.

(n241)Footnote 241. If the director foregoes salary or bonus and elects non-cash compensation (such as stock), that non-cash compensation is not disclosed in the salary or bonus column, but is disclosed in the column appropriate for that type of compensation. Instruction to Item 402(k), Regulation S-K.

(n242)Footnote 242. The awards of stock options, with or without tandem SARs, and including awards that subsequently have been transferred, are to be disclosed in this table. Item 402(k)(2)(iv), Regulation S-K.

(n243)Footnote 243. The range of time used to calculate the aggregate change in the present value of the director's accumulated benefits is the pension plan measurement date used for financial statement reporting purposes with respect to the registrant's audited financial statements for the prior completed fiscal year to the registrant's audited financial statements for the prior completed fiscal year to the pension plan measurement date used for financial statement reporting purposes with respect to the registrant's audited financial statements for the covered fiscal year. Item 402(k)(2)(vi)(A), Regulation S-K.

(n244)Footnote 244. All other compensation includes the following for the covered fiscal year: (i) perquisites and other personal benefits, or property where the aggregate total value is greater than \$10,000; (ii) "gross-ups" for the payment of taxes; (iii) discounts on the purchase of any security of the registrant or its subsidiaries unless that discount is generally available to all security holders or all salaried employees of the registrant; (iv) amounts paid or accrued to any director pursuant to agreements or arrangements concerning change-of-control, termination or retirement; (v) registrant contributions or other allocations to vested and unvested defined contribution plans; (vi) consulting fees; (vii) the annual costs of payments and promises of payments pursuant to director legacy programs and similar charitable award programs; (viii) the dollar value of insurance premiums paid by the registrant for life insurance for the benefit of the director and the dollar value of any dividends; or (ix) other earnings paid on stock or option awards, when those amounts were not factored into the grant date fair value required to be reported for the stock or option award in column (c) or (d). Item 402(k)(2)(vii), Regulation S-K.

Charitable award programs include programs where the registrant agrees to make donations to one or more charitable institutions in a director's name, payable by the registrant currently or upon a designated event, such as the retirement or death of the director. Foot note disclosure is required and must include the total dollar amount payable under the program and other material terms of each such program for which tabular disclosure is provided. Instruction 1 to Item 402(k)(vii).

Where the total value of perquisites and personal benefits exceeds \$10,000, then each perquisite and personal benefit, regardless of the amount, must be identified by type and each perquisite or personal benefit that exceeds \$25,000 or 10% of the total amount of perquisites and personal benefits for that director must be quantified and disclosed in a footnote. Where footnote disclosure is required, the registrant must give the methodology for determining the incremental value of the perquisite or personal benefit. Reimbursements for taxes must also be included in the "All Other Compensation" column and must be identified and qualified along with all other tax "gross-ups." Instruction 3 to Item 402(k)(2)(vii).

(n245)Footnote 245. Instruction to Item 402(k), Regulation S-K.

(n246)Footnote 246. Id.

(n247)Footnote 247. Item 402(l) of Regulation S-K.

(n248)Footnote 248. Any "person" includes any "group" as the term is used in Section 13(d)(3) of the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section F. *See* § 7A.02[2][b][i] *infra*.

(n249)Footnote 249. The registrant is deemed to know the contents of any statements filed with the Commission pursuant to Section 13(d) or 13(g), discussed in § 7A.02[1][a][i] *infra*, and the registrant may rely upon information in those statements unless the registrant has reason to believe that the information is incomplete or inaccurate. Instruction 3 to Item 403, Regulation S-K. For purposes of furnishing information pursuant to paragraph (a) of this item, the registrant may indicate the source and date of such information. Instruction 4 to Item 403, Regulation S-K.

(n250)Footnote 250. This may be a business, mailing, or residence address. Item 403(a), Regulation S-K.

(n251)Footnote 251. Beneficial ownership is determined in accordance with Rule 13d-3 under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G discussed in § 7A.02[2][b][ii] *infra*. If more than one beneficial owner is known to the registrant to be listed for the same securities, appropriate disclosure should be made to avoid confusion. Instruction 5 to Item 403, Regulation S-K.

(n252)Footnote 252. The percentages are to be calculated on the basis of the amount of outstanding securities, excluding securities held by or for the account of the registrant or its subsidiaries, plus securities deemed outstanding under Rule 13d-3(d)(1), i.e., securities subject to options, warrants, rights, or conversion privileges by the person whose ownership is being calculated. Instruction 1 to Item 403, Regulation S-K. If the percentage of shares beneficially owned does not exceed one percent of the class, the registrant may so indicate by means of an asterisk and explanatory footnote. *Id*.

(n253)Footnote 253. Instruction 7 to Item 403, Regulation S-K.

(n254)Footnote 254. Effective for fiscal years ending on or after December 15, 2006, Item 403(b) was amended to require footnote disclosure of the number of shares pledged as security by named executive officers, directors and director nominees. Release No. 34-54302A.

(n255)Footnote 255. Registrants should not count shares more than once when computing the aggregate number of shares owned by directors and officers as a group. Instruction 5 to Item 403, Regulation S-K.

(n256)Footnote 256. Item 403(c), however, does not require a description of ordinary default provisions contained in the charter, trust indentures, or other governing instruments relating to securities of the registrant. Instruction 6 to Item 403(c), Regulation S-K.

(n257)Footnote 257. No information need be given in response to any part of Item 404 for any remuneration or other transaction if that information can be reported in response to, or omitted pursuant to, any other paragraph of Item 402 or Item 404 of Regulation S-K. Instruction 1 to Item 404, Regulation S-K.

If the information called for by Item 404 of Regulation S-K is being presented in a registration statement filed pursuant to the Exchange Act, information should be given both for the periods specified in Item 404 of Regulation S-K and for the two fiscal years preceding the registrant's last fiscal year. Instruction 2 to Item 404, Regulation S-K.

A foreign private issuer may respond to Item 404 only to the extent that the registrant discloses to its security holders or otherwise makes public the information specified in that Item. Instruction 3 to Item 404, Regulation S-K.

(n258)Footnote 258. A person who has a position or relationship with a firm, corporation, or other entity that engages in a transaction with the registrant or its subsidiaries may have an indirect interest in the transaction because of that position or relationship. That person, however, will not be deemed to have a material interest in the transaction if

the interest arises only from:

(1) (a) the person's position as a director of another corporation that is a party to the transaction;

(b) the direct or indirect ownership by that person and all other persons specified in the text *infra*, in the aggregate, of less than a ten percent equity interest in another person, other than a partnership, that is a party to the transaction; or

(c) both (a) and (b);

(2) the person's position as a limited partner in a partnership in which the person and all other persons specified in the text *infra* have an interest of less than ten percent; or

(3) the holding of an equity interest (including a limited partnership interest, but excluding a general partnership interest) or a creditor interest in another person that is a party to the transaction with the registrant and the transaction is not material to that other person.

Instruction 8 to Item 404(a), Regulation S-K.

(n259)Footnote 259. Materiality guidelines were given in the old Instructions 1 and 9, which were deleted by the 2006 executive compensation amendments. The Commission, in its adopting release, stated that the materiality standards themselves did not change, but that the instructions were repetitive. The materiality of any interest will continue to be determined on the basis of the significance of the information to investors in light of all the circumstances. And while the instructions to Item 404(a) do not expressly provide that disclosure is not required in certain instances, where the interest of a related person in a particular transaction is not a direct or indirect material interest, no disclosure is required. Release No. 34-54302A. Among the factors noted under the prior instruction to be considered in determining the significance of the information to investors were:

(1) the importance of the interest to the person having the interest;

(2) the relationship of the parties to the transaction with each other; and

(3) the amount involved in the transaction.

(n260)Footnote 260. An "immediate family member" means any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law of such aforementioned related person, and any person (other than a tenant or employee) sharing the household of such aforementioned related person. Instruction 1 to Item 404(a). The term "immediate family member" was amended, effective for fiscal years ending on or after December 15, 2006, to include stepchildren, stepparents and persons (other than a tenant or employee) sharing a household. Release No. 34-54302A.

For an example of the difficulties which may arise in the application the term "immediate family member," See *Western District Council of Lumber Production and Industrial Workers v. Louisiana Pacific Corp.*, *Fed. Sec. L. Rep. (CCH)* 94,845, 892 F.2d 1412 (9th Cir. 1989) where the acquisition of a firm whose president was a former sister-in-law of a director of the acquiring company was not required to be disclosed. Although the term "sister-in-law" is included in the definition of the term "immediate family," a panel of the Ninth Circuit Court of Appeals said that the ex-wife of the director's deceased brother did not come within the scope of the definition. In this case, the panel said that the death of the director's brother had broken the connection and severed the status of the "sister-in-law."

(n261)Footnote 261. *Id.*

(n262)Footnote 262. The amount involved must be in dollars and includes all periodic installments of any lease or other agreement providing for periodic installment payments. In the case of indebtedness, the amount involved is to be the largest aggregate amount of all indebtedness outstanding at any time since the beginning of the company's last fiscal year and all amounts of interest payable on it during the last fiscal year. Instruction 3 to Item 404(a), Regulation S-K.

(n263)Footnote 263. Item 404(a) was amended in 2006 to extend to the disclosure of indebtedness, consolidating the disclosure formerly required under Item 404(a) regarding transactions involving the company and related persons with the disclosure regarding indebtedness which had been separately required by Item 404(c). Indebtedness is no longer distinguished from any other type of related person transaction. While Section 402 prohibits personal loans made by a company to its officers and directors (as amended by The Sarbanes-Oxley Act of 2002, see § 4.02 *supra*), the scope of the direct and indirect interests covered by disclosure requirements, the recognition that the term "related person" includes persons not covered by the personal loan prohibition, and the availability of certain exceptions to the prohibition all require an inclusion of the requirement to disclose indebtedness under Item 404(a).

(n264)Footnote 264. The following items of indebtedness may be excluded from the calculation of the amount of indebtedness and need not be disclosed: amounts due from the related person for purchases of goods and services subject to usual trade terms, for ordinary business travel and expense payments and for other transactions in the ordinary course of business. If the lender is a bank, savings and loan association, or broker-dealer extending credit under Federal Reserve Regulation T (12 CFR part 220) and the loans are not disclosed as nonaccrual, past due, restructured or potential problems, disclosure under paragraph (a) of this item may consist of a statement, if such is the case, that the loans to such persons: (i) were made in the ordinary course of business; (ii) were made on substantially the same terms as comparable loans to persons not related to the lender; and (iii) did not involve more than the normal risk of collectibility or present other unfavorable features. Instruction 4 to Item 404(a), Regulation S-K.

(n265)Footnote 265. Instruction 4 to Item 404(a), Regulation S-K.

(n266)Footnote 266. Compensation resulting solely from that employment relationship need not be provided pursuant to Item 404(a). Disclosure is not required where the executive officer is not an immediate family member and such compensation would have been reported under Item 402 as compensation earned for services to the registrant if the executive officer was a named executive officer as that term is defined in Item 402(a)(3), and such compensation had been approved, or recommended to the board of directors of the registrant for approval, by the compensation committee of the board of directors (or group of independent directors performing a similar function) of the registrant. Instruction 5 to Item 404(a), Regulation S-K.

(n267)Footnote 267. Instruction 6 to Item 404(a), Regulation S-K.

(n268)Footnote 268. Instruction 7 to Item 404(a), Regulation S-K.

(n269)Footnote 269. Prior to the 2006 amendments, Item 404(b) required disclosure of *specific* business relationships between a director or nominee for director and the company that could bear on the ability of directors and nominees for director to exercise independent judgment in the performance of their duties. The new Item 404(b) changes approach, focusing more on the process, and now requires disclosure about the *determination* of the independence of directors and nominees for director, including information supplementing the amended related person transaction disclosure that would permit qualitative assessment of those independence determinations.

(n270)Footnote 270. There is no requirement under this paragraph to disclose any transaction with one of the following related persons, where the transaction terminated before the related person became such: (i) director or executive officer of the registrant; (ii) a nominee for director; or (iii) an immediate family member of a director or executive officer of the registrant, or of a nominee for director. Instruction to Item 404(b), Regulation S-K.

(n271)Footnote 271. Prior to amendments in 2006, 404(c) pertained to disclosures regarding the indebtedness of management under Section 16(b) of the Exchange Act. This old 404(c) was deleted because the Commission

determined that the purpose of related person transaction disclosure differed from the purposes of Section 16(b). Release No. 34-54302A.

(n272)Footnote 272. This requirement regarding registrants that are shell companies was added in 2006. A group, for the purposes of this paragraph, consists of "two or more persons that agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of a registrant." Item 404(c), Regulation S-K.

(n273)Footnote 273. Item 404(d) of Regulation S-K.

(n274)Footnote 274. Item 405 was adopted by the Commission as part of its comprehensive revision of the rules under Exchange Act Section 16. *Exchange Act Release No. 28,869, Fed. Sec. L. Rep. (CCH) P 84,709 (1991)*.

(n275)Footnote 275. If the registrant receives a written representation from the reporting person that no Form 5 is required; and maintains the representation for two years, making a copy available to the Commission upon request, the registrant need not identify the reporting person as having failed to file a Form 5 with respect to that fiscal year.

(n276)Footnote 276. Item 405 applies to every registrant having a class of equity securities registered under Exchange Act Section 12, every closed-end investment company registered under the Investment Company Act of 1940, and every holding company registered pursuant to the Public Utility Holding Company Act of 1935.

(n277)Footnote 277. A failure to timely file need only be disclosed once. Note to Item 405(a)(2).

(n278)Footnote 278. Item 405(a)(2); *Exchange Act Release No. 37,260, Fed. Sec. L. Rep. (CCH) P 85,810 (1996)*. A Note to Item 405(a) provides that any particular failure to make a timely filing need only be disclosed once and need not be included in subsequent filings once disclosure has been made.

(n279)Footnote 279. Item 405(b). *Exchange Act Release No. 28,869, Fed. Sec. L. Rep. (CCH) P 84,709 (1991)*.

(n280)Footnote 280. For purposes of Item 406, the term "code of ethics" means written standards that are reasonably designed to deter wrongdoing and to promote:

- honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;
- compliance with applicable governmental laws, rules and regulations;
- the prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and
- accountability for adherence to the code.

Item 406(b), Regulation S-K.

(n281)Footnote 281. Item 406(a), Regulation S-K. It is important to note that the NYSE and Nasdaq require a listed company to, among other things, adopt a code of conduct, make the code of conduct publicly available and promptly disclose any waiver of the code of conduct granted to a director or executive officer. NYSE Listed Company Manual, Section 303A.10; Nasdaq Marketplace Rule 5610.

(n282)Footnote 282. *Id.*

(n283)Footnote 283. Item 406(c), Regulation S-K.

(n284)Footnote 284. Item 406(d), Regulation S-K. For additional discussion of Item 10 of Form 8-K, see § 4.02[3][k].

(n285)Footnote 285. Item 407 was added, effective November 7, 2006, as part of the amendments to the executive compensation and related person disclosure rules. See the section on Item 402 of Regulation S-K for compliance dates.

(n286)Footnote 286. Information must be disclosed for any person who served as a director during any part of the last completed fiscal year. Instruction 2 to Item 407(a), Regulation S-K.

(n287)Footnote 287. If the registrant relied upon an exemption provided in the applicable listing standards, that exemption, and the basis for the registrant's conclusion that the exemption is available, must be disclosed. Instruction 1 to Item 407(a), Regulation S-K.

(n288)Footnote 288. This standard may be used where the national securities exchange or the inter-dealer quotation system has requirements that a majority of the board of directors be independent. Item 407(a)(1)(i), Regulation S-K.

(n289)Footnote 289. If the director independence information is being disclosed in registration statement on Form S-1 or Form SB-2 under the Securities Act or Form 10 under the Exchange Act, where the registrant has applied for listing with a national securities exchange or an inter-dealer quotation system which has requirements that a majority of the board of directors be independent, the registrant must use the definitions that were adopted to comply with the listing requirements of the national securities exchange or inter-dealer quotation system to which it is applying for listing. Item 407(a)(1)(iii), Regulation S-K. If the director independence information is being disclosed in a registration statement filed at a time when the registrant is not subject to the reporting requirements of section 13(a) or 15(d) of the Exchange Act, then information respecting any director who is no longer a director at the time of the effectiveness of the registration statement is not required. Instruction 2 to Item 407(a), Regulation S-K.

(n290)Footnote 290. If a current copy of the policies are not available at the registrant's website and not included as an appendix to the registrant's proxy statement or information statement, the registrant must identify the most recent fiscal year in which the policies were so included. Item 407(a)(2), Regulation S-K.

(n291)Footnote 291. Instruction 3 to Item 407(a), Regulation S-K.

(n292)Footnote 292. If the information regarding annual meetings is being disclosed in a proxy statement, the registrant may alternatively provide the registrant's website address where such information appears. Instruction to Item 407(b)(2), Regulation S-K.

(n293)Footnote 293. For the purposes of Item 407(c)(2), the term "nominating committee" refers not only to nominating committees and committees performing similar functions, but also to groups of directors fulfilling the role of a nominating committee, including the entire board of directors. Instruction to Item 407(c)(2), Regulation S-K.

(n294)Footnote 294. Updating the procedure for security holder nominations of director nominees to the nominating committee need only be reported in the registrant's quarterly or annual reports. Instruction 1 to Item 407(c)(3), Regulation S-K. Adoption of procedures for security holder nominations is a material change. Instruction 2 to Item 407(c)(3), Regulation S-K.

(n295)Footnote 295. With regard to each nominee approved by the nominating committee for inclusion on the registrant's proxy card (other than nominees who are executive officers or who are directors standing for re-election),

the registrant must state which one or more of the following categories of persons or entities recommended that nominee: security holder, non-management director, chief executive officer, other executive officer, third-party search firm or other specified source. With regard to each nominee approved by a nominating committee of an investment company, the registrant must state which one or more of the following additional categories of persons or entities recommended that nominee: Item 407(c)(2)(vii), Regulation S-K.

(n296)Footnote 296. The nominating committee must have received the recommendation by a date not later than the 120[th] calendar day before the date of the registrant's proxy statement released to security holders in connection with the previous year's annual meeting. The registrant must identify the candidate and the security holder or security holder group that recommended the candidate and disclose whether the nominating committee chose to nominate the candidate; provided, however, that no such identification or disclosure is required without the written consent of both the security holder or security holder group and the candidate to be so identified. Item 407(c)(2)(ix), Regulation S-K.

(n297)Footnote 297. If the registrant is a subsidiary that is at least 50% beneficially owned by a listed issuer, the registrant is not subject to the requirements of this chapter. Rule 10A-3(c)(2) of the Exchange Act. If the registrant meets one of the following exemptions, the registrant is not subject to the requirements of this chapter: (i) the registrant is reporting pursuant to a listing of a security futures product that has been cleared by a clearing agency that is registered pursuant to section 17A of the Exchange Act or that is exempt from the registrant requirements of section 17A pursuant to paragraph (b)(7)(A) of such section; (ii) the registrant is reporting pursuant to a listing of a standardized option issued by a clearing agency that is registered pursuant to section 17A of the Exchange Act; (iii) the registrant is an asset-backed issuer; (iv) the registrant is issuing unit investment trusts; (v) the registrant is listing securities of a foreign government; or (vi) the listed issuer, as reflected in the applicable listing application, is organized as a trust or other unincorporated association that does not have a board of directors or persons acting in a similar capacity and the activities of the listed issuer are limited to passively owning or holding (as well as administering and distributing amounts in respect of) securities, rights, collateral or other assets on behalf of or for the benefit of the holders of the listed securities. Rule 10A-3(c)(4) through (c)(7) of the Exchange Act.

(n298)Footnote 298. The audit committee report need not be provided in any filings other than a registrant's proxy or information statement relating to an annual meeting of security holders at which directors are to be elected (or special meeting or written consents in lieu of such meeting). Instruction 3 to Item 407(d), Regulation S-K.

(n299)Footnote 299. In adopting Item 306, the predecessor to Item 407(d), the Commission noted that in performing its oversight function, the audit committee likely would have to rely on advice and information that it receives in its discussion with management and the registrant's independent auditors and as such, Item 407(d) permits the audit committee to base its findings on such discussions. *Exchange Act Release No. 42,266, Fed. Sec. L. Rep. (CCH) P 86,230 (1999)*.

(n300)Footnote 300. The disclosure concerning the audit committee financial expert is only required in a registrant's annual report. The registrant need not provide this disclosure in a proxy or information statement unless that registrant is electing to incorporate the information by reference from the proxy or information statement into its annual report pursuant to General Instruction G(3) to Form 10-K. Instruction 1 to Item 407(d)(5), Regulation S-K.

(n301)Footnote 301. If the registrant has more than one financial expert, the registrant is only required to disclose one name. If other names are disclosed, the status of their independence (or lack thereof) should also be disclosed. Instruction to Item 407(d)(5)(i).

(n302)Footnote 302. If a person is qualified as an audit committee financial expert by means of relevant experience, the registrant is to provide a brief listing of that person's relevant experience. Such disclosure may be made by reference to disclosures required under Item 401(e) (regarding disclosure of the business experience of certain persons, including directors). Instruction 2 to Item 407(d)(5).

(n303)Footnote 303. In the event that the member of the compensation committee had any relationship requiring disclosure by the registrant under Item 404, then the disclosure required by Item 404 is to accompany the member identification. Item 407(e)(4)(i)(C), Regulation S-K.

(n304)Footnote 304. This compensation committee report need only be provided in an annual report on Form 10-K, a proxy statement on Schedule 14A or an information statement on Schedule 14C. Instruction 2 to Item 407(e)(5), Regulation S-K. This report need only be provided one time during any fiscal year. Instruction 3 to Item 407(e)(5), Regulation S-K.

(n305)Footnote 305. For the purposes of Item 407(f), security holder communication does not include communications from an officer or director of the registrant, nor does it include communications from an employee or agent of the registrant unless those communications are made solely in such employee's or agent's capacity as a security holder. Instruction 3 to Item 407(f), Regulation S-K. Security holder proposals submitted pursuant to Rule 14a-8 (stockholder proposals) are not considered security holder communications for the purposes of Item 407(f). Instruction 4 to Item 407(f), Regulation S-K.

(n306)Footnote 306. If the registrant's process for collecting and organizing security holder communications, as well as similar or related activities, has been approved by a majority of the independent directors, then the registrant need not disclose such process. Instruction 2 to Item 407(f), Regulation S-K.

(n307)Footnote 307. Instruction 1 to Item 407(f), Regulation S-K.

(n308)Footnote 308. Instruction 2 to Item 407, Regulation S-K.

(n309)Footnote 309. Regulation 407(g) of Regulation S K.

(n310)Footnote 310. Item 601(b)(99), Regulation S-K.

(n311)Footnote 311. Item 601(a)(1), Regulation S-K. Rule 12b-32 provides that any part of a document filed with the Commission or an exchange pursuant to the federal securities laws may be incorporated by reference as an exhibit to any statement or report filed with the Commission or an exchange by the same or any other person. The Rule also provides that if any modification has occurred in the text of any document incorporated by reference since it was filed, the registrant must file with the reference the text and the date of the modification.

Rule 12b-32 is subject to Item 10(d) of Regulation S-K which prohibits incorporation by reference to another document if: (1) the pertinent portion of the document includes an incorporation by reference to a second document, or (2) the document has been on file for more than five years. The five year prohibition, however, does not apply to:

(1) documents contained in registration statements, if the registrant has a reporting requirement with the Commission;

(2) documents the registrant specifically identified by physical location through SEC file number reference, if the documents have not been disposed of pursuant to the Commission's Records Control Schedule (17 C.F.R. § 200.80f). See § 4.03[1][d] *infra*.

(n312)Footnote 312. Under Regulation S-T, exhibits filed in paper prior to the time the filer becomes subject to mandated electronic filing will not have to be refiled in electronic format. Rule 102(e), *Regulation S-T. Exchange Act Release No. 35,113, Fed. Sec. L. Rep. (CCH) P 85,475 (1994)*. See Section 4.05 *infra*.

(n313)Footnote 313. Instruction 3 to Item 601, Regulation S-K.

(n314)Footnote 314. Item 601(a)(2), Regulation S-K. If two or more documents to be filed as exhibits are substantially identical, the registrant need file only one of such documents with a schedule indicating the differing

details. The Commission may require filing of any of the documents so omitted. Instruction 2 to Item 601, Regulation S-K.

Whenever an exhibit is filed in paper pursuant to a hardship exemption, the letter "P" must be placed next to the exhibit in the index and whenever an electronic confirming copy of an exhibit is filed pursuant to a grant of a hardship exemption, the exhibit index shall specify where the confirming electronic copy can be located and the item shall be designated "CE" in the index. Instruction 4 to Item 601, *Regulation S-K. Exchange Act Release No. 38,798, Fed. Sec. L. Rep. (CCH) P 85,947 (1997)*.

(n315)Footnote 315. The number in parenthesis at the beginning of each exhibit refers to the appropriate subsection in Item 601(b) where a description of the exhibit can be found.

(n316)Footnote 316. Item 601(b)(2), Regulation S-K. Schedules or similar attachments to this exhibit need not be filed unless the schedules contain material information not otherwise disclosed in the exhibit or registration statement or report, but the contents of all omitted schedules must be briefly identified in a list accompanying the filed exhibit, which must be accompanied by an agreement to furnish supplementally a copy of any omitted schedule to the Commission upon request. *Id.*

(n317)Footnote 317. Item 601(b)(3), *Regulation S-K. Exchange Act Release No. 31,905, Fed. Sec. L. Rep. (CCH) P 85,111 (1993)*.

If amendments to the articles or bylaws are filed, the registrant must also file a complete copy of the articles or bylaws as amended. *Id.* The registrant may file the form of a charter amendment authorizing new securities to be filed with the appropriate state authority if it is impracticable for the registrant to file the amendment prior to the effective date of the registration statement for the new securities. *Id.* If, however, material changes are made in the form of amendment after it is filed as an exhibit, the registrant must file the form as changed. *Id.*

(n318)Footnote 318. Instruments defining the rights of participants in an employee benefit plan as participants, and not as security holders, need not be filed. Instruction to Item 601(b)(4), Regulation S-K. If the instrument defining the rights of security holders is in the form of a certificate, the text appearing on the certificate must be reproduced in an electronic filing, together with a description of any other graphic or image material. *Exchange Act Release No. 35,113, Fed. Sec. L. Rep. (CCH) P 85,475 (1994)*.

(n319)Footnote 319. Item 601(b)(4), Regulation S-K. The registrant must file all instruments defining the rights of holders of the equity or debt securities being registered, including any relevant portions of the articles or bylaws of the registrant.

In addition, the registrant must file as exhibits all instruments defining the rights of holders of long-term debt of the registrant, its consolidated subsidiaries, and its unconsolidated subsidiaries for which financial statements are required to be filed, except any instrument:

(1) concerning long-term debt not being registered if:

(a) the total amount of securities authorized under the instrument does not exceed ten percent of the total assets of the registrant and its consolidated subsidiaries; and

(b) an agreement to furnish a copy of the instrument to the Commission upon request is filed;

(2) concerning any class of securities if appropriate steps to assure the redemption or retirement of the class will be taken prior to or upon delivery by the registrant of the securities being registered; or

(3) evidencing scrip certificates for fractions of shares.

If any of the securities being registered are, or will be, issued under an indenture to be qualified under the Trust Indenture Act, the copy of such indenture which is filed as an exhibit shall include or be accompanied by:

(1) a reasonably itemized and informative table of contents; and

(2) a cross-reference sheet showing the location in the indenture of the provisions inserted pursuant to sections 310 through 318(a) inclusive of the Trust Indenture Act of 1939. Item 601(b)(4)(ii), (iii) and (iv), Regulation S-K.

The Trust Indenture Act of 1939 is discussed in *Federal Securities Act of 1933*, Matthew Bender, (A.A. Sommer, Jr., General Editor), Chapter 8.

(n320)Footnote 320. Item 601(b)(9), Regulation S-K.

(n321)Footnote 321. Item 601(b)(10), Regulation S-K. Three kinds of material contracts must be filed as exhibits: contracts not made in the ordinary course of business, certain contracts made in the ordinary course of business (i.e., contracts to which directors, officers, promoters, voting trustees, security holders named in the report, or underwriters are parties other than contracts involving only the purchase or sale of current assets having a determinable market price, at such market price; any contract upon which the registrant's business is substantially dependent; any contract calling for the acquisition or sale of property, plant or equipment for a consideration exceeding 15 percent of such fixed assets of the registrant on a consolidated basis; or any material lease under which a part of the property described in the report is held by the registrant), and management contracts and remunerative plans (which include plans relating to options, warrants or rights, pension, retirement, or deferred compensation or bonus, incentive or profit sharing in which any director or "named executive officer," as defined in Item 402(a)(3), participates and any other management contract or compensatory plan, contract, or arrangement in which any other executive officer of the registrant participates, unless immaterial in amount or significance). Any material contract as to which the registrant or any of its subsidiaries: (1) is a party; (2) has succeeded to a party by assumption or assignment; or (3) has a beneficial interest, not made in the ordinary course of business must be filed, if the contract: (1) is to be performed in whole or in part at or after the filing of the registration statement or report, or (2) was entered into not more than two (2) years before the filing of the registration statement or report. Item 601(b)(10)(i), Regulation S-K.

If a material contract is executed or becomes effective during the reporting period reflected by a Form 10-Q or Form 10-K, it must be filed as an exhibit to the Form 10-Q or Form 10-K filed for the corresponding period. *Exchange Act Release No. 35,113, Fed. Sec. L. Rep. (CCH) P 85,475 (1994)*.

(n322)Footnote 322. Item 601(b)(11), Regulation S-K. This statement is not required if the computation can be clearly determined from the material contained in the registration statement or report. *Id.*

(n323)Footnote 323. Item 601(b)(12), Regulation S-K.

(n324)Footnote 324. If required by Item 304 of Regulation S-K, the registrant must include a letter from its former independent accountant regarding that accountant's concurrence or disagreement with the statements made by the registrant in the current report concerning the former accountant's resignation or dismissal. Item 601(b)(16), Regulation S-K. For a discussion of Item 304 of Regulation S-K, see § 4.03(4)[d] *supra*.

(n325)Footnote 325. Item 601(b)(21), Regulation S-K.

(n326)Footnote 326. Item 601(b)(24), Regulation S-K. Where the power of attorney is contained elsewhere in the registration statement or documents filed therewith, a reference shall be made in the index to the location of the power

of attorney. *Id.* A power of attorney that is filed with the Commission can only relate to the specific filing or amendment, and cannot confer general authority. *Exchange Act Release No. 31,905, Fed. Sec. L. Rep. (CCH) P 85,111* (1993).

(n327)Footnote 327. Item 601(b)(99), Regulation S-K.

(n328)Footnote 328. A registrant that participates in the Voluntary eXtensible Business Reporting Language (XBRL) program may submit XBRL-related documents in electronic format as an exhibit to the related filing.

(n329)Footnote 329. Item 601(b)(1), Regulation S-K. The underwriting contract or agreement may be filed with a report on Form 8-K if that report is incorporated into a registration statement subsequent to its effectiveness. *Id.*

(n330)Footnote 330. Item 601(b)(2), Regulation S-K. *See* n. 259 *supra*. In *Franchise Finance Corp. of America* (Div. Corp. Fin. 1985), the staff indicated that where limited partnerships sponsored by a registrant contemplated numerous acquisitions under terms and conditions set forth in a standard form of agreement filed as an exhibit to the registrant's registration statement under the Securities Act, and the acquisitions would differ only in certain particulars, such as the names of the parties, description of the property acquired, including the minimum closing appraised value of the property and the anticipated closing date, and other details unique to the specific acquisition, the staff would raise no objection if each acquisition were reported on Form 8-K by setting forth the details unique to that acquisition and incorporating by reference the standard form of agreement filed with the Commission.

(n331)Footnote 331. Item 601(b)(3).

(n332)Footnote 332. Item 601(b)(4), Regulation S-K. For a filing that discloses the creation of a new class of securities or indebtedness or the modification of existing rights of security holders, the registrant must file all instruments defining the rights of holders of the securities or indebtedness, except for an instrument defining long-term debt not being registered if: (a) the total amount of securities authorized under the instrument does not exceed ten percent of the assets of the registrant and its consolidated subsidiaries, and (b) an agreement to furnish a copy of the instrument to the Commission upon request is filed. Item 601(b)(4)(v), Regulation S-K. *See also* nn.261 and 262 *supra*.

(n333)Footnote 333. Item 601(b)(7).

(n334)Footnote 334. Item 601(b)(14), Regulation S-K; *see* Exchange Act Release No. 47,235 (2003).

(n335)Footnote 335. Item 601(b)(16), Regulation S-K.

(n336)Footnote 336. *Id.*, Item 601(b)(17).

(n337)Footnote 337. *Id.*, Item 601(b)(20). If such document or statement is filed, the information called for by the form may be incorporated by reference from such document or statement.

(n338)Footnote 338. *Id.*, Item 601(b)(23).

(n339)Footnote 339. *Id.*, Item 601(b)(24). *See also* n.269 *supra*. Facsimile signatures will be accepted, provided the registrant maintains the originals for a five-year period. *See* Rule 12b1-11(d).

(n340)Footnote 340. Item 601(b)(99), Regulation S-K.

(n341)Footnote 341. Item 601(b)(100) of Regulation S-K. *See also* footnote 275.1 *supra*.

(n342)Footnote 342. Item 601(b)(2), Regulation S-K. *See also* n.259 *supra*. If the agreement becomes effective during the quarter to which the form relates, it must be filed as an exhibit. *Exchange Act Release No. 31,905, Fed. Sec. L. Rep. (CCH) P 85,111* (1993).

(n343)Footnote 343. Item 601(b)(3), Regulation S-K. *See* n.260 *supra*. *Exchange Act Release No. 53,113, Fed. Sec. L. Rep. (CCH) P 85,475 (1994)*.

(n344)Footnote 344. Item 601(b)(4), Regulation S-K. *See* n.262 *supra*.

(n345)Footnote 345. Item 601(b)(10), Regulation S-K. *See also* n.264 *supra*. Material contracts, or amendments thereto, that become effective during the quarter to which they relate are required to be filed pursuant to this item. *Exchange Act Release No. 31,905, Fed. Sec. L. Rep. (CCH) P 85,111 (1993)*.

(n346)Footnote 346. Item 601(b)(11), Regulation S-K. *See* n.265 *supra*.

(n347)Footnote 347. Item 601(b)(15), Regulation S-K. Registrants have the option of filing this letter with their Securities Act registration statement, or an amendment thereto, or with a Form 10-Q incorporated by reference into the registration statement. *Id.*

(n348)Footnote 348. Item 601(b)(18), Regulation S-K. This letter is not required if:

(1) previously filed, or

(2) the change is made in response to a standard adopted by the Financial Accounting Standards Board (FASB) that:

(a) creates a new accounting principle;

(b) expresses a preference for an accounting principle; or

(c) rejects a specific accounting principle.

Id.

(n349)Footnote 349. Item 601(b)(19), Regulation S-K.

(n350)Footnote 350. These published reports are required by Item 4 of Part II of Form 10-Q, discussed in § 4.02[2][d][iv] *supra*.

(n351)Footnote 351. Item 601(b)(22), Regulation S-K. Rule 12b-23(a)(3) provides that, except for information filed as an exhibit covered by Rule 12b-23, copies of any information or financial statement incorporated into a registration statement or report by reference, or copies of the pertinent pages of the document containing the information or financial statement, must be filed as an exhibit to the registration statement or report, except that a proxy or information statement incorporated by reference in response to Part III of Form 10-K need not be filed as an exhibit.

(n352)Footnote 352. Item 601(b)(23), Regulation S-K.

(n353)Footnote 353. Item 601(b)(24).

(n354)Footnote 354. Item 601(b)(31).

(n355)Footnote 355. Item 601(b)(32)(i). A certification furnished pursuant to Item 601(b)(32) will not be deemed "filed" for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act except to the extent that the registrant specifically incorporates it by reference. Item 601(b)(32)(ii).

(n356)Footnote 356. Item 601(b)(99)(iii). Earnings statements must be filed only where the statement was made available using methods other than including the information in another filing with the *Commission. Exchange Act Release No. 31,905, Fed. Sec. L. Rep. (CCH) P 85,111* (1993); *Exchange Act Release No. 35,113, Fed. Sec. L. Rep. (CCH) P 85,475* (1994).

(n357)Footnote 357. The filing of XBRL-related documents is relevant to electronic filers that participate in the voluntary XBRL program. Item 601(b)(100) of Regulation S-K. See also footnote 275.1 *supra*.

(n358)Footnote 358. See § 4.02[4] *supra*.

(n359)Footnote 359. Item 601(b)(2), Regulation S-K.

(n360)Footnote 360. Item 601(b)(3), Regulation S-K.

(n361)Footnote 361. Item 601(b)(4), Regulation S-K.

(n362)Footnote 362. Item 601(b)(9), Regulation S-K.

(n363)Footnote 363. Item 601(b)(10), Regulation S-K. In addition, for purposes of Form 10-K, a registrant must also file as material contracts any compensatory plan, contract, or arrangement adopted without the approval of security holders pursuant to which equity may be awarded, including options, warrants, or rights in which any employee participates, unless immaterial in amount or significance. Ordinary purchase and sale agreements, agreements with managers of stores in a chain organization, contracts providing for a laborer or salesmen's bonuses or payments to a class of security holders, any compensatory plan, contract or arrangement which by its terms is available to employees, officers or directors generally and which provides for the same method of allocation of benefits between management and non-management, any compensatory plan, contract, or arrangement if the registrant is a foreign private issuer that furnishes compensatory information on an aggregate basis, or any compensatory plan, contract, or arrangement if the registrant is a wholly-owned subsidiary of a company that is filing a report on Form 10-K or registering debt instruments or preferred stock which are not voting securities on Form S-2 maybe excluded. With the exception of management contracts, registrants need not file each individual director or officer's personal agreements under the plans unless necessary to an investor's understanding. Instruction 1 to Item 601(b)(10).

(n364)Footnote 364. Item 601(b)(11), Regulation S-K.

(n365)Footnote 365. Item 601(b)(12), Regulation S-K.

(n366)Footnote 366. Item 601(b)(13), Regulation S-K. The reports are not deemed "filed" as part of the filing except for portions expressly incorporated by reference in the filing. *Id.* If financial statements in the report have been incorporated by reference in the filing, the accountant's certificate must be manually signed in one copy. *Id.* If all or any portion of the annual or quarterly reports to security holders is incorporated by reference into any electronic filing, all, or such portion so incorporated, must be filed in electronic format as an exhibit. *Exchange Act Release No. 31,905, Fed. Sec. L. Rep. (CCH) P 85,111* (1993).

(n367)Footnote 367. Item 601(b)(14), Regulation S-K; see Exchange Act Release No. 47,235 (2003).

(n368)Footnote 368. If required pursuant to Item 304 of Regulation S-K. Item 601(b)(16), Regulation S-K. For a discussion of item 304 of Regulation S-K, see § 4.03(4) *supra*.

(n369)Footnote 369. Item 601(b)(18), Regulation S-K.

(n370)Footnote 370. Item 601(b)(21), Regulation S-K.

(n371)Footnote 371. These reports are required by Item 4 of Part I of Form 10-K, discussed in § 4.02[1][c][iv]

supra.

(n372)Footnote 372. Item 601(b)(22), Regulation S-K.

(n373)Footnote 373. Item 601(b)(23), Regulation S-K.

(n374)Footnote 374. Item 601(b)(24).

(n375)Footnote 375. Item 601(b)(31).

(n376)Footnote 376. Item 601(b)(32)(i). A certification furnished pursuant to Item 601(b)(32) will not be deemed "filed" for purposes of Section 18 of the Exchange Act, or otherwise subject to the liability of that section, and will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act except to the extent that the registrant specifically incorporates it by reference. Item 601(b)(32)(ii).

(n377)Footnote 377. Item 601(b)(33) of Regulation S-K.

(n378)Footnote 378. Item 601(b)(34) of Regulation S-K.

(n379)Footnote 379. This exhibit is for asset-backed securities. Item 601(b)(35) of Regulation S-K.

(n380)Footnote 380. Item 601(b)(99)(iii). Earnings statements must be filed only where the statement was made available using methods other than including the information in another filing with the *Commission. Exchange Act Release No. 31,905, Fed. Sec. L. Rep. (CCH) P 85,111* (1993); *Exchange Act Release No. 35,113, Fed. Sec. L. Rep. (CCH) P 85,475* (1994).

(n381)Footnote 381. The filing of XBRL-related documents is relevant to electronic filers that participate in the voluntary XBRL program. Item 601(b)(100) of Regulation S-K. See also footnote 275.1 *supra*.

(n382)Footnote 382. See § 4.02[4] *supra*.

(n383)Footnote 383. Include sales of required securities, as well as new issues, securities issued in exchange for property, services or other securities, and other new securities resulting from the modification of outstanding securities.

(n384)Footnote 384. If the sales of the securities were made in a series of transactions, the registrant may give this presentation using totals and periods that will reasonably convey the information required. Instruction 2 to Item 701, Regulation S-K.

(n385)Footnote 385. Item 701, Regulation S-K.

(n386)Footnote 386. Information is not required as to notes, drafts, bills of exchange, or bankers' acceptances that mature not later than one year from the date of issuance. Instruction 1 to Item 701, Regulation S-K.

(n387)Footnote 387. *Exchange Act Release No. 37,801, Fed. Sec. L. Rep. (CCH) P 85,852* (1996). As of January 1, 1999, Current Reports are no longer required to provide such information and the information will instead be provided under Item 5 of Form 10-K and Item 2 of Form 10-Q. *Exchange Act Release No. 39,668, Fed. Sec. L. Rep. (CCH) P 86,006* (1998). Compare to discussion in Section 4.02[3][j].

(n388)Footnote 388. Item 703(a), Regulation S-K. Exchange Act Release No. 48766 (2003).

(n389)Footnote 389. Item 5(c), Form 10-K. Exchange Act Release No. 48766 (2003).

(n390)Footnote 390. The instruction to Part (b)(1) of Item 703 states that all issuer repurchases, including those made pursuant to publicly-announced plans or programs and those not made pursuant to publicly-announced plans or

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programs, must be included. The registrant must also disclose, by footnote to the table, the number of shares purchased other than through a publicly-announced plan or program and the nature of the transaction. *Id.*

(n391)Footnote 391. Item 703(b) and Instruction 1 to Parts (b)(3) and (4) thereof, Regulation S-K.

(n392)Footnote 392. Instruction 2 to Item 703, Regulation S-K.

(n393)Footnote 393. The Commission rescinded most of the Guides for the Preparation and Filing of Registration Statements and Reports and designated the remaining *Guides as Securities Act and Exchange Act Industry Guides*, *Exchange Act Release No. 18,525, Fed. Sec. L. Rep. (CCH) P 3,760* (1982) and removed other *Guides in Exchange Act Release No. 37,262, Fed. Sec. L. Rep. (CCH) P 85,812* (1996).

(n394)Footnote 394. The Commission adopted the tenth section of Regulation S-K in 1991 to enhance the quality of information provided to investors in connection with transactions involving roll-ups of limited partnerships or similar entities. The rules included therein require heightened disclosure with respect to the fundamental changes and potential adverse effects arising from roll-up transactions, and the conflicts of interest, reasons for, alternatives to and fairness of such transactions. The rules also call for enhanced disclosure concerning valuation methods and additional pro forma financial statements. In order to highlight for investors the differing effects that roll-up transactions may have on investors in various partnerships, the rules require delivery of individual partnership prospectus supplements illustrating, among other things, the effects of the roll-up transaction on investors in each partnership. *Exchange Act Release No. 29883, Fed. Sec. L. Rep. (CCH) P 72,438* (1991). *See also Exchange Act Release No. 35,036, Fed. Sec. L. Rep. (CCH) P 85,459* (1994). The full text of the roll-up transaction rules appear in Primary Law Sourcebook, Vol. D, Section K.

(n395)Footnote 395. Items 1201-1208, Regulation S-K.

(n396)Footnote 396. Securities Act Release No. 33-8876, Exchange Act Release No. 34-56994 (December 2007).

(n397)Footnote 397. *Id.*

(n398)Footnote 398. *Id.* The revised rules integrate individual Regulation S-B disclosure items (other than Item 310) into Regulation S-K. *Id. See also § 4.03[1][f] supra.*

(n399)Footnote 399. *Id; see also* Rule 12b-2 of the Exchange Act.

(n400)Footnote 400. *Id.*

(n401)Footnote 401. Securities Act Release No. 33-8876, Exchange Act Release No. 34-56994 (December 2007).

(n402)Footnote 402. *Id.*

(n403)Footnote 403. *Id.*



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CHAPTER 4 Exchange Act Registration and Reporting Requirements

1-4 Federal Securities Exchange Act of 1934 § 4.04

AUTHOR: Brandon C. Parris, Andrew D. Thorpe

§ 4.04 Section 21E Statutory Safe Harbor for Forward-Looking Statements

The Private Securities Litigation Reform Act of 1995 "seeks to protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation." n1 The Act provides protections for companies that issue statements about their expected performance and erect hurdles for plaintiffs seeking to bring securities class actions.

From the point of view of a public company's day-to-day operations, the most significant part of the Act is the safe harbor for forward-looking statements. This is also among the most complex portions of the Act.

The Act adds a new Section 21E to the Exchange Act and an identical Section 27A to the Securities Act, in each case creating a safe harbor for certain written or oral forward-looking statements n2 made by any of the following persons:

- an issuer that, at the time the statement is made, is subject to the periodic reporting requirements of Section 13(a) or Section 15(d) of the Exchange Act; n3
- a person acting on behalf of such issuer; n4
- an outside reviewer retained by such issuer making a statement on the issuer's behalf; n5 or
- an underwriter with respect to information provided by such issuer or information derived from information provided by the issuer. n6

Excluded, however, from the protections of the safe harbor are forward-looking statements concerning the business or operations of an issuer if the issuer:

- within the three-year period preceding the statement was convicted of a felony or misdemeanor described in clauses (i) through (iv) of Section 15(b)(4)(B) of the Exchange Act; n7
- has been the subject of a judicial or administrative decree or order arising out of a government action that prohibits future violations of the antifraud provisions of the securities laws, requires the issuer to

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cease and desist from violating the antifraud provisions of the securities laws, or determines that the issuer has violated the antifraud provisions of the securities laws; n8

- makes the statement in connection with an offering of securities of a blank check company; n9
- issues penny stock; n10
- makes the statement in connection with a roll-up transaction; n11 or
- makes the statement in connection with a going private transaction. n12

Also excluded from the safe harbor are forward-looking statements included in financial statements prepared in accordance with generally accepted accounting principles n13 or that are made by an investment company, n14 in connection with a tender offer n15 or an initial public offering, n16 or in a beneficial ownership filing pursuant to Section 13(d). n17 Statements made by, or relating to an offering or the operations of, a partnership, limited liability company or direct participation investment program are also excluded from the protections of the safe harbor. n18

The safe harbor is designed to "enhance market efficiency by encouraging companies to disseminate forward-looking information." n19 The Conference Committee Report noted that many companies do not issue forward-looking information because they fear that they will be sued if their actual results do not meet their projections. n20

The safe harbor applies to any "forward-looking statements," n21 which for this purpose include written or oral statements that project financial performance (such as earnings, revenues, capital expenditures, dividends, and capital structure) or describe management's "plans and objectives" for future operations, including plans and objectives relating to the registrant's products and services. n22 The term "forward-looking statement" also includes a statement of future economic performance, including those contained in management's discussion and analysis of financial condition and results of operations, as well as any statement of the assumptions underlying or relating to any of the foregoing forward-looking statements. n23 Finally, the term includes any report issued by an outside reviewer to the extent the report assumes a forward-looking statement made by the issuer as well as other projections or estimates that may be specified under the rules or regulations of the Commission. n24

The safe harbor has two independent prongs. The first prong protects from liability any statement that is identified as a forward-looking statement if that statement is either "immaterial" n25 or is "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement." n26 Regardless of a company's or person's intent in issuing the statement or the state of mind of the person issuing the statement, a plaintiff's claim cannot proceed if the statement contains these "meaningful" cautions.

Section 21E recognizes that company officials often cannot accompany their oral remarks with the "meaningful cautionary statements" described above. For that reason, the Act will protect oral statements under the first prong of the safe harbor if the following requirements are met:

- the oral forward-looking statement is accompanied by a cautionary statement identifying the oral statement as a forward-looking statement and indicating that results may differ materially from those projected; and
- the oral forward-looking statement is accompanied by an oral statement identifying a "readily available" written document or portion thereof that contains additional information concerning factors that could cause actual results to materially differ from those contained in the forward-looking statement. n27 All documents filed with the Commission or otherwise "generally disseminated" are deemed to

qualify as readily available. n28

The second prong of the safe harbor protects companies from liability for forward-looking statements when the person or business entity making the statement did not issue the statements with "actual knowledge" that they were false or misleading. n29 Under preexisting law, defendants could be liable for "reckless" forward-looking statements. n30 Section 21E rejects this standard. Equally important, under this second, independent prong of the safe harbor, plaintiffs must prove "actual knowledge that the statement was false or misleading" *by the person* issuing the statement. n31 If the statement was issued by a business entity, plaintiffs must prove that the statement was made by or with the approval of an executive officer of that entity with "actual knowledge *by that officer* that the statement was false or misleading." n32

The safe harbor expressly dismisses any duty to update a forward-looking statement. n33 In addition, the Conference Report indicates that the safe harbor is not intended to replace the judicial "bespeaks caution" doctrine n34 or to foreclose further development of that doctrine by the courts. n35

Section 21E specifically authorizes the Commission to expand the safe harbor beyond the current statutory parameters. The Conference Report indicates that the new statutory safe harbor is intended to serve as a starting point and that Congress fully expects the Commission to continue its rulemaking proceedings in this area. Specifically, the Conference Report provides that the Commission "should, as appropriate, promulgate rules or regulations to expand the statutory safe harbor by providing additional exemptions from liability or extending its coverage to additional types of information." n36

FOOTNOTES:

(n1)Footnote 1. See Conference Report, H. Rep. No. 104369, 104th Cong., 1st Sess. (1995) ("Conference Report"), reprinted in the Primary Law Sourcebook, Volume C, Section I.

(n2)Footnote 2. The definition of "forward-looking statement" is contained in Section 21E(i)(1) of the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section F.

(n3)Footnote 3. Section 21E(a)(1).

(n4)Footnote 4. Section 21E(a)(2). Section 21E(i)(4) defines a person acting on behalf of an issuer as any officer, director or employee of the issuer.

(n5)Footnote 5. Section 21E(a)(3).

(n6)Footnote 6. Section 21E(a)(4).

(n7)Footnote 7. Section 21E(b)(1)(A)(i).

(n8)Footnote 8. Section 21E(B)(1)(A)(ii).

(n9)Footnote 9. Section 21E(b)(1)(B). The term "blank check company" is defined in Rule 419 promulgated under the Securities Act.

(n10)Footnote 10. Section 21E(b)(1)(C). The term "penny stock" is defined in Rule 3a51-1 promulgated under the Exchange Act.

(n11)Footnote 11. Section 21E(b)(1)(D). The term "roll-up transaction" is defined in Item 901(a) of Regulation S-K.

(n12)Footnote 12. Section 21E(b)(1)(E). "Going private transactions" are described in Rule 13e-3 promulgated under the Exchange Act.

(n13)Footnote 13. Section 21E(b)(2)(A).

(n14)Footnote 14. Section 21E(b)(2)(B).

(n15)Footnote 15. Section 21E(b)(2)(C).

(n16)Footnote 16. Section 21E(b)(2)(D).

(n17)Footnote 17. Section 21E(b)(2)(F).

(n18)Footnote 18. Section 21E(b)(2)(E).

(n19)Footnote 19. *See* Conference Report.

(n20)Footnote 20. *Id.*

(n21)Footnote 21. The Conference Report indicates that the term "forward-looking statement" adopted the Commission's present definition of the same term in Rule 175(c) with certain additions and clarifying changes. *See* Section 21E(i).

(n22)Footnote 22. Section 21E(i)(1)(A) and (B).

(n23)Footnote 23. Section 21E(i)(1)(C) and (D).

(n24)Footnote 24. Section 21E(i)(1)(E) and (F).

(n25)Footnote 25. Section 21E(e)(1)(A)(ii).

(n26)Footnote 26. Section 21E(e)(1)(A)(i). The Conference Report indicates that boilerplate warnings will not suffice as meaningful cautionary statements. Instead, the cautionary statements "must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement, such as, for example, information about the issuer's business." Conference Report. The Conference Report also indicates that the requirement that the cautionary statements identify "important" factors that could cause actual results to differ materially from those in the forward-looking statement was intended to mean that "the stated factors must be relevant to the projection and must be of a nature that the factor or factors could actually affect whether the forward-looking statement is realized." However, the safe harbor requires only that the cautionary statements identify important, but not all factors, that could cause results to differ from those projected.

The Conference Committee expects that the cautionary statements identify important factors that could cause results to differ materially but not all factors. Failure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor. The Conference Committee specifies that the cautionary statements identify "important" factors to provide guidance to issuers and not to provide an opportunity for plaintiff's counsel to conduct discovery on what factors were known to the issuer at the time the forward-looking statement was made.

The use of the words "meaningful" and "important factors" are intended to provide a standard for the types of cautionary statements upon which a court may, where appropriate, decide a motion to dismiss, without examining the state of mind of the defendant. The first prong of the safe harbor requires courts to examine only the cautionary statement accompanying the forward-looking statement. Courts should not examine the state of mind of the person making the statement. *Id.*

(n27)Footnote 27. Section 21E(c)(2).

(n28)Footnote 28. Section 21E(c)(3).

(n29)Footnote 29. Section 21E(c)(1)(B).

(n30)Footnote 30. *See e.g., Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) .

(n31)Footnote 31. Section 21E(c)(1)(B).

(n32)Footnote 32. *Id.*

(n33)Footnote 33. Section 21E(d).

(n34)Footnote 34. *See, e.g., In re Trump Casino Securities Litigation*, 7 F.3d 357 (3d Cir. 1993) .

(n35)Footnote 35. Conference Report.

(n36)Footnote 36. *Id.* Section 21E(g) provides that:

In addition to the exemptions provided for in this Section, the Commission may, by rule or regulation, provide exemptions from or under any provision of this title, including with respect to liability that is based on a statement or that is based on projections or other forward-looking information, if and to the extent that any such exemption is consistent with the public interest and the protection of investors.



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CHAPTER 4 Exchange Act Registration and Reporting Requirements

1-4 Federal Securities Exchange Act of 1934 § 4.05

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§ 4.05 EDGAR

On July 15, 1992, the Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system became operational and available, on a volunteer basis, to filers that had participated in the pilot program. The Commission adopted interim rules that required most documents processed by the Divisions of Corporation Finance and Investment Management to be filed electronically by direct transmission over the wire, or by diskette or magnetic tape. The releases setting forth the rules also contained "phase-in" schedules to bring registrants onto the EDGAR system, a process that began 1993. n1 Procedures were established for payment of filing fees, by both paper and electronic filers, to the Commission's lockbox at the Mellon Bank in Pittsburgh, Pennsylvania. n2

All registrants filing reports with the Commission, as well as third parties filing with respect to such registrants, are now required to make such filings electronically in EDGAR format on diskettes or magnetic tape or by wire transmission through the EDGAR system, n3 absent an exemption. n4

[1] Regulation S-T

The general rules and regulations for electronic filings are set forth in Regulation S-T, a separate regulation prescribing requirements and procedures for electronic filings. Reports under the Exchange Act must be filed in EDGAR format, n5 including the cover letter. The Commission rejects, and does not accept for filing, documents that are required to be filed electronically, but are instead delivered to the Commissioner in paper format unless the filing satisfies the requirements for a temporary or continuing hardship exemption under Rule 201 or 202 of Regulation S-T. n6

[2] Passwords

Each filer must have an assigned unique identification number (the "CIK"), obtained by filing Form ID with the SEC. The Form ID may be obtained from any office of the Commission and may be submitted by telefacsimile in emergency situations. In addition to the CIK number, which identifies the filer, each filer will have a confidential "Password," assigned by the Commission after Form ID is filed. The Password provides access to the EDGAR filing system, and need not be given to a filing agent, such as a financial printer, if one is used, as they will have their own Password. The registrant's Password may be changed only at login to the EDGAR system and only by the individual holding a confidential Password Modification Authorization Code. Passwords may also be changed by filing an amended Form

ID.

[3] Superseded Procedures and Requirements

Some existing procedural requirements are superseded by Regulation S-T due to the nature of electronic filing. These include submission of signatures, n7 inclusion of graphics, n8 and required number of copies. n9 Provisions relating to type size, fonts, and other legibility requirements do not apply to EDGAR filings, n10 nor do requirements relating to paper size, binding and sequential page numbering. n11

The Commission has committed itself to modernizing EDGAR in the coming years, making the system easier for filers to use and the documents more readable. As a result, the Commission's guidelines for filers have and will continue to evolve as the potential to include graphics, varied fonts, links to other documents, and means of transmission improve. In January 2006, for example, the Commission implemented its latest round of changes in EDGAR Release 9.3.

Changes to EDGAR include the addition of transmission to the system via the Internet and the elimination of other forms of transmission to the system previously permitted. EDGAR is now compatible with Windows operating systems and will soon phase out its compatibility with DOS-based software. In February 2005, the Commission announced a voluntary program which allows participants ("volunteers") to supplement their Commission filings by furnishing financial data on EDGAR as an exhibit using eXtensible Business Reporting Language ("XBRL"). n12 XBRL is a form of interactive data that allows for the creation of documents that are machine-readable. Interactive data tags all of the key financial facts to give investors quicker access to the desired information, which can then be manipulated in analytical tools. As of 2006, two dozen companies, representing more than \$1 trillion of market value, have joined the Commission's test group of volunteers and submit annual, quarterly and other reports with interactive data for a period of one year. Because of these and other similar changes, the Commission recommends that filers periodically consult the EDGAR Filer Manual for the latest technical requirements. n13

[4] Third-Party Filings

Third-party submissions, whether by entities or individuals, relating to an EDGAR filer must be submitted in electronic format.

[5] Exhibits

Exhibits to electronic filings must be filed in EDGAR format. n14 If long or complex exhibits are to be filed electronically for the first time, it is recommended that the conversion process be started substantially prior to the filing deadline to insure timely completion. An electronic filer may be granted a hardship exemption under Rule 202 of Regulation S-T for a document or portion thereof. n15 If the exemption is only granted for a limited time period and the registrant fails to submit an electronic copy within the specified time period, the registrant will be ineligible to use Forms S-2, S-3, S-8, F-2, and F-3. n16

[6] Penalties for Failure to File Electronically

Filing by a registrant in paper in violation of the EDGAR rules results in the registrant's ineligibility to use Securities Act forms n17 incorporating by reference Exchange Act reports, and the inability to incorporate the paper filing by reference. n18 The penalties cease when the violation is corrected.

[7] Document Conversion Assistance

Depending on availability of in-house personnel, many filers are relying on financial printers to convert word processing and accounting documents to EDGAR format. Several private companies provide training sessions on the conversion process for in-house personnel, and the SEC provides the EDGAR Filer Manual (available online) and a free

software program and extensive instructions to assist filers in converting documents to the EDGAR format.

FOOTNOTES:

(n1)Footnote 1. See *Exchange Act Release No. 31,905, Fed. Sec. L. Rep. (CCH) P 85,111* (1993) (general explanation of the EDGAR system); *Invest. Co. Act Release No. 19,284* (1993) (specific rules for investment companies and institutional investment managers under Section 13(f) of the Exchange Act); *Public Utility Holding Co. Act Release No. 25,746* (1993) (specific rules for public utility holding companies).

(n2)Footnote 2. *Exchange Act Release No. 31,908, Fed. Sec. L. Rep. (CCH) P 85,113* (1993) (relating to the payment of fees, pursuant to Rule 3-a of the Rules Relating to Informal and Other Procedures). Wire deposits can be made between 8:30 a.m. and 6:00 p.m., except on Saturdays, Sundays, and federal holidays. Instructions for the FEDWIRE format and examples can be found on the Internet at www.sec.gov/info/edgar/fedwire-new.htm examples. Filers should always request the "FED" reference number for a wire transfer since it will facilitate the tracing should a problem arise.

(n3)Footnote 3. Located on the Internet at: www.sec.gov/edgarhp.htm.

(n4)Footnote 4. *Exchange Act Release No. 42,712, Fed. Sec. L. Rep. (CCH) P 86,302* (2000).

(n5)Footnote 5. Rule 101(a)(iii) of Regulation S-T provides that statements, reports, and schedules filed with the Commission pursuant to Sections 13, 14, 15(d) or 16(a) of the Exchange Act must be filed electronically. Filers must submit Form 13F reports (including amendments to previously filed reports) electronically using either EDGAR submission type 13F-HR or 13F-NT, as appropriate. As a notable exception to electronic filing requirements, preliminary proxy statements for which confidential treatment is requested must be filed in paper format. Rule 101 is proposed to be amended. See *Exchange Act Release No. 7188, Fed. Sec. L. Rep. (CCH) P 85,639* (1995); *Exchange Act Release No. 35,991, Fed. Sec. L. Rep. (CCH) P 85,644* (1995); *Exchange Act Release No. 37,595, Fed. Sec. L. Rep. (CCH) P 85,831* (1996); *Exchange Act Release No. 38,800, Fed. Sec. L. Rep. (CCH) P 85,948* (1997); *Exchange Act Release No. 34,47809* (2003). Effective November 4, 2002, most filings made by foreign companies are required to be filed electronically. *Exchange Act Release No. 45,922 Fed. Sec. L. Rep. (CCH) P 86,640* (2002).

(n6)Footnote 6. Rule 14, Regulation S-T.

(n7)Footnote 7. Signatures for electronic filings are submitted in typed form rather than manual format. Item 302, Regulation S-T. A manually signed signature page (or other document adopting, acknowledging or authenticating the typed signature) must be retained by the electronic filer for a period of five years after the date of filing, and must be available for inspection by the SEC upon request. The manual signatures must be in place when the electronic filing is submitted.

(n8)Footnote 8. Filers can submit graphics and image material, but may not use graphic or image material to submit information such as text or tables. Instead, filers must submit such information as text in an ASCII document, or as text or an HTML table in an HTML document. In addition, EDGAR does not support the inclusion of graphics in modules and segmented filings. *Exchange Act Release No. 42,712, Fed. Sec. L. Rep. (CCH) P 86,302* (2000).

(n9)Footnote 9. Item 309(b), Regulation S-T. Item 402(l) of Regulation S-K has been amended so that supplemental paper copies of performance graphs included in proxy statements are no longer required to be filed, but should be maintained by the registrant for submission to the Commission staff if specifically requested.

(n10)Footnote 10. Item 308, Regulation S-T.

(n11)Footnote 11. Item 309(a), Regulation S-T.

(n12)Footnote 12. SEC Release 33-8529.

(n13)Footnote 13. The EDGAR Filer Manual is available from the SEC, which also provides, free of charge, a software program that is designed to assist in conversion of word processing documents into acceptable EDGAR format. The EDGAR Filer Manual is updated regularly. *See* Exchange Act Release No. 33-8656 (January 27, 2006).

(n14)Footnote 14. Exhibits previously filed in paper format may be incorporated by reference into an EDGAR filing to the extent otherwise permitted by the Rules of the SEC. *See* Item 102(a) of Regulation S-T. Exhibits previously filed in paper format may be amended by filing an amendment in electronic format, and the entire exhibit need not be converted to electronic format in order to file the amendment unless the exhibit is the articles of incorporation or bylaws, or other organizational document, or, in the case of a registered investment company or business development company, the exhibit is the investment advisory agreement. Item 102(a) and (c), Regulation S-T.

(n15)Footnote 15. The Commission's rules take into account the possibility that under certain circumstances, electronic filing may be difficult or impossible by allowing filers relief from electronic filing through hardship exemptions. *Exchange Act Release No. 39,269, Fed. Sec. L. Rep. (CCH) P 85,967* (1997).

(n16)Footnote 16. Note 3 to Item 202, Regulation S-T.

(n17)Footnote 17. *E.g.*, Forms S-2, S-3, S-8. *See* Note to Item 101(a) of Regulation S-T.

(n18)Footnote 18. Item 303(a)(1) of Regulation S-T.



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CHAPTER 4A The SEC and Accounting Standards

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§ 4A.syn Synopsis to Chapter 4A: The SEC and Accounting Standards

Scope

§ 4A.01 General Concepts of Accounting and Financial Statements

- [1] Financial Disclosure and the Securities Markets
- [2] Accounting Reports and Securities Valuation
- [3] Accounting Logic and Presentation of Financial Statements
 - [a] Balance Sheet and Financial Position
 - [b] Recording Events and Preparing a Balance Sheet
 - [c] Reporting Changes in Financial Position
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FOOTNOTES:

(n1)Footnote *.

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CHAPTER 4A The SEC and Accounting Standards

1-4A Federal Securities Exchange Act of 1934

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SUMMARY OF THIS CHAPTER

The determination of accounting standards in the United States is a function of cooperation between the Securities and Exchange Commission ("SEC" or "Commission") and the Financial Accounting Standards Board ("FASB"). In addition, professional bodies such as the American Institute of Certified Public Accountants ("AICPA"), large and small public accounting firms, SEC registrants, academics and even private litigants shape current accounting standards. Only with a genuine understanding of the (1) interaction among these rule-making bodies and (2) the resulting standards, can accountants fluently speak the language of business and fulfill their role in promoting efficient capital markets. Additionally, the above public and private domestic organizations have only recently begun the difficult task of breaking down barriers to effective and efficient financial communications with other countries, principally through the International Accounting Standards Board ("IASB"). The end result of these national and international financial accounting efforts should be an increase in the efficiency with which securities are priced over international markets.

Financial statements are a version of past and uncertain future events produced from accounting systems. From this perspective, it is little wonder that accounting is often referred to as "the language of business." The "grammar" of accounting is the logical rules by which accounting data is organized. Accounting policies determine where to apply that logic: which events to recognize, how to measure them in monetary terms, and how to present them in financial statements. Accounting is an analytical tool of enormous power when properly used; however, it does have its limitations. Ironically, accounting's biggest limitation is its very essence, namely, its focus on monetary phenomena. Accounting cannot measure all aspects of an entity's activity. However, accounting's ability to quantify a significant portion of an entity's overall activity is invaluable to the securities markets.



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CHAPTER 4A The SEC and Accounting Standards

1-4A Federal Securities Exchange Act of 1934 § 4A.01

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§ 4A.01 General Concepts of Accounting and Financial Statements

[1] Financial Disclosure and the Securities Markets

The markets for distribution of securities into public hands and the markets for continuous trading in outstanding securities, collectively referred to as the "securities markets," are said to be more or less efficient. A vital factor in their efficiency is the availability of timely, relevant, and accurate financial information. n1 In order to regulate the sale of securities in the national securities markets, the SEC requires issuers to disclose significant amounts of prescribed information, much of which is financial in nature. In fact, the SEC's stated objective is to assure the public availability in an efficient and reasonable manner and on a timely basis of reliable, firm-oriented information material to informed investment and corporate suffrage decision-makers. This goal, in a nutshell, is to make prices in securities markets more accurate, commonly referred to as "accuracy enhancement." n2 Thus, the more complete and accurate the information used by buyers and sellers in an efficient market, the more closely prices reflect underlying values and the more resources are allocated efficiently to uses that result in the highest benefit to society as a whole. Complete and accurate financial information is a key factor in this efficiency hypothesis.

The efficient market hypothesis is a description of the market as a whole and does not necessarily apply to individual securities or individual investors. The overall view is premised on the effort and skill of investors and their advisers in analyzing and using available information in an attempt to identify undervalued and overvalued securities.

"Accounting" is a specialized information service to periodically produce financial statements for an enterprise. In order to efficiently analyze and use the financial information available to the public, the individual investor or adviser must possess a working knowledge of accounting standards applicable to our securities markets. Advocates of the efficient market hypothesis contend that the market, as a whole, is quite sophisticated when interpreting accounting-based information, such as annual reports, quarterly reports, interim earnings, and dividend announcements. This level of sophistication--the ability to look past accounting changes that alter earnings but have no economic effect, the ability to recognize the effect of certain accounting assumptions and estimates, and the ability to assess the impact of managerial representations--is not widespread. In fact, certain investors and advisers will more effectively interpret available financial information, and act thereon, while others will not.

[2] Accounting Reports and Securities Valuation

The economics of investing in securities is premised on assessments of value. Value is, in turn, a function of subjective assessments of amount, uncertainty, and timing of *future* cash distributions from an issuer to its security holders. n3 The fundamental valuation task investment analysts undertake is to develop predictions of such future distributions. n4

These aforementioned cash distributions to security holders have as their source either: (1) return *of* invested capital, or (2) return *on* invested capital. The latter source is known as "earnings." Thus, a major part of the investment analysis task is the prediction of future earnings.

The primary purpose of financial reporting to investors and analysts is to provide information that will help them estimate the value of securities issued (or to be issued) by the firm. The utility of the information provided in financial reports is conditioned on the degree to which it is predictive of future events, reports recounts and/or summarizes past events, its usefulness to the investing community depends upon the degree to which this information is predictive of future events.

A large portion of financial reporting involves accounting information, which may be regarded as the information contained in financial statements and accompanying notes providing additional detail and explanations of accounting policies. Accounting information shares the general limitations of financial reporting, and is specifically limited in at least two significant respects:

1. They report earnings of past periods, not future periods.
2. The earnings reported are invariably not the economic earnings of the issuer. This is in large part due to the fact that the value of an enterprise may be seen to be the sum of the values of (1) its assets in place and (2) the value of its position to increase value via further asset investment. The relative proportions of these two components vary significantly across enterprises and time. Economic earnings for a period are a function the change in the value of the entity for the period. Our present systems of accounting fail to capture changes in value for many reasons, not least of which are the following:
 - a. Recognition--only assets that have been acquired in a past transaction and have highly probable future value are recognized.
 - b. Measurement--Assets are generally valued at lower of cost or net value to be realized through a hypothetical future sale. This is because objectivity and conservatism in asset valuation is generally preferred in practice to more subjective, yet more economically relevant market-based valuation.

The traditional reporting model centered around historical cost-based financial statements has been roundly criticized as lacking relevance for economic decision making. n5 One of the more obvious patterns of accounting standards to emerge over the past 15 years has been to move toward current value measurements of some assets and liabilities when current values can be determined with a high degree of reliability--such as marketable equity securities with a readily determinable market price--or when historic costs are not materially different from zero, but current values can be very significant--as with interest rate swap contracts and many other derivative financial instruments.

[3] Accounting Logic and Presentation of Financial Statements

[a] Balance Sheet and Financial Position

The starting point for accounting logic is the Fundamental Accounting Equation, stated for an entity as:

Assets = Claims

Where "assets" are economic resources at the disposal of the enterprise. n6

As mathematical expressions go, the Fundamental Accounting Equation is about as simple as it gets, yet its significance to accountants cannot be understated. It was first proposed by an Italian monk in a mathematical treatise over 500 years ago and has been universally accepted for centuries as the logical basis for accounting. The equation simply states that the total value of the claims on the assets of the business cannot be more or less than the total value of the assets--the two *must* be equal.

Before going further with accounting logic, a word of caution is in order. The irrefutable logic of the Fundamental Accounting Equation may lead one to regard accounting as a process whereby the whole truth about the financial position and performance of an enterprise is revealed. This is far from correct. Financial statements along with any accompanying notes should strive to be a *truthful* version of the past. But like any other version of past events, accounting cannot possibly capture the *whole* truth. The Fundamental Accounting Equation is better viewed as a constraint on the versions of the past that we may report in financial statements. In other words, it is a *requirement* that accounting information conforms to the Fundamental Accounting Equation, but this constraint, by itself, does not guarantee truth--or even truthfulness.

The Fundamental Accounting Equation is more commonly expressed as:

$$\text{Assets} = \text{Liabilities} + \text{Equities}$$

or equivalently

$$\text{Assets} - \text{Liabilities} = \text{Equities}$$

The purpose of expanding the claims component of the Fundamental Accounting Equation into two new components is to distinguish between two substantially different types of claims on assets:

- "Liabilities" are the creditors' claims on the assets of a business. For now, we may loosely think of them as contractual or legal claims on assets. Some of these claims may be for specific assets of the enterprise, but for the most part, they are general claims.
- In a business enterprise, "equities" are the ownership interests. They can arise in numerous ways, but are in essence a residual claim, usually seen to result from the legal precedence of creditors' claims on assets. This view is depicted by the second version of the above equation--the amount of assets that would remain after having settled all contractual claims.

[b] Recording Events and Preparing a Balance Sheet

Accountants record events seen to affect assets, liabilities and owners' equity in accounts. An account is simply a place where increases or decreases to a component of the Fundamental Accounting Equation are recorded. It could be a designated column of a worksheet, or a page in a book.

The balance of an account is the sum of the increases and decreases "posted" to the account. Exhibit 1 displays the accounts used by ABC Company in the form of worksheet columns, with their balances as of June 30, 2002. The collection of all the accounts comprising the components of the Fundamental Accounting Equation is called the general ledger.

1-4A Federal Securities Exchange Act of 1934 § 4A.01

Exhibit 1ABC Company Account Balances as of June 30, 20x2

Cash	Accounts Receivable	Supplies	Equipment	Accounts payable	Long-term Debt	Equity
8,000	10,000	1,500	8,000	1,500	-	26,000

This chapter will illustrate the basic procedures of recording transactions by considering the transactions taking place during the following month, July 20x2, for ABC Company:

1. Additional equity in the form of capital stock was issued for cash of \$5,000.
2. Cash of \$6,000 was collected from credit sales (i.e., accounts receivable) made during the previous year.
3. ABC company performed services for which they billed customers \$12,000. Of this amount, \$3,000 was paid in cash and \$9,000 was uncollected by the end of July.
4. Rent of \$1,000 was paid in cash, covering the use of the office space for the month.
5. No new supplies were purchased during the month, but \$1,200 was paid to suppliers in settlement of amounts owed them (i.e., accounts payable).
6. Dividends were paid to stockholders, totaling \$2,000 in cash.
7. Salaries to employees paid in cash were \$3,000.
8. \$10,000 was borrowed for ten years from a bank (a), and the entire proceeds of the loan were used to purchase additional equipment (b).
9. Depreciation on equipment was recorded in the amount of \$1,500.
10. A physical inventory of supplies taken at the end of the year indicates that \$900 of supplies remains. Therefore, \$300 of those supplies was used during the period.

In Exhibit 2, these events are recorded in the accounts. Recording transactions consistent with the accounting logic of the Fundamental Accounting Equation is sometimes called *double-entry bookkeeping*. This is because at least two accounts were affected by each transaction in order for the account balances to maintain the logic of the Fundamental Accounting Equation at all times.

Exhibit 2ABC Company Transactions for the Month Ended July 31, 20x2

Cash	Accounts Receiv- able	Supplies	Equipment	Accounts payable	Long-term Debt	Equity	
Bal., 6/30	8,000	10,000	1,500	8,000	1,500	-	26,000
1	+5,000						+5,000
Balance	13,000	10,000	1,500	8,000	1,500	-	31,000
2	+6,000	-6,000					
Bal-	19,000	4,000	1,500	8,000	1,500	-	31,000

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ance	+3,000	+9,000					+12,000
3							
Bal-	22,000	13,000	1,500	8,000	1,500	-	43,000
ance	-1,000						-1,000
4							
Bal-	21,000	13,000	1,500	8,000	1,500	-	42,000
ance	-1,200				-1,200		
5							
Bal-	19,800	13,000	1,500	8,000	300	-	42,000
ance	-2,000						-2,000
6							
Bal-	17,800	13,000	1,500	8,000	300	-	40,000
ance	-3,000						-3,000
7							
Bal-	14,800	13,000	1,500	8,000	300	-	37,000
ance	+10,000			-		+10,000	
8a	-10,000			+10,000			
8b							
Bal-	14,800	13,000	1,500	18,000	300	10,000	37,000
ance				-1,500			-1,500
9							
Bal-	14,800	13,000	1,500	16,500	300	10,000	35,500
ance			-300				-300
10							
Bal.,	14,800	13,000	1,200	16,500	300	10,000	35,200
7/31							

After each entry in the accounts, new balances have been calculated to illustrate that no event may be recognized in the accounts to cause the account balances taken as a whole to violate the logic of the Fundamental Accounting Equation. That is, each line of balances satisfies the Fundamental Accounting Equation (i.e., the sum of asset account balances equals the sum of equity account balances). A brief explanation of the accounting for each transaction follows:

1. The first transaction increases Cash, because cash was transferred from owners to the control of ABC Company. Owners' Equity is increased by the same amount, because investors' claim on the assets of the business has increased by the amount of their investment. Thus, the effect of the transaction is to increase both assets and equities by \$5,000.

2. Similar to the first entry we made, Cash has been increased. In this case, however, another asset was liquidated. ABC's claim to the cash of others has been settled, and is no longer a resource to the company. Thus, the increase to cash is offset by a decrease to Accounts Receivable. The effect of the transaction on the Fundamental Accounting Equation is to increase one asset account and to decrease another, resulting in no net effect on either total assets or total equities.

3. The assets Cash and Accounts Receivable are increased because they were acquired in exchange for providing services. Since ABC Company earned these assets, its owners claim them, and this is reflected in the accounts by increasing Owners' Equity. The effect on the Fundamental Accounting Equation is to

increase the assets Cash and Accounts Receivable, and to increase Owners' Equity by their sum.

4. Cash has been exchanged for services (the use of office space for one month). As this is a cost of doing business borne by the owners of ABC, Owners' Equity is decreased by the amount of cash paid.

5. Cash has been exchanged in settlement of a liability incurred for supplies purchased prior to 30[th] June. The effect on the Fundamental Accounting Equation is to decrease the asset Cash and to decrease the liability Accounts Payable.

6. Cash is decreased by the amount of the dividend, a transfer of cash from control of the ABC company to its owners. Owners' Equity is decreased by the same amount, because owners' claims on the assets of the business have decreased by the amount of the dividend they have received. Thus, the effect of the transaction is to decrease assets and owners' equity both by \$2,000.

7. Similar to #4, cash has been exchanged for services (in this instance, services of employees). As this is a cost of doing business that must be borne by the owners of ABC, Owners' Equity is decreased by the amount of cash paid.

8. The loan transaction (a) is accounted for by increasing Cash and increasing Long-Term Debt, a liability account. The acquisition of equipment decreases Cash and increases the Equipment (b). The net effect of the two transactions on the Fundamental Accounting Equation is to increase assets by the cost of the equipment purchased and to increase liabilities by the same amount.

9. Equity is decreased as a result of consumption of part of the service potential of an asset. The effect on the Fundamental Accounting Equation is to decrease Equipment and to decrease Owners' Equity.

10. In analyzing the effect on the Fundamental Accounting Equation, it may help to reconstruct the entries to the accounts that were made when the supplies were purchased. The Supplies account (an asset) was increased, and one of two other accounts were affected: either Cash was decreased, or a liability such as Accounts Payable was increased if the supplies had been purchased on credit. In either case, the actual use of the supplies in the current period will necessitate a decrease in Supplies for the cost of the supplies used during the year. Owners' Equity will also decrease from the consumption of the service potential of the supplies.

Exhibit 3 presents the original June 30th balance sheet along side the July 31st balance sheet derived from the latest ledger account balances. Comparative financial statements are common and enable a user to see how the financial position of the enterprise or other trends may be changing over time.

Exhibit 3ABC CompanyComparative Balance SheetsAs of June 30 and July 31, 20x2

ASSETS			LIABILITIES & EQUITY		
6/30/X2	7/31/X2	6/30/X2	7/31/X2		
Current As- sets	Current liabil- ities				
Cash	\$ 8,000	\$ 14,800	Accounts payable	\$ 1,500	\$ 300
Accounts re- ceivable	10,000				
Supplies	1,500	1,200	Non-current liabilities		

1-4A Federal Securities Exchange Act of 1934 § 4A.01

Total current assets	\$	19,500	\$	29,000	Long-term debt	- 10,000	
							0
Total liabilities	\$	1,500	\$	10,300			
Non-current assets		Equity 26,000		35,200			
Equipment	\$	8,000	\$	16,500			
Total assets	\$	27,500	\$	45,500	Total Liabilities & Equity	\$ 27,500	\$ 45,500
						0	

[c] Reporting Changes in Financial Position**[i] The Statement of Cash Flows**

We have referred to the balance sheet as the "principle" financial statement of a business, because of its direct relationship to the Fundamental Accounting Equation. The other financial statements we will examine simply detail the changes in balance sheet amounts (i.e., changes in financial position) from one point in time to another. For example, the statement of cash flows in Exhibit 4 provides the detail of the change in cash for the month of July 2002. Note that the last line of the statement agrees with the difference between the two cash balances on the comparative balance sheets in Exhibit 4 (i.e., $6,800 = 14,800 - 8,000$).

Exhibit 4ABC Company Statement of Cash Flows For the Month Ended 31 July 20x2

Cash from (used in) operating activities

Collections from customers	\$	9,000
Payments to suppliers	(1,200)	
Payments for rent	(1,000)	
Payments for salaries	(3,000)	

Net cash from (used in) operating activities	\$	3,800

Cash from (used in) investing activities

Purchase of equipment	(10,000)	

Net cash from (used in) investing activities	\$	(10,000)

Cash from (used in) financing activities

Proceeds from issuing capital stock	5,000	
Proceeds from incurring long-term debt	10,000	
Payment of dividends	(2,000)	

Net cash from (used in) financing activities	\$	13,000

Net increase (decrease) in cash	\$ 6,800

It may appear that there is no real point to preparing a statement of cash flows if its "bottom line" can be so easily derived from comparing two balance sheets. But even if the final line of a statement of cash flows does not contain incremental information, knowledge of the components of the change does. To further add value to the components of cash flows, they are classified by their having resulted from operating, investing or financing events.

A fundamental distinction between the balance sheet and the statement of cash flows (or for that matter, any financial statement that reports changes in financial position) is that a balance sheet reports stocks and changes in financial position are flows.

- A balance sheet may be seen as a "snapshot" of assets and equities at a point in time. For example, the amount for cash on June 30, 20x2 is the stock of cash as of that date. The amount for long-term debt on July 31, 20x2 can be regarded as the stock of claims on the assets of the ABC Company that come due later than one year from this date. Since all the amounts on the balance sheet should be seen as stocks, balance sheets are dated as of a specific moment in time.

- The items on the statement of cash flows are, as the name of the statement implies, "flows" of cash over time. In fact, the change in any balance sheet category may be seen as a flow of some fund of resources or obligations. Since flows occur over an interval, or period, of time, the date reference on the statement of cash flows is an interval of time. In this case, that period is the month spanning the comparative balance sheets in Exhibit 3

[ii] The Income Statement

An income statement, like a statement of cash flows, describes flows in balance sheet amounts over a period of time. Unlike the statement of cash flows, however, the flows described by the income statement are not all of the flows occurring in a single balance sheet category (e.g. cash). Actually, the income statement summarizes a subset of equity flows occurring over a period of time. By referring to Exhibit 5 we can see that all changes in owners' equity of the ABC Company occurred as the result of four kinds of events. Two of these event types, "income" and "expenses", are reported as components of net income--i.e., profit--in the income statement:

1. Some person or enterprise will transfer the control of resources to the ABC Company, usually in exchange for some reason other than services rendered--usually for some form of equity interest. Transactions of this nature are often referred to as "capital contributions" (Transaction #1).
2. ABC Company sells products or services, usually (but not exclusively) in exchange for cash or the promise to pay cash in the future. These activities generate "revenue" (Transaction #3).
3. ABC sacrifices resources as part of the process of generating revenues. This class of events is known as "expenses" (Transactions #4, #7, #9, #10).
4. ABC distributes resources to its owners (e.g. capital stockholders, in the case of a corporation). The source of these distributions is seen to be from either (a) the earnings of ABC, or (b) a return of the capital stockholders' past investments. Corporations frequently distribute resources to equity holders in

the form of "dividends" (Transaction #6).

The first two of these general effects described above increase equity, and the second two decrease equity. Only the second and third--resulting from transactions with non-owners--are captured in an income statement. These relationships are depicted schematically in Exhibit 5. Exhibit 6 presents the July income statement for ABC Company.

[Click here to view image.](#)

Exhibit 6 ABC Company Income Statement For
the Month Ended 31 July 20x2

Sales revenue	\$	12,000
Expenses		
Rent	1,000	
Supplies	300	
Depreciation	1,500	
Salaries	3,000	
Total expenses	\$	5,800
Net income	\$	6,200

A statement of changes in owners' equity is often presented to "reconcile" all of the changes in owners' equity with their beginning and ending balances. Exhibit 7 presents such a statement for ABC Company.

Exhibit 7 ABC Company Statement of Changes in Equity-
For the month ended 31 July 20x2

Equity, 30 June 20x2	\$	26,000
Net income	6,200	
	0	
Investments	5,000	
	0	
Dividends	(2,000)	
Equity, 31 July 20x2	\$	35,200

FOOTNOTES:

(n1)Footnote 1. See FASB, *Modern Capital Market Theory: Tentative Conclusion on Objectives of Financial Statements of Business Enterprises* (1976).

(n2)Footnote 2. Advisory Committee on Corporate Disclosure, *Report to the Securities and Exchange Commission* 305 (Comm. Print 95-29 1977).

(n3)Footnote 3. Issuers may distribute assets besides cash to its security holders, but for simplicity and without any loss of generality, it is assumed in this chapter that only cash may be distributed.

(n4)Footnote 4. Many distributions take the legal form of dividends (or interest in the case of debt securities), but other transactions are economically equivalent from a firm valuation perspective: e.g., so-called "treasury stock" purchases. Cash flows in the other direction, such as stock issuances, e.g., purchases of treasury stock.

(n5)Footnote 5. The Accounting Profession--Major Issues: Progress and Concerns, (GAO/AIMD-96-98), pp. 15-18, September 1996 (citing several findings of the Jenkins Committee). See *Improving Business Reporting--A Customer Focus: Meeting the Information Needs of Investors and Creditors*, Comprehensive Report of the Special Committee on Financial Reporting (Jenkins Committee), AICPA 1994.

(n6)Footnote 6. Our use of terminology in this portion of the chapter is intended to be informal to keep the focus on basic concepts.



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CHAPTER 4A The SEC and Accounting Standards

1-4A Federal Securities Exchange Act of 1934 § 4A.02

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§ 4A.02 Sources of Definitive Accounting Rules

[1] General

Accounting rules are not contained in one place, n1 and different sets of rules apply to different companies. For example:

- SEC accounting rules applicable to registrants under various securities laws do not apply in the same way to non-public companies.
- SEC registrants who qualify to be foreign private issuers n2 are allowed to prepare the primary financial statements filed with the Commission in accordance with a comprehensive body of GAAP other than U.S. GAAP. To assist U.S. investors in understanding the nature of the accounting differences and their effects on financial statements, foreign issuers are required to provide a reconciliation to U.S. GAAP. n3

Additionally, once found, accounting rules often allow several different forms of accounting treatment for the same economic event, and on occasion, remain silent with respect to the treatment of other transactions. It is particularly interesting, and controversial, that as a result of SEC policy the accounting profession itself has by and large set its own rules rather than having rules set for it by legislative or administrative bodies. n4

[a] Securities Law Administered by the SEC

One of the major deficiencies in U.S. capital markets noted by the Senate Banking and Commerce Committee prior to the passage of the Securities Act of 1933 ("Securities Act") was the high variance in the quality of financial statements used to sell securities. Financial statements frequently were misleading, lacked consistency and comparability. A significant concern was that misleading financial statements were a major contributor to overvalued stocks, which may have contributed to the Crash of 1929.

1-4A Federal Securities Exchange Act of 1934 § 4A.02

Section 19 of the 1933 Act, as amended, delegates to the SEC the power to make rules and regulations necessary to carry out the provisions of the Act, including the power to prescribe "the items or details to be shown in the balance sheet and earning statement, and the methods to be followed in the preparation of accounts..." for companies who file financial statements with the SEC. Thus, the SEC has long been the final authority on accounting principles used in the preparation of financial statements by public companies in the United States.

The provisions of Section 19 of the 1933 Act, giving the SEC the power to establish accounting rules are repeated in the Securities Exchange Act of 1934 (Exchange Act) in Section 13, which also requires public companies to file "periodic" and current reports with the SEC. Section 13 was amended in 1977 by the Foreign Corrupt Practices Act, which is intended to control questionable or illegal foreign payments by U.S. companies. Section 13(b)(2) of the Exchange Act requires that every company subject to the continuous reporting requirements of the Act shall (a) keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer, and (b) maintain a system of internal accounting controls sufficient to provide reasonable assurances that financial statements are free from material misstatements.

Interstate holding companies engaged, through subsidiaries, in the electric utility business or in the retail distribution of natural or manufactured gas are subject to regulation under the Public Utility Holding Company Act (PUHCA).ⁿ⁵ The Securities Act and Exchange Act deal with the securities markets generally and are not able to address the special problems that arose in the public utilities industry.ⁿ⁶

Public utilities must register with the SEC and file initial and periodic reports. The accountant's function is to certify the financial statements and financial data within such reports.ⁿ⁷ Accountants need to pay attention to the Uniform System of Accounts for Public Utility Holding Companies and the Uniform System of Accounts for Mutual Service Companies and Subsidiary Companies. These systems, promulgated by the SEC, represent the only two instances where the SEC has dictated the detailed manner in which accounts shall be kept. Detailed information concerning the organization, financial structure, and operations of the holding company and its subsidiaries is contained in these reports. Thus, there has been a significant increase in non-utility subsidiaries and repeal has been suggested for a number of years premised on the belief that the work of PUHCA has been largely completed. In 2003, there were 28 registered public utility holding company systems, with 150 public utility subsidiaries.ⁿ⁸

The registration process under PUHCA requires disclosure of the company's operations including a description of its management structure. Unlike the Securities Act and the Exchange Act, the thrust of PUHCA is not limited to disclosure. In addition, the SEC has special accounting rules for regulated holding companies.ⁿ⁹ Interpretive releases relating to PUHCA are periodically issued by the SEC.ⁿ¹⁰

The Trust Indenture Act (TIA) applies to bonds, debentures, notes, and similar debt securities offered for public sale and issued under trust indentures with more than \$1 million of securities outstanding at any one time.ⁿ¹¹ The TIA, designed to safeguard the rights and interests of the purchasers, also imposes various informational and disclosure requirements. The TIA is aimed to fill gaps left by other securities acts concerning the relationship between the debt securities issuer and the indenture trustee.

Section 308 of the TIA provides for integration of the information requirements with those of the Securities Act and the Exchange Act, as well as with the PUHCA. This integration is facilitated by permitting incorporation by reference to filings under the other acts.ⁿ¹²

Activities of companies engaged primarily in investing, reinvesting, and trading securities, and whose own securities are offered to the investing public, are subject to certain statutory prohibitions and to SEC regulation under the Investment Company Act (ICA).ⁿ¹³ The ICA has numerous registration, disclosure, and anti-fraud provisions meant to protect the investing public by requiring information relating to the issuer's policies and activities. Since investment company securities must also be registered under the Securities Act, investment companies must file initial and periodic financial

reports. n14

The public accountant's function thereunder is to certify the required statements and schedules and to make periodic examinations of the securities in the custody of the company or in the custody of a member of a national securities exchange.

The Investment Advisers Act of 1940 (IAA) establishes a pattern for the regulation of investment advisers. n15 These investment advisers may be non-broker-dealers who are not regulated under the Exchange Act provisions. In some respects, the IAA has provisions similar to the Exchange Act provision which govern the conduct of brokers and dealers. With some exceptions, the IAA requires that persons or firms compensated for advising others about securities investment must register with the SEC, file periodic reports, and conform to statutory standards designed to protect investors. n16 Pursuant to Rule 206(4)-2 under the IAA, an independent public accountant is required to verify, at least annually, funds or securities in the custody of the investment adviser in which any of his or her clients have a beneficial interest. A related certificate, prepared by the accountant, is then promptly filed with the SEC following the examination.

[b] SEC Accounting Rules and Regulations

The SEC has historically delegated its responsibility to set accounting standards for public companies to private sector accountants. Beginning in 1938, the SEC affirmed its policy of looking to private standard setting bodies designated by the Council of the American Institute of Certified Public Accounts (AICPA) as being authoritative. Since late 1973, the body designated to establish accounting standards has been the Financial Accounting Standards Board. However, the Commission has not committed itself to blanket acceptance of FASB pronouncements. It reserves the option to not accept a pronouncement in a particular area--although such events have been rare. The Commission frequently uses its authority to address those areas of accounting where rules are not explicit and there is a need for interpretive guidance, or there is a need for an authoritative source of requirements. n17

The primary SEC activities on the accounting front, designed to achieve compliance with the accounting and financial disclosure requirements of the federal securities laws, include:

- rulemaking and interpretations that supplement private-sector accounting standards, implements financial disclosure requirements, and establishes independence criteria for accountants;
- the review and comment process for agency filings directed to improving disclosures in filings, identifying emerging accounting issues (which may result in rulemaking or private sector standard-setting), and identifying problems that may warrant enforcement actions;
- enforcement actions that impose sanctions and serve to deter improper financial reporting by enhancing the care with which registrants and their accountants analyze accounting issues; and
- oversight of private sector efforts, principally by the FASB and the PCAOB, which establish accounting and auditing standards designed to improve financial accounting and reporting and the quality of audit practice. n18

The SEC communicates its positions on accounting rules by various means, including Regulation S-X, Financial Reporting Releases (FRRs), Staff Accounting Bulletins (SABs), and Accounting and Auditing Enforcement Releases (AAERs).

[2] The Public Sector

[a] Regulation S-X

The SEC's principal accounting requirements are embodied in Regulation S-X, n19 which governs the form and content of financial statements required to be filed with it. n20

The provisions of Regulation S-X apply to:

- registration statements under the Securities Act of 1933;
- registration statements under Section 12, annual and other reports under Sections 13 or 15(d), and proxy and information statements under Section 14 of the Exchange Act;
- registration statements and annual reports filed under the Public Utility Holding Company Act of 1935; and
- registration statements and annual reports filed under the Investment Company Act of 1940.

Regulation S-X's articles are conveniently organized according to the subject matter in question:

- Article 1 concerns the overall application of Regulation S-X and contains two rules.
- Article 2 concerns the qualifications and reports of accountants and consists of six rules.
- Article 3, a lengthy and commonly referenced section, deals with the general instructions as to financial statements and contains 21 rules.
- Article 3A, entitled "Consolidated and Combined Financial Statements," contains five rules. The periods to be covered by financial statements are three fiscal years for audited statements of income and cash flow (Rules 3-02 and 3-04) and as of the end of two fiscal years for audited balance sheets (Rules 3-01 and 3-03). The requirement that income statements and statements of cash flow be provided for three years is to enable users and advisers to analyze and understand a company's results of operations for at least the two most recent fiscal years. To understand changes in operations for one year, information for the immediately preceding year is needed. Therefore, comparative information for three years is necessary to understand changes in operations for two years.
- Article 4, consisting of ten rules, addresses the presentation-related rules of general application. Article 4 of Regulation S-X contains the rules of general application, including such matters as form, order, and terminology (Rule 4-01); items not material (Rule 4-02); current assets and current liabilities (Rule 4-05); evidences of indebtedness (Rule 4-06); general notes to financial statements (Rule 4-08); and financial accounting and reporting for oil and gas producing activities (Rule 4-10). n21 Further, Rule 4-01(a) requires an issuer or registrant to furnish "such further material information as is necessary to make required statements, in light of the circumstances under which they are made, not misleading" in addition to information explicitly required in all statements filed with the SEC.
- Article 5 deals with commercial and industrial companies and contains only four rules.
- Article 6 deals with registered investment companies and consists of ten rules.
- Article 6A, comprised of five rules, concerns employee stock purchase, savings, and similar plans.

- Article 7, entitled "Insurance Companies," contains five rules.
- Article 9 concerns bank holding companies and consists of seven rules.
- Articles 10 and 11, dealing respectively with interim financial statements and pro-forma financial information, contain only a few rules. Article 10 of Regulation S-X that contains uniform instructions as to the form and content of interim financial statements and the rules governing the periods to be covered by financial statements in the quarterly report filed on Form 10-Q.
- Finally, Article 12 addresses the form and content of schedules and contains 30 detailed rules. n22

[b] Financial Reporting Releases

Prior to 1982 the SEC issued 307 Accounting Series Releases (ASRs). n23 These releases are opinions of the SEC or its Chief Accountant relating to major accounting and auditing questions or to administrative policy concerning financial statements and certain other material of importance to accountants. Some of the releases were announcements of proposals to adopt amendments to Regulation S-X, while other releases announced the adoption of amendments or enforcement actions. With Financial Reporting Release (FRR) No. 1, the SEC codified the relevant guidance on accounting and auditing matters contained in the approximately 200 non-enforcement ASRs issued since 1937. The Financial Reporting Codification (FRP) n24 has been periodically updated by new Financial Reporting Releases (FRR's). A topical index is also published and updated by new FRRs, or to delete prior ASRs or FRRs. As of May 2004, 73 FRR's have been issued.

[c] Staff Accounting Bulletins

In November of 1975, the SEC authorized the Division of Corporation Finance and the Office of the Chief Accountant to publish a series of Staff Accounting Bulletins (SABs). The purpose of the SABs is to make available to the public a compilation of certain existing staff interpretations and practices and provide a means by which new or revised interpretations and practices can be quickly and easily communicated to registrants and their advisers. Thus, the SABs should not only reduce the staff's workload by eliminating repetitious comments and inquiries, but should save registrants both time and money in the registration and reporting process. n25 The statements in the SABs are not rules or interpretations of the SEC nor do they bear the SEC's official approval.

A table of contents and index by subject matter and citation reference is published and periodically updated. The SABs may be referred to by the SEC and others either by their sequential number (as of December 31, 2004 the highest numbered SAB was No. 106) or by their alphanumeric designation in the topical index (e.g., SAB Topic 4B).

The SABs are not rules or interpretations of the SEC and do not carry the SEC's official approval. However, SABs are generally followed in practice and for all practical purposes, departure from their provisions should be regarded with substantially the same concern as departures from rules and regulations promulgated by the SEC. n26

[d] Accounting and Auditing Enforcement Releases

Accounting and Auditing Enforcement Releases (AAERs), a separate body of public information, announce SEC enforcement activities involving accountants and auditors. All of these public interest items should be referenced when evaluating accounting and auditing issues.

[3] The Private Sector

[a] The American Institute of Certified Public Accountants

The AICPA is a national organization whose numerous committees and publications have been extremely influential in the development of accounting principles, standards of auditing, and a code of ethics within the profession. Until relatively recently, the AICPA, in some respects, was analogous to the legal profession's American Bar Association. n27 However, the influence of the AICPA has gradually waned with the advents of the FASB in 1974 and PCAOB in 2002 as the principal private-sector rule maker for accounting and auditing respectively.

The AICPA has published definitive pronouncements on accounting principles since 1938. Primarily as a result of external pressures, the American Institute of Accountants (AIA), later to become the AICPA, created a committee in 1930 to cooperate with the New York Stock Exchange (NYSE) in creating standards for accounting procedures. The widespread growth in the activities of the NYSE had led to expanded ownership and trading activities by an underinformed public. This lack of information, coupled with the stock market crash of 1929, caused the accounting profession to become more involved in the concept of generally accepted accounting principles. Although the profession had made previous contributions toward creating uniform accounting standards prior to 1930, the creation of this committee was unique due to its recognition that complexities in business activities and in ownership dispersion required consistency in accounting measurements and in the selection of accounting procedures. This special committee recommended five rules to the NYSE which were later published as Accounting Research Bulletin (ARB) No. 1 of the Committee on Accounting Procedure.

The Committee on Accounting Procedure published 51 such bulletins until 1959, including Accounting Research Bulletin No. 43 which consolidated Bulletins No. 1-42. The Committee's method of operation came into question in the late 1950s as the need for research into accounting principles became obvious. The result thereof was the creation and succession of the Accounting Principles Board (APB) in order to promulgate principles, through opinions and interpretations, based primarily on the research of the Accounting Research Division (ARD). The ARD was charged to undertake extensive research, publish the results, and allow the APB to lead the discussions which would ensue concerning accounting principles and practices. The APB's authority was enforced primarily through prestige and Rule 203 of the AICPA's Code of Professional Ethics. Approval by the SEC of the APB's issuances gave additional legitimacy to its activities. During the APB's 14 years of existence, 31 opinions and four statements were issued. In reality, the APB acted independently and did not utilize the ARD and issued pronouncements in areas where little research had been done. Likewise, the ARD acted independently and often performed non-exhaustive research. In the end, the APB did not materially differ from its predecessor, the Committee on Accounting Procedure.

The AICPA's Accounting Standards Executive Committee (AcSEC) is the senior technical committee authorized to make public statements on behalf of the AICPA on financial accounting and reporting standards, and may do so without prior clearance of either the AICPA Council or Board of Directors. It was formed by the AICPA in 1973 and consists of fifteen members of the AICPA.

The AcSEC issues pronouncements, known as Statements of Position (SOPs), to guide preparers and auditors of financial statements and to influence the development of reporting and accounting standards in the direction that the AcSEC believes to be in the public interest.

The AcSEC also maintains liaisons and has established procedures for coordinating activities with the FASB and SEC. As of November 2002, the AICPA has agreed to focus on industry-specific accounting guidance and all SOPs are subject to clearance by the FASB.

[b] Financial Accounting Standards Board ("FASB")

In 1972, as a result of the conclusions of the Wheat Study Group, the Financial Accounting Standards Board (FASB) was formed. As a result of the FASB's statements and interpretations, users and advisers now have access to the most definitive standards of generally accepted accounting procedures concerning a broad area of topics. As of January 31, 2005, the FASB has issued 153 Statements on Financial Accounting Standards, n28 various Interpretations and

Technical Bulletins, and has devoted substantial resources towards developing a conceptual framework for financial accounting.

The FASB consists of seven full-time members with diverse backgrounds. This diversity is demonstrated by three members from public accounting, two from private industry, and one each from academia and government. The FASB is assisted by a staff of professionals who conduct research and work directly with the members. Although there is some controversy and disagreement as to its activities and pronouncements, the FASB continues to operate with the confidence of accounting practitioners, business organizations, the SEC, and most importantly, the public.

The authority of the FASB is buttressed by Rule 203 of the AICPA Code of Professional Ethics, which all members of the AICPA must observe. Rule 203 requires AICPA members to treat pronouncements of the FASB, as well as outstanding and effective pronouncements of its two predecessors, as generally accepted accounting principles.

[c] Emerging Issues Task Force of the FASB

The Emerging Issues Task Force (EITF) was formed in 1984 in response to the recommendations of the FASB's task force on timely financial reporting guidance. The EITF was designed to promulgate implementation guidance within the framework of existing authoritative literature to reduce diversity in practice on a timely basis by addressing narrow implementation, application, or other emerging issues that can be analyzed within existing GAAP.

Task Force members are drawn from a cross section of the FASB's constituencies, including auditors, preparers, and users of financial statements. The chief accountant or the deputy chief accountant of the SEC attends Task Force meetings regularly as an observer with the privilege of the floor. Similar privilege is granted to the chairman of the Accounting Standards Executive Committee (AcSEC). FASB Board members also attend EITF meetings and participate in the discussion.

A consensus on an EITF issue is reached if no more than three of the voting members present at the meeting object to a proposed position on an issue. Although FASB Board members do not vote on consensus at Task Force meetings, all consensus are subject to ratification by the FASB at an ensuing open public meeting of the Board. Consensus are ratified if no more than three Board members object.

EITF Abstracts is a summary of the proceedings of the Task Force and includes a separate abstract for each issue considered by the EITF since its inception, plus a topical index. Through 2004, the EITF has published nearly 500 abstracts, and has reported reaching a consensus on a vast majority of the issues it has published.

FOOTNOTES:

(n1)Footnote 1. However, fee-based services exist that integrate many of the various sources in an online, searchable database.

(n2)Footnote 2. As defined in Rule 405 of SEC's Regulation C.

(n3)Footnote 3. See Instruction 3.A, Items 17 and 18 of Form 20-F.

(n4)Footnote 4. The Sarbanes-Oxley Act of 2002, among other provisions, establishes the Public Accounting Oversight Board ("PCAOB"). Despite its name, PCAOB, promulgates auditing standards and oversees the independence of auditors of public companies.

(n5)Footnote 5. Pub. L. No. 74-333, 49 Stat. 803 (1935), codified, as amended, at 15 U.S.C. §§ 79a et seq.

(n6)Footnote 6. Hazen, *Treatise on the Law of Securities Regulation*, vol. 3, p. 119 (3rd ed.) (West Publishing Co.).

(n7)Footnote 7. As a practical matter, most accountants prefer that their reports be referred to as reports or opinions. This preference assumes that the term "certificate" implies a degree of exactness which is arguably not present in financial statements. The SEC accepts all three of the designations.

(n8)Footnote 8. 69th Annual Report of the SEC.

(n9)Footnote 9. *See 17 C.F.R. §§ 256.00-1 et seq.*

(n10)Footnote 10. A list of these releases can be found at *17 C.F.R. Part 251*.

(n11)Footnote 11. *15 U.S.C. §§ 77aaa et seq.*

(n12)Footnote 12. *15 U.S.C. § 77hhh(a).*

(n13)Footnote 13. *15 U.S.C. §§ 80a et seq.*

(n14)Footnote 14. *See 15 U.S.C. § 80a-29. See also Hazen, Treatise on the Law of Securities Regulation*, at 212-219. For detailed information on registration of investment company securities, see *Federal Securities Act of 1933*, Chapter 7B (Matthew Bender & Co.).

(n15)Footnote 15. *15 U.S.C. § 80b-1 et seq.*

(n16)Footnote 16. *15 U.S.C. § 80b-4. See Hazen, Treatise on the Law of Securities Regulation*, at 245-47.

(n17)Footnote 17. The Chief Accountant is the principal adviser to the SEC on accounting and auditing matters arising from the administration of the various securities laws. Actually, three SEC staff members have the phrase "chief accountant" in their title: Chief Accountant, Division of Corporation Finance; Chief Accountant, Division of Enforcement; and Chief Accountant to the Commission, and they work closely together, but the third mentioned here is the principal adviser to the SEC on accounting and auditing matters.

(n18)Footnote 18. 59th Annual Report of the SEC for fiscal year ended September 30, 1993, p. 58.

(n19)Footnote 19. *17 C.F.R. Part 210, available at the SEC's Web site at << www.sec.gov/divisions/corpfin/forms/regsx.htm >>.*

(n20)Footnote 20. Regulation S-X, together with the generally accepted accounting principles promulgated by the profession's standard-setting bodies, and opinions issued by the SEC as Accounting Series Releases ("ASRs") or Financial Reporting Releases ("FRRs"), govern the form and content of most of the financial statements filed with the SEC.

(n21)Footnote 21. *See Exch. Act Rel. No. 34-15108 (1978)*, in which the SEC announced the adoption of *17 C.F.R. § 210.3-18* governing the requirements for financial accounting and reporting practices for oil and gas activities. *See also Exch. Act Rel. No. 34-15416 (1978) and Exch. Act Rel. No. 34-16218 (1979).*

In Accounting Series Release No. 289 (1981), the SEC announced that it no longer considers reserve recognition accounting as a potential method of accounting in primary financial statements. Consequently, the FASB is planning to develop supplemental disclosures to cure the inadequacies of the full cost and successful efforts methods of accounting, the two historical-cost accounting methods currently permitted by Rule 3-18 for oil and gas producing companies. *See also Oil and Gas Accounting* (based on the 14th Annual Institute on Oil and Gas Accounting) (Matthew Bender & Co.).

(n22)Footnote 22. For a thorough review of Regulation S-X and its related rules, as well as the impact of SEC releases, see *Fed. Sec. L. Rep. (CCH) P 69,501 et seq.*

(n23)Footnote 23. ASRs are found in 17 C.F.R. Part 211, Subpart A, and may be obtained free of charge, if in stock, from the SEC's Publications Section in Washington, D.C. ASRs are also reproduced in Fed. Sec. L. Rep. (CCH) P 72,001 et seq.

(n24)Footnote 24. Exch. Act Rel. No. 34-18648, Fed. Sec. L. Rep. (CCH) P 72,401 (1982). Accounting and Auditing Enforcement Release (AAER) No. 1 includes a topical index to those ASRs not included in the financial reporting codification but that contain explanations of the SEC's views on accounting and auditing matters that have given rise to SEC enforcement actions. The topical index is intended to facilitate reference to the ASRs but is not a comprehensive representation of the SEC's views on these enforcement-related matters. In addition, the issuance of the topical index has no effect on the legal status of the ASRs to which it refers.

(n25)Footnote 25. 42nd Annual Report of the SEC, for fiscal year ending September 30, 1976, p. 32.

(n26)Footnote 26. SAB Nos. 1 through 38 have been superseded by SAB No. 40, Fed. Sec. L. Rep. (CCH) P 74,040 (January 23, 1981), that revises, updates, and codifies the material included therein. Additionally, in 1982, the SEC published SAB No. 46, a revised topical index collecting the effect of all actions to date on the SAB series. In 2003, the SEC published SAB No. 103 to once again update the codification and eliminate obsolete accounting guidance due to either the passage of time or superseding guidance from other sources.

(n27)Footnote 27. Wixon, Kell, and Bedford, Accountant's Handbook, p. 10 (5th ed. 1970).

(n28)Footnote 28. The FASB has recently begun a practice of issuing new standards on previously-addressed issues by issuing a revised version of a standard bearing the old number. For example, in December 2004, the FASB revised and re-titled Statement No. 123 from "Accounting for Stock-Based Compensation" to "Share-Based Payment."

(n29)Footnote 29. Rule 203 of the AICPA Code of Professional Ethics, concerning accounting principles, provides that a member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an accounting principle promulgated by the body designated by Council to establish such principles which has a material effect on the statements taken as a whole, unless the member can demonstrate that due to unusual circumstances, the financial statements would otherwise have been misleading. In such cases, his or her report must describe the departure, the approximate effects thereof, if practicable, and the reason why compliance with the principle would result in a misleading statements. 2 AICPA Code of Professional Ethics (CCH) (footnote omitted).



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Federal Securities Exchange Act of 1934

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CHAPTER 4A The SEC and Accounting Standards

1-4A Federal Securities Exchange Act of 1934 § 4A.03

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§ 4A.03 Generally Accepted Accounting Principles

Many commentators categorize Generally Accepted Accounting Principles ("GAAP") as follows:

1. *Assumptions pertaining to the business and its environment* include the separate entity, continuity, constant unit of measurement, and time period assumption
2. *Basic accounting principles* are concerned with the measurement of economic activity (e.g., the historic cost principle), the time when such measurements are made and recorded (e.g., the revenue principle and the matching principle), the disclosures surrounding those activities (e.g., the consistency principle), and the preparation and presentation of summarized economic activity in financial statements. Over time, however, the accounting profession has somewhat modified these principles as the role of accounting has expanded. The historic cost principle, for example, is a basic accounting principle whereby cost is the appropriate basis for initial accounting recognition and for an item's subsequent valuation. This theory, however, has been recently criticized in favor of a current value approach.
3. In combination, the first two categories, above, form the groundwork for development of, and are implemented by *accounting principles and procedures*, which are the detailed rules and methods for recording the monetary effects of specific types of transactions and events. Accounting principles are normally directed toward solutions that are objective, conservative, and verifiable. n1 The two basic categories of accounting principles are measurement and disclosure. Measurement principles are quantitative standards which determine the timing of initial recognition and measurement basis of items which enter the accounting cycle and affect the financial statements. Disclosure principles are qualitative features that complement measurement standards through explanation and expansion on accounting policies, contingencies, uncertainties and other information essential in the analytical process.

As already mentioned, GAAP is vast and comes from disparate sources. To resolve conflicts, the AICPA's Statement of Auditing Standards (SAS) No. 69 establishes a hierarchy of the sources of GAAP as follows:

- Category "A" consists of officially established and mandatory accounting principles such as FASB Statements of Financial Accounting Standards (Statements) and Interpretations, APB Opinions, and AICPA Accounting Research Bulletins (ARBs).
- Category "B" are preferable principles consisting of FASB Technical Bulletins and, if cleared by the FASB, AICPA Industry Audit and Accounting Guides (Guides) and AICPA Statements of Position (SOPs).
- Category "C", also preferable in nature, consists of AICPA Auditing Standards Board Practice Bulletins that have been cleared by the FASB and consensus positions of the FASB Emerging Issues Task Force (EITF).
- Category "D" widely recognized practices or pronouncements, includes AICPA accounting interpretations and implementation guides ("Qs and As") published by the FASB staff, and practices that are widely recognized and prevalent either generally or in the industry.

In the absence of the above established sources of GAAP, n2 other accounting literature may be considered. n3 This literature includes APB Statements, AICPA Issues Papers, Auditing Standards Board Practice Bulletins, FASB Statements of Financial Accounting Concepts, International Accounting Standards Committee Statements of International Accounting Standards, Governmental Accounting Standards Board Statements, Interpretations and Technical Bulletins, Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids, pronouncements of other professional associations or regulatory agencies, and accounting textbooks and articles.

FOOTNOTES:

(n1)Footnote 1. See APB Statement No. 4.

(n2)Footnote 2. See two FASB publications: *The Current Text* and *The Original Pronouncements*. *The Current Text* integrates all of the currently recognized standards of Category A in alphabetical order and it is the most efficient means of addressing a specific question. *The Original Pronouncements*, however, provide more detailed coverage of an issue.

(n3)Footnote 3. For a comprehensive review and analysis of current promulgated GAAP, see Williams, GAAP Guide: *A Comprehensive Restatement of Current Promulgated Generally Accepted Accounting Principles* (Harcourt Brace & Co.).



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CHAPTER 4A The SEC and Accounting Standards

1-4A Federal Securities Exchange Act of 1934 § 4A.04

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§ 4A.04 Overview of Specific Accounting Principles and Procedures

Two prevalent themes among the specific accounting rules are (1) operational assets (e.g., inventory, equipment) are measured in terms of past cash flows--so-called "historic cost", and (2) financial assets and liabilities (e.g., notes, debt, investments in securities) are measured in terms of future cash flows--so-called present value. In specific cases, there is often considerable debate as to implementation of the historic cost principle--for example which expenditures should constitute the historic cost of a particular asset. There are similar issues in respect to determination of present values.

Setting aside the sticky issues for a moment, these two themes establish that accounting for operating assets can be distinctly different than the accounting for financial assets and liabilities. As such, the distinction between operating and financial items is the high-level framework by which this section is organized. The rules governing presentation of the principle financial statements is covered first, followed by operating assets, and financial assets and liabilities. The section is concluded with a discussion of accounting rules related to business acquisitions.

[1] Principal Financial Statements and their Components

[a] Balance Sheet

The purpose of the balance sheet is to report the aggregate financial effect of transactions at a specified point in time. The format of a balance sheet is not specified by any technical pronouncement, rather it has become established as a matter of tradition and industry practices. Generally, two types of formats are used: the report form and the account form. In the report form, the balance sheet continues line-by-line from top to bottom. In the account form, the balance sheet appears in a balancing concept with assets on the left and liabilities and equity amounts on the right.

Assets, liabilities, and owners' equity are separated in the balance sheet so that important relationships can be shown and attention can be focused on significant subtotals. Tradition and practice have led to the classification of assets into current assets, long-term investments, property, plant, and equipment, intangible assets, and other assets. Liabilities are generally displayed in the order of payment: current liabilities, non-current liabilities, and other liabilities. Equity is ordinarily classified as capital stock, additional paid-in capital, donated capital, and retained earnings.

Assets and its subcategories--The term "assets" is defined as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. n1 The following three accounting characteristics must be present for an item to qualify as an asset: (1) the asset must provide probable economic benefit which enables it to provide future net cash inflows, (2) the entity is able to receive the benefit and restrict other entities' access to that benefit, and (3) the event which provides the entity with the right to the benefit has occurred. Assets have features that help identify them as exchangeable, legally enforceable, and have future economic benefit or service potential.

Current assets are cash and other assets or resources commonly identified as those which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle. n2 Current assets normally include cash and cash equivalents, n3 short-term investments, n4 receivables, inventories, and pre-paid expenses.

Long-term investments are those investments that are intended to be held for an extended period of time, longer than one operating cycle. n5 They normally include debt and equity securities, tangible assets not currently used in operations, and investments held in special funds.

Property, plant, and equipment are assets of a durable nature that are to be used in the production or sale of goods, sale of other assets, or rendering of services rather than being held for sale. These assets are disclosed with related accumulated depreciation or depletion. n6

Intangible assets are non-current, non-materialistic assets of an entity, the possession of which provides anticipated benefits to the owner. This asset can be disclosed net of accumulated amortization.

Other assets, not otherwise categorized by GAAP, include long-term pre-paid expenses, non-current receivables, and restricted cash.

Liabilities and its Subcategories--The term "liabilities" is defined as probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. n7 The following three accounting characteristics must be present for an item to qualify as a liability. A liability requires that the entity settle a present obligation by the probable future transfer of an asset on demand when a specified event occurs or at a particular date, the obligation cannot be avoided, and the event which obligates the entity has occurred. An entity will primarily incur liabilities as part of their ongoing economic activities in exchange for economic resources and services required to operate the business.

Current liabilities are those obligations whose liquidation is reasonably expected to require the use of existing resources properly classified as current assets. n8 Exceptions include debt expected to be refinanced through another long-term issue and debt that will be retired through the use of non-current assets.

Non-current liabilities are obligations that are not expected to be liquidated within the current operating cycle. The distinction between current and non-current liabilities generally rests upon both the ability of the entity to liquidate the obligation within the current operating cycle and its related intent.

Equity and its subcategories--The term "equity" is defined in terms of assets and liabilities; for if it were defined independently of these elements of the Fundamental Accounting Equation, the equation would be overspecified. Therefore, equity is the residual interest in the assets that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest. n9 Equity is increased by owners' investments and comprehensive income and is reduced by distributions to the owners and comprehensive loss. Comprehensive income is the change in equity of an entity during a period from transactions and other events and circumstances from non-owner sources. n10

Capital stock is the common or preferred stock issued at the par or stated value. Additional paid-in capital is the excess of par or stated value from the actual issue price. Additional capital from the entity's own stock transactions is

considered a separate category.

Donated capital is a category of donations of a non-cash variety from either stockholders or third parties.

Retained earnings is a category of accumulated earnings not distributed to the shareholders. It is normally classified as appropriated or unappropriated. Appropriated retained earnings is an amount of retained earnings not to be distributed to the stockholders as dividends. Unappropriated retained earnings are available to be distributed as dividends.

In June 1997, the FASB issued Statement No. 130ⁿ¹¹ requiring a balance sheet presentation of a new category of equity, which is usually labeled "accumulated other comprehensive income" to more prominently and clearly identify elements of "dirty surplus" in equity. The forgoing section on accounting logic and presentation of financial statements analyzed and demonstrated the linkages between (1) initial recognition and subsequent measurement of assets and liabilities, and (2) owners' equity. This analysis assumed what the FASB has termed a "clean surplus" relationship between the beginning and ending amount for owners equity; in non-technical terms, that all changes in owners' equity resulting from transactions with non-owners would be reported as a component of net income in the period in which the change to owners' equity was recorded. In a clean surplus system, net income is identical to "comprehensive income." In a dirty surplus system, "comprehensive income" (defined as the change in equity during a period from transactions with non-owners) is seen to consist of two additive components: net income and the dirty surplus created during the period, which is termed "other comprehensive income." Although a clean surplus relationship may be a desirable goal of a system of accounting rules, it is not the current reality of GAAP. The relationship between net income, dirty surplus and balance sheet accounts is depicted in Exhibit 8

[Click here to view image.](#)

The purpose of reporting comprehensive income is to present a measure of all changes in equity that result from recognized transactions and other economic events of the period other than transactions with owners in their capacity as owners. The FASB believes that the information provided by reporting comprehensive income should aid financial statement analysis, in large part because "dirty surplus" accounting policies have been permitted by the SEC for political expediency in furthering other objectives related to high-quality accounting standards. FAS 130 requires that an enterprise classify items of other comprehensive income for a period by their nature in a financial statement, and display Accumulated Other Comprehensive Income separately from retained earnings and additional paid-in capital in the equity section of the balance sheet.

There are currently four specific exceptions to the clean surplus relationship in GAAP:

1. Unrealized holding gains and losses on "marketable securities" designated as "available for sale" in accordance with SFAS 115.
2. Certain effects on owners' equity resulting from the translation of the foreign-currency-denominated financial statements to the reporting currency of the consolidated entity per SFAS 52.
3. Certain changes to net pension liabilities per SFAS 87.
4. Gains and losses on derivative financial instruments and certain foreign currency denominated non-derivative financial instruments designated to be part of a cash-flow hedging relationship per SFAS 133.

[b] Income Statement

The income statement, also referred to as the statement of income, statement of earnings, or statement of operations, summarizes the results of an entity's economic activities for a given accounting period. The purpose of the income statement, unlike the balance sheet, is to report the net income or loss for a defined period of time. Since the early 1960s, the income statement has been widely perceived by users and advisers as the most important of an entity's basic financial statements when forecasting future earnings performance. Even with renewed interest in the balance sheet by accounting rule makers, the income statement remains important due to an overriding concern with the measurement of income. Essentially, the income statement depicts revenues and gains realized less the expenses and losses incurred during a period.

Revenues are gross increases in assets or decreases in liabilities during a period from delivering goods, rendering services, or other activities constituting the entity's central operations. ⁿ¹² Expenses are gross decreases in assets or increases in liabilities during a period resulting from the delivery of goods, rendering of services, or other activities constituting the entity's central operations. ⁿ¹³

Gains are net increases in equity from peripheral transactions of an entity excluding revenues and investments by owners. Alternatively, losses are net decreases in equity from peripheral transactions of an entity excluding expenses and distributions to owners. ⁿ¹⁴ The accounting characteristics of gains and losses include a result from peripheral transactions and circumstances which may be beyond an entity's control, and which may be classified according to sources or as operating and non-operating.

The major components and items presented in the income statement are income from continuing operations, results from discontinued operations, extraordinary items, cumulative effect of a change in accounting principles, net income, and earnings per share.

[c] Statement of Cash Flows

The primary purpose of the statement of cash flows, formerly known as the statement of changes in financial position, the funds statement, and the statement of source and application of funds, is to provide information about an entity's cash receipts and cash payments during a period. ⁿ¹⁵ A secondary purpose of the statement of cash flows is to provide information about the entity's investing and financing activities during a period. For purposes of this statement, the term cash includes cash equivalents and foreign currency. Cash equivalents are any short-term highly liquid investments used as a temporary investment of idle cash. Additionally, the effects of transactions not resulting in the receipt of payment of cash are reported in a separate schedule.

The statement of cash flows is categorized into investing, financing, and operating activities. Investing activities include the acquisition and disposition of long-term productive assets or securities that are not considered cash equivalents. Investing activities also include the lending of money and the collection on loans. Financing activities include obtaining resources from and returning resources to the owners. Financing activities also include obtaining resources from creditors and repaying the amount borrowed. Operating activities include all transactions that are not investing and financing activities. Operating activities include delivering or producing goods for sale and providing services.

The operating activities section of the statement of cash flows can be presented under the direct or indirect method. The direct method illustrates the items that affected cash flow. The indirect method, the more widely used method of presentment, focuses on the difference between net income and cash flows.

In 1987, the FASB issued Statement No. 95, ⁿ¹⁶ which requires a statement of cash flows as part of a full set of financial statements in place of a statement of changes in financial position. Foreign operations must prepare a separate statement of cash flows and translate the statement to the reporting currency using the exchange rate then in effect when transactions affect cash took place or a weighted-average exchange rate if the result is substantially the same. The combined effect on the consolidated cash balance of holding foreign currencies during periods of exchange rate

fluctuation is reported as a separate item on the statement of cash flows.

[d] Statement of Changes in Other Stockholders' Equity

Article 3 of Regulation S-X requires, in addition to the forgoing financial statements "an analysis of the changes in each balance sheet caption of "other stockholders' equity" presented in the balance sheets or in a note or separate statement. Presentation takes the form of a reconciliation of the beginning balance to the ending balance for each period for which an income statement is required to be filed with all significant reconciling items described by appropriate captions. n17 Although most companies choose to provide reconciling information with respect to all categories of stockholders' equity, "other stockholders' equity" excludes the common stock caption. The requirement of FAS 130 to classify items of other comprehensive income by their nature in a financial statement is usually satisfied through inclusion in the statement of, or note on, changes in other stockholders' equity.

[2] Operating Assets and Related Expenses

[a] General Approach

Generally, operating assets are recorded in the financial statements under the historic cost principle. Historic exchange prices are used because they are objective and capable of being independently verified. According to many users and advisers, one limitation of the balance sheet is that most operating assets are reported at cost, which is less relevant than current values.

Historic cost-based measurements are inappropriate when an asset's carrying value overstates a particular measure of its future utility. The precise definition of impairment, depends in large part on the asset category in question, as does the procedure for recognition and measurement of the impairment.

The appropriate timing of expense recognition has been a matter of significant debate. In 1940, W.A. Paton and A.C. Littleton published *An Introduction to Corporate Accounting Standards*, n18 a comprehensive and eloquent defense of the historical cost convention. It also popularized the "matching principle," which places primary emphasis on the matching of costs with revenues, with assets and liabilities being dependent on the outcome of this matching. Once the decision is made as to which revenues and expenses to recognize in a period, the balance sheet is left with a residue of asset and liability balances, which may or may not fit the reasonable definitions of assets or liabilities.

Soon after its formation in 1973, the FASB issued Statement of Financial Accounting Standards (SFAS) 2, on accounting for research and development costs, and SFAS 5, on accounting for contingencies, which signaled the FASB's belief in the primacy of the "asset and liability view" over the traditional "revenue and expense view" inherent in Paton and Littleton's matching principle. Under the "asset and liability view," the definitions of assets and liabilities govern the recording of revenues and expenses, not the other way round, as under the "matching principle." The FASB believed that the better approach was to agree first on whether a transaction had created an asset or liability and then determine the amount of any revenue or expense. This "asset and liability view," which was to play a central role in the FASB's conceptual framework, was foreshadowed in these two early standards.

[b] Tangible Assets

[i] Property, Plant and Equipment

Property, plant and equipment (PP&E) provide an economic benefit to the entity for a number of future years. In addition to determination of the historic cost of acquisition, accounting policies for the allocation of historic cost to the periods in which a benefit from holding and using PP&E is needed. In circumstances indicating that the reported amount for an individual item and/or group of PP&E overstates the economic value--a condition known as "impairment"--recognition and measurement of the impaired is required.

Cost allocations of PP&E to benefited periods normally occur through depreciation, "...a system of accounting which aims to distribute the cost ... less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. *It is a process of allocation, not valuation.*" [italics supplied] n19 Several methods of depreciation are permissible, including straight-line, accelerated methods (such as declining balance or sum-of-the-years digits methods), and units of production methods.

The acquisition cost of an asset is normally the cash purchase price plus shipping and installation costs. Interest costs on borrowings are also capitalized when assets must require a period of time to get them ready for their intended use. Examples are assets that an enterprise constructs for its own use (such as facilities) and assets intended for sale or lease that are constructed as discrete projects (such as ships or real estate projects). n20

In 1995, the FASB issued Statement No. 121, n21 which required that long-lived assets and certain other assets to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The basic approach to SFAS 121 was as follows:

1. Review for indicators that an asset is impaired. Indicators include significant decreases in market prices for similar assets, adverse changes to physical conditions or in the business environment in which the asset is being used.
2. Recognize an impairment *if* the sum of the undiscounted n22 future cash flows expected to be generated by a long-lived asset is less than the assets carrying value. Otherwise, no adjustment is required.
3. Reduce the carrying value of the asset to its fair value n23 and recognize an impairment loss on the income statement for the amount of the reduction. Future recoveries of fair value may not be recognized.

While fairly simple in concept, SFAS 121 proved to be extremely difficult to apply. SAB 100, issued in November 1999 provides clarification's on the SEC staff's views on restructuring and asset impairment charges. In October 2001, the FASB issued Statement No. 144 to address significant issues of implementation of impairment accounting and to accomplish other objectives discussed later in this chapter. Although Statement No. 121 was superseded by No. 144, the basic approach to recognition and measurement of impairment was retained in the new statement.

[ii] Inventory

The preparation of financial statements requires careful determination of an appropriate dollar amount for inventory. This amount is present as a current asset on the balance sheet and directly affects the cost of goods sold in the income statement.

Inventory is usually measured at "cost" or "market", whichever is lower. n24 ARB 43, ch. 4 sets forth general principles for determination of the cost of inventory acquired, permissible methods for determining cost flows out of the inventory account and into cost of goods sold on the income statement (analogous to depreciation of fixed assets), and general guidance for determining "market" values for inventory.

Cost of inventory is understood to mean acquisition and production costs. Production costs include both costs directly related to a product (e.g. materials and direct labor) and indirect costs (e.g. depreciation on the manufacturing portion of a company's building). In November 2004, the FASB issued Statement No. 151 n25 to require treatment of abnormal amounts of handling, shipping, re-working, spoilage and idle facility costs associated with production as current period expenses instead of inventory costs.

Transfers of cost out of inventory to cost of goods sold is problematic because individual items of inventory frequently are indistinguishable, but have been purchased over time at different prices. In these cases, management typically chooses a "cost flow assumption" such as first-in first-out, average, and last-in first-out.

GAAP for the measurement of inventories include APB Opinion No. 20, APB Opinion No. 28, APB Opinion No. 29, ARB No. 43, ARB No. 51, FASB Statement No. 2, FASB Statement No. 48, FASB Statement No. 49, FASB Statement No. 151, FASB Interpretation No. 1, and EITF 86-46.

[iii] Prepaid Expenses

Prepaid expenses n26 are identified as a current asset pursuant to ARB 43, ch. 3A, even though they are not current assets in the sense that they will be converted into cash. This is because if these costs were not paid in advance, they would require the use of current assets during the operating cycle. Prepaid expenses are to be amortized to expense on a ratable basis over the life of the asset.

Common examples of prepaid expense include insurance, rents, taxes, unused royalties, current paid advertising service not yet received, and operating supplies. However, it may not be said that all payments of cash in advance of anticipated future service or benefit (so-called "deferred costs") qualify for recognition on the balance sheet as an asset. For example:

- SOP 93-7 does not permit deferral of advertising costs beyond the date of the advertisement's first appearance. An exception is made for direct response advertising in limited circumstances.
- Companies consider deferral of pre-opening, start-up, or customer acquisition costs on the basis that these expenditures provide some future economic benefit. The SEC Staff has taken the position that deferral is generally not appropriate unless the costs are incremental and bear a direct relationship with future revenue. The staff has also raised questions regarding correlation between the amortization period of the deferred charge and the related revenue stream, and assessment of recoverability of the deferred charge. n27

[iv] Intangible Assets

Intangible assets have no physical substance and may be categorized as identifiable or unidentifiable. The latter is synonymous with the term "goodwill". Identifiable intangible assets may be further classified as definite- or indefinite-lived. Goodwill is also the principle example of an indefinite-lived intangible asset, but other cases can exist. For example, the license to operate a taxicab in New York City would presumably qualify. Note well that "indefinite" is not equivalent to infinite: no asset may be presumed to have an infinite life. Thus, in theory, at some point in the economic life of the license, its remaining period of benefit should become subject to reliable estimation.

Identifiable intangible assets may be acquired separately, but often are acquired as part of a business combination. In June 2001, the FASB issued Statement No. 141, "Business Combinations," which superseded APB Opinion No. 16 of the same title. Statement No. 141 requires recognition at fair value of all assets and liabilities acquired in a transaction meeting the definition of a business combination. The "pooling of interests" method of APB 16 is no longer permitted. n28

Assets to be separately recognized in a business combination include any intangible asset (1) arising from either contractual or other legal rights, and (2) which is separable from the combined entity. Common examples include trademarks, noncompetition agreements, customer lists, production backlog and franchise agreements. n29 Goodwill is recognized as the positive difference between the purchase price of the acquiree and the fair value of the identified net assets. These identified net assets consist of assets (both tangible and identified intangible), less recognized liabilities

assumed.

A significant practical effect of Statement No. 141 is to result in the recognition of goodwill in the vast majority of business combinations due to the elimination of the pooling of interests alternative.

The requirement of APB Opinion No. 17 to amortize goodwill over a period not to exceed 40 years has been eliminated, in large measure as part of a political bargain with some constituencies for the acceptance of the elimination of pooling of interests. In its place are the following requirements:

- Definite-lived intangibles are to be amortized over their economic lives.
- Indefinite-lived intangibles other than goodwill are not amortized until their economic lives become definite. Impairment must be assessed at least annually, and is measured as the excess of the carrying amount of the asset over its fair value.
- Goodwill is not subject to amortization, but is subject to an annual impairment test under Statement No. 142, which was issued in tandem with the aforementioned Statement No. 141. The goodwill impairment test, together with the impairment tests on PP&E in Statement No. 144, are some of the most multifaceted and prosaic aspects of GAAP pertaining to operating assets.

Assessing and measuring goodwill impairment involves a two-step procedure, with the operation of the second step contingent on the results of the first step, as in the following flowchart:

[Click here to view image.](#)

A reporting unit is roughly the same as a reportable business segment, but under certain circumstances may be a smaller unit of the entity. The "implied fair value of goodwill" is the amount of goodwill that would be recognized at the date impairment is being assessed under the supposition that the reporting unit had been purchased by the entity on that date. From a practical standpoint, Step 2, which is the costliest part of implementing the impairment test, can be avoided if the result of Step 1 is "Yes."

The logic of the two-step test retains the logic of the initial measurement of goodwill a residual. The procedure for measuring goodwill impairment proceeds along similar lines; a comparison is made between the book value of goodwill, which was originally calculated as a residual, and a hypothetical amount of the residual--supposing the reporting unit been acquired for its current fair value at the date on which impairment is being tested.

[c] Revenue from Sale of Goods or Services

[i] General Approach

The realization concept states that revenues are recognized when the earnings process is complete or virtually complete and revenue can be evidenced by the existence of an exchange transaction which has taken place. Statement of Financial Accounting Concepts No. 5, a source of GAAP below Category "D," is the only source of general revenue recognition guidance:

[Revenue recognition] involves considerations of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration. n30

In most transactions, both of the above conditions are satisfied at the time goods are delivered or services are performed. There are, however, frequent situations in which special guidance is available in U.S. GAAP. Publications of the SEC's

Division of Enforcement stress that questionable revenue recognition practices have long been an area of accounting abuse and fraud that is one of their greatest financial reporting concerns. In part to address these concerns, in 1989, the SEC issued SAB No. 101, which states that in order for the two criteria in SFAC No. 5 to be satisfied, four conditions must be met:

1. Persuasive evidence of an arrangement exists;
2. Delivery must have occurred or services been rendered;
3. The seller's price to the buyer is fixed or determinable; and
4. Collectibility is reasonably assured.

While these criteria are general, they provide guidance for revenue recognition relating to most traditional business models. For companies that do not employ traditional business models, such as e-commerce companies and companies with a large percentage of Internet transactions, however, SAB 101 provides additional guidance on these revenue recognition issues.

[ii] Long-term Construction

ARB 45 specifies the revenue recognition criteria and procedures for long-term construction-type contracts. It requires the use of the percentage-of-completion method if estimates of cost to complete a project and its stage of completion over time are reasonably estimable. Otherwise, the completed contract method is used. Under the percentage-of-completion method, the amount of revenue and cost recognized in a period is based on the proportion of total work performed during the accounting period. This may appear to violate the concept of realizability enunciated in SFAC No. 5, but two points are worth mentioning in support of percentage-of-completion:

- It results in a fairer presentation over time of the value created by a contractor if the criteria of reasonable estimation can be met.
- Most contracts or U.S. law give both parties to a construction contract enforceable rights. The contractor's activities may be seen as a sale or transfer of those rights as the contract progresses.

The completed contract method postpones revenue recognition and cost matching until the construction project is completed.

SOP 81-1 broadens the scope of long-term contracts to include, for example, the development and production of military and commercial aircraft, weapons delivery systems, space exploration hardware, and computer software and provides more detailed guidance for the application of the two revenue recognition alternatives mentioned above as well as the criteria for determining the applicable method.

[iii] Software Sales

Under U.S. GAAP, software revenue is not recognized until all of the following conditions exist:

- All significant production, modification or customization has been completed.
- There is an arrangement between buyer and seller, usually in the form of a signed contract, purchase order, or on-line authorization.

- Delivery has occurred.
- The fees of the seller are fixed or determinable.
- Collectibility is probable.

Instructions for implementation of these criteria are set forth in SOP 97-2, in which an attempt is also made to consider the many variations that can affect the elements of a sale--such as conditions for customer acceptance, payment and pricing terms, warranties and future service commitments, options for returns, and licensing arrangements.

[3] Financial Assets and Liabilities

It is an economic truth that all financial liabilities of an entity are financial assets of some other party (note that the converse is not true). Despite the frequent symmetry of some financial assets and all financial liabilities, accounting is usually not symmetrical for these contracts. Liabilities are generally measured on the balance sheet at the present value of the payments the entity is obligated to make. It is more difficult to offer a generalization for the measurement of financial assets, but the trend in accounting rules is toward increasing use of fair value measurements of financial assets.

[a] Cash and Receivables

The promulgated GAAP concerning accounting for cash is ARB 43, ch. 3. Cash consists of funds represented by actual coins and currency on hand or demand deposits available without restriction. It must be management's intention that the cash be available for current purposes. n31 It has become common to also include cash equivalents which are other forms of near-cash as well as demand deposits and liquid, short-term securities.

Accounts receivable, open accounts, or trade accounts are agreements by regular customers to pay for services rendered or merchandise obtained. Similar assets include notes receivable, trade acceptances, third-party instruments, and amounts due from officers, shareholders, employees, and affiliated companies. GAAP requires that these different classes of receivables be separately identified and presented at net realizable amounts.

While the accrual of anticipated returns, allowances, and discounts are usually not required, the recording of anticipated uncollectible amounts is almost always required. The matching principle requires an estimation of bad debt expenses through either the percentage-of-sales technique or aging-of-the-accounts method.

Transfers of Receivables

An entity can alter the timing of cash flows relating to its sales by pledging, assigning, or factoring its receivables. Proper disclosure must be made under all of these options, and additional accounting concerns arise when an entity decides to factor its receivables, either with or without recourse. n32

In 2000, the FASB issued Statement No. 140 n33 covering transfers of receivables, including securitizations. Sale accounting with concomitant recognition of a gain or loss is accorded to a transfer if the transferor has no continuing involvement with the transferred assets. Otherwise, the transaction is treated as a financing; the receivables remain on the balance of the entity and a liability is recognized for the proceeds.

Partial sale/financing accounting may occur, and is prevalent in securitization transactions. Sources of partial sale treatment include retained servicing of the receivable(s), transfer of a partial interest, or consideration other than cash is received by the transferor.

[b] Investments in Equity Securities

ARB 43 required that all investments in securities would be carried on the balance sheet at historical cost, subject to a write-down for impairment. In 1975, FASB issued Statement No. 12, on accounting for marketable securities, which requires that many categories of securities be carried at their cost or market, whichever is lower (commonly referred to as "lower of cost or market", or LOCOM). Unrealized holding gains and losses on marketable equity securities classified as current were taken into earnings, but that such gains and losses on marketable equity securities classified as noncurrent be included in the shareholders' equity section in the balance sheet. This SFAS, which was approved by a 5-2 vote, revealed the board's reluctance to reflect upward revaluations of assets in earnings, even though the price of the securities was readily available in the market.

In 1993, the FASB issued Statement No. 115, n34 to address the accounting for investments in equity securities that have readily determinable fair values and all investments in debt securities. Investments outside the scope of FAS 115 continue to be accounted for in accordance with ARB 43. Although the SEC argued strongly for fair value accounting, with all gains and losses taken to earnings, the banking industry vociferously opposed this solution because of the resulting volatility in their earnings from year to year. A 'political' compromise was thus forced on the Board.

Equity securities within the scope of SFAS 115 may be freely classified by management as either "trading" or "available for sale." n35

Securities classified as available-for-sale securities are reported at fair value, with unrealized gains and losses excluded from earnings and reported with its tax effect as other comprehensive income. Upon sale, realized gains and losses are reported in earnings. Dividends are also included in earnings as received. Securities classified as trading securities are reported at fair value with unrealized gains and losses included in earnings. Dividends should also be included in earnings.

[c] Investments in Debt Securities

The accounting for investments in debt securities falls under SFAS 115 and is similar to the accounting in equity securities with one notable difference: debt securities may be classified as "held to maturity" in addition to the trading and available-for-sale categories applicable to equity securities within the scope of SFAS 115. If classified as available for sale, debt securities are measured at "amortized cost", meaning that any difference between cost to acquire the investment and principal amount of the debt is amortized to income over the time interval starting at date of investment and ending at maturity of the debt instrument. The "held to maturity" category was created by the FASB as a compromise to regulated financial institutions such as banks and insurance companies, whose equity and earnings would become highly volatile if their debt portfolios were "marked to market."

Debt securities may be classified as held-to-maturity based on management's positive intent and ability to hold to maturity, which is distinct from the mere absence of an intent to sell. The SEC staff has maintained that sale prior to maturity will taint management's intent for all debt securities held, and will disallow continuation of the use of the held to maturity category by the company for a period of time thereafter.

[d] Equity Investments Resulting in Significant Influence or Joint Control

APB 18 requires that investments in which the investor holds significant influence (but not control) is to be accounted for under the "equity method". In the absence of evidence to the contrary, significant influence is deemed to exist if the investor holds 20-50 percent of the voting shares. APB 18 further states that the equity method is an extension of the consolidation concept (rather than an accrual method of accounting for investments), with the implication that net income will not differ whether an investment is accounted for under the equity method or is consolidated. Subsequent to the acquisition of an investment to be account for under the equity method, the carrying value of the investment changes in the same manner as the owners' equity of the investee: the investment is increased by (the investor's share of) earning,

and decreased by (the investor's share of) dividends.

Frequently, the substantive difference between significant influence and control is small, yet the account result can vary significantly. A consolidated balance sheet will combine the assets of the investor with its proportionate share of the assets of the investee, with the same treatment for liabilities. However, the equity method permits presentation of the investor's share in the assets and liabilities of the investee as one net asset. For example, \$1,000 of assets and \$900 of liabilities will be presented under the equity method as one net asset of \$100, with the effect of hiding the liabilities. For this reason the equity method is considered one of the more common forms of accounting techniques resulting in "off-balance sheet financing."

In order to prevent the equity method from misleading investors regarding the underlying capital structure of a registrant and the sources of its earnings, Rule 4-08(g) of Regulation S-X requires presentation in the notes to the financial statements of summarized balance sheet and income statement information of equity method investees if significant. n36

[e] Investments Requiring Consolidation

ARB No. 51 requires a company to consolidate its financial statements with other entities under its control. Prior to the issuance of FASB Statement No. 141, a consolidation would be effected by either a "pooling of interests" or as a "purchase", depending upon the specific facts and circumstances. A series of restrictive criteria were to be satisfied for a combination to be considered as a pooling of interests. Subsequent to Statement No. 141, all business combinations are considered purchases.

To account for a business acquired, the combined entity reports the assets and liabilities of the target company at fair market value on the date of acquisition. In this process, it may be necessary to recognize assets that were not recognized by the target on its own books, for example, internally developed patents.

Any excess of the fair market of the consideration given over the fair market value of the net assets acquired is reported as goodwill. If there is a deficit, however, the resulting "negative goodwill" is not recognized on the balance, but reported as an extraordinary gain on the income statement. The operating statements for purchase method combinations report combined results only for the period subsequent to the combination.

Regulation S-X, Rule 3-05 governs financial statements of acquired businesses and generally requires an entity to possess complete audited financial statements for a significant target company before it may make a public offering of securities.

In 1989, the SEC issued SAB No. 84, which updated the guidance in SAB No. 51 concerning the ownership of a subsidiary. Under the bulletin, when a parent's percentage ownership of a subsidiary's stock changes due to a sale of some of the stock, the SEC will permit the amount in excess of the parent's carrying value to be reflected as a gain in the consolidated income of the parent provided that the sale is not part of a contemplated broader corporate reorganization.

In 1987, the FASB issued Statement No. 94, n37 which requires the full consolidation of all majority-owned subsidiaries. The statement was aimed at alleviating off-balance-sheet financing. The statement does not require the consolidation of a subsidiary if control is temporary or such control is not possessed by the majority owner.

In 1986, the SEC revised Rule 3A-02 of Regulation S-X concerning the use of consolidated financial statements for a company and its subsidiaries. Under the amendment, the entity and its accountant must evaluate the facts and circumstances to determine whether a company is a controlled subsidiary and must adopt a consolidation policy that clearly reflects the financial position and results of operations of both entities.

In 1985, FASB issued a technical bulletin concerning the proper accounting for the effect of a target company's reacquisition of shares in a "greenmail" transaction. n38 The bulletin requires a target company purchasing its own stock from a corporate raider at a price significantly higher than the current market price of those shares to expense the excess. This treatment will result in a charge to current operations, which will reduce net income, earnings per share, retained earnings, and shareholder's equity.

[i] Translating the Financial Statements of Foreign Subsidiaries and Affiliates

A significant problem for a multinational company is how to present its financial statements on a consolidated basis when one or more of its foreign subsidiaries maintain accounting records that are based in a foreign currency. In 1981, the FASB Issued Statement No. 52, n39 superseding Statement No. 8, which was arguably the most controversial pronouncement of the FASB in its early years. FAS 52 provides considerable latitude to multinationals for translating the financial statements of their foreign subsidiaries.

In order to combine the financial statements of foreign subsidiaries with a parent company, the financial statements of the subsidiaries must first be translated into the reporting currency of the parent. To facilitate the translation process, two key translation method issues must be resolved:

- Which assets and liabilities should be translated at the exchange rate existing at the balance sheet date (i.e., the *current* rate) versus the rates existing when the assets and liabilities were originally measured for financial statement purposes (i.e., *historical* rates)?
- How should variances in the value of translated assets and liabilities (i.e. the effects of differences between the current and historical rates) be characterized on financial statements: as gains and losses on the income statement, or as some component of shareholders' equity on the balance sheet?

SFAS No. 52 provides for two methods of foreign currency translation, depending on the circumstances faced by a company: the "temporal" method and the "current rate" method. Under the current rate method, all assets and liabilities are translated at the current exchange rate--i.e. the rate in effect at the balance sheet date. If the all-current method is used, translation gains and losses must be excluded from income and instead reported on the balance sheet as a component of accumulated other comprehensive income; and, all income statement events must be translated at the rate that prevailed when the revenue or expense was recognized. This rate can be approximated by using the weighted average exchange rate for the period.

All income statement events and balance sheet items can be quantified either in terms of past transactions (e.g., inventory, plant and equipment, common stock, depreciation, cost of goods sold) or in terms of future transactions (e.g., cash, receivables, short-term payables). Under the temporal method of translating foreign financial statements, items quantified in terms of future events are translated at the current exchange rate, whereas items quantified in terms of past events are translated at historical rates. This approach preserves existing accounting logic which argues that if it is proper to quantify an item in relation to its historic cost, it would also seem proper to quantify that item at the exchange rate that existed when the past event took place. SFAS No. 52 also specifies that if the temporal method is used, immediate recognition of translation gains and losses on the income statement is mandatory.

SFAS No. 52 introduced the concept of the "functional currency", the currency of the primary environment in which the entity operates, to determine the appropriate method of translation--and hence the appropriate recognition of foreign currency translation gains, losses and adjustments. In most cases, the functional currency will either be the local currency of the foreign subsidiary or the U.S. dollar.

Management must designate a functional currency for each foreign subsidiary, using the criteria suggested in SFAS No. 52. If the functional currency is determined to be the "local" currency of the subsidiary, the temporal method is used,

and gains or losses resulting from translation are included in income for the period. If the functional currency of the foreign subsidiary is determined by management to be the "reporting" currency (i.e. the U.S. dollar for US-based multinationals), the current rate method is applied; translation gains or losses are not recognized in the income statement, but are included in shareholders' equity as a component of accumulated other comprehensive income.

In general, the criteria for selecting a company's functional currency establish whether or not the foreign subsidiary is an independent, cash-generating center; if it is, then the local currency is considered the functional currency. In coming to this determination, the following factors must be weighed:

- The degree to which cash flows related to the foreign entity's individual assets and liabilities are in the foreign currency or affect the parent's cash flows.
- The responsiveness of sales prices of the foreign entity's products on a short-term basis to changes in exchange rates.
- The existence of an active local market for the foreign entity's product, even though there may be significant amounts of exports.
- Whether labor, materials and other costs for the foreign entity's products are incurred locally or elsewhere.
- The denomination of debt and the extent to which funds generated by the foreign entity's operations are sufficient to service existing and normally expected debt obligations; and,
- The volume of intercompany transactions and the extent of the interrelationship between the operations of the foreign entity and the parent company.

These criteria seek to assess the degree to which the exposure of cash flows from the foreign subsidiary to the parent are a principal source of foreign business risk for the parent. If so, the accounting exposure represented by the temporal method with immediate recognition of translation gains and losses would more closely match the economics of a situation wherein the foreign subsidiary was not an independent generator of cash. The rationale underlying the all current method is that it is merely an arithmetic procedure for restating the financial statements of the foreign subsidiaries, and any gain or loss has no economic interpretation; it is merely a residual of a mechanical arithmetic procedure.

[iii] Variable Interest Entities

Under GAAP (ARB No. 51), a company must consolidate any entity in which it has a "controlling financial interest", which in many circumstances is taken to be ownership of more than 50 percent of the entity's voting interests. The broad applicability of this approach has been called into question over the last two decades by financial arrangements that have created entities controlled by means other than voting shares--often referred to as "special purpose entities." The longstanding politically charged debates over criteria for consolidation of SPEs came to a highly-publicized head as it became known that Enron made liberal use of SPE structures to hide debt and manipulate earnings.

In December 2003, the FASB Issued Interpretation No. 46(R) n40 (superseding FIN 46 issued the previous January. It defines when a company should base controlling financial interest on factors other than voting rights. Entities falling under the scope are termed "variable interest entities" (VIEs) and have at least one of the following characteristics:

- Thinly capitalized--Residual equity holders have not provided a sufficient amount of equity necessary to support the entity's operations. If this is not the case, any voting power legally attributed to

these equity holders is irrelevant in determining who should consolidate the entity.

- Residual equity holders do not control the entity--This runs counter to conventional economic thinking, which suggests that the holder of an entity's residual equity should be in a position to control its destiny.

- Equity holders do not participate fully in an entity's residual economics-- Conventional economic thinking suggests that residual equity holders should enjoy the rewards and be exposed to the risks of owning an entity. This is not the case when contractual arrangements shield equity holders from losses associated with the entity's predominant risks, or when such arrangements cap the return on equity or allow these returns to be shared with other parties.

- Voting interests non-substantive--this is an anti-abuse clause which prevents the sponsor of an entity from structuring or organizing it in a way that allows the sponsor to avoid consolidation under the voting interest model.

Under FIN 46(R), the party exposed to the majority of the risks and rewards associated with the VIE is named its primary beneficiary and must consolidate the entity. The FASB introduced the terms *expected losses* and *expected residual returns* to measure participation in an entity's economic performance in the determination of the party holding the majority of the risks and rewards. These terms relate to statistical concepts that measure deviation from expected results. Expected losses represent negative variance from expected results; they do not represent actual GAAP losses incurred by an entity. Expected residual returns, by contrast, represent the positive variability vis-a-vis expected results and not actual GAAP gains.

[f] Loans

In 1993, the FASB issued Statement No. 114 n41 which addresses the accounting by creditors for impairment of certain loans and amends FASB Statement No. 5, Accounting for Contingencies. n42 A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and contractual principal payments of a loan will be collected as scheduled in the loan agreement in terms of timing and amount.. It also provides that impaired loans within its scope should be measured based on the present value of currently expected future cash flows discounted at the loan's effective interest rate at inception. The effective interest rate of a fixed-rate loan is the rate of return implicit in the loan at inception (i.e., the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan).

FAS 114 does not specify how a creditor should identify loans that are to be evaluated for collectibility. In July 2001, the SEC issued SAB 102 to address its concerns that financial institutions are overestimating future loan losses as a device for cushioning the financial statement impact of unforeseen losses. SAB 102 expresses certain of the staff's views on the development, documentation, and application of a systematic methodology as required by Financial Reporting Release No. 28 for determining allowances for loan and lease losses in accordance with Generally Accepted Accounting Principles. In particular, the guidance focuses on the documentation the staff normally would expect registrants to prepare and maintain in support of their allowances for loan losses.

[g] Debt

Long-term debt represents future sacrifices of economic benefits to be repaid over a period of more than one year. Examples of long-term debt include bonds payable, notes payable, lease obligations, pension and deferred compensation plan obligations, deferred income taxes, and unearned revenue. The proper valuation of long-term debt is

the present value of future payments using the market rate of interest, either stated or implied, at the date the debt was incurred.

An issue of recent concern is the use of off-balance-sheet financing. This practice arises when funds borrowed to finance operations or capital projects do not appear on the entity's balance sheet, thus understating the entity's debt as disclosed in the debt-equity ratio. Debt is kept off the balance sheets by creating and utilizing separate trusts, entering into special contracts, and selling receivables.

Troubled debt restructurings are also a topic of continuing interest. Such restructurings arise where the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants the debtor a concession that would not otherwise be given. Not all concessions constitute troubled debt restructurings. These situations can occur by either a settlement of a debt for less than the carrying amount or a continuation of the debt with modified terms.

[h] Pensions and Other Post-Employment Benefits

The accounting concept underlying post employments benefits is that an employer's promise to provide employees with postemployment benefits represents a form of deferred compensation; the cost of those benefits should be recognized systematically over employees' service periods. GAAP for an employer's accounting for post-employment benefits center on the determination of annual cost, and the presentation of an appropriate amount of liability in the balance sheet. When setting rules in this area, the FASB has utilized techniques to delay recognition of some expenses and liabilities, net costs against income from trust funds, and offsetting liabilities with the assets of trust funds.

The two broad categories of pension plans are defined-contribution and defined-benefit plans. Under a defined contribution plan, the employer agrees to contribute an amount to a pension fund, and the actual benefits employees receives depends on the amount contributed to the plan, and the financial return on pension fund assets. Under a defined benefit plan, the employer agrees to make pension payments to employees during retirement using a benefits formula based on wages earned and number of years of employment. There may or may not be a requirement to pre-fund employee pension benefits, although there usually as--at least in the United States, where the pre-funding decisions are heavily tax driven. Taxes aside, however, the economics of these two plans differ in respect to risk bearing: for a defined contribution plan, the employee bears the risk of return on assets, and the opposite holds true for a defined benefit plan.

As a general rule, pension and other employee benefits expense is attributed to periods in which the employee provides benefits. FASB Statement No. 87 is the principal standard under which expenses and obligations under pension plans are reported. FASB Statement No. 106 covers all other post-retirement benefits.

[i] Defined Contribution Pension

The accounting for defined contribution pension plans is straightforward: pension expense for a period is the amount of contributions employers are required to make as a result of the employee having worked during the period.

[ii] Defined Benefit Pension Plans

Firms must calculate net pension expense each year based on changes in the projected benefits obligation, which means that actuarial calculations of the pension obligation's present value use accumulated service to date and projected future salaries. There are six elements of periodic pension cost. The first three are recognized in the period in which they are incurred, and the last three are recognized on a delayed basis. To delay recognition of any element of pension expense is counterintuitive, but the volatility that would have resulted in the measurement of pension expense was unacceptable to some constituencies of the FASB, who threatened to withhold their support for SFAS 87, without delayed recognition of some costs. The six elements of periodic pension cost are as follows:

1. Service cost--the increase in the projected benefits obligation (PBO) because employees work an additional period of time. The effect is to increase pension cost for a period.
2. Interest cost--the increase in the projected benefit obligation because of the passage of time. The effect is to increase pension cost for a period.
3. Expected return on plan assets--the expected change in the market value of plan assets due to interest, dividends and changes in the market value of investments. The effect is to decrease pension cost for a period.
4. Amortization of the unrecognized transition net pension asset or liability at the date of adoption of SFAS 87. The net pension asset or liability is the PBO less the fair value of assets in the pension fund. The net amount is amortized straight line over the average remaining service life of employees.
5. Amortization of increased in the PBO arising from enhancement of benefits (sweetening) the pension benefit formula. The amortization is generally the average remaining service life of employees.
6. Amortization of excess gains and losses because actual experience differs from actuarial assumptions (e.g., salary, interest rate, employee turnover, mortality asset returns). The minimum amount subject to amortization is equal to the portion of the accumulated actuarial gain/loss exceeding 10% of the PBO or the fair value of plan assets. The amortization period is generally the average remaining service life of employees.

Even though some elements of pension cost may be recognized on a delayed basis, FASB Statement No. 87 requires measurement of a minimum pension liability on the balance sheet for any plan (many firms maintain separate pension plans for each of the various groups of employees). The minimum pension liability is the amount by which the accumulated benefit obligation exceeds the fair value of pension plan assets. The accumulated benefit obligation bases its measure of the pension obligation on accumulated service without any projections of salary increases. In recognizing the minimum pension liability, an intangible asset may be recognized up to the amount of any unrecognized prior service cost on plans with underfunded accumulated benefit obligations; the remaining amount of any incremental liability recognized decreases accumulated other comprehensive income and is reported in accordance with FASB Statement No. 130.

[iii] Retirement Benefits Other Than Pensions

In 1990, the FASB issued Statement No. 106, n43 which sets forth accrual-based rules for employers who provide retirement benefits other than pensions. A primary example of such benefits is retiree healthcare costs. While the accounting for such benefits is highly similar to pensions, the economics and tax treatments of the two plans create some important differences. First, estimates of the present value of the benefit to be paid can be significantly less reliable. For example, future costs of healthcare services defy confident prediction as does the future role of government in healthcare for covered individuals. Second, tax law provides little or no incentive to pre-fund post-retirement benefits other than pensions, so most plans are underfunded. Third, many plans leave open the option for the companies to curtail benefits at any time without permission of employees or retirees.

[i] Derivative Financial Instruments and Hedging Activities

Firms incur various risks when carrying out their business operations, some of which may be mitigated by insurance and others by derivative financial instruments. A derivative financial instrument ("derivative") is generally understood to be a certain kind of financial instrument. Its value at expiration is derived through mathematical combination of an

"underlying", (common examples of which are stock prices, spot commodity prices, interest rates on a specific type of loan, and spot foreign exchange rates) and a "notional" amount of the underlying (e.g., hypothetical shares of stock, bushels of wheat, principal of the loan, units of currency). Common examples of freestanding derivative contracts include commodity and foreign currency forward exchange contracts ("forwards"); options to purchase ("calls") or sell ("puts") commodities, stocks, foreign currencies; and interest rate swaps, which are complex variations of forward contracts.

One significant problem in developing accounting standards for derivatives is that many contracts have embedded derivative elements. For example, a lease contract granting the lessee the option to purchase the leased property for a predetermined price at the end of the lease term contains an embedded call option. Any agreement to purchase a good for future delivery can be construed as a forward exchange contract. In 1998, The FASB issued SFAS No. 133, n44 the first comprehensive standard on derivative financial instruments further specifies that derivatives within its scope are: (1) entered into with little or no initial investment relative to the fair value of the underlying, and (2) the terms of the derivatives contract permit net cash settlement--in contrast to requiring physical delivery of the underlying by one party to satisfy their settlement obligation.

The other significant problem in accounting for derivatives is that management frequently enters into derivative contracts to reduce economic risk of an existing asset, liability or future transaction. Hedge accounting refers to methods that either (1) defer all or some of the gains or losses in the fair value of hedging instruments (usually derivatives), (2) or accelerate all or some of the gains or losses in the fair value of a hedged item to achieve offset with the gain/loss on the derivative. In essence, hedge accounting involves some kind of departure from another provision of GAAP with the objective of smoothing reported income.

The need for additional rules to smooth income arises from two different sources:

- *Measurement inconsistencies* potentially addressed by hedge accounting arise from differences in the bases of measurement applied to hedged items and hedging instruments. For example, the value of wheat held by a company for future sale creates exposure to fluctuations in the market price of wheat. A hedging instrument such as a futures or options contract is measured at fair value. The wheat itself being held in inventory is usually measured at lower of cost or market. A hedge accounting solution would alter the accounting for either the hedged item or the hedging instrument in order to match the gain or loss on one to the period in which any gain or loss on the other is recognized.
- *Recognition inconsistencies* potentially addressed by hedge accounting arise when the hedged item is not recognized, or does not even come into being, until after the hedging instrument is acquired. Without some form of hedge accounting, changes in the value of the hedging instrument may occur and be recognized before the effect on net income of the hedged item is recognized. For example, a food processor desires to hedge its price risk from an anticipated purchase of some quantity of wheat. Under hedge accounting, gains or losses in the market value of a hedging instrument designed to reduce price risk would be deferred until the wheat is physically delivered to the food processor.

Borne out of years of intense debate, FASB Statement No. 133 formalized certain controversial hedge accounting practices and also established new methods of accounting for hedges. There can be no doubt that Statement No. 133 increased the rigor with which hedge accounting must be applied, and added much greater transparency of the effects of hedge accounting on reported net income. The four basic concepts embodied in Statement No. 133 are summarized below:

1. Derivative financial instruments--whether entered into for hedging or any other purpose--should always be measured and reported at fair value. For the most part, only derivatives may be designated as hedging instruments.

2. Special hedge accounting should be available when a high degree of "hedge effectiveness" is demonstrated and documented at the inception of the hedge. Hedge effectiveness may be determined in a number of ways, but in rough terms it means that there should be an expectation that an x percent change in the value of the hedged item should be offset by approximately an x percent change, in the opposite direction, of the hedging instrument.
3. No method of hedge accounting should result in reporting deferred losses or gains on the balance sheet. Deferred gains do not meet the conceptual definition of a liability and deferred losses do not meet the conceptual definition of an asset.
4. The method of hedge accounting to be employed will depend on the type of hedge.

With respect to this last concept, Statement No. 133 specifies three permissible hedge accounting treatments:

1. Fair value hedge accounting -- Gains and losses on the fair value of recognized assets and liabilities, and the fair value of firm commitments are accelerated to the current period to serve as offsets to the gains and losses recognized on the hedging instrument. Thus, hedge accounting is achieved by altering the normal accounting for the hedged item.
2. Cash flow hedge accounting -- Gains and losses on the fair value of the hedging instrument are deferred as a component of accumulated other comprehensive income and matched against the financial statement impact of the hedged item in the period when it is recognized. Thus, hedge accounting is achieved by altering the normal accounting for the hedging instrument (which is to recognize the changes in the fair value of a derivative financial instrument in the period in which the change to fair value occurs).
3. Hedge of a net investment in a foreign operation -- The change in the fair value of the hedging instrument is added to accumulate other comprehensive income to the extent that translation of the foreign operation into the reporting currency affects accumulated other comprehensive income.

[j] Deferred Tax Assets and Liabilities

The tax consequences of most operational events recognized in the financial statements for a given period are included in determining income taxes currently payable. Some of these differences are permanent, and others are temporary.

Permanent differences consist of revenues and expenses that firms include in net income for financial reporting but never appear in the income tax return. Interest revenue on tax-exempt municipal bonds is an example of a permanent difference.

Temporary differences are revenues and expenses that firms include in both income for financial reporting and in taxable income, but in different periods. Depreciation expense is a common temporary difference. For example, straight-line depreciation on an item of equipment may be used for calculating net income for financial reporting purposes and a method based on declining balance depreciation may be used for calculating taxable income. Over the time the equipment is owned by the company, expenses related to the equipment will be the same, regardless of the depreciation method used; however, periodic amounts will differ.

In 1992, the FASB issued Statement No. 109⁴⁵, which supersedes Statement No. 96, Accounting for Income Taxes. Statement No. 109 requires a firm to compute income tax expense based on income for financial reporting before taxes excluding the effect of permanent differences. Thus, income tax expense is not simply the amount of income taxes

currently payable. Firms must also recognize the benefit of future tax deductions and the obligations related to future taxable income that arise because of temporary differences. A deferred tax liability or deferred tax asset represents the increase or decrease in taxes payable or refundable in future years as a result of temporary differences and carryforwards at the end of the current period.

Since deferred tax assets represent future deductions, their realization is subject to the uncertain future condition of sufficient future taxable income against which to offset the deduction. Otherwise, the future tax deduction would have no value. In order to avoid overstatement of the benefit of the future tax deduction, Statement No. 109 requires a valuation allowance against the deferred tax asset to reduce it to the amount the firm judges it more likely than not will realize by way of reduced taxes in the future.

[4] Other Areas of Significance

[a] Leases: Combination of Operating and Financial Elements

Lease contracts belong to a group of contracts referred to by accountants as "executory contracts." Generally, these contractual commitments are accounted for off the balance sheet because the event triggering the commitment has usually not yet occurred. Examples include leases, purchase or supply agreements, take-or-pay contracts and working capital maintenance agreements, to name only a few. Many executory contracts share operating and financing characteristics. For example, a purchase agreement for raw materials in a production process involves obtaining access to a producing asset, and also embodies a commitment to pay cash at a future date.

To illustrate the conundrum created by lease contracts, consider the following contrasting contractual relationships:

1. A company borrows \$1 million from a bank, agreeing to repay \$11,100 per month over ten years. The company agrees to use the proceeds of the loan to fund the purchase price of an item of equipment to be used in the operations of the company. The economic life of the equipment is 20 years.
2. A company signs a noncancellable, nontransferable 10-year lease on an identical piece of equipment. Monthly lease payments are \$11,100, and the company may purchase the asset at the end of the lease term for its fair value as determined by an independent appraisal.

In both cases, the company has incurred an economic liability of equivalent amount and acquired access to an economic resource (the equipment). However, in only the first case do accounting rules require the recognition of the liability and recognition of an asset. A central accounting issue involving leases is the identification of those leases that are treated as sales of the property by lessors and as purchases of the property by lessees. These are known as "capital leases." The counterpart to capital lease accounting is operating lease accounting under which the lessee would recognize expense in accordance with the schedule of lease payments.

SFAS No. 13 is the principle source of GAAP as it relates to lease accounting. Statement No. 13 provides that "if a lease meets any one of the following classification criteria, it is a capital lease: n46

- a. The lease transfer ownership of the property to the lessee by the end of the lease term.
- b. The lease contains an option to purchase the leased property at a bargain price.
- c. The lease term is equal to or greater than 75 percent of the estimated economic life of the leased property.
- d. The present value of rental and other minimum lease payments equals or exceeds 90 percent of the fair

value of the leased property.

If a lease contract meets the accounting requirements for capital lease treatment, lessors must further classify the lease contract as a "financing" or "sales-type" lease. In a sales-type lease, the lease payments contain an element of "dealer profit." In other words, the lessor simultaneously acts as an equipment dealer while also performing the financing function.

[b] Earnings Per Share

Earnings per share, or EPS, is an index widely used by actual and prospective investors to gauge the profitability of an entity. Forecasts of EPS serve as inputs to numerous types of equity valuation models. In February 1997, the FASB issued Statement of Financial Accounting Standard No. 128, n47 which is the result of a joint project between the FASB and the IASC to converge on a single standard for the calculation of EPS. The FASB saw a re-write of the EPS rules to be an opportunity to test the waters of international cooperation in an area that did not affect balance sheet or income statement items. Most observers agreed that U.S. standards prior to this project (principally APB 15) were needlessly complicated and out of step with the approach taken by most other countries.

Two measures of EPS are reported under Statement No. 128. "Basic" EPS is intended to measure performance over a reporting period and is calculated as:

Net income available to common shareholders

Weighted average number of common shares outstanding for the period

where "net income available to common shareholders" is reported net income less dividends on preferred stock.

"Diluted" EPS is intended to measure performance over a reporting period while giving effect to all potentially dilutive securities--i.e., securities that could potentially decrease EPS through increase in the denominator without sufficient offset in the numerator of the EPS calculation. Dilution could occur upon the exercise of stock options, stock warrants or similar instruments, conversion of preferred stock or debt to common stock, or securities to be issued in the future based upon the occurrence of a specific event (i.e., "contingently issuable shares").

In calculating Diluted EPS, the numerator of the above EPS equation is adjusted for preferred claims and any appropriate interest addbacks, and the denominator is increased by all common shares issuable from potentially dilutive securities. For example, conversion of preferred stock to common stock will have both a numerator effect and a denominator effect on the calculation of Dilutive EPS. The numerator of Basic EPS is adjusted upward by the preferred dividends eliminated if the preferred stock were converted, and the denominator increases by the number of common shares issuable upon conversion of the preferred shares. If the effect of the conversion were to make Dilutive EPS greater than Basic EPS (i.e., the conversion is "antidilutive"), then the convertible preferred shares would be left out of the calculation of Dilutive EPS.

In 1989, the SEC issued SAB No. 83, which amends section D of Topic 4 of the SAB Series. The Bulletin provides that where a registrant has filed a statement in connection with an initial public offering ("IPO") and has within one year prior to the filing, issued common stock below the IPO price or other options, warrants, or dilutive instruments below the IPO price, such securities and instruments should be treated as outstanding when computing earnings per share. The SEC will not object to the use of the treasury stock approach in measuring the dilutive effect of such issuances. n48

FOOTNOTES:

(n1)Footnote 1. FASB Statements of Financial Accounting Concepts, SFAC No. 6, Elements of Financial Statements, par. 25.

(n2)Footnote 2. Accounting Research Bulletin No. 43.

(n3)Footnote 3. See FASB Statement No. 95.

(n4)Footnote 4. See FASB Statement No. 115.

(n5)Footnote 5. Accounting Research Bulletin No. 43

(n6)Footnote 6. See APB Opinion No. 12, P 5.

(n7)Footnote 7. FASB Statement of Financial Accounting Concepts ("SFAC") No. 6, Elements of Financial Statements, P 35.

(n8)Footnote 8. See ARB No. 43.

(n9)Footnote 9. SFAC No. 6, n.22 *supra*, at P 49.

(n10)Footnote 10. SFAC No. 6, n.22 *supra*, at P 70.

(n11)Footnote 11. SFAS No. 130, Reporting Comprehensive Income (FASB 1997).

(n12)Footnote 12. See SFAC No. 6, n.22 *supra*, at P 79.

(n13)Footnote 13. See SFAC No. 6, n.22 *supra*, at P 81.

(n14)Footnote 14. SFAC No. 6, n.22 *supra*, at PP 84-86.

(n15)Footnote 15. See SFAS No. 95.

(n16)Footnote 16. Statement of Cash Flows, SFAS No. 95 (FASB 1987).

(n17)Footnote 17. Regulation S-X, 3-04.

(n18)Footnote 18. Reprint edition published by the American Accounting Association, 1986.

(n19)Footnote 19. ARB 43, Ch. 93, P 5.

(n20)Footnote 20. See FASB Statement No. 34

(n21)Footnote 21. SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of (FASB 1995).

(n22)Footnote 22. The term "undiscounted" means that the time value of money is to be ignored for the purpose of making the determination that an impairment exists.

(n23)Footnote 23. "The fair value of an asset (liability) is the amount at which that asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." (FASB Statement No. 144, para. 22).

(n24)Footnote 24. The SEC staff has permitted the use of mark-to-market accounting for inventories for inventories of refined bullion of precious metals. In addition, companies may have used mark-to-market accounting for certain purchased energy contracts under EITF 98-10. However, this practice has been disallowed by the issuance of EITF 02-3, which has rescinded EITF 98-10.

(n25)Footnote 25. SFAS No. 151, Inventory Costs, An Amendment of ARB No. 43, Chapter 4 (FASB 2004).

(n26)Footnote 26. The term "prepaid expense" is somewhat of a misnomer, since not all prepaid items result directly in expense. For example, some prepayments may become part of the cost of inventory before they become an expense. Therefore, "prepaid expenditure" may be more accurate.

(n27)Footnote 27. PriceWaterhouseCoopers, Accounting and Reporting Manual, 2004.

(n28)Footnote 28. The "pooling of interests" method of accounting for a business combination was available under APB 16 in certain specific circumstances. Assets recognized by the acquiree were not remeasured by the acquirer to current fair value, and assets unrecognized by the acquirer (including and especially, goodwill) were not recognized.

(n29)Footnote 29. The Appendix to Statement No. 141 contains an extensive but non-exhaustive list of examples of intangible assets meeting the criteria for recognition apart from goodwill.

(n30)Footnote 30. FASB, Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, P 83,1984.

(n31)Footnote 31. See SFAS 6.

(n32)Footnote 32. See SFAS 77 and EITF 89-2.

(n33)Footnote 33. SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities-a replacement of FASB Statement No. 125, (FASB 2000).

(n34)Footnote 34. SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, (FASB 1993).

(n35)Footnote 35. SFAS No. 115 states that securities that are bought and held principally for the purpose of selling them in the near term should be classified as trading securities. (para. 12a). The SEC staff has stated its view that Questions 34 and 35 of the FASB Special Report, *A Guide to Implementation of FAS 115, Questions and Answers*, make it clear that the FASB did not intend to limit the use of the trading category to only those securities that definitely will be sold in the near term.

(n36)Footnote 36. See Rule 1-02(bb) of Regulation S-X for a definition of "summarized financial information." See Rule 1-02(w) for the quantitative test of significance.

(n37)Footnote 37. Consolidation of All Majority-Owned Subsidiaries, SFAS No.94 (FASB 1987).

(n38)Footnote 38. Accounting for a Purchase of Treasury Shares at a Price Significantly in Excess of the Current Market Price of the Shares and the Income Statement Classification of Costs Incurred in Defending Against a Takeover Attempt, Technical Bulletin No. 85-6 (FASB 1985).

(n39)Footnote 39. SFAS No. 52, Foreign Currency Translation (FASB 1981).

(n40)Footnote 40. Financial Accounting Standards Board Interpretation 46(R), Consolidation of Variable Interest Entities, (FASB 2003).

(n41)Footnote 41. Accounting by Creditors for Impairment of a Loan, SFAS No. 114 (FASB 1993).

(n42)Footnote 42. Statement No. 5 provides that a loss must be accrued if it is probable and the amount of loss can be reasonably estimated.

(n43)Footnote 43. SFAS No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions, (FASB 1990).

(n44)Footnote 44. SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, (FASB 1998).

(n45)Footnote 45. Accounting for Income Taxes, SFAS No. 109 (FASB 1992).

(n46)Footnote 46. FASB Statement No. 13, para. 7

(n47)Footnote 47. SFAS No. 128, Earnings Per Share, (FASB 1997).

(n48)Footnote 48. Staff Accounting Bulletin No. 83, 6 Fed. Sec. L. Rep. (CCH) P 24,083 (1989). *See* 45 Bus. Law. at 1278.



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Federal Securities Exchange Act of 1934

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CHAPTER 4A The SEC and Accounting Standards

1-4A Federal Securities Exchange Act of 1934 § 4A.05

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§ 4A.05 Global Accounting Standards

Our global economy is characterized by electronically accessible stock exchanges and multinational enterprises operating in scores of countries. So, it is natural to believe that accounting standards could be the same throughout the world. Such is not presently the case, but if it were, capital markets and multinational managers could achieve greater efficiencies by not having to cope with the polyglot of accounting standards and practices that presently exist.

The development of accounting standards has been an evolutionary and highly political process, beginning long before the advent of a global economy. Much of the evolution of accounting standards has taken place at the national level. Government bureaucracies, laws and private organizations were established to meet the needs of investors and other stakeholders in the financial reporting process when public dissemination of financial statements was largely restricted to one country at a time. As culture, law, politics and business practice varied significantly among countries, so understandably have national accounting standards promulgated by these national organizations evolved to different points. For example:

- Countries in which investors in large companies have consisted in the main of large *financial institutions* generally require less detail in financial statements and related disclosures, and less rigor in their preparation than countries where there is significant participation by smaller *individual investors*.
- Some cultures are seen to possess a strong desire to avoid repetition of some economic disaster that occurred in its past. In the United States, for example, a widely held view is that the Great Depression of the 1930s was caused in large part by schemes to manipulate and profit from inflated stock market prices, fed through the dissemination of false and misleading financial statement information. In Germany, the post World War I inflation was fuelled by panic.

The reactions in these two countries by accounting standard setters were very different. The United States system consists of highly detailed rules intended to discourage their manipulation. The German system, on the other hand, provides issuers with broad discretion to enable them to report smooth earnings trends. It appears to be designed to reduce investor concerns that could lead to panic, which in

turn might threaten economic stability.

- One of the fundamental aspects of any national system of financial reporting is its relationship to tax law. In Great Britain, for example, companies may report one set of figures in their financial statements and a substantially different set on their tax returns. This is because the objectives of financial reporting are substantially different than tax reporting.

Considerable effort is being made throughout the world to harmonize accounting and financial reporting internationally. n1 Organizations that are principally involved with this effort are: the International Accounting Standards Committee (IASC), the FASB, the International Organization of Securities Commissions (IOSCO), n2 the SEC, and the European Community (EC). The IASC through its standards setting group, the International Accounting Standards Board (IASB) is, along with the FASB, the principal instrument of the accounting profession for achieving global harmonization.

[1] International Financial Reporting Standards (IFRS)

A number of countries have adopted IASC standards, known as International Financial Reporting Standards (IFRS), n3 to constitute their own accounting principles. n4 The International Accounting Standards Committee (IASC) was formed in 1973 through an agreement made by the principle organizations representing the accounting profession from nine major countries. In 1983 it affiliated with the International Federation of Accountants, an organization currently representing approximately 150 national accounting organizations from over 100 countries. In 2001, the IASC separated from IFAC, and the principal standard setter within the IASC was re-organized and renamed as the International Accounting Standards Board (IASB). The purpose of the new organization is to create a funding base to support the IASB and its staff, and to promote efficient and open debate to result in high quality accounting standards.

Nineteen trustees govern the IASC. They also appoint the members of the IASB, the Standing Interpretations Committee (SIC) and the Standards Advisory Council; monitor IASB's effectiveness; raise funds for the IASB; approve its budget and have responsibility for constitutional changes.

Up until the end of 2000, a 34-member committee comprising representatives from 14 countries performed the main standard-setting function. Many constituents criticized this structure because it lead to lengthy deliberations resulting in political compromises, resulting in lack of uniformity in application of IFRS and weakening IFRS quality and image. The IASB is now comprised of 14 individuals (12 full-time members and two part-time members). While the Trustees attempt to avoid dominance by any particular constituency or regional interest, the foremost criteria for appointment to the Board are technical expertise, ability to communicate and capacity to impartially consider varied viewpoints. The intention is that at least five IASB Members have a background as practicing auditors, at least three have a background in the preparation of financial statements, at least three have a background as users of financial statements, and at least one has an academic background.

The IASB has full responsibility for all technical matters addressed by it or other groups within the IASC. The functions of the IASB are similar to the FASB and include:

- Publishing exposure drafts on all projects and to normally publish a draft statement of principles for public comment on major projects
- Setting its own technical agenda
- Reviewing public comments, form steering committees or other types of specialist advisory groups to give advice on major projects, issue bases for conclusions when new authoritative pronouncements are published

The Standards Advisory Council comprises about 30 members, having a diversity of geographic and professional backgrounds. The Council meets approximately three times a year, principally to provide advice to the IASB on major projects and setting priorities.

The International Financial Reporting Interpretations Committee (IFRIC)--formerly named the Standing Interpretations Committee (SIC) prior to the 2002 restructuring--comprises twelve members. Its principal role is to interpret the application of standards promulgated by the IASB, and to provide timely guidance on issues not specifically addressed by existing standards. IFRIC has a chairman and 11 other voting members who are selected to provide an appropriate mix of auditors, preparers and users of accounts. A consensus is achieved when no more than three members vote against an interpretation. The IASB constitution requires IASB approval before a draft or final Interpretation is issued.

IFRS consists of a conceptual framework, accounting standards and interpretations. The "Framework for the Preparation and Presentation of Financial Statements," ("Framework") was adopted in 1989 to assist in the development of standards and review existing standards. Commentators, including FASB staff members, have noted that there are few, if any, substantive differences between the IASB framework and the FASB Statements of Financial Accounting Concepts taken as a whole. The IASB Constitution states that each member shall have regard for the Framework in deciding on and revising standards. n5 In addition, the IASB Framework may assist the following groups or individuals:

- preparers in dealing with topics not specifically addressed by a specific standard;
- auditors in auditing financial statements prepared in accordance with IFRS;
- users in the interpretation of financial statements prepared in accordance with IFRS; and
- those who are interested in the work of the IASB, providing them with information about its approach to the formulation of accounting standards.

[2] Convergence of U.S. GAAP and IFRS

The FASB and IASB have taken a number of initiatives to achieve convergence of accounting standards. They include:

- Joint projects on revenue recognition and business combinations. All future FASB or IASB agenda items are to be considered candidates for future joint projects.
- A "short-term convergence project" to identify those differences between U.S. GAAP and IFRS in which convergence appears achievable in the short-term by selecting between existing U.S. GAAP and IFRS.
- A joint research project seeking to identify all substantive differences between U.S. GAAP and IFRS along with an effort to identify a strategy for resolving each one.

FOOTNOTES:

(n1)Footnote 1. *See Finance and Economics: Global Accounting's Roadblock*, 339 *The Economist* 79 (April 27, 1996).

(n2)Footnote 2. On September 28, 1999, the SEC issued final rules to revise its Form 20-F to conform the non-financial statement disclosure requirements more closely to the International Disclosure Standards endorsed by IOSCO in September 1998 (Rel. No. 33-7745). While the IOSCO standards were specifically developed for equity offerings, the Commission has extended its applicability to other registered offerings, listings, and annual reports.

(n3)Footnote 3. When the IASC reconstituted itself and formed the IASB, it created the IFRS series. The series of pronouncements, known as International Accounting Standards (IAS), has been discontinued while remaining in effect.

(n4)Footnote 4. Some countries supplement IFRS with other accounting rules from various sources. See the IASB's Web site *at* <<www.iasb.org.uk>> for an up-to-date list of countries utilizing IFRS and a description of the manner in which they are used.

(n5)Footnote 5. The IASC Constitution does not require standards that adhere, or are fully consistent with the Framework, but only that there be "regard" for it.



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CHAPTER 5 Civil Liabilities Under the Exchange Act

1-5 Federal Securities Exchange Act of 1934 5.syn

AUTHOR: Marc B. Dorfman and Ellen M. Wheeler

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Marc B. Dorfman and Ellen M. Wheeler n*

FOOTNOTES:

(n1)Footnote *. This chapter was prepared by Marc B. Dorfman and Ellen M. Wheeler, partners with Foley & Lardner LLP in Washington, D.C. and Chicago, with the assistance of J. Ryan Wick and Adrian L. Jensen.



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CHAPTER 5 Civil Liabilities Under the Exchange Act

1-5 Federal Securities Exchange Act of 1934 § 5.01

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§ 5.01 Introduction

The Securities Exchange Act of 1934 ("Exchange Act" or "1934 Act") provides a number of express causes of action. Section 9(e) provides a civil remedy to a person who purchases or sells a security on a national exchange at a price affected by unlawful manipulation. n1 Section 20A furnishes a cause of action to a person who purchases or sells a security in reliance on a false or misleading statement in a document filed under the Exchange Act. n2 Section 20A allows suits against persons trading on non-public information for plaintiffs who trade contemporaneously with such persons. n3 Each of these three express provisions, however, includes significant limitations and is rarely used. n4

The most important right of action under the Exchange Act remains the implied cause of action under Section 10(b) and *Rule 10b-5*. n5 *Rule 10b-5* prohibits any person from engaging in fraudulent practices in connection with the purchase or sale of securities. *Rule 10b-5* cases have principally dealt with fraudulent misrepresentation of, or failures to disclose, material facts, or trading on material non-public information.

To succeed on a *Rule 10b-5* claim, plaintiffs must show (1) there was a "fraud," usually a misrepresentation or failure to disclose a material fact, (2) in connection with plaintiffs' purchase or sale of a security, (3) that defendants acted with "scienter," (4) that plaintiffs "relied" on defendants' misrepresentation or omission, and (5) that such misrepresentation or omission caused plaintiffs' damages. Defendants in *Rule 10b-5* cases have a number of affirmative defenses, available and commonly file motions to dismiss. The Exchange Act provides that federal courts are the exclusive forum for *Rule 10b-5* cases, and class actions tend to be the preferred form of seeking relief. In appropriate circumstances, plaintiffs may file a derivative action under *Rule 10b-5* to obtain a remedy for a defrauded corporation. Finally, if parties to a contract agree to arbitrate disputes under *Rule 10b-5*, their arbitration agreement is valid and enforceable.

Although the elements of the implied right of action under *Rule 10b-5* are well-established, there have been significant limitations placed on securities fraud suits by the courts and by Congress. n6 In the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), Congress sought to eliminate what it perceived as "frivolous" securities fraud suits by requiring plaintiffs to satisfy strict procedural requirements and by heightening the standard for pleading scienter. After class action plaintiffs attempted to avoid these heightened requirements by filing in state rather than federal courts, Congress passed the Securities Litigation Uniform Standards Act of 1998 ("SLUSA"), requiring securities fraud class actions to be filed in federal court.

Limitations placed on *Rule 10b-5* suits by courts and Congress provided a number of weapons to defendants to combat securities fraud suits filed under *Rule 10b-5*. Nevertheless, this implied right of action continues to be a fertile source of significant litigation.

Civil litigation under the Exchange Act may only be one of the causes of action brought against a defendant. Congress included express causes of action in the Securities Act of 1933 ("Securities Act" or "1933 Act"), including Section 11, concerning false statements or material omissions in registration statements, and Section 12, involving unregistered offerings and fraud in connection with prospectuses.ⁿ⁷ Moreover, the express and implied actions under the Exchange Act and the Securities Act do not foreclose suits brought under other federal statutes, or under state securities laws or under common law. Section 28(a) of the Exchange Act expressly provides that "rights and remedies provided by [the Exchange Act] shall be in addition to any and all rights and remedies that may exist at law or in equity."ⁿ⁸

Civil litigation under the Exchange Act may also only be one prong of parallel litigation: the same conduct may give rise to an investigation by the Securities and Exchange Commission ("SEC" or "Commission")ⁿ⁹ and an SEC administrative proceeding or civil injunctive action, including claims for fines, penalties and disgorgement, as well as state and federal criminal prosecutions.

FOOTNOTES:

(n1)Footnote 1. *See* § 5.02[1] *infra*.

(n2)Footnote 2. *See* § 5.02[2] *infra*.

(n3)Footnote 3. *See* § 5.02[3] *infra*.

(n4)Footnote 4. In addition, Section 16 provides a cause of action against "insiders" who profits on purchases and sales made within six months of each other. *See* Chapter 8 *infra*.

(n5)Footnote 5. *See* § 5.04 *infra*.

(n6)Footnote 6. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 180, 114 S. Ct. 1449-1450 (1994) .

(n7)Footnote 7. These causes of action are covered in A.A. Sommer, Jr., *Federal Securities Act of 1933* (Matthew Bender), as well as elsewhere in this treatise.

(n8)Footnote 8. Exchange Act § 28(a), 15 U.S.C. § 78bb(a).

(n9)Footnote 9. *See* Chapter 9 *infra*.



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CHAPTER 5 Civil Liabilities Under the Exchange Act

1-5 Federal Securities Exchange Act of 1934 § 5.02

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§ 5.02 Express Civil Liabilities

The Exchange Act n1 creates two distinct avenues for civil enforcement: public and private. The Exchange Act authorizes the SEC n2 to institute administrative proceedings n3 or file actions in federal district court seeking injunctive relief. n4 As discussed in this section, the Exchange Act also creates express remedies for private parties: Sections 9(e), 18(a) and 20A. n5

Section 9(e) provides a civil remedy to any person who purchases or sells a security registered on a national exchange at a price affected by unlawful manipulation. Section 18(a) grants a cause of action to any person who purchases or sells a security in reliance on, and at a price affected by, a false or misleading statement in a document filed with the SEC under the Exchange Act. These sections were designed "to protect investors against manipulation of stock prices through regulation of transactions upon securities exchanges and in over-the-counter markets, and to impose regular reporting requirements on companies whose stock is listed on national securities exchanges." n6 As discussed below, however, claims under these sections are rarely brought--and even less frequently succeed--because of the difficult burdens of proof. As a result, plaintiffs prefer claims based on Section 10(b) and *Rule 10b-5*.

In addition, Section 20A provides an express remedy for private plaintiffs who have traded contemporaneously with corporate insiders and others who violated provisions of the Exchange Act by trading while possessing material nonpublic information. Litigation and decisions under Section 20A are relatively rare because it appears that potential plaintiffs have been deterred by Section 20A's limitation on damages and its requirement that trading be contemporaneous.

[1] Section 9(e)

Section 9 of the Exchange Act prohibits specified activities designed to manipulate the price of any security registered on a national exchange. In particular, Section 9(a) outlaws wash sales and matched orders intended to create "a false or misleading appearance of active trading," prohibits the effectuation of transactions to create actual or apparent activity in a security or to raise or depress its price to induce its purchase or sale by others, and prohibits manipulation of the market for a security by making false or misleading statements or by touting. n7

Section 9(e) provides a remedy for investors injured by violations of Section 9(a), (b), or (c). This section permits "any person who shall purchase or sell any security at a price which was affected by" one of the prohibited acts or transactions to recover damages from any person who "willfully participate[d]" in the misconduct. n8 To plead an action under Section 9(e), a plaintiff must show that: (1) a series of transactions in a security created actual or apparent trading in that security or raised or depressed market price; (2) the transaction was carried out with scienter to induce the sale or purchase; (3) the transactions were relied upon by the plaintiff; and (4) the transactions affected plaintiff's purchase or selling price. n9

Section 9(e) only is available for manipulations of exchange-traded securities. It does not apply to a manipulation of a stock, for example, on NASDAQ. Additionally, significant procedural hurdles have resulted in Section 9(e) claims rarely being filed. Under Section 9, plaintiffs face a difficult burden of proof; they must demonstrate the defendant intended to induce a sale n10 and that the price of the security was "affected by" defendant's activity. n11 Moreover, if a plaintiff is unsuccessful, he or she may be ordered to pay defendant's costs and attorneys' fees. n12 As a result of these substantial impediments, few plaintiffs have elected to sue under section 9(e). n13

[2] Section 18(a)

Section 18(a) of the Exchange Act creates a private right of action against any person responsible for a false or misleading statement of material fact in an application, report, or document filed with the SEC under the Exchange Act. n14 Any person who has purchased or sold a security n15 relying on the misleading statement, and at a price affected by the statement, may sue for damages resulting from that reliance. n16 The claim must be filed within one year of discovery of the fraud, or three years within accrual of the cause of action. n17

Plaintiffs' burden of proof under Section 18(a) is daunting. n18 Claimants must plead and prove that: (1) the plaintiff read and relied n19 on a misleading statement in a document filed n20 with the SEC ("eyeball reliance") or relied on a repetition of that statement; (2) the price of the security purchased or sold n21 was "affected by" the statement, causing damages; n22 and (3) the plaintiff had no knowledge that the statement was false or misleading. In addition, complaints alleging Section 18 violations must satisfy the requirement under Fed. R. Civ. P. 9(b) that fraud-based claims be stated with particularity n23 and the heightened pleading standards of the Reform Act. n24

Even if a plaintiff survives a motion to dismiss, there is another barrier to recovery. Section 18 contains a statutory defense if the defendant can prove that he or she "acted in good faith and without knowledge that such statement was false or misleading." n25 Mere negligence by a defendant may not be sufficient to justify plaintiff's recovery. n26 If found liable, a defendant may sue other prospective defendants for contribution. n27 Finally, like Section 9(e), Section 18 authorizes the court to require either party to post an undertaking for costs, including reasonable attorneys' fees. n28

Although Congress included Section 18 in the Exchange Act to strengthen enforcement and to compensate injured investors, n29 the statute has provided little benefit to investors. The heavy burden of proof in these cases has dissuaded all but the most determined plaintiffs. n30 In addition, class action relief is, as a practical matter, rarely available under Section 18 because of the actual reliance requirement. n31 Therefore, most plaintiffs prefer to file a claim based on an implied right of action under another provision of the Exchange Act or common law fraud. n32

[3] Section 20A

Section 20A was added to the Exchange Act in 1988 as part of the Insider Trading and Securities Fraud Enforcement Act. n33 Section 20A states:

Any person who violates any provision of [the Exchange Act or corresponding rules and regulations] by purchasing or selling a security while in possession of material, nonpublic information shall be liable ... to any person who, *contemporaneously* with the purchase or sale of securities that is the subject of

such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class. n34

Actions must be brought within five years of the date of the last transaction relating to the underlying violation. n35

As also discussed below, enactment of Section 20A was a significant development in the law of insider trading because it permits plaintiffs to pursue claims under either the classical theory or the misappropriation theory, n36 effectively overturning a Second Circuit decision where the misappropriation theory was rejected as a basis for a private cause of action. n37 In so doing, Congress extended Section 20A liability to include insiders, tippees and outsiders as potential defendants. n38

[a] Elements n39

[i] Possession of Material Nonpublic Information. Under Section 20A, the defendant must have traded while possessing material nonpublic information. Plaintiffs are generally not required to plead specific factual detail about how the defendant obtained that information. n40 As one court has remarked, "[s]uch a requirement would be absurd, especially since it concerns information peculiarly within the defendant's knowledge." n41

[ii] Independent Violation. Section 20A liability must be predicated on the defendant's violation of the Exchange Act or an Exchange Act regulation. n42 Failure to identify the independent predicate violation in the complaint will result in dismissal. n43 It follows that if the allegation relating to the predicate offense is dismissed, the Section 20A claim will be dismissed as well. n44 Because most Section 20A claims are based on alleged violations of Section 10(b), the heightened pleading standards of the Reform Act n45 have impacted Section 20A claims as well. n46 Of course, Section 20A does not, by its terms, prevent the plaintiff from pursuing other claims. n47 In reality, however, dismissal of the Section 20A claim likely precludes the plaintiff from bringing an implied cause of action under Section 10(b), the only remaining avenue of recovery for the contemporaneous trader, unless the Section 20A claim is predicated on violation of a different provision of the Exchange Act. n48

[iii] Contemporaneous Trading. To proceed with a claim under Section 20A, the plaintiff must have traded contemporaneously with the defendant. The plaintiff must plead with particularity facts showing the trades were contemporaneous, although the plaintiff may be afforded a limited opportunity for discovery to determine the relevant facts. n49

Although "contemporaneous" trading is undefined in the statute, the requirement was developed, and adopted by Congress, from 10b-5 cases involving insider trading on material non-public information under *Rule 10b-5*. Thus, case law under *Rule 10b-5* is instructive in determining whether plaintiffs traded contemporaneously with defendants to establish a Section 20A claim.

Legislative history cites precedent from the Second Circuit n50 reflecting the basic concept underlying the contemporaneous requirement: an individual who trades not long after another individual has traded while in possession of material nonpublic information suffers an informational disadvantage. n51 "Contemporaneousness" substitutes for contractual privity. n52 If a substantial period of time lapses between defendant's and plaintiff's trades, the market presumably has sufficient time to react to the insider's trades so that the plaintiff is not harmed. n53

Courts focus on the length of time between defendant's and plaintiff's trades. Trading by the plaintiff before the insider's trades n54 or trades substantially after -- certainly a month or more n55 -- are not contemporaneous. At the other end of the spectrum, same day trading is likely to be considered contemporaneous. n56

Deciding whether the trades are contemporaneous is more difficult when the length of time between defendant's and plaintiff's trades is more than a day but less than a month. The decisions generally suggest that trading six days or less

after defendant's trades is contemporaneous, n57 reflecting the courts' reluctance to interpret the contemporaneous requirement broadly. There is no definitive interpretation of the requirement by most of the circuit courts. This has resulted in case-specific analysis, leading to inconsistent holdings even among district courts in the same circuit. In the Ninth Circuit, for example, some district courts have held that trading must occur on the same day, whereas others have explicitly or implicitly rejected so stringent an approach. n58

As courts reach consensus on the parameters of contemporaneous trading, parties should expect more claims to be disposed of through motions to dismiss. Even lacking definitive guidance, many courts grant motions to dismiss on this issue. n59

The requirement that plaintiff's trades be contemporaneous with defendant's can lead not only to dismissal of the Section 20A claim, but can also affect plaintiff's ability to pursue class actions. A plaintiff's contemporaneous trading must be determined by the court at the certification stage. If the trades are not contemporaneous, plaintiff is precluded from asserting a claim for a class of contemporaneous traders. n60 In addition, the contemporaneous requirement often necessitates the definition of "subclasses" of plaintiffs within the context of a larger class action because some plaintiffs in the underlying fraud action are not contemporaneous traders for purposes of the secondary Section 20A claim. n61

[b] Damages. Section 20A significantly limits damages. Damages are limited to defendant's profits earned or losses avoided n62 minus any amount the defendant was ordered to disgorge by the SEC in a separate proceeding. n63 This damage cap is a substantial deterrent to potential plaintiffs, particularly in class actions where an award based on defendants' profits would likely be split among numerous plaintiffs, resulting in nominal individual recoveries. The impact of the Sarbanes-Oxley fair funds provision remains to be seen.

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 78 et seq. (1999) ("Exchange Act").

(n2)Footnote 2. Certain provisions of the Exchange Act are enforced by other agencies and organizations. *See, e.g.*, Exchange Act § 12(i) (federal bank regulators). In addition, securities exchanges, clearing agencies, and the NASD, the only registered securities association, are required to enforce compliance with the federal securities laws, subject to review by the SEC. *See* Exchange Act §§ 19(d)-(f).

(n3)Footnote 3. The SEC may impose a variety of disciplinary sanctions for violations of the securities laws and regulations, including censure, disgorgement and civil penalties. *See, e.g.*, Exchange Act § 15(b)(4) (broker-dealer misconduct). Administrative actions that proceed to trial are held before administrative law judges, whose initial decisions may be appealed to the SEC. Appeals from decisions of the SEC are made either to the D.C. Circuit or the Circuit where the respondent resides or has its principal place of business. For a discussion of SEC enforcement actions and procedures, *see* Chapter 9 *infra*.

(n4)Footnote 4. *See* Exchange Act § 21.

(n5)Footnote 5. In addition, § 16(d) creates an express right of action in connection with short-swing trading provision. Section 16(a) is of sufficient importance to receive separate treatment. *See* Chapter 8 *infra*.

(n6)Footnote 6. *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 360-361, 111 S. Ct. 2773,

2780 (1991) (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976)) .

(n7)Footnote 7. Section 9 is discussed in detail in Chapter 6 *infra*. Under § 9, the SEC may prescribe rules regulating the "pegging, fixing, or stabilizing" of the price of a security. Sections 9(b) and 9(c) authorize the SEC to make rules governing the acquisition, endorsement, or guarantee of any put, call, straddle, or other option or privilege with relation to which such an option or privilege is outstanding.

(n8)Footnote 8. Exchange Act § 9(e).

(n9)Footnote 9. See *Chemetron Corp. v. Business Funds, Inc.*, 682 F.2d 1149, 1164 (5th Cir. 1982) , vacated and remanded on other grounds, 460 U.S. 1007 (1983) ; see also *Perry v. Eastman Kodak Co.*, 1992 U.S. App. LEXIS 11753, at *18 (7th Cir. May 15, 1992) (dismissing for failure to allege actual reliance).

(n10)Footnote 10. Proving "willfulness" under § 9(e), as well as the manipulative purpose that is an element of a substantive violation of § 9(a), may be more difficult than proving "scienter" under *Rule 10b-5*. See, e.g., *Chemetron*, 682 F.2d at 1162 . For a discussion of the "scienter" requirement under *Rule 10b-5*, see Chapter 5.04 *infra* .

(n11)Footnote 11. See, e.g., *Jolley v. Welch*, 904 F.2d 988, 992-993 (5th Cir. 1990) ; *Chemetron*, 682 F.2d at 1162 ; *Crane Co. v. American Standard, Inc.*, 603 F.2d 244, 251-252 (2d Cir. 1979) ; *Rosenberg v. Hano*, 121 F.2d 818, 821 (3d Cir. 1941) ; *Lowe v. Salomon Smith Barney*, 206 F. Supp. 2d 442, 444 (W.D.N.Y. 2002.).

(n12)Footnote 12. See Exchange Act § 9(e) (authorizing the court to require an undertaking for costs from, and to assess costs and attorneys' fees against, either party litigant).

(n13)Footnote 13. 9 Louis Loss & Joel Seligman, *Securities Regulation* 4279 (3d ed., revised 2004) ("It is small wonder that § 9(e) has been virtually a dead letter so far as producing recoveries is concerned.").

(n14)Footnote 14. Section 18(a) provides in relevant part:

Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this title or any rule or regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of section 15 of this title, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.

Exchange Act § 18(a).

(n15)Footnote 15. The purchaser-seller requirement eliminates many potential plaintiffs and defendants. In *Touche Ross & Co. v. Redington*, 442 U.S. 560 (1979) , plaintiffs could not avail themselves of § 18 because they did not meet this requirement. *Id.* at 572-573 .

(n16)Footnote 16. 442 U.S. at 572-73 .

(n17)Footnote 17. Exchange Act § 18(c). Although Congress extended the statute of limitations for securities fraud actions under Section 10(b), it is an open question whether this provision has modified the limitations period under 18(a). See *Sarbanes-Oxley Act of 2002 § 804*, 28 U.S.C. § 1658 (2003).

(n18)Footnote 18. The burden imposed on the plaintiff seeking damages for a misstatement or omission in an Exchange Act filing is greater than that imposed on the plaintiff who seeks to recover damages under § 11 of the

Securities Act in relation to a Securities Act filing. See Merritt B. Fox, *Securities Regulation in the 21st Century: Rethinking Disclosure Liability in the Modern Era*, 75 Wash. U. L.Q. 903, 904 n.4 (1997) (referring, in part, to the "eyeball reliance" requirement under § 18 and stating that the plaintiff seeking damages in relation to an Exchange Act filing "has much less chance of success than if the same statement appears in a registration statement under the Securities Act").

(n19)Footnote 19. Actual reliance must be alleged and proven. See, e.g., *Ross v. A. H. Robins Co.*, 607 F.2d 545, 552-53 (2d Cir. 1979) ; *Heit v. Weitzen*, 402 F.2d 909, 916 (2d Cir. 1968) . Constructive reliance is insufficient to support a claim under § 18. See, e.g., *In re Digi Internat'l Inc. Sec. Litig.*, 6 F. Supp. 2d 1089, 1103 (D. Minn. 1998) (citing cases).

Of course, "eyeball reliance" does not mean that a plaintiff must have viewed the document filed with the SEC--relying on a copy of statements contained within a document filed is sufficient to sustain a claim under § 18. See, e.g., *Erath v. Xidex Corp.*, 1990 U.S. Dist. LEXIS 20828, at *23 (D. Ariz. June 11, 1990) (citing *Wachovia Bank & Trust v. National Student Marketing*, 461 F. Supp. 999, 1006 n.13 (D.D.C. 1978)) . Nonetheless, at least one court has held that the plaintiff must have known at the time of reliance that the document had been filed with the SEC or incorporated into a filed document. *Erath*, 1990 U.S. Dist. LEXIS 20828, at *27 (dismissing claim because plaintiff did not know that statements had been incorporated into filed document).

(n20)Footnote 20. The most important documents that are filed with the SEC under the Exchange Act are the periodic reports that § 13(a) and § 15(d) require of certain publicly held companies. For most of these companies, the required filings include annual reports on Form 10-K, quarterly reports on Form 10-Q and reports of significant corporate events on Form 8-K. Neither the financial information in Form 10-Q nor the glossy annual report disseminated to shareholders under proxy rules are deemed "filed" with the SEC, however. See Exchange Act Rules 13a-13(d) and 15d-13(d). Therefore, plaintiffs cannot allege reliance on the financial statements as the basis of a claim under § 18. See *Digi Internat'l*, 6 F. Supp.2d at 1103 (citing rule and dismissing claim as a matter of law). If the issuer requests that the glossy annual be treated as a part of the proxy soliciting material or incorporates it by reference in a filed document, then the issuer may be held liable under § 18 for misstatements contained in that document. See Exchange Act Rules 14a-3(c) and 14c-3(b).

(n21)Footnote 21. Note that some courts have held that a plaintiff is not required to allege that he or she was a purchaser or seller of securities in order to survive a motion to dismiss under § 18. See, e.g., *International Broadcasting Corp. v. Turner*, 734 F. Supp. 383, 391 (D. Minn. 1990) . But see, e.g., *FMC Corp. v. Boesky*, 727 F. Supp. 1182, 1193-94 (N.D. Ill. 1989) (holding that plaintiff "must adequately allege that it purchased or sold securities" and dismissing complaint for failure to do so).

(n22)Footnote 22. See *Hoover v. Allen*, 241 F. Supp. 213, 225 (S.D.N.Y. 1965) (holding that injury must be a direct result of purchase or sale and, thus, "remote damages resulting from corporate waste" do not support a § 18(a) claim).

(n23)Footnote 23. See, e.g., *Lindner Dividend Fund, Inc. v. Ernst & Young*, 880 F. Supp. 49, 57 (D. Mass. 1995) (citing cases).

(n24)Footnote 24. Pub. L. No. 104-67, 109 Stat. 737 ("Reform Act").

(n25)Footnote 25. Exchange Act § 18(a).

(n26)Footnote 26. Cf. *Lindner*, 880 F. Supp. at 59 (stating that the publication of statements, subsequently proven to be inaccurate when made, does not "necessarily lead to a finding of liability") (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 211 n.31 (1976)) .

(n27)Footnote 27. Exchange Act § 18(b).

(n28)Footnote 28. Exchange Act § 18(a).

(n29)Footnote 29. S. Rep. No. 73-792, at 12-13 (1934):

Experience with State laws designed to prevent the exploitation of the investor by supervision of the sale of securities has demonstrated the inadequacy of criminal penalties as the sole sanction. Customers are ordinarily reluctant to resort to criminal proceedings, and in the absence of complaints by them, the discovery of violations is often impossible. Furthermore, if an investor has suffered loss by reason of illicit practices, it is equitable that he should be allowed to recover damages from the guilty party. With these considerations in view, the bill provides that any person who ... makes a false or misleading statement in the report of a corporation, shall be liable in damages to those who have bought or sold the security at prices affected by such ... statement.

(n30)Footnote 30. See 9 Louis Loss & Joel Seligman, *Securities Regulation* 4298 (3d ed. revised 2004) ("Relatively few [plaintiffs] have found the courage [to proceed under § 18]").

(n31)Footnote 31. See Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 *Cornell L. Rev.* 1, 3 n.6 (1998) ("Because reliance turns on different questions of fact for each plaintiff (many of whom never read SEC filings), class actions under section 18 are virtually impossible.").

(n32)Footnote 32. See *Ross v. A. H. Robins Co.*, 607 F.2d 545, 556 (2d Cir. 1979) ("We conclude that even as to those documents filed with the S.E.C., plaintiffs may seek to prosecute their claim under Section 10(b) and *Rule 10b-5*"); see also *Wachovia Bank and Trust Co. v. National Student Marketing Corp.*, 650 F.2d 342, 357 (D.C. Cir. 1980) (following *Ross*), cert. denied, 452 U.S. 954 (1981); *In re Scorpion Tech., Inc., Sec. Litig.*, 1996 U.S. Dist. LEXIS 22294, *8-12 (N.D. Cal. Mar. 28, 1996) (following *Ross* but noting older district court cases in which Section 10(b) claims were not permitted where Section 18 applied); 9 Louis Loss & Joel Seligman, *Securities Regulation* 4298-99 (3d ed. revised 2004) (suggesting that a plaintiff consider adding a claim in common law deceit or bring the claim under *Rule 10b-5*) (citing cases); Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 *CORNELL L. REV.* 1, 3 n.6 (1998); ("Most plaintiffs instead use the implied private right of action under Section 10(b) of the 1934 Act."). Cf. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386, 386-387 (1983) (citing *Ross* and holding that Section 11 was not the exclusive remedy available to plaintiffs alleging misrepresentations in Securities Act filings-remedies were also available to plaintiffs under Section 10(b)).

(n33)Footnote 33. Pub. L. No. 100-704, 102 Stat. 4677 (1988).

(n34)Footnote 34. Exchange Act § 20A(a) (emphasis added).

(n35)Footnote 35. Exchange Act § 20A(b)(4).

(n36)Footnote 36. See Howard M. Friedman, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 68 *N.C. L. Rev.* 465, 481-84 (Mar. 1990) (discussing the impact of Section 20A).

(n37)Footnote 37. In *Moss v. Morgan Stanley, Inc.*, 719 F.2d 5 (2d Cir. 1983), the plaintiff traded contemporaneously with an outsider who had misappropriated confidential information from his employer but the claim was dismissed because the defendant had not breached any fiduciary duty to plaintiff. 719 F.2d at 5. The House Committee report states that Section 20A was "specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory." H.R. Rep. No. 100-910 at 26.

(n38)Footnote 38. Several years later, the Supreme Court upheld the misappropriation theory for insider trading. See § 5.04[1][6] *infra*.

(n39)Footnote 39. Although § 20A claims involve elements other than the three discussed in this section, such as the requirement that the securities traded be of the same class, reported decisions to date have focused on these three elements.

(n40)Footnote 40. See, e.g., *Simon v. American Power Conversion Corp.*, 945 F. Supp. 416, 423-424 (D.R.I. 1996) (sufficient to state facts that suggest materiality of and access to information); *H.A.B. Assocs. v. Hines*, 1990 U.S. Dist. LEXIS 14301, *15-17 (S.D.N.Y. Oct. 29, 1990) (same).

(n41)Footnote 41. *H.A.B. Assocs.*, 1990 U.S. Dist. LEXIS 14301, at *17 .

(n42)Footnote 42. See Exchange Act § 20A(a); see also *Jackson Nat'l Life Ins. Co. v. Merrill Lynch & Co., Inc.*, 32 F.3d 697, 703-704 (2d Cir. 1994) (rejecting plaintiffs' § 20A claim because it was based on alleged violations of §§ 11 and 12(2) of the Securities Act); see also *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 541 (3d Cir. 1999) ; *In re Verifone Sec. Litig.*, 11 F.3d 865, 872 (9th Cir. 1993) .

(n43)Footnote 43. See, e.g., *Hogan v. Piasecki*, 1997 U.S. Dist. LEXIS 6858, at *4-5 (N.D. Ill. May 7, 1997) (dismissing § 20A claim with prejudice).

(n44)Footnote 44. See, e.g., *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 541 (3d Cir. 1999) ; *Sterlin v. Biomune Sys.*, 154 F.3d 1191, 1194 (10th Cir. 1998) ; *Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co.*, 940 F. Supp. 1101, 1130-1131 (W.D. Mich. 1996) ; *Thornton v. Micrografx, Inc.*, 878 F. Supp. 931, 938 (N.D. Tex. 1995) .

(n45)Footnote 45. Pub. L. No. 104-67, 109 Stat. 737 ("Reform Act"). For a discussion of the heightened pleading standards under the Reform Act, see Chapter 5.04[2][b][ii] *infra* .

(n46)Footnote 46. See, e.g., *Advanta*, 180 F.3d at 541-42 (holding that plaintiffs' § 10(b) claims failed because, among other things, defendants' alleged misrepresentations were protected statements under the Reform Act's safe harbor and dismissing the 20A claim as derivative of the failed § 10(b) cause of action); *In re Aetna Inc. Sec. Litig.*, 34 F. Supp. 2d 935, 957 (E.D. Pa. 1999) (same). Note: Both of these cases have been criticized many times regarding pleading "scienter" versus pleading "recklessness" after the heightened pleading standards of the PSLRA. There is a circuit split on what is necessary to be pled; the split is discussed in *Nathenson v. Zonagen Inc.*, 267 F.3d 400 (5th Cir., 2001) : "It seems clear to us that the PSLRA has not generally altered the substantive scienter requirement for claims brought under section 10(b) and Rule 10b-5, and therefore severe recklessness, as defined in Broad, remains a basis for such liability. The First, Third, Sixth, and Eleventh Circuits have all explicitly reached similar conclusions. See *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 198-201 (1st Cir. 1999) ; *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 534 (3d Cir. 1999) ; *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 548-49 (6th Cir. 1999) ; *Bryant*, 187 F.3d at 1283-84. The Second Circuit has implicitly so concluded as well. See *Novak v. Kasaks*, 216 F.3d 300, 306 (2d Cir. 2000) (observing that the scienter requirement for securities fraud claims, which includes recklessness, "has been firmly established for at least a generation" and that the PSLRA altered the "procedural" requirements for bringing such a claim); see also *Rothman v. Gregor*, 220 F.3d 81, 90 (2d Cir. 2000) (describing substantive recklessness standard). The Ninth Circuit has reached the slightly different conclusion that, at least under the PSLRA, recklessness suffices to meet the substantive scienter requirement only if it rises to the level of "deliberate recklessness." See *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 975-77 (9th Cir.) , *reh'g denied*, 195 F.3d 521 (9th Cir. 1999) .

(n47)Footnote 47. Section 20A(d) states, "Nothing in this action shall be construed to limit or condition the right of any person to bring an action to enforce a requirement of this title or the availability of any cause of action implied from a provision of this title.

(n48)Footnote 48. See *T. Rowe Price New Horizons Fund, Inc.*, 749 F. Supp. 705, 709-10 (D. Md. 1990) (stating that "the language in § 20A(d) is intended to preserve certain implied rights of action for persons other than contemporaneous traders, a category of plaintiff not addressed in § 20A" and holding that plaintiffs cannot plead § 20A and § 10(b) allegations in the alternative) (emphasis added). The court in *T. Rowe Price* reasoned that § 20A allegations

must be premised on a *Rule 10b-5* violation and, therefore, permitting alternative pleading would subject defendants to multiple damage awards exceeding wrongful profits and undermine the damages cap of § 20A. *See* 749 F. Supp. at 709-710 .

(n49)Footnote 49. *See, e.g., Neubronner v. Milken*, 6 F.3d 666, 671, 672 (9th Cir. 1993) (dismissing insider trading claim with prejudice for failure to sufficiently allege specific dates of trades despite substantial opportunity for limited discovery); *Blanchard v. Edgemark Fin. Corp.*, 1999 U.S. Dist. LEXIS 1096, at *43 (N.D. Ill. Feb. 3, 1999) (denying motion to dismiss despite plaintiffs' failure to identify dates of trades because plaintiffs had not had opportunity to conduct discovery).

(n50)Footnote 50. *See* H.R. Rep. No. 100-910 at 27 (1988) (adopting definition developed through 10b-5 cases). The Report cites three cases where varying lengths of time between plaintiffs and defendant's trades were considered. H.R. Rep. No. 100-910 at 27 (1988) (citing *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88 (2d Cir. 1981) ; *Shapiro v. Merrill, Lynch, Pierce Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974) ; *O'Connor & Assocs. v. Dean Witter Reynolds, Inc.*, 559 F. Supp. 800 (S.D.N.Y. 1983)) .

(n51)Footnote 51. *See, e.g., Wilson*, 648 F.2d at 94-95 (claim under 10b-5); *Neubronner*, 6 F.3d at 670 (same).

(n52)Footnote 52. *See Buban v. O'Brien*, 1994 U.S. Dist. LEXIS 8643, at *7-8 (N.D. Cal. June 16, 1994) ("While an actual trade between plaintiff and defendant need not be expressly shown, harm to the plaintiff is a necessary factor. Such harm may be found where it appears the plaintiff might, in fact, have traded with the defendant."). Considering the fact that contemporaneous trading is a substitute for privity, it is interesting that the Seventh Circuit has held that § 20A does not apply to face-to-face transactions or, in other words, to transactions that *do* involve contractual privity. *See Fujisawa Pharmaceutical Co., Ltd. v. Kapoor*, 115 F.3d 1332, 1337 (7th Cir. 1997) . *But see Hogan v. Piasecki*, 1997 U.S. Dist. LEXIS 6858, *4-5 (N.D. Ill. May 5, 1997) (dismissing the § 20A claim, which was based on a direct sale of plaintiffs securities to defendant, on other grounds).

(n53)Footnote 53. *See, e.g., Buban*, 1994 U.S. Dist. LEXIS 8643, at *8-9 (finding that, in light of the high trading volume and price difference during the time between defendant's trades and plaintiffs trades three days later, the market had already absorbed the defendant's sales and plaintiff suffered no harm).

(n54)Footnote 54. *See, e.g., In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1489-1491 (N.D. Cal. 1992) (dismissing complaint with prejudice) , *aff'd*, 11 F.3d 865, 872 (9th Cir. 1993) ; *O'Connor & Assocs. v. Dean Witter Reynolds, Inc.*, 559 F. Supp. 800, 803 (S.D.N.Y. 1983) ; *see also Brody v. Transitional Hospital Corp.*, 280 F. 3d 997, 1002 (9th Cir. 2002) (insider purchases were not contemporaneous with plaintiffs' sales two months earlier for liability under either § 10(b) or § 14(e)).

(n55)Footnote 55. *See, e.g., Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 95 (2d Cir. 1981) (holding that one month was too long); *In re United States Surgical Corp. Sec. Litig.*, 1995 U.S. Dist. LEXIS 20895, at * 73 (D. Conn. Apr. 12, 1995) (six weeks too long). *Cf. Chanoff v. United States Surgical Corp.*, 857 F. Supp. 1011, 1021-1022 (D. Conn.) (applying federal securities law on contemporaneous trading to state law claim involving alleged breach of fiduciary duty and holding that plaintiff did not trade contemporaneously with defendant where plaintiff traded more than one month after defendant), *aff'd*, 33 F.3d 50 (2d Cir. 1994) .

(n56)Footnote 56. *See, e.g., Simon v. American Power Conversion Corp.*, 945 F. Supp. 416, 436 n.28 (D.R.I. 1996) ("Because the named plaintiffs traded on the same day as [the defendants], the "contemporaneous" requirement is clearly satisfied. As such, the Court need not at this time determine whether a contemporaneous trader under this section includes someone who traded in the days or weeks after the alleged insider trade."); *In re Gupta Corp. Sec. Litig.*, 900 F. Supp. 1217, 1244 (N.D. Cal. 1994) (noting that plaintiff and defendant traded on same day and, thus, claim could not be dismissed).

(n57)Footnote 57. *First Circuit: Colby v. Hologic, Inc.*, 817 F. Supp. 204, 215-216 (D. Mass. 1993) (eight days

too long in case brought under *Rule 10b-5*); *In re Stratus Computer, Inc.*, 1991 U.S. Dist. LEXIS 21587, at *17 (D. Mass. Dec. 10, 1991) ("The defendants argue persuasively, however, that the logic of Judge McNaught's decision requires an interpretation of 'contemporaneous' to mean 'same day.' "); *Backman v. Polaroid Corp.*, 540 F. Supp. 667, 670-671 (D. Mass. 1982) (plaintiffs' trades two and seven days after defendant's not contemporaneous for purposes of implied cause of action under *Rule 10b-5*). Second Circuit: *Shapiro v. Merrill, Lynch, Pierce Fenner & Smith, Inc.*, 495 F.2d 228, 241 (2d Cir. 1974) (four days sufficient); *In re Oxford Health Plans, Inc., Sec. Litig.*, 187 F.R.D. 133, 144 (S.D.N.Y. 1999) ("Five trading days is a reasonable period between the insider's sale and the plaintiffs purchase to be considered contemporaneous."); *In re United States Surgical Corp. Sec. Litig.*, 1995 U.S. Dist. LEXIS 20895, at *73 (D. Conn. Apr. 12, 1995) (six weeks too long).

Seventh Circuit: *Blanchard v. Edgemark Fin. Corp.*, 1998 U.S. Dist. LEXIS 14957, at *42 n.14 (N.D. Ill. Sept. 15, 1998) ("Although the definition of contemporaneous trading has not been decided, trades between one and four days apart have generally been considered contemporaneous while trades between two weeks and one month apart have generally not been considered contemporaneous."); *Feldman v. Motorola, Inc.*, 1994 U.S. Dist. LEXIS 14809, at *15 (N.D. Ill. Oct. 18, 1994) (refusing to adopt a same day requirement and stating that "some degree of imprecision is unavoidable"). *Eighth Circuit*: *In re Eng'g Animation Sec. Litig.*, 110 F. Supp. 2d 1183, 1196 (S.D. Iowa 2000) (three days); *Ninth Circuit*: *Neubronner v. Milken*, 6 F.3d 666, 670 (9th Cir. 1993) (suggesting that trades should be within a few days of each other but declining to establish limits); *In re Silicon Graphics Sec. Litig.*, 970 F. Supp. 746, 761 (N.D. Cal. 1997) (six day limit); *In re AST Research Sec. Litig.*, 887 F. Supp. 231, 234 (C.D. Cal. 1995) (same day) *Note*: *Middlesex Ret. Sys. v. Quest Software Inc.*, 527 F. Supp. 2d 1164 (C.D. CA. 2007) (Distinguishing AST Research by noting "the Ninth Circuit has explicitly declined to define the contours of the "contemporaneous" requirement," and then finding more persuasive the reasoning in *In re Am. Bus. Computers Corp. Sec. Litig.*, 1994 U.S. Dist. LEXIS 21467, (S.D.N.Y. February 24, 1994) which stated: "the better rule with respect to standing seems to be that a class action may be maintained on behalf of all persons who purchased stock on an exchange during the period that defendants were selling that stock on the basis of insider information."); *Gerstein v. Micron Tech., Inc.*, 1993 U.S. Dist. LEXIS 21214, at *19-21 (D. Idaho Jan. 4, 1993) (establishing a four day requirement); *Tenth Circuit*: *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 258 F.Supp.2d 576, 600 (S.D. Tex. 2003) (two or three days).

(n58)Footnote 58. *Compare* *AST Research*, 887 F. Supp. at 234 ("This court concludes that a same-day definition of contemporaneous is proper.") (Note: see above comment in n.57 re: *AST Research*) with *Silicon Graphics*, 970 F. Supp. at 761 (trades should occur within six days to satisfy contemporaneous requirement) and *Gerstein*, 1993 U.S. Dist. LEXIS 21214, at *19-21 (rejecting defendants' argument that trades must have occurred on the same day and establishing a four day requirement).

(n59)Footnote 59. *See, e.g., Picard Chem. Inc. Profit Sharing Plan v. Perrigo Co.*, 940 F. Supp. 1101, 1131 (W.D. Mich. 1996) (citing Fed. R. Civ. P. 9(b)); *In re AST Research Sec. Litig.*, 887 F. Supp. 231, 235 (C.D. Cal. 1995) (dismissing complaint in part because "allegations are bereft of any details whatsoever."); *In re United States Surgical Corp. Sec. Litig.*, 1995 U.S. Dist. LEXIS 20895, at *72-73 (D. Conn. Apr. 12, 1995) (class action claim dismissed where class representative traded more than six weeks after insider traded); *In re Cypress Semiconductor Sec. Litig.*, 1992 U.S. Dist. LEXIS 22480 at *11-12 (N.D. Cal. Sept. 24, 1992) (dismissing complaint without prejudice where plaintiffs failed to allege facts to show contemporaneous trading despite including such facts in separate Declaration).

(n60)Footnote 60. *See, e.g., In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1489 (N.D. Cal. 1992) , *aff'd*, 11 F.3d 865 (9th Cir. 1993) ; *Gerstein*, 1993 U.S. Dist. LEXIS 21214 at *21-22 .

(n61)Footnote 61. *See, e.g., In re Aetna Inc. Sec. Litig.*, 34 F. Supp. 2d 935, 940 (E.D. Pa. 1999) (identifying subclass).

(n62)Footnote 62. Exchange Act § 20A(b)(1).

(n63)Footnote 63. Exchange Act § 20A(b)(2).



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Federal Securities Exchange Act of 1934

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CHAPTER 5 Civil Liabilities Under the Exchange Act

1-5 Federal Securities Exchange Act of 1934 § 5.03

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§ 5.03 Implied Civil Liabilities

Although federal courts have long recognized "implied" rights of action that supplement, and sometimes overshadow, express remedies Congress created for injured investors, the Supreme Court in recent years has become increasingly hostile to implied rights. Despite general hostility to implied private rights of action, the Court has adhered to its decisions allowing private parties to sue under Rule 14a-9, outlawing fraud in proxy solicitations, and *Rule 10b-5*, prohibiting fraud in securities transactions. In addition, the Court has held that defrauded purchasers of securities may bypass express remedies under the Securities Act to seek damages under *Rule 10b-5* instead.

[1] Increasing Judicial Hostility to Implied Rights of Action Generally

Courts once routinely let private plaintiffs sue for damages caused by a violation of a federal statute designed to benefit a special class, even if the statutory language did not create an express cause of action. n1 Despite the care Congress used to create and define civil remedies for injured investors in the Securities Act of 1933 and Securities Exchange Act of 1934, for many years courts supplied additional and different remedies. The Supreme Court approved of this practice in *J.I. Case v. Borak*, n2 which inferred a private right of action under Section 14(a) of the Exchange Act and Rule 14a-9 thereunder. n3 The Court's broad rationale that private actions would aid in "enforcement" of the federal statute encouraged lower courts to recognize numerous additional private rights of action. Following *Borak*, though, the Court has taken an increasingly dim view of implied private rights of action. In *Cort v. Ash*, n4 a non-securities case decided in 1975, the Court held that private rights of action would no longer automatically be inferred. n5 More recent decisions emphasize a private right of action will not be available without some affirmative indication of Congressional intent. n6 Some recent lower court decisions have gone one step further, establishing a presumption against implied private rights of action that can be overcome only by strong evidence of Congressional intent to provide a private right. n7

In 1994, the Supreme Court indirectly reaffirmed its restrictive approach to implied private rights of action in *Central Bank of Denver*. n8 The Court held there is no aiding and abetting liability in private actions under Section 10(b), n9 reasoning that "the statutory text controls the definition of conduct covered by Section 10(b)," n10 and the text of the Exchange Act does not itself encompass aiders and abettors. n11 The Court found it unnecessary to examine legislative history. n12 The Court also said that when the text of the statute is clear, policy arguments will not be considered unless "adherence to the text and structure would lead to a result so bizarre that Congress could not have intended it." n13

Construed narrowly, *Central Bank* does not affect the analysis of private rights of action at all. As the Court emphasized, n14 the case concerned the nature of the statutory right itself rather than whether there was an implied remedy for a statutory right. Nevertheless, *Central Bank's* strict textual approach clearly is in tension with implied private rights of action.

[2] Implied Liabilities under Particular Provisions other than Section 10(b)

The status of implied private liabilities under provisions of the securities laws is now established. Despite general hostility to implied private rights of action, the Supreme Court has reaffirmed that private rights of action are implied by Section 10(b) of the Exchange Act and *Rule 10b-5*, and by Section 14(a) of the Exchange Act and Rule 14a-9. n15 On the other hand, the Court has held that a defeated tender offeror cannot sue for damages under Section 14(e) of the Exchange Act, n16 and that there is no implied right of action under Section 17(a) of that Act. n17 Additionally, in a case where it held that there is no private cause of action under the anti-fraud provision of the Investment Advisers Act of 1940, the Court concluded that the clients of an investment adviser could rescind their contracts with the adviser if those contracts were made or performed in violation of the Act. n18

Whether courts will continue to infer private rights of action under other provisions of the Exchange Act and the Securities Act is less certain. n19 The lower federal courts have recognized implied liabilities under numerous provisions of the federal securities laws, the margin regulations, and the rules of self-regulatory organizations. n20 Because many of these lower court decisions pre-dated the Supreme Court's current restrictive approach to implied private causes of action, however, it is unlikely these decisions would be followed today.

The remainder of this section briefly addresses implied rights of action under Section 17(a) of the Securities Act, as well as implied rights of action under Section 14(e) and under Section 29(b) of the Exchange Act. n21 The latter section may assume greater importance given the curtailment of implied private remedies under particular sections of the Act.

[a] Section 17(a) of the Securities Act. n22 Section 17(a) of the Securities Act makes it unlawful for any person to commit fraud or to make false or misleading statements in the *offer or sale* of securities. n23 This language is very similar to *Rule 10b-5*. Suing under Section 17(a), however, might offer plaintiffs several significant advantages. For one, Section 17 allows plaintiffs to choose a state or federal forum. n24 Second, a plaintiff suing under Section 17(a)(2) or (3) does not have to prove the defendant acted with scienter. n25 In contrast, purchasers suing under *Rule 10b-5* must file in a federal court n26 and must prove scienter. n27 Moreover, courts recognizing a private cause of action under Section 17(a) may grant *offerees* as well as purchasers the right to seek damages under that section, whereas mere offerees cannot sue under *Rule 10b-5*. n28

Although several early lower court decisions concluded there is an implied private right of action under Section 17(a), and the Supreme Court has expressly reserved judgment on the issue, n29 more recent authority is overwhelmingly to the contrary. n30 This reflects the increasing judicial hostility towards private rights of action, a hesitation to let plaintiffs avoid limitations Congress built into the express liability sections of the securities laws, and unwillingness to circumvent restrictions courts have imposed on *Rule 10b-5* actions.

[b] Section 14(e) of the Exchange Act. n31 Section 14(e) prohibits any person from engaging in "fraudulent, deceptive, or manipulative acts or practices ... in connection with any tender offer." When Section 14(e) was enacted in 1968, Congress may well have expected courts to allow private parties to sue to enforce the section's prohibitions. n32 Most courts examining the issue have concluded that some private parties can sue for some kinds of relief.

In *Piper v. Chris-Craft Industries, Inc.*, n33 the Supreme Court held that Section 14(e) does not grant a tender offeror an implied cause of action for damages against a competing bidder. The Court reserved judgment on both whether a target company or its shareholders can assert claims under Section 14(e), n34 and whether a tender offeror can seek

injunctive relief against a competing bidder's violation of the section. n35 Some circuit courts have either held or assumed that Section 14(e) impliedly grants defrauded shareholders a cause of action. n36 In addition, a number of courts have found the section will support an award of injunctive relief to a tender offeror n37 or a target company. n38

[c] Section 29(b) of the Exchange Act Section 29(b) of the Exchange Act provides that contracts made in violation of "any" provision of the Act (with enumerated exceptions) or any rule adopted thereunder, and contracts whose performance would involve such a violation, are "void" as to the rights of (1) any violator and (2) any person, not a party to the contract, who acquires any right with actual knowledge of facts resulting in the violation. n39 The potential effect of this section is great, and assumes heightened significance given the curtailment of implied private remedies under specific sections of the Act. n40 The provision conceivably could be invoked to void a wide variety of other transactions where there has been an Exchange Act violation. n41

Despite this potential importance, Section 29(b) has received little judicial attention. The few cases discussing the provision do resolve some interpretive questions, however. First, despite use of the word "void," Section 29(b) renders the contract *voidable* at the option of the innocent party instead of making the contract a nullity, creating no enforceable rights even in a party innocent of the violation." n42 Second, only a contractual party can invoke Section 29(b). n43 Third, at a minimum, Section 29(b) lets plaintiffs sue for rescission, restitution, and similar equitable relief, n44 with equitable defense similarly allowed.

In other important respects, courts have reached disparate interpretations of Section 29(b). Where some courts held that Section 29(b) voids all contracts that are either illegal when made or as in fact performed, n45 others have interpreted the section to find that it voids only contracts whose terms necessarily involve a violation of the Exchange Act. n46

[3] Construing the Scope of Recognized Implied Private Rights of Action

The analysis for determining the scope of recognized private rights of action evidently is less restrictive than that which decides whether a particular statutory provision implies a private remedy in the first place. As the Supreme Court explained in 1993 in *Musick, Peeler & Garrett v. Employers Insurance of Wausau*, n47 courts possess limited discretion when determining the contours and incidents of well-established implied private remedies:

The private right of action under *Rule 10b-5* was implied by the judiciary on the theory [that] courts should recognize private remedies to supplement federal statutory duties, not on the theory Congress had given an unequivocal direction to the courts to do so Thus, it would be futile to ask whether the 1934 Congress also displayed a clear intent to create a contribution right collateral to the remedy Having implied the underlying liability in the first place, to now disavow any authority to allocate it on the theory that Congress has not addressed the issue would be most unfair to those against whom damages are assessed The federal courts have accepted and exercised the principal responsibility for the continuing elaboration of the scope of the 10b-5 right and the definition of the duties it imposes Indeed, [a Congressional statute limiting the retroactive effect of a Supreme Court decision concerning the statute of limitations applicable to a 10b-5 action] not only treats the 10b-5 action as an accepted feature of our securities laws, but avoids entangling Congress in its formulation. That task, it would appear, Congress has left to us. n48

In exercising this discretion, a court first must decide whether it can reasonably infer how the enacting Congress would have addressed the issue if the implied private right of action been express. If this inquiry yields a convincing answer, that answer is determinative. n49 Often, however, a court cannot discern what Congress might have done. n50 In such cases, policy considerations are relevant in determining the contours of an implied private right of action. n51 In no case may a court construe a private cause of action to create liability for conduct not arguably proscribed by the statute's text. n52

Applying this analysis, the Supreme Court in 1993 concluded that a defendant held liable in a private action under Section 10(b) has an implied cause of action for contribution from joint tortfeasors. n53 On the other hand, in 1991, the Court interpreted the implied private right of action under Exchange Act Section 14(a) and Rule 14a-9 narrowly. It concluded that causation of damages compensable under Section 14(a) cannot be shown by members of a class of minority shareholders whose votes are not required by law or corporate bylaw to authorize the corporate action subject to the proxy solicitation. n54

[4] Relationship between Express and Implied Liabilities

Shortly after courts began to recognize implied private rights of action under federal securities laws, they encountered the argument that implied remedies should not be available to redress wrongs that Congress had expressly remedied. Proponents argued that implying private remedies frustrated Congress' intended statutory scheme by permitting plaintiffs to avoid strictures inherent in express remedies. But, an absolute refusal to afford an implied right of action arguably leads to anomalous results in some cases. It deprives injured investors of an implied remedy in contexts where Congress specifically sought to protect them, while affording a private remedy in areas where Congress arguably was less concerned with investor protection (*i.e.*, areas where it did not expressly provide for an express remedy).

The chief controversy concerned the relationship between the implied right of action under *Rule 10b-5* and the express remedies granted in the Securities Act of 1933. The Supreme Court spoke on the issue in *Herman & MacLean v. Huddleston*. n55 Bypassing a potential remedy under Section 11 of the 1933 Act, the *Huddleston* plaintiffs brought an action under *Rule 10b-5* against defendants that helped prepare a prospectus. A unanimous Supreme Court held that "availability of an express remedy under § 11 of the 1933 Act does not preclude defrauded purchasers of registered securities from maintaining an action under § 10(b) of the 1934 Act." n56 The Court reasoned that Section 11 of the Securities Act and Section 10(b) of the Exchange Act "involve distinct causes of action and were intended to address different types of wrongdoing." n57 Section 11, designed to assure compliance with disclosure provisions of the Securities Act, imposes a strict standard of liability on those who play a direct role in a registered offering. Section 10(b), on the other hand, is a "catch-all" provision that was designed to prohibit the use by any person of any manipulative or deceptive device in connection with the purchase or sale of any security. Although some conduct actionable under Section 11 might also be actionable under Section 10(b), the Court saw "no reason to carve out an exception to Section 10(b) for fraud occurring in a registration statement." n58 This would have deprived purchasers of registered securities of protection that Section 10(b) grants to all persons who engage in the purchase or sale of securities. n59

The Court buttressed its decision by noting that Congress included "savings clauses" in both the Securities Act and the Exchange Act n60 to ensure that express remedies would not preempt other rights of action. n61 Congress also impliedly ratified a cumulative construction of the securities acts in 1975 when it comprehensively reviewed them and chose not to alter Section 10(b), which most federal courts found available to plaintiffs even when express remedies were also available. n62 Finally, the Court concluded that a cumulative construction of the securities laws would further their broad remedial purposes. n63

Construed narrowly, *Huddleston* establishes only that a plaintiff with a possible cause of action under Section 11 of the 1933 Act can bypass that section and sue under *Rule 10b-5*. The decision does not necessarily stand for the broader proposition that *Rule 10b-5* offers a remedy independent of, and cumulative with, *all* express remedies in the securities acts. In *Huddleston*, the Court observed that the recognition of an implied right of action under *Rule 10b-5* does not "nullify" procedural restrictions on Section 11 actions, because private plaintiffs must prove scienter under *Rule 10b-5*. n64 It is more difficult, however, to reconcile the right to sue under *Rule 10b-5* with the existence of the express remedies under Sections 9(e) and 18 of the Exchange Act, because both of these provisions require an intent showing that is at least as stringent as the scienter requirement of *Rule 10b-5*. n65 If a party complaining of misconduct covered by Section 9(e) or Section 18 can forego his express remedy and sue under *Rule 10b-5*, these two express liability provisions are effectively "nullified." n66

Subsequent lower federal court decisions, however, overwhelmingly support a broader reading of *Huddleston*: the private remedy under *Rule 10b-5* is cumulative with all of the securities acts' express remedies. n67 As a number of these decisions recognize, displacing *Rule 10b-5* with any express remedy yields an anomalous result. It makes the Rule's benefits unavailable to one class of persons to whom Congress gave preferential treatment, but available to other securities traders alleging that they were victims of fraud. It seems implausible the Congress that enacted the Exchange Act would have selectively denied the benefits of *Rule 10b-5* to the very investors given an express remedy. n68

FOOTNOTES:

(n1)Footnote 1. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 374, 102 S. Ct. 1825, 1837 (1982) . (Prior to 1975, "[i]f a statute was enacted for the benefit of a special class, the judiciary normally recognized a remedy for members of that class Under this approach, federal courts, following a common-law tradition, regarded the denial of a[n] [implied] remedy as the exception rather than the rule."); *Lampf, Pleva, Lipkind, et al. v. Gilbertson*, 501 U.S. 350, 366, 111 S. Ct. 2773, 2783-2784 (opinion of Stevens, J. dissenting) (1991) ("The private cause of action for violation Section 10(b) was first recognized in *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946) . In recognizing this implied right of action, Judge Kirkpatrick merely applied what was then a well-settled rule of federal law. As was true during most of our history, the federal courts then presumed that a statute enacted to benefit a special class provided a remedy for those members injured by violations of the statute. Judge Kirkpatrick did not make "new law" when he applied this presumption to a federal statute enacted for the benefit of investors in securities that are traded in interstate commerce.").

(n2)Footnote 2. 377 U.S. 426, 84 S. Ct. 1555 (1964) .

(n3)Footnote 3. Section 14(a) of the Exchange Act declares it "unlawful" for any person to solicit proxies in violation of rules prescribed by the SEC. Rule 14a-9 prohibits the making of false or misleading statements in a solicitation of proxies.

(n4)Footnote 4. 422 U.S. 66, 78, 95 S. Ct. 2080, 2087-2088 (1975) .

(n5)Footnote 5. Specifically, the Court indicated that four criteria were relevant in determining whether to infer a private right of action:

In determining whether a private remedy is implicit in a statute not expressly providing one, several factors are relevant. First, is the plaintiff 'one of the class for whose *especial* benefit the statute was enacted,' *Texas Pacific R. Co. v. Rigsby*, 241 U.S. 33, 39 (1916) (emphasis supplied) -- that is, does the statute create a federal right in favor of the plaintiff? Second, is there any indication of legislative intent, explicit or implicit, either to create such a remedy or to deny one? See, e.g., *National Railroad Passenger Corp. v. National Assn. of Railroad Passengers*, 414 U.S. 453, 458, 460 (1974) (Amtrak). Third, is it consistent with the underlying purposes of the legislative scheme to imply such a remedy for the plaintiff? See, e.g., *Amtrak, supra* ; *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412, 423 (1975) ; *Calhoon v. Harvey*, 379 U.S. 134 (1964) . And finally, is the cause of action one traditionally relegated to state law, in an area basically the concern of the States, so that it would be

inappropriate to infer a cause of action based solely on federal law? See *Wheeldin v. Wheeler*, 373 U.S. 647, 652 (1963) ; cf. *J.I. Case Co. v. Borak*, 377 U.S. 426, 434 (1964) ; *Bivens v. Six Unknown Federal Narcotics Agents*, 403 U.S. 388, 394-395, 400 (1971) .

422 U.S. 66, 78, 95 S. Ct. 2080 (1975) .

(n6)Footnote 6. E.g., *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 541, 104 S. Ct. 831, 841 (1984) ; *Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353, 376-78, 102 S. Ct. 1825, 1839 (1982) ; *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 24-25, 100 S. Ct. 242, 249 (1979) ; *Touche Ross & Co. v. Redington*, 442 U.S. 560, 575, 99 S. Ct. 2479, 2489 (1979) .

(n7)Footnote 7. E.g., *Sigmon v. Southwest Airlines Co.*, 110 F.3d 1200, 1205 (5th Cir. 1997) ; *Baggett v. First National Bank of Gainesville*, 117 F.3d 1342, 1345 (11th Cir. 1997) ; *Spicer v. Chicago Board of Options Exchange, Inc.*, 977 F.2d 255, 257-258 (7th Cir. 1992) .

(n8)Footnote 8. *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 114 S. Ct. 1439 (1994) .

(n9)Footnote 9. Subsequent to the Central Bank decision, Congress authorized the SEC to bring civil actions for aiding and abetting a violation of the securities laws. See Section 104(e) of the Reform Act, 15 U.S.C. § 78t(e),

(n10)Footnote 10. 511 U.S. at 175, 114 S. Ct. at 1447 .

(n11)Footnote 11. 511 U.S. at 177, 114 S. Ct. at 1448 .

(n12)Footnote 12. 511 U.S. at 177, 114 S. Ct. at 1448 .

(n13)Footnote 13. 511 U.S. at 188, 114 S. Ct. at 1453-1454 (citations and quotations marks omitted).

(n14)Footnote 14. 511 U.S. at 171-74, 114 S. Ct. at 1445-1447 .

(n15)Footnote 15. See, e.g., *Central Bank v. First Interstate Bank*, 511 U.S. 164, 171, 114 S. Ct. 1439, 1445 (1994) ("The 1933 and 1934 Acts create an extensive scheme of civil liability Private plaintiffs may sue under the express private rights of action contained in the Acts. They may also sue under private rights of action we have found to be implied by the terms of Section 10(b) and Section 14(a) of the 1934 Act.").

(n16)Footnote 16. *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 42, 97 S. Ct. 926, 949-950 (1977) . Section 14(e) outlaws fraudulent practices in connection with a tender offer. See § 5.03[3][b] *infra*. for a discussion of private actions under Section 14(e).

(n17)Footnote 17. *Touche Ross & Co. v. Redington*, 442 U.S. 560, 579, 99 S. Ct. 2479, 2491 (1979) . Section 17(a) requires broker-dealers and others to keep such records and file such reports as the Commission may prescribe.

(n18)Footnote 18. *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 24-25, 100 S. Ct. 242, 249-250 (1979) . The Court held that the clients could seek rescission under Section 215(b) of the Investment Advisers Act. Section 215(b) of the Investment Advisers Act provides that:

Every contract made in violation of any provision of this title and every contract heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of any provision of this title, or any rule, regulation, or order thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, regulation, or order, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract

was in violation of any such provision.

As further discussed below, in § 5.03[2][c], the Court's recognition of a right of rescission under Section 215(b) of the Investment Advisers Act suggests that there is a similar right under Section 29(b) of the Exchange Act, which declares that contracts made or performed in violation of that Act shall be void.

(n19)Footnote 19. Notwithstanding Central Bank, courts have continued to infer private rights of action for various provisions of the Investment Company Act of 1940 (ICA). *E.g.*, *Young v. Nationwide Life Insur. Co.*, 2 F. Supp. 2d 914, 925-926 (S.D. Tex. 1998) (private right of action implied under ICA Section 36(a)); *Strougo v. Scudder, Stevens & Clark, Inc.*, 964 F. Supp. 783, 796-97 (S.D.N.Y. 1997) (same); *In re Nuveen Fund Litig.*, 1996 U.S. Dist. LEXIS 8071, at *38 (N.D. Ill. 1996) (same); *Blatt v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 916 F. Supp. 1343, 1349 (D.N.J. 1996) (private action for damages implied under ICA Section 47). Such decisions are predicated in part on specific legislative history in the ICA affirmatively indicating that Congress expected the courts to infer private remedies.

(n20)Footnote 20. For a list of provisions that have generated implied causes of action, see 2 A.L.I., Federal Securities Code 775-79 (1980).

(n21)Footnote 21. Implied rights of action under Sections 13(d) and 14(a) of the Exchange Act are considered in Chapters 4 and 5A.

(n22)Footnote 22. Section 17(a) states: "It shall be unlawful for any person in the offer or sale of any securities ... by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly (1) to employ any device, scheme or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

Additionally, Section 17(c) explicitly makes the exemptions contained in Section 3 of the Securities Act inapplicable to the provisions of Section 17. The exemptions contained in Section 4 are also inapplicable, since by their own terms they are exemptions only from the operation of Section 5, which establishes the registration and prospectus requirements.

(n23)Footnote 23. As indicated *supra*, the Securities Act is concerned with offers to sell and sales, not with purchases or offers to purchase. The lack of a general federal prohibition on fraudulent purchases was the principal reason for the adoption of *Rule 10b-5*.

(n24)Footnote 24. Section 22(a) of the Securities Act grants the state and federal courts concurrent jurisdiction "of all suits in equity and actions at law brought to enforce any liability or duty created by" the Act. The section also provides that when the plaintiff initiates his suit in a state court, the case cannot be removed to a federal court.

(n25)Footnote 25. In *Aaron v. SEC*, 446 U.S. 680, 697, 697, 100 S. Ct. 1945, 1956 (1980), the Supreme Court held that the language of § 17(a) requires scienter under § 17(a)(1), but not under § 17(a)(2) or § 17(a)(3).

(n26)Footnote 26. Section 27 of the Exchange Act grants the federal courts "exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder."

(n27)Footnote 27. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193, 96 S. Ct. 1375, 1381 (1976).

(n28)Footnote 28. In *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S. Ct. 1917 (1975), which held that persons who have not purchased or sold securities cannot sue for damages under *Rule 10b-5*, the Supreme Court

contrasted the language of Section 10(b) of the Exchange Act with that of Section 17(a) of the Securities Act. 421 U.S. at 733-34, 95 S. Ct. at 1924. The Court noted that while Section 10(b) is directed at fraud "in connection with the purchase or sale of securities," Section 17(a) reaches fraud "in the offer or sale" of securities. 421 U.S. at 733-34, 95 S. Ct. at 1924. Some lower courts have cited the discussion in *Blue Chip Stamps* in support of the proposition that an offeree who did not purchase securities, but who was injured by the defendant's misconduct, can sue under Section 17(a). *Reid v. Madison*, 438 F. Supp. 332, 334-35 (E.D. Va. 1977); *Wulc v. Gulf & Western Industries, Inc.*, 400 F. Supp. 99, 103 (E.D. Pa. 1975).

(n29)Footnote 29. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 378 n. 2, 100 S. Ct. 683, 685 n. 2 (1983); *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 557 n. 9, 99 S. Ct. 790, 795 n. 9 (1979); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 n. 6, 95 S. Ct. 1917, 1925 n. 6 (1975).

(n30)Footnote 30. E.g., *Maldonado v. Dominguez*, 137 F.3d 1, 6 (1st Cir. 1998); *Finkel v. Stratton Corp.*, 962 F.2d 169, 174-175 (2d Cir. 1992); *Newcome v. Esrey*, 862 F.2d 1099, 1107 (4th Cir. 1988); *Corwin v. Marney, Orton Invs.*, 788 F.2d 1063, 1066-1067 (5th Cir. 1986); *Sears v. Likens*, 912 F.2d 889, 893 (7th Cir. 1990); *Krause v. Perryman*, 827 F.2d 346, 349 (8th Cir. 1987); *In re Wash. Pub. Power Supply Sys. Sec. Litig.*, 823 F.2d 1349, 1354 (9th Cir. 1987); *Bath v. Bushkin, Gaims, Gaines and Jonas*, 913 F.2d 817, 819 (10th Cir. 1990); *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 784-785 (11th Cir. 1988).

(n31)Footnote 31. Section 14(e) states: "It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."

(n32)Footnote 32. Just a few years earlier, the Supreme Court had decided *J.I. Case Co. v. Borak*, 377 U.S. 426, 84 S. Ct. 1555 (1964), which encouraged the lower courts to recognize implied private rights of action. See § 5.04[1] *infra*.

(n33)Footnote 33. 430 U.S. 1, 97 S. Ct. 926 (1977).

(n34)Footnote 34. 430 U.S. 1 at 42 n.28, 97 S. Ct. at 949 n.28.

(n35)Footnote 35. 430 U.S. 1 at 47 n.33, 97 S. Ct. at 952 n.33.

(n36)Footnote 36. See, e.g., *Schlesinger Inv. Partnership v. Fluor Corp.*, 671 F.2d 739, 743 (2d Cir. 1982); *Indiana Nat'l Bank v. Mobil Oil Corp.*, 578 F.2d 180, 183 n. 5 (7th Cir. 1978).

In *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 2, 105 S. Ct. 2458, 2459 (1985), the Supreme Court upheld the dismissal of a suit under Section 14(e) on the ground that the plaintiff shareholder had failed to allege any "fraudulent, deceptive, or manipulative" acts or practices on the part of the defendants. The Court did not discuss whether a shareholder has a right to sue under the section.

(n37)Footnote 37. See, e.g., *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 370 (6th Cir. 1981); *Weeks Dredging & Contracting, Inc. v. American Dredging Co.*, 451 F. Supp. 468, 475-476 (E.D. Pa. 1978); *Humana, Inc. v. American Medicorp, Inc.*, 445 F. Supp. 613, 614-615 (S.D.N.Y. 1977).

(n38)Footnote 38. See, e.g., *Polaroid Corp. v. Disney*, 862 F.2d 987, 997-998 (3d Cir. 1988); *Florida Commercial Banks v. Culverhouse*, 772 F.2d 1513, 1515 (11th Cir. 1985); *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 714-15 (5th Cir. 1984); *Pacific Realty Trust v. APC Investments, Inc.*, 685 F.2d 1083, 1085 (9th Cir.

1982); *Prudent Real Estate Trust v. Johncamp Realty, Inc.*, 599 F.2d 1140, 1148 (2d Cir. 1979) .

(n39)Footnote 39. The text of Section 29(b) is as follows:

Every contract made in violation of any provision of this title or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule or regulation: *Provided*, (A) That no contract shall be void by reason of this subsection because of any violation of any rule or regulation prescribed pursuant to paragraph (3) of subsection (c) of section 15 of this title, and (B) that no contract shall be deemed to be void by reason of this subsection in any action maintained in reliance upon this subsection, by any person to or for whom any broker or dealer sells, or from or for whom any broker or dealer purchases, a security in violation of any rule or regulation prescribed pursuant to paragraph (1) or (2) of subsection (c) of section 15 of this title, unless such action is brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation. The Commission may, in a rule or regulation prescribed pursuant to such paragraph (2) of such section 15(c), designate such rule or regulation, or portion thereof, as a rule or regulation, or portion thereof, a contract in violation of which shall not be void by reason of this subsection.

The other securities laws contain essentially similar provisions. See 9 Louis Loss & Joel Seligman, *Securities Regulation* 4301-4312 (3d ed. 1992).

(n40)Footnote 40. See, e.g., *Rhoades v. Powell*, 644 F. Supp. 645, 661-65 (E.D. Cal. 1986) (declining to limit rescission under Section 29(b) to contract violating sections of the Exchange Act that themselves are the source of private rights of action).

(n41)Footnote 41. See generally Gruenbaum & Steinberg, *Section 29(b) of the Securities Exchange Act of 1934: A Viable Remedy Awakened*, 48 Geo. Wash. L. Rev. 1 (1979).

(n42)Footnote 42. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 387-388, 90 S. Ct. 616, 623 (1970) (dicta).

(n43)Footnote 43. E.g., *Natkin v. Exchange Nat'l Bank of Chicago*, 342 F.2d 675, 676-77 (7th Cir. 1965); *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 792 (8th Cir. 1967) .

(n44)Footnote 44. E.g., *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 387, 90 S. Ct. 616, 623 (1970) (dicta) (interests of "innocent party" to a contract are protected by section 29(b)'s "giving him the right to rescind"); *Transamerica Mortgage Advisors, Inc. v. Lewis*, 444 U.S. 11, 19, 100 S. Ct. 242, 247 (1979) (In interpreting section 215(b) of the Investment Advisers Act, which is substantially similar to Section 29(b) of the Exchange Act, the Court stated, "[w]hen Congress declared in Section 215 that certain contracts are void, it intended that the customary legal incidents of voidness would follow, including the availability of a suit for rescission ..., and for restitution."); *Regional Properties v. Financial & Real Estate Consulting Co.*, 678 F.2d 552, 558 (5th Cir. 1982) ("[I]t must be considered as settled that Section 29(b), by implication, does provide a private, 'equitable cause of action for rescission or similar relief.' ").

(n45)Footnote 45. E.g., *Regional Properties*, 678 F.2d at 560 (5th Cir. 1982) (Holding that a person can avoid a contract under section 29(b) if he can show that (1) the contract involved a prohibited transaction, (2) he is in

contractual privity with the defendant, and (3) he is in the class of persons the act was designed to protect. The court noted that it had previously "allowed a contract for the purchase of bonds, after it had already been performed, to be rescinded by the seller. There was nothing to suggest that the contract 'by [its own] terms' violated the Act. We permitted it to be rescinded simply because the purchaser in performing the contract, had in fact violated the Act by doing so without being registered as a broker-dealer."); *See also Mills*, 396 U.S. at 388 n.11, 90 S. Ct. 623 n.11 (dicta) (proxies submitted in favor of merger could be rescinded, even though terms of merger were not themselves unlawful, if proxies had been solicited in a manner violative of the Act.).

(n46)Footnote 46. *E.g., Komanoff v. Mabon, Nugent & Co.*, 884 F. Supp. 848, 857 (S.D.N.Y. 1995) (Dismissing Section 29(b) claim because plaintiff failed to allege that "the contracts entered into with defendants were 'inherently violative' of the 1934 Act or the regulations thereunder.").

(n47)Footnote 47. 508 U.S. 286, 113 S. Ct. 2085 (1993) .

(n48)Footnote 48. *Musick*, 508 U.S. at 291-94, 113 S. Ct. at 2088-2089.

(n49)Footnote 49. "The parties have devoted considerable portions of their briefs to debating whether a rule of contribution or of no contribution is more efficient or more equitable. Just as we declined to rule on these matters in ... [prior cases], we decline to do so here. Our task is not to assess the relative merits of the competing rules but rather to attempt to infer how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the Exchange Act. We do this not as an exercise in historical reconstruction for its own sake, but to ensure that the rules established to govern the 10b-5 action are symmetrical and consistent with the overall structure of the Exchange Act and, in particular, with those portions of the Exchange Act most analogous to the private 10b-5 right of action that is of judicial creation. Although we have narrowed our discretion in this regard over the years, our goals in establishing limits for the 10b-5 action have remained the same: to ensure the action does not conflict with Congress' own express rights of action, to promote clarity, consistency, and coherence for those who rely upon or are subject to, 10b-5 liability, and to effect Congress' objectives in enacting the securities laws. Inquiring about what a given Congress might have done, though not a promising venture as a general proposition, does in this case yield an answer we find convincing." *Musick*, 508 U.S. at 294-95, 113 S. Ct. at 2089-2090 (citations and quotations omitted).

(n50)Footnote 50. 508 U.S. at 295, 113 S. Ct. at 2090 ("Inquiring about what a given Congress might have done ... [is] not a promising venture as a general proposition.").

(n51)Footnote 51. In *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 111 S. Ct. 2749 (1991) , the Court indicated that when an implied cause of action is an established part of the securities laws that has developed without clear indications of congressional intent, "the contours of [the implied private right] need not be frozen absolutely when the result would be demonstrably inequitable to a class of would-be plaintiffs with claims comparable to those previously recognized." 501 U.S. at 1104, 111 S. Ct. at 2764 . Whether expansion of that cause of action is warranted depends on examination of "policy reasons for deciding where the outer limits of the right should lie." 501 U.S. at 1104-05, 111 S. Ct. at 2764-2765 .

(n52)Footnote 52. *Central Bank v. First Interstate Bank*, 511 U.S. 164, 175-176, 114 S. Ct. 1439, 1447-1448 (1994) .

(n53)Footnote 53. *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 286, 113 S. Ct. 2085, 2085 (1993) . *See also infra* § 5.04[7][c].

(n54)Footnote 54. *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1099, 111 S. Ct. 2749, 2761-2762 (1991) .

(n55)Footnote 55. 459 U.S. 375, 103 S. Ct. 683 (1983) .

(n56)Footnote 56. 459 U.S. at 387, 103 S. Ct. at 689-690 .

(n57)Footnote 57. 459 U.S. at 381, 103 S. Ct. at 687 .

(n58)Footnote 58. 459 U.S. at 382, 103 S. Ct. at 687 .

(n59)Footnote 59. 459 U.S. at 383, 103 S. Ct. at 687-688 .

(n60)Footnote 60. Section 16 of the Securities Act and Section 28(a) of the Exchange Act provide that the rights and remedies afforded by the respective Acts are in addition to any other rights and remedies available at law or in equity.

(n61)Footnote 61. 459 U.S. at 383, 103 S. Ct. at 687-688 .

(n62)Footnote 62. 459 U.S. at 384-386, 103 S. Ct. at 688-689 .

(n63)Footnote 63. 459 U.S. at 386-387, 103 S. Ct. at 689-690 .

(n64)Footnote 64. 459 U.S. at 384, 103 S. Ct. at 688 .

(n65)Footnote 65. Section 9(e) of the Exchange Act requires the plaintiff to show that the defendant "willfully" participated in manipulative activity, and Section 18 exonerates a defendant who proves that he "acted in good faith" and without knowledge that a statement attributed to him was false or misleading.

(n66)Footnote 66. Before the Supreme Court decided *Huddleston*, a Fifth Circuit panel held that an action under *Rule 10b-5* would not lie to remedy misconduct actionable under Section 9(e) of the Exchange Act, because that section would be "nullified" if plaintiffs who might have sued under it were permitted to sue under *Rule 10b-5* instead. *Chemetron Corp. v. Business Funds, Inc.*, 682 F.2d 1149, 1169-1170 (5th Cir. 1982) . After deciding *Huddleston*, the Supreme Court vacated the judgment in *Chemetron* and remanded the case to the Fifth Circuit for reconsideration. *Chemetron Corp. v. Business Funds, Inc.*, 460 U.S. 1007, 103 S. Ct. 1244 (1983) . On remand, the panel held that the plaintiff had "an independent cause of action" under *Rule 10b-5*. *Chemetron Corp. v. Business Funds, Inc.*, 718 F.2d 725, 727 (5th Cir. 1983) . The panel concluded that "a fully proved Section 10(b) remedy can no longer be denied because of some other provision of the Securities Acts of 1933 or 1934." *Id.* at 728. The Fifth Circuit subsequently granted a rehearing en banc in *Chemetron*. *Chemetron* was never argued before the full court, however, because the parties reached a settlement.

(n67)Footnote 67. See, e.g., *Ross v. A.H. Robins Co.*, 607 F.2d 545, 557(2nd Cir. 1979) ; *Berger v. Bishop Investment Corp.*, 695 F.2d 302, 305-306 (8th Cir. 1982) ; *Wachovia Bank & Trust Co. v. National Student Marketing Corp.*, 650 F.2d 342, 350 (D.C. Cir. 1980) .

(n68)Footnote 68. See Aldave, "Neither Unusual nor Unfortunate": *The Overlap of Rule 10b-5 with the Express Liability Sections of the Securities Acts*, 60 Tex. L. Rev. 719 (1982).



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Federal Securities Exchange Act of 1934

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CHAPTER 5 Civil Liabilities Under the Exchange Act

1-5 Federal Securities Exchange Act of 1934 § 5.04

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§ 5.04 Implied Civil Liabilities under Section 10(b) and Rule 10b-5

Section 10(b) makes it unlawful for any person to "use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe... ." *Rule 10b-5*, promulgated pursuant to Section 10(b), makes it unlawful for any person:

- (1) [t]o employ any device, scheme, or artifice to defraud;
- (2) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under where they were made, not misleading; or
- (3) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Despite seemingly simple phrasing, Section 10(b) and accompanying *Rule 10b-5* are at the base of much of the Exchange Act's civil litigation, overshadowing any other express or implied action. An implied right of action under *Rule 10b-5* is firmly established, first announced in 1946 in *Kardon v. National Gypsum Co.* ⁿ¹ and later accepted by the Supreme Court. ⁿ² Civil litigation based on 10b-5's implied right of action dwarfs all other express or implied causes of action under the Exchange Act. Section 10(b) and *Rule 10b-5* have proven highly adaptable to a variety of fraud theories, for example, applying when an entity misrepresents or omits to disclose a material fact, when an entity manipulates the price of a stock, and when corporate insiders trade on non-public information.

This Section discusses the principal substantive and procedural issues in a private civil action under Section 10(b), an area undergoing considerable change as a result of the Reform Act. Alarmed by so-called "strike suits," Congress passed the Reform Act to eliminate frivolous litigation by imposing significant changes to both substantive and procedural rules applicable to securities litigation, and 10b-5 cases in particular. As Supreme Court Chief Justice John Marshall said long ago in *Marbury v. Madison*, Congress passes laws, but courts "say what the law is," a jurisprudential truism born out with a vengeance in Reform Act litigation, where the federal courts continue to issue a steady stream of new, important decisions mapping out the meaning and application of that statute.

The Reform Act also made uniform a practice not previously followed in all courts: discovery is stayed in a securities fraud case pending a motion to dismiss "unless the court finds upon motion of any party that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to that party." n3 The automatic stay of discovery provision of the Reform Act applies to all private lawsuits, not exclusively to class actions. Initial disclosures required under the Federal Rules of Civil Procedure and local court rules fall within the "other proceedings" covered by the stay. n4 Some courts have construed "undue prejudice" to mean "improper or unfair detriment." n5 Plaintiffs are not able to show "undue prejudice" by arguing that they need discovery to uncover evidence sufficient to satisfy the pleading requirements under the Reform Act. n6

[1] The Principal Varieties of Fraud

Although Section 10(b) and *Rule 10b-5* have long been regarded as "catchall" provisions, as the Supreme Court has emphasized, the thing that must be caught is "fraud." n7 Although federal courts struggle with whether a "fraud" has been committed for purposes of Section 10(b) and *Rule 10b-5*, particularly when plaintiffs allege corporate mismanagement, n8 reported cases generally involve two broad categories of fraud. The most frequently encountered claims involve allegations that defendants misrepresented or failed to disclose material facts affecting the price of the company's securities, including allegations of fraudulent financial reports. Less frequent are insider trading cases.

[a] Misrepresentations and Omissions

[i] Misrepresentations. Under the Reform Act, a complaint alleging a misleading statement or omission must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading and, if an allegation is made on information and belief, the complaint shall state with particularity all the facts on which that belief is formed." n9 This additional requirement supplements Federal Rule of Civil Procedure 9(b), the general rule governing fraud allegations in federal courts, so that plaintiffs must plead "the circumstances constituting fraud ... with particularity." n10

The complaint must attribute the fraudulent statement to a particular defendant or defendants. n11 As one court said, "the plaintiff 'is obligated to distinguish among those they sue and enlighten each defendant as to his or her part in the alleged fraud.'" n12 Some courts, principally the Ninth Circuit, allow a plaintiff to avoid this requirement by using the "group pleading" doctrine, whereby misrepresentations or omissions are attributed to the "group" of senior officers or directors responsible either for the day-to-day operations, or for statements in the corporation's public filings. n13 This theory is available for outside directors or other individuals only if involved in the corporation's daily management. n14 Other circuits, however, have rejected the group pleading doctrine. n15

Although a complaint is typically based on statements made in a corporation's public filings or by its officers and directors, a corporation may be liable for statements made by third parties, particularly where the corporation is deemed "entangled" with statements made by investment analysts working for securities firms. n16 Before liability attaches, there must be some showing the company somehow controlled the content of the analysts' statements. n17 Liability may attach to an analyst's statements where the defendant expressly or impliedly adopts the statements, places his or her imprimatur on them, or otherwise becomes entangled with the analyst to a significant degree. n18 If company management only meets with or provides information to analysts, the company will generally not be liable for analysts' statements. n19 Thus, Courts will require a claim based on an analyst's statements to state with specificity the person affiliated with the defendant company who gave the information to the analyst, how the information was supplied, and facts allowing an inference that defendants exercised the kind of control over the analyst to be liable for the analyst's statement's content. n20

One trap many complaints fall into is alleging "fraud by hindsight." As one court stated, "temporal proximity between positive statements stressing a firm's strengths and announcements of poor economic performance do not create an

inference that earlier statements were fraudulent." n21 Or, as the Seventh Circuit stated in *DiLeo v. Ernst & Young*, n22 in affirming the complaint's dismissal:

The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud. 'Must be' is the critical phrase, for the complaint offers no information other than the differences between the two statements of the firm's condition. Because only a fraction of financial deteriorations reflect fraud, plaintiffs may not proffer the different financial statements and rest. Investors must point to some facts suggesting that the difference is attributable to fraud... . There is no 'fraud by hindsight,' in Judge Friendly's felicitous phrase, ...and hindsight is all the DiLeos offer.

The Ninth Circuit stated in *GlenFed*:

[I]t is clearly insufficient for plaintiffs to say that the later, sobering revelations make the earlier cheerier statements a falsehood. In the face of such intervening events, a plaintiff must set forth, as part of the circumstances constituting fraud, an explanation as to why the disputed statement was untrue or misleading when made. n23

In *Raab v. Gen. Physics Corp.*, the Fourth Circuit stated: "The market has risks; the securities laws do not serve as investment insurance. Every prediction of success that fails to materialize cannot create on that account an action for securities fraud." n24

[iii] Omissions. Liability for failure to disclose material facts may state a cause of action under Section 10(b) and *Rule 10b-5*. Courts have consistently held, however, that no liability exists for omissions absent a duty to disclose. n25 There are generally three instances creating a duty to disclose: (a) when a corporate insider trades while possessing non-public corporate information; (b) when a corporation realizes that a prior statement was inaccurate, incomplete, or misleading when made; and (c) when a statute or regulation requires disclosure. n26 The absence of any of those circumstances will, in the words of one court, render a complaint alleging material nondisclosure "dead on arrival." n27

Applying these principles, courts have held there is no per se rule requiring a corporation to disclose information, even if the information is material, absent one of those three elements. n28 As the Second Circuit said in *SEC v. Texas Gulf Sulphur*, the existence of a duty to disclose does not "suggest that material facts must be disclosed immediately; the timing of disclosure is a matter for the business judgment of the corporate officers, entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and the SEC." n29 Furthermore, corporations may not have a duty to disclose internal financial projections and other similar soft information, though this limitation is not without exception. n30 The court in *Shaw v. Digital Equipment Corp.* held a company had a duty to disclose results for a quarter ending eleven days after a prospectus was issued, because during the period it was contemplating a stock transaction the corporation was an "insider" and had the duty either to disclose or abstain from trading. n31

Whether a duty to disclose exists often arises when a professional -- an attorney or accountant -- is accused of violating *Rule 10b-5*. In general, a fiduciary relationship is not, absent other facts, sufficient to create a duty of disclosure to third parties. n32 For example, attorneys who draft documents necessary to effect transactions need not disclose facts about their clients. n33 Moreover, an accountant acting "consistent with the role of an accountant" has no duty to disclose information about an issuer. In *Shapiro v. Cantor*, the court held an accountant was not liable for failing to disclose the criminal conviction of one of the issuer's officers and the controlling interest of the officer's minor son in a limited partnership that controlled the issuer. The court affirmed dismissal because the accountants were alleged merely to have acted "together with" the other defendants to sell interests in the issuer, confined themselves to "providing the financial projections that were included with the offering memorandum," and had no "fiduciary or other similar relation of trust

and confidence" with the plaintiffs. Absent such a relationship, the court held there was no duty to disclose. n34

[b] Trading on Non-Public Information. *Rule 10b-5* has also been used to regulate trading by a corporate "insider" using non-public information, although such cases occur less frequently than ones based on misrepresentations or omissions.

It has long been held that, as a general proposition, insiders violate *Rule 10b-5* by using their position to trade based on material non-public information taking unfair advantage of the uninformed shareholder. n35 The Supreme Court established the outlines of liability for insider trading in *Chiarella v. United States* n36 and *Dirks v. SEC.* n37 In *Chiarella*, the Supreme Court overturned the conviction of a printer's employee charged with violating *Rule 10b-5* by purchasing securities using non-public information about impending takeover bids. Chiarella learned the identities of prospective targets from documents his employer printed for the acquiring companies, purchased stock in the targets, and then sold at a profit when the takeover bids were publicly announced. In reversing Chiarella's conviction, the Supreme Court held that "a duty to disclose under Section 10(b) does not arise from the mere possession of non-public market information." n38 The Court said Chiarella had no duty to disclose to shareholders of target companies because he did not have a relationship of trust and confidence with them, and thus, he did not perpetrate a fraud on them by purchasing their securities. n39 In language that would later prove critical eighteen years later in *United States v. O'Hagan* n40 the *Chiarella* Court also rejected the government's claim that Chiarella defrauded his employer and the acquiring company because that theory had not been submitted to the jury. n41

In *Dirks*, the Court reiterated that not *all persons* under *all circumstances* are barred from trading in securities while possessing material non-public information. The Court confirmed that the insiders of a corporation owe a fiduciary duty to the corporation's shareholders, and must either disclose material inside information or refrain from trading in the corporation's securities. n42 The Court then held that a tippee who trades using material non-public information disclosed to him by an insider violates *Rule 10b-5* if the insider breached a fiduciary duty by making the disclosure, and the tippee knew or should have known of the breach. In determining whether the insider had breached his duty, the question is "whether the insider personally will benefit, directly or indirectly, from his disclosures." n43 The Court suggested this benefit might take the form of pecuniary gain or reputational benefit that would translate into future earnings. There might also be "objective facts and circumstances" inferring a benefit. n44 Based on this principle, the Court concluded that *Dirks*, an investment analyst who learned about fraud in an insurance company from the company's employees, did not violate *Rule 10b-5* when he tipped selected clients who sold their stock. *Dirks'* informants acted not for personal gain, but to expose fraud. The Court held that because the insiders had not breached a fiduciary duty to the company's shareholders, *Dirks* had not participated in any breach by them required for him to violate *Rule 10b-5*.

Thus, *Dirks* and *Chiarella* establish that (a) "traditional" insiders -- officers, directors, and controlling shareholders -- have a fiduciary obligation to shareholders to disclose any material inside information in their possession or abstain from trading; (b) "temporary" insiders -- underwriters, attorneys, and accountants who enjoy a special relationship of trust and confidentiality with the company and its shareholders and have access to inside information will be treated as if they were true "insiders;" and (c) a tippee who knowingly participates in an insider's breach of fiduciary duty violates *Rule 10b-5* when he trades on information that has been tipped to him. n45 Moreover, courts deem a corporation trading in its own securities an "insider" for purposes of the "disclose or abstain" rule. n46 Just as an individual insider with material non-public information could not purchase his company's securities without making disclosure, the company may not purchase or offer its own stock while possessing such undisclosed information. n47

One question left unanswered by *Dirks* and *Chiarella* was whether someone who was neither an insider nor received information from an insider could be charged with violating *Rule 10b-5* for trading with material non-public information. Prior to 1997, a number of courts developed the "misappropriation theory" to render "outsiders" liable as long as they breached a duty to (i.e., "misappropriated" information from) the information's source, and they, or someone they tipped, traded on that information. n48 The Fourth and Eighth Circuits had rejected the misappropriation

theory, n49 but the Supreme Court in *United States v. O'Hagan* n50 resolved the circuit split and endorsed it. The Supreme Court held that an individual is liable under *Rule 10b-5* by trading in securities using material non-public information misappropriated in violation of a fiduciary duty to the information's source. n51

O'Hagan was a partner at a law firm representing a company trying to acquire another company via a tender offer. O'Hagan purchased call options in the securities of the target company prior to the tender offer announcement while his firm represented the acquirer. The Court reversed the appeals court's rejection of misappropriation theory and reinstated O'Hagan's criminal conviction under *Rule 10b-5*. The Court had no trouble finding that O'Hagan, who could not have been prosecuted as a "traditional" or "temporary" insider because he had no confidential relationship with the company where he purchased options, utilized a "deceptive device or contrivance in connection with" the purchase or sale of securities. n52 "[M]isappropriators ... deal in deception. A fiduciary who '[pretends] loyalty to the principal while secretly converting the principal's information for personal gain,' 'duplicates' or defrauds the principal." n53 Drawing on *Carpenter v. United States*, n54 the Court observed that "[a] company's confidential information ... qualifies as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information, in violation of a fiduciary duty ... constitutes a fraud akin to embezzlement." n55 The Court had little difficulty finding use of the deceptive information to be " ' in connection with the purchase or sale of [a] security' ... because the fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities." n56

The Court's affirmation of the misappropriation theory may be significant for the viability of private rights of action against misappropriators. As part of the Insider Trading and Securities Fraud Enforcement Act of 1988, Congress authorized contemporaneous traders to sue persons whose trading violated *Rule 10b-5* under Section 20A of the Exchange Act. n57 The House expressly meant to "overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory," referring to *Moss v. Morgan Stanley, Inc.*, n58 a 1983 Second Circuit decision that held the misappropriation theory could not be the basis for civil liability because no duty ran between the misappropriator and the allegedly defrauded shareholder. n59

[2] Elements of Liability under Section 10(b) and Rule 10b-5

Actions under Section 10(b) and *Rule 10b-5* most often allege fraud because defendants either misrepresented or failed to disclose a material fact. It is, therefore, appropriate to use these actions as examples of the elements necessary to support a claim under Section 10(b).

To successfully litigate a misrepresentation or omissions claim, plaintiff must prove:

- (a) defendant made a misrepresentation of or failed to disclose a *material* fact;
- (b) defendant acted with *scienter*;
- (c) plaintiff *relied* upon defendants misrepresentation;
- (d) The misrepresentation or omission occurred *in connection with* a purchase or sale of a security; and
- (e) defendant's actions *caused* plaintiff damages. n60

There is substantial overlap between these seemingly distinct elements. Under certain circumstances, for instance, showing the omission was material may be sufficient to prove the plaintiff relied on the omission. Moreover, the "in connection with" requirement is sometimes analyzed within the rubric of reliance. Finally, the reliance element is commonly viewed as one type of causation -- proof the misrepresentation or omission induced plaintiff to purchase or

sell securities.

Although courts generally agree on the elements of a private right of action under Section 10(b), the contours of each element remain in substantial flux, particularly as courts grapple with the changes instilled by the Reform Act.

[a] Materiality

To support a Section 10(b) claim, there must be a misrepresentation or omission of a "material" fact. The test for materiality was established in *TSC Industries, Inc. v. Northways, Inc.*,ⁿ⁶¹ for Rule 14a-9 and later adapted for purposes of suits under other provisions of both the Securities Act and the Exchange Act.ⁿ⁶² Under Rule 14a-9, an omitted fact is material "if there is a substantial likelihood a reasonable shareholder would consider it important in deciding how to vote." The Supreme Court explained further the standard

does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed *actual significance* in the deliberations of the reasonable shareholder.ⁿ⁶³

The Supreme Court formulated its materiality standard in *TSC* to avoid subjecting corporations to liability for "insignificant omissions or misstatements" and burying "shareholders in an avalanche of trivial information."ⁿ⁶⁴

In *Basic, Inc. v. Levinson*, the Supreme Court adopted the *TSC* standard for 10b-5 cases, holding a fact is material if there is a substantial likelihood a reasonable investor would consider it important in making an investment decision. The Court in both *TSC* and *Basic* explained that, "put another way, there must be a substantial likelihood that the disclosure ... would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."ⁿ⁶⁵

Whether an alleged misstatement or omission is material is decided on a case by case basis, usually by referring to the entirety of the disclosure document or documents in question. Materiality is generally considered a mixed question of law and fact. However, though courts are often reluctant to decide issues of materiality at the pretrial stage, a growing number of courts do decide questions of materiality at a preliminary pleading stage, and dismiss claims when the statement or omission is obviously unimportant to a shareholder.ⁿ⁶⁶

Although any general statements about what is--and is not--material is difficult given this case -specific analysis, the issue ordinarily arises in the following circumstances.

[i] Quantitative Matters. Often, in assessing materiality, a court will be swayed by how the market reacted once the truthful information misrepresented or omitted is disclosed. Thus, the Third Circuit found a misstatement of an increase in sales was immaterial as a matter of law, in part because the press release announcing the actual increase did not affect the price of the company's stock.ⁿ⁶⁷

Courts previously measured materiality against a "crude benchmark," drawing on Rule 14a-8(c)(5), where a misstatement or omission was considered immaterial if, absent evidence of egregious behavior such as self-dealing or misappropriation by management, it resulted in a change of less than percent in the company's assets, net earnings, or gross sales.ⁿ⁶⁸ Thus, courts have found the following immaterial: an alleged overstatement of assets by less than 2 percent;ⁿ⁶⁹ an insignificant change in the method for calculating a bond's yield that added three days to the yield period;ⁿ⁷⁰ and an alleged misrepresentation about whether loans were earning or nonearning when any change in classification would have resulted in write-downs of one percent or less.ⁿ⁷¹

In reaction, the Securities and Exchange Commission published a Staff Accounting Bulletin rejecting reliance on

quantitative "benchmarks" to determine materiality. In Staff Accounting Bulletin (SAB) No. 99--Materiality (August 12, 1999), n72 the staff of the Commission's Chief Accountant's Office stated that "exclusive reliance on certain quantitative benchmarks to assess materiality in preparing financial statements and performing audits of those financial statements is inappropriate: misstatements are not immaterial simply because they fall beneath a numerical threshold." The staff did not object to benchmarks as "the basis for a preliminary assumption that ... a deviation of less than the specified percentage with respect to a particular item on the registrant's financial statements is unlikely to be material." Nevertheless, the staff took the position that materiality must be considered in the context of "all relevant considerations," including "qualitative" factors such as whether the misstatement or omission was deliberate or intentional. Among those "considerations" noted by the staff were whether the misstatement or omission hid "a failure to meet analysts' consensus expectations," changed "a loss into income or vice versa," or concerned a segment of the issuer's business that played "a significant role" in the registrant's operations or profitability. In *Ganino v. Citizens Utilities Co.*, n73 the court approved the SEC staff's approach in SAB 99. Investors in Citizens Utilities Company, a publicly-traded communications and public services company, alleged that Citizens fraudulently recognized income. The district court dismissed the complaint, stating that "Most auditors--and their corporate clients--define materiality as any event or news that might affect a company's earnings positively or negatively by 3% to 10%" Applying this 3% to 10% range, the district court held the amounts in issue, 1.7% of revenues for the relevant time period, were immaterial as a matter of law. n74

The Second Circuit reversed the district court's findings on materiality, holding that reliance on a numerical or percentage benchmark, which the court characterized as a "formulaic approach," was error. The court expressly adopted the approach advocated by the SEC staff in SAB 99, including consideration of whether "various qualitative factors may cause misstatement of quantitatively small amounts to be material." Factors may include "whether the misstatement masks a change in earnings or other trends," and "whether the misstatement hides a failure to meet analysts' consensus expectations." The court also stated in a footnote that although SAB 99 was not promulgated until 1999, it "did not alter the existing law" or guidance in the accounting literature, and was persuasive. n75

There is little doubt that Ganino's endorsement of SAB 99 lowered the materiality threshold. Other circuits have begun to follow this approach. n76

[ii] Failure to Disclose the Obvious. Some omissions are not deemed materially misleading because the information is commonly known, and courts will presume a reasonable investor would be aware of the allegedly concealed information. One court applied this principle in the context of a computer company: "As a general matter, investors know of the risk of obsolescence posed by older products forced to compete with more advanced rivals. '[T]echnical obsolescence of computer equipment in a field marked by rapid technological advances is information within the public domain.'" n77

[iii] Merger Negotiations. The Supreme Court in *Basic* found that materiality of merger negotiations must be decided on a case-by-case basis using a sliding scale balancing the probability the event will occur with its significance to an investor. Materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." n78 This analysis is often applied to decide the materiality of statements about future events in general.

In *Basic*, the company denied on three occasions that it was engaged in merger negotiations, when in fact negotiations were taking place. The Court found that failure to disclose this information was material, thereby rejecting the company's argument that merger negotiations could be material only when they had reached a point at which there was an agreement in principle. Although the parties had not reached an agreement in *Basic*, the court found that merger negotiations had progressed to a material point: regulatory barriers to merger had been removed; two years of negotiations, meetings and discussions had occurred; attorneys had prepared analyses and evaluations for use in merger negotiations; and investment bankers had been retained. n79

Applying the *Basic* test in *Taylor v. First Union Corp.*,ⁿ⁸⁰ the Fourth Circuit found that merger negotiations were immaterial because they were "preliminary, contingent, and speculative"ⁿ⁸¹ and therefore need not have been disclosed. Negotiations produced only "a vague 'agreement' to establish a relationship" with no meeting of minds on price or structure of a deal.ⁿ⁸² There was no evidence of board resolutions, actual negotiations over merger, or instructions to investment bankers to facilitate a merger.ⁿ⁸³ Finally, any merger was contingent on actions by third parties that had not occurred, including a legal opinion from a state court on the constitutionality of a merger, and legislation being passed in two states' legislatures.ⁿ⁸⁴ On the other hand, a court found a duty to disclose negotiations when a potential acquirer retained a law firm specializing in acquisitions, hired a brokerage firm to help it acquire stock, and met with target executives to discuss acquisition.ⁿ⁸⁵

Whether merger negotiations are material may be affected by the corporation's size or structure, with disclosure being mandated earlier in small or close corporations.ⁿ⁸⁶ Moreover, unsolicited friendly offers to merge, without more, will rarely be disclosable, whereas an unsolicited hostile offer might be.ⁿ⁸⁷

[iv] Puffery. Some courts have rejected claims that vague, optimistic statements, or "puffing" amount to actionable misstatements under § 10(b).ⁿ⁸⁸ The theory is that these statements are loose, vague, or exaggerated predictions of future performances and therefore not material because a reasonable investor would not rely on them. For example, statements that management was "optimistic about 1993" and believed the company would "deliver growth consistent with its historically superior performance" were puffery,ⁿ⁸⁹ as was a statement that a company was "poised to carry the growth and success of 1991 well into the future."ⁿ⁹⁰

[v] Statements that Bespeak Caution. Prior to the Reform Act's passage, courts increasingly found that some statements were not material when accompanied by sufficient cautionary language. The "bespeaks caution" doctrine developed. The essence of the doctrine is that "where an offering statement, such as a prospectus, accompanies statements of its future forecasts, projections and expectations with adequate cautionary language, those statements are not actionable as securities fraud."ⁿ⁹¹ Cautionary language need not be in the same document to be effective.ⁿ⁹²

The bespeaks caution doctrine is applied often in cases involving economic projections and optimistic statements. Thus, in *Gasner v. Board of Supervisors*,ⁿ⁹³ the Fourth Circuit affirmed summary judgment for defendants, finding that cautionary language included in a bond offering rendered alleged misrepresentations immaterial as a matter of law. The bond offering financed a composting facility. The venture failed and the bonds defaulted, leading to litigation. The complaint alleged the offering documents contained several misrepresentations and one omission. Plaintiffs alleged the document misrepresented the composting technology as "proven" defendants misrepresented the commercial viability of the composting facility, and defendants failed to disclose the facility would operate only under a one-year permit from the state of Virginia.ⁿ⁹⁴

The Fourth Circuit found that:

From the outset of its operations of the Facility, [the company] encountered serious problems. The materials used proved to be of poor quality. [The company] lacked sufficient financial resources to permit it to operate, mainly because it had been unable to secure contracts with other counties for the processing of their waste. Sufficient revenue was therefore not forthcoming for the operation of the Facility, and funds were not available for payment of principal and interest to bondholders.ⁿ⁹⁵

The court concluded that warnings contained in the Offering Statement sufficiently bespoke caution:

The venture failed because of the occurrence of the very same events outlined as risks in the Offering Statement. As noted, VBFC had no significant assets other than its contracts with the County. The sole source of funds for the payment of interest and principal to bondholders was the income which VBFC was to receive from its contracts with the County and from future contracts with other Virginia counties. County payments commenced in April of 1994, but VBFC was not thereafter able to secure

contracts from other counties. Because it was under-capitalized and had severe cash flow problems, VBFC announced in September of 1994 that it was unable to fulfill its obligations under its contracts with the County. Operations ceased on October 5, 1994, and the County then stopped making payments. On October 31, 1994, Signet, as Trustee, declared the Bonds to be in default. n96

Despite the courts' general receptivity to the bespeaks caution doctrine, the doctrine is applied on a case-by-case basis, and some courts carefully consider cautionary language to determine if it sufficiently bespeaks caution. n97 Courts have found the cautionary language was not "repeated" and "specific" enough or refused to dismiss on the basis of a "generic" warning that disclosed a risk without cautioning the plaintiffs about the risk's magnitude. n98

[vi] Forward Looking Statements. Closely allied with the bespeaks caution doctrine is the safe harbor under the Reform Act that protects a company from liability when it makes "forward looking" statements, such as projections of future earnings, management plans and objections, and similar information. Under the Reform Act, these statements are not actionable so long as they are accompanied by "meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward looking statement" and they are made without "actual knowledge" that they were false or misleading.

The safe harbor for forward looking statements and the bespeaks caution doctrine are not coextensive. The safe harbor only covers certain types of forward looking statements, excluding statements (1) included in financial statements prepared in accordance with GAAP; (2) contained in an IPO registration statement; (3) made in connection with a tender offer; (4) made in connection with a partnership, limited liability company, or direct participation program offering; or (5) made in beneficial ownership disclosure statements filed with the SEC under Section 13(d) of the Exchange Act. n99 Similarly, an issuer cannot take advantage of the safe harbor if: (a) during the three year period preceding the date on which the statement was first made, it has been convicted of a felony or misdemeanor under § 15(b)(4)(i)-(iv), or is the subject of a decree or order involving a violation of the securities laws, (b) it makes the statement in connection with a "blank check" securities offering, "rollup transaction," or "going private" transactions, or (c) it issues penny stock. n100

For an issuer to identify "important factors that could cause actual results to differ materially" it does not have to identify all factors. n101 In one of the first cases decided after the Reform Act, the court in *Rasheedi v. Cree Research, Inc.*, stated, "Failure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor." n102 Thus, defendants do not have to "caution against every conceivable factor that may cause results to differ." n103

The Eleventh Circuit in *Harris v. Ivax Corporation*, affirmed the dismissal of a securities fraud complaint, applying the safe harbor for forward looking statements. n104 Ivax, a manufacturer of generic drugs, issued press releases in August and September of 1996, that did not disclose an intent to take a sizeable write-down of goodwill and, "while acknowledging business problems, also showed some optimism." n105

The plaintiffs claimed that Ivax's hopeful outlook in the press releases concealed an intent to write down goodwill and that Ivax deliberately omitted the risk of a goodwill writedown from its list of identified concerns." n106

The court found that cautionary language appended to both press releases adequately warned investors of the perils of investing in Ivax. The cautionary language was detailed, n107 leading the court to dismiss plaintiff's claim that it was mere "boilerplate." n108 Although the court recognized the cautionary language did not explicitly mention the possibility of a goodwill write-down, it held there need not be "a listing of all factors" nor a listing of the specific factor for the cautionary language to be meaningful. The court noted that the Reform Act's conference report:

specified that '[f]ailure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor.' In short, when an investor has been warned of

risks of a significance similar to that actually realized, she is sufficiently on notice of the danger of the investment to make an intelligent decision about it according to her own preferences for risk and reward. n109

Other courts have been less lenient in interpreting the safe harbor. In *In re Boeing Sec. Litig.* the court held that the cautionary language must identify some factors that, if they occurred, would render the forward looking statement to be untrue. n110 Thus, the court stated:

Here, the forward-looking statement is that the company was making progress in designing systems to improve efficiency and reduce cycle times. Many of the warnings identified by the defendants, particularly the boiler plate warning in the warnings section of the press release and the warnings in the annual report and first quarter 10-Q, do not speak to factors that could adversely affect the company's development of systems to improve efficiency. Rather, they speak to overall production problems and an expectation that margins would be lower as a result of the production problems. Boeing identified no factors that would caution investors that results might be materially different from those described in the forward-looking statement. Thus, the statement in the July 21 press release about Boeing's "long term progress ... in developing and implementing systems to improve efficiency" is not protected by the safe harbor provision of the Reform Act. n111

Echoing case law interpreting the bespeaks caution doctrine, courts generally have held that boilerplate warnings with little detail will not comport with the safe harbor. n112

[b] Scienter

Plaintiffs in a *Rule 10b-5* case must establish that defendants acted with "scienter," or intent to defraud. Scienter, along with materiality, is the most frequently litigated issue in securities cases--particularly at the preliminary stage of a motion to dismiss. The scienter requirement places two separate burdens on a plaintiff: first, the complaint must "state with particularity facts giving rise to a strong inference that the defendants acted with the required state of mind", and second, plaintiffs must prove at trial that defendants acted with the requisite state of mind.

The Reform Act significantly altered the standard for pleading scienter. Some courts found that it also modified the substantive contours of scienter. The standard for pleading scienter is an issue that has spawned a number of important and conflicting circuit court decisions. Substantial disagreement among courts about what plaintiffs must show to prove scienter makes it likely the Supreme Court will need to give the final resolution.

[i] Pre-Reform Act Scienter Standard. Prior to the Reform Act's passage, the Supreme Court held in *Ernst & Ernst v. Hochfelder* that the plaintiff in a private action under *Rule 10b-5* had to prove the defendant acted with scienter, meaning a "mental state embracing intent to deceive, manipulate or defraud." n113 Although the Court did not decide whether a showing of recklessness could satisfy the scienter requirement, n114 every circuit court that considered the issue prior to the Reform Act concluded, or assumed without deciding, that recklessness was sufficient to demonstrate scienter. n115

Courts disagreed somewhat on the definition of recklessness prior to the Reform Act. The Seventh Circuit's standard in *Sundstrand Corp. v. Sun Chem. Co.*, subsequently adopted by most courts, defined recklessness as

a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant, or so obvious that the actor must have been aware of it.
n116

Recklessness in other circuits was defined as an "extreme carelessness approaching indifference" n117 -- apparently an easier standard to satisfy.

Because the Supreme Court in *Hochfelder* provided no guidance on pleading scienter, courts were divided prior to the Reform Act. The Second Circuit adopted the most stringent standard, requiring plaintiffs to allege specific facts creating a "strong inference" that the defendants acted with scienter. A plaintiff could meet this burden by alleging either (a) facts showing defendants had both a motive and the opportunity to commit fraud, or (b) facts constituting strong circumstantial evidence of reckless or conscious misbehavior. n118 The Ninth Circuit, in contrast, allowed plaintiffs to satisfy the scienter requirement simply by pleading the necessary mental state generally, without setting forth any specific facts supporting the allegation. n119

[ii] The Reform Act.

In passing the Reform Act, Congress intended to strengthen the standard for pleading scienter to prevent frivolous securities lawsuits. Thus, the plain language of the Act required that a securities fraud complaint "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." n120 Congress did not define the state of mind requirement or specify the standard for pleading it. Although Congress plainly rejected the lenient Ninth Circuit standard, did not clarify whether the new standard for pleading a "strong inference" of scienter under the Reform Act mirrored or exceeded the Second Circuit standard.

Confusion over what Congress meant by including a heightened scienter standard in the Reform Act stems from three parts of its legislative history: (1) Senate consideration of the bill, (2) the Conference Committee's explanation of the bill, and (3) the congressional override of President Clinton's veto. The Senate bill required plaintiffs to allege "specific facts demonstrating the state of mind of each defendant at the time the alleged violation occurred." n121 The Senate Report explained that "the Committee chose a uniform standard modeled upon the pleading standard of the Second Circuit... The Committee does not intend to codify the Second Circuit's case law interpreting this pleading standard, although courts may find this body of law instructive.." n122 When the bill reached the Senate floor, Senator Specter offered an amendment closely tracking the language of the Second Circuit pleading standard and case law, specifically stating that his amendment was based on Second Circuit case law. n123 The Senate then adopted the Specter Amendment, but the amendment did not survive the Conference Committee.

The Conference Committee Report, commenting on the pleading standard in the bill, stated that the language of the Act is based in part on the Second Circuit's pleading standard: "The standard also is specifically written to conform to Rule 9(b)'s notion of pleading 'with particularity' ... Because the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard." n124 The Conference Committee emphasized its rejection of the Second Circuit case law by stating that, "[f]or this reason, the Conference Report chose not to include in the pleading standard certain language relating to motive, opportunity, or recklessness ..." n125

President Clinton stated that he vetoed the Act because he believed Congress had raised the standard for pleading scienter beyond the Second Circuit's standard, thereby imposing "an unacceptable procedural hurdle to meritorious claims being heard in Federal courts." n126 Both the House and the Senate overrode the President's veto and stated objection, passing the Reform Act into law without any alternation to its pleading standard.

[iii] Post Reform Act Pleading Standards. In the more than a decade following the passage of the Reform Act, most federal appeals courts interpreted the strong inference of scienter standard under the Reform Act, but their interpretations varied significantly. n127 In 2007, however, the Supreme Court provided some clarity as to requirements for pleading scienter in its decision, *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* n128

In *Tellabs*, the Court held that "an inference of scienter must be more than merely plausible or reasonable—it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent." n129 The Court set forth a three-step process for evaluating motions to dismiss for failure to adequately plead scienter. First, a court must "accept

all factual allegations in the complaint as true." n130 Second, the court must consider "whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter." n131 The Court stressed that the appropriate inquiry "is whether all of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." n132 Third, "the court must take into account plausible opposing inferences." n133 After the completion of these steps, a complaint will survive "only if a reasonable person would deem the inference of scienter cogent and at least as compelling as any opposing inference one could draw from the facts alleged." n134

Although the *Tellabs* decision was widely reported as raising the standard for pleading scienter, n135 cases from at least three circuits suggest otherwise. For example, the Ninth Circuit has held that *Tellabs*' requirement that the allegations be read as a whole "permits a series of less precise allegations to be read together to meet the the PLSRA requirement" notwithstanding the Ninth Circuit's prior rulings, and that "[v]ague or ambiguous allegations are now properly considered as part of a holistic review when considering whether the complaint raises a strong inference of scienter." n136 The Sixth Circuit has also suggested that *Tellabs* lessened the pleading standard, noting that the *Tellabs* "formulation is slightly different than that previously used in the Sixth Circuit, where a plaintiff could survive a motion to dismiss only if the inference of scienter was 'the most plausible of competing inferences.'" n137 The First Circuit had similarly pointed out that prior to *Tellabs* "where there were equally strong inferences for and against scienter, this resulted in a win for the defendant." n138 Under *Tellabs*, however, "where there are equally strong inferences for and against scienter, *Tellabs* now awards the draw to the plaintiff." Indeed, in *Mississippi Pub. Employees' Ret. Sys. v. Boston Scientific Corp.*, the First Circuit reversed the district court's decision granting defendants' motion to dismiss, noting that the district court "did not have the benefit of the *Tellabs* opinion, which reversed a higher standard for scienter imposed by the prior law of this circuit. We apply *Tellabs* and that leads us to a different result." n139

Nonetheless, the post-*Tellabs* appellate court decisions have, more often than not, affirmed dismissals based on the failure of plaintiffs to adequately allege scienter. These courts have held that, without more, allegations of accounting irregularities and internal control deficiencies, n140 allegations that defendants did not disclose and/or correct information immediately, n141 allegations regarding the magnitude or widespread nature of the fraud, n142 allegations of insider trading, n143 and allegations that defendants signed Sarbanes-Oxley certifications n144 are not sufficient to establish a strong inference of scienter.

In those cases where circuit courts have found that plaintiffs have or may have adequately pleaded scienter, the courts have cited factors such as the fraud involving the defendants' most important products, n145 an extremely short time period between the misleading statement and corrective disclosure, n146 statements in public filings indicating contemporaneous knowledge, n147 and evidence that defendants investigated or reviewed information that should have revealed the fraud. n148 In the *Tellabs* case itself, on remand, the Seventh Circuit concluded that the plaintiffs had satisfied the pleading standard set forth by the Supreme Court:

Because the alternative hypotheses-either a cascade of innocent mistakes, or acts of subordinate employees, either or both resulting in a series of false statements-are far less likely than the hypothesis of scienter at the corporate level at which the statements were approved, the latter hypothesis must be considered cogent. n149

An issue that has arisen in numerous post-*Tellabs* decisions, regardless of outcome, is the use of confidential sources to establish scienter. In *Higginbotham v. Baxter Int'l Inc.*, the Seventh Circuit stated that

[o]ne upshot of the approach that *Tellabs* announced is that we must discount allegations that the complaint attributes to five 'confidential witnesses' It is hard to see how information from anonymous sources could be deemed 'compelling' or how we could take account of plausible opposing inferences." n150

The court, while acknowledging that there could be situations where statements from anonymous sources could "corroborate or disambiguate evidence from disclosed sources," the statements must be discounted and "[u]sually that discount will be steep." n151

Other courts have taken a somewhat less skeptical view of allegations based on confidential sources. Indeed, in *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, the Seventh Circuit distinguished its prior decision in *Higginbotham* and held that "the absence of proper names does not invalidate the drawing of a strong inference from informants' assertions." n152 The court pointed out that, in *Higginbotham*, very little information was provided about the confidential sources and there was no other information on which to infer scienter. n153 In the present case, however, the court described the confidential source information as follows:

The confidential sources listed in the complaint in this case, in contrast, are numerous and consist of persons who from the description of their jobs were in a position to know at first hand the facts to which they are prepared to testify The information that the confidential informants are reported to have obtained is set forth in convincing detail, with some of the information, moreover, corroborated by multiple sources. n154

In *New Jersey Carpenters Pension & Annuity Funds v. Biogen Idec Inc.*, the First Circuit followed the Seventh Circuit's approach in *Makor*, stating:

We decline to adopt a rule which would exclude confidential source allegations which have every indication both that the source had access to information and that the information has the earmarks of credibility, simply because the identity of the source is not initially revealed. And we see no reason to exclude consideration of such information from the evaluation of whether plaintiffs' strong inferences of scienter are at least as plausible as defendants' inferences. n155

Although *Tellabs* and these appellate cases are unlikely to be the last pronouncements on pleading scienter, these decisions do indicate that, despite any disagreements, courts general application of an increasingly critical eye to allegations of scienter -- the heart of any securities fraud suit.

[c] The "In Connection With" Requirement. *Rule 10b-5* is violated only when a fraud occurs "in connection with" a purchase or sale of securities. Although early decisions involved a transaction directly between a plaintiff and defendant, n156 courts no longer require privity between plaintiffs and defendants. n157 As a result, the "in connection with" requirement became a subject for judicial interpretation.

The "in connection with" requirement is not an issue in most securities cases. Courts generally find that fraud or misrepresentation occurs "in connection with" securities trading "whenever [such] assertions are made ... in a manner reasonably calculated to influence the investing public" n158 or when the fraud touches on "the value of the stock at issue or the value of the consideration in return for it." n159 As the Second Circuit has stated:

When the fraud alleged is that the plaintiff bought or sold a security in reliance on misrepresentations as to its value, made by a defendant whose position made it reasonable for the plaintiff to rely on the representation and imposed some duty on the defendant to be honest or to disclose information, then whatever problems there may be with the case, a connection between the fraud and the transaction should not be one of them. n160

Nevertheless, a plaintiff may not be able to sustain a claim when he or she purchased a security before the alleged fraud occurred. n161 Courts are reluctant to find a fraudulent scheme is "in connection" with the purchase or sale of a security when it takes place entirely after the securities transaction is complete. n162 This conclusion is consistent with encouraging disclosure to investors of all material facts so that investors can make an informed decision to purchase or sell securities -- one of the principal policies behind the federal securities laws. n163 If there is no fraudulent scheme

until after a transaction is complete, there would be nothing to disclose at or before the transaction.

Pleading a complaint based on a "fraud on the market" theory of reliance can affect whether a misrepresentation or omission is "in connection with" the purchase or sale of a security. As explained later in this chapter, the fraud on the market theory rests on the notion that the price of a security incorporates and reflects all public information about the security, including any misrepresentation. Some courts, therefore, have determined that when a misstatement may have affected the market for a security, it was made "in connection with" a purchase or sale. n165 Thus, the Second Circuit concluded that a misrepresentation in an advertisement in a technical journal may have been made "in connection with" a purchase or sale if plaintiffs could prove that market participants, such as stock analysts, used the advertisements to evaluate the security. n166

Litigation over whether a fraud is "in connection with" a purchase or sale of a security most frequently arises in cases "near the borderline," where courts believe "it is important that the standard be fleshed out by a cautious case-by-case approach." n167

Courts have often addressed the "in connection with" requirement in cases involving allegations of corporate mismanagement. The Supreme Court appeared to approve the application of the securities laws in cases alleging internal corporate mismanagement by endorsing a broad statement of the "in connection with" requirement in *Superintendent of Insurance v. Bankers Life & Casualty Co.* n168 In that case, Bankers Life owned all the stock of Manhattan Casualty Co., which it then sold to a group headed by one Begole for \$5,000,000. Begole obtained the purchase money by causing Manhattan to sell approximately \$5,000,000 of government bonds and then misappropriated the proceeds of the sale for his own use. The funds were transferred to Bankers Life, and the misappropriation was concealed on Manhattan's books. When the facts were discovered, the Superintendent of Insurance, as Manhattan's statutory assignee, sued several parties under *Rule 10b-5*.

The Second Circuit concluded there was no fraud "in connection with" the purchase or sale of securities:

What distinguishes the fraud perpetrated on Manhattan in this case from one cognizable under *Rule 10b-5* is that its sole object was to obtain possession of Manhattan's government bonds for the personal use of the perpetrators. No doubt the deception was successful, for had the board known that Sweeney and his associates intended to misappropriate the proceeds for their own use it undoubtedly would not have authorized their sale. But the deception did not infect the subsequent sales transaction. With respect to the terms of the sale itself neither the purchaser nor the seller of the bonds was deceived or defrauded. n169

The Supreme Court reversed. In an opinion by Justice Douglas, the Court determined that Manhattan had been defrauded "in connection with" the sale of its bonds:

Manhattan was injured as an investor through a deceptive device which deprived it of any compensation for the sale of its valuable block of securities.

* * * * *

The crux of the present case is that Manhattan suffered an injury as a result of deceptive practices *touching* its sale of securities as an investor. n170

There is no evidence that Justice Douglas intended use of the word "touching" to in any way alter the landscape of the "in connection with" requirement. More likely, his choice of words was based on his own literary stylings. n171

However, in a subsequent case, *Santa Fe Industries v. Green*, n172 the Supreme Court limited the reach of *Rule 10b-5* in cases involving corporate mismanagement, at least in cases where no misrepresentation or deception was alleged. In

Santa Fe, the defendant corporation, owning more than 90 percent of the stock of Kirby Lumber Company, effected a short-form merger of Kirby into itself. The defendant complied with all the requirements of the applicable Delaware statute and disclosed all the relevant information to both Kirby's minority shareholders and the independent appraiser of their shares. The plaintiff shareholders, however, alleged that the defendant had violated *Rule 10b-5* by cashing them out of Kirby at an unfairly low price, solely for the defendant's own benefit and not for any justifiable business purpose.

The Supreme Court held the complaint failed to state a cause of action under Section 10(b) and *Rule 10b-5*. The Court reasoned that Section 10(b)'s terms only outlaw use of "manipulative or deceptive" devices and contrivances. The plaintiffs had not charged the defendant with any manipulative or deceptive conduct, but only with a breach of fiduciary duty:

The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception... . Thus the claim of fraud and fiduciary breach in this complaint states a cause of action under any part of *Rule 10b-5* only if the conduct alleged can be fairly viewed as 'manipulative or deceptive' within the meaning of the statute... .

As we have indicated, the case comes to us on the premise that the complaint failed to allege a material misrepresentation or material failure to disclose. ... On the basis of the information provided, minority shareholders could either accept the price offered or reject it and seek an appraisal in the Delaware Court of Chancery. Their choice was fairly presented, and they were furnished with all relevant information on which to base their decision. ...

It is also readily apparent that the conduct alleged in the complaint was not 'manipulative' within the meaning of the statute. 'Manipulation' is virtually a term of art when used in connection with securities markets. The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity. ... Indeed, nondisclosure is usually essential to the success of a manipulative scheme. No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices. But we do not think it would have chosen this 'term of art' if it had meant to bring within the scope of § 10(b) instances of corporate mismanagement such as this, in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary. n173

After *Santa Fe*, courts struggled to draw the line as to which types of claims of corporate mismanagement are allowed under Section 10(b) and *Rule 10b-5*. n174 Generally, courts have sustained mismanagement claims brought under the securities anti-fraud laws when non-disclosure or concealment deprives the injured party of an opportunity to prevent the fraud before it occurs. n175

The Supreme Court took up the issue of the "in connection with" requirement again in 2002. *SEC v. Zandford* n176 involved an SEC enforcement action based on the misconduct of a broker-dealer's registered representative's misconduct. The Supreme Court unanimously ruled that the SEC had properly alleged securities fraud in a civil complaint by alleging that a stockbroker sold his customers' securities and diverted the proceeds to his benefit.

The broker, Zandford, persuaded an elderly man to open a joint account for himself and a mentally retarded daughter, with Zandford holding a general power of attorney to engage in securities transactions. When the man died several years later, all the money in the joint account was gone. Zandford was convicted of federal wire fraud crimes for selling the securities in the joint account and making personal use of the proceeds. The SEC filed a civil action in the same court, alleging that Zandford violated Section 10(b) and *Rule 10b-5* by defrauding the customers and misappropriating their securities without their knowledge or consent.

Zandford argued that the sales were lawful and that Section 10(b) of the Exchange Act and *Rule 10b-5* prohibit fraud

only "in connection with the purchase or sale of any security." While conceding that the subsequent misappropriation of the proceeds was fraudulent, Zandford argued that misappropriation of the proceeds was not "in connection with" the sales, but was instead a simple theft. The district court granted the SEC's motion for summary judgment in the civil case based on Zandford's conviction. The United States Court of Appeals for the Fourth Circuit held that Zandford's scheme to steal his customers' assets did not violate *Rule 10b-5*, and ordered the SEC's case dismissed. n177 The Supreme Court reversed, holding that Zandford's scheme to defraud his customers was "in connection with" securities transactions, reasoning that the securities sales and the diversions of proceeds were a unitary course of business rather than independent events. The Supreme Court relied on *Superintendent of Ins. of N.Y. v. Bankers Life & Casualty Co.* n178 as well as the more recent cases of *United States v. O'Hagan*, n179 and *Wharf (Holdings) Ltd. v. United Int'l Holdings, Inc.* n180 to conclude that the SEC's complaint against Zandford described "a fraudulent scheme in which the securities transactions and breaches of fiduciary duty coincide. Those breaches were therefore 'in connection with' securities sales" n181

Courts have read *Zandford's* broad interpretation of the "in connection with" requirement to allow suits under Section 10(b) and *Rule 10b-5* where a customer was charged excess fees and commissions in connection with purchases of mutual funds, n182 and where a company concealed an accounting write-off during the time period when employees could exercise stock options. n183

The "in connection with" requirement was a focal point of *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, a 2006 Supreme Court case that analyzed when certain state court cases are preempted by SLUSA and must be removed to federal court. n184 In *Dabit*, the plaintiffs initially alleged that, in violation of Oklahoma law, Merrill Lynch research analysts had issued overly optimistic opinions that induced the plaintiffs to purchase securities they otherwise would not have and to hold securities they otherwise would have sold. n185 Merrill Lynch moved for dismissal arguing, in part, that the claims based on purchasing securities were precluded by SLUSA. n186 The district court agreed with Merrill Lynch's argument on this point, and dismissed the complaint with leave to amend. n187 The plaintiffs re-pled the action and characterized themselves as a class of individuals who owned and continued to own based on overly optimistic analyst opinions, and the case, along with dozens of similar cases, was transferred to the Southern District of New York. n188 The District Court again found that the case fell "squarely within SLUSA's ambit." n189 The Second Circuit reversed the District Court and found that Congress intended a narrower reading of the "in connection with" requirement in this situation. n190 The Second Circuit permitted the plaintiffs to refile another amended complaint that defined the class to exclude those who purchased securities in connection with the fraud and who, therefore, would be preempted by SLUSA. n191

The Supreme Court overruled the Second Circuit and took a broader view of the "in connection with requirement." The Court explained that, "under our precedents, it is enough that the fraud alleged 'coincide' with a securities transaction--whether by the plaintiff or by someone else." n192 The Court further explained that, the "requisite showing, in other words, is 'deception 'in connection with the purchase or sale of any security,' not deception of an identifiable purchaser or seller.' " n193 The Court closed by noting that the distinction between purchasers and holders of securities is irrelevant for the purposes of SLUSA. n194

[d] Purchase and Sale of a Security. A plaintiff must be a purchaser or seller of securities to sustain a 10b-5 claim. n195 Transactions at the heart of securities fraud suits are rarely something other than a "purchase" or "sale" of a security, in part because courts have found that a "purchase" or "sale" occurred in a wide variety of different contexts. This is due in part to the broad definition of "purchase" and "sale" in the Exchange Act:

[U]nless the context otherwise requires --

(13) The terms "buy" and "purchase" each include any contract to buy, purchase or otherwise acquire.

(14) The terms "sale" and "sell" each include any contract to sell or otherwise dispose of. n196 Thus, contracts for a

purchase or sale of securities are sufficient to sustain a 10b-5 claim regardless of whether the transaction is consummated, as long as the contract is enforceable. n197 While a purchase or sale need not involve cash, a gift is not a purchase or sale. n198 In addition, the Supreme Court has held that the simple exchange of shares in a merger qualifies as a purchase or sale when shareholders become "shareholders in a new company" as a result of "an alleged deception [that] has affected individual shareholders' decisions in a way not at all unlike that involved in a typical cash sale or share exchange." n199 In determining whether changes in the rights of a security holder involve a purchase or sale, courts must decide whether there has occurred "such significant change in the nature of the investment or in the investment risks as to amount to a new investment." n200 Courts have found "a major corporate restructuring requiring the same kind of investment decision by the shareholders as would a proposed merger with a separate existing corporation," n201 or one that constitutes a "fundamental change" in the plaintiff's holdings, n202 constitutes a purchase or sale for purposes of *Rule 10b-5*. The Seventh Circuit has rejected this "fundamental change" or the broader "forced seller" doctrine, "insist[ing] that the wrongdoing affect an investment decision" of the plaintiff. n203

[e] Reliance and Causation

To sustain a claim under *Rule 10b-5*, plaintiffs must show that they relied upon the material misrepresentation in making an investment decision, and that their reliance was justified or reasonable. n204 Whether reliance was justified often involves consideration of the plaintiffs' sophistication and access to information, among other factors. n205

Reliance is sometimes considered "transaction causation" or "causation in fact" -- that is, proof that the misrepresentation or omission "caused" plaintiff to enter into the transaction at issue. n206 Thus, it can be analogized to the common law requirement that fraud be a "but for" cause of the transaction. n207 Unlike common law fraud claims, however, plaintiffs in securities law cases can often satisfy the reliance requirement through using one of two presumptions of reliance: a presumption based on fraud on the market or a presumption when the case involves a failure to disclose material facts. Plaintiffs bringing common law claims normally cannot rely on the same presumptions, n208 and must prove actual reliance.

[i] Fraud on the Market. In *Basic, Inc. v. Levinson*, a plurality of the Supreme Court endorsed the fraud on the market theory, accepting that in an open and efficient securities market, the price of a security incorporates and reflects all relevant, public information regarding a security, including any material misrepresentations. n209

The *Basic* Court rested its opinion on a view of the economic efficiency of certain markets, such as the NYSE or the NASDAQ, for certain securities. As the Court reasoned, "[I]n an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business. ... Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements." n210 In such a market, the price of the stock acts as a proxy for the misrepresentation and the plaintiff, in relying on the price of the stock in making the decision to purchase or sell, is presumed to have relied on the material misrepresentation. This allowed the Court to view transactions in securities different from face-to-face transactions at the heart of common law fraud cases: " 'With the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price ... The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.' " n211 The Court concluded that "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a *Rule 10b-5* action." n212

The fraud on the market presumption shifts the burden of proof on the issue of reliance from plaintiffs to defendants -- relieving plaintiffs from needing to "show that they themselves actually relied on any particular misrepresentation or omission." n213 Rather, "they need only show that they relied on the integrity of the price of the stock as established by the market, which in turn is influenced by information or the lack of it." n214 Plaintiffs' "reliance on the market ... is

equivalent to reliance upon statements made to the market, or the nondisclosure of material information." n215 The presumption therefore "recognizes that most investors rely on the market to evaluate information for them, rather than on their own independent analysis of a stock's value." n216

The First Circuit has further refined the *Basic* standard of reliance in the fraud on the market theory by defining an efficient market as "one in which the market price of the stock fully reflects all publicly available information," rather than just "most" publicly available information. n217 The court further explained:

By "fully reflect," we mean that market price responds so quickly to new information that ordinary investors cannot make trading profits on the basis of such information. This is known as "informational efficiency." We reject a second and much broader meaning of "fully reflect," known as "fundamental value efficiency," which requires that a market respond to information not only quickly but accurately, such that the market price of a stock reflects its fundamental value. n218

At least in principle, this standard lowers the threshold for plaintiffs to claim a reliance under the fraud on the market theory because plaintiffs need only show that the market responded quickly to information, not also "accurately" to reflect "the actual economic values of securities in terms of their expected risks and returns." n219

While courts continue to define the requirements for the presumption to apply, it is clear that the presumption will not in the absence of an efficient market. Therefore, the presumption may not apply if the security in question is exchanged in a face-to-face transaction, n220 or traded in an undeveloped or inefficient market, n221 such as the market for an initial public offering. n222

In the context of certification of a class action, some courts have held plaintiffs seeking a presumption of reliance must first establish loss causation. In other words, a plaintiff must show that the alleged misstatements actually had an effect on the market price for a stock, e.g. through an empirical analysis disambiguating the effects of a subsequent corrective disclosure from the effects of other disclosures made at the same time. n223

The fraud on the market theory only creates a presumption of reliance -- one that can be overcome. A defendant can defeat the presumption by showing that plaintiffs relied on factors other than the stock price. n224 In addition, because the fraud on the market theory assumes the alleged statements were material and misrepresented, defendants can defeat the presumption by demonstrating that accurate information had sufficiently entered the market (there was "truth on the market") n225 or that the alleged false statement was otherwise immaterial.

[ii] Omissions. In *Affiliated Ute Citizens v. United States*, the Supreme Court embraced a different presumption, one applicable when plaintiffs sue on the basis of a failure to disclose a material fact. Under those circumstances, the Court ruled that reliance can be presumed so long as the facts not disclosed were material:

Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact. n226

Defendants may rebut the presumption created by *Affiliated Ute* by showing that plaintiffs would have purchased the securities even if the undisclosed facts had been disclosed to them. n227 Moreover, the presumption may not apply if the plaintiffs plead that defendants made material misrepresentations or both made misrepresentations and omitted material facts. n228 Finally, because the presumption applies only when there are omissions alleged, defendants must have had a duty to disclose before the presumption may apply. n229

[iii] Loss Causation. In addition to reliance or "causation in fact," plaintiffs also must prove that the fraud or deception caused their damages. n230 This has been variously labeled "loss causation" or "proximate cause" in that

some courts require that plaintiffs' damages be a foreseeable consequence of defendants' misrepresentation or omission. n231

Plaintiffs' complaints have often foundered on this element because they may be able to show reliance either directly or through a presumption, but cannot prove that the misrepresentation or omission "caused" their loss. n232 As the Fifth Circuit in *Huddleston v. Herman & MacLean* n233 framed it:

[A]n investor might purchase stock in a shipping venture involving a single vessel in reliance on a misrepresentation that the vessel has a certain capacity when in fact it had less capacity than was represented in the prospectus. However, the prospectus does disclose truthfully that the vessel will not be insured. One week after the investment the vessel sinks as a result of a casualty and the stock becomes worthless. In such circumstances, a fact-finder might conclude that the misrepresentation was material and relied upon by the investor but it did not cause the loss. n234

In 2005, the Supreme Court resolved a split among the Circuit Courts concerning the standard for pleading loss causation in fraud on the market cases, holding that "an inflated purchase price will not itself constitute or proximately cause the relevant economic loss." n235 The Court rejected the standard set by the Eighth and Ninth Circuits -- that a plaintiff need only allege that the purchase price of securities was artificially inflated due to a material misstatement or omission, regardless of the effect on the price of subsequent disclosures. n236 The Court explained that an inflated stock price on the date of purchase is not sufficient to prove loss causation because at the time of purchase, the plaintiff has suffered no loss. n237 Because the plaintiff has suffered no harm at the time of purchase, this approach is irreconcilable with the common law origins of securities fraud actions which require actual damages to be shown. n238 The plaintiff's burden to allege and prove proximate causation and economic loss is congruent with the other circuit decisions cited by the Court in support of its standard of proximate causation as rooted in common law tort theory. n239

The Court held the plaintiff's particularity of pleading in *Dura* was inadequate in light of the traditional elements of causation and loss. n240 "It should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind." n241 Because the plaintiffs in *Dura* were seeking class certification, the Court reiterated the pleading requirements set forth in the Private Securities Litigation Reform Act of 1995 ("PSLRA") that plaintiffs "'specify' each misleading statement," plead facts with particularity, and bear the burden of proving causation. n242 The Court reminded the parties that private securities actions exist not to provide investors general insurance against losses, but to protect them from losses that are actually caused by misrepresentations. n243 Specifically pleading causation and loss reinforces this policy objective.

The Fourth and Seventh Circuits have subsequently cited *Dura* for the proposition that both the alleged misstatement as well as the causal connection of the particular misstatement to the drop in stock price are specifically pled. n244 In the class action context, the Fifth Circuit relied on *Dura* to confer more expansive power on the courts to reach the merits of the case at the certification stage rather than at summary judgment. n245 In sum, *Dura* has resulted in a higher threshold for plaintiffs to meet in alleging sufficient facts to demonstrate to the court their ability to prove loss causation, and therefore has also solidified these circuit courts' distaste for "in terrorem" securities fraud actions. n246

However, not all circuits have embraced *Dura's* potentially expansive reach. The Ninth Circuit refused to extend the *Dura* reasoning to cases alleging loss causation in the context of a privately sold and privately traded stock. In *Livid Holdings, Ltd. v. Salomon Smith Barney*, the Ninth Circuit adhered to its pre-*Dura* reasoning that an artificially inflated stock price can be sufficient to plead loss causation because the transaction was private, and therefore *Dura* did not control. n247 The Second Circuit has refused to extend the *Dura* loss causation analysis to proximate cause analysis in common law fraud claims. n248 The Eighth Circuit has refused to apply *Dura* to loss causation analysis in criminal securities fraud actions. n249 Even the Fifth Circuit, while expanding the scope of courts' analysis at the class certification stage, simultaneously characterized the holding in *Dura* as "very narrow" and tangential to its examination of reliance. n250

[3] Secondary Liability

Plaintiffs in *Rule 10b-5* cases often attempt to include as many defendants as possible in their lawsuit. Prior to 1994, potential defendants included principal violators, those who made or were responsible for making the allegedly false statement or for withholding the allegedly material facts, and secondary violators, those who assisted in or were responsible for the wrongdoer's activities. Employers, corporate directors, banks and other financial institutions, and professionals like auditors and lawyers tended to be the ones most often named as defendants secondarily liable for alleged violations of *Rule 10b-5*. Plaintiffs relied on theories of aiding and abetting, conspiracy, common law principles of respondent superior, and control person liability under Section 20(b) to allege that these individuals and entities were liable for the underlying securities violation.

The 1994 Supreme Court decision in *Central Bank of Denver v. First Interstate Bank of Denver* n251 altered many of the theories upon which defendants were held secondarily liable in suits under *Rule 10b-5*. The Court surprised many by holding that no private civil cause of action for aiding and abetting existed under Section 10(a). After *Central Bank*, courts have had to confront, sometimes with contrary results, questions of what constitutes a primary violation of Section 10(b) and to what extent causes of action still remain against defendants who can only be said to be "secondarily" liable.

This subsection explores the theories of secondary liability after *Central Bank*. The civil liabilities of potential defendants such as lawyers, accountants, and broker-dealers are addressed more specifically and in more detail in other chapters. n252

[a] Aiding and Abetting.

Prior to *Central Bank*, courts generally accepted a private civil cause of action for aiding and abetting violations of Section 10(a) and *Rule 10b-5*. n253 The elements for liability included (i) the existence of a primary violation of § 10(b) or *Rule 10b-5*, (ii) the defendant's knowledge of (or recklessness as to) that primary violation, and (iii) "substantial assistance" of the violation by the defendant. The principal debate among the courts was over the appropriate standard of scienter for these actions, and in particular whether reckless behavior could support a claim for aiding and abetting in the absence of a duty running from defendants to plaintiffs. n254

Indeed, the Supreme Court initially granted certiorari in *Central Bank* to address the scienter standard for aiding and abetting liability. On its own initiative, the Court asked the parties to brief whether there was any basis for a private cause of action for aiding and abetting violations of Section 10(b) and *Rule 10b-5*. n255 It was on this issue that the Court issued its decision.

[i] Central Bank. Central Bank was the indenture trustee for two bond issues in 1986 and 1988, totaling \$26 million, used to finance improvements in a planned residential and commercial development in Colorado Springs, Colorado. The bonds were secured by landowner assessment liens and the covenants required the land subject to the liens to be worth at least 160 percent of the outstanding principle and interest on the bonds.

The bond covenants required the developer to give Central Bank an annual report that the 160 percent test had been met. In January 1988, the developer furnished Central Bank with an appraisal of the land securing the 1986 bond offering and the land proposed to secure the 1988 bond offering. The appraisal showed the assessed value of the land remained virtually unchanged since 1986.

Central Bank received a letter shortly after from the senior underwriter for the 1986 bonds expressing skepticism about the appraisal in light of the downturn in the Colorado Springs' real estate market between 1986 and 1988 and the use of an outdated appraisal for the 1988 bonds. Central Bank's in-house appraiser echoed that view and suggested Central Bank retain an independent appraisal of the property. The developer got Central Bank to delay the appraisal until the

end of 1988, six months after the 1988 bond issue closed, by which time the bonds were in default. n256 After the default, the plaintiffs sued Central Bank for aiding and abetting the violation of Section 10(b) and *Rule 10b-5*. The district court granted summary judgment to Central Bank and the appeals court reversed, with the courts differing over whether Central Bank acted with scienter to support a private aiding and abetting violation.

The Supreme Court affirmed, holding there was no private right of action for aiding and abetting violations of Section 10(b) and *Rule 10b-5*. The Court construed its prior relevant decisions as falling into two groups: one group of cases determined the "*scope of conduct* prohibited by Section 10(b)," and the other group determined *the elements* of "the 10b-5 private liability scheme." As to the latter, because Congress did not create a private cause of action, the Court has had to "infer how the 1934 Congress would have addressed the issue[s] had the 10b-5 action been included as an express provision in the 1934 Act."

Because *Central Bank* involved an issue of the *scope of conduct* covered by Section 10(b), the Court looked to the plain language of the statute: "the text of the statute controls our decision." The Court decided the text of § 10(b) prohibits "only the making of a material misstatement (or omission) or the commission of a manipulative act" but not aiding or abetting these acts; therefore, it held that no private civil liability exists under § 10(b) for aiding and abetting. The Court rejected the argument that the statute covers aiding and abetting because Section 10(b) covers individuals who "directly or indirectly" defraud plaintiffs:

The federal courts have not relied on the "directly or indirectly" language when imposing aiding and abetting liability under Section 10(b), and with good reason. There is a basic flaw with this interpretation The problem, of course, is that aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do. A further problem with respondents' interpretation of the "directly or indirectly" language is posed by the numerous provisions of the Exchange Act that use the term in a way that does not impose aiding and abetting liability. In short, respondents' interpretation of the "directly or indirectly" language fails to support their suggestion that the text of Section 10(b) itself prohibits aiding and abetting. n257

In short, the Court observed, "Congress knew how to impose aiding and abetting liability when it chose to do so ... If ... Congress intended to impose aiding and abetting liability, we presume it would have used the words 'aid' or 'abet' in the statutory text. But it did not." n258

Although it held that "the statute itself resolves the case," the Court also examined "how the 1934 Congress would have addressed the issue had the 10b-5 action been included as an express provision in the 1934 Act." n259 For this analysis, the Court used "the express causes of action in the securities Acts as the primary model The reason is evident: Had the 73d Congress enacted a private Section 10(b) right of action, it likely would have designed it in a manner similar to the other private rights of action in the securities Acts." n260 Given that the Securities Act of 1933 (§§ 11 and 12) and the Securities Exchange Act of 1934 (§§ 9, 16, 18, and § 20A) do not contain explicit provisions for aiding and abetting liability, the Court observed that: each (like § 10(b)) specifies the conduct for which defendants may be held liable. Some of the express causes of action specify categories of defendants who may be liable; others (like 10(b)) state only that 'any person' who commits one of the prohibited acts may be held liable ... however, none of the express causes of action in the Exchange Act further imposes liability on one who aids or abets a violation.

From this, the Court concluded that "we can infer that Congress likely would not have attached aiding and abetting liability to Section 10(b) had it provided a private Section 10(b) cause of action." n261

Based on this analysis, the Court held that Section 10(b) could not support aiding and abetting liability and thus "Central Bank may not be held liable as an aider and abettor." n262

The Court cautioned, however, that:

The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the security Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under *Rule 10b-5* are met. In any complex securities fraud, moreover, there are likely to be multiple violators n263

The Court's language in *Central Bank* was broad enough to bring into question the SEC's ability to bring aiding and abetting charges under Section 10(b). n264 Thus, Congress, in the Reform Act, explicitly gave the Commission power to seek an injunction or money penalties against "any person who *knowingly* provides substantial assistance to another person in violation of a provision" of the '33 or '34 Act "or any rule or regulation issued" under the '33 or '34 Act. n265 In doing so, Congress rejected calls to overturn the holding of *Central Bank* and provide for private civil actions for aiding and abetting. n266

[iii] Aftermath of Central Bank And Scheme Liability. After *Central Bank*, plaintiffs attempted to bring securities fraud suits against secondary actors, such as accountants, lawyers, and consultants, using a theory of liability known as scheme liability. Under this theory, plaintiffs argued that secondary actors who knowingly participated in transactions that resulted in a company issuing fraudulent financial statements, should be considered primary violators and subject to liability for the issuer's violations of Section 10(b). Until recently, the circuits were split as to what extent scheme liability could be used to hold secondary actors liable.

The Ninth Circuit adopted a standard of primary liability that differed little from the aiding and abetting standard that controlled prior to *Central Bank*. In *Simpson v. AOL Time Warner, Inc.* n267, the Ninth Circuit ruled that conduct in the furtherance of a "scheme to defraud" may be the basis of primary liability. n268 The court held that

to be liable as a primary violator of § 10(b) for participation in a 'scheme to defraud,' the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme. n269

The court further clarified its holding by stating it was not enough that a transaction in which a defendant was involved had a deceptive purpose and effect; "the defendant's own conduct contributing to the transaction or overall scheme must have had a deceptive purpose and effect." n270

Other courts rejected plaintiffs' attempts to use scheme liability to state claims against secondary actors, taking a stricter view of what constitutes a primary violator and requiring the actor to have made the false statement or to have directly engaged in a manipulative trading practice to be held liable under Section 10(b) or *Rule 10b-5*. The Second Circuit, in *Wright v. Ernst & Young*, n271 rejecting the "substantial participation" standard of the Ninth Circuit, found that an auditor's "private" review of allegedly misleading financial statements included in a press release did not support primary liability. As the opinion explains, a secondary actor cannot incur primary liability under the [Exchange] Act for a statement not attributed to the actor at the time of its dissemination [T]he misrepresentation must be attributed to that specific actor at the time of public dissemination, that is, in advance of the investment decision. n272

The Supreme Court took up the issue in 2008 in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* n273, In *Stoneridge*, the plaintiffs sued Scientific-Atlanta, Inc., and Motorola, Inc., both suppliers to Charter Communications, Inc. ("Charter"), which allegedly issued false and misleading financial statements. n274 Specifically, plaintiffs alleged that Scientific-Atlanta and Motorola supplied digital cable converter boxes to Charter at inflated prices with the understanding that Scientific-Atlanta and Motorola would use the excess payments to purchase advertising revenue from Charter. n275 Scientific-Atlanta and Motorola allegedly knowingly entered into these agreements, which Charter

improperly accounted for and used to inflate its earnings. n276 Although the defendants played no role in preparing or disseminating Charter's financial statements, the plaintiffs alleged that they were nonetheless liable because the defendants participated in these sham transaction knowing or in reckless disregard of Charter's intention to use the transactions to inflate its revenues and knowing the resulting financial statements would be relied upon by research analysts and investors. n277

The Supreme Court rejected plaintiffs' arguments, finding that the actions of Scientific-Atlanta and Motorola "were not relied upon by the investors and that, as a result, liability cannot be imposed upon respondents." n278 In refusing to presume reliance, the Court explained that

Respondents had no duty to disclose; and their deceptive acts were not communicated to the public. No member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times. Petitioner, as a result, cannot show reliance upon any of respondents' actions except in an indirect chain that we find too remote for liability. n279

The Court concluded that the plaintiffs' theory of scheme liability would impermissibly revive aiding and abetting liability, stating that:

Petitioner's view of primary liability makes any aider and abettor liable under § 10(b) if he or she committed a deceptive act in the process of providing assistance. ... Were we to adopt this construction of § 10(b), it would revive in substance the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud; and we would undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants. n280

Following *Stoneridge*, lower courts have interpreted the Supreme Court's decision to all but eliminate liability for secondary actors. n281

[b] Controlling Persons. Section 20(a) provides that any person who "controls" a person liable under the Act is liable for the violation with the primary violator unless the controlling person acted in good faith and did not induce the violation that gave rise to the cause of action. n282 Although Section 20(a) does not define "control," legislative history indicates that control can exist through stock ownership, a lease or a contract, agency, or other means. n283 The Commission, in a rule that may have applied by analogy to Section 20(a), has declared that "control" means "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." n284

Courts generally have followed the Commission's lead and require persons to have the power to control the conduct underlying the claim. Differences between the courts exist over whether controlling person liability requires "culpable participation" in the fraud, n285 or whether it is sufficient merely to have the indirect or direct power to control or influence the corporate policy that resulted in the violation. n286

[c] Other Bases for Secondary Liability. *Central Bank* also called into question whether there is a private right of action against individuals who would be liable for violations of Section 10(b) under other theories of secondary liability, such as conspiracy and respondeat superior. n287

Most courts, however, have determined that respondeat superior liability has survived *Central Bank*. n288 As one court concluded, the issue of whether respondeat superior is a legitimate basis for liability under Section 10(b) "is not a question of defining the scope of affirmative conduct proscribed by the statute. Instead, the issue is 'deciding on whose shoulders to place responsibility for conduct indisputably proscribed' by the statute." n289

Central Bank also struck a fatal blow on conspiracy claims under *Rule 10b-5*. The Second Circuit, in *Dinsmore v.*

Squadron, Elenoff, Pleasant, Sheinfeld & Sorkin, n290 held that such a conspiracy claim could not survive after *Central Bank*. The case involved a "Ponzi" scheme perpetrated by Towers Financial Corporation. Squadron, Elenoff served as counsel for Towers and two of its executives during investigations by the Securities and Exchange Commission. Plaintiffs alleged that Squadron, Elenoff took part in and prolonged Towers' fraud by making material misstatements and omissions to the SEC and by drafting an offer of rescission to earlier investors who were not plaintiffs in *Dinsmore*.

The Second Circuit noted that every court after *Central Bank* has rejected a private cause of action for securities fraud based on conspiracy. n291 It followed suit and held the reasoning that led the Supreme Court to reject aiding and abetting liability under Section 10(b) and 10b-5 in *Central Bank* applied with equal force to conspiracy claims. The court noted the statute is silent on whether there is liability for co-conspirators; finding liability would therefore " 'extend liability beyond the scope of conduct prohibited by the statutory text.' " n292 Indeed, the Second Circuit noted that, as with aiding and abetting, "none of the express causes of action in the Securities Exchange Act mention conspiracy, despite the fact that the Act imposed other forms of secondary liability -- namely upon controlling persons under § 20." Finally, the Second Circuit was persuaded that adopting a cause of action for conspiracy under Section 10(b) would abrogate the requirement that the plaintiff show reliance:

[A] conspiracy cause of action would similarly render irrelevant the question whether plaintiffs relied on any misstatement or omission by the defendant being sued. The instant case provides an apt example: the only misstatements or omissions alleged to have been made by Squadron Elenoff were made to the 1986 Noteholders and the SEC, and plaintiffs -- far from relying upon these communications in purchasing their securities -- were entirely unaware of them. This fact would be immaterial were we to recognize a conspiracy cause of action and inasmuch as this 'would disregard the careful limits on 10b-5 recovery mandated' by the Supreme Court, *Central Bank*, 511 U.S. at 180, 114 S. Ct. at 1450, we refuse to do so. n293

The Second Circuit also noted, in conclusion, that adopting a cause of action for conspiracy would vitiate the holding of *Central Bank* "inasmuch as many aiding and abetting claims would simply be repleaded as conspiracy claims." n294

[4] Affirmative Defenses

Rule 10b-5 contains no express affirmative defenses, but courts have recognized certain defenses to accompany the private right of action under *Rule 10b-5*. Chief among these affirmative defenses is a statute of limitations for suits under *Rule 10b-5*. Of lesser importance are the doctrine of *in pari delicto* and certain equitable and common law defenses.

[a] Statute of Limitations. In *Lampf, Pleva, Lipkind, Prupis & Pettigrew v. Gilbertson*, n295 the Supreme Court adopted a one-year/three-year statute of limitations for all private actions under *Rule 10b-5*, rejecting state-law statutes of limitations as the closest analog for federal securities law cases. Instead, the Court held there should be a uniform federal statute of limitations for securities fraud cases, and reviewed limitations periods applicable to similar express causes of action under the Exchange Act and Securities Act. n296 Noting that Sections 9 and 18 of the Exchange Act included a one-year/three-year period similar to that contained in Section 13 of the Securities Act of 1933 for express causes of action under the Securities Act, the Court concluded: "Litigation instituted pursuant to § 10(b) and *Rule 10b-5* therefore must be commenced within one year after the discovery of the facts constituting the violation and three years after such violation." n297

In 2002, however, Congress adopted a two-year from discovery/five-year from violation statute of limitations for private actions alleging "fraud, deceit, manipulation or contrivance" in violation of the federal securities laws. n298 Although this statute of limitations clearly applies to actions brought pursuant to *Rule 10b-5*, its application to some other actions is less clear. However, courts have generally declined to apply the extended statute of limitations to actions which do not require proof of fraudulent intent. n299 In addition, every circuit court that has considered the

question has held that Sarbanes-Oxley does not revive claims barred on the Act's effective date. n300

After *Lampf*, courts have generally interpreted "discovery" as imposing a duty of inquiry upon plaintiffs, holding that plaintiffs must bring suit within one year of when they knew, or could have known upon inquiry, of the facts constituting the alleged fraud. n301 To put plaintiffs on notice, there must be "sufficient storm warnings alerting a reasonable person to the possibility that there were either misleading statements or significant omissions involved in the sale." n302 The test is objective -- that is, courts will consider whether a reasonable person would have had notice of the facts, not whether the plaintiff had actual notice. Thus, the analysis turns on information available to the public, regardless of whether plaintiff was aware of the information. Courts have found notice provided by public filings with the Securities and Exchange Commission, n303 an article in a business journal, n304 or unusual moves in the price of the company's stock. n305

[b] *In Pari Delicto* or "Unclean Hands." Defendants in cases under *Rule 10b-5* can assert the doctrine of *in pari delicto*, derived from the Latin maxim *in pari delicto potior est conditio possidentis [defendentis]*: "In a case of equal or mutual fault ... the position of the [defending] party ... is the better one." n306 The doctrine affords a defense if the plaintiff engages in conduct sufficiently egregious to preclude him from recovery, whether or not the defendant committed securities fraud. n307 The Supreme Court, in two cases, established guidelines severely restricting availability of this defense in private securities fraud litigation.

In *Bateman Eichler, Hil, Richards, Inc. v. Berner*, n308 plaintiffs sued, claiming they sustained substantial losses when a securities broker and an officer of the issuer gave them false and misleading information. Defendants moved to dismiss, claiming that plaintiffs themselves violated Section 10(b) and *Rule 10b-5* by trading on what they believed was non-public information. The district court dismissed the suit on the basis of the *in pari delicto* defense. The Ninth Circuit reversed, holding that "securities professionals and corporate officers who have allegedly engaged in fraud should not be permitted to invoke the *in pari delicto* doctrine to shield themselves from the consequences of the fraudulent misrepresentation." n309 The Supreme Court affirmed, holding the *in pari delicto* defense was available only when plaintiffs bore at least substantial responsibility for the violations, and the defense would not significantly interfere with the effective enforcement of the securities laws and protection of the investing public. n310

In light of this two-part test, the Court affirmed. First, it found the tippee-plaintiffs less culpable than the defendant tippers: "In the context of insider trading ... a person whose liability is solely derivative can[not] be said to be as culpable as one whose breach of duty gave rise to that liability in the first place." n311 Second, the Court found that denying the defense to defendants would promote the objectives of the federal securities laws: "the public interest will most frequently be advanced if defrauded tippees are permitted to bring suit and to expose illegal practices by corporate insiders and broker-dealers to full public view for appropriate sanctions." n312

In *Pinter v. Dahl*, a subsequent opinion under Section 12 of the Securities Act of 1933, the Supreme Court held that to bar recovery under the *in pari delicto* doctrine, the plaintiff must be "an active, voluntary participant in the unlawful activity that is the subject of the suit." n313

The Court's decisions in *Bateman Eichler* and *Pinter* have made the *in pari delicto* doctrine, and the companion equitable defense of "unclean hands," substantially less attractive to defendants. The doctrine of unclean hands has generally been applied in bankruptcy cases, against people who allegedly contributed to pre-bankruptcy losses. n314

[c] Laches. Even if a statute of limitations does not bar a plaintiff's *Rule 10b-5* suit, the doctrine of laches may preclude relief. n315 Under this theory, a plaintiff's unreasonable delay in filing suit will bar a claim for equitable relief if the delay has prejudiced defendant. n316

However, the adoption in *Lampf* of a general federal statute of limitations for suits under *Rule 10b-5* and the subsequent extension of the statute of limitations under Sarbanes-Oxley suggests the doctrine of laches should not be applied to

shorten the period where plaintiff may bring suit. In cases arising under the express remedies in the Exchange Act and the Securities Act, a number of courts have held that there is a strong inference the statute of limitations period should not be cut short by the application of laches. n317

[d] Waiver, Estoppel, and Ratification. There are a number of other defenses, including waiver, estoppel, ratification, and due diligence, available to defendants, although each of these defenses are applied narrowly and infrequently.

Each of these defenses rests on the notion that plaintiffs, by not being diligent in discovering defendant's misfeasance or in asserting their rights, n318 should be precluded from pursuing a claim under Section 10(b) and *Rule 10b-5*. n319 As the Second Circuit stated:

The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act. n320

These defenses are often asserted in claims by customers against broker-dealers, with varying results. Early decisions generally turn on the trading experience of the plaintiff and whether the plaintiff knowingly consented to defendant's actions. n321 These claims are now most often arbitrated. n322 There are relatively few recent federal court decisions addressing estoppel, waiver or ratification.

[5] Jurisdiction and Venue under the Exchange Act

[a] Jurisdiction over the Subject Matter

Federal courts have exclusive jurisdiction over private actions under *Rule 10b-5*. Once a court has accepted jurisdiction, it may exercise "supplemental jurisdiction" over a closely related state law claim. In a number of cases in recent years, the federal courts have been called upon to decide whether they have subject matter jurisdiction over 10b-5 claims arising out of transnational securities transactions.

[i] The Jurisdictional Statute. Section 27 of the Exchange Act gives the federal courts exclusive jurisdiction over violations of the Act or the rules thereunder, and over suits in equity and actions at law to enforce liabilities arising under the Act or the rules. n323 The Securities Litigation Uniform Standards Act of 1998 (SLUSA) n324 bars most class actions for securities fraud from being filed in state court, and provides defendants with the right to remove any such suit filed in state court to federal court.

Under SLUSA, a "covered class action" alleging "(a) an untrue statement or omission of a material fact in connection with the purchase or sale of a covered security; or (b) that the defendant used or employed any manipulative or deceptive device or contrivance in connection with the purchase or sale of a covered security" cannot be brought in state court. n325 A "covered class action" is one filed for 50 or more "persons or prospective class members" or by one or more shareholders "in a representative capacity." n326 The Supreme Court has held that the scope of pre-emption under SLUSA may include state law class actions which could not be brought under the federal laws -- e.g. suits by securities holders -- provided the suit alleges fraud "in connection with" the purchase or sale of a covered security. n327

There are several exceptions to the class actions governed by the Act. First, a "covered class action" does not include "exclusively" derivative actions. n328 Second, Congress carved out a "Delaware" exception -- allowing class actions brought under the statutory or common law of the state of incorporation about (a) the purchase or sale of securities by the issuer to or from its shareholders or (b) any recommendation, position, or other communication by the issuer to its shareholders relating to a vote of the shareholders' securities, a tender or exchange offer, or the exercise of dissenters' or appraisal rights. n329 Third, the Act does not affect the ability of a state or state pension fund to bring an action, either individually or as a member of a class composed solely of other states or state pension funds.

A "covered security" subject to SLUSA is any security that "satisfies the standards specified" in Section 18(b)(1) and (2) of the Exchange Act "at the time during which" the alleged fraud occurred. n330 This includes securities listed or authorized for listing on the NYSE, AMEX, or any other major exchange or on the NASDAQ National Market System. Given its reliance on the standards in Section 18, SLUSA excludes from its coverage penny stocks, shares in limited partnerships, private placements and similar securities. Explicitly excluded is any debt security exempt from registration pursuant to Section 4(2) of the Securities Act of 1933.

To further its purpose of funneling "covered" class actions into federal court, SLUSA provides that class actions filed in state court "shall be removable" to "the federal district court for the district in which the action is pending." n331

Two other aspects of SLUSA deserve comment. First, the Act provides that a federal court shall have the power to stay discovery in a parallel state court class action. Second, the Act applies only prospectively. n332

[ii] Supplemental Jurisdiction. If a federal court has jurisdiction over an action under *Rule 10b-5*, it also possesses "supplemental jurisdiction" over any state claims "so related to claims in the action ... that they form part of the same case or controversy under Article III of the United States Constitution." n333 A court may decline to exercise supplemental jurisdiction if (1) the state law claim raises a novel or complex issue of state law, (2) the state law claim substantially predominates over the 10b-5 claim and any other claims over which the district court has original jurisdiction, (3) the district court has dismissed the 10b-5 claim and any other claims over which it has original jurisdiction, or (4) in exceptional circumstances, there are other compelling reasons for declining jurisdiction. n334

Plaintiffs' ability to append state law claims significantly affects the scope of damages in securities fraud cases. Because punitive damages are not available in actions under Section 10(a) or *Rule 10b-5* n335 but may be available under state common law, the exercise of supplemental jurisdiction over state law claims allows plaintiffs to seek punitive damages.

[iii] Transnational Transactions. As capital markets have become increasingly internationalized, federal courts have had to decide the extraterritorial application of the antifraud provisions of the securities laws. Courts have attempted to define, for example, the extent to which *Rule 10b-5* applies to sales of securities by foreign issuers to Americans and to foreigners, and the extent to which *Rule 10b-5* applies to securities transactions that take place in part in this country and in part in other nations.

"[T]he Securities Exchange Act is silent as to its extraterritorial application." n336 Courts (principally the Second Circuit) have developed two jurisdictional tests. One of these tests focuses on the *conduct* of foreign persons within the United States; the other focuses on effects within the United States of conduct occurring in foreign nations. A court may use either or both of two tests.

Under the "effects" test, a U.S. court has subject matter jurisdiction when illegal activity abroad causes a "substantial effect" within the United States. n337 For example, the Second Circuit concluded the "effects" test was met in a derivative suit brought by an American investor against the directors of a Canadian corporation. n338 The corporation sold treasury stock to two non-American companies. Although the fraudulent sales transactions occurred outside the United States, the transactions reduced the value of the Canadian corporation's stock, which was listed on an American stock exchange. The resulting "impairment of the value of American investments by sales by the issuer in a foreign country" amounted to "a sufficiently serious effect upon United States commerce to warrant assertion of jurisdiction for the protection of American investors..." n339 On the other hand, the effects test is not met when, for example, all parties involved in a transaction are foreign, even though nonparty U.S. purchasers ultimately acquire some fraudulently issued securities. The presence of a foreign investor's agent in the United States does not matter because it was "entirely fortuitous and personal." n340 Similarly, defrauding a foreign investment trust is not a "substantial effect" when United States residents own only a *de minimis* proportion of the trust's securities. n341

The rationale for the "conduct" test is that "Congress does not want the United States to be used as a base for

manufacturing fraudulent security devices for export, even when they are peddled only to foreigners." n342 Under the Second Circuit's formulation of this test, a federal court has subject matter jurisdiction if (1) the defendant's activities in the United States are more than "merely preparatory" to a securities fraud conducted elsewhere, and (2) these activities or culpable failures to act within the United States "directly caused" the losses. n343 Applying the conduct test, the Second Circuit found subject matter jurisdiction in a case where an American corporation charged the defendants violated *Rule 10b-5* by conspiring to cause it to purchase some of the stock of a British corporation at an excessive price. n344 Although sales transactions had taken place outside the United States, the plaintiff alleged the defendants made a number of material misrepresentations during meetings between the parties in the United States. In contrast to the Second Circuit, other courts have concluded that a lesser quantum of conduct within the United States is necessary to support subject matter jurisdiction. In particular, they have indicated the domestic conduct need be only significant to the fraud rather than a direct cause of it. n345 Applying this more permissive approach, the Ninth Circuit found subject matter jurisdiction based upon a single U.S. meeting on the purchase of one foreign corporation by another. n346

The conduct and effects tests can be applied in conjunction with each other (e.g., the more significant the effects of the fraud in the United States, the lesser the quantum of conduct required to establish subject matter jurisdiction). n347 Thus, for example, the Second Circuit has indicated that anti-fraud provisions of the securities laws:

(1) "Apply to losses from sales of securities to Americans resident in the United States whether or not acts (or culpable failures to act) of material importance occurred in this country;" n348

(2) "Apply to losses from sales of securities to Americans resident abroad or to a foreign corporation with a significant proportion of United States shareholders if acts (or culpable failures to act) of material importance in the United States have significantly contributed thereto;" n349

(3) "Do not apply to losses from sales of securities to foreigners outside the United States unless acts (or culpable failures to act) within the United States directly caused such losses." n350

[b] Jurisdiction over Parties. "The Securities Exchange Act permits the exercise of personal jurisdiction to the limits of the *Due Process Clause of the Fifth Amendment*." n351 Section 27 of the Exchange Act authorizes worldwide service of process in any suit to enforce any liability created by the Act or by rules and regulations under the Act. n352 The Federal Rules of Civil Procedure, in turn, authorize worldwide service where a federal statute authorizes this service, personal jurisdiction exists over the defendant, and service does not otherwise offend constitutional principles. n353

To be subject to service, a foreign defendant must have minimum contacts with the United States. Thus, courts will apply the same analysis used in state law cases to decide whether extraterritorial jurisdiction over out-of-state defendants is constitutionally permissible. n354 The leading case examining the issue is *Leasco Data Processing Equipment Corp. v. Maxwell*. n355 There, the Second Circuit held that although there was jurisdiction over a British corporation because its managing director appeared at meetings and made misrepresentations in the United States, there was not jurisdiction over the corporation's British accounting firm, which had not performed relevant acts or caused foreseeable consequences in this country. The court declared that "where a defendant has acted within a state or sufficiently caused consequences there, he may fairly be subjected to its judicial jurisdiction even though he cannot be served with process in the state..." n356

Moreover, courts generally have found that if there is personal jurisdiction over a corporation, there is personal jurisdiction over officers and directors or others who are "control persons" for purposes of the Exchange Act, even if they reside outside of the United States, and do not have minimum contacts with the United States. n357

Personal jurisdiction may also increasingly be an issue in cases involving off-shore Internet Web sites. In a number of cases not involving securities fraud, courts generally have found that a "passive" Internet Web site, through which a

putative defendant does not target residents of a particular state, will not support exercise of personal jurisdiction over the company that established or maintained the Web site. For example, in *Soma Medical International v. Standard Chartered Bank*, the Tenth Circuit, in a case involving a British bank, held that jurisdiction could not be founded on the Bank's operation of a Web site when it appeared "to be a passive Web site that does little more than make information available to those who are interested" and one where [the Bank] "has simply posted information on an Internet Web site which is accessible to users in foreign jurisdictions." n358 The court in *Zippo Manufacturing Co. v. Zippo Dot Com, Inc.*, n359 succinctly summarized the case law that has developed concerning personal jurisdiction based on the operation of an Internet Web site:

At one end of the spectrum are situations where a defendant clearly does business over the Internet. If the defendant enters into contracts with residents of a foreign jurisdiction that involve the knowing and repeated transmission of computer files over the Internet, personal jurisdiction is proper. *E.g.*, *CompuServe, Inc. v. Patterson*, 89 F.3d 1257 (6th Cir. 1996) . At the opposite end are situations where a defendant has simply posted information on an Internet Web site which is accessible to users in foreign jurisdictions. A passive Web site that does little more than make information available to those who are interested in it is not grounds for the exercise personal jurisdiction. *E.g.*, *Bensusan Restaurant Corp., v. King*, 937 F.Supp. 295 (S.D.N.Y. 1996) . The middle ground is occupied by interactive Web sites where a user can exchange information with the host computer. In these cases, the exercise of jurisdiction is determined by examining the level of interactivity and commercial nature of the exchange of information that occurs on the Web site. *E.g.*, *Maritz, Inc. v. Cybergold, Inc.*, 947 F. Supp. 1328 (E.D. Mo. 1996) . n360

Given the increasing use of the Internet to effect securities transactions, promote companies, and disseminate information about securities, these decisions may assume increased importance in cases under *Rule 10b-5*.

[c] Venue. A private action under *Rule 10b-5* may be brought in any district where any act or transaction constituting the alleged violation of the Rule occurred, or in any district where the defendant is found or is an inhabitant or transacts business. n361 If the plaintiff's cause of action stems from a fraudulent scheme among a group of defendants, venue will lie in any district where any of the defendants committed a material act in furtherance of the scheme. n362 Courts sometimes refer to this as the "co-conspiracy venue theory." n363 Venue can be based on an act that was not "crucial" to the consummation of the fraud, n364 but the act must have been "more than an immaterial part of the alleged violation." n365

Even though the plaintiff initiates his suit in a proper forum, the case may be transferred to another forum "[f]or the convenience of parties and witnesses, in the interest of justice..." n366 In ruling on a motion for a change of venue, a court will give substantial weight to the plaintiff's choice of forum. n367 Otherwise, "[i]f transfers were granted in securities cases with too much abandon, the effect would be to undermine Congressional efforts to enforce securities laws by minimizing burdens on plaintiffs in civil suits." n368 In addition, however, the court will consider which alternatives is superior in terms of factors such as availability of process to compel the attendance of witnesses, the cost of obtaining the attendance of witnesses, and the ease of access to sources of proof. n369

[6] Remedies

Section 28(a) of the Exchange Act provides that a plaintiff cannot recover more than "actual damages" in a *Rule 10b-5* suit (although plaintiffs may also seek any other remedy available in law or equity). n370 Because Section 28(a) does not define "actual damages," courts have adopted a number of alternative theories of damages available in a private securities fraud case. In addition, courts have allowed plaintiffs to seek rescission, contribution, and injunctive relief.

[a] Damages.

[i] Measurement of Damages. A plaintiff's "out-of-pocket" loss is generally the "correct" measurement of

damages in a *Rule 10b-5* action. n371 At least one Court of Appeals has noted that courts are "unanimous" in limiting damages to "out of pocket" losses except when "defendant was a broker-dealer or the plaintiff and defendant were in privity." n372 A plaintiff's "out of pocket" loss is the difference between the "true value" of the security at the time the plaintiff purchased or sold the security (that is, the price unaffected by the misrepresentation or omission alleged) and the price plaintiff paid or received for the security. n373 Plaintiffs generally allege that the degree to which the alleged fraud affected the price of the security is evidenced by the change in the price of the security once the allegedly fraudulent statement, omission, or activity is corrected or becomes public. To prevent a recovery being influenced by the volatility of the price of the security, the Reform Act provided that, in cases involving open market transactions, damages are to be measured by the average share price over a 90-day period after the allegedly fraudulent statement, omission, or activity is corrected or becomes public. n374

In any event, the determination of plaintiffs' "out of pocket" losses, and particularly the "true value" of the security, typically requires expert testimony. n375 Not infrequently, this results in a "battle of the experts" between plaintiffs' expert, who claims the price of the security (or the change in the price once the fraud is discovered) is wholly or substantially influenced by the alleged fraud, and defendants' expert, who opines the price of the stock (or the change in the stock price once the fraud is discovered) reflects industry or market trends rather than the influence of the alleged fraud. n376

Under an out of pocket measure of damages, plaintiffs may be awarded consequential damages n377 but cannot recover "lost" profits or other "foreseeable" damages. n378 Plaintiffs are not restricted to an "out of pocket" measurement of damages, however. A district court has the discretion to consider several alternative damage measurements. First, when defendants receive more than plaintiffs' loss, such as when they fraudulently purchase securities from plaintiff and sell the securities at a profit, damages can be measured by defendants' profit. n379 The rationale behind this principle is that it prevents the "unjust enrichment of a fraudulent buyer." n380 In language quoted with approval by the Supreme Court, the First Circuit observed that "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." n381

Second, some courts may award "benefit of the bargain" damages if proven with "reasonable certainty." n382 This measure of damages is based on the difference between the value of the security as represented and the value actually received. These damages may be awarded when plaintiff received less than promised in a business combination n383 or suffered losses as a result of the churning of his securities account. n384

Third, rescissory damages may be appropriate in certain circumstances -- normally limited to when money damages will not adequately compensate plaintiff. n385 These damages are equal to the consideration paid by plaintiff minus any value received on the investment. n386 They cannot be reduced by any tax benefits the plaintiffs might receive on the investment. n387 A rescissory damage award is intended to "return the defrauded purchaser to the status quo ante: it contemplates the return of the injured party to the position he occupied before he was wrongfully induced to enter the transaction." n388

The court in *Gould v. American-Hawaiian S.S. Co.*, n389 held that: "(1) 'lost opportunity' damages are available unless the loss is 'wholly speculative'; and (2) if the fact of loss is not 'wholly speculative,' the risk of uncertainty as to amount of damages is cast on the wrongdoer and it is the duty of the fact finder to determine the amount of the damages as best he can from all the evidence in the case." n390 Although the "lost opportunity" theory of damages had not been applied to a 10b-5 case in the Third Circuit, n391 the plaintiffs in *Tse v. Ventana Medical Systems* sought these damages on their 10b-5 claim. n392 As former shareholders of an acquired company, the plaintiffs asserted that they suffered a loss by not knowing, before voting on the merger, the acquiring company had agreed to give compensation packages to two directors of the acquired company. n393 The plaintiffs claimed they would have negotiated a better deal or blocked the merger had they known about the compensation. n394 The court held the shareholders' loss was "wholly speculative", and thus not recoverable. n395

[ii] Punitive Damages. Because damages under Section 28(a) are limited to "actual damages," courts have uniformly held that punitive damages are not allowed for suits under *Rule 10b-5*. n396 Nevertheless, plaintiffs may be able to seek punitive damages by including common law causes of action in a federal securities fraud case.

[iii] Prejudgment Interest. A plaintiff may recover prejudgment interest on any damages awarded in a 10b-5 action. n397 Interest is measured in accordance with the federal statute on prejudgment interest in civil suits. n398

[b] Rescission and Restitution. "Rescission" is the avoidance of a contract or transaction. n399 "Restitution" or "restoration" is often used to denote the return to each person who participated in an exchange of what he gave up in the exchange. n400 Either remedy, alone or in combination, is available under *Rule 10b-5*. n401

If the contract at issue in the lawsuit is still executory, its rescission ordinarily will afford plaintiff complete relief. If the contract has been executed, the plaintiff can sue for damages or for rescission and restitution. n402 A plaintiff who is granted rescission may obtain specific restitution -- the recovery of the property defendants fraudulently obtained -- or rescissory damages. For example, if the defrauded plaintiff sold securities to the defendant, and the defendant still owns the securities at the time of judgment, the plaintiff can recover the securities themselves. n403 If, however, defendant no longer owns the securities, and cannot purchase and tender other securities of the same class, the plaintiff is entitled to rescissory damages. n404

[c] Contribution and Indemnity. The Supreme Court in 1993 confirmed defendants have a right of contribution in securities fraud cases under Section 10(b) and *Rule 10b-5*. n405 Nevertheless, this right in practical terms may provide little benefit to defendants in securities fraud cases, if the sole remaining defendants are able to pay damages while the principal wrongdoers are either effectively judgment-proof or incarcerated.

Congress, in the Reform Act, imposed rules governing contribution in private federal securities fraud cases. Although the Act confirms that contribution is available in all private actions, n406 it imposes proportionate liability depending on the state of mind of the defendants. Defendants found to have committed "knowing violations" are jointly and severally liable for the total amount of all damages. n407 Defendants whose liability rests on less than a "knowing" violation, however, are liable only for their proportionate share of damages, unless this would inadequately compensate plaintiffs with a low net worth. n408 An action for contribution must be brought within six months of entry of judgment. n409

Defendants cannot sue for indemnity, because courts have generally found that it is against public policy to allow one party to shift liability for a violation of the federal securities laws to another party. n410 Directors and officers of corporations will also commonly have a right to indemnification under the corporate by-laws and state corporate statutes. n411

[d] Injunctive Relief. Plaintiffs can seek an injunction in a private *Rule 10b-5* suit. Almost all of the 10b-5 cases discussing the propriety of injunctive relief are concerned with the granting of preliminary injunctions. Although the precise formulation of the preliminary injunction standard varies somewhat from circuit to circuit, a plaintiff, to be awarded injunctive relief, must typically demonstrate the following factors:

- (1) plaintiffs have no adequate remedy at law and will be irreparably harmed if the injunction does not issue; (2) the balance of hardships tilts toward plaintiffs; and (3) plaintiffs have at least a reasonable likelihood of success on the merits. n412

Because plaintiffs must show they do not have an adequate remedy at law, and given that plaintiffs will usually have available to them an action for damages under *Rule 10b-5*, injunctive relief may only be awarded when damages would be unusually difficult to fix or when uncertainty about the amount of damages could cause great injustice to one of the parties. n413

[e] The Use of Experts When Calculating Damages

While courts have generally applied the "out-of pocket" measure of damages in *Rule 10b-5* cases, the Exchange Act and the PSLRA do not sanction a specific method for calculating damages. n414 Because courts have used different methods to calculate damages, parties rely largely on expert witnesses to convince the court of the best method for calculating damages in each specific case.

Measuring damages typically requires a valuation of the stock absent the alleged misrepresentation or omissions. Courts have relied on "event studies" produced by experts as evidence of what the value of the stock would have been had the alleged misrepresentation or omission not occurred. n415 "An event study is a statistical regression analysis that examines the effect of an event on a dependant variable, such as a corporation's stock price." n416 While the "failure to perform an event study comparing the stock's price to the market as a whole or a selected index of similar businesses is enough to cause an expert's opinion to be excluded," the completion of an event study in itself does not validate an expert witness' testimony. n417

In *Carpe*, the court granted the defendant's motion to exclude the plaintiff's expert witness' testimony after it was revealed that "the plaintiffs' expert did not perform a proper event study and failed to follow the accepted methodology of his field, making his opinions in this case inherently unreliable." n418 Without an event study or a valid event study, a plaintiff can be left unable to demonstrate the actual losses that were suffered as a consequence of the fraud and are then vulnerable to summary judgment in favor of the defendant. n419

[i] Transaction-Based Methodology v. Aggregated Methodology. Expert testimony often centers around a debate between the parties concerning whether economic loss should be calculated using a transaction-based methodology or a cumulative methodology that aggregates all of the stock transactions. n420 Using a transaction-based methodology benefits the plaintiff, because it treats each transaction separately and considers only the transactions that resulted in a loss during the loss period when calculating damages. In contrast, a cumulative methodology allows the aggregation of all transactions during the loss period regardless of whether the transactions resulted in gains or losses, which often results in significant off-setting of the economic losses and lower damages. n421 Courts have accepted both methodologies as valid ways to calculate damages in 10b-5 actions. n422 The transaction-based methodology has been viewed as more in line with the intent of securities laws to deter fraud. n423 In *In re Cigna Corp. Sec. Litig.*, the court refused to grant summary judgment for the defendant even though the defense's expert witness demonstrated that the plaintiff did not suffer an economic loss once all of the plaintiff's transactions were aggregated. n424 In reaching this decision, the court considered conflicting expert testimony as to the better measure of damages and concluded that there was no precedent preventing a jury from considering both an aggregated and a transaction-based methodology for calculating damages. n425 In *Rocker Management, LLC v. Lernout & Hauspie Speech Products N.V.*, where there were hundreds of short transactions involving millions of shares over an extended period of time, the court used an aggregated approach because "it best reflects the activities of the investor during the damages period." n426 The court noted that "whether the netting or transactional approach is utilized depends on the circumstances." n427 As the court in *Rocker Management* indicates, the approach that the court takes in calculating damages can differ based the facts of each case and the quality of the expert testimony presented by the parties.

FOOTNOTES:

(n1)Footnote 1. 69 F. Supp. 512 (E.D. Pa. 1946) .

(n2)Footnote 2. E.g., *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6 (1971) .

(n3)Footnote 3. Sec. Exch. Act § 21D(b)(3)(B), 15 U.S.C. § 77u-4(b)(3)(B) (2008).

(n4)Footnote 4. *Medhekar v. United States Dist. Court for the Northern Dist. of California*, 99 F.3d 325, 328-29 (9th Cir. 1996) .

(n5)Footnote 5. *Medical Imaging Centers of America v. Lichtenstein*, 917 F. Supp. 717, 720 (S.D. Cal. 1996) .

(n6)Footnote 6. *SG Cowen Securities Corp. v. U.S. Dist. Court for Northern Dist. of CA*, 189 F.3d 909, 912, 913 (9th Cir. 1999) .

(n7)Footnote 7. *Chiarella v. United States*, 445 U.S. 222, 235, 100 S. Ct. 1108, 1118 (1980) .

(n8)Footnote 8. See § 5.04[2][c] *infra*.

(n9)Footnote 9. 15 U.S.C. § 78u-4(b)(1)(1994). Pursuant to Fed. R. Civ. P. 9(b), courts insisted upon some degree of particularity in cases filed before the Reform Act. For example, *Grossman v. Novell, Inc.*, 120 F.3d 1112 (10th Cir. 1997) , affirmed the dismissal of a complaint because, among other things, plaintiff failed to allege that certain statements were false. *Grossman* 120 F.3d at 1124 . Similarly, *Williams v. WMX Technologies Inc.*, 112 F.3d 175 (5th Cir.) , the court reversed and remanded with instructions to dismiss a complaint because the plaintiff failed to allege how certain statements were misleading or false and failed to specify the time and place of other statements. See also *In re GlenFed Sec. Litig.*, 42 F.3d 1541, 1548 (9th Cir. 1994) (en banc) ("the plaintiff must set forth what is false and misleading about a statement and why it is false. In other words, the plaintiff must set forth an explanation as to why the statement or omission complained of was false or misleading").

(n10)Footnote 10. *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1417 (3d Cir. 1997) .

(n11)Footnote 11. *Robertson v. Strassner*, 32 F. Supp. 2d 443, 446 (S.D. Tex. 1998) ; *In re Silicon Graphics Inc. Sec. Litig.*, 970 F. Supp. 746, 752 (N.D. Cal. 1997) .

(n12)Footnote 12. *In re Silicon Graphics Inc. Sec. Litig.*, 970 F. Supp. at 752 . See also *Grant-Brooks v. WMC Mortg. Corp.*, 2003 U.S. Dist. LEXIS 22593 (N.D. Tex., 2003) .

(n13)Footnote 13. See, e.g., *SEC v. Yuen*, 221 F.R.D. 631, 635 (C.D. Cal. 2004) ; *In re Real Estate Assocs. Ltd. P'ship Litig.* 223 F. Supp. 2d 1142 (C.D. Cal 2002); see also *In re System Software Assocs. Sec. Litig.*, 2000 U.S. Dist. LEXIS 3071 (D. Ill. 2000) ; *In re Qwest Commun. Int'l. Secs. Litig.*, 2004 U.S. Dist. LEXIS 584 (D. Co. 2004) .

(n14)Footnote 14. *Yuen*, 221 F.R.D. at 635 .

(n15)Footnote 15. See, e.g., *Winer Family Trust v. Queen*, 503 F.3d 319, 335-337 (3d Cir. 2007) ; *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 710 (7th Cir. 2008) ; *Southland Sec. Corp. v. INSpire Ins. Solutions Inc.*, 365 F.3d 353, 366 (5th Cir. 2004) .

(n16)Footnote 16. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156 (2d Cir. 1980) ; *Raab v. General Physics Corp.*, 1993 U.S. Dist. LEXIS 17443 (D. Md. Jan. 7, 1993) , aff'd, 4 F.3d 286 (4th Cir. 1993) ; *In re Cabletron Systems, Inc.*, 311 F.3d 11 (1st Cir. 2002) .

(n17)Footnote 17. *Newbridge*, 926 F. Supp. at 1171 (citations omitted); see also *Raab*, 4 F.3d at 288 (4th Cir. 1993) ; *In re Syntex Corp. Sec. Litig.*, 95 F.3d 922, 934 (9th Cir. 1996) .

(n18)Footnote 18. *In re Cabletron Systems, Inc.*, 311 F.3d 11, 37-38 (1st Cir. 2002) .

(n19)Footnote 19. See *Elkind*, 635 F.2d at 163 ; *In re Newbridge Networks Sec. Litig.*, 926 F. Supp. 1163, 1171 (D.D.C. 1996) ("It is not sufficient to allege that defendants provided analysts with the information on which the analysts' reports were based") (quoting *In re Gupta Corp. Sec. Litig.*, 900 F. Supp. 1217, 1237 (N.D. Cal. 1994)) .

(n20)Footnote 20. See *Herman v. Legent Corp.*, No. 94-1445, 1995 U.S. App. LEXIS 5568, at *33-34 (4th Cir. Mar. 20, 1995) ; *Raab*, 4 F.3d at 288-89 ; *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 264-266 (2d Cir. 1993) .

(n21)Footnote 21. *Arazie v. Mullane*, 2 F.3d 1456, 1468 (7th Cir. 1993) ; see also *Glassman v. Computervision Corp.*, 90 F.3d 617, 630 (1st Cir. 1996) (holding that pricing of an initial public offering entails a forecast of firm's future and is not actionable if the price declines when that forecast does not turn out to be true).

(n22)Footnote 22. 901 F.2d 624, 628-29 (7th Cir. 1990) .

(n23)Footnote 23. *In re GlenFed Sec. Litig.*, 42 F.3d 1541, 1548-49 (9th Cir. 1994) ; see also *Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1278 (D.C. Cir. 1994) ("The fact that the company's performance did not conform to that predicted supports no inference that MCI's statements lacked a reasonable basis when made."); *Hershfang v. Citicorp*, 767 F. Supp. 1251, 1259 (S.D.N.Y. 1991) ("A complaint must contain more than vague allegations that, as shown by subsequent developments, the corporation's true financial picture was not so bright in some respects as ... painted and that the defendants knew, or were reckless in failing to know, this.")

(n24)Footnote 24. *Raab v. Gen. Physics Corp.*, 4 F.3d 286, 291 (4th Cir. 1993) .

(n25)Footnote 25. *Basic, Inc. v. Levinson*, 485 U.S. 224, 108 S. Ct. 978 (1988) .

(n26)Footnote 26. *Chiarella v. United States*, 445 U.S. 222, 235 (1980) ; *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 860-61 (2d Cir. 1968) ; *Roeder v. Alpha Indus., Inc.*, 814 F.2d 22, 26-27 (1st Cir. 1987) ; 7 Louis Loss & Joel Seligman, *Securities Regulation* 3517 (3d Ed. 1992).

(n27)Footnote 27. *Backman v. Polaroid Corp.*, 910 F.2d 10, 13 (1st Cir. 1990) (*en banc*).

(n28)Footnote 28. *Chiarella*, 445 U.S. at 235, 100 S. Ct. at 1118 ; *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1202, 1203 (1st Cir. 1996) ; *Roeder*, 814 F.2d at 26.

(n29)Footnote 29. *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 851 n.12 (2d Cir. 1968) , cert. denied, 394 U.S. 976, 89 S. Ct. 1454 (1969) .

(n30)Footnote 30. *Heliotrope General v. Ford Motor Co.*, 189 F.3d 971, 980-82 (9th Cir. 1999) ; *In re Convergent Tech. Sec. Litig.*, 948 F.2d 507, 516 (9th Cir.1991) ; *Vaughn v. Teledyne, Inc.*, 628 F.2d 1214, 1221 (9th Cir.1980) .

(n31)Footnote 31. *Shaw*, 82 F.3d 1194, 1203-04 .

(n32)Footnote 32. *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1043 (11th Cir. 1986) .

(n33)Footnote 33. *Schatz v. Rosenberg*, 943 F.2d 485, 490-492 (4th Cir. 1991) (distinguishing cases in which attorneys issued misleading opinion letters or who drafted false prospectuses or other documents "made in the solicitation of securities;" *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 497 (7th Cir. 1986) ; *In re Infocure Sec. Litig.*, 210 F.Supp.2d 1331, 1351 (N.D. Ga. 2002) ; *In re Cascade Int'l Sec. Litig.*, Case No. 91-8652-CIV--NESBITT, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,110 (S.D. Fla., Dec. 15, 1993).

(n34)Footnote 34. *Shapiro v. Cantor*, 123 F.3d 717, 721-22 (2d Cir. 1997) . See at § 5.04[3].

(n35)Footnote 35. The seminal case is *In re Cady, Roberts & Co.*, where the Commission extended *Rule 10b-5* in finding that trading by insiders on non-public information violated *Rule 10b-5(3)* since it "operated as a fraud or deceit upon the purchasers." 40 S.E.C. 907, 913 (1961) . A partner in a brokerage firm had learned from one of the firm's employees, also a director of Curtiss-Wright Corporation, that Curtiss-Wright planned to cut its dividend. Armed with this non-public information, the broker sold his customers' Curtiss-Wright stock. In sanctioning the broker, the SEC relied on state precedents to impose a "special obligation" of disclosure on "corporate insiders [such as] officers, directors and controlling shareholders" and other "persons who are in a special relationship with a company and privy to its internal affairs":

[T]he obligation rests on two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

40 S.E.C. at 912 (footnote omitted).

Some seven years after *Cady, Roberts*, the Second Circuit issued its landmark opinion in *SEC v. Texas Gulf Sulphur*. There, the court held that a number of corporate insiders had violated *Rule 10b-5* when they purchased stock when possessing knowledge of a major mineral strike that had not yet been announced to the public. In addition, the court held that an insider who had passed the non-public information to others who then traded on it had violated *Rule 10b-5* by his tipping. *Texas Gulf Sulphur* thus announced a broad "disclose or abstain" rule: "anyone in possession of material inside information must either disclose it to the investing public or ... must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed." 401 F.2d 833, 848 (2d Cir. 1968) . *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, extended the holding of *Texas Gulf Sulphur* to tippees, holding that tippees could be liable for trading on the basis of material non-public information. 495 F.2d 228 (2d Cir. 1974) .

(n36)Footnote 36. 445 U.S. 222 (1980) .

(n37)Footnote 37. 463 U.S. 646 (1983) .

(n38)Footnote 38. 445 U.S. 222, 235 (1980) .

(n39)Footnote 39. 445 U.S. at 232-33 .

(n40)Footnote 40. 92 F.3d 612 (8th Cir. 1996) , cert. granted, 519 U.S. 1087 (1997) , rev'd, 521 U.S. 642, 117 S. Ct. 2199 (1997) .

(n41)Footnote 41. 445 U.S. at 236-37 .

(n42)Footnote 42. 463 U.S. 646, 653-54 (1983) . This limited the "disclose or abstain" doctrine announced by the Second Circuit in *Texas Gulf Sulphur*. See *Chiarella* 445 U.S. at 235 .

(n43)Footnote 43. 463 U.S. at 663 .

(n44)Footnote 44. 463 U.S. at 664-65 .

(n45)Footnote 45. One unsettled issue in the wake of *Dirks* and *Chiarella* is what, if any, causal connection must be shown between the trader's possession of inside information and his or her trading. The Securities and Exchange Commission has long taken the position that "knowing possession" is sufficient. In *U.S. v. Smith*, 155 F.3d 1051 (9th Cir. 1998) and *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998) , the Ninth and Eleventh Circuits rejected that proposition, concluding that an insider trading violation requires "actual use" of inside information by the insider.

In August 2000, the SEC adopted new rules addressing the issue of when insider trading liability arises in connection with a trader's "use" or "knowing possession" of material nonpublic information. Final Rule: Selective Disclosure and Insider Trading, Rel. No. 7881 (Aug. 15, 2000). Rule 10b5-1 provides that a person trades on the basis of material nonpublic information when that person purchases or sells securities while "aware" of the information when the purchase or sale is made. 17 C.F.R. 240.10b5-1.

(n46)Footnote 46. See, e.g., *McCormick v. Fund American Cos., Inc.*, 26 F.3d 869, 876 (9th Cir. 1994) (collecting cases) ("[T]he corporate issuer in possession of material non-public information, must, like other insiders in the same situation, disclose that information to its shareholders or refrain from trading with them."); 7 Louis Loss & Joel Seligman, *Securities Regulation* 3505 (3d ed. 1992) ("When the issuer itself wants to buy or sell its own securities, it has a choice: desist or disclose."); 18 Donald C. Langevoort, *Insider Trading: Regulation, Enforcement & Prevention* § 3.02[1][d] at 3-5 (3d ed. 1994) ("Issuers themselves may buy or sell their own securities, and have long been held to an obligation of full disclosure... . Conceptually, extending the insider trading prohibition to instances of issuer insider trading makes perfect sense.").

(n47)Footnote 47. See, e.g., *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1203-04 (1st Cir. 1996) ; *Rogen v. Ilikon Corp.*, 361 F.2d 260, 268 (1st Cir. 1966) .

(n48)Footnote 48. See, e.g., *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981) .

(n49)Footnote 49. *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996) , cert. granted, 519 U.S. 1087, 117 S. Ct. 759 (1997) , rev'd, 521 U.S. 642, 117 S. Ct. 2199 (1997) ; *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995) .

(n50)Footnote 50. 521 U.S. 642 (1997) .

(n51)Footnote 51. The Ninth Circuit recently held that, under the misappropriation theory of insider trading, it is enough that the defendant owed a duty to the defendant's source of information and a "continuous chain of duties" is not required. In other words, the misappropriation theory does not require that a duty be owed to the originating source of confidential information. *SEC v. Talbot*, 530 F.3d 1085, 1093 (9th Cir, 2008) .

(n52)Footnote 52. 521 U.S. at 653 .

(n53)Footnote 53. 521 U.S. at 653-54.

(n54)Footnote 54. 484 U.S. 19, 108 S. Ct. 316 (1987) .

(n55)Footnote 55. 521 U.S. at 654 .

(n56)Footnote 56. 521 U.S. at 656 .

(n57)Footnote 57. See § ____ infra for a fuller discussion of Section 20A.

(n58)Footnote 58. H.R. Rep. No. 100-910, pt. 5, at 6063 (1988).

(n59)Footnote 59. 719 F.2d 5, 16 (2d Cir. 1983) .

(n60)Footnote 60. See, e.g., *Castellano v. Young and Rubicam, Inc.*, 257 F.3d 171, n. 79 (2d Cir. 2001) ; *Philips v. LCI Int'l, Inc.*, 190 F.3d 609, 613 (4th Cir. 1999) ; *In re Bilzerian*, 153 F.3d 1278, 1282 (11th Cir. 1998) .

(n61)Footnote 61. 426 U.S. 438, 444-45, 96 S. Ct. 2126, 2130-31 (1976) .

(n62)Footnote 62. *Basic Inc. v. Levinson*, 485 U.S. 224, 230-32 n.8, 108 S. Ct. 978, 983 (1988) (10b-5 action). Lower courts have adopted the TSC standard for actions under Sections 11 and 12(a)(2) of the Securities Act. See *Alton Box Board Co., v. Goldman, Sachs & Co.*, 560 F.2d 916, 919-20 (8th Cir. 1977) (§ 12(a)(2) actions); *Elfenbein v. American Fin. Corp.*, 487 F. Supp. 619, 626-27 (S.D.N.Y. 1980) , *aff'd without op.*, 652 F.2d 53 (2d Cir. 1981) ; *Greenapple v. Detroit Edison Co.*, 468 F. Supp. 702, 708 (S.D.N.Y. 1979) (§ 11 actions), *aff'd*, 618 F.2d 198 (2d Cir.1980) .

(n63)Footnote 63. TSC, 426 U.S. at 449, 96A S. Ct at 2132 (emphasis added).

(n64)Footnote 64. 426 U.S. at 449, 96 S.Ct. at 2132.

(n65)Footnote 65. 426 U.S. at 449, 96 S.Ct. at 2130; *Basic, Inc.*, 485 U.S. at 231-32, 108A S. Ct. at 983.

(n66)Footnote 66. *Kapps v. Torch Offshore, Inc.*, 379 F.3d 207, 216 (5th Cir. 2004) ; *Shaev v. Saper*, 320 F.3d 373, 384 (3d Cir. 2003) ; see also *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539, 546 (8th Cir. 1997) (finding that materiality is in many cases best determined by the trier of fact but in some circumstances dismissal as a matter of law is appropriate).

(n67)Footnote 67. *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1425 (3d Cir. 1997) . See also *ABC Arbitrage v. Tchuruk*, 291 F.3d 336, 361-62 (5th Cir. 2002) ; *Oran v. Stafford*, 226 F.3d 275, 282-83 (3d Cir. 2000) .

(n68)Footnote 68. See 4 Louis Loss & Joel Seligman, *Securities Regulation* 2103-04 (Rev. 4th ed. 2000).

(n69)Footnote 69. *Parnes*, 122 F.3d at 547 (8th Cir. 1997) ; see also *Romine v. Axiom Corp.*, 296 F.3d 701, 708 (8th Cir. 2002) .

(n70)Footnote 70. *Press v. Chemical Inv. Sec. Corp.*, 166 F.3d 529, 539 (2d Cir. 1999) .

(n71)Footnote 71. *In re Westinghouse Sec. Litig.*, 90 F.3d 696, 714 (3d Cir. 1996) ; but see *In re Unisys Corp. Sec. Litig.*, 2000 U.S. Dist. LEXIS 13500 (E.D. Pa. 2000) (finding that misrepresentations regarding contracts amounting to less than 0.6% of company's annual revenue were not immaterial as a matter of law).

(n72)Footnote 72. 64 Fed. Reg. 45150 (1999) .

(n73)Footnote 73. 228 F.3d 154, 163-64 (2d Cir. 2000) .

(n74)Footnote 74. 56 F. Supp. 2d 222, 227 (D. Conn. 1999) .

(n75)Footnote 75. *Ganino*, 228 F.3d at 162-64 n. 6.

(n76)Footnote 76. See, e.g., *City of Monroe Emples. Ret. Sys. v. Bridgestone Corp.*, 387 F.3d 468 (6th Cir. 2004) ; *U.S. v. Nacchio*, 519 F.3d 1140, 1162 (10th Cir. 2008) .

(n77)Footnote 77. *In re Convergent Tech. Sec. Litig.*, 948 F.2d 507, 513 (9th Cir. 1991) (internal quotations omitted). See also *Eisenstadt v. Allen*, 113 F.3d 1240 (9th Cir. 1997) .

(n78)Footnote 78. *Basic, Inc.*, 485 U.S. at 238, 108A S. Ct. at 987 (quoting *SEC v. Texas Gulf Sulphur*, 401 F.2d

at 849).

(n79)Footnote 79. 485 U.S. at 238, 108A S. Ct. at 987.

(n80)Footnote 80. 857 F.2d 240 (4th Cir. 1988) .

(n81)Footnote 81. 857 F.2d at 244 .

(n82)Footnote 82. 857 F.2d at 244 .

(n83)Footnote 83. 857 F.2d at 244 .

(n84)Footnote 84. 857 F.2d at 244 . In a subsequent case, the Fourth Circuit found that a statement made by a company officer that the company was "not for sale," made shortly before the company agreed to a merger, was immaterial. See *Phillips v. LCI Int'l Inc.*, 190 F.3d 609, 616-619 (4th Cir. 1999) . See also *Sedighim v. Donaldson, Lufkin & Jenrette, Inc.*, 167 F. Supp. 2d 639, 649-650 (S.D.N.Y. 2001) (granting motion to dismiss on grounds that company had exploratory discussions with other businesses in the "normal course of business.")

(n85)Footnote 85. *Rowe v. Maremont Corp.*, 850 F.2d 1226, 1228-31 (7th Cir. 1988) ; see also *Kronfeld v. Trans World Airlines, Inc.*, 832 F.2d 726, 735-37 (2d Cir. 1987) (when a company retained investment bank to consider selling a subsidiary and investment bank had discussed the sale with company executives, but not presented a proposal to the board).

(n86)Footnote 86. See 4 Louis Loss & Joel Seligman, *Securities Regulation* at 2080-82.

(n87)Footnote 87. 4 Louis Loss & Joel Seligman, *Securities Regulation* at 2083-86.

(n88)Footnote 88. *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1427-28 (3rd Cir. 1997) ; *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1218 (1st Cir. 1996) .

(n89)Footnote 89. *San Leandro Emergency Med. Group Profit Sharing Plan. v. Philip Morris Cos., Inc.*, 75 F.3d 801, 811 (2d Cir. 1996) .

(n90)Footnote 90. *Raab v. General Physics Corp.*, 4 F.3d 286, 290 (4th Cir. 1993) . Other cases finding statements to be puffing include *Rombach v. Chang*, 355 F.3d 164, 174 (2nd Cir. 2004) ; *Southland Sec. Corp. v. INSpire Ins. Solutions, Inc.*, 365 F.3d 353, 372-80 (5th Cir. 2004) ; *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1119-1120 (10th Cir. 1997)

(n91)Footnote 91. *In re Donald J. Trump Casino Sec. Litig.*, 793 F. Supp. 543, 549 (D.N.J. 1992) , *aff'd*, 7 F.3d 357 (3d Cir. 1993) . A clear majority of circuit courts have adopted some form of the bespeaks caution doctrine. See *Employers Teamsters Local Nos. 175 and 505 Pension Fund v. Clorox Co.*, 353 F.3d 1125, 1127 (9th Cir. 2004) ; *Halperin v. eBanker USA.COM, Inc.* 295 F.3d 352, 359-360 (2nd Cir. 2002) ; *Grossman v. Novell, Inc.*, 120 F.3d 1112, 1120 (10th Cir. 1997) .

(n92)Footnote 92. See *Grossman*, 120 F.3d at 1122; *San Leandro Emergency Med. Group Profit Sharing Plan*, 75 F.3d at 811 (cautionary language in Annual Report held to "bespeak caution" with regard to optimistic statements in press releases and newspaper articles).

(n93)Footnote 93. 103 F.3d 351 (4th Cir. 1996) .

(n94)Footnote 94. 103 F.3d at 356 .

(n95)Footnote 95. 103 F.3d at 354 .

(n96)Footnote 96. *103 F.3d at 359-60* .

(n97)Footnote 97. *E.g. Blatt v. Merrill Lynch, Pierce, Ferner & Smith, Inc.*, 916 F. Supp 1343 (D.N.J. 1996) (finding that, "not just any cautionary language will trigger application of the bespeaks caution doctrine. Instead, disclaimers must relate directly to that on which investors claim to have relied").

(n98)Footnote 98. *In re Marion Merrell Dow Sec. Litig.*, Fed. Sec. L. Rep. (CCH) P 97,776 (W.D. Mo. 1993); see *Credit Suisse First Boston Corp. v. ARM Fin. Group, Inc.*, Fed. Sec. L. Rep. (CCH) P 91,363 (S.D.N.Y. 2001); *In re Jenny Craig Sec. Litig.*, 1992 U.S. Dist. LEXIS 22769 (S.D. Cal. Dec. 22, 1992) (refusing to dismiss because statements of caution were "too weak and too general to counterbalance its statement of optimism...").

(n99)Footnote 99. See Securities Act § 27A(b)(2), 15 U.S.C. § 77z-2(b)(2)(2000); Exchange Act § 21E(b)(2), 15 U.S.C. 78u-5(b)(2)(2000), H.R. Conf. Rep. No. 104-369 at 46, reprinted in 1995 U.S.C.C.A.N. 745.

(n100)Footnote 100. See Securities Act § 27A(b)(1), 15 U.S.C. § 77z-2(b)(1) (2000); Exchange Act § 21E(b)(1), 15 U.S.C. 78u-5(b)(1) (2000), H.R. Conf. Rep. No.104-369 at 46, reprinted in 1995 U.S.C.C.A.N. 745.

(n101)Footnote 101. *Rasheedi v. Cree Research, Inc.*, No. 1196 CV00890, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,566, (M.D.N.C. Oct. 17, 1997).

(n102)Footnote 102. *Rasheedi v. Cree Research, Inc.*, No. 1196 CV00890, [1997 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,566, (M.D.N.C. Oct. 17, 1997); see also *In re Home Health Corp., Inc., Sec. Litig.*, Fed. Sec. L. Rep. (CCH) P 90,414 (E.D. Pa. Jan. 29, 1999).

(n103)Footnote 103. *Rasheedi*, Fed. Sec L. Rep. (CCH) P 99,566 .

(n104)Footnote 104. *182 F.3d 799 (11th Cir. 1999)* .

(n105)Footnote 105. *Harris 182 F.3d at 802*.

(n106)Footnote 106. *Harris, 182 F.3d at 804*.

(n107)Footnote 107. The August 2 press release in *Harris, 182 F.3d at 809*, contained this cautionary language:

Statements made in this press release, including those relating to expectations of increased reorders, receipt of a credit facility waiver, earnings distribution, and the generic drug industry, are forward looking and are made pursuant to the safe harbor provisions of the Securities Litigation Reform Act of 1995. Such statements involve risks and uncertainties which may cause results to differ materially from those set forth in these statements. Among other things, additional competition from existing and new competitors will impact reorders; the credit facility waiver is subject to the discretion of the bank syndicate; and IVAX's ability to distribute earnings more evenly over future quarters is subject to industry practices and purchasing decisions by existing and potential customers. In addition, the U.S. generic drug industry is highly price competitive, with pricing determined by many factors, including the number and timing of product introductions. Although the price of a generic product generally declines over time as competitors introduce additional versions of the product, the actual degree and timing of price competition is not predictable. In addition to the factors set forth elsewhere in this release, the economic, competitive, governmental, technological and other factors identified in IVAX's filing with the Securities and Exchange Commission, could affect the forward looking statements contained in this press release.

The September 30 press release in *Harris, 182 F.3d at 813*, included the following cautionary language:

Statements made in this press release, including those relating to the estimated cost reductions, the amount of the restructuring charge expected in the third quarter, the purchase of the Kirkland facility, the time frames for closing and consolidating facilities and eliminating employee positions, the expected manufacturing costs of products made at the Kirkland facility, the expected transfer of verapamil production from Miami to Ireland, the amount of the write-off expected in the third quarter relating to the wholesaler customer's receivable, the expected loss for the third quarter, expectations for the fourth quarter, the prospects of the generic drug industry, and the expected submissions of NDAs for Cervene (R) and PaxenetM are forward looking and are made pursuant to the safe harbor provisions of the Securities Litigation Reform Act of 1995. Such statements involve risks and uncertainties which may cause results to differ materially from those set forth in these statements. Among other things, the cost reductions are estimated based on preliminary information as well as certain assumptions which management believes to be reasonable at this time and are subject to the successful completion of the actions described in this press release; the expected restructuring charge is an estimate based on certain assumptions which management believes to be reasonable at this time; the purchase of the Kirkland facility is subject to a number of contractual conditions, including governmental approvals; the timing of the closing and consolidating of facilities and the elimination of employee positions are subject to the acquisition of the Kirkland facility, the construction and leasing of the Kentucky distribution center, and FDA approval to transfer manufacturing of certain products; the amount of the write-off of the wholesaler customer's receivable is subject to developments in the related reorganization which could impact the value of the receivable; the transfer of verapamil production is subject to FDA approval; and the expected submissions of NDAs for Cervene (R) and PaxenetM are subject to the successful completion of clinical trials and the development of additional data required for the NDAs. The waiver of, and amendment to, the credit agreement is subject to the discretion of the participating banks. Expectations concerning financial results for the 1996 third and fourth quarters are not actual results and are based on preliminary estimates as well as certain assumptions which management believes to be reasonable at this time, including estimates and assumptions concerning the price and number of competitors for IVAX's generic drugs, the volume and product mix of sales, and the levels of required reserves for returns, shelf stock adjustments, and other items. The U.S. generic drug industry is extremely competitive, with pricing determined by many factors, including the number and timing of products introductions. Although the price of a generic drug product generally declines over time as competitors introduce additional versions of the product, the actual degree and timing of price competition is not predictable. In addition to the factors set forth elsewhere in this release, the economic, competitive, governmental, technological and other factors identified in IVAX's filings with the Securities and Exchange Commission could affect the forward looking statements contained in this press release.

Id. at 808-13 .

(n108)Footnote 108. 182 F.3d at 806 .

(n109)Footnote 109. 182 F.3d at 806-07 (quoting H.R. Conf. Rep. 104-369, at 44 (1995), reprinted in 1995 U.S.C.C.A.N. 730, 743).

(n110)Footnote 110. *In re Boeing Sec. Litig.*, 40 F. Supp. 2d 1160 (W.D. Wash. 1998) .

(n111)Footnote 111. 40 F.Supp.2d at 1169.

(n112)Footnote 112. See *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d at 371.

(n113)Footnote 113. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n. 12 (1976) .

(n114)Footnote 114. *Ernst*, 425 U.S. at 193 .

(n115)Footnote 115. See, e.g., *In re AdvantaCorp. Sec. Litig.*, *Advanta Corp. Sec. Litig.*, 180 F.3d 525, 531(3d Cir. 1999) .; *Alpern v. UtilCorp United, Inc.*, 84 F.3d 1525, 1534 (8th Cir. 1996) ; *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1233 (10th Cir. 1996) ; *Stone v. Kirk*, 8 F.3d 1079, 1086 (6th Cir. 1993) ; *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569-70 (9th Cir. 1990) , amended, *Hollinger v. Titan Capital Corp.*, 1990 U.S. App. LEXIS 19892 , cert. denied, *Titan Capital Corp. v. Hollinger*, 499 U.S. 976, 111 S. Ct. 1621, 113 L. Ed. 2d 719, 1991 U.S. LEXIS 2279, 59 U.S.L.W. 3724 ; *Magna Inv. Corp. v. John Does One Through Two Hundred*, 931 F.2d 38, 39 (11th Cir. 1991) ; *Rolf v. Blyth, Eastman, Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978) ; *Sundstrand Corp. v. Sun Chem. Co.*, 553 F.2d 1033, 1045 (7th Cir.1977) ; *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977) .

(n116)Footnote 116. *Sundstrand*, 553 F.2d at 1045 .

(n117)Footnote 117. *Hoffman*, 587 F.2d 509 at 516.

(n118)Footnote 118. *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 269 (2d Cir. 1993) .

(n119)Footnote 119. See *In re GlenFed Inc. Sec. Litig.*, 42 F.3d 1541, 1545-47 (9th Cir. 1994) (en banc).

(n120)Footnote 120. Reform Act § 21D(b)(2), 15 U.S.C. § 78 u-4(b)(2)(1994) (emphasis added).

(n121)Footnote 121. S. 240, 104th Cong. § 104 (1995).

(n122)Footnote 122. S. Rep. No. 104-98 at 15 (1995).

(n123)Footnote 123. 141 Cong. Rec. S9171 (daily ed. June 27, 1995).

(n124)Footnote 124. H.R. Conf. Rep. No. 104-369 at 41 (1995). The proposal would have specifically adopted the "motive and opportunity" pleading language.

(n125)Footnote 125. H.R. Conf. Rep. No. 104-369 at 41 at 41, n.23, *reprinted* in 1995 U.S.C.C.A.N. 740, 747.

(n126)Footnote 126. 141 Cong. Rec. H15214 (daily ed. Dec. 20, 1995).

(n127)Footnote 127. See, e.g., *In re Silicon Graphics Inc. Securities Litigation*, 183 F.3d 970, 977 (9th Cir. 1999) (imposing a heightened standard of, at a minimum, "deliberate recklessness"); *Press v. Chemical Investment Services Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (holding that plaintiff "must either allege (a) facts to show that 'defendant has not the motive and opportunity to commit fraud' or (b) allege facts that 'constitute strong circumstantial evidence of conscious misbehavior or recklessness.' "); *In re Comshare, Inc. Securities Litigation*, 183 F.3d 542, 549 (6th Cir. 1999) (holding that plaintiffs must allege facts "giving rise to a strong inference of recklessness," and cannot rest solely on allegations of "motive and opportunity."); *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 867 (5th Cir. 2003) (same); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1283 (11th Cir. 1999) (rejecting notion that allegations of motive and opportunity could serve as an independent means of alleging scienter, and instead requiring plaintiffs to show that defendants acted with "severe recklessness."); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 188 (1st Cir. 1999) (adopting a pleading standard consistent with the First Circuit's pre-Reform Act standard, which included "a narrowly defined concept of recklessness which does not include ordinary negligence, but is closer to being a lesser form of intent."); *City of Philadelphia v. Fleming Cos.*, 264 F.3d 1245 (10th Cir. 2001) (holding that motive and opportunity are typically insufficient in themselves to show scienter, but they may be important to the "totality of the pleadings"); *In re K-Tel Int'l., Inc. Sec. Litig.*, 300 F.3d 881, 894 (8th Cir. 2002) (holding that motive and opportunity are "enerally relevant, but particularly important to establishing scienter is a showing of unusual or heightened motive")..

(n128)Footnote 128. 127 S.Ct. 2499 (2007) .

(n129)Footnote 129. 127 S.Ct. at 1504-05.

(n130)Footnote 130. 127 S.Ct. at 2509 .

(n131)Footnote 131. 127 S.Ct. at 2509 .

(n132)Footnote 132. 127 S.Ct. at 2509 .

(n133)Footnote 133. 127 S.Ct. at 2509 .

(n134)Footnote 134. 127 S.Ct. at 2510 .

(n135)Footnote 135. See, e.g., Jess Bravin, High Court Raises the Bar for Filing Shareholder Suits, WALL ST. J., June 22, 2007, at A4; Stephen Labaton, Investors' Suits Face Higher Bar, Justices Rule, N.Y. TIMES, June 21, 2007, at A1; Walter Hamilton & Jim Puzzanghera, Bar Raised For Suits By Investors; A Supreme Court Ruling Is Likely To Lower the Number of Cases Filed, L.A. TIMES, June 22, 2007 at C1.

(n136)Footnote 136. *South Ferry LP, #2 v. Killinger*, 542 F.3d 776, 784 (9th Cir. 2008) . But see *Metzler Inv. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049, 1069 (9th Cir. 2008) ("But the Tellabs Court's directive that a complaint must be read in its entirety cuts both ways. Although a defendant cannot gain dismissal by de-contextualizing every statement in a complaint that goes to scienter, a plaintiff cannot avoid dismissal by reliance on an isolated statement that stands in contrast to a host of other insufficient allegations.").

(n137)Footnote 137. *Ley v. Visteon Corp.*, 543 F.3d 801, 810 (6th Cir. 2008) (quoting *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001)) .

(n138)Footnote 138. *ACA Financial Guaranty Corp. v. Advest, Inc.*, 512 F.3d 46, 59 (1st Cir. 2008) (citing *In re Credit Suisse First Boston Corp.*, 431 F.3d 36, 49 (1st Cir. 2005)) .

(n139)Footnote 139. 523 F.3d 75, 89 (1st Cir. 2008) ,

(n140)Footnote 140. See, e.g., *Indiana Electrical Workers' Pension Trust Fund IBEW v. Shaw Group, Inc.*, 537 F.3d 527, 534 (5th Cir. 2008) ; *Visteon Corp.*, 543 F.3d at 811 ; *Winer Family Trust v. Queen*, 503 F.3d 319, 334 (3rd Cir. 2007) .; *Central Laborers' Pension Fund v. Integrated Elec. Servs. Inc.*, 497 F.3d 546, 552 (5th Cir. 2007) .

(n141)Footnote 141. *New Jersey Carpenters Pension & Annuity Funds v. Biogen Idec Inc.*, 537 F.3d 35, 57-58 (1st Cir. 2008) (finding that ten-day period between knowledge fatal diagnosis of patient in drug trial and disclosure was reasonable given drug company's need to investigation causal connection between its drug and the diagnosis); *Higginbotham v. Baxter Int'l Inc.*, 495 F.3d 753, 759 (7th Cir. 2007) ("Taking the time necessary to get things right is both proper and lawful. Managers cannot tell lies but are entitled to investigate for a reasonable time, until they have a full story to reveal.").

(n142)Footnote 142. *Mizzaro v. Home Depot, Inc.*, 544 F.3d 1230, 1251 (11th Cir. 2008) ("the amended complaint contains no allegations directly linking the named defendants to the ... fraud, and the allegations about the geographic scope, duration, and amount of the alleged fraud are insufficient to create a 'stron inference' (meaning a 'cogent and compelling' one) that the individual defendants orchestrated the fraud, knew about it, or were severely reckless in not knowing about it."); *Killinger*, 542 F.3d at 784-85 ("Where a complaint relies on allegations that management had an important role in the company but does not contain additional detailed allegations about the defendants' actual exposure to information, it will usually fall short of the PSLRA standard."); but see *Berson v. Applied Signal Tech. Inc.*, 527 F.3d 982, 987-88 (9th Cir. 2008) (inferring knowledge by defendants, without particularized allegations, of the existence of two stop work orders halting work on the company's largest contract with one of its most important customers).

(n143)Footnote 143. *Corinthian Colleges*, 540 F.3d at 1066-67 ("While 'suspicious stock sales by corporate insiders may constitute circumstantial evidence of scienter,' such sales only give rise to an inference of scienter when they are 'dramatically out of line with prior trading practices at times calculated to maximize the personal benefit from undisclosed inside information.' ") (quoting *Silicon Graphics*, 183 F.3d at 986); see also *In re Ceridian Corp. Sec. Litig.*, 542 F.3d 240, 246-47 (8th Cir. 2008) ; *Biogen Idec Inc.*, 537 F.3d at 56 ; *Indiana Electrical*, 537 F.3d at 543-44 ; *Higginbotham*, 495 F.3d at 759 ; *Cornelia I. Crowell GST Trust v. Possis Med., Inc.*, 519 F.3d 778, 783 (8th Cir. 2008) ; *Integrated Elec. Servs.*, 497 F.3d at 552-53 .

(n144)Footnote 144. See, e.g., *Integrated Elec. Servs.*, 497 F.3d at 554 ; *Indiana Electrical*, 537 F.3d at 544-45 ; *Ley v. Visteon Corp.*, 543 F.3d 801, 812 (6th Cir. 2008) ; *Ceridian Corp.*, 542 F.3d at 248.

(n145)Footnote 145. *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 709 (7th Cir. 2008) .

(n146)Footnote 146. *Mississippi Pub. Employees' Ret. Sys. v. Boston Scientific Corp.*, 523 F.3d 75, 91 (1st Cir. 2008)

(n147)Footnote 147. *Id.* at 88 .

(n148)Footnote 148. *Belizan v. Hershon*, 495 F.3d 686, 691-92 (D.C. Cir. 2007) ; *Boston Scientifi.*, 523 F.3d at 88 .

(n149)Footnote 149. *Makor Issues & Rights*, 513 F.3d at 711 .

(n150)Footnote 150. 495 F.3d at 756-57 .

(n151)Footnote 151. *Id.* at 757 ; see also *Visteon Corp.*, 543 F.3d at 811 ("While we agree that anonymous sources are not altogether irrelevant to the scienter analysis, Plaintiffs' allegations here are too vague and conclusory to be accorded much weight."); *Possis Med.*, 519 F.3d at 783 (statements from anonymous sources lacked sufficient detail to provide meaning ful support to scienter allegation); *Integrated Elec. Servs.*, 497 F.3d at 552 (statements from confidential sources "lack sufficient detail to credit them as a bases for a strong inference of scienter... ").

(n152)Footnote 152. 513 F.3d at 712 .

(n153)Footnote 153. *Id.*

(n154)Footnote 154. *Id.*

(n155)Footnote 155. 537 F.3d at 52 .

(n156)Footnote 156. *Northern Trust Co. v. Essaness Theatres Corp.*, 103 F. Supp. 954 (N.D. Ill. 1952) .

(n157)Footnote 157. *Baretge v. Barnett*, 553 F.2d 290, 291 (2d Cir. 1977) .

(n158)Footnote 158. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968) (*en banc*); see also *Wessel v. Buhler*, 437 F.2d 279, 282 (9th Cir. 1971) ; *Gottlieb v. Sandia America Corp.*, 452 F.2d 510, 516 (3rd Cir.) ; *Akin v. Q-L Investments, Inc.*, 959 F.2d 521, 528-29 (5th Cir. 1992) ; *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 100-01 (10th Cir. 1971) ; *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1171 (D.C. Cir. 1978) .

(n159)Footnote 159. *Gurwara v. LyphoMed, Inc.*, 937 F.2d 380, 383 (7th Cir. 1991) .

(n160)Footnote 160. *In re Ames Dept. Stores Inc. Stock Litig.*, 991 F.2d 953, 967 (2d Cir. 1993) .

(n161)Footnote 161. *Kaplan v. Utilicorp United, Inc.*, 9 F.3d 405 (5th Cir. 1993) ; *Abato v. Marcam Corp.*, 162

F.R.D. 8 (D. Mass. 1995) ; Panos v. Island Gem Enters. Ltd., N.V., 880 F. Supp. 169 (S.D.N.Y. 1995) .

(n162)Footnote 162. *See, e.g., Ohashi v. Verit Indus. 536 F.2d 849, 853 (9th Cir.) (1976); Shamrock Assocs. v. Moraga Corp., 557 F. Supp. 198, 204 (D. Del. 1983) .*

(n163)Footnote 163. *Shamrock, 557 F. Supp. at 205 (discussing 10b-5); see also SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186, 84 S. Ct. 275, 279 (1963) (discussing federal securities law generally).*

(n164)Footnote 165. *McGann v. Ernst & Young, 102 F.3d 390, 393 (9th Cir. 1996) ; In re Carter-Wallace Inc. Sec. Litig., 150 F.3d 153 (2d Cir. 1998) .*

(n165)Footnote 166. *In re Carter-Wallace, Inc., 150 F.3d 153 .*

(n166)Footnote 167. *Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 942-43 (2d Cir. 1986) (quoting Smallwood v. Pearl Brewing Co., 489 F.2d 579, 595 (5th Cir. 1974)) ; see also Semerenko v. Cendant Corp., 223 F.3d 165, 175 (3d Cir. 2000) (noting the Third Circuit makes the "in connection with" determination on a case-by-case basis).*

(n167)Footnote 168. *404 U.S. 6 (1971) .*

(n168)Footnote 169. *Superintendent of Ins. v. Bankers Life & Casualty, 430 F.2d 355, 360 (2d Cir. 1970) .*

(n169)Footnote 170. *404 U.S. at 10, 12-13, 92 S. Ct. 165 at 168-69 .*

(n170)Footnote 171. *See Ames Dep't Stores, Inc. Stock Litig., 991 F.2d 953, 963 n.5 (2d Cir. 1993) ; In re Financial Corp. of America Shareholder Litig., 796 F.2d 1126, 1130 (9th Cir. 1986) .*

(n171)Footnote 172. *430 U.S. 462 (1977) .*

(n172)Footnote 173. *430 U.S. at 473-77 (internal citations omitted).*

(n173)Footnote 174. *Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977) ; Healey v. Catalyst Recovery of Pennsylvania, Inc., 616 F.2d 641, 645 (3rd Cir. 1980) ; Madison Consultants v. Federal Deposit Ins. Corp., 710 F.2d 57, 63, (2d Cir. 1983) ; Mayer v. Oil Field Sys. Corp., 721 F.2d 59, 67-68 (2d Cir. 1983) ; Estate of Soler v. Rodriguez, 63 F.3d 45 (1st Cir. 1995) .*

(n174)Footnote 175. *Goldberg, 567 F.2d 209 ; Soler, 63 F.3d 45, 55 .*

(n175)Footnote 176. *535 U.S. 813, 122 S. Ct. 1899, 153 L. Ed 2d 1 (2002) .*

(n176)Footnote 177. *SEC v. Zandford, 238 F.3d 559 (4th Cir. 2001) .*

(n177)Footnote 178. *404 U.S. 6 (1971) .*

(n178)Footnote 179. *521 U.S. 642 (1997) .*

(n179)Footnote 180. *532 U.S. 588 (2001) .*

(n180)Footnote 181. *Zandford, 535 U.S. 813 at 814.*

(n181)Footnote 182. *Behlen v. Merrill Lynch, 311 F.3d 1087, 1094 (11th Cir. 2002) .*

(n182)Footnote 183. *Falkowski v. Imation Corp., 309 F.3d 1123, 1129 (9th Cir. 2002) .*

(n183)Footnote 184. *547 U.S. 71 (2006)* .

(n184)Footnote 185. *547 U.S. at 75-76* .

(n185)Footnote 186. *547 U.S. at 76* .

(n186)Footnote 187. *547 U.S. at 76* .

(n187)Footnote 188. *547 U.S. at 76* .

(n188)Footnote 189. *Ciccarelli v. Merrill Lynch & Co., 2003 U.S. Dist. LEXIS 5999, (S.D.N.Y. 2003)* .

(n189)Footnote 190. *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 395 F.3d 25, 51 (2d Cir. 2005)* .

(n190)Footnote 191. *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 395 F.3d 25, 45-46 (2d Cir. 2005)*.

(n191)Footnote 192. *Dabit, 547 U.S. at 58*.

(n192)Footnote 193. *Dabit, 547 U.S. at 85 (citing O'Hagan, 521 U.S., at 658)*.

(n193)Footnote 194. *Dabit, 547 U.S. at 89*.

(n194)Footnote 195. *Blue Chip Stamps v. Manor Drug Stores 421 U.S. 723 (1975)* (no liability under the federal securities laws for statements made, even if false, that induce an investor to hold, rather than sell, his securities). Notably, California has interpreted its "blue sky" statute to omit the purchase and sale requirement. *Small v. Fritz Companies, Inc., 132 Cal. Rptr. 2d 490, 65 P.3d 1255 (Cal. 2003)* .

(n195)Footnote 196. Exchange Act § 3(a)(13) and (14), *15 U.S.C. § 78c(a)(13),(14) (1994)*. The term "security" as used in Section 10(b) and *Rule 10b-5* is interpreted broadly, as is the case generally under the Exchange Act.

(n196)Footnote 197. *Cohen v. Stratosphere Corp., 115 F.3d 695 (9th Cir. 1997)* ; *Yoder v. Orthomolecular Nutrition Inst., 751 F.2d 555, 559 (2d Cir. 1985)* .

(n197)Footnote 198. *Portnoy v. Memorex Corp., 667 F.2d 1281, 1283 (9th Cir. 1982)* (holding that a genuine gift of security is not a sale).

(n198)Footnote 199. *SEC v. Nat'l Sec., Inc., 393 U.S. 453, 467 (1969)* .

(n199)Footnote 200. *Abrahamson v. Fleschner, 568 F.2d 862, 868 (2d Cir. 1977)* . See also *Allard v. Arthur Andersen & Co., 957 F. Supp. 409, 420-21 (S.D.N.Y. 1997)* .

(n200)Footnote 201. *In re Penn Central Sec. Litig., 494 F.2d 528, 34 (3d Cir. 1974)* .

(n201)Footnote 202. *Rathborne v. Rathborne, 683 F.2d 914, 920 (5th Cir. 1982)* ; *7547 Corp. v. Parker & Parsley Dev. Partners., L.P., 38 F.3d 211, 226-27 (5th Cir. 1994)* .

(n202)Footnote 203. *SEC v. Jakubowski, 150 F.3d 675, 680 (7th Cir. 1998)* ; *Isquith by Isquith v. Caremark Int'l, Inc., 136 F.3d 531, 535-37 (7th Cir. 1998)* .

(n203)Footnote 204. *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 178-80 (1994)* .

(n204)Footnote 205. *E.g., Brown v. E.F. Hutton Group, Inc., 991 F.2d 1020, 1032 (2d Cir. 1993)* .

(n205)Footnote 206. *E.g., Castellano v. Young & Rubicam, Inc.*, 257 F.3d 171, 186 (2d Cir. 2001) ("transaction causation is generally understood as reliance"); *Suez Equity Investors, L.P. v. Toronto-Dominion Bank*, 250 F.3d 87, 95 (2d Cir. 2001) ("a plaintiff must allege...transaction causation, *i.e.*, that *but for* the fraudulent statement or omission, the plaintiff would not have entered into the transaction...").

(n206)Footnote 207. *Bastian v. Petren Res. Corp.*, 892 F.2d 680, 683-85 (7th Cir. 1990) .

(n207)Footnote 208. *Mirkin v. Wasserman*, 5 Cal. 4th 1082, 1090-91 (1993) . This distinction between federal and state law posed problems for plaintiffs who, in the wake of the Reform Act, sought to bring class actions in state court under state common law. These cases were, generally, dismissed at the pleadings stage because reliance would not be presumed based on a fraud on the market theory. The passage of the Securities Litigation Uniform Standards Act of 1998 mooted this issue by generally requiring that securities fraud class actions be brought in federal court.

(n208)Footnote 209. *Basic, Inc. v. Levinson*, 485 U.S. 224, 241-250 (1988) .

The genesis for the fraud on the market theory was *Blackie v. Barrack*, 524 F.2d 891, 905-06 (9th Cir. 1975) . The Second Circuit followed *Blackie* in *Panzirer v. Wolf*, 663 F.2d 365, 367 (2d Cir. 1981) , *vacated*, 459 U.S. 1027, 103 S. Ct. 434 (1982) . Other circuits have followed suit. See *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1218 (1st Cir. 1996) ; *Peil v. Speiser*, 806 F.2d 1154, 1160-61 (3d Cir. 1986) ; *Cooke v. Manufactured Homes, Inc.*, 998 F.2d 1256, 1260-61 (4th Cir. 1993) ; *Fine v. Am. Solar King Corp.*, 919 F.2d 290, 299 (5th Cir. 1990) , cert. granted, 501 U.S. 1229, 111 S. Ct. 2849 , cert. dismissed, 502 U.S. 976, 112 S. Ct. 576 (1991) ; *Freeman v. Laventhol & Horwath*, 915 F.2d 193, 197-98 (6th Cir. 1990) ; *Flamm v. Eberstadt*, 814 F.2d 1169, 1179-80 (7th Cir.) ; *Harris v. Union Elec. Co.*, 787 F.2d 355, 367 n.9 (8th Cir.) ; *Grossman v. Novell, Inc.*, 120 F.3d 1112 (10th Cir. 1997) ; *Lipton v. Documation, Inc.*, 734 F.2d 740, 747-48 (11th Cir. 1984) . The D.C. Circuit has not addressed the issue. *Kowal v. MCI Communications Corp.*, 16 F.3d 1271, 1276 n.1 (D.C. Cir. 1994) ; *In re Newbridge Networks Securities Litigation*, 926 F. Supp. 1163, 1175 (D.C. Cir. 1996) .

(n209)Footnote 210. *Basic*, 485 U.S. at 241-42 (citation omitted).

(n210)Footnote 211. *Basic*, 485 U.S. at 244 (citation omitted).

(n211)Footnote 212. *Basic*, 485 U.S. at 247 .

(n212)Footnote 213. *In re Convergent Tech. Sec. Litig.*, 948 F.2d 507, 512 n.2 (9th Cir. 1991) .

(n213)Footnote 214. *Convergent Tech.*, 948 F.2d at 512 .

(n214)Footnote 215. *Convergent Tech*, 948 F.2d at 512 .

(n215)Footnote 216. *Convergent Tech*, 948 F.2d at 512 .

(n216)Footnote 217. *In re Polymedica Corp. Securities Litigation*, 432 F.3d 1, 16 (1st Cir. 2005) .

(n217)Footnote 218. *Polymedica*, 432 F.3d at 19 .

(n218)Footnote 219. *Id.*, citing Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 640 (2003).

(n219)Footnote 220. See § 5.04[2][3][ii] *infra*.

(n220)Footnote 221. *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1158-59 (6th Cir. 1994) .

(n221)Footnote 222. *In re Initial Public Offerings Sec. Litig.*, 471 F.3d 24, 42-43 (2d Cir. 2006) .

(n222)Footnote 223. *Oscar Private Equity Investments vs. Allegiance Telecom, Inc.*, 487 F.3d 261, 271 (5th Cir. 2007) .

(n223)Footnote 224. *Basic*, 485 U.S. at 248-49 . 978; *Peil*, 806 F.2d at 1163 .

(n224)Footnote 225. *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1114-115, 1116 (9th Cir. 1989) . See also *City of Monroe Employees Ret. Sys. v. Bridgestone Corp.*, 387 F.3d 468, 493, n. 22 (6th Cir. 2004) , amended by 399 F.3d 651 (6th Cir. 2005) , cert. denied, 546 U.S. 936, 126 S.Ct. 423 (2005) , *aff'd*, 430 F.Supp.2d 728, (M.D.Tenn. 2006) .

(n225)Footnote 226. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972) .

(n226)Footnote 227. See *Biechele v. Cedar Point, Inc.*, 747 F.2d 209, 214-15 (6th Cir. 1984) .

(n227)Footnote 228. *Cox v. Collins*, 7 F.3d 394, 395-96 (4th Cir. 1993) ; *Morris v. Wachovia Secs., Inc.*, 223 F.R.D. 284, 301 (E.D. Va. 2004) .

(n228)Footnote 229. *Basic*, 485 U.S. 224, 239 n. 17 (1988) ("Silence, absent a duty to disclose, is not misleading under *Rule 10b-5*"); *Ockerman*, 27 F.3d at 1159 ("in a face-to-face transaction, reliance on defendant's failure to disclose material information may also be presumed where the defendant had a duty to disclose").

(n229)Footnote 230. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 549 (5th Cir. 1981) , *aff'd in part, rev'd in part*, 459 U.S. 375 (1983) ; *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997) .

(n230)Footnote 231. 9 Louis Loss & Joel Seligman, *Securities Regulation* 4408 (3d ed. 1992).

(n231)Footnote 232. See, e.g., *Gannon v. Continental Ins. Co.*, 920 F. Supp. 566 (D.N.J. 1996) .

(n232)Footnote 233. 640 F.2d 534 (5th Cir. 1981) , *aff'd in part, rev'd in part*, 459 U.S. 375 (1983) .

(n233)Footnote 234. 640 F.2d at 549 n.25 .

(n234)Footnote 235. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342, 125 S.Ct. 1627 (2005) .

(n235)Footnote 236. *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 831 (8th Cir. 2003) ; *In re Control Data Corp. Sec. Litig.*, 933 F.2d 616, 619-20 (8th Cir. 1991) ; *Broudo v. Dura Pharmaceuticals, Inc.*, 339 F.3d 933, 938 (9th Cir. 2003) , cert. granted, 124 S. Ct. 2904 (2004) ; *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1437-38 (9th Cir. 1996) .

(n236)Footnote 237. 544 U.S. at 343.

(n237)Footnote 238. 544 U.S. at 344.

(n238)Footnote 239. 544 U.S. at 344 (citing *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 198-99 (2nd Cir. 2003) ; *Semerenco v. Cendant Corp.*, 223 F.3d 165, 185 (3rd Cir. 2000) ; *Bastian v. Petren Resources Corp.*, 892 F.2d 680, 683 (7th Cir. 1990) ; *Robbins v. Koger Properties, Inc.* 116 F.3d 1441 (11th Cir. 1997)) .

(n239)Footnote 240. 544 U.S. at 346.

(n240)Footnote 241. 544 U.S. at 347.

(n241)Footnote 242. 544 U.S. at 345, citing 15 U.S.C. §§ 78u-4(b)(1)-(4), 109 Stat. 737.

(n242)Footnote 243. 544 U.S. at 345.

(n243)Footnote 244. See *Tricontinental Industries, Ltd. v. PriceWaterhouseCoopers, LLP*, 475 F.3d 824, 843-44 (7th Cir. 2007), cert. denied, 128 S.Ct. 357, 169 L.Ed.2d 34 (holding the relationship between the misstatement and decline in stock price too weak to sustain a 10b-5 action); *Teachers Retirement System of Louisiana v. Hunter*, 477 F.3d 162, 186 (4th Cir. 2007) (requiring specificity of pleading facts and causation to sustain a 10b-5 action).

(n244)Footnote 245. *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261 (5th Cir. 2007) (holding that Plaintiffs must show that the decline in stock price was attributed to the specific misstatement and not other simultaneous negative information in order to be certified as a class).

(n245)Footnote 246. 477 F.3d at 186; 487 F.3d at 267.

(n246)Footnote 247. 416 F.3d 940, 944 (2005).

(n247)Footnote 248. *Merrill Lynch & Co. Inc. v. Allegheny Energy, Inc.*, 500 F.3d 171, 182 (2d Cir. 2007).

(n248)Footnote 249. *U.S. v. Mooney*, 425 F.3d 1093 (8th Cir. 2005).

(n249)Footnote 250. 487 F.3d at 265, n.16.

(n250)Footnote 251. 511 U.S. 164 (1994).

(n251)Footnote 252. See Chapter 5A, 5B and 5C.

(n252)Footnote 253. Justice Stevens' dissent in *Central Bank* noted that "[A]ll 11 Courts of Appeals to have considered the question have recognized a private cause of action against aiders and abettors under § 10(b) and Rule 10b-5." *Central Bank*, 511 U.S. at 192 (citing *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 799-800 (3d Cir. 1978); *Schatz v. Rosenberg*, 943 F.2d 485, 496-97 (4th Cir. 1991); *Fine v. American Solar King Corp.*, 919 F.2d 290, 300 (5th Cir. 1990), cert. granted, 501 U.S. 1229, 111 S. Ct. 2849, cert. dismissed, 502 U.S. 976, 112 S. Ct. 576 (1991); *Moore v. Fenex, Inc.*, 809 F.2d 297, 303 (6th Cir. 1987); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 947 (7th Cir. 1989); *K & S Partnership v. Continental Bank, N.A.*, 952 F.2d 971, 977 (8th Cir. 1991); *Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1483 (9th Cir. 1991); *Farlow v. Peat, Marwick, Mitchell & Co.*, 956 F.2d 982, 986 (10th Cir. 1992); *Schneberger v. Wheeler*, 859 F.2d 1477, 1480 (11th Cir. 1988), cert. denied, 490 U.S. 1091 (1989)).

The majority opinion noted, however, that there was some disagreement over the existence of a cause of action for aiding and abetting:

After our decisions in *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977), and *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), where we paid close attention to the statutory text in defining the scope of conduct prohibited by § 10(b), courts and commentators began to question whether aiding and abetting liability under § 10(b) was still available. Professor Fischel opined that the "theory of secondary liability [under § 10(b) was] no longer viable in light of recent Supreme Court decisions strictly interpreting the federal securities laws." *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Calif. L. Rev. 80, 82 (1981). In 1981, the District Court for the Eastern District of Michigan found it "doubtful that a claim for 'aiding and abetting' ... will continue to exist under 10(b)." *Benoay v. Decker*, 517 F. Supp. 490, 495 (E.D. Mich. 1981), aff'd, 735 F.2d 1363 (6th Cir. 1984). The same year, the Ninth Circuit stated that the "status of aiding and abetting as a basis for liability under the securities laws [was] in some doubt." *Little v. Valley National Bank of Arizona*, 650 F.2d 218, 220, n. 3 (1981). The Ninth Circuit later noted that "[a]iding and abetting and other 'add-on' theories of liability have been

justified by reference to the broad policy objectives of the securities acts ... The Supreme Court has rejected this justification for an expansive reading of the statutes and instead prescribed a strict statutory construction approach to determining liability under the acts." *SEC v. Seaboard Corp.*, 677 F.2d 1301, 1311, n. 12 (1982) . The Fifth Circuit has stated: "[I]t is now apparent that open-ended readings of the duty stated by *Rule 10b-5* threaten to rearrange the congressional scheme. The added layer of liability ... for aiding and abetting ... is particularly problematic ... There is a powerful argument that ... aider and abettor liability should not be enforceable by private parties pursuing an implied right of action." *Akin v. Q-L Investments, Inc.*, 959 F.2d 521, 525 (1992) . Indeed, the Seventh Circuit has held that the defendant must have committed a manipulative or deceptive act to be liable under § 10(b), a requirement that in effect forecloses liability on those who do no more than aid or abet a 10b-5 violation. *See, e.g., Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (1986) .

Central Bank, 511 U.S. at 169-70.

(n253)Footnote 254. *See, e.g., Central Bank*, 511 U.S. at 194 & n.3, (Stevens, J., dissenting). As David Ruder, former Chairman of the SEC, phrased it, in discussing the state of the law prior to *Central Bank*:

1. Some courts held that there could be aiding and abetting liability for inaction coupled with knowledge and a high conscious intent to assert the primary violator. Some courts denied liability for inaction, absent a duty to disclose.

2. Recklessness was considered by some courts as satisfying both the *rule 10b-5* scienter requirement and the aiding and abetting knowledge requirement.

David Ruder, *The Future Of Aiding And Abetting And Rule 10b-5 After Central Bank Of Denver*, 49 *Bus. Law* 1479, 1484 (August 1994) (citations omitted).

(n254)Footnote 255. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 508 U.S. 959, 113 S. Ct. 2927 (1993) (granting certiorari on issue of scienter and asking parties to brief additional issue: "Whether there is an implied private right of action for aiding and abetting violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5").

(n255)Footnote 256. *Central Bank*, 511 U.S. at 167-68.

(n256)Footnote 257. 511 U.S. at 176.

(n257)Footnote 258. 511 U.S. at 176-77.

(n258)Footnote 259. 511 U.S. at 178.

(n259)Footnote 260. 511 U.S. at 178

(n260)Footnote 261. 511 U.S. at 179-80.

(n261)Footnote 262. 511 U.S. at 191.

(n262)Footnote 263. 11 U.S. at 191 (citations omitted).

(n263)Footnote 264. Justice Stevens noted in dissent that the majority opinion in *Central Bank* "leaves little doubt that the Exchange Act does not even permit the SEC to pursue aiders and abettors in civil enforcement actions under § 10(b) or *Rule 10b-5*." *Id.* at 200 (Stevens, J., dissenting). Indeed, the majority opinion stated that "Congress has not

enacted a general civil aiding and abetting statute -- either for suits by Government (when the Government sues for civil penalties or injunctive relief) or for suits by private parties." *Id.* at 182.

(n264)Footnote 265. Pub. L. No. 104-67 § 104, 109 Stat. 737, 757 (1995) (emphasis added).

(n265)Footnote 266. *See* S. Rep. No. 104-98, at 19 (1995).

(n266)Footnote 267. *452 F.3d 1040 (9th Cir. 2006)*

(n267)Footnote 268. *Id.* at 1043 .

(n268)Footnote 269. *Id.* at 1048 .

(n269)Footnote 270. *Id.*

(n270)Footnote 271. *152 F.3d 169, 175 (2d Cir. 1998)* , cert. denied, *525 U.S. 1104, 119 S. Ct. 870 870 (1999)* .

(n271)Footnote 272. *152 F.3d at 175* . *See also Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, *482 F.3d 372, 386-388 (5th Cir. 2007)* (holding that a secondary actor can be liable as a primary violator if the actor made public and material misrepresentations, failed to satisfy a duty to disclose to the plaintiff, or directly manipulated the market for the relevant security); *Anixter v. Home-Stake Production Co.*, *77 F.3d 1215 (10th Cir. 1996)* (rejecting the substantial assistance standard as too vague and holding that for accountants to be liable as primary violators, "they must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors.").

(n272)Footnote 273. *128 S. Ct. 761, 766-67 (2008)*

(n273)Footnote 274. *Stoneridge*, *128 S.Ct. at 766-67*.

(n274)Footnote 275. *Id.*

(n275)Footnote 276. *Id.*

(n276)Footnote 277. *Id.* at 767 .

(n277)Footnote 278. *Id.* at 769 .

(n278)Footnote 279. *Id.*

(n279)Footnote 280. *Id.* at 771 .

(n280)Footnote 281. *See e.g. Pugh v. Tribune Co.*, *521 F.3d 686 (7th Cir. 2008)* ; *Katz v. Image Innovations Holdings, Inc.*, *542 F. Supp. 2d 269 (S.D.N.Y. 2008)* ; *In re Dura Pharmaceuticals, Inc. Sec. Litig.*, *548 F. Supp. 2d 1126 (S.D. Cal. 2008)* ; *In re DVI Inc. Sec. Litig.*, *249 F.R.D. 196 (E.D. Pa. 2008)* .

(n281)Footnote 282. Section 20(a), *15 U.S.C. § 78t(1994)*, reads as follows:

(a) Joint and several liability; good faith defense. Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

(n282)Footnote 283. H.R. Rep. No. 73-1383, at 26 (1934).

(n283)Footnote 284. Rule 12b-2, 17 C.F.R. § 240.12b-2(1999); Rule 405, 17 C.F.R. § 230.405 (1999) (Securities Act).

(n284)Footnote 285. *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 889-90 (3d Cir. 1975) ; *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1299 (2d Cir. 1973) ; see also *In re Worldcom, Inc. Securities Litig.*, 294 F. Supp. 2d 392, 414-16 (S.D.N.Y. 2003) (reviewing the history and use of the "culpable participation" standard).

(n285)Footnote 286. See, e.g., *Brown v. Enstar Group, Inc.*, 84 F.3d 393, 396 (11th Cir. 1996) ; *Harrison v. Dean Witter Reynolds, Inc.*, 974 F.2d 873, 881 (7th Cir. 1992) ; *Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985) .

(n286)Footnote 287. Justice Stevens anticipated this result from the *Central Bank* opinion. See *Central Bank*, 511 U.S. at 200 n.12.

(n287)Footnote 288. See *Makor Issues & Rights, Ltd. v. Tellabs Inc.*, 513 F.3d 702, 708 (7th Cir. 2008) (noting that while the Supreme Court has rejected common law principles such as aider and abettor liability, "the doctrines of respondeat superior and apparent authority remain applicable to suits for securities fraud."); see also *Suez Equity Investors v. Toronto-Dominion Bank*, 250 F.3d 87, 101 (2d Cir. 2001) ; *AT&T v. Winback & Conserve Program*, 42 F.3d 1421, 1429-32 (3d Cir. 1994) ; *Vento & Co of NY, LLC v. Metromedia Fiber Network, Inc.*, 1999 U.S. Dist. LEXIS 3020 ; *Seolas v. Bilzerian*, 951 F. Supp. 978 (D. Utah 1997) .

(n288)Footnote 289. *Seolas*, 951 F. Supp. at 983 (quoting *AT&T*, 42 F.3d at 1430-31).

(n289)Footnote 290. 135 F.3d 837 (2d Cir. 1998) .

(n290)Footnote 291. *Dinsmore*, 135 F.3d at 841 (citing *In re GlenFed, Inc. Sec. Litig.*, 60 F.3d 591, 592 (9th Cir. 1995) ; *Kidder Peabody & Co. v. Unigestion Int'l, Ltd.*, 903 F. Supp. 479, 496-98 (S.D.N.Y. 1995) ; *In re, MTC Elec. Techs. Shareholders Litig.*, 898 F.Supp. 974, 982 (E.D.N.Y. 1995) ; *In re College Bound Consol. Litig.*, Nos. 93 Civ. 2348 & 94 Civ. 3033, 1995 U.S. Dist. LEXIS 10684 (S.D.N.Y. July 31, 1995) ; *Van De Velde v. Coopers & Lybrand*, 899 F. Supp. 731, 738 (D. Mass. 1995) ; *Upton v. McKerrow*, 887 F.Supp. 1573, 1580 (N.D.Ga. 1995) ; *In re Medimmune, Inc. Sec. Litig.*, 873 F. Supp. 953, 964 n. 8 (D.Md. 1995) ; *Otto v. Variable Annuity Life Ins. Co.*, No. 82 Civ. 4762, 1995 U.S. Dist. LEXIS 3352 (N.D. Ill. Mar. 17, 1995) ; *In re Syntex Corp. Sec. Litig.*, 855 F. Supp. 1086, 1098 (N.D. Cal. 1994) , *aff'd*, 95 F.3d 922 (9th Cir. 1996)) .

(n291)Footnote 292. 135 F. 3d at 842 (quoting *Central Bank*, 511 U.S. at 177).

(n292)Footnote 293. 135 F.3d at 843 (citations omitted).

(n293)Footnote 294. 135 F.3d at 843 .

(n294)Footnote 295. 501 U.S. 350 (1991) .

(n295)Footnote 296. See 501 U.S. at 362 .

(n296)Footnote 297. 501 U.S. at 364 , (footnote omitted). In *Plaut v. Spendthrift Farms, Inc.*, 115 S. Ct. 1447 (1995) , the Court held unconstitutional a statute that purported to reinstate certain actions otherwise barred under *Lampf*.

(n297)Footnote 298. Sarbanes-Oxley Act of 2002 § 804, 28 U.S.C. § 1658(b) (2003).

(n298)Footnote 299. For example, in *In re Exxon Mobil Corp. Sec. Litig*, 500 F.3d 189 (3rd Cir. 2007) , the Court held that claims under § 14(a) of the Exchange Act were not governed by the limitations period in § 1658(b), because

no proof of fraudulent intent is required for a violation of § 14(a). *Id.* at 197. *See also In re Alstom SA Sec. Litig.*, 406 F.Supp.2d 402 (S.D.N.Y. 2005) (holding that § 1658(b) does not apply to actions grounded on negligence or strict liability, and so does not apply to actions brought under §§ 11 and 12(a)(2) of the Securities Act.)

(n299)Footnote 300. *Berman v. Blount Parrish & Co., Inc.*, 525 F.3d 1057, 1058 (11th Cir. 2008) ; *Margolies v. Deason*, 464 F.3d 547, 551 (5th Cir. 2006) ; *In re ADC Telecomm., Inc. Securities Litigation*, 409 F.3d 974 (8th Cir. 2005) ; *Glaser v. Enzo Biochem, Inc.*, 126 Fed. Appx. 593 (4th Cir. 2005) ; *Lieberman v. Cambridge Partners, L.L.C.*, 432 F.3d 482, 492 (3d Cir. 2005) ; *Foss v. Bear, Stearns & Co.*, 394 F.3d 540 (7th Cir. 2005) ; *In re Enterprise Mortgage Acceptance Co. Securities Litigation*, 391 F.3d 401 (2d Cir. 2004) ..

(n300)Footnote 301. *Betz v. Trainer Wortham & Co., Inc.*, 519 F.3d 863, 874 (9th Cir. 2008) ; *Shah v. Meeker*, 435 F.3d 244, 251 (2d Cir. 2006) ; *Franze v. Equitable Assur.*, 296 F.3d 1250 (11th Cir. 2002) (statute runs from time of "knowledge of facts that would lead a reasonable person to begin investigating"); *Anixter v. Home-Stake Prod. Co.*, 939 F.2d 1420, 1437 (10th Cir. 1992) , *amended on reh'g*, 947 F.2d 897 (10th Cir. 1991) , *vacated sub nom.*, *Dennler v. Trippet*, 503 U.S. 978, 112 S. Ct. 1658 (1992) ; *Great Rivers Co-op of S.E. Iowa v. Farmland Indus., Inc.*, 120 F.3d 893, 896-97 (8th Cir. 1997) ; *Ockerman v. May Zima & Co.*, 27 F.3d 1151, 1155 (6th Cir. 1994) ; *Tregenza v. Great American Communications Co.*, 12 F.3d 717, 718 (7th Cir. 1993) ; *Menowitz v. Brown*, 991 F.2d 36, 41-42 (2d Cir. 1993) ; *Howard v. Haddad*, 962 F.2d 328, 329-30 (4th Cir. 1992) ; *Topalian v. Ehrman*, 954 F.2d 1125, 1134-35 (5th Cir. 1992) .

(n301)Footnote 302. *Anixter*, 939 F.2d at 1437 (quoting *Cook v. Avien, Inc.*, 573 F.2d 685, 697 (1st Cir. 1978)) .

(n302)Footnote 303. *Havenick v. Network Express, Inc.*, 981 F. Supp. 480, 520 (E.D. Mich. 1997) ; *Reisman v. KPMG Peat Marwick, L.L.P.*, 965 F. Supp. 165, 171 (D.Mass. 1997) .

(n303)Footnote 304. *Sterlin v. Biomune Systems*, 154 F.3d 1191 (10th Cir. 1999) ; *Dodds v. Cigna Sec., Inc.*, 12 F.3d 346, 350-51 (2d Cir. 1993) .

(n304)Footnote 305. *Tregenza*, 12 F.3d at 720 .

(n305)Footnote 306. Black's Law Dictionary 711 (5th ed. 1979).

(n306)Footnote 307. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985) ; *see also Peltz v. SHB Commodities, Inc.*, 115 F.3d 1082, 1090 (2d Cir. 1997) .

(n307)Footnote 308. 472 U.S. 299 (1985) .

(n308)Footnote 309. *Berner v. Lazzaro*, 730 F.2d 1319, 1320 (9th Cir. 1984) , *aff'd*, 472 U.S. 299 (1985) .

(n309)Footnote 310. *Bateman Eichler*, 472 U.S. at 310-11 .

(n310)Footnote 311. 472 U.S. at 313 .

(n311)Footnote 312. 472 U.S. at 319 .

(n312)Footnote 313. *Pinter v. Dahl*, 486 U.S. 622, 635-39 (1988) .

(n313)Footnote 314. Jonathan Eisenberg, *Beyond the Basics: Seventy-Five Defenses Securities Litigators Need to Know*, 62 BUS. LAW 1281, 1335 (2007)

(n314)Footnote 315. *Patterson v. Hewitt*, 195 U.S. 309, 318 (1904) .

(n315)Footnote 316. *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1208 (9th Cir.1970) ; *Kennedy v. Tallant*,

710 F.2d 711 (11th Cir. 1983) (laches defense not available when no prejudice to defendant).

(n316)Footnote 317. 10 Louis Loss & Joel Seligman, *Securities Regulation*, at 4529 & n.149 (Rev. ed. 1996) (citing cases).

(n317)Footnote 318. *Mercury Air et al. Inc. v. Mansour*, 237 F.3d 542, 546 (5th Cir. 2001) .

(n318)Footnote 319. Estoppel is "available against a nongovernmental party who has made a knowing false representation or concealment of material facts to a party ignorant of the facts, with the intention that the other party should rely on it, where the other party actually and detrimentally relies on it." *Mukherjee v. I.N.S.*, 793 F.2d 1006, 1009 (9th Cir. 1986) ; *Socop-Gonzalez v. INS*, 208 F.3d 838, 842 (9th Cir. 2000) .

Waiver is the "intentional relinquishment of a known right." *United States v. RePass*, 688 F.2d 154, 158 (2d Cir. 1982) . Without full knowledge of her rights, plaintiff cannot intentionally waive them. *Royal Air Props., Inc. v. Smith*, 333 F.2d 568, 571 (9th Cir. 1964) . It differs from estoppel in that it does not require a showing of reliance on the part of the defendant: "It is elementary and well settled that waiver and estoppel are two distinct and different doctrines. ... Waiver is a voluntary relinquishment, expressly or impliedly, of a known right and depends upon the intention of one party only." Estoppel, on the other hand, "requires detrimental reliance or prejudice." *Association of California Water Agencies Joint Powers Ins. Auth. v. Transcontinental Ins. Co.*, 92 F.3d 1191, 1192 (9th Cir. 1996) (unpublished opinion)

Ratification is the intentional and knowing approval of a prior act. Black's Law Dictionary 1135 (5th ed. 1979). "An effective ratification requires that a party be put on notice as to the true state of affairs." *Nye v. Blyth Eastman Dillon & Co.*, 588 F.2d 1189, 1197 (8th Cir. 1978) .

(n319)Footnote 320. *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210, 213-14 (9th Cir. 1962) (defenses of estoppel, waiver and laches are available to defendants in securities fraud cases).

(n320)Footnote 321. Compare *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202, 1208 (9th Cir. 1970) (suitability claim dismissed given that plaintiff spoke with broker every day, discussed trades with broker once a week, had her trading activities independently examined by her tax accountants and was occasionally represented by an attorney); *Landry v. Hempill, Noyes & Co.*, 473 F.2d 365, 473 F.2d 365, 373-374 (1st Cir. 1973) (plaintiffs "obvious experience" and failure to object to trades done over a twenty-two month period failed to support a claim for churning) with *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206, 1213 (8th Cir. 1990) (unsophisticated investor did not waive rights by receiving and not responding to documentation); *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 822 (9th Cir. 1980) (same). The court in *Stephenson v. Paine Webber Jackson & Curtis, Inc.*, 839 F.2d 1095, 1099 (5th Cir. 1988) , *cert. denied*, 488 U.S. 926, 109 S. Ct. 310 (1988) , found under similar circumstances that plaintiffs failure to act upon receiving monthly account statements warranted dismissal based on plaintiffs lack of due diligence.

(n321)Footnote 322. See § 5.04[7][d] *infra*.

(n322)Footnote 323. Section 27 reads in part as follows:

"The district courts of the United States and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this Act or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this Act or the rules and regulations thereunder. ..." 15 U.S.C. 78a (1994).

(n323)Footnote 324. Pub. L. No. 105-353 (1998), codified at 15 U.S.C.A. § 77p. (1994).

(n324)Footnote 325. 15 U.S.C.A. § 77p(b).

(n325)Footnote 326. 15 U.S.C.A. § 77p(f)(2)(A).

(n326)Footnote 327. *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 85-87 (2006) .

(n327)Footnote 328. 15 U.S.C.A. § 77p(f)(2)(B).

(n328)Footnote 329. 15 U.S.C.A. § 77p(d).

(n329)Footnote 330. 15 U.S.C.A. § 77p(f)(3).

(n330)Footnote 331. 15 U.S.C.A. § 77p(c).

(n331)Footnote 332. Pub. L. No. 105-353, § 101(c), provided that: "The amendments made by [SLUSA] shall not affect or apply to any action commenced before and pending on the date of enactment of this Act [Nov. 3, 1998]." 1998 U.S.C.C.A.N. 112 Stat. 3233.

(n332)Footnote 333. 28 U.S.C. § 1367(a) (1994).

(n333)Footnote 334. 28 U.S.C. § 1367(c) (1994).

(n334)Footnote 335. See § 5.04[8] *infra*.

(n335)Footnote 336. *Itoba Ltd. v. LEP Group PLC*, 54 F.3d 118, 121 (2d Cir. 1995) .

(n336)Footnote 337. *Alfadda v. Fenn*, 935 F.2d 475, 478 (2d Cir. 1991) .

(n337)Footnote 338. *Schoenbaum v. Firstbrook*. 405 F.2d 200, (2d Cir.) , *rev'd in part on other grounds*, 405 F.2d 215, (2d Cir. 1968) , *cert. denied en banc*, 395 U.S. 906, 89 S. Ct. 1747 (1969) .

(n338)Footnote 339. 405 F.2d at 208-09 .

(n339)Footnote 340. See *Europe & Overseas Commodity Traders, S.A. v. Banque Paribas London*, 147 F.3d 118 (2d Cir. 1998) .

(n340)Footnote 341. See *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1017 (2d Cir.) , *on remand*, 411 F. Supp. 1094 (S.D.N.Y. 1975) .

(n341)Footnote 342. *Itoba Ltd.*, 54 F.3d at 122 .

(n342)Footnote 343. 54 F.3d at 122 . The Fifth Circuit and the District of Columbia Circuit have adopted the Second Circuit's conduct test. See *Robinson v. TCI/US West Cable Communications, Inc.*, 117 F.3d 900, 905-06 (5th Cir. 1997) ; *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 31-33 (D.C. Cir. 1987) .

(n343)Footnote 344. *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326 (2d Cir. 1972) .

(n344)Footnote 345. *SEC v. Kasser*, 548 F.2d 109, 114 (3d Cir. 1977) , *cert. denied*, 431 U.S. 938, 97 S. Ct. 2649 (1977) ; *Continental Grain (Australia) Pty. Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 420-21 (8th Cir. 1979) ; *Travis v. Anthes Imperial, Ltd.*, 473 F.2d 515, 524 (8th Cir. 1973) ; *Butte Mining PLC v. Smith*, 76 F.3d 287 (9th Cir. 1996) ; *Grunenthal GmbH v. Hotz*, 712 F.2d 421, 424-25 (9th Cir. 1983) .

(n345)Footnote 346. *Grunenthal* 712 F.2d at 422-23 . (the court found that to hold that there was no subject matter jurisdiction would "make it convenient for foreign citizens and corporations to use this country and its lawyers, accountants and underwriters to further fraudulent securities schemes")

(n346)Footnote 347. *Itoba Ltd.*, 54 F.3d at 122 ("[i]ndeed an admixture or combination of the two often gives a better picture of whether there is a sufficient United States involvement to justify the exercise of jurisdiction by an American court.").

(n347)Footnote 348. *Bersch v. Drexel Firestone, Inc.*, 519 F.2d 974, 993 (2d Cir. 1975) .

(n348)Footnote 349. *Id.*

(n349)Footnote 350. *Id.*

(n350)Footnote 351. *Application to Enforce Administrative Subpoenas Duces Tecum of SEC v. Knowles*, 87 F.3d 413, 417 (10th Cir. 1996) . *But see* *Peay v. BellSouth Medical Assistance Plan*, 205 F.3d 1206, 1209 (10th Cir. 2000) (noting that "Knowles merely stands for the narrow proposition that under the facts and circumstances presented in that case [i.e., to enforce the SEC's subpoenas duces tecum against the defendant], § 77v(a) authorized the district court to exercise and enforce its subpoena power worldwide.")

(n351)Footnote 352. Section 27 reads in part as follows: "Any suit or action to enforce any liability or duty created by this Act or rules and regulations thereunder, or to enjoin any violation of such Act or rules and regulations, may be brought in [the district wherein any act or transaction constituting the violation occurred] or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. ..." 15 U.S.C. § 78aa (1994).

(n352)Footnote 353. *Fed. R. Civ. P. 4(k)(2)*. *See also* *Knowles*, 87 F.3d at 417 .

(n353)Footnote 354. *See, e.g., Stauffacher v. Bennett*, 969 F.2d 455, 461 (7th Cir. 1992) ; *Bourassa v. Desrochers*, 938 F.2d 1056 (9th Cir. 1991) ; *SIPC v. Vigan*, 764 F.2d 1309, 1316 (9th Cir. 1985) ; *Bersch*, 519 F.2d at 998-1000 ; *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1339-1341 (2nd Cir. 1972) . As suggested by foregoing, in the case of service under a federal statute, it is contacts with the United States rather than with a particular state that are relevant. *See, e.g., SEC v. Carrillo*, 115 F.3d 1540, 1544 (11th Cir. 1997) ("Because in this case our personal jurisdiction is invoked based on the applicable federal securities laws, which provide for world wide service of process, we conclude that the proper forum for minimum contacts analysis is the United States."); *United Liberty Life Ins. Co. v. Ryan*, 985 F.2d 1320, 1330 (6th Cir. 1993) (the question is whether a party has sufficient contacts with the United States, not any particular state).

(n354)Footnote 355. *Leasco*, 468 F.2d at 1326 .

(n355)Footnote 356. *Leasco*, 468 F.2d at 1340 .

(n356)Footnote 357. *SEC v. Carrillo*, 115 F.3d 1540, 1547 (11th Cir. 1997) (holding that personal jurisdiction over the defendants was proper where Costa Rican defendants, who were officers of a Costa Rican Corporation, "effectively controlled the operations of the corporation"); *Derensis v. Coopers & Lybrand Chtd. Accountants*, 930 F. Supp. 1003, 1014 (D.N.J. 1996) (holding that personal jurisdiction over foreign defendant was proper where plaintiffs made a *prima facie* showing that Canadian defendants, who were officers of a Canadian corporation, were "controlling persons" who allegedly provided and disseminated financial statements that they knew would influence the price of corporation's securities on the NASDAQ market); *Itoba Ltd. v. LEP Group PLC*, 930 F. Supp. 36, 41 (D. Conn. 1996) (holding that defendant was subject to the personal jurisdiction of the court where the plaintiff made a *prima facie* showing that a British defendant, who was the deputy chairman and director of a London-based company whose securities were traded on the NASDAQ, knew or should have known that the Form 20-F he approved would be filed with the SEC and would be relied on by potential investors); *Landry v. Price Waterhouse Chtd. Accountants*, 715 F. Supp. 98, 102 (S.D.N.Y. 1989) (holding that a Canadian third party defendant was subject to the court's jurisdiction where plaintiff made a *prima facie* showing that the defendant was "controlling person").

(n357)Footnote 358. 196 F.3d 1292, 1296 (10th Cir. 1999) . See also *Mink v. AAAA Dev. LLC*, 190 F.3d 333, 336 (5th Cir. 1999) ; *Cybersell, Inc. v. Cybersell, Inc.*, 130 F.3d 414, 415 (9th Cir. 1997) *Weber v. Jolly Hotels*, 977 F. Supp. 327, 333 (D.N.J. 1997) . But see *Inset Systems, Inc. v. Instruction Set, Inc.*, 937 F. Supp. 161 (D. Conn.1996) (maintaining a Web site and telephone number is sufficient to establish personal jurisdiction in every state).

(n358)Footnote 359. 952 F. Supp. 1119 (W.D. Pa. 1997) .

(n359)Footnote 360. 952 F. Supp. at 1124 . See also *Toys'R Us, Inc. v. Step Two, S.A.*, 318 F.3d 446, 452 (3d Cir. 2003) ; *Carefirst of Maryland, Inc. v. Carefirst Pregnancy Centers Inc.*, 334 F.3d 390, 400-401 (4th Cir. 2003) (examining personal jurisdiction in the case of a semi-interactive website); *Jennings v. A.C. Hydraulic*, 383 F. 3d 546, 549-50 (7th Cir. 2004) (finding that passive websites are insufficient to sustain personal jurisdiction).

(n360)Footnote 361. Section 27 of the Exchange Act generally governs venue in *Rule 10b-5* actions. 15 U.S.C. § 78aa (1994).

(n361)Footnote 362. *Berk v. Ascott Inv. Corp.*, 759 F. Supp. 245 (E.D. Pa. 1991) ; *Sargent v. Genesco, Inc.*, 492 F.2d 750, 759 (5th Cir. 1974) ; *SEC v. National Student Mktg. Corp.*, 360 F. Supp. 284, 291-92 (D.D.C. 1973) ; But cf., *Davis v. Advantage Int'l, Inc.*, 818 F. Supp. 1285 (E.D. Mo. 1993) (when there are separate causes of action by different plaintiffs, venue must be proper as to each separate cause of action).

(n362)Footnote 363. E.g., *Securities Investor Protection Corp. v. Vigman*, 764 F.2d 1309, 1317 (9th Cir. 1985) .

(n363)Footnote 364. *Hilgeman v. National Ins. Co. of Am.*, 547 F.2d 298, 301 (5th Cir. 1977) ("the jurisdictional act cannot be trivial; it must be 'of material importance to the consummation of the scheme.' "). See also *Sohns v. Dahl*, 392 F. Supp. 1208, 1215 (W.D. Va. 1975) (act need not "constitute the core of the claim");.

(n364)Footnote 365. *Frank E. Basil, Inc. v. Leidsdorf*, 713 F. Supp. 1194, 1196 (N.D. Ill. 1989) (act must be one that "represents more than an immaterial part of the allegedly illegal events"); *Warren v. Bokum Resource Corp.*, 433 F. Supp. 1360, 1363 (D.N.M. 1977) . See also *City of Harrisburg v. Bradford Trust Co.*, 621 F. Supp. 463, 467-68 (M.D. Pa. 1985) (defendant's response to phone calls from investor sufficient basis for venue in investor's forum); *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195, 205 (5th Cir. 1960) (venue can be based on act "of material importance to the consummation of the scheme").

(n365)Footnote 366. Section 1404(a) of the United States Judicial Code provides as follows: "For the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought." 28 U.S.C. § 1404(a) (1994).

(n366)Footnote 367. *Vigman at 1317*; *Shutte v. Armco Steel Corp.*, 431 F.2d 22, 25 (3d Cir. 1970) ; *Carty v. Health-Chem Corp.*, 567 F. Supp. 1, 3 (E.D. Pa. 1982) ; *Owatonna Mfg. Co. v. Melore Co.*, 301 F. Supp. 1296, 1307 (D. Minn. 1969) ; But cf., *Seilon, Inc. v. Lamb*, 559 F. Supp. 563 (W.D. Pa. 1983) (plaintiffs choice of forum entitled to less weight when plaintiff not a resident of judicial district where action was brought).

(n367)Footnote 368. *Lemberger v. Westinghouse Elec. Corp.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,762, at 90,742 (E.D.N.Y. Nov. 1976).

(n368)Footnote 369. See, e.g., *Gulf Oil Corp. v. Gilbert*, 330 U.S. 501, 67 S. Ct. 839 . 91 L. Ed. 1055 (1947)) ; *Texas Gulf Sulphur Co. v. Ritter*, 371 F.2d 145, 147 (10th Cir. 1967) .

(n369)Footnote 370. Section 28(a) provides:

The rights and remedies provided by this Act shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under

the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.

Securities Exchange Act of 1934 § 28(a), 15 U.S.C. § 78bb(a) (1994).

(n370)Footnote 371. *Randall v. B.J. Loftsgaarden*, 478 U.S. 647, 661-62, 106 S. Ct. 3143, 3152 (1986) ; *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155 (1972) ; *Ambassador Hotel Co., Ltd. v. Wei-Chuan Inv.*, 189 F.3d 1017, 1030 (9th Cir. 1999) ; H, 92 S. Ct. 1456, 1473; *Huddleston v. Herman & MacLean*, 640 F.2d 534, 555-556 (5th Cir. 1981) , *aff'd in part, rev'd in part*, 459 U.S. 375, 193 S. Ct. 683 (1983) .

(n371)Footnote 372. *Scattergood v. Perelman*, 945 F.2d 618, 624 n. 2 (3d Cir. 1991) .

(n372)Footnote 373. *Randall*, 478 U.S. at 662, 106 S. Ct. at 3152 ; *Affiliated Ute Citizens*, 406 U.S. at 155 ; *Ambassador Hotel Co., Ltd.*, 189 F.3d at 1030 ; *Anixter*, 977 F.2d 1549, 1553-54 (10th Cir. 1992) . *See generally* 9 Louis Loss & Joel Seligman, *Securities Regulation* 4414 (3d ed. 1992).

(n373)Footnote 374. 15 U.S.C.A. § 78u-4(e)(1) (Supp. IV 1998).

(n374)Footnote 375. *Huddleston*, 640 F.2d at 556 ; *Sowell v. Butcher & Singer, Inc.*, 926 F.2d 289, 301 (3d Cir. 1991) ; *Behrens v. Wometco Enter., Inc.*, 118 F.R.D. 534, 542 (S.D. Fla. 1988) , *aff'd*, 899 F.2d 21 (11th Cir. 1990) ; *In re Warner Communications Sec. Litig.*, 618 F. Supp. 735, 744 (S.D.N.Y. 1985), *aff'd*, 798 F.2d 35 (2d Cir. 1986); *Cf. Wortley v. Camplin*, 333 F.3d 284, 296-297 (1st Cir. 2003) ("The cases of which this court is aware that can be read to require expert testimony on damages in federal securities fraud cases all involve court review of the sufficiency of a class action settlement. ...[A]lthough expert testimony on damages is likely to be helpful, it is not required in every category of federal securities case."

(n375)Footnote 376. *Seidman v. American Mobile Sys.*, 965 F. Supp. 612, 620 (E.D. Pa. 1997) .

(n376)Footnote 377. *DCD Programs, Ltd. v. Leighton*, 90 F.3d 1442, 1447 (9th Cir. 1996) ; *Volk v. D.A. Davidson & Co.*, 816 F.2d 1406, 1413 (9th Cir. 1987) ; *Blackie v. Barrack*, 524 F.2d 891, 909 (9th Cir. 1975) ; *Esplin v. Hirschi*, 402 F.2d 94, 104-05 (10th Cir. 1968) .

(n377)Footnote 378. *Astor Chauffeured Limousine Co. v. Runnfeldt Inv. Corp.*, 910 F.2d 1540, 1551-52 (7th Cir. 1990) ; *Wool v. Tandem Computers, Inc.*, 818 F.2d 1433, 1437 n.2 (9th Cir. 1987) .

(n378)Footnote 379. *Randall*, 478 U.S. at 663; *Affiliated Ute Citizens*, 406 U.S. at 155, 92 S. Ct. at 1473.

(n379)Footnote 380. *Randall*, 478 U.S. at 663, 106 S. Ct. at 3152-3513; *Affiliated Ute Citizens*, 406 U.S. at 155, 92 S. Ct. at 1473.

(n380)Footnote 381. *Janigan v. Taylor*, 344 F.2d 781, 786 (1st Cir. 1965) *quoted in* *Randall*, 478 U.S. at 663, 106 S. Ct. at 3513.

(n381)Footnote 382. *See McMahan & Co. v. Wherehouse Entertainment, Inc.*, 65 F.3d 1044, 1049-50 (2d Cir. 1995) .

(n382)Footnote 383. *Osofsky v. Zipf*, 645 F.2d 107, 111 (2d Cir. 1981) .

(n383)Footnote 384. *See, e.g., Fey v. Walston & Co.*, 493 F.2d 1036, 1054 n.26 (7th Cir. 1974) .

(n384)Footnote 385. *Ambassador Hotel Co.*, 189 F.3d at 1030 ; *Anixter v. Home-Stake Prod. Co.*, 977 F.2d 1549, 1554 ; *Blackie v. Barrack*, 524 F.2d at 909 (10th Cir.1992) . The court in *Huddleston* stated that rescissory damages are

only available when plaintiff is in privity with defendants or when defendant owes plaintiff some type of fiduciary duty. *Huddleston*, 640 F.2d at 554 .

(n385)Footnote 386. *Volk*, 816 F.2d at 1413 .

(n386)Footnote 387. *Randall*, 478 U.S. at 662-63, 106 S. Ct. at 3152-53 .

(n387)Footnote 388. *Huddleston*, 640 F.2d at 554 .

(n388)Footnote 389. 535 F.2d 761, 781 (3d Cir. 1976) .

(n389)Footnote 390. *Tse v. Ventana Medical Systems, Inc.*; 297 F.3d 210, 220 (3d Cir. 2002) (quoting *Gould*, 535 F.2d at 781-82).

(n390)Footnote 391. *Ventana*, 297 F.3d at 221, n. 3 .

(n391)Footnote 392. 297 F.3d at 219 .

(n392)Footnote 393. 297 F.3d at 221-23 .

(n393)Footnote 394. 297 F.3d at 221-23 .

(n394)Footnote 395. 297 F.3d at 223 .

(n395)Footnote 396. See, e.g., *Randall*, 478 U.S. at 661, 106 S. Ct. at 3151 ; *Stone v. Kirk*, 8 F.3d 1079, 1093 (6th Cir. 1993) .

(n396)Footnote 397. *Grogan v. Garner*, 806 F.2d 829, 838 (8th Cir. 1986) . See Louis Loss & Joel Seligman, *supra* at 4422.

(n397)Footnote 398. 28 U.S.C. § 1961(a) (1994).

(n398)Footnote 399. Dan B. Dobbs, *Handbook on the Law of Remedies* § 4.3 at 254 (1973).

(n399)Footnote 400. See generally *id.* § 4.3 at 222-23.

(n400)Footnote 401. See, e.g., *Flaks v. Koegel*, 504 F.2d 702, 707 (2d Cir. 1974) ; *Sackett v. Beaman*, 399 F.2d 884, 891 (9th Cir. 1968) ; *Rogen v. Ilikon Corp.*, 361 F.2d 260, 269 (1st Cir. 1966) .

(n401)Footnote 402. See, e.g., *Glick v. Campagna*, 613 F.2d 31, 36-37 (3d Cir. 1980) ; *Holdsworth v. Strong*, 545 F.2d 687, 697 (10th Cir. 1976) ; *Flaks*, 504 F.2d at 707 ; *Sackett*, 399 F.2d at 891 ; *Myzel v. Fields*, 386 F.2d 718, 742 (8th Cir. 1967) .

(n402)Footnote 403. *Glick*, 613 F.2d at 37 .

(n403)Footnote 404. *Myzel*, 386 F.2d at 742 . The computation of rescissory damages is discussed in § 5.04[8][a] *supra*.

(n404)Footnote 405. *Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 508 U.S. 286, 288 (1993) .

(n405)Footnote 406. 15 U.S.C. § 78u-4(f)(8).

(n406)Footnote 407. 15 U.S.C. § 78u-4(f)(2).

(n407)Footnote 408. 15 U.S.C. § 78u-4(f)(2).

(n408)Footnote 409. 15 U.S.C. § 78u-4(f)(9).

(n409)Footnote 410. *Baker, Watts & Co. v. Miles & Stockbridge*, 876 F.2d 1101, 1102 (4th Cir. 1989) ; *Globus v. Law Research Serv., Inc.*, 418 F.2d 1276, 1288-89 (2d Cir. 1969) .

(n410)Footnote 411. 876 F.2d at 1102 ; 418 F.2d at 1288-89 .

(n411)Footnote 412. *Burns v. Paddock*, 503 F.2d 18, 28 (7th Cir. 1974) .

(n412)Footnote 413. See, e.g., *Baumel v. Rosen*, 283 F. Supp. 128, 146 (D. Md. 1968) , *aff'd in part, rev'd in part*, 412 F.2d 571 (4th Cir. 1969) , *cert. denied*, 396 U.S. 1037 (1970) .

(n413)Footnote 414. In *Re Cigna Corp. Securities Litigation*, 459 F. Supp. 2d 338, 349 (E.D. Pa. 2006) ; *Rocker Management, LLC v. Lernout & Hauspie Speech Products N. V.*, No. 00-5965, 2007 U.S. Dist. LEXIS 70912 at *44 (D. NJ. Sep. 24, 2007) .

(n414)Footnote 415. *Gordon Partners v. Blumenthal*, No. 02 Civ. 7377, 2007 U.S. Dist. LEXIS 9110 at *43-*44 (S.D.N.Y. Feb. 9, 2007) (Plaintiff did not adequately demonstrate the relationship between its losses and the inflation of the share price because it did not submit an event study); *Carpe v. Aquila, Inc.*, No. 02-0388-CV-W-FJG, 2005 U.S. Dist. Lexis 44667 at *12 (W.D. Mo. Mar. 23, 2005) ("The accepted means of distinguishing between fraud-related and non-fraud related changes in a stock's behavior is an 'event study' ").

(n415)Footnote 416. *In re Imperial Credit Indus., Inc. Sec. Litig.*, 252 F. Supp. 2d 1005, 1014 (C.D. Cal. 2003) , *aff'd*, 145 Fed. Appx. 218 (9th Cir. 2005) .

(n416)Footnote 417. *Carpe v. Aquila, Inc.*, No. 02-0388-CV-W-FJG, 2005 U.S. Dist. Lexis 44667 at *13 (W.D. Mo. Mar. 23, 2005).

(n417)Footnote 418. 2005 U.S. Dist. Lexis 44667 at *14 .

(n418)Footnote 419. *Gordon Partners v. Blumenthal*, No. 02 Civ. 7377, 2007 U.S. Dist. LEXIS 9110 at *43-*44 (S.D.N.Y. Feb. 9, 2007) ; See *JMS Rural LP v. GMG Capital Partners III, LP*, No. 04 Civ. 8591, 2006 U.S. Dist. LEXIS 46080 at * 42 (granting summary judgment for the defendant because the plaintiff's 10b-5 claim failed as a matter of law when plaintiff failed to indicate how it suffered an actual loss or give the factfinder a method by which it can determine the amount of the loss that should be attributed to the alleged fraud); *In re Imperial Credit Indus., Inc. Sec. Litig.*, 252 F. Supp. 2d 1005, 1014-16 (C.D. Cal. 2003) , *aff'd*, 145 Fed. Appx. 218 (9th Cir. 2005) (granting summary judgment to the defendant because the plaintiffs failed to produce an event summary or a similar analysis).

(n419)Footnote 420. See *In Re Cigna Corp. Sec. Litig.*, 459 F. Supp. 2d at 349 .

(n420)Footnote 421. *Id.* at 350 .

(n421)Footnote 422. The Second, Fifth, Ninth and Tenth Circuits limit actual losses to those calculated using a method that offsets losses with gains due to the same fraud. See *Abrahamson v. Fleschner*, 568 F. 2d 862, 878-79 (2d Cir. 1976) , *cert. denied*, 436 U.S. 913 (1978) ; *Byrnes v. Faulkner, Dawkins & Sullivan*, 550 F. 2d 1303, 1313-14 (2d Cir. 1977) ; *Blackie v. Barrack*, 524 F. 2d 891, 908-09 (9th Cir. 1975) , *cert. denied*, 429 U.S. 816 (1976) ; *Wolf v. Frank*, 477 F.2d 467, 478, 479 (5th Cir. 1973) , *cert. denied*, 414 U.S. 975 (1973) ; *Richardson v. MacArthur*, 451 F.2d 35, 43-44 (10th Cir. 1971) .

(n422)Footnote 423. See *In re Blech Sec. Litig.*, 2003 U.S. Dist. LEXIS 4650 at *72 (S.D.N.Y. 2003) (refusing to allow offsetting during damages calculations); *Kane v. Shearson Loeb Rhoades, Inc.* 1989 U.S. Dist. LEXIS 19022 at

*15-*23 (*S.D. Fla. 1989*) (saying aggregation during damage calculations undermines the intent of the statute to deter).

(n423)Footnote 424. *459 F. Supp. 2d at 354* .

(n424)Footnote 425. *Id. at 354* .

(n425)Footnote 426. *2007 U.S. Dist. Lexis 70912 at *47 (D. N.J. Sep. 24, 2007)* .

(n426)Footnote 427. *Id.*



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Federal Securities Exchange Act of 1934

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CHAPTER 5A Accountants' Liability Under the Federal Securities Laws

1-5A Federal Securities Exchange Act of 1934 5A.syn

AUTHOR: Marvin G. Pickholz Elliot Cohen Robert M. Carmen

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FOOTNOTES:

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CHAPTER 5A Accountants' Liability Under the Federal Securities Laws

1-5A Federal Securities Exchange Act of 1934

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Summary of this Chapter

The federal securities laws contain various provisions under which civil and criminal liability may potentially be imposed upon an accountant for professional misconduct, including Sections 11, 12(2) and 17(a) of the Securities Act of 1933 (the "Securities Act") and Sections 10(b), 14 and 18 of the Securities Exchange Act of 1934 (the "Exchange Act"). Before the potential liability of accountants under each of these statutory provisions is analyzed, it is useful to provide an historical background concerning accountants' liability under the federal securities law.



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CHAPTER 5A Accountants' Liability Under the Federal Securities Laws

1-5A Federal Securities Exchange Act of 1934 § 5A.01

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§ 5A.01 Introduction

[1] Prior to the 1960's--Hints That Accountants Faced Potential Liability Under the Federal Securities Laws

The potential imposition of civil liability against accountants under the federal securities laws is a relatively new development. Until roughly the latter half of the twentieth century, private parties holding grievances against accountants were essentially relegated to whatever state law causes of action were available for "fraud," "negligence" or "breach of contract."

Even when private litigants relied on state law, they faced significant hurdles in bringing claims against accountants. The most significant hurdle for parties other than the accountant's client has been securing "standing" to sue, although this limitation has eased in more recent decades.

More particularly, prior to approximately the last 40 years, accountants were largely insulated from liability in lawsuits brought by parties other than their clients (*e.g.*, lenders, trade creditors and investors) who claimed injury due to the accountants' alleged negligent conduct. The issue of whether a non-client may sue an accountant for professional negligence was first addressed by the New York State Court of Appeals in 1931 in *Ultramares Corp. v. Touche, Niven & Co.* n1 The court in that case recognized that the risk to the profession of exposure to claims from anyone who could conceivably rely upon a financial statement, as to which an accounting firm has expressed an opinion, was potentially enormous. n2 Accordingly, the court determined to limit liability for professional negligence to only those in contractual privity with the firm or in a relationship closely approximating that of privity. *Ultramares* expressly noted that the defense of privity would be applicable only to negligence claims and not to claims where the firm's level of misconduct would support a claim of fraud.

Subsequently, commencing generally in the 1960's, various state courts (and federal courts applying state law) began to question the continued propriety of the "privity" defense. Since then, three standards (none of which require strict privity) have evolved as the courts continue to grapple with the issue:

- (a) Based on continued adherence to the basic principles of *Ultramares*, the most demanding standard requires the existence of a relationship between the plaintiff and the accountant which is close to that of

privity; n3

(b) "Foreseeability," the least restrictive standard, which permits claims to be asserted against an accounting firm by all reasonably foreseeable third-persons who might rely on reports prepared by it; n4 and

(c) The Restatement of Torts standard which permits a negligence claim against an accountant to be asserted by a third party who is one of a limited group of persons whom the accountant knew might rely on the accountant's report. n5

Although private litigation against accountants was long subject to the type of limitations just discussed, the Securities and Exchange Commission (the "SEC" or "Commission") provided early hints of the substantial expansion of an accountant's potential liability to third parties (*i.e.*, parties other than his or her client), beyond the bounds set by *Ultramares*, which later began during the 1960's under the federal securities laws. For example, in 1939, only a few years after the enactment of the Securities Act and the Exchange Act, the public learned that the consolidated financial statements of McKesson Robbins ("McKesson"), a substantial pharmaceutical company, were fraudulent because millions of dollars of assets reported on McKesson's consolidated balance sheet were only traceable to a sham subsidiary which did not exist. The accountant who audited McKesson's consolidated financial statements did not discover the fraud. The SEC (which had just recently been established by the Exchange Act) conducted an investigation of the McKesson fiasco. Foreshadowing the future expansion of accountants' liability under the Securities Act and the Exchange Act, the SEC emphasized in its McKesson report that while McKesson's auditors satisfied their then existing professional responsibilities, the auditor "must now recognize fully his responsibility to *public investors* by including the activities of the management itself within the scope of his work and *by reporting thereon to investors*." n6

In 1957, in *In re Touche, Niven, Bailey & Smart* n7 the SEC reiterated its position that the responsibility of an independent public accountant based on its certification of a company's financial statements "is not only to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statements which he certifies. ... The public accountant must report fairly on the facts as he finds them whether favorable or unfavorable to his client. His duty is to safeguard the public interest, not that of his client." n8

[2] The 1960's--The Birth of Accountants' Liability Under the Federal Securities Laws

The emergence of accountants' liability under the federal securities laws as a significant phenomenon began during the 1960's. The opening took hold with the acceptance by federal courts of an implied private right of action under Section 10(b) of the Exchange Act. n9 This section soon became the primary vehicle for the potential liability of accountants (and others) under the federal securities laws. Although the existence of a private cause of action under Section 10(b) became axiomatic, n10 the Supreme Court eliminated any doubt as to this question in 1971 in *Superintendent of Ins. v. Bankers Life & Casualty Co.* n11

Initially, the newly established private right of action under Section 10(b) was mainly invoked against (i) corporations whose stock was purchased or sold by aggrieved investors, (ii) corporate insiders and (iii) broker-dealers. However, during the late 1960's the federal district court's decision in *Fischer v. Kletz*, n12 which was one of the earliest actions brought against accountants under the federal securities laws, received wide attention in the legal community. In that case the court, denying a motion to dismiss, held that an accounting firm which failed to disclose that it had discovered that a client's financial statements, which it had earlier certified, were, in fact, materially false and inaccurate, could potentially be liable under Section 10(b).

It is also noteworthy that the *Fischer* court expressly refused to dismiss the 10(b) claim on the ground that no privity existed between the plaintiffs and the accountants. In that regard, the court harkened back to the language from *In re Touche Niven Bailey & Smart* n13 which stated that the responsibility of an independent public accountant "is not only

to the client who pays his fee, but also to investors, creditors and others who may rely on the financial statements which he certifies." n14

On the heels of the *Fischer* decision, in 1968 the court in *Escott v. BarChris Construction Corp.* n15 provided further impetus for the coming explosion of litigation instituted against accountants under the federal securities laws. In *Escott*, the court found an accounting firm liable to various debenture holders under Section 11 of the Securities Act (subject to certain defenses such as statute of limitations) based on its certification of false financial statements of a client which were subsequently included in a registration statement the client filed with the SEC. In essence, the court concluded that the accounting firm had failed to satisfy its duty of "due diligence" when it audited its client's financial statements. n16

[3] The 1970's Through the 1990's--Growth and Then Restriction of Accountants' Liability Under the Federal Securities Laws

Although the potential availability of federal securities claims against accountants was not generally recognized until the end of the 1960's, once the genie had escaped, it was impossible to put it back in the lamp. During approximately the last forty years, plaintiffs have instituted thousands of lawsuits against accountants under the Securities Act and the Exchange Act. This trend was reinforced because the plaintiffs' bar increasingly recognized that large national accounting firms were potential "deep pockets" both because of their size and the substantial amount of professional liability insurance they generally carry.

While the maintenance of securities claims against accountants has been a constant since the 1970's, there have been various significant judicial and legislative developments during this time period which either expanded (mostly during the 70's and 80's) or limited (mostly during the 90's) the reach of such claims against accountants. For example:

[a] Section 10(b) Claims Cannot Be Asserted Against Accountants (or Other Defendants) Based on Merely Negligent Conduct

As noted above, the potential scope of accountants' liability under the federal securities laws largely expanded during the 1970's and 1980's. However, in 1976, in an important milestone for the profession, the U.S. Supreme Court in *Ernst & Ernst v. Hochfelder* n17 removed any doubt as to the requirement of proving "scienter" (i.e., some form of "knowing" misconduct), as opposed to merely negligent conduct, as a prerequisite to civil liability under Section 10(b).

In *Ernst & Ernst*, the Supreme Court did not clarify whether "scienter" is limited to actual intentional misconduct or also encompasses some lesser level of wrongdoing greater than negligence. As will be explained later, virtually all courts which have addressed the matter since *Ernst & Ernst* was decided have generally accepted "recklessness" as the functional equivalent of intentional behavior for purposes of satisfying the "scienter" requirement.

[b] Accountants Were Exposed to the Substantial Risk of Aiding and Abetting Liability Under Section 10(b) of the Exchange Act Until That Threat Was Eliminated by the Supreme Court

From approximately 1970 until 1994, accountants and other secondary actors in a securities transaction (e.g., attorneys and underwriters), who themselves did not purchase or sell any stock, were exposed to substantial securities law liability based on the concept, which was regularly followed by the courts, that such persons could be held liable as aiders and abettors under Section 10(b) of the Exchange Act. In fact, each of the federal circuit courts of appeal expressly allowed plaintiffs to state claims of aiding and abetting under Section 10(b) against accountants and others based on their involvement in schemes perpetrated by others to wrongfully buy and sell securities. n18

In 1994, in a significant triumph for accountants (and other professionals), the Supreme Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* n19 swept aside all the above precedents and ruled by a 5-4 margin that a private right of action for aiding and abetting liability did not exist under Section 10(b) of the Exchange

Act. Based on this decision, accountants and other secondary actors can now only be liable under Section 10(b) if they are determined to be "primary" violators of the statute.

Since *Central Bank*, many securities law plaintiffs have sought with mixed results to cast accountants (and attorneys and underwriters) as primary violators (rather than aiders and abettors) under Section 10(b) of the Exchange Act. As detailed later in this chapter, in the years since *Central Bank* was decided, the federal courts have differed over what conduct is required by accountants (and other secondary actors) to incur Section 10(b) primary liability. Two lines of cases have emerged: cases applying the "bright line" test which requires that the defendant must actually make a false or misleading statement to be liable under Section 10(b); and cases applying the "substantial participation" test which imposes primary liability on secondary actors who play a "significant role" in the creation of the false or misleading statement.

In addition, as discussed later in this chapter, in 2008, the Supreme Court, in *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*,ⁿ²⁰ effectively eliminated "scheme liability" under Section 10b-5(a) and (c) as a mechanism to extend primary Section 10(b) liability to secondary actors, such as accountants.

[c] Accountants Were Exposed to the Risk of Treble Damages Under RICO Until This Threat Was Virtually Eliminated by the Supreme Court and Congress

During the 1980's (and early 90's) accountants were besieged by civil lawsuits under the federal Racketeer Influenced Corrupt Organization Act ("RICO").ⁿ²¹ Although initially conceived as a tool in the fight against organized crime, RICO was drafted broadly enough to potentially encompass more garden variety commercial disputes, with fraud as the usual predicate for the claim. Where potentially applicable, RICO dramatically impacted claims against accountants. The statute provides for an award of treble damages and allows the successful plaintiff to recover its attorneys' fees, thus escalating potential monetary exposure. Moreover, the continuing overlay of an organized crime connotation to the offense added to the *in terrorem* effect of RICO claims.

Applying language from the statute, the most common RICO claim against an accountant alleged that by certifying a corporation's false financial statements the accountant "conduct[ed] or participate[d] ... in the conduct of ... [an] enterprise's [i.e., the aforesaid corporation] affairs through a pattern of racketeering."ⁿ²² Under RICO, a "pattern of racketeering" consists of two or more predicate acts of racketeering--typically mail fraud, wire fraud, or (until recently) *securities fraud*--which took place within a ten-year period.ⁿ²³

During RICO's heyday, numerous lawsuits brought against accountants under the federal securities laws also asserted a RICO count, which claimed that the alleged securities law violations also constituted multiple predicate acts of "racketeering." While very few RICO judgments were actually entered against accountants, many accountants who were sued under RICO were compelled to settle the claims against them in order to avoid the Damocles swords of treble damages and professional opprobrium.

In 1993, in a major victory for the accounting profession, the U.S. Supreme Court substantially eliminated the menace of RICO claims against accountants when it ruled in *Reves v. Ernst & Young*ⁿ²⁴ that an accountant's mere certification of a corporation's financial statements does not by itself satisfy the requirement that the defendant "conduct or participate ... in the conduct" of a RICO "enterprise." As a practical matter, under *Reves*, an accountant must participate in the actual *operation* or *management* of its client's business in order to be potentially liable under RICO.

Subsequently, in 1995, Congress put to rest virtually any potential risk of RICO claims against accountants by including a provision in the Private Securities Litigation Reform Act which removed securities fraud as a predicate act under RICO (unless the defendant was criminally convicted in connection with the fraud).ⁿ²⁵

[d] The Potential Reach of Securities Law Claims Against Accountants Was Narrowed Under the Private

Securities Litigation Reform Act

The Private Securities Litigation Reform Act (the "PSLRA") was enacted in 1995. n26 The primary intent of the PSLRA was to curb abusive shareholder class action lawsuits, which were often based on nothing more than an unexpected decline in a corporation's stock price. To accomplish this objective, the PSLRA imposed many new hurdles to the prosecution of private actions under the federal securities laws, including, among others:

- (1) The express requirement that plaintiffs alleging the scienter element of a Section 10(b) claim "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." n27
- (2) Absent unusual circumstances, discovery in securities actions is stayed during the pendency of any motion to dismiss. As a result, plaintiffs are unable to use discovery as a "fishing expedition" to search for a factual basis to support claims which they cannot properly plead in their complaints. n28
- (3) In order to reduce the influence of "professional" plaintiffs, substantial restrictions are placed on who can serve as a class representative in a securities action. For example, a proposed class representative must certify that he or she did not purchase the securities at the direction of counsel or to participate in a lawsuit. In addition, in appointing a "lead plaintiff," the court must use the "most adequate plaintiff" standard, which, presumptively, requires selection of the plaintiff with the largest financial interest. n29
- (4) To reduce the incentive for bringing frivolous securities claims against accountants and other potential "deep pockets," joint and several liability under the Exchange Act is limited to defendants who "knowingly commit" a securities law violation. n30 Also, under certain circumstances, there is a "cap" on the amount of damages which can be recovered by a plaintiff. n31
- (5) As previously noted, securities fraud can no longer serve as a predicate act for an alleged RICO violation unless the defendant was criminally convicted in connection with the fraud.

Although the above provisions of the PSLRA grant accountants (and others) potential relief from abusive litigation, another provision added Section 10A to the Exchange Act. Section 10A imposes significant new obligations on accountants. In general, the PSLRA mandates that auditors of public companies (a) design procedures to provide reasonable assurance that illegal acts will be detected, (b) report illegal acts (or internal irregularities) which are detected to corporate management, and if no appropriate action is taken, to the board of directors, and (c) report certain illegal acts to the SEC if the client fails to do so. n32

While increasing the whistle-blowing responsibilities of accountants, the PSLRA expressly insulates audit firms from liability in a private action for anything contained in a report submitted by them to the SEC under the requirements of the statute. On the other hand, a willful failure by the accounting firm to comply with the applicable reporting requirements may lead to adverse action by the SEC, including the imposition of civil penalties and other relief. Moreover, the failure to report, as required, could form the basis of a civil damage claim. n33

Not surprisingly, to avoid the restrictions imposed by the PSLRA, class action plaintiffs soon began instituting a large number of class actions in state courts rather than in the federal system. To prevent such state suits from frustrating the objectives of the PSLRA, Congress passed the 1998 Securities Litigation Uniform Standards Act ("SLUSA"), n34 which was designed to establish "national standards for securities class action lawsuits involving nationally traded securities" n35 Among other things, SLUSA provides (subject to limited exceptions) that "covered class action[s]" n36 based on the statutory or common law of any state relating to material misrepresentations or omissions (or the use of any manipulative or deceptive device) in connection with the purchase or sale of publicly-traded securities may not be maintained in state (or federal) court.

Notwithstanding SLUSA's substantial limitations on the maintenance of state law securities class actions, the statute carves out a few categories of "covered class actions" which may be litigated under state law (in state or federal court). These exceptions include certain actions brought (i) pursuant to the state law of the issuer corporation's state of incorporation, (ii) by a State, a political subdivision of a State or a State pension plan, and (iii) to enforce contractual agreements between issuers and indenture trustees. n37

Procedurally, if a "covered class action" subject to SLUSA is instituted in state court, the defendant's remedy is to remove the action to federal district court in contemplation of dismissal by that court. Under the statute, if the federal court determines that a removed action may be maintained in state court based on one of the above carve-outs, it must remand the action to state court. n38

Until recently, there was dispute as to whether SLUSA's application was limited to claims that could otherwise have been brought as federal securities fraud claims. On the one hand, the Second Circuit held that while SLUSA barred state law class actions brought by *purchasers or sellers of securities*, it permitted state law class actions by shareholders who acquired stock in a company prior to any alleged wrongdoing and then *held* their stock during the entire class period (*i.e.*, until after disclosure of the alleged wrongdoing). n39 In contrast, the Seventh Circuit construed SLUSA more broadly, ruling that state law "holding" claims were subject to the *same* prohibitions under SLUSA as claims brought by purchasers or sellers of securities. n40 The U.S. Supreme Court resolved this conflict in March 2006 when it unanimously held in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit* n41 that stockholders are *barred* under SLUSA from bringing state law class action lawsuits if the wrongful conduct alleged in the action "coincide[s] with a securities transaction - whether by the plaintiff or by someone else." n42 Thus, like the Seventh Circuit, the Supreme Court concluded that any distinction between (i) purchasers or sellers and (ii) holders of securities is irrelevant in determining the applicability of SLUSA.

Despite SLUSA (and the Supreme Court's decision in *Dabit*), state law securities cases will not completely disappear. As previously noted, based on the statutory language of SLUSA, certain actions are not subject to the statute's prohibitions. For example, SLUSA does not bar actions involving securities brought by or on behalf of 50 or fewer stockholders. n43 Accordingly, among other shareholders, large pension funds may continue to find it advantageous to institute such actions in state court in order to avoid the obstacles imposed in federal court by the PSLRA.

[4] The Aftermath of Enron

As noted above, during the 1990's, accountants scored important judicial and legislative victories which decreased the scope of their potential liability under the federal securities laws. Possibly as a result of those victories (especially, the restrictions on litigation imposed by the PSLRA), the number of investor class action lawsuits instituted against accountants in federal court declined. Illustratively, according to a report issued by Prof. Joseph A. Grundfest of Stanford Law School (a former SEC Commissioner), only five such cases were filed during 2005. In contrast, during the same period there were approximately 1,200 earnings restatements. n44

On the other hand, the dramatic collapse of Enron, in late 2001, amid allegations concerning the role of Enron's accounting firm, Arthur Andersen, caused reconsideration of the proper equilibrium for the scope of securities fraud claims. n45 This reconsideration was expressed in July 2002 with the enactment of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"). Among other things, as detailed later in this chapter, this legislation established the Public Accounting Oversight Board (the "PCAOB"), a new regulatory body for accountants who audit public companies, and increased criminal penalties for violations of securities and related laws.

In addition, the question of whether technical compliance with generally accepted accounting principles ("GAAP") will insulate an accountant from liability has received renewed attention in the aftermath of Enron. For example, while serving as the SEC's Chairman, Harvey L. Pitt stated in a speech addressing the aftershocks of Enron's collapse that

"literal compliance with GAAP" may not necessarily be sufficient. n46

Another hovering issue with potentially significant securities liability consequences for accounting firms relates to the scope of audit materiality. As detailed in SEC Staff Accounting Bulletin 99 ("SAB 99"), even small misstatements or omissions may be deemed material if "all relevant considerations," including "the factual context in which the user of financial statements would view the financial statement item," require that the accounting discrepancy be corrected. n47 In order to make the above assessment, SAB 99 lists numerous factors which should be weighed by accountants (and others), including, for example, (i) whether a misstatement masks a change in earnings or other trends, (ii) the extent to which management "intentionally" misstated items in the financial statements, and (iii) the location of the misstatement on the financial statement. n48

It appears that aspects of SAB 99 are in the process of being re-assessed. Recently, in August 2008, the SEC Advisory Committee on Improvements to Financial Reporting issued its "Final Report" n49 which noted (among other things) that a recent increase in financial restatements n50 may be attributable to "an overly broad application of the concept of materiality and misinterpretations of the existing guidance regarding materiality in SAB 99... . As a result of this broad application ... [of SAB 99], errors may have been deemed to be material when an investor may not consider them to be important." n51 In the context of eliminating unnecessary restatements, the Final Report recommends (among other things) that "the existing materiality guidance be enhanced to clarify that the total mix of information available to investors should be the main focus of a materiality judgment and that *qualitative* factors are relevant in analyzing the materiality of all errors." n52 In particular, the Final Report provided the following examples of qualitative factors (in addition to those already in SAB 99) which should be taken into consideration when assessing the materiality of "all errors":

- "The error impacts metrics that do not drive investor conclusions or are not important to investor models.
- The error is a one-time item and does not alter investors' perceptions of key trends affecting the company.
- The error does not impact a business segment or other portion of the registrant's business that investors regard as driving valuation or risks." n53

As an outgrowth of Enron, issuers and their accountants entered into a new period of increased oversight by the SEC. High profile accounting failures, like Enron (as well as Global Crossing, Sunbeam and Waste Management), which have caused private investors (including, many who, directly or through 401K plans, have retirement plans tied to stock performance) to suffer huge financial losses, focused attention on financial statement disclosures.

For example, then SEC Chairman, Harvey L. Pitt suggested that:

- (i) Public companies and their auditors should identify the three, four or five most critical accounting principles upon which a company's financial status depends, and which involve the most complex, subjective or ambiguous decisions or assessments;
- (ii) Investors should be told, concisely and clearly, how these principles are applied, as well as information about the range of possible effects in differing application of these principles;
- (iii) Public companies should disclose significant trend and evaluative data to enable investors to assess a company's financial posture as it evolves and changes;
- (iv) Financial statements should be clear and informative so that investors can easily interpret and understand them;

(v) Audit committees should be proactive, not merely reactive, to ensure the quality and integrity of corporate financial reports; and

(vi) Audit committees, senior management and outside auditors should improve interaction. n54

An important focus of SEC oversight has been the potential imposition of tighter "independence" standards for auditors of public companies. In 2000, the SEC adopted new independence standards in an attempt to limit the circumstances where accountants might provide consulting services to their public audit clients. n55 As detailed in § 5A.09, the fallout from Enron and other recent business failures provided strong impetus for even more stringent SEC standards and pronouncements in this area.

The SEC has also moved to require more rigid adherence to prior pronouncements. For example, in its January 2002 "Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations" n56 (the "MDA Statement"), the SEC provided various "suggestions" for compliance with existing disclosure rules. Among other matters, the SEC addressed "liquidity and off balance sheet arrangements;" "related party transactions," and what was termed "relationships and transactions with persons or entities that derive benefits from their non-independent relationship with the registrant or the registrant's related parties." The SEC reminded registrants that disclosure must be timely and "both useful and understandable." n57 Registrants are obliged to "provide the most relevant information and provide it using language and formats that investors can be expected to understand." n58 On the issue of "liquidity," the SEC eschewed "overly general" disclosure in favor of registrants clearly describing the sources of short-term funding and the effects thereon of changes in the economy, technology or other factors. n59 In words clearly aimed at the financial crisis arising from the Enron situation, the SEC stated that "if commercial paper is a principal source of liquidity, the registrant should consider the need to disclose how the facility could be adversely affected by a debt rating downgrade or deterioration in certain of the company's financial ratios or other measures of financial performance." n60 The SEC added that: "If the registrant's liquidity is dependent on the use of off- balance sheet financing arrangements, such as ... obtaining access to assets through special purpose entities, the registrant should consider factors that are reasonably likely to affect its ability to continue using these off-balance sheet financing arrangements." n61 The SEC's MDA Statement specifically addressed off-balance sheet special purpose entities which are not required to be consolidated, but which have arrangements that impose obligations on the registrant to fund or make up losses in cash or stock of the public company.

Subsequently, in January 2003, the SEC issued rules that codified some of the interpretative guidance set forth in its above MDA Statement. n62 Among other things, the SEC's new rules (i) clarify disclosures that registrants are obligated to make concerning off-balance sheet arrangements, (ii) require registrants to set apart disclosure with regard to off-balance sheet arrangements in a separately contained subsection of the MD&A section of disclosure documents and (iii) obligate registrants (except for small business issuers) to disclose certain known contractual obligations in a tabular format. n63

In June 2005, the SEC again addressed off-balance sheet arrangements (and related matters) when it released a staff report entitled "Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities and Transparency of Filings by Issuers" (the "Report"). n64 According to the staff, in preparing the Report, it took "a relatively expansive approach to the scope and meaning of the term 'off-balance sheet.'" n65 In particular, the staff examined "a variety of business arrangements that may be viewed as having off-balance sheet implications and that are deemed important from a policy perspective," including: (i) investments in the equity of other entities, (ii) transfers of financial assets (where there is continuing involvement), (iii) certain retirement arrangements, (iv) leases, (v) contingent obligations and guarantees, (vi) derivatives and (vii) other contractual obligations (with an emphasis on the use of special purpose entities where relevant. n66 Based largely on this examination, the Report identified the following "key initiatives" to improve the transparency of financial reporting related to the balance sheet:

- Discourage transactions and transaction structures motivated primarily and largely by accounting and reporting considerations rather than economics. According to the Report "many of the areas dealing with off-balance sheet arrangements involve significant use of accounting-motivated structured transactions." n67

- Expand the use of objectives-oriented standards, which would have the desirable affect of reducing complexity in accounting standards.

- Improve the consistency and relevance of disclosures that supplement the basic financial statements.

- Focus financial reporting on communications with investors rather than just compliance with rules. n68

In 2006, the Financial Accounting Standards Board (the "FASB") issued a response to the above Report. n69 Among other things, the FASB stated that it concurred with the standard-setting recommendations and other goals set forth in the Report and strongly supported the objective of "reducing complexity and increasing the overall understandability, transparency, and usefulness of financial reporting." n70 The FASB emphasized that achieving the initiatives contained in the Report will require coordinated and concerted efforts by the PCAOB, the SEC, the FASB and others. n71

[5] Looking to the Future

Based on recent events, it appears that the "Enron" era may be coming to a close. During the last few years, the government's heightened effort to regulate corporations (*and their accountants*) and punish corporate wrongdoers has suffered some judicial setbacks, as well as pushback from the business community. In addition, during the 2005-2008 time period, the U.S. Supreme Court issued three significant decisions which create new impediments for shareholders seeking to assert claims under Section 10(b), especially against secondary actors such as accountants.

[a] Supreme Court's Reversal of Conviction of Arthur Andersen LLP

In 2005, in a unanimous opinion, the U.S. Supreme Court overturned the 2002 federal conviction of Arthur Andersen LLP ("Andersen") (previously, a "Big 5" accounting firm) for obstruction of justice which was predicated on the destruction of various Enron-related documents by firm personnel. n72 The Supreme Court's decision is based on a conclusion that the jury instructions allowed too low a threshold of culpable intent and on an express recognition that not all withholding of material from the government is wrongful. n73

Shortly after Andersen was convicted by the trial court, the firm went out of business and thousands of its personnel (almost all of whom had nothing to do with the Enron engagement) lost their jobs. Based on these draconian consequences, the Supreme Court's subsequent reversal of Andersen's conviction exposed the government to substantial second-guessing concerning its decision to bring criminal charges against the firm in the first instance. n74 In the eyes of some, the *Andersen* decision has also caused prosecutors to back off from seeking criminal convictions of other supposedly culpable entities (as opposed to persons affiliated with those entities). n75

[b] Dismissal of Charges Against Former Partners and Employees of KPMG

In June 2006, the federal judge overseeing the criminal prosecution of various former partners and employees of the accounting firm KPMG LLP ("KPMG") ruled in *United States v. Stein* that the federal government had violated their constitutional right to a fair trial (and legal representation) by pressuring KPMG to refuse to pay their legal fees. n76

In this matter, KPMG avoided criminal prosecution on charges arising from its alleged marketing of fraudulent tax

shelters by agreeing in a "deferred prosecution" agreement with the government to pay a \$456 million fine and satisfy certain other conditions. n77 Before entering this agreement with the government, KPMG told all partners and employees who appeared to be under suspicion that it would pay their legal fees and expenses up to \$400,000 *on the condition they cooperated* with prosecutors and would *stop* paying the fees and expenses of any person who was indicted. n78 According to the *Stein* court, "KPMG refused to pay [the defendants] because the government held the proverbial gun to its head... . [A]bsent the Thompson Memorandum and the actions of the U.S. Attorney's Office, KPMG would have paid the legal fees and expenses of all of its partners and employees both prior to and after indictment, without regard to cost." n79

The "Thompson memo" referred to in the *Stein* decision is a Justice Department memorandum (prepared by former Deputy Attorney General Larry D. Thompson) that advises prosecutors to (among other things) "scrutin[ize] ... the authenticity of a corporation's cooperation" when determining whether to bring a criminal action against the entity. n80 According to the Thompson memo, among other "cooperation" factors n81 to be considered by the prosecutor, is "whether the corporation appears to be protecting its culpable employees and agents. Thus, while cases will differ depending on the circumstances, a corporation's promise of support to culpable employees and agents ... through the advancing of attorney's fees ... may be considered by the prosecutor in weighing the extent and value of a corporation's cooperation." n82

Although the *Stein* court did not immediately impose a remedy, it stressed that the appropriate resolution would be for KPMG "*either on its own or at the government's urging or insistence*," to pay the past and ongoing legal expenses of the indicted personnel. n83 As an alternative, the court stated that it possessed "ancillary jurisdiction" in the criminal action to entertain civil claims by the indicted personnel against KPMG to compel payment of their legal expenses and it instructed the clerk of the court to open a civil docket number to accommodate such claims. n84

Shortly after the *Stein* court's "invitation" to do so, the indicted former KPMG partners and employees instituted a civil suit against KPMG in the pending criminal proceeding to obtain payment of their legal expense and expenses. While the *Stein* court denied KPMG's motion to dismiss this suit, n85 the Second Circuit reversed, dismissing plaintiffs' complaint on the grounds that the district court in the criminal action lacked "ancillary" jurisdiction to hear Plaintiffs' claims for legal expenses. n86

In July 2007, following the Second Circuit's dismissal of the above action for legal expenses, the *Stein* court dismissed the criminal charges against thirteen of the indicted KPMG personnel on the grounds that the government had deprived them of their constitutional right to a fair trial. n87 Recently, in August 2008, the Second Circuit affirmed this decision dismissing criminal charges against indicted KPMG personnel. n88 In doing so, the Second Circuit emphasized that "the government deprived Defendants ... of their right to counsel under the *Sixth Amendment* by causing KPMG to place conditions on the advancement of legal fees to Defendants ... and to cap the fees and ultimately end them." n89

[c] Retreat from the Thompson Memo

The *Stein* court's objections to the Thompson memo reflected a growing consensus in the business community (and among civil liberties organizations) that this memo had created an uneven playing field in favor of the government. n90 In apparent response to these criticisms, in December 2006, the Justice Department issued a new memorandum (prepared by Deputy Attorney General Paul J. McNulty) entitled "Principles of Federal Prosecution of Business Organizations" (the "McNulty memo") to supersede and replace the guidance contained in the Thompson memo. n91 Among other things, in contrast to the Thompson memo, the McNulty memo expressly states that when making a charging decision prosecutors "generally should *not* take into account whether a corporation is advancing attorneys' fees to employees or agents under investigation and indictment." n92

In August 2008, the Justice Department issued a memorandum prepared by Deputy Attorney General Mark Filip (the "Filip memo") which further revised corporate charging guidelines contained in the McNulty memo. Among other

things, the revised guidance in the Filip memo provides that "credit for cooperation will not depend on the corporation's waiver of attorney-client privilege or work product protection, but rather the disclosure of relevant facts." n93 In addition, the Filip memo instructs prosecutors not to take into consideration a corporation's advancement of attorneys' fees to its employees when evaluating the corporation's level of cooperation. n94

It remains to be seen whether the Filip memo will satisfy critics of federal corporate charging guidelines. For example, some critics may assert that the Filip memo's focus on a corporations' disclosure of "relevant facts" as distinguished from its waiver of privilege ignores the practical reality that pressure by the Justice Department to waive privilege will not abate if the government believes that the protected information constitutes "relevant facts" which should be disclosed.

[d] Efforts to Limit the Applicability or Burdens of the Sarbanes-Oxley Act

Serious efforts are now underway to limit the applicability or burdens of the Sarbanes-Oxley Act. For example (as detailed at § 5A.09), this new legislation established the PCAOB to (among other things) register, monitor and discipline accounting firms in connection with their audits of public companies. In response to this delegation of authority, the Free Enterprise Fund (a free-markets lobbying group) and the accounting firm of Beckstead & Watts LLP instituted a lawsuit n95 challenging the constitutionality of the PCAOB on the grounds that the agency lacks required oversight from the executive branch. n96 In August 2008, the United States Court of Appeals for the District of Columbia (in a 2-1 decision) affirmed the district court's earlier grant of summary judgment in favor of the government. n97 Among other things, the appeals court held that the (i) SEC's power to appoint members of the PCAOB does not intrude on the President's constitutional "appointment" power because Board members are "inferior officers" who are "subject to [the] direction and supervision" of the SEC and (ii) "for-cause limitations" on both the SEC's power to remove PCAOB members and the President's power to remove SEC Commissioners "do not strip the President of sufficient power to influence the Board" so as to violate "separation of powers" under the Constitution. n98

In addition, as discussed later at § 5A.09[3], compliance with the Sarbanes-Oxley Act (especially, Section 404's requirement that a company's auditors attest to and report on management's assessment of internal controls) can be costly. Among other things, in response to this financial burden, legislation has recently been introduced in Congress to exempt many companies from adherence to Section 404's internal control audit requirements or limit the burden of such compliance. n99

[e] Chamber of Commerce "Action Plan" To Protect Accountants From "Over-Litigation"

The Chamber of Commerce has issued an "action plan" to (among other things) protect the accounting profession against "overlitigation" and "unfair enforcement." For example, the Chamber has requested that the PCAOB adopt a safe harbor standard that establishes the procedures that must be applied by an accounting firm to detect fraud. According to the Chamber, compliance with that "safe harbor" standard should insulate accounting firms from legal liability. n100 In addition, the Chamber has, *inter alia*, (i) requested Congress to restrict the circumstances under which accounting firms may be criminally indicted and (ii) supported the establishment of an alternative dispute process for the resolution of certain audit disputes by experts, outside the judicial process. n101

[f] The Supreme Court's Decision in *Dura Pharmaceuticals v. Broudo* Tightened the Requirements for Pleading Causation under Rule 10b-5

In 2005, the Supreme Court in *Dura Pharmaceuticals, Inc. v. Broudo* n102 addressed the critical issue of causation under *Rule 10b-5* and made clear that even at the pleading stage of litigation, a plaintiff must clearly set forth that the loss it claims was actually caused by the wrongdoing charged. In this regard, the *Dura* court unanimously held that a private plaintiff cannot satisfy the loss causation (*i.e.*, proximate cause) element of a *Rule 10b-5* action by merely alleging that the price of the security in question was inflated on the date of purchase as a result of defendant's alleged

misrepresentations. According to the Supreme Court, the objective of private actions under the securities laws is to protect investors "against those economic losses that misrepresentations actually cause," but "not to provide investors with broad insurance against market losses." n103 In this regard, the Supreme Court observed that normally in "fraud on the market" cases an inflated purchase price by itself does not establish the necessary causal connection between alleged wrongdoing and economic loss because:

■ As "a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that *at that instant* possesses equivalent value." n104 Accordingly, if "the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss." n105

■ Even when a stock sale occurs at a lower price after the truth makes its way into the marketplace, it does not necessarily follow that the initially inflated purchase price was the proximate cause of any relevant economic loss. Numerous other factors or intervening causes, such as an industry specific market collapse, may have caused, or at least impacted, the drop in the value of the stock. In addition, the longer the time between purchase and sale, the more likely it is that factors unrelated to the initially inflated purchase price are the reason for all or some of the decline in the stock's market value. n106

While the Supreme Court indicated that the *Dura* complaint was fatally defective because it did not assert that the "share price fell significantly after the truth became known," n107 the opinion did not set forth the level of detail that is required to properly allege (and prove) loss causation. It is therefore necessary to look to lower court decisions applying *Dura* to obtain this type of practical guidance. n108

[g] The Supreme Court's Decision in Tellabs, Inc. v. Makor Issues & Rights, Ltd. Establishes A High Burden To Establish Scienter

In 2007, in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, n109 the Supreme Court clarified the meaning of the term "strong inference" as used in the PSLRA n110 by holding, *inter alia*, that "[t]o qualify as 'strong' ... an inference of scienter must be *at least as compelling* as any opposing inference of nonfraudulent intent." n111 Accordingly, under *Tellabs*, allegations of scienter will *not* survive a motion to dismiss as long as a legitimate explanation for claimed misconduct "tips the scales ever so slightly" in defendant's favor against plaintiffs' competing interpretation of the alleged facts. n112 As discussed later in this chapter, this decision creates a significant obstacle which securities law plaintiffs must overcome in order to successfully establish a claim under Section 10(b).

[h] The Supreme Court's Decision in Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. Eliminates A Method For Asserting 10(b) Claims Against Secondary Actors

Recently, in early 2008, the Supreme Court issued a 5-3 decision in *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*, n113 which effectively eliminated "scheme liability" under *Rule 10b-5(a)* and *(c)* as a mechanism to extend primary Section 10(b) liability to secondary actors (such as accountants) and thereby circumvent the impediment to secondary actor liability imposed by the Supreme Court's rejection of aider and abetter liability in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* n114

As discussed later in this chapter, in determining that plaintiffs could not sustain their Section 10(b) claim against those defendants, the Supreme Court expressly rejected plaintiffs' contention that such liability could be imposed on those parties, even absent any public statement by them, based on their participation in a "scheme" to violate 10(b). According to the Court, applying "scheme liability" would "not answer the objection that ... [the plaintiffs] did not, in fact, rely upon ... [the defendant's] own deceptive conduct." n115 Based on *Stoneridge*, it appears that "scheme liability" may not be utilized to expand the reach of Section 10(b) private action beyond cases involving misstatements, omissions by a party who has a duty to disclose or certain types of manipulative trading activity (such as "churning" and "wash sales").

n116

[6] The 2008 Financial Crisis

In 2008, the United States (and much of the rest of the world) was hit with the worst financial crisis since the Great Depression as a result of the shockwaves emanating from the sub-prime mortgage meltdown. Given that many blame this crisis (and the substantial market losses incurred by investors) on corporate "greed" and misconduct, a strong likelihood exists that many participants in the sub-prime marketplace (*e.g.*, financial institutions, insurance companies and broker/dealers) and, possibly, their accountants will soon find themselves subject to heightened government attention and an increase in civil litigation under the securities laws. n117

FOOTNOTES:

(n1)Footnote 1. 255 N.Y. 170, 174 N.E. 441 (N.Y. 1931) .

(n2)Footnote 2. In this regard, the *Ultramares* court emphasized that lifting the shield of privity would unfairly "expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class." 255 N.Y. at 179, 174 N.E. at 444 .

(n3)Footnote 3. Since the *Ultramares* decision, courts which had adhered to its basic principles have refined the privity concept to further define the contours of an accountant's liability to third-parties. In *Credit Alliance Corp. v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 551, 493 N.Y.S.2d 435, 443, 483 N.E.2d 110, 118 (N.Y. 1985) , the New York Court of Appeals held that a noncontractual party could not hold accountants liable for negligence unless three prerequisites are met:

- (1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes;
- (2) in the furtherance of which a known party or parties was intended to rely; and
- (3) there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces the accountants' understanding of that party or parties reliance.

The third prong of the test raises the question of the nature and extent of the "conduct on the part of the accountants" linking them to the third-party which would be sufficient to meet the test. This issue was addressed by the *New York Court of Appeals in Security Pacific Bus. Credit, Inc. v. Peat Marwick Main & Co.*, 79 N.Y.2d 695, 586 N.Y.S.2d 87, 597 N.E.2d 1080 (N.Y. 1992) , where the only linking "conduct" was a single telephone conversation between the accountant and the lender, initiated by the lender in which the lender announced its intended reliance and made certain inquiries regarding the audit then in progress. The court held that this was not sufficient to establish the necessary link and dismissed the claim.

Various courts outside New York have followed the general approach of *Credit Alliance*. See, *e.g.*, *Toro Co. v. Krouse, Kern & Co.*, 827 F.2d 155 (7th Cir. 1987) (applying Indiana law); *Colonial Bank of Alabama v. Ridley & Schweigert*, 551 So. 2d 390 (Ala. 1989) ; *Twin Mfg. Co. v. Blum Shapiro & Co.*, 602 A.2d 1079 (Conn. Super. Ct. 1991) .

(n4)Footnote 4. The foreseeability standard abandons any notion of privity and exposes accountants to potential negligence liability to a spectrum of potential claimants limited only by the requirement that the claimant fall within a class of potential claimants who might reasonably be expected to rely on the financial statement in question. Only two states: (i) Wisconsin; see *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361 (1983) ; and (ii) Mississippi; see *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315 (Miss. 1987) ; *Travelers*

Casualty & Surety Co. v. J.L. Holloway, 2007 U.S. Dist. LEXIS 33891 (S.D. Miss. May 8, 2007) (applying Touche Ross); MISS. CODE ANN. § 11-7-20 (2008) ("privity shall not be a requirement" to prosecute action for "economic loss brought on account of negligence"); currently follow this approach. New Jersey which had been a leading proponent of the foreseeability standard; see *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 351, 461 A.2d 138, 153 (1983) ; statutorily reversed itself and adopted a near privity standard similar to that of New York; see, N.J. STAT. ANN. § 2A:53A-25 (West Pocket Part 1998) and *E. Dickerson & Son, Inc. v. Ernst & Young, LLP*, 179 N.J. 500, 846 A.2d 1237 (N.J. 2004) (interpreting New Jersey's "near privity" statute). In the case of banks, the statute requires as a predicate to standing that the accountant acknowledge the bank's intended reliance and the client's knowledge of that reliance in writing.

(n5)Footnote 5. The restatement standard provides that liability is limited to loss suffered "(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction." Restatement (Second) of Torts § 552 (ALI 1977). Thus, the Restatement approach does not require that the accountant be aware of a particular person's reliance, but rather permits liability if the person is part of a "limited group" of persons (whether or not specifically identified to the accountant) who the accountant intends or expects to be influenced by the information supplied. Unlike the test under *Credit Alliance*, the accountant need not be affirmatively linked to the third-party by its own specific conduct. California, previously a "foreseeability" state, adopted the Restatement standard in *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370, 11 Cal. Rptr.2d 51, 834 P.2d 745 (1992) , in connection with negligent misrepresentation claims. See also, e.g., *Scottish Heritable Trust, PLC v. Peat Marwick Main & Co.*, 81 F.3d 606 (5th Cir.) , cert. denied, 519 U.S. 869 (1996) ; *Nycal Corp. v. KPMG Peat Marwick LLP*, 426 Mass. 491, 688 N.E.2d 1368 (1998) ; *Boykin v. Arthur Andersen & Co.*, 639 So. 2d 504 (Ala. 1994) ; *Bethlehem Steel Corp. v. Ernst & Whinney*, 822 S.W.2d 592 (Tenn. 1991) ; *First Fla. Bank, N.A. v. Max Mitchell & Co.*, 558 So. 2d 9 (Fla. 1990) ; *Badische Corp. v. Caylor*, 257 Ga. 131, 356 S.E.2d 198 (1987) ; *Nycal Corp. v. KPMG Peat Marwick LLP*, 426 Mass. 491, 688 N.E.2d 1368) ; *Haddon View Inv. Co. v. Coopers & Lybrand*, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982) ; *Loop Corp. v. McIlroy*, 2004 Minn. App. LEXIS 1146 (Minn. Ct. App., Oct. 5, 2004) ; *Law Offices of Lawrence J. Stockler, P.C. v. Rose*, 174 Mich. App. 14, 436 NW.2d 70 (1989) ; *Blue Bell v. Peat Marwick, Mitchell & Co.*, 715 S.W.2d 408 (Tex. App. 1986) .

Some states adhere to a variation of the Restatement approach through statutes that apply what is known as the "primary intent rule." See, e.g., ARK. CODE ANN. § 16-114-302 (2008); 225 ILL. COMP. STAT. 450/30.1 (2005); KAN. STAT. ANN § 1-402 (2005); MICH. COMP. LAWS § 600.2962 (2005). As a general matter, under these statutes, an accountant's liability to a non-client based on negligence may arise when the accountant is aware that "a primary intent" of the client is for the professional services to benefit or influence the particular person (or entity) bringing the action. In addition, these statutes generally provide that if the accountant (a) identifies in writing to its client those persons (or entities) who are intended to rely on the services rendered and (b) sends a copy of that writing to the persons (or entities) identified therein, the accountant may be held liable *only* to the persons (or entities) identified in the writing (in addition to any party in privity of contract with the accountant). See, e.g., *Freeman, Freeman & Salzman, P.C. v. Lipper*, 349 Ill. App. 3d 677, 812 N.E.2d 562 (Ill. App. Ct. 2004) (interpreting above Illinois statute and applying the "primary intent rule").

(n6)Footnote 6. *In re McKesson & Robbins*, 1940 S.E.C. LEXIS 1528, at * 10 (Dec. 5, 1940), 11 Fed. Reg. 10918 (Dec. 5, 1940) (emphasis supplied).

(n7)Footnote 7. 1957 SEC LEXIS 1014 (Mar. 25, 1957), 37 S.E.C. 629 (1957) .

(n8)Footnote 8. 1957 S.E.C. LEXIS 1014, at * 89 - * 91, 37 S.E.C. at 670- 71 .

(n9)Footnote 9. See e.g., *Kohler v. Kohler Co.*, 319 F.2d 634 (7th Cir. 1963) ; *Estate Counseling Serv., Inc. v. Merrill, Lynch, Pierce Fenner & Smith, Inc.*, 303 F.2d 527 (10th Cir. 1962) ; *Boone v. Baugh*, 308 F.2d 711 (8th Cir. 1962) ; *Hooper v. Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960) ; *Connelly v. Balkwill*, 279 F.2d 685 (6th

Cir. 1960) ; *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951) .

(n10)Footnote 10. *See Fischer v. Kletz*, 266 F. Supp. 180, 190 (S.D.N.Y. 1967) .

(n11)Footnote 11. 404 U.S. 6, 13 n. 9 (1971) .

(n12)Footnote 12. 266 F. Supp. 180 (S.D.N.Y.1967) .

(n13)Footnote 13. 1957 S.E.C. LEXIS 1014 (Mar. 25, 1957), 37 S.E.C. 629 (1957) .

(n14)Footnote 14. 1957 S.E.C. LEXIS 1014, at * 89 - * 91, 37 S.E.C. at 1014 .

(n15)Footnote 15. 283 F. Supp. 643 (S.D.N.Y. 1968)

(n16)Footnote 16. The court's decision in *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969) , *cert. denied*, 397 U.S. 1006 (1970) , which upheld criminal convictions of three accountants for violations of the Exchange Act based on their certification of false financial statements, also heralded the expansion of accountants' liability under the federal securities laws.

(n17)Footnote 17. 425 U.S. 185 (1976) .

(n18)Footnote 18. *See* § 5A.07 *infra*.

(n19)Footnote 19. 511 U.S. 164 (1994) .

(n20)Footnote 20. ___ U.S. ___, 128 S. Ct. 761 (2008) .

(n21)Footnote 21. 18 U.S.C. §§ 1961-1968 (2000 & Supp. 2008).

(n22)Footnote 22. 18 U.S.C. § 1962(c) (2000 & Supp. 2008).

(n23)Footnote 23. 18 U.S.C. § 1961 (1) and (5) (2000 & Supp. 2008). As set forth below, the 1995 Private Securities Litigation Reform Act abrogated civil securities law violations as predicate acts under RICO.

(n24)Footnote 24. 507 U.S. 170 (1993) .

(n25)Footnote 25. 18 U.S.C. § 1964(c) (2000 & Supp. 2008).

(n26)Footnote 26. Pub. L. No. 104-67, 109 Stat. 737 (1995).

(n27)Footnote 27. 15 U.S.C. § 78-u4(b)(2) (1997 & Supp. 2008). As explained later in this chapter at § 5A.07[2], in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, the Supreme Court recently clarified the meaning of the term "strong inference" as used in the PSLRA, holding, *inter alia*, that "[t]o qualify as 'strong' ... an inference of scienter must be *at least* as compelling as any opposing inference of non-fraudulent intent." 127 S. Ct. 2499, 2504-05 (2007) (emphasis added).

(n28)Footnote 28. 15 U.S.C. § 78-u4(b)(3) (1997 & Supp. 2008). *See, e.g., S.G. Cowen Secs. Corp. v. U.S. Dist. Court for Northern Dist. of California*, 189 F.3d 909, 912 (9th Cir. 1999) (it is impermissible to lift the PSLRA discovery stay so that plaintiffs "might uncover facts sufficient to satisfy the Act's pleading requirements"); *Faulkner v. Verizon Communications, Inc.*, 156 F. Supp.2d 384, 402-03 (S.D.N.Y. 2001) .

(n29)Footnote 29. 15 U.S.C. § 78u-4(a)(3) (1997 & Supp. 2008).

(n30)Footnote 30. 15 U.S.C. § 78u-4(f)(2) (1997 & Supp. 2008).

(n31)Footnote 31. 15 U.S.C. § 78u-4(e)(1) and (2) (1997 & Supp. 2008).

(n32)Footnote 32. 15 U.S.C. § 78j-1 (1997 & Supp. 2008).

(n33)Footnote 33. 15 U.S.C. § 78j-1. Section 10A is discussed in greater detail in § 5A.08.

(n34)Footnote 34. 15 U.S.C. § 77p (1997 & Supp. 2008).

(n35)Footnote 35. 15 U.S.C. § 78a Note (1997 & Supp. 2008).

(n36)Footnote 36. As a general rule, the definition of a "covered class action" under 15 U.S.C. § 78bb(f)(5)(B) "is a lawsuit in which damages are sought on behalf of more than 50 people." *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71, 83 (2006) . Exclusively derivative actions brought by one or more shareholders on behalf of a corporation are outside the scope of SLUSA. 15 U.S.C. § 78bb(f)(5)(C).

(n37)Footnote 37. 15 U.S.C. 77p(d)(1) -- (3) (1997 & Supp. 2008).

(n38)Footnote 38. 15 U.S.C. 77p(d)(4) (1997 & Supp. 2008). See *Kircher v. Putnam Funds Trust*, 547 U.S. 633, 643-644 (2006) . A split of authority exists concerning whether SLUSA applies to entire actions or just individual claims. In this regard, the Second Circuit determined in *Gray v. Seaboard Securities, Inc.*, 126 Fed. Appx. 14, 16, 2005 U.S. App. LEXIS 4098, *2 (2d Cir. 2005) that only claims subject to SLUSA's prohibitions should be dismissed (as opposed to entire actions). On the other hand, the Third Circuit strongly suggested in *Rowinski v. Salomon Smith Barney, Inc.*, 398 F.3d 294, 305 (3d Cir. 2005) , that if any one claim is barred under SLUSA, then the entire action must be dismissed. See also *In re Lord Abbott Mut. Funds Fee Litig.*, 463 F.Supp. 2d 505, 508 (D. N.J. 2006) . Recently, in *Anderson v. Merrill Lynch Pierce Fenner & Smith, Inc.*, 521 F.3d 1278, 1288 (10th Cir. 2008) , the Tenth Circuit acknowledged this split of authority, but avoided taking a position when it dismissed an entire action on the grounds that plaintiffs had incorporated by reference allegations subject to SLUSA's prohibitions into *each* of their causes of action. See also *U.S. Mortg. Inc. v. Saxton*, 494 F.3d 833, 846 (9th Cir. 2007) .

In *Superior Partners v. Chang*, 471 F.Supp. 2d 750, 758 (S.D. Tex. 2007) , the court determined that SLUSA applies to actions rather than claims, *but* held that if some individual claims of a "covered class action" should be remanded to state court based on an applicable "carve-out," *the entire action should be remanded*, despite the existence of additional claims which were otherwise subject to SLUSA's prohibitions. See also *Greaves v. McAuley*, 264 F.Supp. 2d 1078, 1086 (N.D. Ga. 2003) .

(n39)Footnote 39. *Dabit v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 395 F.3d 25 (2d Cir. 2005) , *rev'd*, *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 547 U.S. 71 (2006) .

(n40)Footnote 40. *Kircher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir. 2005) , *vacated*, 547 U.S. 633 (2006) .

(n41)Footnote 41. 547 U.S. 71 (2006) .

(n42)Footnote 42. 547 U.S. at 84 . In this regard, the Supreme Court rejected the argument that SLUSA incorporates the federal securities laws' purchaser/seller standing requirement.

In *Prof'l Mgmt. Assocs., Inc. Employees Profit Sharing Plan v. KPMG LLP*, 335 F.3d 800 (8th Cir. 2003) , *cert. denied*, 540 U.S. 1162 (2004) , a decision preceding and consistent with *Merrill Lynch*, the putative class action plaintiffs, shareholders of an issuer, Green Tree Financial Corporation, attempted to assert state law claims for aiding and abetting a breach of fiduciary duty, breach of a state consumer fraud statute, negligent misrepresentation, and negligence, against Green Tree's accounting firm, KPMG. Plaintiffs alleged that: (i) KPMG made its own misrepresentations and (ii) aided and abetted Green Tree in making misrepresentations. 335 F.3d at 802 . The misrepresentations were made by Green Tree or KPMG beginning in 1994 and continuing through 1997. The putative

class included those who bought and held Green Tree stock from January 30, 1996 to January 27, 1997. Plaintiff only claimed damages suffered as a result of its holding the stock. 335 F.3d at 803 . Thus, in this case misrepresentations made as early as 1994 were alleged to have caused the inaction of the plaintiff as much as three (3) years later. This, the court held, was sufficient to satisfy the requirement that "misrepresentations and omissions were made in connection with the purchase of securities and thus SLUSA requires dismissal." *Id.*

(n43)Footnote 43. *See, e.g., 15 U.S.C. §§ 78bb(f)(3)(A)-(C) and (5)(C)-(D).*

(n44)Footnote 44. *See* Stephen Labaton, *Earnings Restated? Don't Blame a Lawsuit for It*, The New York Times, Feb. 3, 2006, at C7.

(n45)Footnote 45. As a result of the uproar over the Enron situation, government prosecutors substantially increased their attempts to crack down on alleged corporate wrongdoing. According to the Justice Department, between mid-2002 to mid-2006 this effort resulted in more than 1,000 convictions (or guilty pleas) related to corporate malfeasance. *See* Paul Davies and Karen Scannell, *Guilty Verdicts Provide "Red Meat" to Prosecutors Chasing Companies*, Wall Street Journal, May 26, 2006, at A1. Among others, high profile convictions include (i) Kenneth Lay (Chairman and CEO of Enron) (technically vacated upon his death), (ii) Jeffrey Skilling (President and CEO of Enron), (iii) Bernard Ebbers (CEO of WorldCom), (iv) John Rigas (Chairman and CEO of Adelphia) and (v) L. Dennis Kozlowski (CEO of Tyco) (state court conviction).

Some government prosecutions have failed; for example, a jury acquitted former Health South CEO, Richard Scrushy, of numerous criminal counts brought against him (although he was subsequently convicted on unrelated bribery charges). The Supreme Court's 2005 decision reversing the criminal conviction of Arthur Andersen LLP (for the destruction of various Enron-related documents) is discussed at §§ 5A.01[5] and 5A.10, *infra* .

(n46)Footnote 46. Remarks of Harvey L. Pitt on February 19, 2002 at the Winter Bench and Bar Conference of the Federal Bar Council.

(n47)Footnote 47. SAB 99, at 2-3.

(n48)Footnote 48. Traditionally, assessments of materiality have generally relied on numerical thresholds.

(n49)Footnote 49. This Final Report is available at <http://www.sec.gov/about/offices/oca/acifr/acifr-finalreport.pdf>.

(n50)Footnote 50. According to the Final Report (p. 76) the number of financial restatements in the U.S. financial markets reached approximately 1,600 companies in 2006.

(n51)Footnote 51. *See* Final Report, pp. 76-77.

(n52)Footnote 52. *See* Final Report, p. 81 (emphasis added).

(n53)Footnote 53. *Id.* According to the Final Report, the above list of qualitative factors is not an exhaustive list of all relevant facts and companies and their auditors should continue to examine "the totality of all factors" when making a judgment concerning materiality. *Id.*

(n54)Footnote 54. Harvey L. Pitt, *How to Prevent Future Enrons*, Wall St. J., Dec. 11, 2001 at A18.

(n55)Footnote 55. *See* SEC Release Nos. 33-7919, 34-43602 and 35-28279, published November 21, 2000.

(n56)Footnote 56. Sec. Act Rel. No. 8056, Fed. Sec. L. Rep. (CCH) P 86,617 (January 22, 2002).

(n57)Footnote 57. Fed. Sec. L. Rep. (CCH) P 86,617 at 85,154.

(n58)Footnote 58. Fed. Sec. L. Rep. (CCH) P 86,617.

(n59)Footnote 59. Fed. Sec. L. Rep. (CCH) P 86,617.

(n60)Footnote 60. Fed. Sec. L. Rep. (CCH) P 86,617.

(n61)Footnote 61. Fed. Sec. L. Rep. (CCH) P 86,617.

(n62)Footnote 62. See Final Rule: *Disclosure on Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations*, at www.sec.gov/rules/final/33-8182.htm (May 7, 2003). In connection with the foregoing, Section 401 of the Sarbanes-Oxley Act requires the SEC to adopt final rules that obligate a registrant, in each annual and quarterly financial report filed with the SEC, to disclose "all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues and expenses."

(n63)Footnote 63. The effective date of the above rules was April 7, 2003. SEC registrants must comply with the above off-balance sheet arrangement disclosure requirements in certain disclosure documents that are required to include financial statements for their fiscal years ending on or after June 15, 2003. Registrants (other than small business issuers) must include the table of contractual obligations in such disclosure documents that are required to include financial statements for the fiscal years ending on or after December 15, 2003.

(n64)Footnote 64. The Report, which was prepared by the Office of the Chief Accountant, the Office of Economic Analysis and the Division of Corporation Finance, was intended to satisfy the mandate of Section 401(c) of the Sarbanes-Oxley Act which required the SEC to issue a report that addressed (among other things) (i) the prevalency of off-balance sheet arrangements and (ii) whether current financial statements of issuers transparently reflect the economics of such arrangements.

The Report may be found at www.sec.gov/news/studies/soxoffbalancercpt.pdf.

(n65)Footnote 65. Report, p. 1.

(n66)Footnote 66. Report, p. 1.

(n67)Footnote 67. Report, p. 3.

(n68)Footnote 68. See Report, p. 3, and SEC Release 2005-91, "SEC Staff Report On Off-Balance Sheet Arrangements, Special Purpose Entities and Related Issues" (June 15, 2005). As detailed in the Report, the staff also provided recommendations for changes in accounting and reporting requirements, each of which furthers one or more of the above initiatives. *Id.*

(n69)Footnote 69. The FASB response is available at: http://www.fasb.org/articles&reports/fasb_response_sec_study_obs.pdf.

(n70)Footnote 70. See FASB response at p. 9.

(n71)Footnote 71. *Id.*

(n72)Footnote 72. *Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005).

(n73)Footnote 73. While the *Andersen* decision was a setback for the Justice Department, it is unclear how much prospective guidance it provides in light of provisions of the Sarbanes-Oxley Act, enacted after *Andersen's* conviction.

See § 5A.10, *infra*.

(n74)Footnote 74. See Paul Davies and Karen Scannell, *Guilty Verdicts Provide "Red Meat" To Prosecutors Chasing Companies*, Wall Street Journal, May 26, 2006, at A1.

(n75)Footnote 75. *Id.* In lieu of criminal prosecution, the government has entered into "deferred prosecution agreements" with some entities (*e.g.*, KPMG LLP and Computer Associates Inc.) under which the entity agrees to certain conditions to avoid prosecution (for example, the retention of an independent monitor) and leaves itself open to likely conviction if it fails to satisfy those conditions.

On the other hand, in May 2006 the law firm of Milberg Weiss Bershad & Schulman LLP (together with two of its partners) was indicted for allegedly making illegal payments to class action plaintiffs represented by them after the firm refused to enter into a deferred prosecution agreement. See Julie Creswell, *U.S. Indictment For Big Law Firm in Class Actions*, The New York Times, May 19, 2006, at A1. Subsequently, as part of a deal with the Milberg firm, the government dropped all criminal charges against the firm.

(n76)Footnote 76. 435 F. Supp. 2d 330 (S.D.N.Y. 2006) . In addition to focusing on the deprivation of the defendants' constitutional rights, the court also stated: "[A]n employer often must reimburse an employee for legal expenses when the employee is sued, or even charged with a crime, as a result of doing his or her job... . Persons in jobs big and small, private and public, rely on it every day. Bus drivers sued for accidents, cops sued for allegedly wrongful arrests ... and corporate chieftains embroiled in securities litigation generally have similar rights to have their employers pay their legal expenses if they are sued as a result of their doing their jobs. This right is as much a part of the bargain between employer and employee as salary and wages." *Id.*, at 335 .

(n77)Footnote 77. *Id.* at 349-350 . As described earlier, under a deferred prosecution agreement, a party avoids a criminal conviction as long as it satisfies the conditions set forth in that agreement.

(n78)Footnote 78. *Id.* at 345 .

(n79)Footnote 79. *Id.* at 336 and 353.

(n80)Footnote 80. See Thompson memo p. 1 (which is available at http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm).

(n81)Footnote 81. As a matter of "General Principle," the Thompson memo states: "In determining whether to charge a corporation, that corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate with the government's investigation may be relevant factors. In gauging the extent of the corporation's cooperation, the prosecutor may consider the corporation's willingness to identify the culprits within the corporation, including senior executives; to make witnesses available; to disclose the complete results of its internal investigation; and to waive attorney-client and work product protection." Thompson memo, p. 5.

(n82)Footnote 82. Thompson memo, p. 5. Under the memo, if a corporation is required by governing law to pay the legal fees of officers under investigation prior to a formal determination of their guilt, this circumstance is not considered a failure to cooperate. *Id.* at p. 10 n. 4 .

(n83)Footnote 83. 435 F. Supp. 2d at 381 .

(n84)Footnote 84. *Id.* at 377-380 .

(n85)Footnote 85. *United States v. Stein*, 452 F. Supp. 2d 230 (S.D.N.Y. 2006) .

(n86)Footnote 86. *Stein v. KPMG, LLP*, 486 F. 3d 753, 755-756 (2d Cir. 2007) . In reaching this decision, the

Second Circuit expressly stated that it offered no opinion concerning whether the government's conduct in the matter violated the rights of the indicted personnel under the *Fifth* and *Sixth Amendments*. *Id.* at 762 .

(n87)Footnote 87. *United States v. Stein*, 495 F. Supp. 2d 390 (S.D.N.Y. 2007) .

(n88)Footnote 88. *United States v. Stein*, 541 F.3d 130 (2d Cir. 2008) .

(n89)Footnote 89. *Id.* at 135 .

(n90)Footnote 90. See Ashby Jones, *Thompson Memo Out, McNulty Memo In*, Wall Street Journal, December 12, 2006, at A18.

(n91)Footnote 91. The McNulty memo is available at http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf.

(n92)Footnote 92. See McNulty memo, p. 11 (emphasis added).

(n93)Footnote 93. See Department of Justice press release dated August 28, 2008, available at www.usdoj.gov. Moreover, in its recently adopted "Enforcement Manual" (the "Manual"), the SEC's Division of Enforcement addresses the issue of "waiver of privilege," in the context of assessing a party's level of "cooperation," in a manner similar to the approach adopted by the Justice Department in the Filip memo. See SEC (Division of Enforcement) "Enforcement Manual" at p. 99 (available at <http://www.sec.gov/divisions/enforce/enforcementmanual.pdf>).

(n94)Footnote 94. See Department of Justice press release dated August 28, 2008.

(n95)Footnote 95. See *Free Enterprise Fund v. Public Company Accounting Oversight Board*, Civil Action 1:06-CV-00217-JR (D. D.C., 2006).

(n96)Footnote 96. Among other things, the plaintiffs complain that the President lacks authority to appoint or fire members of the PCAOB or to approve its budget. Instead, by law, the SEC appoints the PCAOB's members and controls the agency's budget. See Karen Scannell and Brody Mullins, *Suit Seeks to Overturn Sarbanes-Oxley Law -- Lobbyists, Accounting Firm Challenge Oversight Board; Similar Efforts May Follow*, Wall Street Journal, Feb. 8, 2006, at C6.

(n97)Footnote 97. *Free Enterprise Fund v. Public Accounting Oversight Board*, 537 F.3d 667 (D.C. Cir. Aug. 22, 2008) . In March 2007, the United States District Court for the District of Columbia granted defendants' motion for summary judgment because plaintiffs "present[ed] nothing but a hypothetical scenario of an over-zealous or rogue PCAOB investigator." *Free Enterprise Fund v. The Public Company Accounting Oversight Board*, 2007 U.S. Dist. LEXIS 24310 (D.D.C. March 21, 2007) . According to the Court, plaintiffs did not answer defendants' argument "that, if such a scenario became real, the SEC could change the rules to prevent improper investigations or remove PCAOB members for 'good cause.' " *Id.*, at p. 18 .

(n98)Footnote 98. *Id.* at 669 .

(n99)Footnote 99. See Recent Work of the Public Company Accounting Oversight Board: Registration, Inspections, Enforcement and Standard Setting, submitted by Daniel L. Goelzer, Claudius B. Modesti and Helen A. Munter for the American Law Institute/American Bar Association seminar on Accountants' Liability (May 15-16, 2008), pp. 39-42.

(n100)Footnote 100. See *Chamber of Commerce Offers Action Plan to Strengthen Auditing Profession*, SEC TODAY, Vol. 2006-15, at 1-2 (Jan. 24, 2006).

(n101)Footnote 101. *Id.*

(n102)Footnote 102. 544 U.S. 336 (2005) .

(n103)Footnote 103. *Id.* at 345 (emphasis added).

(n104)Footnote 104. *Id.* at 342 .

(n105)Footnote 105. *Id.*

(n106)Footnote 106. *Id.* at 342-343 .

(n107)Footnote 107. 544 U.S. at 347 .

(n108)Footnote 108. It is apparent from subsequent lower court rulings that the easiest way to comply with *Dura's* holding on loss causation is to allege (and prove) that the market price of a corporation's security dropped in response to a public disclosure by the company itself or another source that exposed a prior fraudulent misrepresentation or omission concerning the value of that security. Post-*Dura* guidance, however, is unclear concerning the extent to which an alleged corrective disclosure must specifically address the subject matter of the alleged fraudulent misrepresentation or omission. For example, while some courts have stated that there is no requirement under *Dura* that an alleged corrective disclosure must be the "linguistic mirror" of the alleged fraud, *e.g.*, *In re Bristol-Myers Squibb Sec. Litig.*, 2005 U.S. Dist. LEXIS 18448 at *57 (D.N.J. Aug. 17, 2005) , other courts have required a stricter "linguistic mirror," *e.g.*, *Teacher's Retirement System of Louisiana v. Hunter*, 477 F.3d 162, 185-188 and 194 (4th Cir. 2007) .

(n109)Footnote 109. ___ U.S. ___, 127 S. Ct. 2499 (2007) .

(n110)Footnote 110. See § 5A.01[3][d], *supra*.

(n111)Footnote 111. 127 S. Ct. at 2504-05 .

(n112)Footnote 112. *New Jersey v. Sprint Corp.*, 531 F. Supp. 2d 1273, 1281 (D. Kan. 2008) . The Supreme Court also stressed in *Tellabs* that the relevant inquiry is "whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." 127 S. Ct. at 2509 .

(n113)Footnote 113. U.S. ___, 128 S. Ct. 761 (2008) .

(n114)Footnote 114. As previously noted in this chapter, the Supreme Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) , previously determined that a private right of action for aiding and abetting liability does not exist under Section 10(b).

(n115)Footnote 115. 128 S. Ct. 761, 769 (2008) . According to the Supreme Court, Section 10(b) liability is not necessarily foreclosed by the absence of "a specific oral or written statement," if the plaintiff relied to its detriment on some other "conduct" of the defendant. *Id.*

(n116)Footnote 116. As also detailed later in this chapter, it is possible (although unlikely) that the Supreme Court in *Stoneridge* did not intend to categorically foreclose all future applications of scheme liability.

(n117)Footnote 117. According to a report released on July 29, 2008 by Cornerstone Research in cooperation with Stanford Law School's Securities Class Action Clearinghouse, the sub-prime meltdown has already led to a marked increase in class action filings under the securities laws. In this regard, the Cornerstone report discloses (among other things) that (i) such filings "jumped from 119 in the twelve months ending June 2007 to 217 over the next twelve months," (ii) there "were 110 [such] filings between January 1 and June 30, 2008, suggesting as many as 220 filings by the end of the year" and (iii) approximately "half of the filings in the first half of 2008 were driven by sub-prime mortgage/credit crunch with 58 filings containing related allegations." See July 29, 2008 press release of the Stanford

Law School's Securities Class Action Clearinghouse, available at <http://securities.stanford.edu/index.html>.



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Federal Securities Exchange Act of 1934

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CHAPTER 5A Accountants' Liability Under the Federal Securities Laws

1-5A Federal Securities Exchange Act of 1934 § 5A.02

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§ 5A.02 Liability for False or Misleading Statements Under Section 11 of the Securities Act

Section 11 of the Securities Act imposes liability upon public accountants to every person who acquires a security issued under a registration statement for false or misleading statements or omissions of material facts contained in portions of the registration statement where the accountant, with his consent, is named as having prepared or certified any part of the registration statement or any report or valuation used in connection therewith. n1 Thus, Section 11 provides relief to any purchaser of securities who received or relied upon the particular registration statement regardless of contractual privity or a requirement of a special relationship with the independent accountants. Under Section 11, if the action is brought within the applicable period of limitations, the purchaser is required only to prove that he acquired securities covered by the registration statement, generally suffered a loss and the registration statement contained a misstatement or omission of material importance. The purchaser is not required to allege negligence, reliance, or even a causal connection between the misstatement or omission and the loss. n2 The courts have consistently held, however, that Section 11 remedies cover only shares newly issued under the registration statement. n3

As indicated above, Section 11 exposes the accountant and other experts n4 to liability for material misstatements and omissions in registration statements even without a showing of negligence. But Section 11 liability is limited with respect to accountants, and other experts to those material misrepresentations contained in portions of "the registration statement they have certified or prepared." n5

Section 11(b) provides an accountant with two defenses: n6 "disassociation" or "good faith and due diligence." To establish a "disassociation" defense, the accountant may establish that either prior to the effective date of the registration statement or upon becoming aware of its effectiveness, he had:

- taken appropriate steps to sever the relationship with the issuer;
- advised the accountant, the SEC, and the issuer in writing that such steps had been taken and would not take responsibility for that portion of the registration statement attributed to him; (i.e., withdrew the consent to the use of the accountant's name and report in the registration statement) and
- if the registration statement became effective without the accountant's knowledge, upon becoming

aware of such fact, the accountant "forthwith" advised the SEC given reasonable notice to the public. n7

To demonstrate "good faith and due diligence," the auditor may show that "he had, after reasonable investigation, reasonable grounds to believe and did believe, at the time such part of the Registration Statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein and necessary to make the statements therein not misleading." n8

The scope and applicability of Section 11 (including, the above "due diligence" defense) was explored in the seminal decision of *Escott v. BarChris Construction Corp.* n9 BarChris had been in the business of constructing and installing bowling alleys. During 1961, BarChris sold convertible debentures under a registration statement to raise additional working capital. However, the fortunes of the bowling industry declined that year, primarily due to over-expansion. Consequently, in October 1962, BarChris filed a petition in bankruptcy. Thereafter, an action was brought by the purchasers of the debentures against those potentially liable under Section 11, including BarChris' accountants. The purchasers' claims were based upon alleged misstatements contained in a registration statement that included audited financial statements for the calendar years 1958, 1959, and 1960, as well as interim unaudited statements.

Significantly, the *BarChris* court held that the accountants were not responsible for any misrepresentation contained in the unaudited interim statements because the accountants had not audited those statements. n10 Subsequent cases have confirmed that the liability of accountants under Section 11 is limited to those financial statements included within the auditor's audit opinion. n11 As to the allegedly false audited financial statements, the accountants in *BarChris* pled a "due diligence defense." In holding that the accountants had failed to establish this defense, the court found that the accountants' Form S-1 audit program, n12 as formulated, conformed to the standards of the profession and would have been sufficient to sustain a due diligence defense and thus avoid liability if the BarChris auditors had actually followed the audit program.

The *BarChris* court found, however, that the S-1 review actually conducted by the accountants was inadequate in the following respects: (1) the auditors had not reviewed the minutes of the executive committee and subsidiary meetings, major contracts, important financial records and the prospectus itself; (2) no inquiry was made of BarChris' creditors; and (3) only one officer of the company was interviewed. The court decided that "glib answers" received in response to the auditor's questions should have prompted more questions and that the appearance of "danger signals" should have elicited further investigation. n13 Unfortunately, the court did not illuminate its definition of these terms, nor did it set forth detailed performance standards for the accounting and auditing procedures required. Thus, while the court underscored the importance of thorough examination and independent verification in a review program, the accounting profession received no definitive guidance from the *BarChris* decision for establishing audit procedures and conducting proper audits.

In addition to the defenses set forth in Section 11(b), courts have recognized additional defenses under Section 11, including: (i) lack of "loss causation" (i.e., absence of a causal connection between the misstatement or omission and the loss) and (ii) the "bespeaks caution" doctrine.

As explained in *McKowan Lowe & Co., Ltd. v. Jasmine, Ltd.*, n14 "[i]n contrast with *Rule 10b-5*, loss causation is not a necessary element of the plaintiff's [Section 11] claim. Rather, under Section 11, a defendant may assert loss causation -- more precisely, the lack thereof -- as an affirmative defense." n15 In *McKowan*, the court dismissed a Section 11 claim brought by shareholders against an accounting firm because (among other things) the accountants had "adduced compelling evidence" that (i) the misrepresentations at issue were not publicly corrected until after the company's stock had ceased to be publicly traded and (ii) the company's poor business results (as opposed to any revelation of alleged misrepresentations) caused the value of the company's stock to decline. n16

Under the "bespeaks caution" doctrine, a defendant may not be held liable under Section 11 for alleged misrepresentations in a stock offering if "it cannot be said that any reasonable investor could consider them important in

light of adequate cautionary language set out in the same offering." n17 Thus, in dismissing Section 11 claims brought against an accounting firm and others, the court in *Pew v. Carderelli* stated that "in view of the extensive factual disclosures and cautionary statements, the absence of a going concern qualification [by the accounting firm] did not render the Annual Reports or Registration Statements misleading." n18 The "bespeaks caution" doctrine only applies to forward-looking representations as opposed to material misstatements (or omissions) of historical fact. n19

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 77k(a)(4) (1997 & Supp. 2008). Section 13 of the Securities Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section F, 15 U.S.C. § 77m, provides that an action brought under Section 11 must be brought within one year after the false or misleading statement was or should have been discovered, but no more than three years after the security was offered to the public. In *Finkel v. Stratton Corp.*, 962 F.2d 169, 174 (2d Cir. 1992), it was held that the statute of limitations begins to run on the effective date of the registration statement; and in *Summer v. Land & Leisure, Inc.*, 664 F.2d 965 (5th Cir. 1981), cert. denied, 458 U.S. 1106 (1982) it was held that normal tolling rules do not apply to actions brought under Section 11.

(n2)Footnote 2. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 382 (1983), where the court stated that under Section 11, "[i]f a plaintiff purchased a security issued pursuant to a registered statement, he need only show a material misstatement or omission to establish his *prima facie* case." A plaintiff may be required to prove reliance, however, when he purchases the security after the issuance of an earnings statement covering a period of at least 12 months following the effective date of the registration statement. See 15 U.S.C. § 77k (1997 & Supp. 2008).

Most Circuit Courts have ruled that claims under Section 11 are subject to F.R.Civ. P.9(b) if the plaintiff affirmatively relies on fraud allegations to support such a claim. See *Rombach v. Chang*, 355 F.3d 164, 170 (2d Cir. 2004); *Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 288 (3d Cir. 1992); *Melder v. Morris*, 27 F.3d 1097, 1100 n.6 (5th Cir. 1994); *Sears v. Likens*, 912 F.2d 889, 893 (7th Cir. 1990); *In re Stac Elecs. Secs. Litig.*, 89 F.3d 1399, 1404-05 (9th Cir. 1996). In dictum, the First and Tenth Circuits have also indicated their approval of this approach. See *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1223 (1st Cir. 1996); *Schwartz v. Celestial Seasonings, Inc.*, 124 F.3d 1246, 1252 (10th Cir. 1997). On the other hand, the Eighth Circuit has held that Rule 9(b) does not apply in such circumstances because "fraud" is not an essential element of a claim under Section 11. See, e.g., *Carlton v. Thaman*, 130 F.3d 309, 314 (8th Cir. 1997).

(n3)Footnote 3. *McFarland v. Memorex Corp.*, 493 F. Supp. 631, 641 (N.D. Cal., 1980), citing *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967); see also *Harden v. Raffensperger, Hughes & Co.*, 933 F. Supp. 763, 767 (S.D. Ind. 1996); *Perksy v. Turley*, No. CIV 88-1830-PHX-SMM, CIV. 88-2089-PHX-SMM (consolidated), 1991 U.S. Dist. LEXIS 19841, at *18 (D. Ariz. Dec. 19, 1991).

(n4)Footnote 4. An expert is defined in Sections 7 and 11(a)(4) of the Securities Act and Rule 435 under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G, thereunder as an "accountant engineer or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement or ... [any portion as described herein] ... used in connection with the registration statement." 15 U.S.C. § 77g (1997); 15 U.S.C. § 77k (1997 & Supp. 2008).

(n5)Footnote 5. Section 11(a)(4) expressly provides that an accountant's liability may be predicated on misstatements and omissions present in portions of the registration statements where the accountant "with his consent [has] been named as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement, report or valuation, which purports to have been prepared or certified by him." The cases generally have held that even if part of a registration statement is misleading, there is no accountant liability unless the misleading data can be expressly attributed to the accountant. See, e.g., *Herman &*

MacLean v. Huddleston, 459 U.S. 375, 386 n.22 (1983) ; *Endo v. Arthur Andersen & Co.*, 163 F.3d 463, 466 (7th Cir. 1999) (quoting 15 U.S.C. § 77k(a)(4) (1997)); *Monroe v. Hughes*, 31 F.3d 772, 774 (9th Cir. 1994) (accountant is only liable for those documents he certifies); *Rebenstock v. Deloitte & Touche*, 907 F. Supp. 1059 (E.D. Mich. 1995) (liability is limited to portions prepared or certified by accountant); *McFarland v. Memorex Corp. supra.* at 643 .

(n6)Footnote 6. 15 U.S.C. § 77k (1997 & Supp. 2008).

(n7)Footnote 7. 15 U.S.C. § 77k.

(n8)Footnote 8. 15 U.S.C. § 77k.

(n9)Footnote 9. 283 F. Supp. 643 (S.D.N.Y. 1968) .

(n10)Footnote 10. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 683-4 and 698 (S.D.N.Y. 1968) .

(n11)Footnote 11. See *Endo v. Arthur Andersen & Co.*, 163 F.3d 463, 466 (7th Cir. 1999) (quoting 15 U.S.C. § 77k(a)(4)(1997)); *Monroe v. Hughes*, 31 F.3d 772, 774 (9th Cir. 1994) (accountant is only liable for those documents he certifies); *Grimm v. Whitney-Fildago Seafoods, Inc.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,029 (S.D.N.Y. Dec. 4, 1973); *McFarland v. Memorex Corp.*, 493 F. Supp. 631 at 643 (N.D. Cal. 1980) .

In late 1979, the SEC clarified its position on the liability of accountants for misstatements in a registration statement by adopting a rule providing that a report prepared or audited by an accountant within the meaning of Section 11 shall not include a report by an independent accountant on a review of unaudited interim information. See Fed. Sec. L. Rep. (CCH) P 72,296 (1979). The SEC noted that this rule conformed to existing case law, specifically *BarChris* and *Grimm*, in that the liability of the accountant who consents to be named in a registration statement is limited to those audited financial statements it has certified. See *McFarland v. Memorex Corp.*, 493 F.Supp. at 643 n. 16 .

(n12)Footnote 12. The S-1 review included a review of events subsequent to the date of *BarChris*'s certified 1960 balance sheet to ascertain whether any material changes had occurred in the company's financial position which should be disclosed to prevent the balance sheet figures from being misleading. See 283 F.Supp. at 701 .

(n13)Footnote 13. *Escott v. BarChris, supra* at 701-703 .

(n14)Footnote 14. 2005 U.S. Dist. LEXIS 32164 (D. N.J., June 30, 2005) , *aff'd*, *McKowan Lowe & Co. v. Jasmine, Ltd.*, 231 Fed. Appx. 216, 2007 U.S. App. LEXIS 19774, Fed. Sec. L. Rep. (CCH) P94480 .

(n15)Footnote 15. *Id.* at *36-37 [citing *In re Adams Golf, Inc. Secs. Litig.*, 381 F.3d 267, 277 (3d Cir. 2004)] ; see also 15 U.S.C. § § 77k(e) and 77l(b).

(n16)Footnote 16. 2005 U.S. Dist. LEXIS 32164, at *37 , *aff'd*, *McKowan Lowe & Co. v. Jasmine, Ltd.*, 231 Fed. Appx. 216, 2007 U.S. App. LEXIS 19774 .

(n17)Footnote 17. See *Rombach v. Chang*, 355 F.3d 164, 175 (2d Cir. 2004) (holding registration statement contained sufficient cautionary language to apply "bespeak caution" doctrine); *Halperin v. Ebanker USA.com*, 295 F.3d 352, 357 (2d Cir. 2002) .

(n18)Footnote 18. 2005 U.S. Dist. Lexis 40018, at *27-28 (N.D.N.Y., Mar. 17, 2005) , *aff'd*, *Pew v. Cardarelli*, 164 Fed. Appx. 41, 2006 U.S. App. LEXIS 2132 .

(n19)Footnote 19. See *P. Stolz Family P'ship L.P. v. Daum*, 355 F.3d 92, 96-97 (2d Cir. 2004) . As explained by the *Stolz* court: "The cautionary language associated with the 'bespeaks caution' doctrine is aimed at warning investors that bad things may come to pass -- in dealing with the contingent or unforeseen future. Historical or present fact -- ... is a different matter. Such facts exist and are known; they are not unforeseen or contingent." 355 F.3d at 97 .

Accordingly, "cautionary words about future risk cannot insulate from liability for the failure to disclose that the risk has transpired." *Rombach v. Chang*, 355 F.3d 164, 173 (2d Cir. 2004) .



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CHAPTER 5A Accountants' Liability Under the Federal Securities Laws

1-5A Federal Securities Exchange Act of 1934 § 5A.03

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§ 5A.03 Liability for False or Misleading Statements Under Section 12(2) of the Securities Act

Section 12(2) of the Securities Act provides that "sellers" are liable for material misrepresentations or omissions contained in a "prospectus" or any "oral communications" made in connection with the offer or sale of any security. However, as the U.S. Supreme Court clarified in *Gustafson v. Alloyd Co.*,ⁿ¹ such claims are limited to misrepresentations (or omissions) made in connection with primary or initial offerings of securities and may not arise from misrepresentations (or omissions) made in aftermarket transactions or in private placements not involving use of a "prospectus."

Unlike Section 11, which is expressly limited to material misrepresentations or omissions contained in registration statements filed with the SEC, Section 12(2) liability can be imposed even in connection with transactions exempt from registration under the Securities Act other than those exempted by section 3(a)(2). Moreover, liability can be imposed upon sellers who merely acted negligently.

By its terms, however, liability under Section 12(2) is limited to "sellers" only and does not apply broadly to the "expert" as that term is described in and applied under Section 11. In 1988, the Supreme Court effectively eliminated claims under Section 12(1) against accountants, holding that "liability extends only to the person who successfully solicited the purchase" ⁿ² Most Circuit Courts of Appeal have extended that ruling to cover Section 12(2) claims against accountants, finding that liability is limited to those who either actually sold or solicited investors to purchase securities. ⁿ³

Accordingly, accountants who are merely alleged to have rendered a materially false or misleading opinion or financial statement will escape liability because they are not deemed to be sellers within the literal meaning of Section 12(2). ⁿ⁴

FOOTNOTES:

(n1)Footnote 1. *513 U.S. 561 (1995)* .

(n2)Footnote 2. *Pinter v. Dahl, 486 U.S. 622, 650 (1988)* .

(n3)Footnote 3. *See, e.g., Ackerman v. Schwartz*, 947 F.2d 841 (7th Cir. 1991) ; *Ryder Int'l Corp. v. First Am. Nat'l Bank*, 943 F.2d 1521 (11th Cir. 1991) ; *Mercer v. Jaffe, Snider, Raitt & Huer, P.C.*, 933 F.2d 1008 (6th Cir 1991) ; *Craftmatic Sec. Lit. v. Kraftsow*, 890 F.2d 628 (3d Cir. 1989) ; *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 106 O.&G.R. 444, 106 O.&G.R. 446 (7th Cir. 1989) ; *Moore v. Kayport Package Express, Inc.*, 885 F.2d 531 (9th Cir. 1989) ; *Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1126 (2d Cir. 1989) ; *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988) , *vacated on other grounds*, 109 S. Ct. 3236 (1989) .

(n4)Footnote 4. *See Moore v. Kayport Package Express, Inc.*, 885 F.2d 531 (9th Cir. 1989) . In *Moore*, plaintiff alleged Section 12(2) of the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section F, claims against attorneys and accountants which prepared financial statements used to sell unregistered securities. The Court states that "these professionals are only subject to Section 12(2) liability if they solicited purchases" and that "merely performing professional services, without actively soliciting a purchase of underlying securities does not give rise to liability under Section 12." *Id. at 537* .



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CHAPTER 5A Accountants' Liability Under the Federal Securities Laws

1-5A Federal Securities Exchange Act of 1934 § 5A.04

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§ 5A.04 Liability for Violations of Section 17(a) of the Securities Act

Section 17(a) makes it unlawful for persons in the offer or sale of securities "(1) to employ any device, scheme or artifice to defraud; or (2) to obtain money... by means of any untrue statement ...; or (3) to engage in any transaction... which operates... as a fraud or deceit upon the purchaser." n1 The wording of *Rule 10b-5* was derived from, and is nearly identical to, Section 17(a). n2 Plaintiffs, however, would generally prefer to sue under Section 17(a) because there is no scienter requirement for actions under Sections 17(a)(2) and 17(a)(3). n3 However, most Circuit Courts of Appeal have held that no private cause of action exists under Section 17(a). n4

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C. 77q (1997 & Supp. 2008)*.

(n2)Footnote 2. *Kirshner v. United States*, 603 F.2d 234, 241 (2d Cir. 1978), cert. denied, 442 U.S. 909 (1979) (comparing Sections 10(b) and 17(a)). Section 17(a) of the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section F, contains the more narrow language of "in the offer or sale" while *Rule 10b-5* speaks more broadly in terms of "in connection with the purchase or sale."

(n3)Footnote 3. *SEC v. Electronics Warehouse, Inc.*, 689 F. Supp. 53, 59-60 (D. Conn. 1988), aff'd sub nom, *S.E.C. v. Calvo*, 891 F.2d 457 (2d Cir. 1989), cert. denied, 496 U.S. 942 (1990).

(n4)Footnote 4. See, e.g., *Finkel v. Stratton Corp.*, 962 F.2d 169 (2d Cir. 1992); *Newcome v. Esrey*, 862 F.2d 1099, 1107 (4th Cir. 1988); *Landry v. All American Assurance Co.*, 688 F.2d 381, 391 (5th Cir. 1982); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 943 (7th Cir. 1989); *Deviries v. Prudential-Bache Securities, Inc.*, 805 F.2d 326, 328 (8th Cir. 1986); *In re Washington Public Power Supply System Securities Litigation*, 823 F.2d 1349, 1358 (9th Cir. 1987); *Bath v. Bushkin, Gaims, Gaines and Jonas*, 913 F.2d 817, 819-20 (10th Cir. 1990); *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 784-85 reh'g denied, 841 F.2d 399 (11th Cir. 1988).



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CHAPTER 5A Accountants' Liability Under the Federal Securities Laws

1-5A Federal Securities Exchange Act of 1934 § 5A.05

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§ 5A.05 Liability for Violations of Section 14 of the Exchange Act

Section 14(a) of the Exchange Act and the SEC's related rules make it unlawful to make materially false or misleading statements in soliciting proxies. By its express terms, Section 14(a) applies only to any person who actually solicits proxies and to anyone who "permit[s] the use of his name" in the solicitation. However, the mere appearance of one's name in a proxy statement does not trigger liability for any misstatement appearing therein. Instead, there must have been "a substantial connection between the use of the person's name and the solicitation effort." n1

It is generally recognized that an independent accountant functioning purely as an auditor can rarely meet the "solicitation" or "substantial connection" tests, and therefore accountants are not usually charged as principal violators of Section 14(a). n2

In re Clinton Oil Co. Securities Litigation, n3 is typical of the courts' treatment of accountants in solicitation cases. In *Clinton*, the court held that direct liability could not be imposed upon the independent auditor because the "accounting firm... was not involved in the solicitation of the proxy." n4

FOOTNOTES:

(n1)Footnote 1. *Yamamoto v. Omiya*, 564 F.2d 1319, 1323 (9th Cir. 1977) .

(n2)Footnote 2. Rule 14a-11(b)(6)(iii) under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G, which deals with election contests, contains a clause that expressly excludes from the definition of "participant in a solicitation": "(ii) any person employed by a participant in the capacity of attorney, accountant, or advertising, public relations or financial adviser, and whose activities are limited to the performance of his duties in the course of such employment" (Emphasis added).

(n3)Footnote 3. [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,015 (D. Kan. Mar. 18, 1977).

(n4)Footnote 4. Fed. Sec. L. Rep. (CCH) P 96,015 at 91,576; *see also Adams v. Standard Knitting Mills*, 623 F.2d 422 (6th Cir. 1980) , *cert. denied sub. nom.*, *Adams v. Peat, Marwick, Mitchell & Co.*, 449 U.S. 1067 (1980) ; *Mendell*

v. Greenberg, 612 F. Supp. 1543, 1552 (S.D.N.Y. 1985) , *aff'd in part and rev'd in part*, 1990 U.S. App. LEXIS 19770 (2d Cir. 1990) (accountant is not liable where plaintiff did not allege accountant's direct participation in proxy solicitation).



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Federal Securities Exchange Act of 1934

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CHAPTER 5A Accountants' Liability Under the Federal Securities Laws

1-5A Federal Securities Exchange Act of 1934 § 5A.06

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§ 5A.06 Liability for False or Misleading Statements Under Section 18 of the Exchange Act

To insure the accuracy of the financial and other information contained in the various reports required to be filed with the SEC, Section 18 of the 1934 Act makes any person who makes any "false and misleading" statement in any document "filed" with the SEC under the Exchange Act liable to any person "who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by the statement." n1 Obviously, the scope of an accountant's liability under Section 18 is very narrow, since Section 18 applies only to documents actually filed, and not to all documents sent to, received or reviewed by purchasers. In fact, Rules 14a-3(c) and 14c-5(b) specifically state that annual reports to shareholders are not deemed to be documents "filed" with the Commission for purposes of Section 18.

The reliance requirement under Section 18 has been determined to mean actual "eyeball reliance." In *Heit v. Weitzen*, n2 the Court of Appeals stated that "[r]eliance on the actual 10-K report is an essential prerequisite for a Section 18 action and constructive reliance is not sufficient." n3 Similarly, in *Barotz v. Monarch General Inc.*, n4 the Court held that the "plaintiff must allege that he actually read a filed document or documents, and this he has not done. To this, plaintiff responds that such 'eyeball reliance' should not be necessary. I believe the present law in this circuit supports defendants." n5

Moreover, the plaintiff must prove that his damages were caused "directly" by his reliance on the false or misleading statement. n6 As a result of these strict standards, Section 18 has proved to be an unsatisfying vehicle for imposing liability on accountants. n7

FOOTNOTES:

(n1)Footnote 1. Section 18(a) of the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section F.

(n2)Footnote 2. 402 F.2d 909, 916 (2d Cir. 1968) , cert. denied, 395 U.S. 903 (1969) .

(n3)Footnote 3. 402 F.2d 909 .

(n4)Footnote 4. [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,933 (S.D.N.Y. 1975).

(n5)Footnote 5. Fed. Sec. L. Rep. (CCH) P 94,933 at 97,237. *Accord*, *Ross v. A.H. Robins Co.*, 607 F.2d 545 (2d Cir. 1979) , *cert. denied*, 446 U.S. 946 (1980) ; *Stromfield v. Great Atlantic & Pacific Tea Co., Inc.*, 484 F. Supp. (S.D.N.Y.), *aff'd*, 646 F.2d 563 (2d Cir. 1980) ; *Ross v. Warner*, 480 F. Supp. 268 (S.D.N.Y. 1979) ; *Jacobson v. Peat, Marwick, Mitchell & Co.*, 445 F. Supp. 518 (S.D.N.Y. 1977) ; *Meer v. United Brands Co.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,648, 90,214 (S.D.N.Y. Jul. 6, 1976); *Rich v. Touche Ross & Co.*, 415 F. Supp. 95, 102 (S.D.N.Y. 1976) ; *cf. In re Republic National Life Insurance Co.*, 387 F. Supp. 902, 905 (S.D.N.Y. 1975) .

(n6)Footnote 6. *See, e.g., Walner v. Friedman*, 410 F. Supp. 29, 32 (S.D.N.Y. 1975) ; *Hoover v. Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965) .

(n7)Footnote 7. *Hagert v. Glickman, Lurie, Eiger & Co.*, 520 F. Supp. 1028, 1033 (D. Minn. 1981) (dismissal of Section 18 count against auditors and lawyers where none of the annual reports to shareholders, or the registration statement, and prospectus relied upon were filed with SEC under the Exchange Act but rather solely under the Securities Act); *Heit v. Weitzen*, 402 F.2d 909, 915 (2d Cir. 1968) , *cert. denied*, 395 U.S. 903 (1969) (auditor co-defendant); *Rich v. Touche Ross & Co.*, 415 F. Supp. at 102 (auditor defendant); *Ross v. Warner*, 480 F.Supp. 268 (S.D.N.Y. 1979) (auditor co-defendant); *Jacobson v. Peat, Marwick, Mitchell & Co.*, 445 F. Supp. 518, 525 (S.D.N.Y. 1977) (auditor co-defendant). *But see Magna Investment Corp. v. John Does One Through Two Hundred*, 931 F.2d 38 (11th Cir. 1991) (In action against an accounting firm, Section 18(a) does not require intent to deceive and burden of proof on good faith defense is put on defendant.).



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CHAPTER 5A Accountants' Liability Under the Federal Securities Laws

1-5A Federal Securities Exchange Act of 1934 § 5A.07

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§ 5A.07 Liability for False or Misleading Statements Under Section 10(b) of the Exchange Act

Section 10(b) of the Exchange Act and *Rule 10b-5* promulgated thereunder have been the most fertile source of litigation under the federal securities laws. Section 10(b) makes it "unlawful for any person, directly or indirectly, ... to use or employ, in connection with the purchase or sale of any security ... , any manipulative or deceptive device or contrivance" n1 Although neither Section 10(b) nor *Rule 10b-5* expressly makes accountants subject to liability for improperly certifying financial statements, the statute and the rule are sufficiently broad to provide such relief against accountants. For example, clause (b) of *Rule 10b-5* is potentially applicable to accountant misrepresentations in financial statements since a plaintiff need only establish that "any person" has made "any untrue statement of material fact" or has omitted "to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading." n2

Although such fraudulent misrepresentations or omissions must occur "in connection with" the purchase or sale of any security, courts have applied *Rule 10b-5* to defendants, such as accountants, who are associated with others more directly involved in the wrongful purchase and sale of securities, even though they have not entered into any securities transactions themselves.

Typically, the accountants' liability flows from an independent audit report which (i) states that an audit of a client's financial statements was conducted in accordance with Generally Accepted Auditing Standards ("GAAS") and (ii) opines that those financial statements present fairly, in all material respects, the financial position and results of operation of the client in conformity with Generally Accepted Accounting Principles ("GAAP"). n3

Section 10(b) does not expressly provide for a private cause of action as distinct from, for example, Sections 11 and 12 of the Securities Act and Sections 14, 16 and 18 of the Securities Exchange Act. n4 However, as early as 1946, courts recognized the existence of a private right of action under Section 10(b) and *Rule 10b-5*. n5 That right, consistently held to exist by the federal courts, was eventually recognized by the Supreme Court in 1971. n6

[1] Conduct for Which Liability Under Section 10(b) is Imposed

To prove a Section 10(b) claim, a plaintiff must generally establish that a material misrepresentation or omission was

made with the requisite scienter causing injury in connection with the purchase or the sale of a security. n7 The inherent ambiguities in the statutory language of Section 10(b) have led to innumerable judicial explanations of its scope. n8

In *Santa Fe Industries v. Green*, the Supreme Court considered whether Section 10(b) "reached breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure." n9 The Supreme Court held that it did not, noting that the "language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception." n10

Later, in *Chiarella v. United States*, n11 the Supreme Court considered whether Section 10(b) is violated when a person trades securities without disclosing inside information. The Court held that where the plaintiff's Section 10(b) claim is predicated on an allegation that the defendant failed to disclose material information, the plaintiff must additionally prove that the defendant had assumed a duty to disclose: "Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud. When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak." n12

In *Ernst & Ernst v. Hochfelder*, n13 the Supreme Court held that proof of merely negligent conduct is insufficient to impose liability under *Rule 10b-5* and that some measure of scienter or intentional misconduct is required. The SEC had argued that the broad congressional purposes behind the Act--to protect investors from false and misleading practices that might injure them--suggested that Section 10(b) should also reach negligent conduct. n14 The Supreme Court rejected that argument, concluding that the SEC's interpretation would "add a gloss to the operative language of the statute quite different from its commonly accepted meaning." n15

Although the Supreme Court has never ruled on the issue, most Circuits have held that an inference of fraud (sufficient to satisfy the scienter requirement) can be predicated upon reckless behavior. n16 However, aside from a general consensus that "[a]n inference of fraud does *not* arise from the mere fact that an auditor 'certified' an inaccurate report," n17 courts have disagreed concerning what level of wrongdoing is enough to constitute recklessness. For example, some federal courts have held recklessness to be more in the nature of intentional misconduct as distinguished from gross negligence. Thus, in *Pegasus Fund, Inc. v. Laraneta*, n18 mere inadequate accounting or auditing procedures without a showing of bad faith was not enough for the court to impose liability. n19 In that case, plaintiff and three mutual funds sued Arthur Young & Company, charging the firm with reckless performance of an audit of the funds' financial statements. The basis of the claims was Arthur Young's alleged failure during its audit to properly investigate various transactions relating to the purchase of restricted debentures secured by deeds of trust on realty. Plaintiff's primary charge was that Arthur Young's auditors had failed to discover that the debentures were worthless at the time of the audit.

Plaintiffs in *Pegasus Fund* established that the auditors had not inspected the deeds of trust, but rather, had accepted written and oral assertions that they were first deeds of trust, which could, and apparently did, represent a junior security interest. As a result, the auditors failed to discover that the transactions at issue were part of a fraudulent scheme by certain officer-directors of the mutual funds to siphon the investment capital of the fund through investments made by the fund into corporations the directors owned or controlled.

On those facts, the Ninth Circuit affirmed a lower court grant of summary judgment in favor of the auditors. The court held that the failure to discover the fraud perpetrated on the funds by their officer-directors did not amount to recklessness. Inadequate accounting or auditing without a showing that the accountant acted in "bad faith" was not sufficient to establish a Section 10(b) claim. Quoting language from the Seventh Circuit, the *Pegasus* court summarized:

Even a custom or statutory directive that an auditor who accepts a particular sort of commission must perform a certain "ministerial" accounting task cannot ground the inference that corrupt motives underlie [the very] failure to perform that task. We quite agree that the recklessness that *rule 10b-5* requires must come "closer to being a lesser form of intent [to deceive] than merely a greater degree of

ordinary negligence." n20

Some courts have described recklessness in terms which suggest a closer approximation to negligence (albeit in an extreme form) than the *Pegasus Fund* standard. In *Sharp v. Coopers & Lybrand*, n21 an accounting firm was held liable under Section 10(b) for the reckless conduct of a nonpartner employee. According to the *Sharp* court, "[r]eckless conduct may be defined as a highly unreasonable omission (or misrepresentation), involving not merely simple, or even inexcusable, negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." n22

The *Sharp* case concerned a tax opinion prepared in connection with an oil drilling limited partnership offering. The court found that the jury properly could have determined that the accountant was culpable and reckless in failing to state the tax impact of nonrecourse loans that were not secured by valuable collateral, failing to point out that certain of the partnership loans, critical from a tax point of view, were merely paper loans, and failing to disclose that the accountant, had a relationship with the clients that may have affected his independence. n23 In addition, the court found the accounting firm liable notwithstanding the jury's finding that no partner had "caused any misstatement." The court based its decision in part on the theory that the accounting firm had a special duty to supervise the accountant-employee. n24

As set forth below, although courts continue to grapple with the question of what level of alleged wrongdoing constitutes recklessness, since 1995 this and other matters related to pleading scienter under Section 10(b) have been addressed against the backdrop of the Private Securities Law Reform Act (the "PSLRA"). n25

[2] Pleading Standards

Since the passage of the PSLRA in 1995, the courts have been split in their interpretations of the PSLRA's pleading requirements in order to sufficiently allege scienter, a requisite element of liability under Section 10(b). The PSLRA requires that to sufficiently allege scienter, "the complaint shall, with respect to each act or omission alleged to violate th[e] chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind. " n26 The division among the circuits relates to what gives rise to the requisite "strong inference."

The PSLRA pleading standards as interpreted by the circuit courts are discussed below.

In addition, as also set forth below, the Supreme Court in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* n27 recently clarified an important aspect of the term "strong inference" as used in the PSLRA, but left unresolved the split among the circuits concerning the proper method for pleading scienter under the PSLRA.

[a] The Pleading Standard in the United States Courts of Appeal for the Second and Third Circuits

Prior to the enactment of the PSLRA, the Second Circuit's pleading standard for scienter could be met either "(a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." n28 The Second Circuit held in *Press v. Chemical Inv. Servs. Corp.*, n29 that "[t]he [PSLRA] heightened the requirement for pleading scienter to the level used by the Second Circuit." n30 However, in *Novak v. Kasaks* n31 a little more than one year after deciding *Press*, the Second Circuit, while reaffirming its decision in *Press*, n32 took the position that "Congress's failure to include language about motive and opportunity suggests that we need not be wedded to these concepts in articulating the prevailing standard." n33

Although the Second Circuit arguably applies the most plaintiff-friendly standard for asserting scienter, in *Rothman v. Gregor* n34 that court upheld dismissal of a 10(b) claim brought against an accounting firm on the grounds that the complaint failed to sufficiently plead scienter. In particular, the Second Circuit found that defendant Arthur Andersen's

alleged disregard of certain sales data in issuing its audit opinion did not meet the court's standard for recklessness and as a result the plaintiff failed to adequately plead "facts supporting a strong inference of Andersen's scienter." n35 The court stated: "For recklessness on the part of a non-fiduciary accountant to satisfy securities fraud scienter, such recklessness must be conduct that is highly unreasonable, representing an extreme departure from the standards of ordinary care. It must, in fact, approximate an actual intent to aid in the fraud being perpetrated by the audited company." n36

As discussed at § 5A.07[5], only the SEC (as opposed to private plaintiffs) may assert aiding and abetting claims under Section 10(b). Recently, some district courts in the Second Circuit have held that the SEC must establish "knowing misconduct" (as opposed to simply reckless conduct) to establish such liability. n37

The Third Circuit, in *In re Advanta Corp. Securities Litigation*, n38 in adopting the Second Circuit's standard for pleading scienter after the passage of the PSLRA, held that "it remains sufficient for plaintiffs [to] plead scienter by alleging facts 'establishing a motive and an opportunity to commit fraud, or by setting forth facts that constitute circumstantial evidence of reckless or conscious behavior.'" n39

Subsequently, the Third Circuit in *In re Ikon Office Solutions, Inc. Securities Litigation* n40 held that a Section 10(b) claim against Ernst & Young, LLP ("Ernst") failed because Ernst did not act with scienter. According to the *Ikon* court, to show "recklessness," plaintiffs "must establish ... at a minimum, 'highly unreasonable (conduct), involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, ... which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it' ... [s]imple computation errors or slight accounting mistakes will not suffice to establish scienter." n41 The *Ikon* court further observed that for purposes of Section 10(b) "recklessness" is closer to "intent" than "indifference." n42

[b] The First, Fourth, Fifth, Sixth, Eighth, Tenth and Eleventh Circuits' Standard

The First, Fourth, Fifth, Sixth, Eighth, Tenth and Eleventh Circuits have taken the position that to establish scienter, a plaintiff must at least allege facts giving rise to a strong inference of recklessness, and have expressly rejected the "motive and opportunity" standard accepted by the Second and Third Circuits as sufficient by itself to adequately support a claim of scienter against a motion to dismiss. n43

[c] The Ninth Circuit Standard

The Ninth Circuit has adopted the highest pleading standard for scienter under the PSLRA. In *In re Silicon Graphics Inc. Securities Litigation*, n44 the Ninth Circuit, upon a review of the legislative history of the PSLRA, decided that the PSLRA pleading standard is higher than the Second Circuit's standard. n45 In announcing the pleading standard in the Ninth Circuit, the court stated: "[P]laintiffs proceeding under the PSLRA can no longer aver intent in general terms of mere 'motive and opportunity' or 'recklessness,' but rather, must state specific facts indicating no less than a degree of recklessness that strongly suggests actual intent." n46 In utilizing the term "recklessness," the court explained that "recklessness is a form of intent rather than a greater degree of negligence." n47

[d] The Supreme Court's Decision in *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, n48 the Supreme Court clarified the meaning of the term "strong inference" as used in the PSLRA by holding, *inter alia*, that "[t]o qualify as 'strong' ... an inference of scienter must be at least as compelling as any opposing inference of nonfraudulent intent." n49

In *Tellabs*, plaintiffs instituted a Section 10(b) class action that alleged that Tellabs, Inc. ("Tellabs") and its chief executive officer and president knowingly issued false statements indicating that Tellabs was enjoying strong demand

for its products and earning record revenues when, in fact, the opposite was true. n50 After the district court dismissed plaintiffs' pleading on the ground that it did not adequately allege scienter, n51 the Seventh Circuit reversed this decision. n52 According to the Seventh Circuit, in order to plead "sufficient facts to create a strong inference of scienter," it was enough to "allege facts from which, if true, a reasonable person could infer that the defendant acted with the required intent." n53 In adopting this standard, the Seventh Circuit specifically considered and rejected the stricter standard of the Sixth Circuit, i.e., that "plaintiffs are entitled only to the most plausible of competing inferences." n54

On appeal, the Supreme Court held that the Seventh Circuit's relaxed formulation for alleging a "strong inference" of scienter "did not capture the stricter demand Congress sought to convey" in the PSLRA. n55 Emphasizing that the "strength of an inference cannot be decided in a vacuum," n56 the Supreme Court thus ruled that:

To qualify as 'strong' within the intendment of § 21D(b)(2) [of the PSLRA], we hold, an inference of scienter must be more than merely plausible or reasonable?it must be cogent and at least as compelling as any opposing inference of nonfraudulent intent. n57

Based on the foregoing, under *Tellabs*, allegations of scienter will *not* survive a motion to dismiss as long as a legitimate explanation for claimed misconduct "tips the scales ever so slightly" in defendant's favor against plaintiffs' competing interpretation of the alleged facts. n58

The Supreme Court also stressed in *Tellabs* that the relevant inquiry is "whether *all* of the facts alleged, taken collectively, give rise to a strong inference of scienter, not whether any individual allegation, scrutinized in isolation, meets that standard." n59 In addition, the Court cautioned that "omissions and ambiguities *count against* scienter, for plaintiffs must state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." n60

As the *Tellabs* court failed to resolve the aforementioned division among the circuits concerning the correct PSLRA standard for pleading that a "defendant acted with the required state of mind," n61 courts addressing allegations of scienter after *Tellabs* have generally (i) adhered to their pre-existing pleading standards *and* (ii) added the requirement imposed by *Tellabs* that an inference of fraud must be at least as compelling as any opposing inference of non-fraudulent intent. n62

While it is premature to fully assess the effect of the *Tellabs* decision, it is reasonable to assume that aggrieved shareholders may find it difficult to comply with its strict standards, especially since they generally must allege scienter before obtaining any discovery (which might bolster their case). n63

[3] Violations of Generally Accepted Accounting Principles or Generally Accepted Auditing Standards Do Not on Their Own Rise to the Level of a Violation of Section 10(b)

An issue of great significance to accountants both before and after the enactment of the PSLRA is whether the failure to adhere to GAAP or GAAS may, by itself, constitute recklessness for purposes of determining liability under Section 10(b). As discussed below, the courts have almost uniformly answered this question in the negative.

For example, the Ninth Circuit has held that "[t]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more, does not establish scienter." n64 Addressing the matter in further detail, the Ninth Circuit stated:

The [plaintiff] must prove that the accounting practices were so deficient that the audit amounted to no audit at all, or an egregious refusal to see the obvious, or to investigate the doubtful, or that the accounting judgments which were made were such that no reasonable accountant would have made the

same decisions if confronted with the same facts. n65

Similarly, the Second Circuit stated in *Chill v. General Electric Co.*, n66 that "[a]llegations of a violation of GAAP provisions or SEC regulations, without corresponding fraudulent intent, are not sufficient to state a securities fraud claim." n67

The First Circuit has stated in *dicta* that: "Violations of GAAP standards ... could provide evidence of scienter." However, the court went on to note that "[t]o support even a reasonable inference of scienter ... the complaint must describe the violations with sufficient particularity." n68

By the same token, as emphasized by the court in *In re Bristol-Myers Squibb Sec. Litig.*, a company's financial restatement in and of itself does not provide a basis for inferring scienter. n69 The fact that a corporation later states that earlier recorded transactions should have been treated differently "does not mean, however, that the inaccurate way the transactions were originally recorded was fraudulent." n70

Although bare allegations of violations of GAAP or GAAS (or a corporate restatement) are insufficient, some courts have addressed what additional allegations joined with such alleged violations might be enough to properly plead recklessness against an accountant under Section 10(b). For example, in *In re Suprema Specialties, Inc. Sec. Litig.*, n71 the court held that allegations that an auditor violated GAAS *coupled* with allegations that it turned a blind eye to "red flags" that provided warnings that its clients' financial statements were artificially inflated were sufficient to survive a motion to dismiss. Among others, the "red flags" overlooked in *Suprema Specialties* included (i) astronomical growth in net sales, gross margin and net earnings despite substantially increased negative cash flow, (ii) growth that was radically disproportionate with the performance of the industry as a whole, (iii) weak internal controls and (iv) restrictions on auditor access to key corporate accounting personnel. n72

Moreover, in some cases involving alleged GAAP or GAAS violations, courts have stated that the "sheer magnitude" of the alleged accounting error may permit the inference that the defendant accountant engaged in reckless conduct. n73 On the other hand, other courts have declined to follow those authorities reasoning that "[a]llowing ... an inference of scienter based on the magnitude of fraud would eviscerate the principle that accounting errors alone cannot justify a finding of scienter." n74

[4] Compliance with Generally Accepted Accounting Principles and Generally Accepted Auditing Standards Generally Insulates Accountants from Liability Under Section 10(b)

As previously discussed, in general, violations of GAAP or GAAS do not on their own rise to the level of a violation of Section 10(b). In addition, as recognized by numerous authorities, accountants can, in most instances, insulate themselves from liability by complying with GAAP and GAAS. n75

For example, in *SEC v. Arthur Young & Co.*, n76 the SEC urged that "the proper standard is whether the accountant performed his audit functions in a manner that would have revealed to an ordinary prudent investor, who examined the accountant's audits or other financial statements, a reasonably accurate reflection of the financial risk such an investor presently bears or might bear in the future if he invested in the audited endeavor." In opposition, Arthur Young contended that "good faith compliance with [GAAS] under the circumstances of this case will immunize it from liability under the securities laws." n77 The Ninth Circuit agreed with Arthur Young and held that no more than compliance with GAAS was required of the auditor. n78

Moreover, citing its prior decision in *SEC v. Arthur Young*, the Ninth Circuit held in *Monroe v. Hughes* n79 that "an accountant's good faith compliance with Generally Accepted Accounting Principles and Generally Accepted Auditing Standards discharges the accountant's professional obligation to act with reasonable care." n80

On the other hand, there is authority for the proposition that technical compliance with GAAP may not insulate an accountant from liability under Section 10(b) when the accountant has chosen not to disclose a known material fact or acted in bad faith. This was illustrated in the criminal case, *United States v. Simon*,ⁿ⁸¹ in which the Second Circuit took the position that compliance with GAAP is not enough if the accountant fails to reveal improper conduct it discovers during its audit:ⁿ⁸² "Generally accepted accounting principles instruct an accountant what to do in the usual case where he has no reason to doubt that the affairs of the corporation are being honestly conducted. Once he has reason to believe that this basic assumption is false, an entirely different situation confronts him ... If ... he finds his suspicions [of misconduct] to be confirmed, full disclosure must be made ... " ⁿ⁸³ Similarly, the Ninth Circuit also took this view in *SEC v. GLT Dain Rauscher, Inc.*,ⁿ⁸⁴ holding that compliance with GAAS alone did not immunize an accountant who failed to reveal material facts that were known or which, but for a deliberate refusal to become informed, should have been known.

In an accountant's liability case, the trier of fact often places heavy reliance on expert testimony (offered by both sides) in determining whether the accountant satisfied or departed from the required standard of conduct. Showing the deference generally accorded to compliance with GAAP and GAAS, the court in *Danis v. USN Communications, Inc.*ⁿ⁸⁵ held that "[w]hen qualified experts disagree on whether GAAP and GAAS procedures were properly followed, the accounting procedures *cannot* be deemed reckless" for purposes of determining liability under Section 10(b).ⁿ⁸⁶

[5] The Elimination of Aiding and Abetting Liability Under Section 10(b)

In 1994, in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, the Supreme Court eliminated the long established concept of aiding and abetting liability under Section 10(b) of the Exchange Act for secondary actors (*i.e.*, those other than the purchaser or seller) in a securities transaction, such as attorneys, accountants, underwriters and others.ⁿ⁸⁷ These secondary actors can now be liable only as primary violators of Section 10(b).

The Court used a strict textual analysis of Section 10(b) to override decisions of each United States circuit court,ⁿ⁸⁸ in holding that Congress did not intend liability for aiding and abetting a violation of Section 10(b). The Central Bank of Denver was the indenture trustee of two bond issues. The bond covenants required that the bonds be secured by land appraised at a value of at least 160% of the outstanding principal and interest. Central Bank delayed a second appraisal it had decided was advisable, until after the second offering closed. Plaintiffs purchased the second issue bonds which went into default before the appraisal could be completed.

The Court found that Section 10(b) only prohibits making misrepresentations (or omissions where there is a duty to disclose) and committing manipulative acts; it does not prohibit giving aid to a person who commits a deceptive or manipulative act. This reasoning mandated the rejection of aiding and abetting liability under Section 10(b) because such liability reaches persons who did not engage in the proscribed activities.ⁿ⁸⁹

The Court found further support for its reasoning in the requirement that to recover in an action for primary liability, the plaintiff must show reliance on the defendant's misstatement or omission. Permitting an aiding and abetting action could impose liability on a defendant without any showing that the plaintiff relied upon the aider and abettor's statements or actions.ⁿ⁹⁰ The Court did, however, specifically note that the absence of aiding and abetting liability does not mean that "secondary actors" are immune from Section 10(b) liability. The oft-quoted language is, "Any person or entity, including a lawyer, accountant or bank, who employs a manipulative device or makes a material misstatement [or omission] on which a purchaser or seller of securities relies" may be liable as a primary violator.ⁿ⁹¹ This left open the question of what types of conduct by a secondary actor could constitute primary liability under Section 10(b).

In the years since *Central Bank* was decided, the federal courts have differed over what conduct is required by secondary actors, such as accountants, to incur Section 10(b) primary liability. Two lines of cases have emerged: cases applying the "bright line" test which requires that the defendant must actually make a false or misleading statement to be liable under Section 10(b); and cases applying the "substantial participation" test which imposes primary liability on

secondary actors who play a "significant role" in the creation of the false or misleading statement.

In addition, at least one district court has followed a test proposed by the SEC that potentially makes secondary actors primarily liable under Section 10(b) if they "create" a misrepresentation even if they are not identified with the misrepresentation by name. n92

[a] The "Bright Line" Test

This test and the line of cases that have applied it hold that "if *Central Bank* is to have any real meaning, a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b). Anything short of such conduct is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b)." n93

The Second Circuit has been the strongest advocate of the "bright line" test. For example, in *Wright v. Ernst & Young*, n94 the Second Circuit affirmed the district court's dismissal of securities claims which asserted that an accounting firm was liable for its client's allegedly false and misleading statements because the firm had "reviewed and approved" those "misstatements." n95 In dismissing the action, the *Wright* court held that "a secondary actor cannot incur primary liability under the Act for a statement not attributed to that actor at the time of its dissemination. Such a holding would circumvent the reliance requirements of the Act, as reliance only on representations made by others cannot itself form the basis of liability. Thus, the misrepresentation must be attributed to that specific actor at the time of public dissemination, that is, in advance of the investment decision." n96

In recent years, however, there appears to be a discernable movement towards relaxing the "bright line" test even in courts within the Second Circuit. First, in *Scholastic Corp. Sec. Litig.* n97 (decided after *Wright v. Ernst & Young*), the Second Circuit, itself, upheld a ruling that a company's vice president could be liable under Section 10(b) for misstatements which were *not* specifically attributed to him. In that case, the vice president had been "primarily responsible" for communications with investors, and he had been "involved in the drafting, producing, reviewing and/or disseminating of the false and misleading statements." n98

Subsequently, the Southern District of New York in *In re Global Crossing Ltd. Sec. Litig.* n99 sent a clear signal that strict attribution may not be required to impose primary securities liability on an accountant. In *Global Crossing*, the bulk of the plaintiffs' allegations against Arthur Andersen (Global Crossing's auditors) arose from allegedly misleading public statements made by Global Crossing in various press releases, unaudited quarterly statements and "pro forma" financials concerning improper "swap" transactions engaged in by Global Crossing. On a motion to dismiss, Andersen asserted that it could not be held liable for its client's "misstatements" because (among other things) they were never publicly attributed to Andersen, as required by the Second Circuit's decision in *Wright v. Ernst & Young*. In denying Andersen's motion, the court noted that the Second Circuit's more recent decision in *In re Scholastic Corp. Sec. Litig.* "might indicate some relaxation of *Wright's* [attribution] requirement ... [but] it d[id] not provide any guidance as to when a statement not attributed to a defendant might cross the line into a primary violation." n100 Attempting to supply such guidance, the court adopted the rule that "a plaintiff may state a claim for primary liability under Section 10(b) for a false statement (or omission), *even where the statement is not publicly attributed to the defendant*, where the defendant's participation is substantial enough that s/he may be deemed to have *made* the statement, and where investors are sufficiently aware of the defendant's participation that they may be found to have relied on it as if the statement had been attributed to the defendant." n101 Applying the "participation" element of this rule, the court held that "[a]llegations that Andersen 'prepared, directed or controlled,' 'helped create' or 'materially assisted in preparing false statements' issued by Global Crossing place its involvement well beyond the realm of 'aiding and abetting' liability precluded by *Central Bank*." n102 With respect to attribution, the court emphasized that "it [wa]s undisputed, as a matter of public record, that Andersen's audit reports were included in all of [Global Crossing's] registration statements and annual reports from 1998 to 2000, and that they were widely available to shareholders during the class period," thereby permitting a reasonable inference that Andersen was one of the "makers" of the allegedly false statements and

that investors viewed Andersen as such. n103

The above formulation of the "bright-line" test in *Global Crossing*, which permits "constructive" attribution, appears to be significantly closer to the "substantial participation" test than earlier applications of the "bright-line" test. n104

The Tenth n105 and Eleventh Circuits n106 and courts in the First n107 and Third Circuits n108 have also applied the "bright line" test to determine secondary actor liability under § 10(b). In a recent decision, the Tenth Circuit noted that it has "never adopted an attribution requirement" as part of the "bright line" test in private securities litigation. n109

[b] The "Substantial Participation" Test

The courts applying the "substantial participation" test, led by the Ninth Circuit, hold that secondary actors, such as accountants, can be held primarily liable under Section 10(b) for statements made by others, when they substantially participate or play a significant role in the preparation of the statement. n110 In finding liability for secondary actors under Section 10(b), these courts do not require as high a level of involvement by the secondary actor as the courts that utilize the "bright line" rule. While this view has been primarily limited to the courts in the Ninth Circuit, at least two district courts, one in the Northern District of Illinois and one in the Southern District of Indiana has applied the "substantial participation" test. n111

[c] The SEC Approach Based on the Defendant's Alleged Making of a Misrepresentation

In *Enron Corp. Securities and Derivative Litigation*, n112 the SEC filed an *amicus curiae* brief that argued that the "bright-line test" should not be followed because it serves to provide a safe harbor from primary liability for everyone except for those identified with the alleged misrepresentation by name. n113 As an alternative, the SEC proposed the following rule for primary liability of a secondary party under section 10(b): "when a person, acting alone or with others, creates a misrepresentation [on which the investor-plaintiffs relied], the person can be liable as a primary violator ... if ... he acts with the requisite scienter." Under this proposed rule, "it would not be necessary for a person to be the initiator of a misrepresentation in order to be a primary violator ... Furthermore, 'a person who prepares a truthful and complete portion of a document would not be liable as a primary violator for misrepresentations in other portions of the document.' ... Finally, of course, the plaintiff must plead and prove the elements of scienter and reliance." n114 The *Enron* court adopted the SEC's approach to liability under Section 10(b) and *Rule 10b-5*, stating the view that it was "a reasonable interpretation of the text of the statute and serves its underlying policies." n115

[d] Liability Under Sections 10b-5 (a) and (c)

[i] Cases Prior to the Stoneridge Decision

The vast majority of *Rule 10b-5* cases target false or misleading statements prohibited by subsection (b) of the Rule. Before *Central Bank* eliminated aider and abetter liability, subsections (a) and (c), if they were referred to at all, were usually used to target certain types of manipulative trading activity (such as "churning" and "wash sales."). n116

After *Central Bank*, however, private plaintiffs increasingly attempted to use subsections (a) and (c) of *Rule 10b-5* n117 to extend securities liability to secondary actors based on what is generally referred to as "scheme liability." "Scheme liability" is based on the concept that a party who participates in a fraudulent "scheme" violates 10b-5 even though that party did not make a public misstatement or violate any duty to disclose. n118

Until the Supreme Court's recent *Stoneridge Partners, LLC v. Scientific Atlanta, Inc. decision* n119 (discussed below), a clear division existed among circuit courts concerning the legal viability of "scheme liability." In this regard, the Fifth and Eighth Circuits expressly rejected "scheme liability" holding that *Rule 10b-5* liability requires that a defendant violate a duty to disclose material information and that it is not sufficient to plead that the defendant participated in a "scheme to defraud." n120 In contrast, the Ninth Circuit held that a defendant could be liable as a primary violator of

Rule 10b-5 for participation in a "scheme to defraud" if that party "engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme." n121

In addition, in *In re Global Crossing Ltd. Sec. Litig.* (an accountants' liability case discussed above), n122 the plaintiffs sued defendant Arthur Andersen in the Southern District of New York for alleged violation of 10b-5(a) and (c), as well as asserting false statements under (b). In denying Andersen's motion to dismiss, the court found that plaintiffs had "clearly alleged ... that Andersen committed a manipulative or deceptive act in furtherance of the alleged scheme to defraud." n123 According to the court, "Andersen's allegedly central role" in "*creat[ing]* the accounting schemes used to inflate ... [its client's] financials, ... as their chief architect and executor, leaves no doubt as to its potential liability as a primary violator." n124

[iii] The Supreme Court's Decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*

In early 2008, the Supreme Court issued a 5-3 decision in *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*, n125 which effectively eliminated "scheme liability" as a mechanism to extend primary Section 10(b) liability to secondary actors, such as accountants.

In *Stoneridge*, the class action plaintiffs -- shareholders of Charter Communications, Inc. ("Charter") (a cable operator) -- sought to impose Section 10(b) primary liability on corporate entities who, acting both as customers and suppliers of Charter, allegedly agreed to fraudulent arrangements that allowed Charter to mislead its auditor and issue misleading financial statements that adversely affected Charter's stock price. Notwithstanding this alleged misconduct by the customer/supplier defendants, plaintiffs did *not* assert that those parties had played any role in the preparation or dissemination of Charter's false financial statements. Based on the foregoing, the Supreme Court held that plaintiffs did not assert an actionable Section 10(b) claim against the customer/suppliers because they could not show that they *relied* on any deceptive acts or statements of those defendants. In this regard, the Court emphasized that defendants' alleged deceptive acts "were *not* disclosed to the investing public" and were "too remote to satisfy the requirement of reliance." n126 The Court further stated that it was Charter, not the customer/suppliers, that misled Charter's auditor and filed false financial statements and that nothing that defendants did "made it necessary or inevitable for Charter to record ... [fraudulent] transactions as it did." n127

In determining that plaintiffs could not sustain their Section 10(b) claim against the customer/supplier defendants, the Supreme Court expressly rejected plaintiffs' contention that such liability could be imposed on those parties, even absent a public statement, based on principles of "scheme liability." According to the Court, applying "scheme liability" would not "answer the objection" that the plaintiffs did not, in fact, rely upon the defendant's own "deceptive conduct." n128

Among other things, the Supreme Court also emphasized that adopting plaintiffs' theory of "scheme liability" would "put an unsupportable interpretation on Congress' specific response to *Central Bank* in § 104 of the PSLRA." n129 After the Supreme Court's decision in *Central Bank* eliminated aiding and abetting liability under Section 10(b), Congress included a provision in the PSLRA (§ 104) which authorized Section 10(b) liability for aiders and abettors in SEC actions, but *not* in actions brought by private parties. According to the Supreme Court, if it adopted plaintiffs' broad construction of Section 10(b):

it would revive in substance the implied cause of action against all aiders and abettors except those who committed no deceptive act in the process of facilitating the fraud ... and ... undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants.
n130

In this regard, the Court also noted that it is not necessary to employ "scheme liability" to insure that secondary actors are held accountable for their misconduct because such parties are subject to (i) civil enforcement by the SEC, (ii)

criminal penalties, (iii) certain state securities laws that allow state regulators to seek fines and restitution from aiders and abettors *and* (iv) federal securities law liability when they commit primary violations of Section 10(b). n131

In addition, the Supreme Court stated that applying "scheme liability" to Section 10(b) litigation would improperly expose "a new class of defendants" to the risk that plaintiffs with "weak claims" might use "extensive discovery and the potential for uncertainty and disruption" in such litigation to "extort settlements from innocent companies." n132 According to the Court, expanding potential Section 10(b) liability in this manner might (i) raise "the costs of doing business" if parties find it necessary to protect themselves against the threat of increased litigation, (ii) deter "[o]verseas firms with no other exposure to our securities laws" from doing business in the U.S., (iii) increase "the cost of being a publicly traded company" under U.S. law and (iv) "shift securities offerings away from domestic capital markets." n133

Based on *Stoneridge*, it appears that plaintiffs will not be able to utilize "scheme liability" to expand the reach of Section 10(b) private action beyond cases involving misstatements, omissions by a party who has a duty to disclose or the type of "manipulative" trading activity previously discussed. n134 Nevertheless, it may be argued that the Supreme Court in *Stoneridge* did not intend to categorically foreclose all future applications of 'scheme liability.' In this regard, in *Stoneridge*, the Court observed that applying "scheme liability" to the case before it would extend Section 10(b) liability "beyond the securities markets the realm of financing business to purchase and supply contracts the realm of ordinary business operations." n135 Based on this language, it may be asserted that the Supreme Court left the door open to apply the "scheme liability" concept to litigation arising from what the Court described as the "investment sphere" (an area often involving accountants and other professionals). n136 However, that potential argument was significantly undercut, if not eliminated, by the fact that the Supreme Court subsequently denied plaintiffs' petition for certiorari in *Regents of the Univ. of Cal. v. Credit Suisse First Boston*, n137 which asked the Court to review the Fifth Circuit's refusal to apply "scheme liability" to Section 10(b) claims brought against *banks* allegedly connected to the demise of Enron.

[6] Proportionate Liability and Settlement

Prior to the enactment of the PSLRA in 1995, parties who violated Section 10(b) (and *Rule 10b-5*) were subject to joint and several liability which meant that a defendant could be required to pay an amount greatly in excess of its equitable share of the plaintiff's total damages. Now, under the PSLRA, n138 the imposition of joint and several liability under the Exchange Act is limited to only those defendants who "knowingly" commit securities law violations n139 and the liability of other "violators" is subject to a system of proportionate liability. As such, secondary actors, such as accountants, whose activities do not rise to the level of "knowing" violations, but may satisfy a lower standard of liability, will only be held liable for their proportionate share of the plaintiff's damages.

In addition, the PSLRA laid to rest the often conflicting and confusing framework which previously governed partial settlements in cases brought under the Exchange Act. Resolving this issue, the PSLRA states that "[i]f a covered person enters into a settlement with the plaintiff prior to final verdict or judgment, the verdict or judgment with respect to other defendants shall be reduced by the greater of--(i) an amount that corresponds to the percentage responsibility of that covered person; or (ii) the amount paid to the plaintiff by that covered person." n140

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C. § 78j (1997 & Supp. 2008)*. Rule 10(b)-5, promulgated pursuant to Section 10(b), makes it unlawful for any person:

(a) [t]o employ any device, scheme or artifice to defraud;

(b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order

to make the statements made, in light of the circumstances under which they were made, not misleading;
or

(c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or
deceit

upon any person in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5(b) (2007).

(n2)Footnote 2. 17 C.F.R. § 240.10b-5(b).

(n3)Footnote 3. Financial statements are prepared by an audit client for examination and the expression of an opinion by the auditor. Therefore, Rule 10(b)-5 cases brought against accountants generally turn on the issue of whether the auditor performed its audit examination in a manner indicating that it knowingly or recklessly disregarded or failed to apply GAAS or GAAP or intentionally participated in the audit client's financial statement wrongdoing.

(n4)Footnote 4. The Supreme Court has noted that the "text of § 10(b) does not provide for private claims," and has therefore "made no pretense that it was Congress' design to provide the remedy afforded." *Lampf, Pleva, Lipkind v. Gilbertson*, 501 U.S. 350, 358-359 (1991) ; see *Musick, Peeler & Garrett v. Employers Ins.*, 508 U.S. 286, 291 (1993) ("The private right of action under *Rule 10b-5* was implied by the judiciary on the theory courts should recognize private remedies to supplement federal statutory duties, not on the theory Congress had given an unequivocal direction to the courts to do so."); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976) ("There is no indication that Congress, or the [Securities and Exchange] Commission when adopting *Rule 10b-5*, contemplated such a remedy."). One of the principal drafters of *Rule 10b-5* has remarked "[o]bviously neither I, nor the Commission that promulgated the Rule, had any ... idea [that this Rule was the basis for a private suit] when the Rule was adopted." Milton V. Freeman, *Foreword to Happy Birthday 10b-5: 50 Years of Antifraud Regulation*, 61 *Fordham L. Rev.* 1, 2 (1993).

(n5)Footnote 5. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946) (the very first decision to recognize a private cause of action under Section 10(b) and *Rule 10b-5*).

(n6)Footnote 6. See *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 13 n.9 (1971) ; *Touche Ross v. Redington*, 442 U.S. 560, 577 n.19 (1979) ("[I]n *Superintendent* this Court simply explicitly acquiesced in the 25- year-old acceptance by the lower federal courts of an implied action under § 10(b)"). In 1993, the Supreme Court reaffirmed that private actions under Section 10(b) and *Rule 10b-5* are "an accepted feature of our securities laws, "and that the federal courts have appropriately "accepted and exercised the principal responsibility for the continuing elaboration of the scope" of such actions. *Musick, Peeler & Garrett*, 508 U.S. at 292 ; see also *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983) .

(n7)Footnote 7. See, e.g., *Dirks v. S.E.C.*, 463 U.S. 646, 653 (1983) ; *Chiarella v. United States*, 445 U.S. 222, 234-35 (1980) ; *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 , *reh'g denied*, 425 U.S. 986 (1976) ; *M & B. Contracting Corp. v. Dale*, 795 F.2d 531, 536 (6th Cir. 1986) ; *Zobrist v. Coal-X, Inc.*, 708 F.2d 1511, 1516 (10[th] Cir. 1983) ; *Weitzman v. Stein*, 436 F. Supp. 895, 902-04 (S.D.N.Y. 1977) .

(n8)Footnote 8. See, e.g., *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) ; *Dirks v. S.E.C.*, 463 U.S. 646 (1983) ; *Aaron v. S.E.C.*, 446 U.S. 680 (1980) ; *Chiarella v. United States*, 445 U.S. 222 (1980) ; *Santa Fe Industries Inc., v. Green*, 430 U.S. 462 (1977) ; *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 , *reh'g denied*, 425 U.S. 986 (1976) .

(n9)Footnote 9. 430 U.S. 462, 470 (1977) (Citation omitted).

(n10)Footnote 10. 430 U.S. at 473 .

(n11)Footnote 11. 445 U.S. 222 (1980) .

(n12)Footnote 12. 445 U.S. at 234-235 .

(n13)Footnote 13. 425 U.S. 185 (1976) .

(n14)Footnote 14. 425 U.S. at 198 .

(n15)Footnote 15. 425 U.S. at 198 .

(n16)Footnote 16. *Fine v. American Solar King Corp.*, 919 F.2d 290 (5th Cir. 1990) ; *Mansbach v. Prescott, Ball & Turben*, 598 F.2d. 1017, 1023-25 (6th Cir. 1979) ; *Sanders v. John Nuveen & Co.*, 554 F.2d 790 (7th Cir. 1977) , cert. denied, 450 U.S. 1005 (1981) ; *Van Dyke v. Coburn Enterprises, Inc.*, 873 F.2d 1094, 1100 (8th Cir. 1989) ; *Hackbart v. Holmes*, 675 F.2d 1114, 1117-18 (10th Cir. 1982) ; *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44-47 (2d Cir. 1978) , cert. denied, 439 U.S. 1039 (1978) ; see also *Akin v. Q-L Invest, Inc.*, 959 F.2d 521 (5th Cir. 1992) ; *Arthur Young v. Reves*, 937 F.2d 1310 (8th Cir. 1991) .

(n17)Footnote 17. *Ross v. Warner*, 480 F. Supp. 268, 272 (S.D.N.Y. 1979) (emphasis added); *Weinberger v. Kendrick*, 451 F. Supp. 79, 83 (S.D.N.Y. 1978) (nor can an inference of fraud arise with respect to an auditor by the mere fact that fraud allegedly occurred at the audited company); *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 120 (2d Cir. 1982) . Cf. *Skubik v. Leeds*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,986 at 91,069 (S.D.N.Y. 1981) (financial misstatements do not give rise to an inference that auditors were involved in fraud); *Crystal v. Foy*, 562 F. Supp. 422, 431-432 (S.D.N.Y. 1983) ("the law is clear that the mere fact that a financial report contains overstatements does not *ipso facto* give rise to an inference of impropriety"); *Jacobson v. Peat, Marwick, Mitchell & Co.* 445 F. Supp. 518, 523 (S.D.N.Y. 1977) . See also *CL-Alexanders Laing & Cruickshank v. Goldfeld*, 739 F. Supp. 158 (S.D.N.Y. 1990) , where an investment bank was unable to sustain its claim against an accounting firm which had issued a "comfort letter" in connection with allegedly false projections contained in a prospectus. The comfort letter, included in the prospectus, expressly disclaimed any opinion on the accuracy of the projections and, accordingly, the court found that the bank's claimed reliance on the projections was unreasonable as a matter of law.

(n18)Footnote 18. 617 F.2d 1335 (9th Cir. 1980) .

(n19)Footnote 19. 617 F.2d at 1341 .

(n20)Footnote 20. 617 F.2d at 1341 , quoting *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977) . Regardless of the formulation adopted by a court, recklessness is merely a description of a state of mind that generally in the end must be inferred from evidence constituting behavior. As a result, similar evidence may or may not support a finding of recklessness, depending on how it is viewed by the trier of fact. See *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976) , rev'd, 599 F.2d 1190 (3d Cir. 1979) (negligence but not recklessness); see also *Adams v. Standard Knitting Mills, Inc.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,683 (E.D. Tenn. May 19, 1976) (fraud by auditor), rev'd, 623 F.2d 422 (6th Cir. 1980) (negligence in part, innocent behavior in part), cert. denied sub nom, *Adams v. Peat, Marwick, Mitchell & Co.*, 449 U.S. 1067 (1980) .

(n21)Footnote 21. 457 F. Supp. 879 (E.D. Pa. 1978) , aff'd in part, vacated in part, 649 F.2d 175 (3d Cir. 1981) .

(n22)Footnote 22. 457 F. Supp. at 889 (citations omitted). See also *SEC v. Infinity Group Co.*, 212 F.3d 180, 192 (3d Cir. 2000) , cert. denied, 532 U.S. 905 (2001) ; *McLean v. Alexander*, 599 F.2d 1190, 1197-98 (3d Cir. 1979) .

(n23)Footnote 23. As noted above, this case suggests that gross negligence may be sufficient to constitute "recklessness." However, this raises the question as to how "gross" the accountant's negligence must be to amount to

"recklessness." In *Hubshman v. Alexander Grant & Co.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,923, 91,485 (S.D.N.Y. Mar. 7, 1977), the court observed:

While, taken separately, these claims might only be indicative of negligence or professional malpractice, when taken together they may read to support plaintiff's allegations of a pattern of behavior from which plaintiffs may draw an inference of scienter. ...

See also Magna Inv. Corp. v. John Does One Through Two Hundred, 931 F.2d 38 (11th Cir. 1991) (severe recklessness by an accounting firm would satisfy the scienter requirement).

(n24)Footnote 24. Liability was also predicated on Section 20 of the Exchange Act which provides that a person "controlling" any person liable under the Exchange Act is likewise liable unless "the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation." *See Sharp v. Coopers & Lybrand*, *supra* at 891. *But see Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986) (accounting firm not liable under Section 20(a) as controlling person, since control involves the power to direct the activities of an issuer and does not arise merely from providing advice and counsel).

(n25)Footnote 25. The PSLRA, enacted in 1995, was a reaction to the perceived abusive use of the federal securities laws against accountants and others. Since the potential exposure of accountants and others to damage claims sought in class actions brought by investors was enormous, and since damage awards were generally rendered on a "joint and several" basis, the impetus to settle even highly questionable claims to avoid potentially catastrophic financial consequences, was strong. The PSLRA sought to readjust the balance.

(n26)Footnote 26. 15 U.S.C. § 78u-4(b)(2) (1997 & Supp. 2008).

(n27)Footnote 27. ___ U.S. ___, 127 S. Ct. 2499 (2007) .

(n28)Footnote 28. *Shields v. Citytrust Bancorp, Inc.* 25 F.3d 1124, 1128 (2d Cir. 1994) . Prior to PSLRA's enactment, the Ninth Circuit adopted a standard for pleading scienter which was less demanding than the above Second Circuit test: "[P]laintiffs may aver scienter *generally* ... simply by saying that scienter existed." *In re GlenFed, Inc. Securities Litigation*, 42 F.3d 1541, 1545 (9th Cir. 1994) (emphasis added). However, as will be discussed below, based on its interpretation of the PSLRA's effect on the standard for pleading scienter, the Ninth Circuit subsequently raised its required standard to a level *higher* than that used by the Second Circuit. *See In re Silicon Graphics Inc. Securities Litigation*, 183 F.3d 970 (9th Cir. 1999) .

(n29)Footnote 29. 166 F.3d 529 (2d Cir. 1999) .

(n30)Footnote 30. 166 F.3d at 537-538 (restating the standard previously set forth in *Shields*). *See also Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital, Inc.*, 531 F.3d 190, 195 (2d Cir. 2008) (properly alleging motive and opportunity to commit fraud raises a strong inference of scienter); *Bay Harbour Mgmt. LLC v. Carothers*, 282 Fed. Appx. 71, 74 (2d Cir. 2008) (PSLRA's pleading standard requires plaintiff to allege either both motive and opportunity or strong circumstantial evidence of conscious misbehavior or recklessness).

(n31)Footnote 31. 216 F.3d 300 (2d Cir. 2000) , *cert. denied*, 531 U.S. 1012 (2000) .

(n32)Footnote 32. *See* 216 F.3d at 310 ("We conclude that the PSLRA effectively raised the nationwide pleading standard to that previously existing in this circuit and no higher (with the exception of the 'with particularity' requirement)."); *see also Levitt v. Bear Stearns & Co.*, 340 F.3d 94, 104 (2d Cir. 2003) , *vacated*, *Levitt v. Rogers*, 257 Fed. Appx. 450 ; *In re Scholastic Corp. Securities Litigants*, 252 F.3d 63, 74 (2d Cir.) , *cert. denied*, 534 U.S. 1071, 122 S. Ct. 678, 151 L. Ed. 2d 590 (2001) (citing *Novak*).

(n33)Footnote 33. 216 F.3d at 310-311 ("Although litigants and lower courts need and should not employ or rely on magic words such as 'motive and opportunity,' we believe that our prior case law may be helpful in providing guidance as to how the 'strong inference' standard may be met."). See also *Kalnit v. Eichler*, 264 F.3d 131, 139 (2d Cir. 2001) .

(n34)Footnote 34. 220 F.3d 81 (2d Cir. 2000) .

(n35)Footnote 35. 220 F.3d 81, 98 .

(n36)Footnote 36. 220 F.3d 81, 98 (quoting *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 120-21 (2d Cir. 1982)) (internal quotations omitted).

(n37)Footnote 37. *SEC v. Cedric Kushner Promotions, Inc.*, 417 F. Supp. 2d 326, 335 (S.D.N.Y. 2006) (emphasis added). As detailed later (§ 5A.07[5]), (i) private aiding and abetting claims under 10(b) are barred by the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994) and (ii) the PLSRA provides specific authority to the SEC to bring 10(b) aiding and abetting claims in court actions. Apparently, the *Kushner* court concluded that the provision of the PSLRA that permits aiding and abetting claims by the SEC also establishes "knowing misconduct" as the required level of scienter to impose aiding and abetting liability in a SEC action. 417 F. Supp. 2d at 335 .

See also *SEC v. KPMG LLP*, 412 F. Supp. 2d 349, 372-75 (S.D.N.Y. 2006) . But see *SEC v. Penthouse Int'l, Inc.*, 390 F. Supp. 2d 344, 355 (S.D.N.Y. 2005) (holding that recklessness was sufficient to establish 10(b)(5) aiding and abetting liability); *SEC v. Koenig*, 2007 U.S. Dist. LEXIS 26088 at **24-25 (N.D. Ill. April 5, 2007); *SEC v. Milan Capital Group, Inc.*, 2000 U.S. Dist. LEXIS 16204, at *27 (S.D.N.Y. Nov. 9, 2000) .

(n38)Footnote 38. 180 F.3d 525 (3d Cir. 1999) .

(n39)Footnote 39. 180 F.3d at 535 (while the Second Circuit may have stepped away from "motive and opportunity" in *Novak*, those magic words should remain sufficient in the Third Circuit for now).

(n40)Footnote 40. 277 F.3d 658 (3d Cir. 2002) .

(n41)Footnote 41. 277 F.3d at 667 (citations omitted).

(n42)Footnote 42. 277 F.3d at 667 . Likewise, in dismissing a Section 10(b) claim against corporate officers, the *Advanta* court described the applicable definition of a reckless statement as "involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." 180 F. 3d at 539 (quoting *McLean v. Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979)) . In deciding that defendants' alleged decision to implement aggressive techniques to attract new customers without accounting for the increased risks did not constitute recklessness, the *Advanta* court found that such actions did not demonstrate an extreme departure from the standards of ordinary care, and were at most simple mismanagement). See 180 F.3d at 540 . See also *Key Equity Investors Inc. v. Sel-Leb Marketing, Inc.*, 246 Fed. Appx. 780, 787 (3d Cir. 2007) ("[t]he mere fact of a misstatement is not evidence of recklessness"); *In re Tyson Foods, Inc.*, 155 Fed. Appx. 53, 57 (3d Cir. 2005) ; *In re Intelligroup Sec. Litig.*, 527 F. Supp. 2d 262, 283 (D.N.J. 2007) ; *Fox Int'l Rels. v. Fiserv Secs., Inc.* , 490 F. Supp. 2d 590, 608 (E.D. Pa. 2007) .

(n43)Footnote 43. See *In re Cabletron Systems, Inc.*, 311 F.3d 11, 39 (1st Cir. 2002) (" 'catch-all allegations' which merely assert motive and opportunity, without something more, fail to satisfy the PSLRA"); *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 197 (1st Cir. 1999) ("[M]erely pleading motive and opportunity, regardless of the strength of the inferences to be drawn of scienter, is not enough".); *Geffon v. Micrion Corp.*, 249 F.3d 29, 36 (1st Cir. 2001) (citing *Greebel*); *Ottmann v. Hanger*, 353 F.3d 338, 344 (4th Cir. 2003) (to determine the sufficiency of scienter

pleading courts should examine *all* of the allegations as opposed to limited categories of alleged facts, such as those related to motive and opportunity); *Ind. Elec. Workers' Pension Trust Fund Ibew v. Shaw Group, Inc.*, 537 F.3d 527, 533-34 (5th Cir. 2008) (allegations of motive and opportunity standing alone will not suffice to support a strong inference of scienter); *Goldstein v. MCI WorldCom*, 340 F.3d 238, 246 (5th Cir. 2003) ("We have concluded that '[a]ppropriate allegations of motive and opportunity may meaningfully enhance the strength of the inference of scienter,' but that allegations of motive and opportunity, without more, will not fulfill the pleading requirements of the PSLRA"); *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 412 (5th Cir. 2001) ; ("[I]t would seem to be a rare set of circumstances" where allegations of motive and opportunity "alone are both sufficiently persuasive to give rise to a scienter inference of the necessary strength"); *Ley v. Visteon Corp.*, 2008 U.S. App. LEXIS 20994 ; 2008 FED App. 0360P (6th Cir. Oct. 6, 2008) (holding that plaintiffs' motive and opportunity allegations did not raise an inference of scienter and noting that allegations of motive and opportunity alone will not meet PSLRA pleading requirements); *Miller v. Champion Enterprises Inc.*, 2003 U.S. App. LEXIS 20431 *20 (6th Cir. 2003) ("[F]or statements of present or historical fact, the state of mind required is recklessness ... [which] is defined as 'highly unreasonable conduct which is an extreme departure from the standards of ordinary care' "); *Hoffman v. Comshare, Inc. (In re Comshare Inc. Sec. Litig.)*, 183 F.3d 542, 551 (6th Cir. 1999) ("[W]e hold that plaintiffs may meet PSLRA pleading requirements by alleging facts that give rise to a strong inference of reckless behavior but not by alleging facts that illustrate nothing more than a defendant's motive and opportunity to commit fraud"); *Helwig v. Vencor, Inc.*, 251 F.3d 540, 550 (6th Cir. 2000) (citing *Comshare*); *Kushner v. Beverly Enters.*, 317 F.3d 820, 829 (8th Cir. 2003) (Scienter may be pled by alleging severe recklessness involving "highly unreasonable omissions or misrepresentations amounting to an extreme departure from the standards of ordinary care ... that present a danger of misleading buyers or sellers which is either known to the defendant or is so obvious that the defendant must have been aware of it."); *Chen v. Navarre Corp. (In re Navarre Corp. Secs. Litig.)*, 299 F.3d 735, 745 (8th Cir. 2002) (The scienter pleading "standard is not satisfied by any one particular method, such as the motive-and-opportunity formulation adopted by the Second Circuit, but rather through various criteria developed throughout the circuits that look for badges of fraud") (citation omitted); *Florida State Bd. of Admin. v. Green Tree Financial Corp.*, 270 F.3d 645, 661 (8th Cir. 2001) (allegations of "unusual heightened showing of motive to commit fraud may be sufficient to plead scienter"); *Caprin v. Simon Transp. Servs.*, 99 Fed. Appx. 150, 161 (10th Cir. 2004) (allegations of motive and opportunity alone cannot establish scienter, but they may be considered in the context of the totality of the circumstances); *Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1191 (10th Cir. 2003) ("While ... evidence of motive and opportunity does not in itself establish a strong inference of scienter, we consider it in reviewing the 'totality of the pleadings' "); *City of Philadelphia v. Fleming Companies, Inc.*, 264 F.3d 1245, 1261-62 (10th Cir. 2001) ("Allegations of motive and opportunity ... are typically not sufficient in themselves to establish a 'strong inference' of scienter."); *Bryant v. Dupree*, 252 F.3d 1161, 1163 (11th Cir. 2001) ("[I]n order to meet the PSLRA's heightened pleading requirement, a plaintiff must plead with particularity facts which give rise to a strong inference that the defendant acted in a severely reckless fashion, but ... allegations of motive and opportunity, without more do not meet this burden"); *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1287 (11th Cir. 1999) ("We conclude that in the Eleventh Circuit, a securities fraud plaintiff must plead scienter with particular facts that give rise to a strong inference that the defendant acted in a severely reckless manner ... we hold that a showing of mere motive and opportunity is insufficient to plead scienter.").

(n44)Footnote 44. 183 F.3d 970 (9th Cir. 1999) . See also *Saeger v. Pacific Life Ins. Co.*, 94 Fed. Appx. 544 (9th Cir. 2004) .

(n45)Footnote 45. See 183 F.3d at 979 .

(n46)Footnote 46. 183 F.3d at 979 .

(n47)Footnote 47. 183 F.3d at 977 . In affirming the dismissal of Section 10(b) claims against corporate officers, the *Silicon* court found that positive statements made by corporate officers followed by a downturn in the corporation's business were not reckless. See also *Metzler Inv. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049, 1065-66 (9th Cir. 2008) (relying on the Ninth Circuit's pre-*Tellabs* decisions interpreting the PSLRA's scienter requirement, court noted that a plaintiff must allege facts that strongly suggest actual intent); *Betz v. Trainer Wortham & Co.*, 519 F.3d 863,

867-68 (9th Cir. 2008) (mere motive and opportunity does not support a strong inference of deliberate recklessness); *Livid Holdings, Ltd. v. Salomon Smith Barney, Inc.*, 416 F.3d 940, 948 (9th Cir. 2005) ("To show a strong inference of deliberate recklessness, plaintiffs must state facts that come closer to demonstrating intent as opposed to motive and opportunity [to commit fraud]."); *Broudo v. Dura Pharms., Inc.*, 339 F.3d 933, 940 (9th Cir. 2003), rev'd, 544 U.S. 336 (2005) ("[T]he pleading requirement for the element of scienter in a securities fraud case is high" in that the allegations must "create a strong inference that defendants acted with deliberate or conscious recklessness"). But c.f. *Berson v. Applied Signal Technology, Inc.*, 527 F.3d 982, 987-88 (9th Cir. 2008) (recognizing an inference of intent to deceive as sufficient under the PSLRA without particularized allegations about defendants' access to the relevant information where plaintiffs alleged the information was so important to the company that the defendant directors must have known about it).

(n48)Footnote 48. ___ U.S. ___, 127 S. Ct. 2499 (2007) .

(n49)Footnote 49. 127 S. Ct. at 2504-05 .

(n50)Footnote 50. *Id.* at 2505 .

(n51)Footnote 51. *Johnson v. Tellabs, Inc.*, 02 Civ. 4356 (N.D. Ill. 2002).

(n52)Footnote 52. 437 F.3d 588 (7th Cir. 2006) .

(n53)Footnote 53. *Id.* at 602 .

(n54)Footnote 54. *Id.* at 602 [citing *Fidel v. Farley*, 392 F.3d 220, 227 (6th Cir. 2004)] . See also 127 S. Ct. at 2504 .

(n55)Footnote 55. 127 S. Ct. at 2504 .

(n56)Footnote 56. *Id.* at 2510 .

(n57)Footnote 57. *Id.* at 2504-05 .

(n58)Footnote 58. *New Jersey v. Sprint Corp.*, 531 F. Supp. 2d 1273, 1281 (D. Kan. 2008) .

Some federal courts have recently expressed the view that the strict pleading standard mandated by *Tellabs* did not change (or dramatically alter) prior law in this area. For example, in *Central Laborers' Pension Fund v. Integrated Electrical Services Inc.*, 497 F.3d 546, 551 (5th Cir. 2007) , the Fifth Circuit interpreted *Tellabs* as strengthening its pre-existing view that the court should "engage in some weighing of the allegations to determine whether the inferences toward scienter are strong or weak" [quoting *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 867 (5th Cir. 2003)] . See also *Dotson v. Collins*, 2008 U.S. App. LEXIS 1120 at *11 (6th Cir. Jan. 15, 2008) (noting that *Tellabs* court "recently reiterated" the controlling pleading requirements) (emphasis added); *Middlesex Retirement System v. Quest Software Inc.*, 527 F. Supp. 2d 1164, 1181 (C.D. Cal. 2007) ; *Elam v. Neidorff*, 502 F. Supp. 2d 988, 993-995 (E.D. Mo. 2007) .

(n59)Footnote 59. 127 S. Ct. at 2509 .

In addition, although the court in *Mizzaro v. Home Depot, Inc.*, 2008 U.S. App. LEXIS 21091 at **13-14 (11th Cir. Oct. 8, 2008), recognized that the Supreme Court had clarified the meaning of the term "strong inference" in *Tellabs*, it noted that *Tellabs* failed to address more specific issues concerning how courts should evaluate allegations to determine whether the inference of scienter is "cogent and compelling."

(n60)Footnote 60. *Id.* at 2511 (emphasis added).

(n61)Footnote 61. 15 U.S.C. § 78u-4(b)(2) (1997 & Supp. 2008).

(n62)Footnote 62. For example, after *Tellabs* was decided, the Second Circuit reiterated in *ATSI Communications Inc. v. Wolfson*, 493 F.3d 87, 99 (2d Cir. 2007) that the basic test for pleading scienter *remained* whether plaintiff had alleged facts "(1) showing that the defendants had both motive and opportunity to commit fraud or (2) constituting strong circumstantial evidence of conscious misbehavior or recklessness." However, based on *Tellabs*, the *ATSI* court also stated that for an "inference of scienter to be strong [enough to satisfy the PSLRA], 'a reasonable person [must] deem [it] cogent and *at least as compelling* as any opposing inference one could draw from the facts alleged.'" *Id.* (quoting *Tellabs*) (emphasis in original).

Likewise, in *Key Equity Investors Inc. v. Sel-Leb Marketing Inc.*, 246 Fed. Appx. 780, 786, (3d Cir. 2007) (decided after *Tellabs*), the Third Circuit made it clear that *Tellabs* supplemented, but did *not* replace, its pre-*Tellabs* standard for pleading scienter under the PSLRA, stating, *inter alia*, that plaintiffs must allege facts that either show "motive and opportunity" to commit fraud or which constitute "strong circumstantial evidence of conscious misbehavior or recklessness."

In addition, in *In re Winn-Dixie Stores, Inc. Sec. Litig.*, 531 F. Supp. 2d 1334, 1349 (M.D. Fla. 2007), the court acknowledged the *Tellabs* decision, but noted that 'the Eleventh Circuit continues to "'adhere to the rule that a showing of severe recklessness [is needed] to satisf[y] the scienter requirement' " (citations omitted). Similarly, the First Circuit and at least one court in the Ninth Circuit have confirmed in post-*Tellabs* decisions that those circuits continue to follow their preexisting standards for pleading scienter. See *ACA Financial Guaranty Corp. v. Avest, Inc.*, 512 F.3d 46, 58 (1st Cir. 2008) ("a plaintiff may satisfy the scienter requirement with a showing of either conscious intent to defraud or a high degree of recklessness") [quoting *Aldridge v. A.T. Cross Corp.*, 284 F.3d 72, 82 (1st Cir. 2002)] ; *Tripp v. IndyMac Bancorp, Inc.*, 2007 U.S. Dist. LEXIS 95445 at * 5 (C.D. Cal. Nov. 29, 2007) .

(n63)Footnote 63. See Jonathan D. Glater, *Wave of Lawsuits Over Losses Could Hit a Wall*, New York Times, May 8, 2008, at C1.

(n64)Footnote 64. *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1426 (9th Cir. 1994) . See also *Sparling v. Daou (In re Daou Sys.)*, 411 F.3d 1006 (9th Cir. 2005) , cert. denied, *Daou Sys. v. Sparling*, 546 U.S. 1172, 126 S. Ct. 1335, 164 L. Ed. 2d 51 ; *In re Hansen Natural Corp. Sec. Litig.*, 527 F. Supp. 2d 1142, 1157 (C.D. Cal. 2007) .

(n65)Footnote 65. 35 F.3d 1407 (quoting *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1240 (S.D.N.Y. 1992) (internal quotations omitted). Citing *Worlds of Wonder*, the United States District Court for the Southern District of California stated: "[V]iolations of GAAP or GAAS, standing alone, do not constitute reckless conduct sufficient to establish scienter under *Rule 10b-5*." *Reiger v. Altris Software, Inc.*, 1999 U.S. Dist. LEXIS 7949, at *22 (S.D. Cal. Apr. 30, 1999) .

(n66)Footnote 66. 101 F.3d 263 (2d Cir. 1996) .

(n67)Footnote 67. 101 F.3d at 270 ; see also *Stevelman v. Alias Research Inc.*, 174 F.3d 79, 84 (2d Cir. 1999) (citing *Chill*); but see *Jacobs v. Coopers & Lybrand*, 1999 U.S. Dist. LEXIS 2102, at *44 (S.D.N.Y. Mar. 1, 1999) ("Failing to adhere to one or two Auditing Interpretation may be only negligence, but Coopers is alleged to have disregarded many different Auditing Interpretations. Based on the facts as alleged, a trier of fact could find Cooper's audit so reckless that Coopers should have had knowledge of the underlying fraud."). See also *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994) ("boilerplate averments that the accountants violated particular accounting standards are not, without more, sufficient to support inferences of fraud"); *Ley v. Visteon Corp.*, 2008 U.S. App. LEXIS 20994 at *39-40 , 2008 FED App. 0360P (6th Cir. Oct. 6, 2008) (GAAS violations alone insufficient to raise a strong inference of scienter); *Ind. Elec. Workers' Pension Trust Fund Ibeu v. Shaw Group, Inc.*, 537 F.3d 527, 534 (5th Cir. 2008) (mere publication of inaccurate accounting figures, or failure to follow GAAP, without more, does not establish scienter); *Wyser Pratte Mgmt. Co. v. Telxon Corp.*, 413 F.3d 553 (6th Cir. 2005) ("The failure to follow GAAP ... does

not by itself establish fraud on the part of an outside auditor."); *In re Corning, Inc. Sec. Litig.*, 2005 U.S. App. LEXIS 5259, at *n.5 (2d Cir. 2005) ("Allegations of generally accepted accounting principles violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim"); *In re Comshare, Inc. Sec. Litig.*, 183 F.3d 542, 553 (6th Cir. 1999) ("The failure to follow GAAP is, by itself, insufficient to state a securities fraud claim"); *In re Faro Technologies Secs. Litig.*, 534 F. Supp. 2d 1248, 1266 (M.D. Fla. 2008) (court stated that pleading standard for claim asserted against an auditor is "particularly high" and that alleged violations of GAAP do not satisfy "scienter" requirement); *In re Intelligroup Sec. Litig.*, 527 F. Supp. 2d 262, 354-364 (D.N.J. 2007) (allegations of scienter based on violations of GAAP and inaccurate Sarbanes-Oxley certifications were legally insufficient); *In re Refco, Inc. Sec. Litig.*, 503 F. Supp. 2d 611, 657-58 (S.D.N.Y. 2007) (the standard for pleading scienter on the part of an accountant requires more than a failure to follow GAAP); *In re Polaroid Corp. Secs. Litig.*, 465 F. Supp. 2d 232, 248 (S.D.N.Y. 2006) ("[t]hat KPMG may have violated generally accepted auditing standards by basing its going concern decision in part on DKW's representations may establish a lack of thoroughness, but it does not, without more, demonstrate recklessness"); *In re Datatec Sys. Sec. Litig.*, No. 04-CV-525 (GEB), 2006 U.S. Dist. LEXIS 78843 at **34-35 (D.N.J. Oct. 30, 2006) ("[a]llegations of GAAP violations or accounting irregularities, standing alone, are insufficient to state a securities fraud claim") (quotation omitted); *In re Smith-Gardner Securities Litig.*, Fed. Sec. L. Rep. P 91,732 at 98,400 (S.D. Fla. 2002) (mere GAAP violation inadequate to meet "scienter" requirement); *Reiger v. Price Waterhouse Coopers LLP*, 117 F. Supp. 2d 1003, 1009 (S.D. Cal. 2000), *aff'd sub nom.*, *DSAM Global Value Fund v. Altris Software, Inc.*, 288 F.3d 385 (9th Cir. 2002) (violations of GAAP, without more, may establish negligence, but do not establish "scienter"); *Danis v. USN Communications, Inc.*, 121 F. Supp.2d 1183, 1194 (N.D. Ill. 2000) ("Merely establishing GAAP violations does not prove Deloitte acted with scienter"); *Cheney v. Cyberguard Corp.*, [2000-2001 Transfer Binder] Fed. Sec. L. Rep. P 91,258 at 95,416 (S.D. Fla. 2000) *on reconsideration rev'd on other grounds*, 2001 U.S. Dist. LEXIS 25485 (S.D. Fla., March 20, 2001) (court stated that violations of GAAP and GAAS "alone are insufficient").

(n68)Footnote 68. *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 203 (1st Cir. 1999). *See also In re Stone & Webster, Inc.*, 414 F.3d 187 (1st Cir. 2005).

(n69)Footnote 69. 312 F. Supp. 2d 549, 565 (S.D.N.Y. 2004). Based on this decision, the *In re Bristol-Myers* court entered a judgment which dismissed the Consolidated Class Action Complaint with prejudice. Subsequently, pursuant to a joint motion by all parties, the court vacated this judgment for settlement purposes.

See also Funke v. Life Fin. Corp., 237 F. Supp. 2d 458, 468 (S.D.N.Y. 2002) (restatement of financials and allegations of repeated violations of GAAP are not sufficient to plead conscious misbehavior); *In re Galileo Corp. Shareholders Litig.*, 127 F. Supp. 2d 251, 270 (D. Mass. 2001) (court rejected argument that necessity of restatement demonstrated fraud "because error is acknowledged").

(n70)Footnote 70. *Levine v. Safeguard Health Enters.*, 2000 U.S. Dist. LEXIS 16039, *16 (C.D. Cal., Sept. 12, 2000), *rev'd on other grounds*, 2002 U.S. App. LEXIS 2995 (9th Cir. Feb. 22, 2002).

(n71)Footnote 71. 438 F.3d 256 (3d Cir. 2006).

(n72)Footnote 72. 438 F.3d at 279-281. *See also In re Paincare Holdings Sec. Litig.*, 541 F. Supp. 2d 1283 (M.D. Fla. 2008) (complaint that alleged "massive restatement" and defendants' knowledge of GAAP violations found legally sufficient); *Jefferson Ins. Co. v. Rouhana (In re Winstar Communs.)*, 2006 U.S. Dist. LEXIS 7618, at *n.7 (S.D.N.Y., Feb. 27, 2006) (allegations of scienter against auditor properly predicated upon alleged violations of GAAP and GAAS and auditor's alleged reckless disregard of "red flags"); *United States SEC v. Gold*, 2006 U.S. Dist. LEXIS 87042 at **11-12 (E.D.N.Y. Aug. 18, 2006) ("scienter may be inferred where an auditor consciously disregards 'red flags' or substantially ignores GAAS"); *In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1344 (S.D. Fla. 1999) [scienter properly pled against an accounting firm charged with GAAS violations because (among other things) firm was allegedly "tipped off" by an employee of its client that the client had overstated certain reserves]; *In re Health Management, Inc. Sec. Litig.*, 970 F.Supp. 192, 203 (E.D.N.Y. 1997) (allegations that an accounting firm violated

GAAS together with allegations that it ignored certain "red flags," including an analyst letter which warned of artificially inflated accounts receivable levels, were sufficient to withstand a motion to dismiss). On the other hand, the court in *Cheney v. Cyberguard Corp.*, [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,258 at 95,417 (S.D. Fla. 2000), held that an accounting firm's alleged failure to address certain "red flags" (e.g., the allegation that the client was motivated to engage in fraudulent accounting because it was attempting to locate an acquirer or merger partner) did not support an inference of scienter because (unlike in *Sunbeam* above) there were no allegations that the accountant was ever "told" about the alleged improper accounting practices. *See also Fidel v. Farley*, 392 F.3d 220, 230 (6th Cir. 2004) (allegations of scienter failed because plaintiffs were unable to properly plead that defendant auditor knew or should have known of any of the claimed financial improprieties occurring at its client); *Montalvo v. Tripos, Inc.*, 2005 U.S. Dist. LEXIS 22753 (E.D. Mo., Sept. 30, 2005) .

(n73)Footnote 73. *In re Cabletron Sys., Inc.*, 311 F.3d 11 (1st Cir. 2002) (significant GAAP violations could provide evidence of scienter when the complaint made particularized allegations of large-scale fraudulent practices over a sustained period); *In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1345 (S.D.Fla. 1999) . *See also Danis v. USN Communications, Inc.*, 121 F. Supp. 2d 1183, 1194 (N.D.Ill 2000) ("In considering whether auditors acted recklessly, courts consider (1) the magnitude of the accounting error; (2) whether defendants had prior notice of the error; and (3) whether defendants were responsible for calculating and disseminating the financial data"); *Carley Capital Group v. Deloitte & Touche LLP*, 27 F. Supp. 2d 1324, 1340 (N.D. Ga. 1999) ("[t]he Court concludes that the allegations concerning the totality and magnitude of the Defendant's accounting violations constitute strong circumstantial evidence of reckless or conscious misbehavior.").

(n74)Footnote 74. *Fidel v. Farley*, 392 F.3d 220, 231 (6th Cir. 2004) [citing *In re SCB Computer Tech., Inc. Sec. Litig.*, 149 F. Supp. 2d 334, 359 (W.D. Tenn 2001)] . *See also Ley v. Visteon Corp.*, 2008 U.S. App. LEXIS 20994 at *38 , 2008 FED App. 0360P (6th Cir. Oct. 6, 2008) (stating that the Sixth Circuit has declined to follow the cases that hold that the magnitude of financial fraud contributes to an inference of scienter on the part of the defendant, and noting that even if the "magnitude" was relevant, the magnitude at issue was not sufficient to raise a strong inference of scienter); *In re Cardinal Health, Inc. Sec. Litigs.*, 426 F. Supp. 2d 688, 2006 U.S. Dist. LEXIS 18687, *1 (S.D. Ohio, April 12, 2006) . ("The magnitude of an erroneous financial statement caused by allegedly fraudulent representations, without more, cannot sustain a finding that an auditor acted with scienter.")

(n75)Footnote 75. *See, e.g., Midwest Imports, Ltd. v. Les Coval*, 71 F.3d 1311, 1317-1319 (7th Cir. 1995) (accountants entitled to summary judgment dismissing plaintiff's contract and negligence claims because "the record fails to create a genuine issue of fact as to whether ... [the accountants] violated any professional auditing standard"); *In re Hawaii Corp.*, 567 F. Supp 609, 617 (D. Haw. 1983) ("Generally, an accountant or auditor discharges his professional obligations by complying with industry standards, Generally Accepted Accounting Principles ... and Generally Accepted Auditing Standards"); *Shahmoon v. General Dev. Corp.*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,308 (S.D.N.Y. 1973) (in dismissing Section 10(b) action, court stated that "[d]efendant's financial statements and accounting procedures cannot be considered fraudulent when they conform with generally accepted accounting procedures as that term is understood by at least a majority of accounting experts in the field and when the methods used are endorsed by the accounting profession as a whole"); *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643, 703 (S.D.N.Y. 1968) (in action brought under Section 11 of the Securities Act, court stated that "[a]ccountants should not be held to a standard higher than that recognized in their profession").

(n76)Footnote 76. 590 F.2d 785 (9th Cir. 1979) .

(n77)Footnote 77. 590 F.2d at 788 .

(n78)Footnote 78. 590 F.2d at 788 .

(n79)Footnote 79. 31 F.3d 772 (9th Cir. 1994) .

(n80)Footnote 80. 31 F.3d at 774 .

(n81)Footnote 81. 425 F.2d 796 (2d Cir. 1969) . See also *Siemens Info. Sys., Inc. v. TPI Enter., Inc.*, 1992 U.S. Dist. LEXIS 3018, at *1 (S.D.N.Y., Mar. 12, 1992) .

(n82)Footnote 82. In *United States v. Simon*, the court upheld a jury charge that proof of compliance with generally accepted accounting principles was "evidence which may be very persuasive but not necessarily conclusive that he [the auditor] acted in *good faith*, and that the facts as certified were not materially false or misleading." 425 F.2d at 805-806 (emphasis added).

(n83)Footnote 83. 425 F.2d at 806 ; see also *Monroe v. Hughes*, 31 F. 3d 772, 774 (9th Cir. 1994) ("[C]ompliance with GAAP and GAAS do not immunize an accountant who consciously chooses not to disclose on a registration statement a known material fact"); *Siemens Information Systems, Inc. v. TPI Enterprises, Inc.*, [1991-1992 Transfer Binder] Fed. Sec. L. Rep (CCH) P 96,573 at 92,662 (S.D.N.Y. 1992) ("If Touche failed to disclose any suspicious practices uncovered during the course of its audit, ... it might conceivably be held liable for fraud even if the Financial Statements it certified required no technical adjustment under GAAP"); *In re Hawaii Corp.*, 567 F. Supp. 609, 617 (D. Haw. 1983) ("Compliance with GAAP and GAAS ... will not immunize an accountant when he consciously chooses not to disclose on a financial statement a known material fact").

As noted in the Introduction to this chapter, while serving as the SEC's Chairman, Harvey L. Pitt stated in a speech addressing the aftershocks of Enron's collapse that "literal compliance with GAAP" may not necessarily be sufficient to insulate an accountant from liability.

(n84)Footnote 84. 254 F.3d 852 (9th Cir. 2001) .

(n85)Footnote 85. 121 F. Supp. 2d 1183 (N.D. Ill. 2000) .

(n86)Footnote 86. 121 F. Supp. 2d at 1195 . See also *SEC v. Todd*, 2007 U.S. Dist. LEXIS 38985 at **27-31, ; *SEC v. Price Waterhouse*, 797 F. Supp. 1217, 1241 (S.D.N.Y. 1992) .

(n87)Footnote 87. 511 U.S. 164 (1994) . The majority opinion in *Central Bank* left open the question of whether the Commission can prosecute aiding and abetting violations. The Private Securities Litigation Reform Act of 1995, however, provides specific authority to the Commission in court actions under the Exchange Act to seek relief against anyone who "knowingly provides substantial assistance" to another person who violates the securities laws. The provision gives the Commission the authority to seek injunctive relief and civil remedies against aiders and abettors of Exchange Act violations pursuant to Exchange Act Sections 21(d)(1) and (3).

(n88)Footnote 88. See *Central Bank*, 511 U.S. at 192 citing, *inter alia*, *Cleary v. Perfectune, Inc.* 700 F.2d 774, 777 (1st Cir. 1983) ; *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980) ; *Monsen v. Consol. Dressed Beef Co.*, 579 F.2d 793, 799-800 (3d Cir. 1978) ; *Schatz v. Rosenberg*, 943 F.2d 485, 496 (4th Cir. 1991) ; *Fine v. American Solar King Corp.*, 919 F.2d 290, 300 (5th Cir. 1990) ; *Moore v. Fenex, Inc.*, 809 F.2d 297, 303 (6th Cir. 1987) ; *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 946 (7th Cir. 1989) ; *K & S P'ship v. Continental Bank, N.A.*, 952 F.2d 971, 977 (8th Cir. 1991) ; *Levine v. Diamantheset, Inc.*, 950 F.2d 1478, 1483 (9th Cir. 1991) ; *Farlow v. Peat, Marwick, Mitchel & Co.*, 956 F.2d 982, 986 (10th Cir. 1992) ; *Schneberger v. Wheeler*, 859 F.2d 1477, 1480 (11th Cir. 1988) .

(n89)Footnote 89. See *Central Bank*, 511 U.S. at 177 .

(n90)Footnote 90. See 511 U.S. at 179 .

(n91)Footnote 91. See 511 U.S. at 191 .

(n92)Footnote 92. *In re Enron Corp. Secs. & Derivative Litig.*, 235 F. Supp. 2d 549 (S.D.Tex. 2002) .

(n93)Footnote 93. *In re MTC Elec. Techs. Shareholders Litig.*, 898 F. Supp. 974, 987 (E.D.N.Y. 1995) , vacated in part, on other grounds, 993 F. Supp. 160 (E.D.N.Y. 1997) . See also *United States v. Finnerty*, 533 F.3d 143, 150 (2d Cir. 2008) (affirming district court's order setting aside conviction because defendant made no deceptive statements).

(n94)Footnote 94. 152 F.3d 169 (2d Cir. 1998) , cert. denied, 525 U.S. 1104 (1999) .

(n95)Footnote 95. 152 F.3d at 175 .

(n96)Footnote 96. 152 F.3d at 172-175 (emphasis added). See also *Morrison v. Nat'l Austl. Bank Ltd.*, 2008 U.S. App. LEXIS 21986, at *26-27 (2d Cir. Oct. 23, 2008) (quotes Wright for the proposition that "[a]nything short of ... [making a false or misleading statement] is merely aiding and abetting, and no matter how substantial that aid may be, it is not enough to trigger liability under Section 10(b)"); *Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 156 (2d Cir. 2007) (Section 10(b) liability could not be imposed on accounting firm because misstatements contained in its client's interim financial statements could not be "attributed" to the firm).

(n97)Footnote 97. 252 F.3d 63 (2d Cir. 2001) .

(n98)Footnote 98. 252 F.3d at 75-76 . Earlier, in *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450 (2d Cir. 1996) , cert. denied, 522 U.S. 812 (1997) , the Second Circuit found primary liability against a person who had knowledge of the fraud and participated in the fraudulent scheme. The court stated, "primary liability may be imposed not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration." 101 F.3d at 1471 . However, this case appears to be sui generis because the individual defendant was the 100% stockholder in First Jersey and the court specifically found that he "orchestrated every facet of First Jersey's branch office network." 101 F.3d at 1472 .

(n99)Footnote 99. 322 F. Supp. 2d 319 (S.D.N.Y. 2004) .

(n100)Footnote 100. 322 F. Supp. 2d at 331 .

(n101)Footnote 101. 322 F. Supp. 2d at 333 (emphasis added). In providing the above guidance, the *Global Crossing* court used the "constructive" attribution rule espoused in *In re Lernout & Hauspie Sec. Litig.*, 230 F.Supp. 2d 152 (D. Mass. 2002) . In *Lernout*, the district court refused to dismiss investors' claims against an auditor where the defendant's role was both widely known to the public and where it was "appropriate to infer that ... investors reasonably attributed the statements" to the auditor. 230 F. Supp. 2d at 166-67 . The *Global Crossing* court noted that the rationale of *Lernout* "reconciles the Second Circuit's reasoning in [*In re Scholastic Corp.*] with the focus on reliance that was central to its holding in *Wright*." 230 F. Supp. 2d at 153.

(n102)Footnote 102. See 322 F. Supp. 2d at 333 .

(n103)Footnote 103. See 322 F.Supp.2d at 334 . In connection with attribution, the court also relied on Andersen's alleged aggressive marketing of certain novel accounting strategies which would "raise[] an inference that sophisticated investors would have known of Andersen's role in creating the reporting practices behind ... [*Global Crossing's*] false statements." Id.

(n104)Footnote 104. See also *Menkes v. Stolt-Nielsen, S.A.*, 2006 U.S. Dist. LEXIS 42644 * 23 (D. Conn. June 19, 2006) (holding that wholly-owned subsidiary and directors of the subsidiary could be held responsible under Section 10(a) for false or misleading statements attributed to parent holding company because parent was either "a mere conduit" for the subsidiary, through its directors, to carry out a fraud or "was a co-conspirator."); *SEC v. KPMG LLP*, 412 F. Supp. 2d 349 (S.D.N.Y. 2006) (refusing to dismiss plaintiff's claims against three individual defendants who served as engagement partners on the audits because they should be "deemed to have made the misstatements"); *In re Alstrom SA Sec. Litig.*, 406 F. Supp. 2d 433 (S.D.N.Y. 2005) (refusing to dismiss plaintiff's claims against a subsidiary because *Global Crossing* emphasizes a constructive attribution rule, which was satisfied because "it is plausible and

reasonable to infer that investors...implicitly relied on the financial information provided by the subsidiary itself"); see also 2005 U.S. Dist. LEXIS 39032 (S.D.N.Y. Dec. 28, 2005) ; *In re Van Der Moolen Holding N.V. Sec. Litig.*, 405 F. Supp. 2d 388 (S.D.N.Y. 2005) ; *Fields v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 301 F. Supp. 2d 259, 2004 U.S. Dist. LEXIS 913 (S.D.N.Y., Jan. 27, 2004) ; *Teachers Ret. Sys. v. ACLN Ltd.*, 2004 U.S. Dist. LEXIS 25927 (S.D.N.Y., Dec. 27, 2004) . C.f. , *Schnall v. Annuity & Life Re (Holdings), Ltd.*, 2006 U.S. Dist. LEXIS 55439 , at **16-18 (D. Conn. Aug. 10, 2006) (finding that Section 10(b) claim against accounting firm did not satisfy Global Crossing's constructive attribution test because there was "no allegation that the public was 'aware' of KPMG US's alleged participation in the ANR audits"); *Jefferson Ins. Co. v. Rouhana (In re Winstar Communs.)*, 2006 U.S. Dist. LEXIS 7618 (S.D.N.Y., Feb. 27, 2006) (dismissing plaintiff's claims against auditor, finding that the auditor's review and approval of the company's unaudited quarterly reports did not rise to the level of Andersen's involvement in *Global Crossing*); *Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC*, 446 F. Supp. 2d 163, 179, 182 (S.D.N.Y. 2006) .

Outside the Second Circuit, the court in *In re Mutual Funds Investment Litig.*, 384 F. Supp. 2d 845, 857-858 (D. Md. 2005) relied on *Global Crossing* when it upheld a complaint against trader defendants who "[were] alleged to have been involved in the fraudulent schemes from the outset and to have been at least one of the architects... [T]hese are not the activities of a mere aider and abettor but those of a primary participant in the unlawful conduct.").

In a different context, the Second Circuit broadened the scope of an accountant's potential liability for securities fraud when it held in *Overton v. Todman & Co.*, 478 F.3d 479 (2d Cir. 2007) , that an auditor can be found primarily liable under Section 10(b) if it violates its duty to correct a certified opinion that was false or misleading when made. Specifically, the *Todman* court determined that an auditor incurs such Section 10(b) liability if:

it (1) makes a statement in its certified opinion that is false or misleading when made; (2) subsequently learns or was reckless in not learning that the earlier statement was false or misleading; (3) knows or should know that potential investors are relying on the opinion and financial statements; yet (4) fails to take reasonable steps to correct or withdraw its opinion and/or the financial statements; and (5) all the other requirements for liability are satisfied.

Id. at 486-87 .

(n105)Footnote 105. *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215 (10th Cir. 1996) . The claims against the defendant accountant were based both on the accountant's opinion letters on financial statements and assistance in preparing parts of prospectuses distributed to investors. The court found that for a secondary actor to violate Section 10(b), it must itself make a false or misleading statement that it knows or should know will reach potential investors. Merely giving aid to a person who commits securities fraud, in the form of assistance in drafting offering documents or in some other manner, no matter how significant, is nothing more than aiding and abetting and is insufficient after *Central Bank* to create Section 10(b) liability. See *id.* at 1225-6 . Here, the accountant was accused of making false statements himself (i.e., false opinion letters on financial statements), so his conduct was within the ambit of post - *Central Bank* § 10(b) primary liability. See also *Steed v. Warrior Capital, LLC*, 2007 U.S. Dist. LEXIS 27308 *15 (W.D. Okla. Apr. 11, 2007) (dismissing Section 10(b) claim against lawyer and law firm for allegedly assisting a corporate client in fraudulent conduct because "[p]laintiffs have not alleged that lawyer and law firm made any statements at all to plaintiffs or that lawyer and law firm engaged in any manipulative or deceptive acts on which plaintiffs relied"); *Stichting Pensioenfonds, ABP v. Qwest Communs. Int'l, Inc.*, 2005 U.S. Dist. LEXIS 9026, at *32-33 (D. Colo., Mar. 28, 2005) (dismissing 10b-5(b) claim against accountants "to the extent that claim is based on allegations that [the accountants] participated in a scheme or artifice to defraud by providing substantial assistance to the representations of others").

(n106)Footnote 106. *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) ("Following the Second Circuit, we conclude that, in light of *Central Bank*, in order for the defendant to be primarily liable under Section 10(b)

and *Rule 10b-5*, the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at the time that the plaintiff's investment decision was made"). See also *SEC v. Dauplaise*, 2006 U.S. Dist. LEXIS 9589, at *18-22 (M.D. Fla., Feb. 22, 2006) (finding that SEC stated a claim for primary liability against directors because "one can infer from these allegations that [the directors] w[ere] responsible for the misrepresentations and omissions [contained in] a deceptive Form 8-K").

(n107)Footnote 107. *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26 (D. Mass. 1994) . The court decided that an accountant's role in reviewing and approving quarterly financial statements and prospectuses does not constitute the making of a material misstatement and, therefore, does not establish a primary violation. 868 F. Supp. at 28 . According to the court, the misstatements were attributable only to the client: "Because ... [the accounting firm] did not actually engage in the reporting of the financial statements and Prospectuses, but merely reviewed and approved them, the statements are not attributable to ... [the firm] and thus ... [it] cannot be found liable for making a material misstatement." 868 F. Supp. at 28 .

(n108)Footnote 108. Although the district court in *SEC v. Lucent Techs., Inc.*, 363 F. Supp. 2d 708, 722 (D.N.J. 2005) , acknowledged that the Third Circuit has yet to definitively decide which test should be applied to determine Section 10(b) secondary actor liability, it employed the "bright line" test when it dismissed the SEC's primary liability claim against a corporate finance director because the claimed financial misstatement was "not alleged to have been made by ... [her] and was "not directly attributed to her." In this regard, the court noted that while the bright-line test "is more closely aligned with the language of Section 10(b) and *Rule 10b-5*, thereby limiting the scope of actors who can be primarily liable, the adoption of this test does not mean that those who fall outside this net will escape punishment as the SEC readily can bring an aiding and abetting action against such actors." *Id.* at 724 .

In re Ikon Office Solutions, Inc. Sec. Litig., 131 F. Supp. 2d 680 (E.D. Pa. 2001) , *aff'd on other grounds*, 277 F.3d 658 (3d Cir. 2002) . Relying on Second Circuit authority, the court declined to hold an accounting firm potentially liable for a primary violation of Section 10(b) where the firm approved an audit client's press release concerning its financial status, but the press release did not mention the defendant accountant or refer to an audit. 131 F. Supp. 2d at 685 n.5 . See also *In re Royal Dutch/Shell Transp. Sec. Litig.*, 380 F. Supp. 2d 509, 559 (D.N.J. 2005) ("allegations that [directors] participated in meetings and conferences in which material misrepresentations were made are insufficient to survive the instant motion to dismiss"); *In re Rent-Way Secs. Litig.*, 209 F. Supp. 2d 493, 501-05 (W.D. Pa. 2002) (court found that *Central Bank* precluded holding accountant liable under Section 10(b) based on its alleged review and approval of client's unaudited quarterly reports); *Copland v. Grumet*, 88 F. Supp. 2d 326, 332-3 (D.N.J. 1999) (Based on Second Circuit law, court found conduct of defendants to be insufficient to hold them liable as primary violations under Section 10(b)).

In *Klein v. Boyd*, 1998 U.S. App. LEXIS 2004 (3d Cir. 1998), *rehearing en banc granted, judgment vacated*, 1998 U.S. App. LEXIS 4121 (3d Cir. 1998), a panel of the Third Circuit apparently rejected the "bright line" test when it found that a law firm which allegedly participated in the creation of misleading documents for distribution to investors could be liable as a primary violator under Section 10(b) even though the attorneys did not sign those documents and the investors did not know that the attorneys had participated in the documents' creation. However, the Third Circuit vacated the foregoing panel decision when it granted a rehearing *en banc*. The case was settled before the Third Circuit could conduct its *en banc* review.

(n109)Footnote 109. *SEC v. Wolfson*, 539 F.3d 1249, 1259 (10th Cir. 2008) . In the *Wolfson* case, the Tenth Circuit expressly held that the "attribution requirement" does *not* apply to SEC enforcement actions because imposing such a requirement "directly conflicts with our jurisprudence recognizing that the SEC need not plead and prove reliance in a § 10(b) case." *Id.* at 1259-60 . As previously noted, to the extent courts have adopted an "attribution requirement," it arises from the need for plaintiffs in private litigation to prove reliance on an alleged fraud.

(n110)Footnote 110. *McGann v. Ernst & Young*, 102 F.3d 390 (9th Cir. 1996) , *cert. denied*, 117 S. Ct. 1460 (1997) . A securities fraud claim brought against accountants based upon the preparation of an audit report containing

allegedly false information. In this case, the accountants knew that the financial statements would be filed with the SEC as part of the issuer's annual 10-K report. The Ninth Circuit held that *Central Bank* did not preclude finding the accounting firm primarily liable. The accounting firm's false statements were made in a manner reasonably calculated to influence the investing public and were therefore made "in connection with" the purchase or sale of securities as required under § 10(b). The accounting firm petitioned the Supreme Court for certiorari on the grounds that primary liability should be limited to those who trade in securities. The petition was denied.

In re Software Toolworks Inc. Sec. Litig., 50 F.3d 615 (9th Cir. 1994) . The Ninth Circuit reversed (in part) the district court's grant of summary judgment in favor of an underwriter and accountant where certain claims were premised on the defendants' "direct participation" in drafting offering documents which contained allegedly fraudulent representations. See 50 F.3d at 625 . The underwriters were potentially liable for having participated in the preparation of an allegedly false letter sent to the SEC and knew or should have known of the alleged fraud in quarterly financial statements. The accountants' participation in the drafting of two letters that Toolworks, Inc. sent to the SEC, was "sufficient to sustain a primary cause of action under § 10(b) and, as a result, *Central Bank* does not absolve Deloitte on these issues." 50 F.3d at 628 n.3 . See also *Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000) ("substantial participation or intricate involvement in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the statements") (citing *In re Software Toolworks*); *In re Maxim Integrated Prods.*, 2008 U.S. Dist. LEXIS 69527, at *29 (N.D. Cal. August 27, 2008) (citing *Howard*, court reaffirms continuing validity of "substantial participation" test in district courts within Ninth Circuit).

In re ZZZZ Best Sec. Litig., 864 F. Supp. 960 (C.D. Cal. 1994) ("Z Best"). Ernst & Young ("E&Y") was alleged to have taken part in a fraud committed by Z Best by releasing a review report on first quarter interim financial information, which was included in an offering prospectus. The report stated, "we are not aware of any material modifications that should be made to the consolidated interim financial statements referred to above for them to be in conformity with GAAP." 864 F. Supp. at 963 . E&Y allegedly knew that there were major discrepancies in Z Best's internal accounting procedures and that the figures released by Z Best were not accurate. Thus, E&Y allegedly knowingly engaged in a fraudulent scheme resulting in the issuance of the review report which contained misrepresentations and/or omissions that directly affected the purchase or sale of securities in violation of § 10(b). The plaintiffs also alleged E&Y took part in the fraud through its involvement in the creation, review or issuance of other publicly released statements like press releases, a 10-Q and 8-K form and through its failure to make certain disclosures, such as failing to reveal or correct misrepresentations in public statements and failing to disclose that it knew or believed that at least some of Z's Best business was a sham. E&Y moved for summary judgment, claiming that all the allegations other than those regarding the review report were eliminated by *Central Bank*. The court emphasized that, "[i]t is also well settled that '[a] plaintiff must show reliance on the defendant's misstatement or omission to recover under 10b-5;' " 864 F. Supp. at 968 . The court then found that an accountant may be liable for a violation of Section 10(b) if its "participation in the misrepresentation is direct and if it knows or is reckless in not knowing that the facts reported in the prospectus materially misrepresent the condition of the issuer." 864 F. Supp. at 970 (quoting *SEC v. Seaboard*, 677 F.2d 1301 (9th Cir. 1982)) . See also *In re Broadcom Corp. Secs. Litig.*, 2004 U.S. Dist. LEXIS 28090, *4 (C.D. Cal., Nov. 23, 2004) (court refused to award defendant director summary judgment because his review and approval of press releases and SEC filings before they were released rose to "substantial participation").

(n111)Footnote 111. *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425 (N.D. Ill. 1995) . Accountants who advised a company regarding restructuring its business and were "centrally involved" in the drafting and preparation of a prospectus and other promotional material were found primarily liable. The complaint charged that the accountants knew that their representations would be reflected in statements in the prospectus and that these representations would induce the investors' decisions. See 877 F. Supp. at 433 . See also *SEC v. Church Extension of The Church of God*, 2005 U.S. Dist. LEXIS 34510 (S.D. Ind., December 9, 2005) .

In *McNamara v. Bre-X Minerals, Ltd.*, 57 F.Supp. 2d 396, 429-30 (E.D. Tex. 1999) , the court appeared to state that

primary Section 10(a) liability can be imposed on secondary actors under either the "bright line" or the "substantial participation" test.

(n112)Footnote 112. 235 F. Supp. 2d 549 (S.D. Tex. 2002) .

(n113)Footnote 113. 235 F. Supp. 2d at 586-587 .

(n114)Footnote 114. 235 F. Supp. 2d at 588 .

(n115)Footnote 115. 235 F. Supp. 2d at 590-591 . See also SEC v. Hopper, 2006 U.S. Dist. LEXIS 17772, at *32-34 (S.D. Tex. 2006) .

(n116)Footnote 116. See In re Parmalat Sec. Litig., 376 F. Supp. 2d 472, 497 (S.D.N.Y. 2005) .

(n117)Footnote 117. Rule 10b-5 states that:

It shall be unlawful for any person, directly or indirectly...

(a) To employ any device, scheme, or artifice to defraud,

...

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit

upon any person, in connection with the purchase or sale of any security.

17 C.F.R. 240.10b-5.

(n118)Footnote 118. See, e.g., Simpson v. AOL Time Warner, 452 F.3d 1040 (9th Cir. 2006) , cert. granted & judgment vacated, Avis Budget Group, Inc. v. California State Teachers' Retirement System, ___ U.S. ___, 128 S. Ct. 1119 (2008) .

(n119)Footnote 119. ___ U.S. ___, 128 S. Ct. 761 (2008) .

(n120)Footnote 120. See Regents of the Univ. of Cal. v. Credit Suisse First Boston, 482 F.3d 372, 384 (5th Cir. 2007) , cert. denied, Regents of the Univ. of Cal. v. Merrill Lynch, 128 S. Ct. 1120 (2008) ; Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 443 F.3d 987, 992 (8th Cir. 2006) , aff'd, ___ U.S. ___, 128 S. Ct. 761 (2008) . The Eighth Circuit also stated in Stoneridge that 10b-5 liability could be triggered if a defendant "engage[d] in manipulative securities trading practices." Id.

(n121)Footnote 121. Simpson v. AOL Time Warner, 452 F.3d at 1049 .

(n122)Footnote 122. 322 F. Supp. 2d 319 (S.D.N.Y. 2004) .

(n123)Footnote 123. 322 F. Supp. 2d at 336 .

(n124)Footnote 124. 322 F. Supp. 2d at 346-347 (emphasis added). See WM High Yield Fund v. O'Hanlon, 2005 U.S. Dist. LEXIS 12064 (E.D. Pa., May 16, 2005) (finding that plaintiffs had alleged actionable claims against accountants and other defendants on the basis of Rule 10b-5(a) and (c) liability). See also In re Parmalat Sec. Litig., 376 F. Supp.2d 472 (S.D.N.Y. 2005) ; Quaak v. Dexia S.A., 357 F. Supp. 2d 330 (D. Mass. 2005) ; In re Salomon Analyst AT&T Litigation, 350 F. Supp. 2d 455 (S.D.N.Y. 2004) ; Filler v. Lernout (In re Lernout & Hauspie Sec. Litig.),

236 F. Supp. 2d 161 (D. Mass. 2003) ; *In re Enron Corp. Secs., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Texas 2002) .

Although the prohibition on private aiding and abetting claims imposed by *Central Bank* does not apply to the SEC, the SEC has also relied on *Rule 10b-5(a)* and *(c)* in cases in which it sought to establish *primary* liability on the part of a secondary act. For example, in *SEC v. U.S. Environmental, Inc.*, 155 F.3d 107 (2d Cir. 1998) , *cert. denied*, 526 U.S. 1111 (1999) , the Second Circuit held that the SEC had an actionable claim for primary liability under subsections (a) and (c) against defendant, a registered trader, "for following a stock promoter's directive to execute stock trades that ... [he] knew, or was reckless in not knowing, were manipulative, even if ... [he] did not share the promoter's specific overall purpose to manipulate the market for that stock." *Id.* at 108. In deciding this case, the court stated that "[w]e have noted further that a primary violator is one who 'participated in the fraudulent scheme' or other activity proscribed by the securities laws." *Id.* at 111 [citing *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1471 (2d Cir. 1996)] . While the foregoing statement was made in a "manipulation" case (rather than a "misrepresentation" case), at least one district court suggested that the Second Circuit, as a general matter, "permit[ed] plaintiffs to allege 'participation in' a securities fraud scheme as one manner in which a plaintiff may state a claim under § 10(b) and *Rule 10b-5*." *Rich v. Maidstone Fin., Inc.*, 2002 U.S. Dist. LEXIS 24510, at *23 (S.D.N.Y., Dec. 19, 2002) .

(n125)Footnote 125. ____ U.S. ____, 128 S. Ct. 761 (2008) .

(n126)Footnote 126. *Id.* at 769 . In addition to stressing that defendants' alleged deceptive acts were not communicated to the public, the Court noted that defendants did *not* have a duty under the securities laws to make any public disclosures concerning those matters. *Id.* at 769 .

(n127)Footnote 127. *Id.*

(n128)Footnote 128. *Id.* at 770 . According to the Supreme Court, Section 10(b) liability is not necessarily foreclosed by the absence of "a specific oral or written statement," if the plaintiff relied to its detriment on some other "conduct" of the defendant. *Id.*

(n129)Footnote 129. *Id.* at 770 .

(n130)Footnote 130. *Id.* at 770 .

(n131)Footnote 131. *Id.* at 770 . The conduct required by secondary actors to incur Section 10(b) primary liability is discussed at § 5A.07[5][a]-[c], *supra*.

(n132)Footnote 132. *Id.* at 771 .

(n133)Footnote 133. *Id.* at 772 .

(n134)Footnote 134. *See also* *Avis Budget Group, Inc. v. California State Teachers' Retirement System*, ____ U.S. ____, 128 S. Ct. 1119 (2008) , *granting cert. and vacating judgment*, *Simpson v. AOL Time Warner*, 452 F.3d 1040 (9th Cir. 2006) (remanding action in which Ninth Circuit held that a defendant can be liable as a primary violator of *Rule 10b-5* for participation in a "scheme to defraud" for "further consideration in light of *Stoneridge* ...").

(n135)Footnote 135. *Id.* at 777 .

(n136)Footnote 136. *Id.* at 762 .

(n137)Footnote 137. *Univ. of Cal. v. Merrill Lynch*, 128 S. Ct. 1120, denying cert., 482 F.3d 372 (5th Cir. 2007).

(n138)Footnote 138. 15 U.S.C. § 78u-4(f)(2)(a)(1997 & Supp. 2008).

(n139)Footnote 139. The PSLRA defines a "knowing violation" as one in which a "covered person makes an untrue statement of a material fact, with actual knowledge that the representation is false, or omits to state a fact necessary in order to make the statement made not misleading, with actual knowledge that, as a result of the omission, one of the material representations of the covered person is false; and persons are likely to reasonably rely on that misrepresentation or omission." 15 U.S.C. § 78u-4(f)(10)(A) (1997 & Supp. 2008). A "covered person" is defined as "(i) a defendant in any private action arising under this chapter; or (ii) a defendant in any private action arising under section 77k of this title, who is an outside director of the issuer of the securities that are the subject of this action." *Id.* at § 78u-4(f) (1997 & Supp. 2008).

(n140)Footnote 140. 15 U.S.C. § 78u-4(f) (1997 & Supp. 2008). At least one court has held that this provision of the PSLRA also applies to partial settlements of claims brought under Section 11 of the Securities Act. *See In re Worldcom, Inc. Sec. Litig.*, 2005 U.S. Dist. LEXIS 1805, at *32-45 (S.D.N.Y., Feb. 9, 2005) .



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Federal Securities Exchange Act of 1934

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CHAPTER 5A Accountants' Liability Under the Federal Securities Laws

1-5A Federal Securities Exchange Act of 1934 § 5A.08

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§ 5A.08 Section 10A: New Audit Requirements and Limitation on Auditor Liability

In enacting the PSLRA, Congress added Section 10A to the Exchange Act, which imposes significant new requirements on the accounting profession, including searching out fraud and reporting certain wrongdoing to the SEC.

Under Section 10A, auditors are now required to devise audit procedures "to provide reasonable assurance of detecting illegal acts n1 that would have a direct and material effect on the determination of financial statement amounts" and "procedures designed to identify related party transactions that are material to the financial statements, *or otherwise require disclosure*" n2

The Congress then created a "required response" by auditors to audit discoveries which not only raised the expectational bar for auditors, but imposed upon them requirements to make legal judgments, for which they are not suited by training. Thus, Section 10A(b)(1) provides:

(b) Required Response to Audit Discoveries.

(1) Investigation and Report to Management. If, in the course of conducting an audit pursuant to this title to which subsection (a) applies, the independent public accountant detects or otherwise becomes aware of information *indicating* that an illegal act (whether or not perceived to have a *material effect* on the financial statements of the issuer) has or *may have* occurred, the accountant *shall*, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission --

(A)(i) determine whether it is likely that an illegal act has occurred; and

(ii) if so, determine and consider the *possible effect* of the illegal act on the financial statements of the issuer, including any *contingent monetary effects*, such as *finances, penalties, and damages*. n3

The foregoing leaves open questions such as what degree of information is required to reach the level of "indicating?" Is an unsupported statement adequate? How does the accountant "determine" if it is likely an *illegal act* occurred since "illegal acts" in a corporate context may be masked as proper business activities? How does the accountant determine if

the act is "illegal" when, in many cases, illegality turns on motives and objectives not readily discernible? Worse from the accountants perspective is 10A(b)(A)(ii), quoted above. Not only must the auditor determine if an illegal act occurred, but it must engage in prophesying what the "contingent" prospects are for fines, penalties and damages. This may involve numerous jurisdictions, governmental or quasi-governmental bodies, licensing standards and issues of who might sue the issuer, where and, then, the standards applicable in that jurisdiction.

Section 10A then instructs the auditor:

(B) as soon as practicable, inform the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such accountant in the course of the audit, *unless the illegal act is clearly inconsequential*. n4

In light of the above references to the phrases "material" and "whether or not perceived to have a material effect on the financial statements," the meaning of the phrase "unless the illegal act is clearly *inconsequential*" introduces another concept, without benefit of an articulated standard. Is "inconsequential" to be construed by a monetary materiality standard, or the non-monetary *consequentially* standard? What "illegal acts" are inconsequential? Need they relate only to the company? What if the "consequence" is the loss of an executive? Must the auditor determine the importance of the executive to the audit client internally and externally in customer relations? What is the length of time needed to replace the executive?

Section 10A then reintroduces the concept of "materiality" in a confusing manner and one which raises more questions.

(2) Response to Failure to Take Remedial Action. If, *after* determining that the *audit committee of the board of directors of the issuer, or the board of directors of the issuer* in the absence of an audit committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of the accountant in the course of the audit of such accountant, the independent *public accountant concludes that-*

(A) the illegal act *has a material effect* on the financial statements of the issuer;

(B) the senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act; and

(C) the failure to take remedial action is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement;

the independent public accountant *shall*, as soon as practicable, *directly report its conclusions to the board of directors*. n5

In other words, is the auditor required to make a "materiality" judgment only *after* telling the audit committee or the board of directors? Is that judgment to be made independently or may the auditor rely on the company or its counsel? Does reference here to "material effects on the financial statements of the issuer" create a different standard and duty than was set forth in Section 10A(a)? Are these two provisions of Section 10A to be read as a progression, a continuum of what is to occur or separately with separate standards and duties? Which "conclusions" is the auditor to report? Those relating to "material effects" on the financial statements? Those illegal acts which may have occurred, without regard to the financial materiality of them?

Section 10A then states that an issuer who receives a report under Section 10A(b)(2) shall inform the SEC within one business day after receipt of the report and provide a copy of the notice to the auditor. Absent receipt of such a report from the company, within one business day thereafter, the independent accountant shall resign the engagement *or* furnish all its information and documents to the SEC. n6

In exchange for all the foregoing, the independent accountant is granted "auditor limited liability" n7 by absolving the auditor from liability in a *private* action -- but not in an action by the SEC or other governmental body -- for any finding, conclusion or statement in the report. Put otherwise, if the independent auditor "blows the whistle," even if erroneously, it will avoid suit from the company and private claimants. On the other hand, a wilful failure by the accounting firm to comply with applicable reporting requirements may lead to adverse action by the SEC, including the imposition of civil penalties. n8

To enforce compliance with Section 10A, the SEC has instituted various administrative and civil proceedings against accountants based on their alleged failure to satisfy responsibilities established by the statute. Illustratively, in *SEC v. Chancellor Corp.*, n9 the Commission sued an accounting firm (and an engagement partner) under Section 10A claiming that defendants learned during their audits of Chancellor Corporation ("Chancellor") that it was likely that Chancellor had fabricated corporate documents, but failed to properly report this circumstance to Chancellor's audit committee or take other steps called for by Section 10A. The relief sought by the SEC against defendant accountants included (i) entry of a permanent injunction prohibiting future violations of Section 10A, (ii) disgorgement of fees received for their audits of Chancellor and (iii) civil monetary penalties. n10

In *SEC v. Solucorp Industries Ltd.*, n11 a court in the Southern District of New York held that scienter is not needed to find an auditor liable under Section 10A. In the *Solucorp* case, the SEC contended that a defendant accountant (i) became aware while conducting an audit of information indicating that his client had backdated a license agreement for the purpose of improperly recognizing license fees in violation of GAAP and (ii) failed to satisfy his Section 10A obligations to (a) adequately investigate whether an illegal act had occurred, (b) notify management and (c) assure that the audit committee was apprised of his concerns. The accountant moved for summary judgment on the grounds that the SEC failed to allege facts which showed that he had actual knowledge of or recklessly disregarded the existence of any illegal acts. Based on the language of Section 10A, the court determined that an auditor need not "become aware of illegal acts" in order for the statute to apply and that an auditor is subject to 10A requirements "upon acquiring knowledge of information *indicating* that an illegal act *may* have occurred." n12

In an enforcement proceeding instituted by the PCAOB n13, an accounting firm consented to an order of censure based on the PCAOB's finding that the firm violated Section 10A(b)(2) "in failing to take prompt and appropriate steps in response to indications that an issuer audit client may have committed an illegal act." n14

In particular, the PCAOB made the following findings (among others) in the above matter:

- On January 13, 2004 Respondent accounting firm learned that its client had "filed an unauthorized audit report [with the SEC] falsely representing that ... [its] FY 2003 financial statement had been audited by Respondent." The accounting firm knew that its client's "apparently illegal act had a material effect on ... [the client's] financial statements."

- On the same day, the accounting firm notified its client's management and a member of the company's board of directors that its audit was incomplete and that it had not given the company permission to use its name in connection with the financial statements included in the company's SEC filing.

- During the following 15 weeks, the accounting firm was aware that its client's management failed to

take appropriate remedial actions, *but the firm took no further steps in response to that failure.*

■ After 15 weeks, when it was prompted by the prospect of an imminent PCAOB inspection, the accounting firm advised its client (among other things) that it should notify the SEC of the above situation. On May 4, 2004, the client made disclosures to the SEC.

The PCAOB concluded that the accounting firm violated Section 10A(b)(2) by failing to directly report its client's "apparently illegal act" to the company's board of directors "*as soon as practicable.*" n15

FOOTNOTES:

(n1)Footnote 1. "Illegal acts" are defined to mean "an act or omission that violates *any* law, or *any* rule or regulation having the force of law." Section 10A(f) (emphasis added). This can be read to require auditors to know every law, rule and regulation in every country, state, county or the equivalent where the client operates, and every regulatory statute, rule, regulation or interpretative memorandum issued by any regulatory organization, worldwide, that has an oversight function for the audit client.

(n2)Footnote 2. Section 10A(a)(1)-(2) (emphasis added).

(n3)Footnote 3. Emphasis added.

(n4)Footnote 4. Section 10(A)(b)(1)(B) (emphasis added).

(n5)Footnote 5. Section 10A(b)(2) (emphasis added).

(n6)Footnote 6. Section 10A(b)(3).

(n7)Footnote 7. Section 10A(c).

(n8)Footnote 8. Section 10A(d).

(n9)Footnote 9. No. 03-10762 MEL (D. Mass. 2003), *available at* www.sec.gov/litigation/complaints/comp18104.htm.

(n10)Footnote 10. The matter was subsequently settled. In addition, in an administrative cease and desist proceeding, *In re Rossetti & Yonkers*, Administrative Release 34-43497, *available at* <http://www.sec.gov/litigation/admin/34-43497.htm> (Oct. 31, 2000), the SEC alleged that two accountants discovered fraud in a client's quarterly financial statements, but failed to notify the company's management and board of directors in violation of Section 10A. Pursuant to a settlement, both accountants were ordered to cease and desist from further Section 10A violations and barred from appearing or practicing before the SEC for one and three years, respectively.

Several complaints filed by the SEC under Section 10A may be found *at* <http://www.sec.gov> by conducting a search under the litigation tab for "Section 10A."

(n11)Footnote 11. *197 F. Supp. 2d 4 (S.D.N.Y. 2002)* .

(n12)Footnote 12. *197 F. Supp. 2d at 10* (footnote omitted) (emphasis supplied). The court noted that requiring an auditor to be *aware* of illegal actions before applying Section 10A would be inconsistent with the requirement that an auditor must determine whether "it is likely that an illegal act has occurred" after it acquires information indicating that such an act may have occurred. *197 F. Supp. 2d at 10* .

Since the SEC alleged that the defendant accountant had *actual* knowledge indicating that an illegal act may have occurred, the court did not consider whether negligence and/or recklessness would similarly satisfy Section 10A.

(n13)Footnote 13. The functions of the PCAOB (including its enforcement powers) are addressed in detail at § 5A.09, *infra* .

(n14)Footnote 14. *Order Instituting Disciplinary Proceedings, Making Findings and Imposing Sanctions*, PCAOB Release No. 2006-002 (April 18, 2006). In agreeing to settle the disciplinary proceeding brought against it, the firm neither admitted nor denied the findings of the PCAOB (except as to the PCAOB's jurisdiction over it and the subject matter of the proceedings, which was admitted). *Id.*

(n15)Footnote 15. *Id.*



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Federal Securities Exchange Act of 1934

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CHAPTER 5A Accountants' Liability Under the Federal Securities Laws

1-5A Federal Securities Exchange Act of 1934 § 5A.09

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§ 5A.09 Provisions of the Sarbanes-Oxley Act of 2002 Pertaining to the Audit of Public Companies

[1] Enactment of the Sarbanes-Oxley Act of 2002

As noted in the Introduction to this chapter, in July 2002, in reaction to the collapse of Enron Corp. and other high level corporate failures, the Sarbanes-Oxley Act n1 was enacted in an effort to increase the regulatory oversight of financial statements and accountants. n2 Among other things, the Sarbanes-Oxley Act establishes a new regulatory body for accountants who audit public companies, increases criminal penalties for violations of securities and related laws, and imposes far-reaching requirements on public companies, their officers and directors.

This section focuses on certain provisions of the Sarbanes-Oxley Act that particularly pertain to accountants.

[2] The Public Company Accounting Oversight Board

The Sarbanes-Oxley Act established the Public Company Accounting Oversight Board ("PCAOB") whose functions include the registration, monitoring and discipline of independent accounting firms in connection with their audits of public companies. As of October 22, 2003, accounting firms must be registered with the PCAOB prior to preparing or issuing an audit report with respect to a public company or playing a substantial role in the preparation or furnishing of such a report. n3

As indicated in PCAOB Rule 2106(a), "the Board will approve applications consistent with its responsibilities under the Sarbanes-Oxley Act ... to protect investors and to further the public's interest in the preparation of informative, accurate and independent audit reports." n4 An accounting firm which receives written notice from the PCAOB that its registration application has not been approved may request (i) a hearing before the PCAOB followed by review by the SEC if the hearing does not result in approval of the application or (ii) immediate SEC review of the PCAOB's decision to deny registration. n5

Applications to register require a substantial amount of information about the accounting firm's recent history relating to public company audit clients, including:

- The name of each public company audit client.

- Disclosure of the fees received from each public company audit client for audit services, other accounting services and non-accounting services.
- A statement of the firm's quality control policies for its auditing and accounting practices.
- Information about criminal, civil, administrative or disciplinary proceedings against the applicant or its associated persons.
- A listing of filings disclosing the firm's accounting disagreements with public company audit clients.
- Information about each accountant at the firm who participates in the preparation of audit reports.
- A consent of the firm to comply with PCAOB requests for testimony or documents and an agreement to secure a similar consent from each accountant as a condition of continued employment. n6

As of December 4, 2008, 1874 accounting firms are registered with the PCAOB. n7 Moreover, the PCAOB has issued 18 orders denying registration applications. n8

In addition to requiring registration of public accounting firms, the Sarbanes-Oxley Act provides that each such firm must submit an annual report to the PCAOB and may also be required to report more frequently to provide information specified by the PCAOB or the SEC. n9 In June 2008, the PCAOB adopted rules (and forms) to govern and facilitate this reporting requirement and to require, govern and facilitate special reporting of certain other information if certain specified events take place. n10

Among the above rules is a requirement that obligates an auditor to file a report with the PCAOB when it withdraws a prior audit report on financial statements and the issuer has failed to report this circumstance to the SEC. n11 In this regard, at the time this requirement was proposed, PCAOB member Charles D. Niemeier stated that "[t]he disclosure requirements only go to the issuer, but if the company doesn't say anything there's no mechanism for the auditor to file anything for the public to see. Now we create an obligation on the part of the accounting firm that relieves them of that awkward situation with a client." n12

[3] Interim and Permanent Professional Standards

[a] Interim Standards

As contemplated by Section 103 of the Sarbanes-Oxley Act, the PCAOB proposed certain interim professional standards to govern the conduct of registered public accounting firms, which were approved by the SEC. n13 These interim standards essentially adopted various standards previously established by the American Institute of Certified Public Accountants ("AICPA") and its Auditing Standards Board ("ASB"), n14 which relate to (i) auditing, n15 (ii) attestation engagements, n16 (iii) quality control, n17 (iv) ethics n18 and (v) independence. n19 The PCAOB has been taking what amounts to a "wait-and-see" approach before recommending to the SEC that any of these interim standards become permanent PCAOB standards. n20

On October 21, 2008, the PCAOB proposed seven new auditing standards, which would (i) supersede the Board's interim auditing standards related to audit risk and materiality, n21 audit planning and supervision, n22 consideration of internal control in an audit of financial statements, n23 audit evidence, n24 and performing tests of accounts and disclosures before year end n25 and (ii) update existing requirements for assessing and responding to risk during an audit. n26 As described by the PCAOB, the following is an "overview" of the proposed new risk assessment standards:

● **Audit Risk in an Audit of Financial Statements.** This proposal "describes the components of audit risk and the auditor's responsibilities for reducing audit risk to an appropriately low level in order to obtain reasonable assurance in an audit of financial statements."

● **Audit Planning and Supervision.** This proposal "describes the auditor's responsibilities for planning the audit, including assessing matters that are important to the audit, and establishing an appropriate audit strategy and audit plan. The proposed standard also describes the responsibilities of the engagement partner and other engagement team members for supervising and reviewing the work of the engagement team."

● **Identifying and Assessing Risks of Material Misstatement.** This proposal "describes the auditor's responsibilities for identifying and assessing risks of material misstatement. The risk assessment process discussed in the proposed standard includes information-gathering procedures to identify risks (e.g., obtaining an understanding of the company, its environment, and its internal control) and analysis of the identified risks."

● **The Auditor's Responses to the Risks of Material Misstatement.** This proposal "sets forth the auditor's responsibilities for responding to the risks of material misstatement, including overall responses related to the general conduct of the audit and responses involving specific audit procedures."

● **Evaluating Audit Results.** This proposal "describes the auditor's responsibilities regarding the process of evaluating the results of the audit in order to form the opinion(s) to be presented in the auditor's report. This process includes evaluating uncorrected misstatements and control deficiencies identified during the audit."

● **Consideration of Materiality in Planning and Performing an Audit.** This proposal "sets forth the auditor's responsibilities for applying the concept of materiality, as described by the federal securities laws, in planning the audit and determining the scope of the audit procedures."

● **Audit Evidence.** This proposal "sets forth the auditor's responsibilities regarding designing and applying audit procedures to obtain sufficient appropriate evidence to support the opinion(s) in the auditor's report. In particular, it discusses the principles for determining the sufficiency and appropriateness of audit evidence." n27

After the applicable comment period has closed, the Board will decide whether to take final action on the above proposed standards. Any such "final action" will be submitted to the SEC for approval. n28

[b] Permanent Standards

[i] Auditing Standard No. 1

In late 2003, the PCAOB adopted its first permanent professional standard, Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*, n29 which mandates that auditors' reports on engagements performed pursuant to standards of the PCAOB include the statement that the engagement was performed in accordance with PCAOB standards. In the past, auditors' reports were required to state that the engagement was performed in conformity with Generally Accepted Auditing Standards.

[ii] Auditing Standards No. 2 and 5

Under rules issued by the SEC pursuant to Section 404 of the Sarbanes-Oxley Act, each public company's annual report

must include an internal control report that (i) states that management is responsible for establishing and maintaining adequate internal controls and procedures for financial reports, (ii) identifies the "framework" that management used to conduct the required internal control evaluations, (iii) sets forth management's assessment of the effectiveness of the company's internal controls and identifies any "material weaknesses" in those controls, *and* (iv) includes a statement that the company's auditors have provided an attestation report relating to management's above assessment of internal controls. n30

With respect to the foregoing, Section 404 of the Sarbanes-Oxley Act expressly requires the company's auditors to attest to and report on management's assessment of the effectiveness of the company's internal controls. In March 2004, the PCAOB issued Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* n31 to govern an auditor's review of internal controls. Later, in May 2007 the PCAOB adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements*, to replace Auditing Standard No. 2 as its controlling internal control auditing standard. n32

[A] Auditing Standard No. 2

As a general matter, Auditing Standard No. 2 stated that "the auditor must plan and perform the audit to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting as of the date specified in management's assessment." n33

On May 16, 2005, the PCAOB issued a policy statement relating to the implementation of Auditing Standard No. 2, n34 which stated, *inter alia*, that, to properly plan and perform an effective audit of internal controls, auditors should:

- **"integrate their audits** of internal control with their audits of the client's financial statements, **so that evidence gathered and tests conducted in the context of either audit contribute to completion of both audits;"**
- **"exercise judgment to tailor their audit plans to the risks facing individual audit clients**, instead of using standardized 'checklists' ..."
- **"use a top-down approach** that begins with company-level controls, to identify for further testing only those accounts and processes that are, in fact, relevant to internal control over financial reporting ...;"
- **"take advantage of the significant flexibility that the standard allows to use the work of others;"** and
- **"engage in direct and timely communication with audit clients** when those clients seek auditors' views on accounting or internal control issues before those clients make their own decisions on such issues, implement internal control processes under consideration, or finalize financial reports." n35

Based on its inspections (and other monitoring) relating to the initial year that Auditing Standard No. 2 was put into effect, the PCAOB issued a report on November 30, 2005 which identified the "most common reasons" why internal control audits were not as "effective or efficient" as the PCAOB expected them to be in the future. n36 As the audits selected for inspection by the PCAOB were conducted (and most were completed) before issuance of the PCAOB's May 16, 2005 Policy Statement, many of the observations in the November 30, 2005 Report relate to matters addressed in that guidance. n37

Subsequently, based on Board inspections conducted in 2006 (and other monitoring), the PCAOB issued a report dated April 18, 2007 which assessed audit firms' second-year implementation of Auditing Standard No. 2. n38

According to the PCAOB, inspections conducted during 2006 n39 disclosed that progress had been achieved in enhancing the efficiency of audits of internal controls. n40 In addition, the PCAOB stated that firms had performed better in certain areas the Board had earlier addressed in its May 16, 2005 Policy Statement. n41 Nevertheless, the Board found room for improvement in those areas because (among other things) some auditors (a) failed to "fully integrate their audits," (b) did not "apply a top-down approach to testing controls," (iii) probably "expended more effort than necessary when testing controls for assertions that were lower risk" and (iv) could have more extensively "use[d] the work of others."

[B] Auditing Standard No. 5

As noted above, on May 25, 2007, the PCAOB adopted (and the SEC subsequently approved) Auditing Standard No. 5 to replace Auditing Standard No. 2 as the Board's controlling internal control auditing standard.

According to the PCAOB, its new internal control auditing standard resulted from its above monitoring of auditors' implementation of Auditing Standard No. 2, through, among other things, Board inspections of internal control audits. n42 While the PCAOB observed substantial benefits produced by audits conducted pursuant to Auditing Standard No. 2 (including, higher quality financial reporting), the Board noted that sometimes the effort involved appeared greater than what was needed to perform an effective audit. n43 Largely as a response to those observations, Auditing Standard No. 5 is specifically designed to achieve the following four objectives:

1. Focus the Internal Control Audit on The Most Important Matters: The Board's new standard focuses on the areas that create the greatest risk that a client's internal controls will not prevent or detect a material misstatement in its financial statements. For example, the new standard accomplishes this "by incorporating certain best practices designed to focus the scope of the audit on identifying material weaknesses in internal control, before they result in material misstatements of financial statements, such as in a top-down approach to planning the audit." The new standard also stresses the importance of auditing "higher risk areas, such as the financial close process and controls designated to present fraud by management." At the same time, this standard offers auditors a "range of alternatives for addressing lower risk areas, such as by more clearly demonstrating how to calibrate the nature, training and extent of testing based on risk, as well as how to incorporate knowledge accumulated in previous years' audits into the auditors' assessment of risk, as well as how to incorporate knowledge accumulated in previous years' audits."

2. Eliminate Procedures that are Unnecessary to Achieve the Intended Benefits: The PCAOB stated that it looked into every aspect of the internal control audit to ascertain whether Auditing Standard No. 2 encouraged audit firms to conduct procedures that are not required to obtain the intended benefit of the audit. Among other things, based on this examination, Auditing Standard No. 5 "does not include the previous standard's detailed requirements to evaluate management's own evaluation process and clarifies that an internal control audit does not require an opinion on the adequacy of management's process." In addition, Auditing Standard No. 5 "refocuses the multi-location direction on risk rather than coverage" by eliminating the requirement that auditors "test a 'large portion' of the company's operations or financial position."

3. Make the Audit Clearly Scalable to Fit the Size and Complexity of Any Company: In line with the PCAOB's ongoing effort to provide guidance for auditors of smaller, less complex issuers, Auditing Standard No. 5 explains how internal control audits can be tailored to fit the size and complexity of the issuer being audited.

4. Simplify the Text of the Standard: According to the PCAOB, its new standard is streamlined and easier to read. Among other things, the new standard, "eliminates the previous standard's discussion of materiality, thus clarifying that the auditor's evaluation of materiality for purposes of an internal control audit is based on the same long-standing principles applicable to financial statement audits." n44

[C] Costs Associated with Compliance With Section 404's Internal Control Requirements.

As compliance with Section 404's internal control requirements can be costly and time consuming, a heated debate has developed concerning whether small and medium-sized companies should be exempt from some or all of those provisions. In this regard, in April 2006 the SEC Advisory Committee on Smaller Public Companies (the "SEC Advisory Committee") formally proposed that companies with market caps (i) less than \$128 million be excused from having to report on their internal controlsⁿ⁴⁵ and (ii) \$128 million to \$787 million be required to issue such reports, but not be obligated to engage an outside auditor to attest to those reports.ⁿ⁴⁶ While proponents of such exemptions argued that Section 404's internal control provisions are too burdensome for smaller companies,ⁿ⁴⁷ opponents countered that smaller companies are more inclined to have internal control weaknesses that should be disclosed to investors.ⁿ⁴⁸

Subsequently, the argument made by smaller businesses that the cost of complying with Section 404 is prohibitive was potentially undercut by a study conducted by CRA International (and sponsored by the Big Four accounting firms) that found that the average costs of compliance for smaller companies (market caps of \$75 million to \$700 million) dropped almost 31% to \$860,000 in 2005, the second year that the new internal control rules were in force.ⁿ⁴⁹ For large companies (market caps greater than \$700 million), the study determined that average costs dropped 44% to \$4.8 million in 2005.ⁿ⁵⁰ According to CRA group vice president, Greg Bell, these costs dropped because companies better understood the Section 404 process in the second year and "a lot of ... start up costs didn't have to be repeated."ⁿ⁵¹

In addition, a research study conducted by Lord & Benoit LLC ("Lord & Benoit") (in conjunction with the online research firm Auditanalytics.com) provided further support for maintaining Section 404's requirements by disclosing that public companies that did not report internal control deficiencies in either 2004 or 2005 experienced an average share-price *gain* of 27.7% between March 31, 2004 and March 31, 2006 while those that reported deficiencies in 2004 and 2005 experienced an average share-price *decline* of 5.7%.ⁿ⁵² The Lord & Benoit study also revealed that companies that reported internal control deficiencies in 2004, but not in 2005, experienced an average share-price increase of 25.7%.ⁿ⁵³ Based on these findings, Robert Benoit (founder of Lord & Benoit) stated that "[t]he value of the increase in the internal controls more than offsets the outlay" needed to comply with Section 404.ⁿ⁵⁴

In May 2006, the SEC largely resolved the above debate concerning Section 404 (at least for the time being) by rejecting the exemptions previously proposed by its Advisory Committee.ⁿ⁵⁵ In addition, the SEC recently determined that smaller U.S. public companies (with caps of less than \$75 million), which have been excused from reporting on their internal controls, will be required to include such reports in their 2007 annual reports.ⁿ⁵⁶

On the other hand, in June 2007, in an effort to reduce Section 404 costs for companies of all sizes, while still preserving the benefits of Section 404, the SEC issued new guidance for management's required assessment under Section 404.ⁿ⁵⁷ Addressing the needs of "smaller" companies, SEC Chairman Christopher Cox stated that this guidance "was specifically written with smaller companies' unique control systems in mind. It encourages management to tailor their documentation and evaluation approaches to their particular business."ⁿ⁵⁸

In addition, on June 20, 2008, the SEC announced that "smaller" companies will *not* be subject to Section 404's audit requirements until issuance of their annual reports for fiscal years ending on or after December 15, 2009.ⁿ⁵⁹ On the same day, the SEC also stated that it would "proceed with data collection for a study of the costs and benefits of Section 404 implementation, focusing on the consequences for smaller companies and the effects of the Section 404 auditor attestation requirements."ⁿ⁶⁰ As stated by the SEC, this "cost-benefit study" will help determine whether recent management guidance provided by the Commission on evaluating internal controls over financial reporting and newly adopted Auditing Standards No. 5 "are having the intended effect of facilitating more cost-effective internal control evaluations and audits of smaller reporting companies."ⁿ⁶¹

The PCAOB continues to believe that the efficiencies contemplated by its adoption of Auditing Standard No. 5 (as a replacement for Auditing Standard No. 2) will make the internal audit process less costly, especially for smaller public

companies. In this regard, in October 2007, the PCAOB's staff published its preliminary guidance on how auditors can apply Auditing Standard No. 5 to audits of smaller companies and it devoted considerable attention to the provisions of that standard which provide direction to auditors on "scaling the audit" based on the company's size and complexity. n62

In the end, Congress may have the last word concerning Section 404's requirements as bills have been introduced in both houses to limit the cost of compliance. For example, proposed legislation would exempt many public companies; *i.e.*, any company with (i) a market value under \$700 million, (ii) product revenue less than \$125 million or (iii) less than 1,500 owners of record; from mandatory adherence to Section 404's audit requirements. n63

[iii] Auditing Standard No. 3

In June 2004, the PCAOB issued Auditing Standard No. 3, *Audit Documentation*, n64 which establishes general requirements for documentation which must be prepared and retained by auditors in connection with engagements conducted pursuant to PCAOB standards, including (i) audits of financial statements, (ii) audits of internal control over financial reporting and (iii) reviews of interim financial information. Among other important requirements of Auditing Standard No. 3:

- Audit documentation must be sufficient to (i) "demonstrate that the engagement complied with the standards of the PCAOB," (ii) "support the basis for the auditor's conclusions concerning every relevant financial statement assertion" and (iii) "demonstrate that the underlying accounting records agreed or reconciled with the financial statements."
- Audit documentation "must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement ... [t]o [among other things] understand the nature, timing, extent, and results of the procedures performed, evidence obtained and conclusions reached." n65
- An auditor should consider the following factors when determining the nature and extent of the documentation for an assertion in the financial statements: (i) "nature of the auditing procedure," (ii) "risk of material misstatement associated with the assertion," (iii) "extent of judgment required in performing the work and evaluating the results, for example, accounting estimates require greater judgment and commensurately more extensive documentation," (iv) "significance of the evidence obtained to the assertion being tested," and (v) "responsibility to document a conclusion not readily determinable from the documentation of the procedures performed or evidence obtained."
- Audit documentation "must include information the auditor has identified relating to significant findings or issues that is inconsistent with or contradicts the auditor's final conclusions." n66

As a general matter, under Auditing Standard No. 3, the auditor must retain required "audit documentation" for seven years from the release date of the auditor's report in connection with the issuance of the company's financial statements. n67

Auditors must remember that in addition to Auditing Standard No. 3 they are subject to record retention requirements imposed by SEC rules that implement Section 802 of the Sarbanes-Oxley Act. Under these rules accounting firms must retain specified records relating to their audits or reviews of issuers' and registered investment companies' financial statements for seven years n68 after the completion of the audit or review of those financial statements. n69 In large measure, these record retention rules apply to workpapers and other documents that support the work performed during the audit or review, such as correspondence and other communications. n70 In addition, these rules obligate accountants to retain records that either support their final conclusions on such an engagement or that contain information about a significant accounting matter that is inconsistent with their final conclusion. For example, such documents would

address consultations on the resolution of differences in professional judgment. n71

On the other hand, the above SEC rules provide that non-substantive materials (such as administrative records and other documents that do not contain relevant financial data or the accountant's conclusions, opinions or analyses) do not have to be retained. n72 Accordingly, as clarified by the SEC staff, the following documents generally do not have to be retained: superseded drafts of memoranda, financial statements or regulatory filings, notes on those superseded drafts, previous copies of workpapers that have been corrected for typographical errors or errors due to the training of new employees, duplicates of documents, and voice-mail messages. n73 In addition, financial information, records, databases and reports that an accountant examines at the client's premises, but are not made part of the accountant's workpapers, do not have to be retained under the SEC's new rules. n74

While Auditing Standard No. 3 and the above SEC rules are similar in many respects, they are not co-extensive. n75 For example, according to PCAOB, the SEC obligates auditors to retain, *in addition to documentation required by Auditing Standard No. 3*, all "memoranda, correspondence, communications (for example, electronic mail), other documents and records (in the form of paper, electronic or other media) that are created, sent, or received in connection with an engagement conducted in accordance with auditing and related professional practice standards and that contain conclusions, opinions, analyses or data related to the engagement." n76 Accordingly, to avoid potential regulatory difficulties, auditors must carefully check that they have created and retained all documentation mandated by *both* the PCAOB and the SEC.

[iv] Auditing Standard No. 4

In July, 2005, the PCAOB issued Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, n77 which sets forth requirements for auditors who are retained to report on whether a material weakness in internal controls (previously described in an auditor's report issued pursuant to Auditing Standard No. 2), that management believes has been remediated, continues to exist. These engagements (i) are strictly voluntary and only performed at the election of management and (ii) do not have to be conducted in conjunction with any attestation services. n78

Under Auditing Standard No. 4, the form of the resulting auditor's report is generally an opinion on whether the previously reported material weakness continues to exist. However, if any limitations exist relating to the scope of the auditor's work, the auditor is barred from expressing any opinion. The above standard does not permit the issuance of a qualified opinion under any circumstances. n79

[v] Auditing Standard No. 5

Auditing Standard No. 5 was previously discussed at § 5A.09[3][b][ii].

[vi] Auditing Standard No. 6

In January 2008, the PCAOB announced its adoption of Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* (and conforming amendments to the Board's interim auditing standards) n80. This new standard was approved by the SEC on September 16, 2008 and became effective on November 15, 2008. n81

Under Auditing Standard No. 6 auditors must evaluate the consistency of an issuer's financial statements and report any inconsistencies. n82 This new standard concentrates on the responsibilities of auditors concerning certain events that warrant recognition in their reports on financial statements, i.e., changes in accounting principles and corrections of misstatements in previously issued statements. n83 In addition, this standard makes it clear that auditors' reports must state whether an adjustment made to prior-period financials results from a change in accounting principle or the correction of a misstatement. n84

[4] Inspections, Investigations and Disciplinary Proceedings Conducted by the Public Company Accounting Oversight Board

Under Section 104 of the Sarbanes-Oxley Act, the PCAOB is required to regularly inspect each registered accounting firm to assess its compliance with the Sarbanes-Oxley Act and the PCAOB's rules. Firms that audit more than 100 public companies are inspected annually; other firms are inspected at least once every three years. n85 The inspection reports are made public, except that portions of the reports relating to defects in quality control systems are not made public if appropriate action is taken within 12 months to address the defect. n86

As stated by the PCAOB, "[w]hen audit deficiencies are identified after the date of the audit report, PCAOB standards require a firm to take appropriate actions to assess the importance of the deficiencies to the firm's present ability to support its previously expressed opinions, and failure to take such actions could be a basis for Board disciplinary sanctions." n87

[a] Summary of PCAOB Inspections

In 2003, the PCAOB commenced its inspection program with limited inspections of the four largest U.S. public accounting firms, Deloitte & Touche LLP ("Deloitte"), Ernst & Young LLP ("Ernst"), KPMG LLP ("KPMG") and PricewaterhouseCoopers LLP ("Pricewaterhouse"). n88 According to PCAOB member Daniel Goelzer, these first year inspections focused on the "tone at the top," the audit firm's mechanisms for evaluating, compensating and promoting professional employees, client acceptance and retention practices, internal training procedures and the effect of non-audit services (and other factors) on auditor independence. n89

On August 26, 2004, the PCAOB issued reports on the results of the limited inspections it conducted of the above four largest U.S. public accounting firms. Among other things, the public portion of these inspection reports n90 identified instances in which (i) financial statements of the firms' public clients did not appear to comply with GAAP and (ii) the firms' workpapers did not properly document the audit work which was performed. n91 Although these inspection reports focused on criticisms, then PCAOB Chairman William J. McDonough emphasized the positive aspects of the 2003 inspection program, as follows:

"As our reports state, their emphasis on criticisms do not reflect any broad negative assessment of the firms' audit practices. * * * The Board's inspections are unprecedented, and in this first year, our findings say more about the benefits of the robust, independent inspection process envisioned in the Sarbanes-Oxley Act of 2002 than they do about any infirmities in these firms' audit practices.

None of our findings has shaken our belief that these firms are capable of the highest quality auditing. * * * The Board is also encouraged by the firms' demonstrably cooperative attitude toward our inspections, which are designed to drive the firms to improve any aspects of their practices that may stand as impediments to the highest quality audit performance." n92

During 2004, the PCAOB conducted inspections of the eight largest U.S. public accounting firms and 91 smaller accounting firms which were based on those firms' 2003 audits. n93 In separate inspection reports on Deloitte, Ernst, KPMG and Pricewaterhouse, the PCAOB stated that "[i]n some cases, the deficiencies identified were of such significance that it appeared to the inspection team that the Firm had not, at the time it issued its audit report, obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements. In some of these audits, that conclusion followed from the omission or insufficient performance of a simple procedure, while other audits included more than one such failure." n94 While each of these firms submitted individual responses that addressed criticisms specific to them, they all emphasized that they took the PCAOB's findings seriously and were committed to continued cooperation with the PCAOB. n95

In 2005, the PCAOB expanded its inspection program from 91 to approximately 300 smaller firms (as well as the eight largest firms). n96 Among other things, the "issues of continuing concern" disclosed by the PCAOB's 2005 inspections included "related party issues," "revenue recognition," "auditing of expenses" and "independence." n97

According to George Diacont, PCAOB director of registration and inspections, the PCAOB sought to concentrate in 2006 on inspections of larger small firms (i.e., multi-office firms with more partners) and (as in the past) firms that audit Fortune 500 companies. n98 In effecting this plan, the Board inspected the eight largest U.S. firms, the largest firm in Canada and 183 smaller firms. n99

During 2007, the Board conducted inspections of the nine largest U.S. firms, the largest firm in Canada and 226 smaller firms. n100

[b] Recent PCAOB Reports Based on Observations Made During Inspections

In a report dated January 22, 2007, the PCAOB addressed certain observations, made in the course of its inspections, concerning failures by some auditors to satisfy their responsibilities relating to the detection of fraud under existing Board audit standards (principally, AU § 316, *Consideration of Fraud in a Financial Statement Audit*). n101 According to the PCAOB, these observations are "sufficiently important or arise with sufficient frequency" to warrant reminding auditors about adherence to procedures relevant to their consideration of fraud. n102

At the outset, the PCAOB noted that under AU § 316 an auditor is required to plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, including any caused by fraud. Accordingly, the auditor is obligated to assess risks and apply procedures directed specifically to the detection of a material fraudulent misstatement of its client's financial statements. n103

In the main body of its report, the PCAOB provided various examples of failures by audit firms to comply with AU § 316 that were observed by Board inspection teams, including (among others):

- In some cases, auditors failed to properly expand audit procedures after identifying specific fraud risk factors.
- On some engagements, audit teams failed to hold required "brainstorming sessions" during the planning stage of the audit to address fraud-related matters.
- Some auditors failed to investigate identified departures from GAAP in order to determine whether those departures were indicative of fraud.
- On occasion, auditors have not properly analyzed late adjustments proposed by management that significantly affect financial results and partially or completely offset adjustments previously proposed by the auditors.
- In some instances, it appears that auditors did not appropriately address the risk of management override of internal controls with respect to journal entries and accounting estimates.
- Some auditors failed to test the underlying data utilized in analytical procedures.
- In some situations, auditors who did not request confirmations of accounts receivable balances (or did not receive responses to positive confirmation requests) either failed to obtain, or failed to document that they had obtained, sufficient other evidence regarding the existence of those balances. n104

At the conclusion of its report, the PCAOB stated that it communicated quality control concerns to the audit firms at which the above deficiencies were identified. According to the report, those firms are responding to the Board's criticisms in a positive manner. n105

Subsequently, on October 22, 2007, the PCAOB issued a report that discusses audit areas where Board inspectors "observed significant or frequent deficiencies" during their inspections of smaller firms (i.e., those that audit no more than 100 issuers), which (as noted above) are subject to triennial Board inspections. n106 The observations in this report were identified during the course of the PCAOB's 2004, 2005 and 2006 inspections of domestic triennially inspected firms. n107

Specifically, in identifying audit areas of concern, the October 22, 2007 report stated that Board inspectors have (among other things):

- identified "deficiencies relating to firms' testing of *issuers' recognition of revenue*, including the firms' failure to (a) perform any or adequate substantive procedures to test the existence, completeness and valuation of revenue; (b) review representative contracts or appropriately evaluate the specific terms and provisions included in significant contractual arrangements; or (c) test whether revenue was recorded in the appropriate period,"
- observed "deficiencies related to firms' failures to identify and address the lack of disclosure of *related party transactions*. They also have identified deficiencies relating to the effectiveness of firms' testing of the nature, economic substance and business purpose of transactions with related parties."
- noted "instances where firms failed to test or insufficiently tested, the *accounting for equity transactions*, including evaluating the adequacy of the disclosure of these transactions in the notes to the financial statements."
- observed "that some firms failed to perform, or to perform adequately ... procedures" to "evaluate whether there is substantial doubt about ... *[an] entity's ability to continue as a going concern*"
- identified several ways in which firms have failed to comply with *independence requirements of the SEC and the Board*, especially with respect to prohibited non-audit services and improper agreements between an auditor and its issuer client that limit the auditor's potential liability n108

Notwithstanding the above deficiencies, the October 22, 2007 report also emphasized that the majority of the triennially inspected firms appreciate the feedback they obtained during the inspection process and are taking measures to enhance the quality of their audits. n109

In a report dated December 5, 2008, the PCAOB discussed various observations it identified during the course of its 2004, 2005, 2006 and 2007 inspections of the eight domestic accounting firms that have been inspected every year since the commencement of the Board's inspection program. n110 Among other things, based on its inspections, the report noted that the following "trends have emerged":

- Board inspections continue to uncover deficiencies in important audit areas including "critical and high-risk parts of audits, such as revenue, fair value, management's estimates, and the determination of materiality and audit scope." According to the PCAOB, "[i]n some cases, the deficiencies appeared to have been caused, at least in part, by the failure to apply an appropriate level of professional skepticism when conducting audit procedures and evaluating audit results."
- On the other hand, "[i]n certain well-established audit areas, such as the confirmation of accounts

receivable and the auditing of income tax accounts, the incidence of deficiencies encountered has declined." In addition, in some other areas, "such as the performance of analytical procedures, the nature of the deficiencies identified by inspectors has generally narrowed during the four year [inspection] period, with fewer of them relating to the overall failure to apply the governing standard and more relating to only one or a few aspects of the standard."

- In response to the Board's identification of quality control deficiencies during the inspection process, accounting firms "have changed their audit methodologies, processes or related quality control systems." In this regard, in remediation plans submitted to the Board, firms have described changes in "their structure, partner evaluation processes, internal inspection programs, procedures for using the work of foreign affiliates, and processes for compliance with independence standards." n111

Addressing the substance of the Board's December 5, 2008 report, George Diacont, PCAOB director of registration and inspections, stated:

While we are encouraged by the efforts of firms to remediate quality control deficiencies that we have observed, the report highlights the need for continued focus on performing high quality audits. Even in recent years, we are seeing deficiencies in the most important and high-risk areas of the audits, where appropriate levels of care and professional skepticism are needed. n112

[c] PCAOB Investigations and Disciplinary Proceedings n113

In addition to conducting inspections, the PCAOB has broad authority to investigate any act or practice, or omission to act, by a registered firm (or associated person) "that may violate any provision of ... [the Sarbanes-Oxley] Act, the rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto ... or professional standards." n114

In a PCAOB investigation, registered firms (and associated persons) may be required to produce documents and provide testimony and are subject to specified sanctions for noncooperation with the investigation. n115 While the PCAOB only has disciplinary authority over accountants, it is authorized to seek information from other persons, including clients of registered firms. n116

When the PCAOB detects violations of applicable law or standards, it may institute disciplinary proceedings against a registered firm (or an associated accountant). n117 Sanctions available to the PCAOB include:

- Temporary or permanent revocation of a firm's registration.
- Temporary or permanent bar of an individual from associating with a registered firm.
- Temporary or permanent limits on the activities of a firm or individual. n118
- Fines up to \$100,000 for individuals and \$2,000,000 for entities and up to \$750,000 and \$15,000,000, respectively, in the case of intentional or other knowing conduct.
- Censure.
- Additional education and training.
- Requiring a firm to engage an independent monitor to observe and report on the firm's compliance with applicable law and standards.

- Requiring a firm to engage counsel or another consultant to design policies to effectuate compliance with applicable law and standards.

- Requiring a firm to obtain an independent review and report on one or more audit engagements.

n119

Sanctions may also be imposed on an accounting firm for failure to supervise employees where the employee commits a violation of the federal securities laws or the rules of the PCAOB. n120

As of December 4, 2008, the PCAOB has issued nineteen disciplinary proceeding decisions which imposed sanctions on registered firms and associated persons. n121 Illustratively, in *In the Matter of Clyde Bailey, P.C., and Clyde B. Bailey, CPA*, n122 pursuant to offer of settlement, the PCAOB revoked the registration of an accounting firm and banned its sole shareholder from being an associated person of a registered firm after finding that they failed to exercise due professional care, exercise professional skepticism and obtain sufficient competent evidential manner in connection with audits they performed for certain public clients. n123 In particular, the PCAOB found (among other things) that respondents failed to perform audit procedures sufficient (i) to evaluate representations made by a client's management, (ii) to evaluate whether a client had engaged in material related party transactions and (iii) to assess the valuation of marketable securities held by a client. n124

[5] Pre-approval of Audit and Non-Audit Services by Audit Committee

Under the Sarbanes-Oxley Act, auditing services (including providing comfort letters in connection with securities underwritings and certain statutory audits) and permitted non-audit services must be pre-approved by the issuer's audit committee (which approval must be disclosed in periodic reports). n125

[6] Restrictions on Non-Audit Services and Independence Issues

To enhance auditor independence, Section 201 of the Sarbanes-Oxley Act prohibits registered accounting firms from providing to issuers, contemporaneously with an audit, any of the following non-audit services:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client. n126
- Financial information systems design and implementation. n127
- Appraisal or valuation services, fairness opinions or contribution-in-kind reports. n128
- Actuarial services. n129
- Internal audit outsourcing services. n130
- Management functions n131 or human resources. n132
- Broker or dealer, investment adviser or investment banking services. n133
- Legal services n134 and expert services unrelated to the audit. n135
- Any other service that the PCAOB determines, by regulation, is impermissible. n136

Auditors should not assume that the above list (and related SEC rules) gives them a "green light" to perform all non-audit services that are not specifically prohibited. As emphasized by then-SEC Commissioner Cynthia Glassman, audit committees should carefully examine every proposed non-audit service and make an informed judgment concerning its effect on the auditor's independence.

Commissioner Glassman further noted that any pre-approval by an audit committee of a "basket" of non-audit services would be inconsistent with the Sarbanes-Oxley Act's requirement that the committee pre-approve each service. n137 For example, while an accounting firm can generally provide tax services (which are not listed above) to its audit clients without compromising the firm's independence, the SEC has cautioned that "merely labeling a service as a 'tax service' will not necessarily eliminate its potential to impair independence...". Specifically, accountants would impair their independence by representing an audit client before a tax court, district court, or federal court of claims. In addition, audit committees also should scrutinize carefully the retention of an accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment of which may not be supported in the Internal Revenue Code and related regulations." n138

In addition, on July 26, 2005, the PCAOB proposed rules, which were subsequently approved by the SEC, that further limit tax services accountants may perform for their public audit clients (and certain senior officers of those clients). n139 For example, under these rules, an auditor's independence unquestionably would be impaired if it provides (i) certain aggressive tax shelter services to audit clients (Rule 3522), (ii) contingent fee tax-related services to audit clients (Rule 3521) or (iii) tax services to certain individuals who serve in financial reporting oversight roles for audit clients (and immediate family members of those persons) (Rule 3523). n140 These new rules took effect at varying times depending upon specified effective dates established by the PCAOB. n141

Moreover, to further enhance auditor independence, the SEC has adopted a rule that states that an accountant is not independent from an audit client if an audit partner on the engagement received compensation based on selling engagements to that client for services other than audit, review and attest services. n142 The foregoing rule does not apply to an audit partner who is a "specialty partner" (e.g., a tax specialist or a valuation specialist). n143

In April 2008, the PCAOB adopted Rule 3526, *Communication with Audit Committees Concerning Independence*, in an effort to improve communication between registered accounting firms and their clients' audit committees concerning independence issues. n144 As described by the PCAOB, this rule obligates accounting firms, prior to accepting an initial engagement, "to describe in writing to the audit committee all relationships between the firm or any of its affiliates and the issuer or persons in a financial reporting oversight role at the issuer that may reasonably be thought to bear on the firm's independence." n145 In addition, accounting firms are obligated to discuss with their clients' audit committees the potential consequences of any such relationships on their independence. n146

In an administrative proceeding brought by the SEC against Ernst & Young LLP ("E&Y") for alleged violations of auditor independence standards, a SEC administrative law judge suspended E&Y from accepting new public audit clients for six months. According to the judge's decision, E&Y's independence was compromised because of a joint business relationship it maintained with an audit client. In reaching this decision, the judge declined to consider E&Y's defenses based on alleged immateriality. According to the judge, the SEC has consistently refused to apply any materiality standard when addressing auditor independence. n147

[7] Audit Partner Rotation

Under Section 203 of the Sarbanes-Oxley Act, the lead audit partner having primary responsibility for the audit of an issuer and the concurring partner responsible for reviewing that audit are each prohibited from providing audit services to the client for more than five consecutive years. n148 In May 2003, the SEC adopted rules under the Sarbanes-Oxley Act that provide that after being rotated off an audit engagement, the lead and concurring partners must be subject to a five-year "time-out" period before they can return to the engagement. n149 In addition, "audit partners" other than lead

and concurring partners (*e.g.*, "relationship partners who serve the client at the issuer or parent level") must rotate after no more than seven years and are subject to a two-year "time-out" period. n150

Audit firms with fewer than five audit clients that are issuers and fewer than ten partners may seek an exemption from the above SEC partner rotation requirements. n151 In order to obtain this exemption, qualifying firms must allow the PCAOB to review all of their professional engagements subject to the rotation requirement at least once every three years. n152 According to the SEC, "[t]his special review should focus on the overall quality of the audit and, in particular, the independence and competence of key personnel on the audit engagement teams." n153

The SEC allowed for the orderly transition of firms' audit engagement teams by establishing transition provisions related to partner rotation requirements. n154 For example, since lead partners already were subject to rotation requirements under the AICPA (SEC Practice Section) membership requirements, the SEC stated that its rotation requirements for lead partners were not effective until the first fiscal year ending after the effective date of the rotation rule [May 6, 2003]. n155 The lead partner's time served in that position prior to the effective date of the rotation rule was included in determining when that partner must rotate. n156 If the lead partner was in his or her fifth, sixth or seventh year as lead partner for an audit client, he or she were required to rotate off the following year's engagement. n157

Under Section 207 of the Sarbanes-Oxley Act, the Comptroller General of the United States is directed to report to Congress as to whether there should be a mandatory rotation of auditing firms of the issuer.

[8] Hiring Auditor Personnel

The Sarbanes-Oxley Act prohibits a registered accounting firm from providing audit services for an issuer if the issuer's chief executive officer, controller, chief financial officer, chief accounting officer or person serving in an equivalent position for the issuer was employed by the accounting firm and participated in any capacity in the audit during the one-year period preceding the date of the initiation of the current audit. n158

[9] Appearance and Practice Before the Securities and Exchange Commission

Section 602 of the Sarbanes-Oxley Act codifies the SEC's pre-existing power under Rule 102(e) n159 of its Rules of Practice to sanction accountants, lawyers and other professionals who "appear or practice" before the Commission. n160 Specifically, Section 602 authorizes the SEC to censure, or deny, temporarily or permanently, any person the privilege of appearing or practicing before the SEC in any way if the SEC finds that the person (1) does not possess the requisite qualifications to represent others, (2) is lacking in character or integrity or has engaged in unethical or improper professional conduct, or (3) has willfully violated, or has willfully aided and abetted the violation of, any securities laws or regulations. n161 For accounting firms and accountants, improper professional conduct is defined to include intentional, knowing or reckless conduct that results in a violation of applicable professional standards, or negligent conduct in the form of a single instance of highly unreasonable conduct that results in a violation of such standards in circumstances in which the firm or accountant knew, or should have known, that heightened scrutiny was warranted or repeated instances of unreasonable conduct, each resulting in a violation of such standards.

The following are examples of Rule 102(e) proceedings instituted against accountants since the enactment of the Sarbanes-Oxley Act:

1. In *In the Matter of Barry C. Scuttillo, CPA and Mark F. Jensen, CPA*, n162 the Order Instituting Proceedings (the "OIP") charged that the engagement partner failed (among other things) to plan or perform appropriate procedures to audit accounts relating to Sky Scientific's ("Sky") Russian Certificates of Deposit and mineral properties, maintain control over the confirmation process and take appropriate steps to satisfy itself that Sky's financial statements complied with GAAP. Based on the foregoing, the Division of Enforcement's requested a permanent Rule 102(e) bar against the

engagement partner. After hearing the matter, the Administrative Law Judge (the "ALJ") barred the partner from practicing before the Commission for three years. In imposing this sanction, the ALJ noted that the engagement partner had surrendered his professional judgment to the demands of his client in placing undue reliance on a doubtful confirmation. On review, the Commission affirmed the three-year Rule 102(e) bar.

2. In *In the Matter of Philip L. Pascale*, n163 the OIP charged (among other things) that the engagement partner on certain audits of Composite Holdings, Inc. ("Composite") engaged in improper professional conduct within the meaning of Rule 102(e) based on his failure to detect Composite's improper accounting for a patent it acquired pursuant to an acquisition, its subsequent failure to take an impairment charge on the patent, and its improper recording of a deferred tax asset. n164 The ALJ determined that the engagement partner had not committed any actionable conduct and dismissed the proceeding. On appeal, the Commission found that the engagement partner had failed to maintain an attitude of professional skepticism, obtain sufficient competent evidential matter and exercise due professional care and it issued a cease-and-desist order against the partner based on specified statutory violations. On the other hand, while the Commission also ruled that the engagement partner violated Rule 102(e), it stated, without any other explanation, that "[i]n light of our issuance of a cease and desist order, under the particular circumstances of this case, we have determined not to sanction Pascale [the engagement partner] for his improper professional conduct under Rule 102(e)(1)(ii)." n165

3. In *In the Matter of Kevin M. Harris, C.P.A.*, n166 Kevin Harris ("Harris"), a CPA who served as Akorn, Inc.'s ("Akorn") CFO for six months, was charged with various statutory and other violations in connection with Akorn's understatement of its allowance for doubtful accounts and failure to properly account for chargebacks and rebates. In its request for relief, the Division of Enforcement sought a cease-and-desist order, disgorgement of \$38,000, and a Rule 102(e) sanction against Harris. While the ALJ found willful violations on Harris' part, the judge did not grant the requested relief on account of Harris' short tenure with Akorn, his lack of profit from any violations, and his general credibility and positive demeanor. In addition, in declining to grant any sanction under Rule 102(e), the ALJ stated that this measure "tarnishes an accountant's professional career for life, and [was] too severe in these circumstances." n167

4. In *In the Matter of Kenneth L. Rubin, CPA and Michael W. Lewis, CPA*, n168 the OIP alleged various violations against the audit engagement partner and manager that arose from their client's (Eisner Securities Inc.) failure to accrue a contingent liability that resulted from its offer to settle claims asserted by customers whose funds had been misappropriated by a former registered representative. The OIP further alleged that the audit partner and manager failed to obtain sufficient competent evidential matter, exercise due professional care and maintain professional skepticism with respect to the underlying transactions. Based on the foregoing, the ALJ imposed a three-year Rule 102(e) bar against both the audit partner and the manager.

5. In *In the Matter of James Thomas McCurdy, CPA*, n169 McCurdy was charged with having issued an unqualified audit report on the 1998 financial statements of JWB Aggressive Growth Fund without adequate consideration of a substantial receivable whose collectability was not probable. The Division of Enforcement also claimed that McCurdy failed to obtain sufficient competent evidential matter, maintain an attitude of professional skepticism and exercise due professional care. While the ALJ determined that McCurdy should have obtained more audit evidence from additional sources, the judge declined to impose a Rule 102(e) sanction because McCurdy had not acted recklessly or highly unreasonably in the matter. On review, the Commission reversed the ALJ's decision, holding that the auditor had acted in a culpable manner. In addition, the Commission imposed a one-year Rule 102(e) suspension on McCurdy and this suspension was affirmed on appeal by the Court of Appeals for the District of Columbia Circuit.

Shortly after the enactment of the Sarbanes-Oxley Act, in December 2002, Stephen Cutler, then Director of the SEC's Enforcement Division, proposed a new enforcement model in which the SEC would hold accounting firms legally accountable for the actions of their partners as opposed to only suing individual members of audit engagement teams. n170 Later in May 2003, the SEC announced that it had settled an enforcement action against PricewaterhouseCoopers LLC ("PwC") for improper professional conduct. n171 In this announcement, Associate Enforcement Director Antonia

Chion said the case was an example of the division's new enforcement model.

[10] The Statute of Limitations

Section 804 of the Sarbanes-Oxley Act increases the statute of limitations for actions alleging securities fraud to the earlier of two years after discovery of the facts constituting the violation or five years from the time of the violation.
n172

Under Section 804, the above increased limitations periods only apply to actions instituted after July 30, 2002, the date of enactment of Sarbanes-Oxley. In addition, virtually every court which has addressed the issue has held that Section 804 cannot be applied retroactively to revive claims which were already time-barred on July 30, 2002. n173

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 107-204, 116 Stat. 746 (July 30, 2002); *15 USC §§ 7201 et seq.*

(n2)Footnote 2. As appropriate, certain section numbers of the Sarbanes-Oxley Act embodying indicated provisions thereof are set forth in text and notes below.

(n3)Footnote 3. Section 102 and *Frequently Asked Questions Regarding Registration with the Board*, PCAOB Rel. No. 2003-011A (Nov. 13, 2003). *See also* final rules issued by the PCAOB to implement Section 102 [PCAOB Rel. No. 2003-007 (May 6, 2003)] which were approved by the SEC on July 16, 2003 [*Order Approving Proposed Rules Relating to Registration System*, Securities Exchange Act Release No. 48180 (July 16, 2003)].

The deadline for foreign firms to register was July 19, 2004. *See Registration Deadline for Non-U.S. Accounting Firms*, PCAOB Rel. No. 2004-003 (Mar. 11, 2004).

Accounting firms are required to update their registrations annually. Section 102.

(n4)Footnote 4. *See* PCAOB Rel. No. 2003-011A (Nov. 13, 2003). The PCAOB also considers "the accuracy and completeness of each application." *Id.*

(n5)Footnote 5. Section 102. In addition, the PCAOB has issued rules relating to investigations and adjudications (including registration application hearings) [*Rules on Investigations and Adjudications*, PCAOB Rel. No. 2003-015 (September 29, 2003)] which were approved by the SEC on May 14, 2004 [*Order Approving Proposed Rules Relating to Investigations and Adjudications*, Securities Exchange Act Release No. 49704 (May 14, 2004)].

(n6)Footnote 6. Section 102.

(n7)Footnote 7. *See* PCAOB Registration at <http://www.pcaobus.org>. (December 4, 2008). The above total includes 10 pending applications by accounting firms to withdraw from registration. *Id.*

(n8)Footnote 8. *See* PCAOB Registration Disapproval Notices at <http://www.pcaobus.org>. (December 4, 2008).

(n9)Footnote 9. Section 102.

(n10)Footnote 10. *See* Rules on Periodic Reporting by Registered Public Accounting Firms, PCAOB Rel. No. 2008-004 (June 10, 2008). These rules are subject to approval by the SEC.

(n11)Footnote 11. *See* PCAOB Rel. No. 2008-004, *supra* at, e.g., p. 20. *See also* David Reilly, *Rule Would Boost Audit Disclosure*, Wall Street Journal, May 24, 2006, at C5.

(n12)Footnote 12. *Id.* It is anticipated that the above requirement might deter companies from attempting to

conceal financial restatements. According to a report by the firm of Glass Lewis & Co., in 2005, such "stealth restatements" comprised one-third of the restatements made by domestic public companies. *Id.*

(n13)Footnote 13. See SEC Rel. No. 33-8222 (April 25, 2003). See also *SEC Finds That PCAOB Satisfies Requirements of the Sarbanes-Oxley Act*, SEC TODAY, Vol. 2003-82 (Apr. 30, 2003).

(n14)Footnote 14. Order Regarding Section 103(a)(3)(B) of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 23335 (May 1, 2003) .

(n15)Footnote 15. In particular, under PCAOB Rule 3200T, Interim Auditing Standards, registered public accounting firms must follow Generally Accepted Auditing Standards as they existed on April 16, 2003. See Order Regarding Section 103(a)(3)(B) of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 23335 (May 1, 2003) .

(n16)Footnote 16. PCAOB Rule 3300T, Interim Attestation Standards, requires registered public accounting firms to comply with those Statements on Standards for Attestation Engagements and related Interpretations and Statements of Position adopted by the ASB, as they existed on April 16, 2003. See *Establishment of Interim Professional Auditing Standards*, PCAOB Rel. No. 2003-006, at <http://www.pcaobus.org> (Apr. 18, 2003).

(n17)Footnote 17. Rule 3400T, Interim Quality Control Standards, designates (i) the Statements on Quality Control Standards adopted by the ASB and (ii) certain AICPA SEC Practice Section membership requirements as they existed on April 16, 2003, as the PCAOB's Interim Quality Control Standards. See Order Regarding Section 103(a)(3)(B) of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 23335 (May 1, 2003) .

Based on the foregoing, the requirements incorporated in Rule 3400T relate, among other things, to:

- Continuing professional education of audit personnel;
- Concurring partner review of the audit report and the financial statements of Commission registrants. It should be noted that instead of incorporating the AICPA SEC Practice Section membership provision that allows the AICPA's peer review committee to "authorize alternative procedures" when the requirement for a concurring review cannot be met because of the small size of the firm, Rule 3400T provides that requests for such authorization should be directed to the Board itself;
- Communication by written statement to all professional personnel of firm policies and procedures on the recommendation and approval of accounting principles, present and potential client relationships, and the types of services provided;
- Notification of the Commission of resignations and dismissals from audit engagements for Commission registrants; and
- Policies and procedures to comply with applicable independence requirements.

See *Establishment of Interim Professional Auditing Standards*, PCAOB Rel. No. 2003-0006, at <http://www.pcaobus.org> (Apr. 18, 2003); Order Regarding Section 103(a)(3)(B) of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 23335 (May 1, 2003) .

On February 26, 2008, the PCAOB proposed an auditing standard, *Engagement Quality Review*, that would supersede the Board's interim requirements relating to concurring partner review. See *Proposed Auditing Standard -- Engagement Quality Review and Conforming Amendment to the Board's Interim Quality Control Standards*, PCAOB Rel. No. 2008-002 (February 26, 2008). Under existing requirements, in order for a concurring reviewer to provide "approval of

issuance," he or she must conclude that no matters have come to his or her attention that would cause him or her to believe that the issuer's financial statements did not conform with GAAP or that the audit was not performed in accordance with applicable Board Standards, *Id.*, p. 6. Among other things, the proposed standard adds the new requirement that "the reviewer must *not* provide concurring approval of issuance if he or she knows, or should know based upon the requirements of the standard, that the engagement team failed to obtain sufficient competent evidence, the engagement team's overall conclusion or report is inappropriate, or the firm is not independent of its client." *Id.* (*emphasis added*). In addition, the proposed standard also states that approval of the concurring reviewer must be obtained before an audit firm can grant permission to its client to use the firm's engagement report (or communicate any conclusion to its client if no such report is issued.) *Id.*

Now that the applicable comment period has closed, the Board will decide whether to adopt final rules concerning the concurring review requirement. Any final rules will be submitted to the SEC for approval.

(n18)Footnote 18. Rule 3500T, Interim Ethics Standards, provides that in connection with the preparation or issuance of any audit report, a registered public accounting firm (and its associated persons) must comply with the ethics standards set forth in the AICPA's Code of Professional Conduct Rule 102, and interpretations and rulings thereunder, as in existence on April 16, 2003. *See Order Regarding Section 103(a)(3)(B) of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 23335 (May 1, 2003).*

(n19)Footnote 19. Rule 3600T, Interim Independence Standards, provides that in connection with the preparation or issuance of any audit report, a registered public accounting firm (and its associated persons) must comply with (i) the independence standards set forth in the AICPA's Code of Professional Conduct Rule 101, and interpretations and rulings thereunder, as in existence on April 16, 2003 and (ii) certain standards and interpretations of the Independence Standards Board. *See Order Regarding Section 103(a)(3)(B) of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 23335 (May 1, 2003).* To the extent that an auditor independence rule previously established by the SEC under Rule 2-01 of Reg. S-X (17 C.F.R. 240.2-01) is more restrictive-or less restrictive-than the Board's Interim Standards, a registered public accounting firm must comply with the more restrictive rule. *Id.*

(n20)Footnote 20. *See Establishment of Interim Professional Auditing Standards*, PCAOB Rel. No. 2003-006, at <http://www.pcaobus.org> (Apr. 18, 2003). In addition, on December 17, 2003, the PCAOB approved technical amendments to the above interim standards rules indicating that "when the Board adopts a new auditing and related professional standard that addresses a subject matter that also is addressed in the interim standards, the affected portion of the interim standards will be superseded or effectively amended. Accordingly, the Board approved adding the phrase 'to the extent not superseded or amended by the Board' to each of the interim standards rules." *Technical Amendments to Interim Standards Rules*, PCAOB Rel. No. 2003-26 (Dec. 17, 2003), Exchange Act Release No. 49624 (April 28, 2004) (SEC approval).

(n21)Footnote 21. AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*.

(n22)Footnote 22. AU sec. 311, *Planning and Supervision*.

(n23)Footnote 23. AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*.

(n24)Footnote 24. AU sec. 326, *Evidential Matter*.

(n25)Footnote 25. AU sec. 313, *Substantive Tests Prior to the Balance Sheet Date*.

(n26)Footnote 26. *Proposed Auditing Standards Related to the Auditor's Assessment of and Response to Risk*, PCAOB Rel. No. 2008-06 (October 21, 2008). *See also* PCAOB's October 21, 2008 press release entitled *Board Proposes New Auditing Standards Related to the Auditor's Assessment of and Responses to Risk*, available at http://www.pcaobus.org/News_and_Events/News/2008/10-21.aspx.

(n27)Footnote 27. PCAOB Rel. No. 2008-06 (October 21, 2008) (pp. 9-10).

(n28)Footnote 28. *Id.*

(n29)Footnote 29. PCAOB Rel. No. 2003-025 (Dec. 17, 2003), which was subsequently approved by the SEC. See *Order Approving Proposed Auditing Standard No. 1, References in Auditor's Reports to the Standards of the Public Company Oversight Board*, Securities Exchange Act Rel. No. 49707 (May 14, 2004).

(n30)Footnote 30. See Final Rule: *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, at <http://www.sec.gov/rules/final/33-8183a.htm> (June 11, 2003).

The United States Sentencing Commission's Ad Hoc Advisory Group has urged an amendment to the Sentencing Guidelines related directly to internal control compliance at the corporate level. The proposed Guidelines would hold directors and those in leadership posts of all organizations, including government agencies, responsible for failures in the compliance system. The Advisory Group recommended that the "governing authority" of an organization--often the board of directors--be held responsible for their company's compliance program and its effectiveness in white collar crime detection and prevention. See *Report of the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines*, at www.ussc.gov/corp/advgrprpt/advgrprpt.htm.

(n31)Footnote 31. PCAOB Rel. No. 2004-001 (March 9, 2004), which was subsequently approved by the SEC. See *Order Approving Proposed Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, Securities Exchange Act Rel. No. 49884 (June 17, 2004).

(n32)Footnote 32. PCAOB Rel. No. 2007-005 (May 24, 2007), which was subsequently approved by the SEC on July 25, 2007. See *Order Approving Proposed Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements*, Securities Exchange Act. Rel. No. 2007-144 (July 25, 2007). Auditing Standard No. 5 is effective for audits of fiscal years on or after November 25, 2007.

(n33)Footnote 33. Auditing Standard No. 2, para 4.

(n34)Footnote 34. *Policy Statement Regarding Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, PCAOB Rel. No. 2005-009 (May 16, 2005) (the "May 16, 2005 Policy Statement").

(n35)Footnote 35. See May 16, 2005 Policy Statement, p. 2 (emphasis in original).

(n36)Footnote 36. *Report on the Initial Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, PCAOB Release No. 12005-023 (Nov. 30, 2005) (the "November 30, 2005 Report").

(n37)Footnote 37. For example, this report (pp. 2-4) observed that some auditors did not (i) integrate their internal control audits with their audits of financial statements, (ii) alter the notice, timing and extent of their internal control testing to reflect the level of risk, (iii) effectively apply a "top-down approach," (iv) utilize the work of others to the extent allowable by Auditing Standard No. 2 and (v) perform sufficient testing of the internal controls over the preparation of financial statement disclosures.

(n38)Footnote 38. *Report on the Second-Year Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, PCAOB Rel. No. 2007-004 (April 18, 2007).

(n39)Footnote 39. During 2006, PCAOB inspectors reviewed portions of approximately 275 audits that were

conducted of internal control over financial reporting. *Id.*, at p. 1.

(n40)Footnote 40. *Id.*

(n41)Footnote 41. *Id.*, pp. 1-2.

(n42)Footnote 42. See PCAOB Press Release entitled, *Board Approves New Audit Standard for Internal Control Over Financial Reporting and, Separately, Recommendations on Inspection Frequency Rule* (May 24, 2007) (p.2), available at http://www.pcaobus.org/News_and_Events/News/2007/05-24.aspx.

(n43)Footnote 43. *Id.*, The PCAOB stated that it adopted its new internal control auditing standard based on its above observations and the approaching date for smaller issuers to comply with Sarbanes-Oxley's internal control reporting requirement. *Id.*

(n44)Footnote 44. *Id.*

(n45)Footnote 45. In the past, based on deferrals granted by the SEC, smaller public companies (with caps of less than \$75 million) did not have to comply with Section 404's reporting and auditing requirements. However, based on recent SEC directives, "smaller" public companies must begin reporting on their internal controls in their 2007 annual reports. In addition, according to the SEC, those companies will become subject to Section 404's audit requirements in connection with their annual reports for fiscal years ending on or after December 15, 2009. See SEC Release entitled SEC Approves One-Year Extension for Small Businesses From Auditor Attestation Requirement in Sarbanes-Oxley Act (June 20, 2008), available at <http://www.sec.gov/news/press/2008/2008-116.htm>. See also SEC brochure entitled Sarbanes-Oxley Section 404, A Guide for Small Business available at <http://www.imanet.org/pdf/SBC404guide.pdf>; Judith Burns, SEC Seeks Rules Delay For Small Companies, Wall Street Journal, December 13, 2007, at C4.

(n46)Footnote 46. If these exemptions were put into place, approximately 80% of all public companies would be excused from the provisions of Section 404. See *Senator Sarbanes Does Not Support Section 404 Exemption for Small Companies*, SEC TODAY, Vol. 2006-59 (Mar. 28, 2006).

(n47)Footnote 47. For example, a report issued by the Government Accountability Office (the "GAO") noted that smaller companies subject to Section 404 internal control requirements were paying more as a percentage of revenue than larger companies to satisfy those requirements. Siobhan Hughes, *GAO Seeks Smaller Exemption to Sarbanes-Oxley Provisions*, Wall Street Journal, May 9, 2006, at C4. Despite this finding, the GAO report concluded that while "some interim regulatory relief [for smaller public companies] on a limited scale may be appropriate, ... given the number of public companies that would potentially qualify, a significant reduction in scope of the ... relief [proposed by the SEC Advisory Committee] needs to occur to preserve the overriding investor protection purpose of the Sarbanes-Oxley Act." *Id.*

Among other critics of Section 404, Congressman Tom Feeney of Florida complained that its requirements was "outsourcing America's lead in capital markets" by causing public companies to list their stock in foreign countries. Floyd Norris, *SEC Eases Audit Rules But Rejects Exemptions*, The New York Times, May 18, 2006, at C1.

(n48)Footnote 48. See Michael Rapoport, *SEC Panel to Turn In Report on Sarbanes Debate*, Wall Street Journal, April 17, 2006, at C3. In addition, according to a report from Glass Lewis & Co., the companies subject to partial or full exemption under the SEC Advisory Committee's proposal accounted for 59% of restatements of financial results by public companies in 2005. Karen Scannell and David Reilly, *Small Firms' Sarbanes Suffering? -- SEC Seems Unwilling to Exempt Little Guys from Internal Controls*, Wall Street Journal, April 6, 2006, at C1.

In addition to the debate over whether smaller companies should be excused from complying with Section 404, there are differing views concerning whether the SEC has the statutory power to exempt any public companies from Section 404's requirements. See *Oxley and Baker Say SEC Has Authority to Provide Section 404 Exemptions*, SEC TODAY,

Vol. 2006-54 (Mar. 21, 2006); *Senator Sarbanes Does Not Support Section 404 Exemption for Small Companies*, SEC TODAY, Vol. 2006-59 (Mar. 28, 2006).

(n49)Footnote 49. David Reilly, *Internal Control Help Becomes Less Costly*, Wall Street Journal, April 19, 2006, at C3; Floyd Norris, *Audit Law's Costs Decline Survey Shows*, The New York Times, April 19, 2006, at C2..

(n50)Footnote 50. *Id.* According to the CRA study, total costs included both internal company costs and the costs of the audits required by Section 404. While Section 404 auditing fees dropped for all businesses, the decline for the larger business was offset by higher regular audit fees. Floyd Norris, *Audit Law's Costs Decline Survey Shows*, The New York Times, April 19, 2006, at C2.

(n51)Footnote 51. *Id.*

(n52)Footnote 52. David Reilly, *Outside Audit: Checks on Internal Controls Pay Off*, Wall Street Journal, May 8, 2006, at C3. It should be noted that the Lord & Benoit study did not encompass public companies with a market cap of less than \$75 million because they were not yet required to comply with Section 404's requirements. *Id.*

(n53)Footnote 53. *Id.*

(n54)Footnote 54. *Id.*

(n55)Footnote 55. See Floyd Norris, *SEC Eases Audit Rules But Rejects Exemptions*, The New York Times, May 18, 2006, at C1; David Reilly and Karen Scannell, *SEC Won't Exempt Small Firms From Controls Rules*, Wall Street Journal, May 18, 2006, at C4.

(n56)Footnote 56. See SEC brochure entitled *Sarbanes-Oxley Section 404, A Guide for Small Business*, available at <http://www.imanet.org/pdf/SBC404guide.pdf>; Judith Burns, *SEC Seeks Rules Delay For Small Companies*, Wall Street Journal, December 13, 2007, at C4.

(n57)Footnote 57. See SEC Press Release entitled *SEC Begins Small Business Costs and Benefits Study of Sarbanes-Oxley Act Section 404* (February 1, 2008), available at <http://www.sec.gov/news/press/2008/2008-8.htm>. According to the SEC, this new guidance will assist companies in focusing their reviews "on the internal control issues that matter most to investors." *Id.*

(n58)Footnote 58. See December 12, 2007 testimony of SEC Chairman Christopher Cox before the U.S. House of Representatives Committee on Small Business, available at <http://www.sec.gov/news/testimony/2007/ts121207cc.htm>.

(n59)Footnote 59. See SEC Press Release entitled *SEC Approves One-Year Extension for Small Businesses From Auditor Attestation Requirement in Sarbanes-Oxley Act* (June 20, 2008), available at <http://www.sec.gov/news/press/2008/2008-116.htm>.

(n60)Footnote 60. *Id.* The SEC stated that it would gather "new data from a broad array of companies about the costs and benefits" of compliance with Section 404's requirements through "interviews and other outreach," including a "Web-based survey." *Id.*

(n61)Footnote 61. *Id.* It is anticipated that the results of the SEC's study will become available during the extension period recently established by the Commission for "smaller" companies to comply with Section 404's audit requirements.

(n62)Footnote 62. See (i) *Preliminary Staff Views, An Audit of Internal Control That is Integrated with an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies*, dated October 17, 2007 and (ii) PCAOB Press Release entitled *PCAOB Issues Staff Guidance On Auditing Internal Control in Smaller Public Companies* (October 17, 2007); both available at

http://www.pcaobus.org/Standards/Standards_and_Related_Rules/AS5/Guidance.pdf. See also SEC brochure entitled *Sarbanes-Oxley Section 404, A Guide for Small Business* available at <http://www.sec.gov/info/smallbus/404guide.pdf>.

(n63)Footnote 63. See Recent Work of the Public Company Accounting Oversight Board: Registration, Inspections, Enforcement and Standard Setting, submitted by Daniel L. Goelzer, Claudius B. Modesti and Helen A. Munter for the American Law Institute/American Bar Association seminar on Accountants' Liability (May15-16, 2008), pp. 39-42. In addition, as discussed above, litigation has been instituted by a private group to obtain a ruling that the establishment of the PCAOB was unconstitutional.

(n64)Footnote 64. PCAOB Rel. No. 2004-006 (June 6, 2004), which was subsequently approved by the SEC. See *Order Approving Proposed Auditing Standard No. 3, Audit Documentation, and an Amendment to Interim Auditing Standards -- AU sec 543, Part of Audit Performed by Other Independent Auditors*, Securities Exchange Release No. 50253 (August 25, 2004).

(n65)Footnote 65. Auditing Standard No. 3 (par. 6) states that "[a]n *experienced auditor* has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry." (emphasis in original).

(n66)Footnote 66. Auditing Standard No. 3, par. 8. Based on the foregoing, "[t]he relevant records to be retained include, but are not limited to, procedures performed in response to the information, and records documenting consultations on, or resolution of, differences in professional judgment among members of the engagement team or between the engagement team and others consulted." *Id.*, par. 8.

(n67)Footnote 67. *Id.*, par. 14. If the auditor's report is not issued in connection with an engagement, the auditor must retain the "audit documentation" for seven years from the date that "fieldwork was substantially completed." In circumstances where an auditor was unable to complete the engagement, the auditor must retain the "audit documentation" for seven years from the date the engagement ceased. *Id.*

(n68)Footnote 68. Section 802 of the Sarbanes-Oxley Act originally created explicit criminal liability, including fines and/or no more than ten years in prison, for auditors of a public company failing to retain all audit or review workpapers for at least five years from the end of the fiscal period in which the audit or review was concluded. See 18 U.S.C. § 1520(a)(2) (2008). Pursuant to Section 802, the SEC was required to adopt rules specifying the records to which the foregoing record retention provision applies.

Under the above SEC rule, the five-year record retention period contemplated by Section 802 was extended to seven years. This increased retention requirement coordinates with Section 103(a)(2)(A)(i) of the Sarbanes-Oxley Act which required that the PCAOB adopt an auditing standard (i.e., Auditing Standard No. 3) that mandates registered firms to "prepare and maintain for a period of not less than 7 years, audit work papers, and other information related to any audit report, in sufficient detail to support the conclusions reached in such report." See *SEC Adopts Record Retention Rules for Auditors*, SEC TODAY, Vol. 2003-18, at 1 (Jan. 28, 2003).

The criminal sanctions established by Section 802 are more fully addressed at § 5A.10, *infra*.

(n69)Footnote 69. See Retention of Audit and Review Records, 17 C.F.R. § 210.2-06 (2008).

(n70)Footnote 70. 17 C.F.R. § 210.2-06.

(n71)Footnote 71. 17 C.F.R. § 210.2-06

(n72)Footnote 72. See *SEC Adopts Record Retention Rules for Auditors*, SEC TODAY, Vol. 2003-18, at 1 (Jan. 28, 2003).

(n73)Footnote 73. SEC TODAY, Vol. 2003-18 at 1.

(n74)Footnote 74. SEC TODAY, Vol. 2003-18 at 2.

(n75)Footnote 75. According to the PCAOB, the objective of Auditing Standard No. 3 is different from the objective of the SEC's record retention requirement: "The objective of the Board's standard is to require auditors to *create* certain documentation to enhance the quality of audit documentation, thereby improving the quality of audits and other related engagements... . In contrast, the focus of the SEC rule is to require auditors to *retain* documents that the auditor does create in order that those documents will be available in the event of a regulatory investigation or other proceeding." See Appendix A to Auditing Standard No. 3, paras. A43-44. (emphasis in original).

(n76)Footnote 76. See Auditing Standard No. 3, n. 5.

(n77)Footnote 77. PCAOB Rel. No. 2005-015 (July 26, 2005), which was subsequently approved by the SEC. See *Order Approving Proposed Auditing Standard No. 4, Reporting on Whether a Previously Reported Material Weakness Continues to Exist*, Securities Exchange Act Release No. 34-53227 (February 6, 2006).

(n78)Footnote 78. On the other hand, a public company is *required* to disclose in its quarterly SEC filing any remediation of a material weakness (or other material changes) in internal control over financial reporting that occurred during the company's most recent fiscal quarter. See Item 308(c) of Regulation S-K, 17 C.F.R. § 229.308(c); Auditing Standard No. 4, Appendix B, P B3.

(n79)Footnote 79. Pursuant to Auditing Standard No. 4, in addition to the above reporting alternatives, an auditor may decide not to report on whether a previously reported material weakness continues to exist and, instead, withdraw from the engagement.

(n80)Footnote 80. *Auditing Standard No. 6 -- Evaluating Consistency of Financial Statements and Conforming Amendments*, PCAOB Rel. No. 2008-001 (January 29, 2008).

(n81)Footnote 81. See *Order Approving Proposed Rule on Auditing Standard No. 6, Evaluating Consistency of Financial Statements and Conforming Amendments*, Securities and Exchange Commission Rel. No. 34-58555 (September 16, 2008).

(n82)Footnote 82. *Auditing Standard No. 6 -- Evaluating Consistency of Financial Statements and Conforming Amendments*, PCAOB Rel. No. 2008-001 (January 29, 2008) p. 4. According to the PCAOB, this new standard updates existing requirements in this area and aligns them more closely with Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections*, by providing that the auditor's report must recognize an issuer's correction of a material misstatement, regardless of whether it involves the application of an accounting principal. *Id.*

(n83)Footnote 83. *Id.*

(n84)Footnote 84. *Id.* In addition, in Auditing Standard No. 6, the Board removed the hierarchy of GAAP from its interim auditing standards. This decision was prompted by the proposal of the Financial Accounting Standards Board to incorporate the GAAP hierarchy into the accounting standards. *Id.* at pp. 14-15 .

(n85)Footnote 85. Under certain circumstances, the PCAOB may, by rule, adjust the above inspection schedules. Section 104.

(n86)Footnote 86. Under Section 104, accounting firms are also subject to special investigations at any time by the PCAOB to deal with issues raised by the PCAOB or the SEC.

(n87)Footnote 87. The above quotation is included as standard language in the introductory portion of inspection reports issued by the PCAOB. In addition, the Act provides that when the PCAOB identifies potential violations of law,

PCAOB rules, SEC rules, or professional standards in the course of an inspection, it "should, where appropriate, begin a formal investigation or disciplinary proceeding (including a hearing on the record) or report the matter to the Commission or the appropriate state regulatory authority." *Statement Concerning the Issuance of Inspection Reports*, PCAOB Rel. No. 104-2004-001 (Aug. 26, 2004). *See also* Section 104 of the Act.

(n88)Footnote 88. Although the above firms were not required to submit to any inspection procedures before the PCAOB approved their registration applications in October 2003, they voluntarily submitted to such procedures in advance of registration. *See* PCAOB Release No. 104-2004-001 (Aug. 26, 2004).

(n89)Footnote 89. *See* PCAOB Member *Goelzer Cautions Against Certain Tax Services by Auditors*, SEC TODAY, Vol. 2003-179, at 1 (Sept. 17, 2003).

(n90)Footnote 90. The public portions of PCAOB inspection reports may be reviewed at <http://www.pcaobs.org>.

(n91)Footnote 91. *See The Work of the Public Company Accounting Oversight Board; Registration, Inspections, Enforcement and Standard Setting*, submitted by Daniel L. Goelzer for the 37th Annual Institute on Securities Regulation (PLI) (November 3, 2005) pp. 552-554.

(n92)Footnote 92. *Board Releases Reports on 2003 Limited Inspections of Big Four Accounting Firms*, PCAOB Press Rel. 104-2004-001 (Aug. 26, 2004).

In similar fashion, the initial inspections conducted by Britain's Professional Oversight Board for Accountancy (the "POBA") of the Big Four accounting firms found failures in some audits to apply proper procedures or document the performance of required work on those engagements, but uncovered no "systemic weaknesses" in the firms' policies and procedures. *See* Floyd Norris, *Big Four Audit Firms are Chided in Britain*, New York Times, June 21, 2005, at C5. As stated by POBA director Paul George: "The firms are capable of doing very good audits. But we identify some areas where they are not applying their procedures and practices across all audits." *Id.*

(n93)Footnote 93. *See* Goelzer, *supra* at p. 557.

(n94)Footnote 94. PCAOB Rel. Nos. 104-2005-088 (September 29, 2005), 104-2005-089 (October 6, 2005), 104-2005-119 (November 17, 2005) and 104-2005-120 (November 17, 2005).

(n95)Footnote 95. In particular, each of the above firm submissions consisted of comments on a draft of the formal inspection report for that firm. A copy of the applicable submission is included as an appendix to the final inspection reports cited above.

(n96)Footnote 96. *See* Goelzer, *supra* at p. 557.

(n97)Footnote 97. *Id.* In addition, the PCAOB's 2005 inspections included limited inspection reviews of firms' implementation of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. *Id.* This "auditing standard" was addressed at Section 5A.09[3], *supra*.

(n98)Footnote 98. *PCAOB Officials Discuss Diverse Issues at AICPA Conference*, SEC TODAY Vol. 2005-237, at 1 (Dec. 12, 2005). Mr. Diacont observed that the contemplated inspections were difficult and involve complex accounting and auditing issues. *Id.*

(n99)Footnote 99. *See Recent Work of the Public Company Accounting Oversight Board: Registration, Inspections, Enforcement and Standard Setting*, submitted by Daniel L. Goelzer, Claudius B. Modesti and Helen A. Munter for the American Law Institute/American Bar Association seminar on Accountants' Liability (May 15-16, 2008), p. 13.

During 2006, the Board also conducted limited inspection reviews of audit firms' implementation of Auditing Standard No. 2 (relating to audits of internal control over financial reporting). *Id.*

(n100)Footnote 100. During 2007, the Board continued to conduct limited inspection reviews of audit firms' implementation of Auditing Standard No. 2. *Id.*

(n101)Footnote 101. *Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud*, PCAOB Rel. No. 2007-001 (January 22, 2007).

As previously discussed (§ 5A.09[3][a]), in April 2003, the PCAOB adopted various pre-existing auditing (and other professional) standards to serve as interim Board standards to be used on a transitional basis. AU § 316 is included among those interim standards. See PCAOB Rel. No. 2007-01, p. 1.

(n102)Footnote 102. *Id.* at pp. 1-2.

(n103)Footnote 103. *Id.* at p. 2.

(n104)Footnote 104. *Id.* at pp. 2-14.

(n105)Footnote 105. *Id.* at p. 14.

(n106)Footnote 106. *Report on the PCAOB's 2004, 2005 and 2006 Inspections of Domestic Triennially Inspected Firms*, PCAOB Rel. No. 2007-010 (October 22, 2007).

(n107)Footnote 107. *Id.* at p. 1. During the 2004-2006 time period, the Board performed 497 inspections of U.S. "triennial" firms. *Id.* at p. 2.

(n108)Footnote 108. *Id.* at pp. 5-19 (emphasis added). In addition to the areas set forth above, the report also identified (i) "Business Combinations and Impairment of Assets," (ii) "Loan and Accounts Receivable (including allowance accounts)," (iii) "Service Organizations," (iv) "Use of other Auditors," (v) "Use of the Work of Specialists" and (vi) "Concurring Partner Review" as areas of concern. *Id.*

(n109)Footnote 109. *Id.* at p. 3.

(n110)Footnote 110. *Report on the PCAOB's 2004, 2005, 2006 and 2007 Inspections of Domestic Annually Inspected Firms*, PCAOB Rel. No. 2008-008 (December 5, 2008). As a general matter, the above inspections involved the review of audits of financial statements for 2003 through 2006. *Id.* at p. 2.

As reported by the PCAOB, the eight domestic firms covered by this report are collectively responsible for the audits of approximately 66 percent of all public companies based in the United States. In addition, four of those firms audit public companies that comprise 98 percent of the total domestic market capitalization. See PCAOB's December 5, 2008 press release entitled PCAOB Report Reviews First 4 Years of Inspections of the 8 Largest U.S. Audit Firms, *available at* http://www.pcaobus.org/Inspections/Other/2008/1205_Release_2008-008.pdf.

(n111)Footnote 111. PCAOB Rel. No. 2008-008 *supra* at p. 2; PCAOB press release dated December 5, 2008, *supra*.

(n112)Footnote 112. PCAOB press release dated December 5, 2008, *supra*.

(n113)Footnote 113. Mr. Diacont observed that the contemplated inspections were difficult and involve complex accounting and auditing issues. *Id.* In addition, in May 2006, the PCAOB announced that it would focus its 2006 inspections on whether auditors had achieved cost-savings efficiencies in the audits they performed under Auditing

Standard No. 2 and on whether they had followed prior PCAOB guidance urging them to do so. *See* SEC Press Rel.: *SEC Announces Next Steps for Sarbanes-Oxley Implementation*, 2006-75 (May 17, 2006).

(n114)Footnote 114. Section 105. In addition, as noted above, the PCAOB has issued rules relating to investigations and adjudications which have subsequently been approved by the SEC. PCAOB Rule 5100 addresses, in general terms, the circumstances in which the PCAOB may conduct an investigation.

(n115)Footnote 115. Section 105 and PCAOB Rule 5102.

(n116)Footnote 116. Section 105 and PCAOB Rule 5105. While the PCAOB is only empowered to request (as opposed to demand) documents and testimony from parties who are not subject to its regulation [PCAOB Rule 5105(a)], it may seek the issuance of a SEC subpoena to require that such parties furnish information needed by the PCAOB. *See* Section 105 and PCAOB Rule 5111.

(n117)Footnote 117. Section 105 and PCAOB Rule 5200-5201.

(n118)Footnote 118. According to PCAOB Rule 5300: "Limitations on the activities, functions or operations of a firm may include prohibiting a firm from accepting new audit clients for a period of time, requiring a firm to assign a reviewer or supervisor to any associated person, requiring a firm to terminate one or more audit engagements and requiring a firm to make functional changes in supervisory personnel organization and/or in engagement team organization."

(n119)Footnote 119. Section 105 and PCAOB Rule 5300.

(n120)Footnote 120. Section 105. As set forth at § 5A.09[2], the PCAOB adopted rules that address procedures for PCAOB investigations and adjudications.

(n121)Footnote 121. *See* PCAOB Disciplinary Proceedings at <http://www.pcaobus.org>. (December 4, 2008).

(n122)Footnote 122. PCAOB Rel. No. 2005-21 (Nov. 22, 2005).

(n123)Footnote 123. In settling this disciplinary proceeding, the accounting firm and its shareholder, neither admitted nor denied the findings made by the PCAOB (except as to matters relating to the PCAOB's jurisdiction). *See* PCAOB Rel. No. 2005-021, *supra*.

(n124)Footnote 124. *See* PCAOB Rel. No. 2005-21, *supra*.

(n125)Footnote 125. There is a very narrow exception to the pre-approval requirement for non-audit services, which applies if all three of the following requirements are satisfied:

- The aggregate amount of all such non-audit services does not exceed 5% of the total fees paid by the issuer to the accounting firm during the fiscal year in which the non-audit services are provided.
- The services were not recognized by the issuer at the time of engagement to be non-audit services.
- The services are promptly brought to the attention of the audit committee and approved by the committee or a designated member of the committee prior to the completion of the audit. Section 202.

(n126)Footnote 126. To clarify the foregoing, the SEC has adopted rules stating that all bookkeeping services cause auditors to lack independence, unless one can reasonably conclude that the results will not be subject to audit procedures. *See* Final Rule: Strengthening the Commission's Requirements, Securities Act Release No. 8183

(2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003).

(n127)Footnote 127. The applicable SEC rule prohibits accounting firms from providing any service related to the audit client's information system, unless one can reasonably conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. An accounting firm may work on hardware or software systems that are unrelated to the audit client's financial statements or accounting, provided that the audit committee pre-approves those services. See Final Rule: Strengthening the Commission's Requirements, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003).

In addition, the SEC rule expressly prohibits auditors "from designing or implementing a hardware or software system that aggregates source data or generates information that is 'significant' to the financial statements taken as a whole." Information is "significant if it is reasonably likely to be material to the financial statements of the audit client. Since materiality determinations may not be complete before financial statements are generated, the audit client and accounting firm by necessity will need to evaluate the general nature of the information as well as system output during the period of the audit engagement." *Id.*

(n128)Footnote 128. The applicable SEC rule prohibits an accountant from providing such services unless it can be reasonably concluded that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. See Final Rule: Strengthening the Commission's Requirements, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003).

On the other hand, an accounting firm is not prohibited "from providing the above services for non-financial reporting (e.g., transfer pricing studies, cost segregation studies, and other tax-only valuations) purposes. Also, the rule does not prohibit an accounting firm from utilizing its own valuation specialist to review the work performed by the audit client itself or an independent third-party specialist employed by the audit client, provided the audit client or the client's specialist (and not the specialist used by the accounting firm) provides the technical expertise that the client uses in determining the required amounts recorded in the client financial statements. In those instances the accountant will not be auditing his or her own work because a third party or the audit client is the source of the financial information subject to the audit. Additionally, the quality of the audit may be improved where specialists are utilized in such situations." *Id.*

(n129)Footnote 129. The applicable SEC rule prohibits an accounting firm from providing to an audit client any actuarially oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client unless one can reasonably conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. The accountant, however, may assist a client in understanding the methods, models, assumptions and inputs used in computing such an amount. See Final Rule: Strengthening the Commission's Requirements, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003).

(n130)Footnote 130. The applicable SEC rule prohibits the accountant from providing any internal audit service that has been outsourced by the audit client that relates to the audit client's internal accounting controls, financial systems or financial statements unless one can reasonably conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements. On the other hand, the above "prohibition on outsourcing" does not preclude engaging the accountant to perform nonrecurring evaluations of discrete items or other programs that are not in substance the outsourcing of the internal audit function. See Final Rule: *Strengthening the Commission's Requirements Regarding Auditor Independence*, at <http://www.sec.gov/rules/final/33-8183a.htm> (May 7, 2003).

In addition, since evaluating an audit client's internal controls and recommending improvements to those controls are part of the accountant's responsibilities under GAAS (or other applicable attestation standards), providing those services are not prohibited under the above SEC rule. *Id.*

(n131)Footnote 131. The applicable SEC rule prohibits "accountants from acting, temporarily or permanently, as a director, officer or employee of an audit client, or performing any decision-making, supervisory or ongoing monitoring functions for the audit client." *See* Final Rule: Strengthening the Commission's Requirements, Regarding Auditor Independence, at <http://www/sec.gov/rules/final/33-8183a.htm> (May 7, 2003).

(n132)Footnote 132. The applicable SEC rule provides that an accountant's independence is impaired with respect to an audit client when the accountant seeks out prospective candidates for management, executive or director positions; acts as negotiator on the audit client's behalf; or undertakes reference checks of prospective candidates. Under the rule, an accountant's independence will also be impaired when the accountant engages in psychological testing or other formal testing or evaluation programs or recommends or advises the audit client to hire a specific candidate for a specific job. *See* Final Rule: *Strengthening the Commission's Requirements*, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003).

(n133)Footnote 133. The SEC added "serving as an unregistered broker-dealer to [its] rules that prohibit serving as a promoter or underwriter, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client's investments, or executing a transaction to buy or sell an audit client's investment, or having custody of assets of the audit client." *See* Final Rule: Strengthening the Commission's Requirements, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003). According to the SEC, "[w]hen an accountant, in any capacity, recommends to anyone (including non-audit clients) that they buy or sell the securities of an audit client or an affiliate of the audit client, the accountant has an interest in whether those recommendations were correct. That interest could affect the audit of the client whose securities, or whose affiliate's securities, were recommended. These concepts are echoed in the 'simple principles' included in the legislative history to the Sarbanes-Oxley Act." *Id.* *See also* Floor Statement of Senator Sarbanes, 148 Cong. Rec. § 7364 (July 25, 2002).

(n134)Footnote 134. The SEC has "long maintained that an individual cannot be both a zealous legal advocate for management or the client company and maintain the objectivity and impartiality that are necessary for an audit." *See* Final Rule: Strengthening the Commission's Requirements, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003). Under the new SEC rule, an accountant may not provide any service to an audit client "that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided." www.sec.gov/rules/final/33-8183a.htm.

(n135)Footnote 135. The applicable SEC rule prohibits an accountant from providing expert opinions or other services to an audit client, or an audit client's legal representative, for the purpose of advocating that audit client's interests in litigation or in a regulatory or administrative proceeding or investigation. *See* Final Rule: Strengthening the Commission's Requirements, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003). On the other hand, the SEC rule does not prohibit an audit committee (or, at its direction, legal counsel) from engaging the accountant to perform internal investigations or fact-finding engagements or preclude an accountant from explaining the positions taken or conclusions reached during the performance of any service by the accountant. *Id.*

(n136)Footnote 136. Section 201.

(n137)Footnote 137. *See Glassman Raises Concern About Understanding of Internal Control Rules*, SEC TODAY, Vol. 2003-137, at 1 (Jul. 18, 2003).

(n138)Footnote 138. *See* Final Rule: Strengthening the Commission's Requirements, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003). *See also* Lawrence Goldfein and David Cace, *No Wiggle Room with Sarbanes-Oxley, Companies Need a Tight Control System to Fight Financial Fraud and Miscues*, Mergers & Acquisitions, Vol. 38, No. 4, (Mar. 2003).

To provide additional guidance concerning various independence issues (including the provision of non-audit services), the SEC's Office of the Chief Accountant recently issued its responses to "Frequently Asked" independence questions, which are posted at www.sec.gov/info/accountants/oacaFAQind080703.htm.

(n139)Footnote 139. See *Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Release No. 2005-014, PCAOB Rulemaking Docket Matter No. 017 (July 16, 2005). Subsequently, the PCAOB adopted certain technical amendments to these rules. See, e.g., *PCAOB Adopts Budget and Amends Ethics Rule*, SEC TODAY, Vol. 2005-225 at 1 (Nov. 23, 2005).

The SEC approved the PCAOB's proposed rules on April 19, 2006. See *Order Approving Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees and Notice of Filing and Order Granting Accelerated Approval of the Amendment Delaying Implementation of Certain of these Rules*, SEC Rel. No. 34-53677 (April 19, 2006).

(n140)Footnote 140. See also *SEC Issues Notice of PCAOB Rules on Independence and Tax Services*, SEC TODAY, Vol. 2006-47, at 1 (Mar. 10, 2006).

On March 7, 2006, the SEC published the PCAOB's proposed rules for comment and the comment period closed on April 3, 2006. Various entities, including each of the Big Four accounting firms, submitted comments expressing reservations or seeking clarification concerning the above proposed rules. For example, Deloitte & Touche expressed concern that the proposed restrictions on providing tax services to various persons who serve in financial oversight roles is too broad and that monitoring for compliance will be overly burdensome. See *Commenters Seek Clarification of PCAOB Rules*, SEC TODAY, Vol. 2006-67, at 1-2 (April 7, 2006).

(n141)Footnote 141. See *SEC Issues Notice of PCAOB Rules on Independence and Tax Services*, SEC TODAY, vol. 2006-47, at 1 (Mar. 10, 2006); *Implementation Schedule for Certain Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees*, PCAOB Rel. No. 2006-001 (March 28, 2006); SEC Rel. No. 34-53677 (April 19, 2006).

See also *Concept Release Concerning Scope of Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles*, PCAOB Release No. 2007-002 (April 3, 2007), p. 2.

In addition, in April 2008, the PCAOB adopted (subject to SEC approval) an amendment to the above-mentioned Rule 3523 (Tax Services for Persons in Financial Reporting Oversight Roles) which states that an accounting firm's independence is not necessarily impaired to the extent it provides tax services to a person covered by the rule during the portion of the audit period that precedes the beginning of the professional engagement period. See *Amendment to Rule 3523 Tax Services for Persons in Financial Reporting Oversight Roles*, PCAOB Rel. No. 2008-003 (April 22, 2008) (e.g., pp. 14-17), which was subsequently approved by the SEC. See *Order Approving Amendment to Rule 3523, Tax Services for Persons in Financial Reporting Oversight Roles*, Securities Exchange Act Rel. No. 34-58415 (August 22, 2008).

(n142)Footnote 142. See *Final Rule: Strengthening the Commission's Requirements*, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003).

(n143)Footnote 143. *Id.*

(n144)Footnote 144. See *Ethics and Independence Rule 3526, Communication with Audit Committees Concerning Independence*, PCAOB Rel. No. 2008-003 (April 22, 2008), which was approved by the SEC. See *Order Approving Proposed Ethics and Independence Rule 3526, Communication with Audit Committees Concerning Independence*, Securities Exchange Rel. No. 34-58415 (August 22, 2008).

(n145)Footnote 145. See PCAOB's April 22, 2008 press release entitled *Board Adopts New Ethics and Independence Rule Concerning Communications with Audit Committees and an Amendment to its Existing Tax Services Rule*, available at http://www.pcaobus.org/News_and_Events/News/2008/04-22.aspx.

(n146)Footnote 146. *Id.* Under Rule 3526, accounting firms are also required to make a similar communication each year for their continuing engagements. *Id.*

(n147)Footnote 147. See *Audit Firm Sanctioned for Violating Independence Rules*, SEC TODAY, Vol. 2004-76, at 7 (April 20, 2004). Based on the judge's decision (and the SEC order that finalized that decision), E&Y was also required to, *inter alia*, (i) disgorge the audit fees it received from the above client during the relevant time period and (ii) retain an independent consultant (acceptable to the SEC) to review its policies relating to business arrangements with audit clients.

(n148)Footnote 148. Under pre-existing requirements of the AICPA, SEC Practice Section, Requirements of Members (item e), the "lead" partner was required to rotate off the audit engagement of SEC registrants after seven years with a two-year "time-out" period.

(n149)Footnote 149. Final Rule: *Strengthening the Commission's Requirements*, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003).

(n150)Footnote 150. *Strengthening the Commission's Requirements*, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003). As used in the SEC rule, "the term audit partner means a partner (or person in an equivalent position) who is a member of the audit engagement team...who has responsibility for decision-making or significant auditing, accounting, and reporting matters that affect the financial statements or who maintains regular contact with management and the audit committee. The team audit partners would include the lead and concurring partners, partners such as relationship partners who serve the clients at the issuer or parent level, other than a partner who consults with others on the audit engagement during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events, and the lead partner on subsidiaries of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenues of the issuer."

The SEC rule concerning partner rotation contains specific provisions that address certain unique circumstances involving audits of investment companies. See Final Rule: *Strengthening the Commission's Requirements*, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003).

(n151)Footnote 151. Final Rule: *Strengthening the Commission's Requirements*, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003).

(n152)Footnote 152. *Id.*

(n153)Footnote 153. *Id.*

(n154)Footnote 154. *Id.*

(n155)Footnote 155. *Id.*

(n156)Footnote 156. *Id.*

(n157)Footnote 157. *Id.* *Strengthening the Commission's Requirements*, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003). Rotation requirements for concurring partners became effective as of the end of the second fiscal year after the effective date of the rotation requirements. *Id.* Thus, concurring partners for calendar year audit clients in which 2003 was their fourth or more year

in that role were able to serve as concurring partners for the 2004 audit before having to rotate. *Id.*

The SEC rule became effective for audit partners other than lead and concurring partners as of the beginning of the first fiscal year after the effective date of the rule. *Id.* As those partners were not mentioned in the Sarbanes-Oxley Act or previously subject to rotation requirements, the SEC established the first fiscal year as the first year of service for such partners, regardless of how many years they previously served. *Id.*

(n158)Footnote 158. Section 206. In connection with the foregoing, the SEC promulgated a rule under Section 206 of the Sarbanes-Oxley Act that states that "when the lead partner, the concurring partner, or any other member of the audit engagement team who provides more than ten hours of audit, review or attest services for the issuer accepts a position with the issuer in a financial reporting oversight role within the one year period preceding the commencement of audit procedures for the year that included employment by the issuer of the former member of the audit engagement team, the accounting firm is not independent with respect to that registrant." *See* Final Rule: Strengthening the Commission's Requirements, Securities Act Release No. 8183 (2002-2003 Transfer Binder) Fed. Sec. L. Rep. (CCH) P 86,822 (January 28, 2003). This SEC rule provides for a limited number of exemptions from its restrictions, including an exemption for "emergency or unusual circumstances." *Id.*

(n159)Footnote 159. 17 C.F.R. 201.102(e). Prior to 1995, Rule 102(e) was set forth in substantially its present form as Rule 2(e).

(n160)Footnote 160. Although the federal securities statutes do not expressly authorize the SEC to sanction professionals or to bar them from practice before the Commission, courts upheld its power to promulgate Rule 102(e) as "reasonably related" to the purposes of the federal securities laws. *See Sheldon v. SEC*, 45 F.3d 1515, 1518 (11th Cir. 1995) ; *Davy v. SEC*, 792 F.2d 1418, 1421 (9th Cir. 1986) ; *Touche Ross & Co. v. SEC*, 609 F.2d 570, 582 (2d Cir. 1979) ; *Checkosky v. SEC*, 23 F.3d 452, 479 (D.C. Cir. 1994) .

(n161)Footnote 161. Section 206.

(n162)Footnote 162. Init. Dec. Rel. No. 183 (May 3, 2001); Rel. No. 34-48238, AAER No. 1822 (July 28, 2003).

(n163)Footnote 163. Init. Dec. Rel. No. 251 (May 17, 2004); Rel Nos. 33-8555, 34-51393, AAER No. 2214 (March 18, 2005).

(n164)Footnote 164. The OIP also charged that the engagement partner violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act (and *Rule 10b-5* promulgated thereunder).

(n165)Footnote 165. Rel. No. 33-8555 at 22 n. 40.

(n166)Footnote 166. Init. Dec. Rel. No. 259 (Sept. 27, 2004), Finality Order, Rel. No. 34-51486, AAER No. 2228 (April 6, 2005).

(n167)Footnote 167. Init. Dec. Rel. No. 259 at 43.

(n168)Footnote 168. Init. Dec. Rel. No. 295 (Sept. 8, 2005), Finality Order, Rel. No. 34-52607, AAER No. 2336 (Oct. 14, 2005).

(n169)Footnote 169. Init. Dec. Rel. No. 213 (Aug. 13, 2002); Rel. No. 34-49182, AAER No. 1952 (Feb. 4, 2004); 396 F.3d 1258 (D.C. Cir. 2005) .

(n170)Footnote 170. *See SEC Applies New Enforcement Paradigm in Actions Against Accounting Firm*, SEC TODAY, Vol. 2003-104, at 1 (June 2, 2003).

(n171)Footnote 171. SEC TODAY, Vol. 2003-104, at 1. According to the SEC, after an audit had been completed,

PwC made undocumented changes to its workpapers and discarded certain documents that were relevant to its audit. The SEC further took the position that the above changes to the workpapers were made with the knowledge of several PwC partners who had firm-wide responsibilities and were not documented. Pursuant to its settlement with the SEC, PwC agreed to (i) pay \$1 million, (ii) establish and maintain policies and procedures to retain workpapers after the completion of post-audit reviews, (iii) properly document revisions to workpapers and (iv) retain an independent consultant to review the firm's compliance with the foregoing. SEC TODAY, Vol. 2003-104, at 1.

(n172)Footnote 172. Previously, the above limitation periods were one year and three years, respectively.

(n173)Footnote 173. *See, e.g., In re ADC Telcoms., Inc. Sec. Litig.*, 409 F.3d 974 (8th Cir. 2005) ; *Foss v. Bear Stearns & Co., Inc.*, 394 F.3d 540 (7th Cir. 2005) ; *Glaser v. Enzo Biochem, Inc.*, 2005 U.S. App. LEXIS 4598 (4th Cir. Mar. 21, 2005) , *cert. denied*, *Glaser v. Enzo Biochem, Inc.*, 127 S. Ct. 1876, 167 L. Ed. 2d 363, 2007 U.S. LEXIS 3586, 75 U.S.L.W. 3511 ; *In re Enterprise Mortgage Acceptance Co., LLC, Sec. Litig.*, 391 F.3d 401 (2d Cir. 2004) . *But see Roberts v. Dean Witter Reynolds, Inc.*, 2003 U.S. Dist. LEXIS 5676 (M.D. Fla., Mar. 14, 2003) , *vacated*, 410 F.3d 1275 (11th Cir. 2005) .



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Federal Securities Exchange Act of 1934

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CHAPTER 5A Accountants' Liability Under the Federal Securities Laws

1-5A Federal Securities Exchange Act of 1934 § 5A.10

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§ 5A.10 Criminal Liability Under the Federal Securities Laws

Section 24 of the Securities Act provides criminal penalties for wilfully making an untrue statement or omitting any material fact in a registration statement. Similarly, Section 32(a) of the Exchange Act provides criminal penalties for wilfully making false or misleading statements in reports required to be filed under the Act. Violations of the anti-fraud provisions of Exchange Act Section 10(b) are also punishable under Section 32(a). These criminal sanctions were dramatically applied in *United States v. Natelli*,ⁿ¹ where the Second Circuit affirmed the conviction of defendant, a partner at Peat, Marwick, Mitchell & Co. ("Peat Marwick"), for criminal fraud in connection with the National Student Marketing offering.

Peat Marwick reported on National Student Marketing's financial statements. Just before National Student Marketing issued a proxy statement in September 1969, the auditors learned that over \$1 million of \$1.7 million in "unbilled accounts receivable" included in the 1968 financial statements had been written off by the company. However, instead of requiring a restatement of the 1968 earnings to reflect the write-off, the auditor approved netting the receivables write-off with a tax credit of approximately the same amount that he learned of when he prepared the financial information for inclusion in the September 1969 proxy statement. The netting procedure effectively negated the retroactive adjustment that would have shown materially decreased earnings for 1968. The court held that a jury could properly have found that the concealment of the retroactive adjustments to the company's 1968 year revenues and earnings was intentional.ⁿ²

The proxy statements also contained a nine-month unaudited statement that was prepared by the company with Peat Marwick's assistance. The unaudited statement included revenue from a suspicious sale. The question raised with respect to this report was whether the auditor had a duty to object to issuance of the unaudited statement or to insist upon independent verification of the "suspicious" transaction. The court held that there was a duty to object here, even though the statements were unaudited and under ordinary circumstances the auditor would not be required to discover the invalidity of booked accounts receivable. The court noted, among other things, that the company had a history of invalidly booked entries. Moreover, the auditor's ability to reject the transaction indicated that Peat, Marwick controlled the unaudited figures. Under these circumstances, the court found that "the accountant may [not] shut his eyes in reckless disregard of his knowledge that highly suspicious figures, known to him to be suspicious, were being included in the unaudited earnings figures with which he was 'associated' in the proxy statement."ⁿ³

In addition, as previously noted, in a unanimous opinion, the U.S. Supreme Court overturned the 2002 federal conviction of Arthur Andersen for destruction of various Enron-related documents by firm personnel. n4 The court's decision is predicated on a conclusion that the jury instructions allowed too low a threshold of culpable intent and on an express recognition that not all withholding of material from the government is wrongful. While this decision is a setback for the Justice Department, it is unclear how much prospective guidance it provides in light of provisions of the Sarbanes-Oxley Act, enacted after Andersen's conviction.

As noted by the Supreme Court, shortly after Andersen learned about potential accounting improprieties involving Enron, certain partners and employees of the firm urged members of its Enron engagement team (and other Andersen personnel) to comply with the firm's established document retention policy. n5 According to the court, this was "followed by substantial destruction" of Enron-related documents. n6 The document destruction ceased after Andersen was served with a document subpoena by the SEC. n7

Andersen was convicted of violating a general federal obstruction of justice statute [18 U.S.C. § 1512(b)] which "makes it a crime to 'knowingly use intimidation or physical force, threaten, or corruptly persuade another person ... with intent to ... cause' that person to 'withhold' documents from, or 'alter' documents for use in, an 'official proceeding.'" n8 In reversing Andersen's conviction, the Supreme Court held that the jury instructions failed to require the requisite statutory level of specific intent by instructing that the jury could convict the firm even if it honestly believed that its suggestions to its employees that they comply with the firm's document retention policy were lawful. According to the court, "[o]nly persons conscious of wrongdoing can be said to 'knowingly ... [and] corruptly persuade'." n9 In arriving at this conclusion, the court observed that "[d]ocument retention policies", which are created in part to keep certain information from getting into the hands of ... the Government, are common in business ... It is, of course, not wrongful for a manager to instruct his employees to comply with a valid document retention policy under ordinary circumstances." n10

The Supreme Court also held that the jury instructions incorrectly led the jury "to believe that it did not have to find *any* nexus between the 'persuasion' to destroy documents and any particular proceeding." According to the court, a person cannot be convicted under the charged statute for "'knowingly" and "corrupt[ly]" persuading someone to destroy documents unless the actor contemplated a particular proceeding in which the documents "might be material." n11

Just a month after the Andersen conviction, Congress included in the Sarbanes-Oxley Act three new provisions of the federal Criminal Code of particular interest to accountants: 18 U.S.C. §§ 1512(c), 1519 and 1520.

Section 1520(a), added by section 802 of the Act and implemented in related SEC rules, requires accounting firms to retain for seven years numerous workpapers and other documents relevant to their audits or reviews of public companies, including documents that do not support their final conclusions concerning certain matters. n12 Section 1520(b) subjects an accountant who knowingly and willfully violates the statutory requirement to preserve documents or any of the Commission's implementing rules to criminal liability, including fines and imprisonment up to ten years. n13

18 U.S.C. § 1519, anticipating some of the Supreme Court's criticisms in *Andersen*, imposes criminal liability for any person who knowingly "alters, destroys, mutilates, conceals, ... any document ... with the intent to impede, obstruct or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States ... or in relation to or contemplation of any such matter ..." n14 The element of corrupt intent, which is required by § 1512(b) under which Andersen was prosecuted, is removed. In addition, some courts in the past have been reluctant to allow convictions under obstruction of justice statutes unless the defendant's misconduct was connected to a pending or imminent proceeding. n15 However, § 1519 is not confined merely to current or imminent proceedings. It sweeps more broadly to include any federal agency matter within the actor's contemplation. n16 Moreover, it should be noted that § 1519 also goes beyond destruction or mutilation to cover mere alteration. The maximum incarceration

under § 1519 is twenty years.

Section 1512(c) was enacted as a separate section to impose criminal liability for (among other things) altering documents to make them unavailable for use in an "official proceeding" where the intent was corrupt. Thus, while § 1512(b) - the section used in *Andersen* - requires both knowledge and corrupt intent and sets a ten-year maximum; new § 1512(c) increases the maximum to twenty years for purely corrupt conduct. n17

Notably, in 2003, the United States Attorney for the Northern District of California instituted a criminal proceeding against a former Ernst & Young ("E&Y") partner charging (i) falsification of records in a federal investigation in violation of § 1519 and (ii) obstruction of the examination of a financial institution in violation of 18 U.S.C. § 1517. n18 According to the government, the defendant allegedly (i) destroyed, altered and falsified both hard and electronic copies of workpapers related to audit and review services E&Y provided to a financial institution, (ii) assisted in the collection and production of altered workpapers to the Office of the Comptroller of the Currency, pursuant to a subpoena and (iii) gave sworn testimony to the SEC in which he concealed his alteration and destruction of documents. n19 Subsequently, the defendant pled guilty and was sentenced to one year in prison. n20 In the same matter, a former senior manager at E&Y pled guilty to a criminal count charging him with obstructing the examination of a financial institution. n21

Also, as discussed above, n22 in apparent response to criticisms from the judiciary (arising from the criminal prosecution of various former KPMG partners and employees), the business community and civil liberties organizations, the Justice Department has revised its corporate charging guidelines. For example, in contrast to the guidance contained in the superceded Thompson memo, the government's revised guidance instructs prosecutors *not* to take into consideration a corporation's advancement of attorneys' fees to its employees when evaluating the corporation's level of cooperation.

FOOTNOTES:

(n1)Footnote 1. 527 F.2d 311 (2d Cir. 1975) , cert. denied, 425 U.S. 934, 96 S. Ct. 1663, 48 L. Ed. 2d 175 (1976) .

(n2)Footnote 2. 527 F.2d 311 .

(n3)Footnote 3. 527 F.2d at 320 . See also *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969) , cert. denied, 397 U.S. 1006 (1970) ("It simply cannot be true that an accountant is under no duty to disclose what he knows when he has reason to believe that, to a material extent, a corporation is being operated not to carry out its business in the interest of all the stockholders but for the private benefit of its president"); *United States v. Benjamin*, 328 F.2d 854, 863 (2d Cir.) cert. denied sub nom, *Howard v. U.S.*, 377 U.S. 953 (1964) ; *United States v. Zane*, 495 F.2d 683 (2d Cir.) ; cert. denied sub nom, *Persky v. U.S.*, 419 U.S. 895 (1974) ; *United States v. Bruce*, 488 F.2d 1224 (5th Cir. 1973) reh'g denied, 491 F.2d 1407 (5th Cir. 1974) . Cf. *United States v. Arthur Young & Co.*, 465 U.S. 805 , cert. denied, 466 U.S. 936 (1984) , an IRS case, in which the Supreme Court stated in a dictum that a CPA must be a "public watch-dog." This characterization was not developed by the Supreme Court but was taken from an English case where the quote appears whole, not amputated as in *United States v. Arthur Young*.

(n4)Footnote 4. *Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005) . See § 5A.01[5][a], *supra*.

(n5)Footnote 5. 544 U.S. at 700-701 .

(n6)Footnote 6. 544 U.S. at 701 .

(n7)Footnote 7. 544 U.S. at 702 .

(n8)Footnote 8. 544 U.S. at 698 .

(n9)Footnote 9. 544 U.S. at 706 .

(n10)Footnote 10. 544 U.S. at 704 .

(n11)Footnote 11. 544 U.S. at 707-708 (emphasis in original).

(n12)Footnote 12. While § 1520 requires 5 years, the SEC regulations require 7 years. See § 5A.09[3][b][iii], *supra*.

(n13)Footnote 13. See 18 U.S.C. § 1520(a)(2) (2008). See also § 5A.09[3][b][iii], *supra*.

(n14)Footnote 14. 18 U.S.C. § 1519 (2008).

(n15)Footnote 15. See Senate Comm. On the Judiciary, The Corporate and Criminal Fraud Accountability Act of 2002, Report Together with Additional Views, S. Rep. No. 107-146 (May 6, 2002), at 14-15. See also THE SARBANES-OXLEY DESKBOOK, by John T. Bostelman, Vol. 2, § 24:2.2 (Practising Law Institute 2006).

(n16)Footnote 16. Cf. The Department of Justice Field Guidance on New Criminal Authorities Enacted in the Sarbanes-Oxley Act of 2002 (H.R. 3763) Concerning Corporate Fraud and Accountability, at usdoj.gov/readingroom/sarox, last visited July 20, 2006.

(n17)Footnote 17. This increase in maximum incarceration is also reflected in other provisions of the Sarbanes-Oxley Act, e.g., Section 903, which increases the term of imprisonment in the mail and wire fraud statutes for non-financial institutions cases from 5 to 20 years. Mail and wire fraud charges are common additional counts in securities prosecutions, as virtually all significant transactions and examinations involve some movement of material over state lines.

(n18)Footnote 18. See SEC Rel. No. 2003-123, at <http://www.sec.gov/news/press/2003-123.htm> (Sept. 25, 2003).

(n19)Footnote 19. See SEC Rel. No. 2003-123, at <http://www.sec.gov/news/press/2003-123.htm> (Sept. 25, 2003).

(n20)Footnote 20. See Beryl A. Howell and Andrew Weissmann, *Obstruction for Data Destruction After 'Andersen'*, New York Law Journal, June 8, 2006, at p. 7.

(n21)Footnote 21. See SEC Rel. No. 2003-123, at <http://www.sec.gov/news/press/2003-123.htm> (Sept. 25, 2003). Addressing the above criminal proceedings against the former E&Y manager, Robert McCallum, then Chairman of the President's Corporate Fraud Task Force and Acting Deputy Attorney General, stated: "Today's actions mark one of the first instances in which prosecutors have been able to use an important weapon in the fight against corporate fraud given to us by Congress under the Sarbanes-Oxley Act of 2002 - the ability to prosecute those who would seek to destroy, alter or falsify financial information and records. Today's plea and arrest should remind accountants and lawyers not only of their commitment to represent their clients professionally, but also of our strong commitment to enforcing the law." SEC Rel. No. 2003-123, at <http://www.sec.gov/news/press/2003-123.htm> (Sept. 25, 2003).

(n22)Footnote 22. See § 5A.01[5][b and c], *supra*.



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CHAPTER SA-5B SPECIAL ALERT TO CHAPTER 5B

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CHAPTER SA-5B SPECIAL ALERT TO CHAPTER 5B

1-SA5B Federal Securities Exchange Act of 1934

SPECIAL ALERT TO CHAPTER 5B

A Reorganization and Restructuring in Light of Recent Developments n*

The last few years have witnessed considerable expansion in the responsibilities of attorneys under the federal securities laws, as well as increasing exposure to liability and sanction. Most prominent among these developments is the Sarbanes-Oxley Act of 2002, pursuant to which the Securities and Exchange Commission (the "SEC") has issued rules setting forth minimum professional conduct standards for attorneys appearing and practicing before the SEC in the representation of issuers and, in certain circumstances, requiring that attorneys report within the issuer organization evidence of material violations of law. The last few years have also witnessed the beginning of a revitalization in private litigation seeking to impose liability on attorneys for their role in securities transactions under both established and still-evolving theories.

In the next release, Chapter 5B will be restructured and revised to take account of these developments. Highlights of the chapter will include:

- An in-depth discussion of the Sarbanes-Oxley attorney conduct rules, as well as the most recent pronouncements of the SEC staff and others on the subject.
- A survey of recent activity involving attorneys under SEC Rule 102(e).
- A detailed analysis of attorney liability under Section 10(b) of the Securities Exchange Act of 1934, including discussion of theories of primary and secondary liability after *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* and its progeny.

The recent developments in attorney responsibility and exposure will impact both in-house and outside counsel. The revised Chapter 5B is intended as a resource to help attorneys evaluate these developments.

FOOTNOTES:

(n2)Footnote *. This Special Alert was prepared by Antonio Yanez, Jr. of Willkie Farr & Gallagher LLP, New York, New York. Mr. Yanez specializes in securities and financial reporting, and his experience includes representation of issuers, officers, directors, accounting firms, and others in securities class actions, SEC matters, and criminal matters.



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CHAPTER 5B Attorney Liability Under the 1934 Act *

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§ 5B.syn Synopsis to Chapter 5B: Attorney Liability Under the 1934 Act *

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CHAPTER 5B Attorney Liability Under the 1934 Act *

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Summary of This Chapter

There is a renewed interest in secondary actors in securities transactions including attorneys; private litigants are pursuing attorneys as aggressively as ever, though their efforts were dealt a blow by the Supreme Court's decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* ⁿ¹ which holds that only those whose actions rise to the level of a primary violation of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") can be subject to liability. At the same time, the Securities and Exchange Commission (the "SEC") has stepped up enforcement efforts, naming attorneys as respondents in dozens of enforcement actions in the past few years. And, of course, attorneys remain subject to the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), pursuant to which the SEC has issued rules requiring attorneys to report material illegality "up the ladder" within the issuer organization.

This chapter provides an overview of these potential bases of attorney liability and sanction. First, the chapter discusses attorney liability under the 1934 Act itself, with particular emphasis on Section 10(b) and *Rule 10b-5*--which historically have been, and continue to be, principal means by which alleged attorney wrongdoing in securities transactions is pursued. Second, the chapter discusses SEC proceedings against attorneys. Third, the chapter discusses the attorney conduct rules issued under Sarbanes-Oxley, violation of which is treated as a violation of the 1934 Act itself.

FOOTNOTES:

(n1)Footnote 1. 128 S.Ct. 761 (2008).

* This chapter was prepared by Antonio Yanez, Jr. of Willkie Farr & Gallagher LLP, New York, New York. Mr. Yanez specializes in securities and financial reporting. His experience includes representation of issuers, officers, directors, accounting firms, and others in securities class actions, SEC investigations, internal investigations, and other matters. Derek M. Schoenmann, Rina Vazirani, and Alan A. Stevens, associates of the firm, assisted in researching and writing this chapter.



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CHAPTER 5B Attorney Liability Under the 1934 Act *

1-5B Federal Securities Exchange Act of 1934 § 5B.01

§ 5B.01 Introduction

Attorneys have a wide range of roles under the federal securities laws touching on virtually every aspect of a client's use of the securities markets to raise capital, to manage or make investments, and to enter into mergers, acquisitions, and other transactions. The attorney may represent a corporation making an initial public offering. The attorney may represent an individual or entity that is acting on behalf of another, such as an investment banking firm or other financial advisor. The attorney may render an opinion concerning some aspect of a transaction involving securities. And there are any number of other possibilities. Each of these roles carries with it potential exposure to liability. When something in a securities transaction goes amiss, attorneys may find themselves among the targets of lawsuits seeking large damages or subject to potential sanction by the SEC. Historically, the most common 1934 Act claim against attorneys (and others) is a claim pursuant to Section 10(b) and Rule 10b-5, which make it unlawful to make false statements of material fact in connection with the purchase or sale of securities. ⁿ¹ And while the U.S. Supreme Court's decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* ⁿ² makes clear that private litigants may not maintain claims for aiding and abetting Section 10(b) violations against attorneys and other secondary actors, the SEC retains authority to bring civil enforcement actions for aiding and abetting 1934 Act violations. Attorneys may also be subject to liability under other 1934 Act provisions including Sections 14, 18 and 20. Attorneys may also face disciplinary action from the SEC, which has the power, pursuant to SEC Rule of Practice 102(e), to suspend an attorney from practicing before it. Finally, attorneys may also face sanction under the Sarbanes-Oxley Act. Each of these bases of liability and sanction--under the 1934 Act itself, under SEC Rule of Practice 102(e) and under Sarbanes-Oxley--is discussed in turn.

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 78j(b).

(n2)Footnote 2. 128 S.Ct. 761 (2008).

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CHAPTER 5B Attorney Liability Under the 1934 Act *

1-5B Federal Securities Exchange Act of 1934 § 5B.02

§ 5B.02 Attorney Liability Under Section 10(b) of the 1934 Act

Section 10(b) of the 1934 Act prohibits the use of any "manipulative" or "deceptive" device in connection with the purchase or sale of securities. n1 *Rule 10b-5*, promulgated by the SEC pursuant to Section 10(b), gives effect to the statute and states, in relevant part, that it is unlawful "[t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading ... in connection with the purchase or sale of any security." n2 In other words, the elements of a *Rule 10b-5* claim are:

- a misstatement or omission;
- of a material fact;
- made with scienter;
- in connection with the purchase or sale of securities;
- on which investors relied;
- that proximately caused the investor's injury. n3

Attorneys who serve clients in securities transactions may provide legal advice on the structure of a transaction, the necessary disclosure to be made in connection with the transaction, the language to be used in the agreements and other documents associated with the transaction, and other matters. In addition, attorneys may participate in negotiating and drafting sessions with issuers, underwriters, purchasers, sellers, accountants and others who have a role in the undertaking. Attorneys may also be asked to provide information, such as opinion letters, that may be communicated directly to potential investors. All of these activities can subject attorneys to Section 10(b) liability. The most common bases for attorney liability under Section 10(b) are: (1) liability for misstatements; (2) liability for nondisclosures; and, (3) liability for insider trading, each of which is discussed in more detail below. n4

But one point to be made clear at the outset is that, at least in the context of lawsuits by private litigants, it appears that

liability must be premised on the attorney's conduct as a principal--for example, as one who makes a misstatement to the investing public.

Liability in a private lawsuit for aiding and abetting the Section 10(b) violation of another appears to be foreclosed by the Supreme Court's decision in *Stoneridge*, which affirmed the Court's earlier ruling in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* n5

In *Stoneridge*, a shareholder brought suit against an issuer (a cable service provider) and two of its suppliers under 10(b), alleging that the issuer entered into fraudulent transactions with the suppliers for the purpose of inflating the issuer's reported revenues. n6 The plaintiff did not allege that the suppliers themselves made any direct misstatements upon which the plaintiff relied. Rather plaintiff sought to hold the suppliers liable (both as principals and as aidors and abettors) for misstatements made by the issuer in its financial statements on the basis that those misstatements were only made possible because the suppliers agreed to enter into fraudulent transactions with the issuer. n7 The suppliers moved to dismiss the complaint, arguing that the plaintiff could not prove reliance as the suppliers had no role in preparing or disseminating the financial statements that contained the misrepresentations. n8 The district court dismissed the claims against the suppliers, and the Eighth Circuit affirmed the dismissal.

The Supreme Court affirmed the dismissal as well, holding that the claim in substance amounted to an aiding and abetting claim, and that Section 10(b) provides no private right of action for aiding and abetting. n9 The Court reasoned that Congress decided against including in Section 10(b) a private right of action for aiding and abetting, and that in Section 104 of the Private Securities Litigation Reform Act of 1995 (the "Reform Act"), Congress permitted only the SEC to pursue aiding and abetting claims. n10 The Court further observed that the power to expand the reach of Section 10(b) to include aiding and abetting liability belongs to the legislature, and absent clear Congressional guidance the Court will not imply a right of action unfounded in the statute. n11

The *Stoneridge* Court went on to hold that in order to sustain liability against a secondary actor, "conduct of the secondary actor must satisfy each of the elements or preconditions for liability," including the reliance requirement. n12 Because the plaintiff could not prove that the suppliers made any misstatements upon which the plaintiff directly relied, and because the suppliers neither had a duty to speak to investors nor made any public statements affecting the stock price, the Court concluded that the claims against the suppliers were properly dismissed. n13 In reaching this decision, the Court rejected a so-called "scheme liability" theory, in effect that the suppliers should be held liable for the misstatements in the issuer's financial statements because "in an efficient market investors rely not only upon the public statements relating to a security but also upon the transactions those statements reflect." n14 The Court concluded that the suppliers' "deceptive acts, which were not disclosed to the investing public, [were] too remote to satisfy the requirement of reliance." n15

The *Stoneridge* Court's rejection of aiding and abetting liability reaffirms its earlier decision in *Central Bank*. In that case, the defendant Central Bank of Denver, N.A. served as indenture trustee for \$26 million in bonds to be issued by a public building authority to finance public improvements in a residential and commercial development in Colorado Springs. n16 The bonds were secured by liens on the property to be developed, and the bond covenants required that the property subject to the liens be worth at least 160 percent of the bonds' outstanding principal and interest. Annual reports confirming that this threshold was met were also required. After the authority defaulted on the bonds, plaintiff investors brought an action claiming that the underwriters and the public building authority violated Section 10(b). In addition, plaintiffs claimed that Central Bank, as trustee, aided and abetted the underlying violation, since it had received certain questionable appraisals of the property securing the bonds but took no action. n17 Central Bank's own internal assessment of the appraisals also suggested they were too optimistic. n18

There too, the Supreme Court rejected the claim for aiding and abetting liability under Section 10(b) on the grounds based on the plain language of the statute, which does not specifically proscribe aiding and abetting activity. n19 The Court reached this conclusion despite the fact that the private right of action for a primary violation of Section 10(b) is

implied, not express. The Court reasoned that since Section 10(b) prohibits only manipulative or deceptive acts, and "aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do," n20 such a claim was beyond the statute's prohibitions.

Several post-*Stoneridge* cases have further clarified the scope of secondary-actor liability. Of particular interest is a recent decision by the district court for the Eastern District of Pennsylvania which addresses attorney liability specifically. In *In re DVI Inc. Sec. Litig.*, shareholders brought a class action against an issuer, its law firm, and others, alleging that the various defendants all participated in a scheme to artificially inflate the issuer's stock price. n21 With respect to the law firm, the plaintiffs alleged that the attorneys "attained knowledge of DVI's financial situation and substantially assisted in all elements of its fraudulent scheme, including *inter alia*, drafting fraudulent public financial reports, making fraudulent disclosures related to DVI's internal controls, and deflecting inquiries" from the SEC." n22 The law firm objected to class certification, arguing that there was no presumption of reliance by investors on the attorneys because the attorneys neither had a duty to speak nor made any misrepresentations that were communicated to the public. n23

The court denied class certification as to the law firm. The court noted that the plaintiffs did not allege that the law firm "directly made any public misstatements that affected the market for DVI securities." Instead, the Lead Plaintiffs argued that the law firm should have been "held liable under section 10(b) because it participated in a scheme to defraud investors in DVI." n24 The plaintiffs attempted to distinguish *Stoneridge* on the basis that the law firm's allegedly "unique role in initiating and masterminding certain aspects of the overall scheme was sufficiently related to the injury suffered by DVI's investors as to satisfy the reliance element." n25 The court found that the plaintiffs

have not overcome the objection that investors in DVI did not rely upon the allegedly deceptive conduct of [the law firm]. Though Lead Plaintiffs allege that [the law firm] knew of the scheme, and at times took a more active part in assisting DVI in the scheme, the fact remains that none of this alleged conduct was publicly disclosed such that it affected the market for DVI's securities." n26

The court further held that the law firm owed no duty of disclosure to DVI's investors.

[1] Attorney Liability for Misstatements

Stoneridge did not foreclose attorney liability for misstatements under 10(b); rather, it merely clarified that to hold an attorney (or other secondary actor) liable in a private lawsuit requires proving all the elements under 10(b) and that vague allegations of participation in a "scheme to defraud" will not suffice. In a way, *Stoneridge* was an easy case, insofar as there was no real allegation that the secondary actors there ever undertook to speak either to the plaintiff directly or to the market -- rather, the claim against the secondary actors was premised upon their participation in underlying business transactions that affected the issuer's financial statements. *Stoneridge*, therefore, will not in all cases resolve a fundamental question on which many 10(b) cases against attorneys turn, that is, what constitutes a misstatement by an attorney, as opposed to a misstatement by the client.

The guiding principle with respect to attorney liability for misstatements appears to be that, in order for an attorney to be liable under Section 10(b), the misstatements in question must have been made by the attorney in some concrete sense. Analysis of that issue requires reference to pre-*Stoneridge* cases. At one end of the spectrum, preparation of transaction documents that contain misstatements will generally not, by itself, subject an attorney to liability. That conclusion seems manifest after *Stoneridge* but was relatively clear even before that decision.

For example, in *Schatz v. Rosenberg*, n27 a law firm represented a corporation in the purchase of two other corporations. The law firm drafted the closing documents and supplied the sellers at closing with an update letter prepared by the purchaser stating that the purchaser's financial condition had not materially changed. n28 The sellers

later premised a Section 10(b) claim against the law firm on misstatements made in these documents. The lower court granted the law firm's motion to dismiss for failure to state a claim. The Fourth Circuit affirmed, finding that because the law firm did not make any "independent affirmative misstatements" to the sellers, the firm did not violate Section 10(b). n29 The court stated, "[the law firm's] drafting of closing documents which contained representations by [its client] does not mean that they warranted or promised that [the client] had been honest." n30 Rather, when the law firm had "only 'papered the deal,' and did not participate in negotiation or solicitation," the firm was not responsible for any misstatements made in the documents. n31

At the other end of the spectrum, where attorneys do make representations, they must ensure those representations are free of misstatement even when based on client-supplied projections or opinions and even when the attorneys' representations themselves take the form of an opinion. n32 The Third Circuit's decision in *Eisenberg v. Gagnon* is particularly instructive. n33 In that case, an attorney and two others allegedly purchased coal rights and then sold those rights to tax-advantaged limited partnerships which they had formed. n34 The offering memoranda for two of these limited partnerships included a tax opinion letter prepared by the attorney and issued under the name of his law firm. n35 The plaintiffs bought shares in the limited partnerships but subsequently lost their investment, and were not afforded the tax deduction indicated in the opinion. n36 The case went to trial and the jury found for the attorney on the Section 10(b) allegations. n37

The Third Circuit overturned the jury verdict, holding that the trial court incorrectly instructed the jury that Section 10(b) liability must be predicated on misstatements about existing facts and not projections or opinions. n38 The court held that "an opinion that has been issued without a genuine belief or reasonable basis is an 'untrue' statement which, if made knowingly or recklessly, is culpable conduct actionable under § 10(b) and *Rule 10b-5*." n39 Furthermore, "[w]hen the opinion or forecast is based on underlying materials which on their face or under the circumstances suggest that they cannot be relied on without further inquiry," this may support a finding that the opinion was issued without a genuine belief that the information relied on was true. n40 The opinion letters at issue relied on management assumptions regarding projections for future options. n41 The management assumptions, in turn, relied on an engineering report which was later altered, as evidenced by a typeface change in the middle of the report. n42 The Third Circuit held that these facts were sufficient to order a new trial based on the above standards. n43

Beyond these two extremes, the law was to some extent unsettled before *Stoneridge*, and will remain that way until the impact of *Stoneridge* is fully considered. Courts have reached varying conclusions about the level of involvement a plaintiff must show to impose misstatement-based Section 10(b) liability on indirect participants, such as attorneys or accountants. Some courts, including the Ninth Circuit and district courts in the Seventh and Fifth Circuits (among others), n44 deem it sufficient that the defendant had "substantial participation" in the steps leading to the publication of the allegedly fraudulent statements. n45 This "substantial participation" test n46 is satisfied where there is "substantial participation or intricate involvement" of the secondary party in the preparation of fraudulent statements "even though that participation might not lead to the actor's actual making of the statements." n47

Other courts, including the Second Circuit, have adopted a more stringent "bright line" test. n48 Under this formulation, in order for Section 10(b) liability to be imposed, a defendant must not only make a material misstatement, but the misstatement must be attributed to the defendant at the time of public dissemination. n49 The defendant itself need not have communicated the misstatement to investors so long as it knew or had reason to know that it would be communicated. n50 In addition to the Second Circuit, the "bright line" test has been employed by the Eleventh Circuit, n51 and district courts within the First and Third Circuits. n52 The Tenth Circuit also applies the "bright line" test but does not require attribution to the secondary actor at the time of dissemination to the public. n53

Finally, at least one court--the district court in the high-profile Enron case--has employed yet another test that appears to borrow elements of both the "substantial participation" and "bright line" standards. The test employed in *In re Enron* n54 was as follows: "when a person, acting alone or with others, creates a misrepresentation [on which the investor-plaintiffs relied], the person can be liable as a primary violator." n55 "Provided that a plaintiff can plead and

prove scienter, a person can be a primary violator if he or she writes misrepresentations for inclusion in a document to be given to investors, even if the idea for those misrepresentations came from someone else." n56 Furthermore, "a person who prepares a truthful and complete portion of a document would not be liable as a primary violator for misrepresentations in other portions of the document. Even assuming such a person knew of misrepresentations elsewhere in the document and thus had the requisite scienter, he or she would not have created those misrepresentations." n57

The *Enron* court concluded based on this test that the plaintiff class had adequately alleged a Section 10(b) claim against a law firm that supposedly actively participated with its largest client, Enron, in an intricate Ponzi scheme. n58 The court rejected the law firm's contention that plaintiffs alleged only that the firm "merely represented and kept confidential the interests of its client." Rather, the court found that the law firm "was not merely a drafter, but essentially a co-author of the documents it created for public consumption concealing its own and other participants' actions," and, as such, was itself the maker of misstatements. n59 The court did add, however, that "had [the law firm] remained silent publicly, the attorney/client relationship and the traditional rule of privity for suit against lawyers might protect [it]." n60

[2] Attorney Liability for Nondisclosures

Attorney Section 10(b) liability on the basis of non-disclosure turns on whether there is a duty to disclose the material information at issue. In *Chiarella v. United States*, n61 the Supreme Court held that whether a secondary actor in a securities transaction owes such a duty generally depends on whether a "fiduciary or similar relation of trust and confidence" exists between the secondary actor and the investor. n62

Courts look to a number of factors to determine whether the requisite relationship exists, which, in large part, depends on the specific circumstances in which these claims arise. But one clear principle that emerges is that a relationship obliging attorneys to make full disclosure on a subject is created where the attorney begins to speak on that subject. The Third Circuit's decision in *Kline v. First Western Government Securities, Inc.* is a leading case. In *Kline*, purchasers of forward contracts sued a law firm that issued three opinion letters concerning the tax consequences of those investments, alleging both affirmative misrepresentations and material omissions. n63 Plaintiffs alleged, among other things, that defendants failed to include in their opinion letters any mention of multiple investigations which had been commenced by the IRS, SEC and the Minnesota Department of Commerce relating to the transactions. n64 The Third Circuit held that the attorneys could be liable for material omissions in the tax opinion letters. n65 The court reasoned that, because the law firm had elected to speak by issuing opinion letters, it had a duty to disclose information that bore directly on the accuracy of its opinion. n66 The court therefore refused to grant the defendant's summary judgment motion. n67

The Sixth Circuit reached the same conclusion in an en banc decision in *Rubin v. Schottenstein, Zox & Dunn*. n68 The issue in that case was whether an attorney and his law firm would be held liable based on an opinion letter to a corporate client regarding a transaction in which the company issued notes and stock. n69 The defendant attorney did not reveal that the transaction would result in the company's default on certain outstanding bank loans in either the opinion letter or two subsequent conversations the attorney had with the plaintiff investors. n70 The trial court granted summary judgment to the defendant attorney on the basis that no fiduciary or confidential relationship existed between the attorney and the plaintiffs, and that the opinion letter--which stated only that the company was acting within its corporate powers and did not speak to its financial stability--contained no affirmative misstatements. n71 The Sixth Circuit, sitting *en banc*, reversed, holding that while an attorney representing the seller in a securities transaction may not have an independent duty to disclose information, that attorney "assumes a duty to provide complete and nonmisleading information with respect to subjects on which he undertakes to speak." n72 The court went on to find that since the attorney's omission regarding the financial viability of the corporation was material, reliance by the plaintiffs may be presumed; thus plaintiffs had presented sufficient facts to warrant a trial on the merits. n73 Defendants' argument that attorneys should be treated differently due to their obligation of confidentiality was rejected

by the court out of concern that such an exception would "allow an attorney to mislead investors with impunity." n74

Beyond this basic principle, whether there exists a "fiduciary or similar relationship of trust and confidence" sufficient to give rise to a duty to speak requires exceedingly fact-intensive inquiry. n75 That said (though by no means uniformly accepted), a number of courts around the country distill the inquiry down to a five-part test that looks to:

- the defendant's relationship to the plaintiff;
- the defendant's access to the information as compared to the plaintiff's access;
- the benefit the defendant derives from the relationship;
- the awareness by the defendant of the plaintiff's reliance on him; and
- the defendant's activity in initiating the transaction. n76

The Eleventh Circuit's decision in *Ziemba v. Cascade Int'l, Inc.* is illustrative. n77 In that case, the Eleventh Circuit affirmed the dismissal of claims against a law firm on the basis that the attorneys had no duty to speak in connection with certain securities offerings. n78 The plaintiff-investors based their claims against the law firm on, among other things, the fact that the firm "played a significant role in drafting, creating, reviewing or editing allegedly fraudulent letters or press releases." n79 The court applied the five part test, and affirmed the dismissal because (1) there was no attorney-client relationship between the law firm and the plaintiffs; (2) the law firm had certain privileges not to disclose information about its client owing to its fiduciary obligations to that client; (3) no statements attributable to the law firm were made to the plaintiffs (in other words, the law firm had not undertaken to speak to the plaintiffs at all); and (4) there were no allegations that the law firm had initiated the transaction. n80

An illustrative case reaching the opposite conclusion is the decision in *Walco Investments, Inc. v. Thenen*, n81 a case arising out of a failed Ponzi scheme in which the court denied two law firm defendants' motions to dismiss. n82 Plaintiffs alleged that the law firms "were retained to ensure compliance with state and federal securities laws and to prepare Offering Documents to be relied upon by prospective investors," and that the law firms "knew the Offering Documents were designed to and in fact would induce investors to purchase the securities at issue." n83 The court applied the five-part test, and held that defendants' awareness that investors would be relying upon the information contained in the Offering Documents "may be sufficient to create a relationship between the law firms and Plaintiffs... which would give rise to a duty to disclose." n84

[3] Attorney Liability for Insider Trading

Attorneys may also face liability under Section 10(b) in an insider trading action. Under the conventional approach, first articulated by the SEC in *In re Cady, Roberts & Co.*, n85 and endorsed by the Supreme Court in *Chiarella v. United States*, n86 corporate "insiders" are prohibited from trading in the company's securities if they are in possession of material nonpublic information. n87 In such circumstances, insiders must either disclose the material non-public information or abstain from trading in the company's securities. The duty to disclose or abstain arises from "(i) the existence of a relationship affording access to inside information intended to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." n88 Put differently, the responsibility arises out of a fiduciary duty insiders have to the shareholders of the corporation they serve. n89

An outside attorney representing a company engaged in a securities transaction may not be an "insider" in the traditional sense that an employee or member of a company's board of directors is. At the same time, both outside and in-house attorneys who provide legal services to their clients in connection with a securities transaction or who otherwise come

into possession of material inside information face grave risks of insider trading liability if they engage in transactions in the company's stock as either a "tippee" or a "quasi" or "temporary" insider. Under conventional insider trading prohibitions, "tippee" liability may be imposed on one who receives nonpublic information from an insider in breach of the insider's fiduciary duty if the "tippee" trades on the information while knowing of the insider's breach. n90 At the same time, the Supreme Court, in *Dirks v. SEC*, expressly recognized "quasi" or "temporary" insider status for attorneys and other professionals. n91 The Court stated:

Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes ... When such a person breaches his fiduciary relationship, he may be treated more properly as a tipper than a tippee ... For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty. n92

A related theory of insider trading liability--and one equally applicable to attorneys--is the so-called "misappropriation theory." Under the misappropriation theory, those who obtain material inside information through a confidential or fiduciary relationship are prohibited from using that information in connection with a securities transaction. n93 That was the Supreme Court's holding in *United States v. O'Hagan*. n94 In *O'Hagan*, a partner in a law firm that served as local counsel for a corporation planning a tender offer purchased stock in the target corporation based on non-public information. n95 The partner was not personally involved in advising over the transaction. The government nevertheless pursued criminal charges under Section 10(b) based on the misappropriation theory. The Eighth Circuit rejected the theory, stating that:

the misappropriation theory bases liability upon the mere misappropriation of material nonpublic information in breach of a fiduciary obligation and subsequent use of that information in a securities transaction. By its very definition then, it does not require either a material misrepresentation or nondisclosure. Thus, the misappropriation theory runs counter to [Supreme Court] holdings that the mere breach of a fiduciary obligation, without misrepresentation or nondisclosure, is not deception within the meaning of § 10(b). n96

The Supreme Court reversed and held that criminal liability for violations of Section 10(b) may be grounded on the misappropriation theory. n97 The Court explained that liability for misappropriation satisfies the statute's requirement that the conduct must be a "deceptive device or contrivance" because it involves a fiduciary's "feigning fidelity to the source of information" and because such deception may be cured by disclosure to the source of the intent to trade. n98 The Court further explained that such conduct was "in connection with the purchase or sale of a security" because the misappropriated information at issue "ordinarily" derives its value from such trading. n99 A number of courts (both before and after *O'Hagan*) have likewise held that attorneys may be liable for Section 10(b) violations under the misappropriation theory. n100 The First Circuit's decision in *United States v. Larrabee* illustrates a special risk of securities liability, and misappropriation in particular, in the law firm setting. In *United States v. Larrabee*, n101 the defendant Larrabee, a law firm employee, was found to have misappropriated material non-public information that the firm possessed in connection with its representation of a client in a potential merger. n102 Larrabee, who was not an attorney, served as Director of Fiduciary Services and had daily contact with the firm's attorneys and access to highly confidential information. n103 Larrabee used this information to tip off a stockbroker with whom he had both professional and personal dealings. n104 The First Circuit held that the tipper's knowledge that he was breaching a duty to his employer, the law firm, which was the owner of the confidential information, was sufficient to establish an expectation that the information might be misused by the tippee stockbroker. n105 The law firm was not charged in the matter. Finally, in at least one reported decision, an attorney was found liable for insider trading for conduct entirely

outside his professional functions. In *SEC v. Jakubowski*, n106 a financial institution issued stock in connection with a conversion from mutual to stock ownership, and gave preferential treatment to certain eligible accountholders. n107 Jakubowski, an attorney, was not such an accountholder, but a secretary in his firm was. n108 Jakubowski had the secretary sign a stock order form, and then sign an agreement transferring the stock rights to him. n109 Jakubowski's, not the secretary's, address was filled in on the stock order form, which clearly stated that the stock rights were not transferable. The Seventh Circuit held that in falsely representing on the order form that the stock was being purchased for the secretary's account, Jakubowski made a material misrepresentation directly to the issuer in order to induce acceptance of his offer to buy stock, thus his actions satisfied the "in connection with the purchase or sale of any security" language of Section 10(b). n110 Factoring Jakubowski's occupation into its finding of scienter, the court noted, "for a lawyer to fail to read a document central to a business transaction is reckless indeed... . Deliberate ignorance ... is a form of knowledge." n111

[4] Aiding and Abetting Liability Under Section 10(b)

As discussed above, private litigants may not pursue claims for aiding and abetting Section 10(b) violations. For a short time after *Central Bank*, it seemed possible that the Supreme Court would find that all actions for aiding and abetting a Section 10(b) violation were prohibited. This prospect was eliminated with respect to SEC actions in December 1995 when Congress overrode a presidential veto to pass the Private Securities Litigation Reform Act of 1995 (the "Reform Act"). Section 104 of the Reform Act explicitly granted the SEC the authority to bring an action against "any person that knowingly provides substantial assistance to another person in violation of [the antifraud provisions of the 1934 Act]," and provided that such persons "shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided." n112

In 1996, the Ninth Circuit interpreted Section 104 in the context of attorney liability in a case that remains instructive. In *SEC v. Fehn*, n113 Fehn (an attorney) was hired to represent a company as well as its officers and directors in an SEC inquiry arising from the company's initial public offering. n114 Subsequently, Fehn also assisted the company in preparing its quarterly securities filings. n115 The SEC brought an action under Section 10(b) against the corporation and Wheeler (the corporation's original promoter, president and Chief Executive Officer) as primary violators, and against Fehn as an aider and abettor on the basis of certain alleged misstatements and nondisclosures in the company's quarterly reports. n116 The SEC alleged that the quarterly reports at issue stated that Wheeler had only recently been appointed as the company's chief executive officer and president when, in fact, he had been the company's promoter, incorporator, and had effectively controlled the company since its incorporation in 1987. n117 The SEC also alleged that the quarterly reports failed to disclose certain prior securities violations by the corporation and Wheeler in connection with the initial public offering. n118 Although Fehn did not actually prepare the first report which initially contained the alleged errors, he reviewed it, made technical changes to it, and mailed it to the SEC. n119 Fehn's law firm then prepared two subsequent quarterly reports based on the information contained in the first. n120

The Ninth Circuit considered Section 104's legislative history as well as its text and held that the section authorizes the SEC to seek injunctions against those who aid and abet securities violations. n121 The court also concluded that, since the language of Section 104 mirrors the elements of aiding and abetting actions as expressed in prior case law, it "simply restores the pre- *Central Bank* status quo with respect to SEC injunctive actions." n122 Accordingly, in order to establish a claim against Fehn, the SEC was required to show: "(1) an independent primary violation; (2) actual knowledge by the alleged aider and abettor of the primary violation and of his or her own role in furthering it; and (3)'substantial assistance' by the defendant in the commission of the primary violation." n123

Applying this standard, the court found that Wheeler and the corporation had committed primary violations of Section 10(b) because the misstatements and nondisclosures were material and because they were made with reckless disregard for their truth or falsity. n124 The court then held that Fehn had substantially assisted these violations, finding that Fehn had actual knowledge of his role in the primary violation because he knew that the statements were inaccurate and knew that Wheeler had refused to include the correct information. n125 Thus, the court concluded that Fehn was liable for

aiding and abetting and that a permanent injunction was appropriate. n126

[5] Conspiracy To Violate Section 10(b)

Prior to *Central Bank*, many courts recognized that attorneys could also be subject to secondary liability based on conspiracy to violate the federal securities laws. After *Central Bank*, essentially every court that has considered this issue has held that there is no implied cause of action for conspiracy. n127 The *Central Bank* court determined that there could be no aiding and abetting liability under Section 10(b) because the text of that section did not explicitly impose it. Extending this rationale, courts have since held that Section 10(b)'s failure to include a cause of action for conspiracy precludes that theory as a basis for liability as well. n128

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 78j(b).

(n2)Footnote 2. 17 C.F.R. § 240.10b-5(b). The majority of cases against attorneys have arisen from *Rule 10b-5(b)*. But claims also have been brought under *Rule 10b-5(a)*, 17 C.F.R. § 240.10b-5(a), which makes it unlawful "[t]o employ any device, scheme, or artifice to defraud," and *Rule 10b-5(c)*, 17 C.F.R. § 240.10b-5(c), which makes it unlawful to engage in "any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." See generally *Scholes v. Stone, McGuire and Benjamin*, 786 F. Supp. 1385, 1400 (N.D. Ill. 1992) .

(n3)Footnote 3. *In re IKON Office Solutions, Inc., Sec. Litig.*, 277 F.3d 658, 666 (3d Cir. 2002) ; *Rothman v. Gregor*, 220 F.3d 81, 89 (2d Cir. 2000) ; *Ross v. Bank South, N.A.*, 885 F.2d 723, 728 (11th Cir. 1989) .

(n4)Footnote 4. In an unusual case, *Popovice v. Milides*, the Eastern District of Pennsylvania held that a client adequately stated a claim for securities fraud against her divorce attorney for misrepresentation of the value of his legal services. 11 F. Supp. 2d 638 (E.D. Pa. 1998) . The attorney performed substantial work for the client for eight months but refused to discuss his fee with her until just before the child custody phase of the trial was set to begin; at that point, the attorney presented the plaintiff with a fee agreement obligating her to deliver one million dollars worth of securities to his firm. 11 F. Supp. 2d at 640 . The court found that the plaintiff reasonably relied upon the attorney's misrepresentation of the value of his services and that an agreement exchanging services for stock is a "sale" for purposes of Section 10(b) and *Rule 10b-5*. 11 F. Supp. 2d at 643 .

(n5)Footnote 5. 511 U.S. 164 (1994).

(n6)Footnote 6. 128 S.Ct. at 766-68.

(n7)Footnote 7. *Id.* at 766.

(n8)Footnote 8. *Id.*

(n9)Footnote 9. *Id.* at 772-74.

(n10)Footnote 10. *Id.*

(n11)Footnote 11. *Id.* The Supreme Court stated: "The § 10(b) private cause of action is a judicial construct that Congress did not direct in the text of the relevant statutes. See, e.g., *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 358-359, 111 S.Ct. 2773, 115 L.Ed.2d 321. Separation of powers provides good reason for the now-settled view that an implied cause of action exists only if the underlying statute can be interpreted to disclose the intent to create one, see, e.g., *Alexander v. Sandoval*, 532 U.S. 275, 286-287, 121 S.Ct. 1511, 149 L.Ed.2d 517. The decision to extend the cause of action is thus for the Congress, not for this Court. This restraint is appropriate in light of the PSLRA, in which Congress ratified the implied right of action after the Court moved away from a broad willingness to imply such private rights, see, e.g., *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran*, 456 U.S. 353, 381-382,

and n. 66, 102 S.Ct. 1825, 72 L.Ed.2d 182. It is appropriate for the Court to assume that when PSLRA § 104 was enacted, Congress accepted the § 10(b) private right as then defined but chose to extend it no further. *See, e.g., Alexander, supra*, at 286-287, 121 S.Ct. 1511."

Despite the Supreme Court's rejection of aiding and abetting liability under the federal securities laws, aiding and abetting liability may still exist under state securities laws. *See Houston v. Seward & Kissel LLP*, No. 07cv6305, 2008 U.S. Dist. LEXIS 23914 (S.D.N.Y. March 27, 2008) (holding that federal law does not preempt claims of aiding and abetting brought under state securities laws).

(n12)Footnote 12. *Id.* at 770.

(n13)Footnote 13. *Id.*

(n14)Footnote 14. *Id.* The Court further described the plaintiff's theory as follows: "Liability is appropriate, petitioner contends, because respondents engaged in conduct with the purpose and effect of creating a false appearance of material fact to further a scheme to misrepresent [the issuer's] revenue. The argument is that the financial statement [the issuer] released to the public was a natural and expected consequence of respondents' deceptive acts... . That causal link is sufficient, petitioner argues, to apply [the] presumption of reliance to respondents' acts."

(n15)Footnote 15. *Id.* at 770.

(n16)Footnote 16. 511 U.S. at 167, 114 S. Ct. 1443.

(n17)Footnote 17. 511 U.S. at 168, 114 S. Ct. at 1443-1444.

(n18)Footnote 18. 511 U.S. at 167, 114 S. Ct. at 1143.

(n19)Footnote 19. 511 U.S. at 169, 114 S. Ct. at 1444.

(n20)Footnote 20. 511 U.S. at 176, 114 S. Ct. at 1447.

(n21)Footnote 21. No. 2:03-CV-05336-LDD, 2008 U.S. Dist. LEXIS 34978, *9-10 (E.D. Pa. April 29, 2008).

(n22)Footnote 22. *Id.* at *11-12.

(n23)Footnote 23. *Id.* at *73-78.

(n24)Footnote 24. *Id.* at *76.

(n25)Footnote 25. *Id.* at *76. Specifically, the plaintiffs alleged that the law firm initiated and masterminded a "workaround" that allowed DVI to fraudulently state in its 10-Q that its internal controls were adequate, despite knowing otherwise. *Id.* at *76 n.39.

(n26)Footnote 26. *Id.* at *77. The court further held that "though Lead Plaintiffs allege that [the law firm] directed and coordinated [the 10-Q disclosure], it remains uncontested that the misleading 10-Q was issued solely by DVI and contains no indication that any statement therein is attributable to [the law firm]." *Id.* at *76 n.39.

(n27)Footnote 27. 943 F.2d 485 (4th Cir. 1991) , *cert. denied*, 503 U.S. 936 (1992) .

(n28)Footnote 28. 943 F.2d at 489 .

(n29)Footnote 29. 943 F.2d at 494 .

(n30)Footnote 30. 943 F.2d at 494 .

(n31)Footnote 31. 943 F.2d at 494 n.3 .

(n32)Footnote 32. *Eisenberg v. Gagnon*, 766 F.2d 770 (3d Cir. 1985) , cert. denied, 474 U.S. 946 (1985) ; *Gilmore v. Berg*, 761 F. Supp. 358, 370 (D.N.J. 1991) .

(n33)Footnote 33. 766 F.2d 770 (3d Cir. 1985) .

(n34)Footnote 34. 766 F.2d at 773 .

(n35)Footnote 35. 766 F.2d at 773 .

(n36)Footnote 36. 766 F.2d at 773 .

(n37)Footnote 37. 766 F.2d at 774 .

(n38)Footnote 38. 766 F.2d at 775 .

(n39)Footnote 39. 766 F.2d at 776 .

(n40)Footnote 40. 766 F.2d at 776 .

(n41)Footnote 41. 766 F.2d at 777 .

(n42)Footnote 42. 766 F.2d at 777 .

(n43)Footnote 43. 766 F.2d at 776 . The Third Circuit has also rejected efforts by a law firm to minimize its exposure by including a disclaimer in tax opinions. In *Kline v. First Western Government Securities, Inc.*, the Third Circuit found that attorneys must disclose any data that calls into question the accuracy of their opinions and that "[t]his responsibility cannot be evaded by the inclusion of a statement that the opinion is based on facts provided by someone else." 24 F.3d 480, 487 (3d Cir. 1994) , cert. denied, 513 U.S. 1032 (1994) .

(n44)Footnote 44. See *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) (using substantial participation test to determine accountants' liability); *Cashman v. Coopers & Lybrand*, 877 F. Supp. 425, 432-34 (N.D.Ill. 1995) (same); *McNamara v. Bre-X Minerals Ltd.*, 57 F. Supp. 2d 396, 429 (E.D. Tex. 1999) ("if a defendant played a significant role in preparing a false statement actually uttered by another, primary liability will lie") (internal quotations omitted).

(n45)Footnote 45. See, e.g., *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000) .

(n46)Footnote 46. *Howard*, 228 F.3d at 1061 n.5 ; *In re Software Toolworks*, 50 F.3d 615, 628 n.3, 629 (9th Cir. 1994) (using substantial participation test to determine accountant's liability).

(n47)Footnote 47. *Howard*, 228 F.3d at 1061 n.5 .

(n48)Footnote 48. See, e.g., *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) , cert. denied, 525 U.S. 1104 (1999) .

(n49)Footnote 49. 152 F.3d 169, 175 (2d Cir. 1998) .

(n50)Footnote 50. 152 F.3d 169, 175 (2d Cir. 1998) .

(n51)Footnote 51. See *Ziembra v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205-7 (11th Cir. 2001) (In order for a secondary actor, such as a law firm or an accounting firm, "to be primarily liable under § 10(b) and Rule 10b-5, the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at

the time that the plaintiff's investment decision was made.")

Although not calling it the "bright line test," the Fourth Circuit applied essentially the same test in *Schatz*. See 943 F.2d at 943 (attorney who drafted closing documents containing misstatements was not liable because misstatements were attributed to issuer, not attorney).

(n52)Footnote 52. See, e.g. *In re DVI Inc. Sec. Litig.*, No. 2:03-CV-05336-LDD, 2008 U.S. Dist. LEXIS 34978, *73-78 & n.39 (E.D. Pa. April 29, 2008); *Vosgerichian v. Commodore Int'l*, 862 F. Supp. 1371, 1378 (E.D. Pa. 1994) ; *In re Kendall Square Research Corp. Sec. Litig.*, 868 F. Supp. 26 (D. Mass. 1994) .

(n53)Footnote 53. See, e.g., *Anixter v. Home-Stake Production Co.*, 77 F.3d 1215, 1225 (10th Cir. 1996) .

(n54)Footnote 54. *In re Enron Corp.*, 235 F.Supp. 2d 549 (S.D. Tex. 2002) , *rev'd in part on other grounds*, *Newby v. Enron Corp.*, No. H-01-3624, 2003 U.S. Dist. LEXIS 1668 (S.D. Tex. Jan. 28, 2003). The Enron test was subsequently employed in *SEC v. Hopper*, Fed. Sec. L. Rep. (CCH) P93, 878 (S.D. Tex. 2006).

(n55)Footnote 55. 235 F.Supp. 2d at 588 .

(n56)Footnote 56. 235 F.Supp. 2d at 588 .

(n57)Footnote 57. 235 F.Supp. 2d 549, at 588 .

(n58)Footnote 58. 235 F.Supp. 2d 549, at 705 .

(n59)Footnote 59. 235 F.Supp. 2d 549, at 705 .

(n60)Footnote 60. 235 F.Supp. 2d 549, at 705 .

(n61)Footnote 61. 445 U.S. 222, 228, 100 S. Ct. 1108, 1114, 63 L. Ed. 2d 348 (1980) .

(n62)Footnote 62. 445 U.S. at 228, 100 S. Ct. at 1114 (internal quotation omitted). See also *Fortson v. Winstead, McGuire, Sechrest & Minick*, 961 F.2d 469 (4th Cir. 1992); *Molecular Technology Corp. v. Valentine*, 925 F.2d 910, 917 (6th Cir. 1991); *Schatz v. Rosenberg*, 943 F.2d 485 (4th Cir. 1991), *cert. denied*, 503 U.S. 936 (1992); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986). See *In re Cascade Int'l Sec. Litig.*, 840 F. Supp. 1558, 1564 (S.D. Fla. 1993); *Austin v. Bradley, Barry & Tarlow, P.C.*, 836 F. Supp. 36, 38 (D. Mass. 1993); *Buford White Lumber Co. Profit Sharing and Savings Plan & Trust v. Octagon Properties, Ltd.*, 740 F. Supp. 1553, 1560 (W.D. Okla. 1989).

At least with regard to the misappropriation theory of insider trading, the Supreme Court seems to have expanded the situations under which a person owes a fiduciary duty requiring disclosure of material information. *O'Hagan*, 521 U.S. 642, 117 S. Ct. at 2208 (a deceptive device or contrivance is found where "[a] fiduciary... pretends loyalty to the principal while secretly converting the principal's information for personal gain") (internal citations omitted). Whether the analysis of *O'Hagan* will be applied outside the misappropriation context remains an open question.

(n63)Footnote 63. 24 F.3d at 481 .

(n64)Footnote 64. 24 F.3d at 484 .

(n65)Footnote 65. 24 F.3d at 489-90 .

(n66)Footnote 66. 24 F.3d at 490-91 .

(n67)Footnote 67. 24 F.3d at 491-92 .

(n68)Footnote 68. *Rehearing en banc granted, judgment vacated by 120 F.3d 603 (6th Cir. 1997) , on rehearing, 143 F.3d 263 (6th Cir. 1998) .*

(n69)Footnote 69. *110 F.3d at 1249 .*

(n70)Footnote 70. *110 F.3d at 1249 .*

(n71)Footnote 71. *110 F.3d at 1255.*

(n72)Footnote 72. *143 F.3d at 268 . See also* *Burket v. Hyman Lippitt, P.C.*, No. 05-72110, 2008 U.S. Dist. LEXIS 33546, *35-38 (E.D. Mich. April 23, 2008) (presumption of reliance appropriate because attorney had assumed duty to disclose by preparing subscription agreements which purported to disclose certain risks but which did not disclose risk that ultimately led to plaintiff's loss).

(n73)Footnote 73. *143 F.3d at 268 .*

(n74)Footnote 74. *143 F.3d at 270 .*

(n75)Footnote 75. To take one example, in *Molecular Technology Corp. v. Valentine*, 925 F.2d 910 (6th Cir. 1991) , the Sixth Circuit considered Section 10(b) liability for nondisclosures in a private placement offering circular and other materials made available to potential investors. As to the attorney defendants, who were the attorneys for certain directors of the issuer, the court found that sufficient evidence had been presented to permit the jury to decide whether the attorneys had violated Section 10(b). The court based its decision on evidence that the attorneys had attended meetings and drafted documents that would have made them aware of alleged misrepresentations in the offering documents and further found that the attorneys had participated in marketing the offering by preparing marketing materials. On the basis of all of that, the court concluded that "a reasonable jury could find that [the attorneys] knew certain information in the amended offering circular was misleading and... had a duty to disclose that information to investors..." *925 F.2d at 918 . See also* *Lopes v. Vieira*, No. CV-F-06-1243, 2006 U.S. Dist. LEXIS 19481, *77 (E.D. Ca. March 12, 2008) (holding that whether attorney has a duty to disclose depends on the facts, and therefore cannot be resolved at pleading stage).

(n76)Footnote 76. *Gilmore*, 761 F. Supp. at 367 . *See also* *Sturm v. Marriott Marquis Corp.*, 85 F. Supp. 2d 1356 (N.D. Ga. 2000); *Cascade International*, 840 F. Supp. at 1563; *Kaplan v. Utilicorp United, Inc.*, 9 F.3d 405 (5th Cir. 1993) ; *Arthur Young v. Reves*, 937 F.2d 1310, 1329-31 (8th Cir. 1991) ; *In re National Mortgage Equity Corp. Mortgage Pool Certificates Sec. Litig.*, 636 F. Supp. 1138, 1165 (C.D. Cal. 1986) . Although the viability of the five part test (sometimes referred to as the "Flexible Duty Standard") in the 9th and 2nd Circuits has been called into question - *see Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1570 (9th Cir. 1990) and *Alexandra Global Master Fund, Ltd. v. Ikon Office Solutions, Inc.*, 2007 U.S. Dist. LEXIS 52546 (S.D.N.Y. July 19, 2007)--courts in the 9th Circuit continue to use the test when determining if a secondary actor in a transaction had a duty to speak. *See Paracor Finance, Inc. v. General Electric Capital Corporation*, 96 F.3d 1151, 1157-58 (9th Cir. 1996) .

(n77)Footnote 77. *256 F.3d 1194 (11th Cir. 2001) .* The Sixth Circuit has rejected the approach of Ziemba. *See* *Burket v. Hyman Lippitt, P.C.*, 2008 U.S. Dist. LEXIS 33546 (E.D. Mich. Apr. 23, 2008) ("The HL Defendants also rely on [Schatz and Ziemba] in arguing that [the law firm] owed no duty to disclose to the non-client Plaintiffs. These holdings, in addition to lacking precedential value in this Circuit, conflict with Rubin as they apply a stricter standard in determining whether a lawyer or law firm can be held liable for primary violations of § 10(b) and Rule 10b-5").

(n78)Footnote 78. *256 F.3d at 1207 .*

(n79)Footnote 79. *256 F.3d at 1202-3* (internal citation omitted).

(n80)Footnote 80. *256 F.3d at 1206-7 .*

(n81)Footnote 81. 881 F. Supp. 1576 (S.D. Fla. 1995) .

(n82)Footnote 82. 881 F. Supp. at 1582 .

(n83)Footnote 83. 881 F. Supp. at 1581 .

(n84)Footnote 84. 881 F.Supp. at 1581-82 .

(n85)Footnote 85. Exch. Act Rel. No. 34-6668, 1961 SEC LEXIS 385 (Nov. 8, 1961) .

(n86)Footnote 86. 445 U.S. 222, 226, 100 S. Ct. 1108, 1113 (1980) .

(n87)Footnote 87. 445 U.S. at 226, 100 S. Ct. at 1113 .

(n88)Footnote 88. 445 U.S. at 227, 100 S. Ct. at 1114 .

(n89)Footnote 89. 445 U.S. at 234, 100 S. Ct. at 1117 .

(n90)Footnote 90. *Dirks v. S.E.C.*, 463 U.S. 646, 660, 103 S. Ct. 3255, 3264 (1983) .

(n91)Footnote 91. *Dirks*, 463 U.S. at 646, 103 S. Ct. 3255 .

(n92)Footnote 92. 463 U.S. at 655 n.14, 103 S. Ct. at 3262 n.14 (citations omitted). Other courts have recognized this theory of liability for attorneys as well as other professionals. *See, e.g., United States v. Newman*, 664 F.2d 12, 17 (2d Cir. 1981) , *later proceeding*, 722 F.2d 729 (2d Cir. 1983) , *cert. denied*, 464 U.S. 863 (1983) (attorney); *SEC v. Downe*, No. 92 CIV. 4092 (PKL), 1993 U.S. Dist. LEXIS 753, at *25 (S.D.N.Y. Jan. 26, 1993) (public relations consultant); *SEC v. Ingram*, 694 F. Supp. 1437, 1440 (C.D. Cal. 1988) (stock broker); *United States v. Elliott*, 711 F. Supp. 425 (N.D. Ill. 1989) (attorney); *SEC v. Tome*, 638 F. Supp. 596, 621 (S.D.N.Y. 1986) (financial consultant).

(n93)Footnote 93. *Newman*, 664 F.2d at 16 .

(n94)Footnote 94. 521 U.S. 642, 117 S. Ct. 2199, 138 L. Ed. 2d 724 (1997) .

(n95)Footnote 95. 521 U.S. at 649, 117 S. Ct. at 2205-06.

(n96)Footnote 96. 92 F.3d at 618.

(n97)Footnote 97. 521 U.S. at 665-666, 117 S. Ct. at 2214.

(n98)Footnote 98. 521 U.S. at 665-666, 117 S. Ct. at 2214.

(n99)Footnote 99. 521 U.S. at 665-666, 117 S. Ct. at 2214.

(n100)Footnote 100. *See, e.g., Newman*, 664 F.2d at 17 ; *SEC v. Kornman*, 391 F. Supp. 2d 477 (N.D. Tex. 2005); *United States v. Elliott*, 711 F. Supp. 425 (N.D. Ill. 1989) .

(n101)Footnote 101. 240 F.3d 18 (1st Cir. 2001) .

(n102)Footnote 102. 240 F.3d at 20 .

(n103)Footnote 103. 240 F.3d at 22 .

(n104)Footnote 104. 240 F.3d at 19-20 .

(n105)Footnote 105. 240 F.3d at 24-25 .

(n106)Footnote 106. *150 F.3d 675 (7th Cir. 1998) , cert. denied, 525 U.S. 1103 (1999) .*

(n107)Footnote 107. *150 F.3d at 677-78 .*

(n108)Footnote 108. *150 F.3d at 676, 678.*

(n109)Footnote 109. *150 F.3d at 678 .*

(n110)Footnote 110. *150 F.3d at 676 .* Relying on *O'Hagan*, the Court held that misrepresentation need not concern the value of the security. *150 F.3d, at 679-81 .*

(n111)Footnote 111. *150 F.3d at 681-82 .*

(n112)Footnote 112. *15 U.S.C. § 78t (LEXIS 2004)*, Pub. L. No. 104-67, 109 Stat. 737 (1995).

(n113)Footnote 113. *97 F.3d 1276 (9th Cir. 1996) , cert. denied, 118 S. Ct. 59 (1997) .*

(n114)Footnote 114. *97 F.3d at 1280 .*

(n115)Footnote 115. *97 F.3d at 1281 .*

(n116)Footnote 116. *97 F.3d at 1281 .*

(n117)Footnote 117. *97 F.3d at 1280 .*

(n118)Footnote 118. *97 F.3d at 1280 .*

(n119)Footnote 119. *97 F.3d at 1281 .*

(n120)Footnote 120. *97 F.3d at 1281 .*

(n121)Footnote 121. *97 F.3d at 1282-83 .* See S. Rep. No. 98, 104th Cong. (1995); 141 Cong. Rec. § 17,965 (daily ed. Dec. 5, 1995).

(n122)Footnote 122. *97 F.3d at 1288 .*

(N123)Footnote 123. *97 F.3d at 1288 .* See also *SEC v. Norton*, 21 F. Supp. 2d 361, 364 (S.D.N.Y. 1998) (following Fehn, applying Private Securities Litigation Reform Act retroactively to SEC action for aiding and abetting). Nor has the SEC shied away from exercising its authority to pursue aiding and abetting claims in recent years. See, e.g., *SEC v. Finkelstein*, Lit. Rel. No. 18701, 2004 SEC LEXIS 958 (May 11, 2004) (charging lawyer with aiding and abetting violations of the reporting provisions of the Exchange Act in connection with client annual and quarterly reports containing material misstatements of which the lawyer knew or should have known); *SEC v. Heritage Film Group, LLC*, Lit. Rel. No. 17658, 2002 SEC LEXIS 2022 (Aug. 6, 2002) (charging lawyer with aiding and abetting violations in connection with securities offering in which a substantial portion of the offering proceeds were used for undisclosed cash commissions to the persons who organized and conducted the offerings); *SEC v. Intracom Corp.*, Lit. Rel. No. 17659, 2002 SEC LEXIS 2023 (Aug. 6, 2003) (same); *SEC v. Wynne*, Lit. Rel. No. 17164, 2001 SEC LEXIS 2018 (Sept. 28, 2001) (charging lawyer with aiding and abetting violations in connection with securities offerings in which lawyer drafted offering documents, acted as escrow agent for funds raised by the offerings, and transferred investor funds to offshore accounts upon learning that the SEC was investigating the company).

(n124)Footnote 124. *97 F.3d at 1290-92 .*

(n125)Footnote 125. *97 F.3d at 1288-95 .*

(n126)Footnote 126. 97 F.3d at 1288-95 . Other courts have also held that permanent injunctions are appropriate when attorneys have committed securities fraud. *See, e.g., SEC v. Electronics Warehouse, Inc.*, 689 F. Supp. 53, 71 (D. Conn. 1988) , *aff'd*, 891 F.2d 457 (2d Cir. 1989) , *cert. denied*, 496 U.S. 942 (1990) ; *SEC v. Everest Management Corp.*, 466 F. Supp. 167, 174 (S.D.N.Y. 1979) ; *SEC v. Century Mortgage Co.*, 470 F. Supp. 300, 311 (D. Utah 1978) .

(n127)Footnote 127. *See, e.g., Regents of the Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372, 391 (5th Cir. Tex. 2007); *Glaser v. Enzo Biochem, Inc.*, 126 Fed. Appx. 593, 599 (4th Cir. Va. 2005); *In re GlenFed, Inc. Sec. Litig.*, 60 F.3d 591, 592 (9th Cir. 1995) ; *Kidder, Peabody & Co. v. Unigestion International, Ltd.*, 903 F. Supp. 479, 496 (S.D.N.Y. 1995) ; *Pitten v. Jacobs*, 903 F. Supp. 937, 950 (D. S.C. 1995) ; *Van De Velde v. Coopers & Lybrand*, 899 F. Supp. 731, 737 (D. Mass. 1995) ; *In re Cypress Semiconductor Sec. Litig.*, 891 F. Supp. 1369, 1381 (N.D. Cal. 1995) ; *Otto v. Variable Annuity Life Insurance Co.*, No. 82 C4762, 1995 U.S. Dist. LEXIS 3352, at *1 (N.D. Ill. Mar. 16, 1995), *subsequent appeal*, 134 F.3d 841 (7th Cir. 1998) *rehg. en banc denied* (March 18, 1998); *Faleck & Margolies, Ltd. v. Margolies (In re Faleck & Margolies, Ltd.)*, Nos. 89 CIV. 8548 (SWK), 90 CIV. 1356 (SWK), 1995 U.S. Dist. LEXIS 970, at **34-35 (S.D.N.Y. Jan. 27, 1995); *In re Medimmune, Inc. Sec. Litig.*, 873 F. Supp. 953, 964 n.8 (D. Md. 1995) ; *In re Ross Sys. Sec. Litig.*, No. C-94-0017-DLJ, 1994 U.S. Dist. LEXIS 21263, at ** 10-13 (N.D. Cal. July 21, 1994); *In re Syntex Corp. Sec. Litig.*, 855 F. Supp. 1086, 1098 (N.D. Cal. 1994) , *aff'd*, 95 F.3d 922 (9th Cir. 1996) ; *In re Rasterops Corp. Sec. Litig.*, C-93-20349 RPA (EAI), 1994 U.S. Dist. LEXIS 18245, at *11 (N.D. Cal. Oct. 31, 1994). *But see Wenneman v. Brown*, 49 F. Supp. 2d 1283, 1289 n.3 (D. Utah 1999) (stating that there are fundamental differences between aiding and abetting and conspiracy, and *Central Bank* only precluded a cause of action for the former).

(n128)Footnote 128. *In re Syntex Corp. Sec. Litig.*, 855 F. Supp. 1086, 1098 (N.D. Cal. 1994).

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CHAPTER 5B Attorney Liability Under the 1934 Act *

1-5B Federal Securities Exchange Act of 1934 § 5B.03

§ 5B.03 Attorney Liability Under The Proxy Solicitation Provisions

Section 14(a) of the 1934 Act n1 and Rule 14a-9 n2 promulgated thereunder prohibit the solicitation of proxies by means of a proxy statement or other communication "containing any statement which ... is false or misleading with respect to any material fact, or which omits to state any material fact necessary to make the statement therein not false or misleading." n3

Attorney liability for misleading statements in proxy solicitations under Section 14 has rarely been litigated and does not appear to have been considered in recent years. But two 1970s decisions from the District of Delaware shed some light on the how courts might treat such a claim. In *Gould v. American Hawaiian Steamship Co.*, n4 decided in 1972, investors sued numerous defendants for disseminating misleading proxy materials in connection with the merger of two corporations. n5 These defendants included the surviving corporation and several of its outside directors, but did not include attorneys. n6 The Delaware District Court held that negligence must be proven in order to recover under Section 14, n7 and observed in dicta that "[s]ection 14(a) imposes liability on individuals soliciting proxies, and not on the attorneys or accountants preparing them." n8 Of course, the precedential value of this observation may be limited by the fact that there were no attorney defendants in the action. Four years later, the Delaware District Court squarely faced the question of attorney liability under Section 14 in *National Home Products, Inc. v. Gray*, n9 a case that arose from the battle for control of a company between two factions of the company's board of directors. n10 The court found that an attorney "recklessly" prepared proxy solicitation materials that contained a material misstatement. Against the background of the attorney's long-standing representation of one of the directors, including representation in another action arising from the same corporate control contest, n11 the court held that the attorney violated Section 14(a) and was liable for the corporation's solicitation expenses. n12

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 78n(a) (LEXIS 2004).

(n2)Footnote 2. 17 C.F.R. § 240.14a-9 (LEXIS 2004).

(n3)Footnote 3. 15 U.S.C. § 78n(a) (LEXIS 2004).

(n4)Footnote 4. 351 F. Supp. 853 (D. Del. 1972) , vacated in part on other grounds, 535 F.2d 761 (3d Cir. 1976)

(n5)Footnote 5. *351 F. Supp. at 856 .*

(n6)Footnote 6. *351 F. Supp. at 856 .*

(n7)Footnote 7. *351 F. Supp. at 856 .*

(n8)Footnote 8. *351 F. Supp. at 865 .*

(n9)Footnote 9. *416 F. Supp. 1293 (D. Del. 1976) .*

(n10)Footnote 10. *416 F. Supp. at 1297-1311 .*

(n11)Footnote 11. *416 F. Supp. at 1317 .*

(n12)Footnote 12. *416 F. Supp. at 1317 .*

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CHAPTER 5B Attorney Liability Under the 1934 Act *

1-5B Federal Securities Exchange Act of 1934 § 5B.04

§ 5B.04 Attorney Liability Under Section 18

Section 18 of the 1934 Act n1 provides an express private right of action to any person who suffers damages in the purchase or sale of a security in reliance on materially false or misleading statements. Section 18 thus permits private lawsuits against persons who "make or cause to be made" materially misleading statements in any reports or other documents filed with the SEC pursuant to the Exchange Act. n2

Judicial discussion of Section 18 liability is relatively rare--and discussion of attorney liability basically non-existent--because Section 18 imposes an actual reliance requirement that deters many prospective plaintiffs. n3 But there is no reason to assume that a Section 18 claim cannot be stated against an attorney in the same way as against any other actor in a securities transaction. n4

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C. § 78r (LEXIS 2004)*.

(n2)Footnote 2. *15 U.S.C. § 78r (LEXIS 2004)*.

(n3)Footnote 3. *See Heit v. Weitzen, 402 F.2d 909, 916 (2d. Cir. 1968) , cert denied, 395 U.S. 903 (1969) .*

(n4)Footnote 4. *See Hagert v. Glickman, Lurie, Eiger & Co., 520 F. Supp. 1028, 1033 (D. Minn. 1981)* (dismissing Section 18 claims against law firm based on misstatements in registration statement, prospectus, and annual report, because such documents are not filed pursuant to the 1934 Act).

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CHAPTER 5B Attorney Liability Under the 1934 Act *

1-5B Federal Securities Exchange Act of 1934 § 5B.05

§ 5B.05 Attorneys as Controlling Persons

Section 20 of the 1934 Act n1 imposes liability upon those who "control" any person who commits a primary violation of the federal securities laws. More precisely, Section 20(a) provides that "[e]very person who ... controls any person liable under any provision of [the 1934 Act] ... shall ... be liable jointly and severally ... unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation" n2

Attempts to impose liability against attorneys as controlling persons under Section 20(a) have generally been unsuccessful because attorneys rarely exercise sufficient control over the principals in a securities transaction to meet the stringent standards established by Section 20(a). In *Barker v. Henderson, Franklin, Starnes & Holt*, n3 for example, the Seventh Circuit considered whether two attorneys exercised sufficient control over their client, a foundation operating a retirement village, to be liable under Section 20(a) for that client's violations of Section 10(b). n4 One attorney was a director of the foundation and chairman of its trust committee. n5 The other attorney had given advice since the inception of the project. n6 Both attorneys were incorporating directors of the foundation, but were immediately replaced upon incorporation by permanent directors. n7 Both attorneys also drafted the bylaws, negotiated the purchase of the land, and reviewed the selling documents. n8 Considering all of these facts, the Seventh Circuit rejected the claim of control person liability against the attorneys. The court found that "[t]he [law] [f]irms had no ability to control the [client]. Their ability to persuade and give counsel is not the same thing as 'control,' which almost always means the practical ability to direct the actions of the people who issue or sell the securities." n9

Decisions in the district courts are in accord. Thus, courts have held that there is no controlling person liability if an attorney merely serves as a legal advisor and agent of a corporation without exercising any actual control. n10 For example, in *Morin v. Trupin*, n11 investors sued the in-house counsel of a partnership that allegedly made a fraudulent offering of its shares to the public. n12 The court held that allegations asserting that this status created controlling person liability under Section 20(a) were insufficient. n13 In particular, the complaint failed insofar as it alleged only the lawyer's status as in-house counsel and did not allege that the lawyer "exercise[d] influence or control over, participated in the day-to-day operations of, or was a principal of" the limited partnership. n14

However, attorneys that do influence and participate in their client's decisions may be subject to controlling person liability. n15 In *In Re Parmalat*, n16 for instance, purchasers of Parmalat securities filed a class action lawsuit against a number of defendants for securities law violations, including Parmalat's outside counsel and that counsel's law firm. The court found that the attorney was "one of Parmalat's most important outside lawyers" who had "drafted, negotiated and

reviewed many of the legal documents that were necessary to effectuate the fraudulent transactions." n17 Accordingly, the court held that he could be considered a "control person" under Section 10(b). The court also found that his law firm could be considered "control person" for purposes of Section 20(a) because "the partnership had the power to manage or direct any single partner." n18

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 78t(a) (LEXIS 2004).

(n2)Footnote 2. 15 U.S.C. § 78t(a) (LEXIS 2004).

(n3)Footnote 3. 797 F.2d 490 (7th Cir. 1986) .

(n4)Footnote 4. 797 F.2d at 490-91 .

(n5)Footnote 5. 797 F.2d at 492 .

(n6)Footnote 6. 797 F.2d at 492 .

(n7)Footnote 7. 797 F.2d at 492 .

(n8)Footnote 8. 797 F.2d at 492 .

(n9)Footnote 9. 797 F.2d at 494 .

(n10)Footnote 10. See *Marshall v. Quinn-L Equities, Inc.*, 704 F. Supp. 1384, 1391 (N.D. Tex. 1988) (granting summary judgment in favor of attorneys who acted as legal counsel to a limited partnership who sold unregistered securities); see also *Davis v. Cole*, 999 F. Supp. 809, 813-14 (E.D. Va. 1998) (granting motion to dismiss where no "relationship" alleged between attorney and allegedly controlled person). But see *Seidel v. Public Service Co. of New Hampshire*, 616 F. Supp. 1342, 1362 (D.N.H. 1985) (denying motion to dismiss when the allegation was that attorneys were controlling persons merely by virtue of preparation of fraudulent statements).

(n11)Footnote 11. 778 F. Supp. 711 (S.D.N.Y. 1991) .

(n12)Footnote 12. 778 F. Supp. at 717 .

(n13)Footnote 13. 778 F. Supp. at 717 .

(n14)Footnote 14. 778 F. Supp. at 718 . See also *Dietrich v. Bauer*, 76 F. Supp. 2d 312, 333 (S.D.N.Y. 1999).

(n15)Footnote 15. See *Bomarko, Inc. v. Hemodynamics, Inc.*, 848 F. Supp. 1335, 1341 (W.D. Mich. 1993) (holding that claim against director and attorney for corporation that issued falsely optimistic reports to investors raised factual issue of control person liability under Section 20(a)); *Cammer v. Bloom*, 711 F. Supp. 1264, 1292 (D.N.J. 1989) , appeal dismissed, 993 F.2d 875 (3d Cir. 1993) ; *Felts v. National Account Systems Association*, 469 F. Supp. 54, 68 (N.D. Miss. 1978) (finding attorney liable as a control person where he served as president of the corporation, acted as its lawyer, permitted the corporation to use his signature stamp, and secured a certificate of exemption from registration without diligently investigating the relevant facts).

(n16)Footnote 16. 383 F. Supp. 2d 616 (S.D.N.Y. 2005)

(n17)Footnote 17. 383 F. Supp. 2d 616, 619 (S.D.N.Y. 2005)

(n18)Footnote 18. 383 F. Supp. 2d 616, 626. See also *Westlake v. Abrams*, 504 F. Supp. 337 (N.D. Ga. 1980) (finding that there was sufficient evidence of involvement by general counsel in the day-to-day operations of the

company to present a genuine issue of material fact over whether the counsel was a "controlling person" under Section 20. The court pointed to the defendant's near-constant contact with the brokerage firm's management and his awareness of the firm's disputes with administrative agencies, allegations of fraud made against the firm, and the firm's unconventional sales practices.)

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CHAPTER 5B Attorney Liability Under the 1934 Act *

1-5B Federal Securities Exchange Act of 1934 § 5B.06

§ 5B.06 SEC Proceedings

The SEC, of course, may bring enforcement proceedings for violations of the federal securities laws against attorneys in the same way it can commence proceedings against anyone else. Additionally, Rule 102(e) of the SEC's Rules of Practice n1 provides that the SEC may suspend an attorney from practicing before it if it finds that the attorney is unqualified, is "lacking in character or integrity or ... engaged in unethical or improper professional conduct," or "willfully violated or willfully aided and abetted the violation of any provision of the Federal securities laws." n2 The Rules of Practice define the term "practice" broadly, to include "[t]ransacting any business with the Commission." n3

[1] The SEC and Attorney Liability

The SEC has stepped up its scrutiny of attorneys in recent years, increasingly demonstrating a willingness to commence both enforcement proceedings under the substantive provisions of the securities laws and proceedings under Rule 102(e). n4 Several recent speeches by SEC Commissioners and Staff reaffirm the SEC's interest in the role of attorneys as "gatekeepers." n5 For instance, in March 2007, Chairman Christopher Cox described attorneys as "crucial gatekeepers" responsible for safeguarding shareholder interests and reiterated the SEC's intention to ensure attorney compliance through enforcement actions. n6 Similarly, Director of Enforcement Linda Thomsen recently confirmed, in connection with the options backdating scandal, that the SEC "will still look at lawyers." n7 And the SEC's enforcement program demonstrates an increasing willingness to pursue not only lawyers who engage in wrongdoing for direct personal gain, but also those who find themselves implicated in client wrongdoing -- in other words, those who fail to satisfy their responsibility as "gatekeepers" either intentionally or through reckless inattention. Several recent SEC proceedings against attorneys illustrate this trend. n8 In *In the Matter of John B. Zankowski*, the SEC alleged that Zankowski, outside counsel for Nutraceutical Clinical Laboratories International, Inc., violated various antifraud and registration provisions of the federal securities laws. n9 Zankowski was alleged to have orchestrated a fraudulent reverse merger and stock sale for Nutraceutical, as well as actively "deceiving Nutraceutical's transfer agent with a legal opinion falsely representing that the company's shares were exempt from the registration provision of the securities law." n10 At the conclusion of these activities, Zankowski then sold \$200,000 worth of Nutraceutical's shares. n11 The SEC instituted proceedings against Zankowski, and suspended him from appearing or practicing before the Commission under Rule 102(e). n12

Similarly, in *SEC v. Scott*, the SEC brought charges against attorney Craig Scott for aiding and abetting violations of SEC reporting rules for FFP Marketing Company, Inc. ("FFP"). n13 Through his employment at FFP, Scott served as

both Chief Financial Officer and general counsel. Scott was also responsible for preparing and filing notices of late filings (Forms 12b-25). However, in preparing these filings, Scott "fraudulently omitted to disclose that an internal investigation of the company's accounting lapses caused the company to delay filing its periodic reports." n14 Under Rule 102(e), the SEC denied Scott from appearing or practicing before the Commission as an attorney for a minimum of three years. n15

Finally, in *SEC v. Leboe and Rasmussen*, the SEC alleged that Dale Rasmussen, a former Enron attorney, actively negotiated and drafted agreements that enabled Enron to circumvent GAAP standards and recognize improper gains. n16 The complaint further alleged that Rasmussen actively sought to keep outside auditors unaware of undocumented side agreements, thereby further enabling Enron to depart from GAAP standards. n17 Rasmussen ultimately consented to the entry of an administrative order pursuant to Rule 102(e), under which he was barred from practicing before the Commission as an attorney for at least three years. n18

The SEC has also actively pursued attorneys involved in potentially improper options practices. Beginning in 2006 when the options backdating scandal first came to light, the SEC commenced proceedings against numerous attorneys for their roles in alleged options backdating. For instance, on August 9, 2006, the SEC charged William F. Sorin, former general counsel of Comverse Technology, Inc., with numerous securities laws violations arising out of his involvement in options backdating at Comverse. n19 The SEC alleged that Sorin and others engaged in a decade-long fraudulent scheme to grant undisclosed in-the-money options to themselves and to others by backdating stock option grants to coincide with historically low closing prices of Comverse common stock. n20 Among other things, the SEC alleged that Sorin created company records that falsely indicated that Comverse's compensation committee had approved a grant of stock options on a date when, in reality, no such corporate action took place. The SEC also alleged that Sorin created false company records that facilitated a similar backdating scheme at one of Comverse's subsidiaries. n21 On January 10, 2007, Sorin agreed to a settlement with the SEC which included, in addition to civil penalties, disgorgement, and an injunction against further violations of the securities laws, the entry of an administrative order pursuant to Rule 102(e) suspending him from appearing or practicing before the Commission as an attorney. n22

FOOTNOTES:

(n1)Footnote 1. 17 C.F.R. § 201.102(e) (LEXIS 2004). Many commentators have questioned the validity of Rule 102(e) and its predecessor, Rule 2(e), suggesting that the rule permits the SEC to usurp the judicial function of disciplining attorneys, that it is an unauthorized incursion by a federal agency into state rights to practice law, and that it is an unchartered alternative forum to seek to bring a de facto proceeding to enforce substantive law violations free of the procedural and tactical limitations imposed by the federal district courts. *See, e.g.,* Mitchell F. Dolin, *SEC Rule 2(e) After Carter-Johnson: Toward a Reconciliation of Purpose and Scope*, 9 Sec. L. J. (1982); Note, *SEC Disciplinary Proceedings Against Attorneys Under Rule 2(e)*, 79 Mich. L. Rev. 1270 (1981). At least one SEC commissioner agreed with the criticism that Rule 2(e) was an invalid exercise of the SEC's power. *In re Keating, Muething & Klekamp*, Exch. Act Rel. No. 34-15982, 1979 SEC LEXIS 1186, at *49 (July 2, 1979) (Comm. Roberta Karmel, dissenting). Courts that have considered this issue, however, have consistently found that Rule 102(e) (and its predecessor, Rule 2(e)) is a valid exercise of the SEC's power. *See, e.g.,* *Touche Ross & Co. v. SEC*, 609 F.2d 570 (2d Cir. 1979); *Davy v. SEC*, 792 F.2d 1418, 1421 (9th Cir. 1986); *Danna v. SEC*, No. C-93-4158 CW, 1994 U.S. Dist. LEXIS 7256, at *5 (N.D. Cal. Feb. 8, 1994); *Sheldon v. SEC*, 45 F.3d 1515, 1518 (11th Cir. 1995); *Checkosky v. SEC*, 23 F.3d 452, 493 (D.C. Cir. 1994), *remanded*, 139 F.3d 221, 225 (D.C. Cir. 1998) (dismissing proceedings due to SEC's failure to provide a "clear mental state standard").

(n2)Footnote 2. The Rules of Practice also allow the SEC temporarily to suspend an attorney without a preliminary hearing if that attorney has been "by name," in an action brought by the SEC, permanently enjoined, or found to have violated, the securities laws, either primarily or as an aider and abettor. 17 C.F.R. § 201.102(e)(3)(i-iii) (LEXIS 2004). *See In re Emanuel Fields*, Exch. Act Rel. No. 33-5404, 1973 SEC LEXIS 2816, at *10 (June 18, 1973) (rejecting respondent's assertion that this section of the Rules of Practice violates federal due process guarantees).

(n3)Footnote 3. 17 C.F.R. § 201.102(f)(1). *See, e.g., In re Emanuel Fields*, 1973 SEC LEXIS 2816, at *10 n.20 ("A lawyer barred from appearing before us is still free to hold himself out to the world as a lawyer, to practice before all tribunals save this one, and to counsel clients with respect to the infinite variety of legal problems that do not impinge on the area affected by the federal securities statutes."). Although proceedings under Rule 2(e) (the predecessor to Rule 102(e)) were once private, the SEC amended Rule 2(e) in 1988 to require that such proceedings be public unless otherwise ordered by the SEC on its own motion or the motion of a party. 17 C.F.R. § 201.102(e)(6) (LEXIS 2004).

(n4)Footnote 4. The seminal Rule 2(e) decision (the predecessor of the current Rule 102(e)) is *In re Carter & Johnson*. *In re Carter & Johnson* was a Rule 2(e) proceeding brought against attorneys who represented a company during a year-long period in which the company failed to disclose matters relating to a credit agreement in numerous documents. The company's chairman, controlling stockholder, and founder allegedly refused to make certain disclosures even though the attorneys urged him to do so on numerous occasions. The SEC claimed that the failure of the attorneys to report the nondisclosures to the company's board amounted to unethical conduct in violation of Rule 2(e), and brought a proceeding against Carter & Johnson alleging violations of the securities laws. The administrative law judge found against the attorneys on all counts. On review, the Commission reversed these findings. Exch. Act Rel. No. 34-17597, 1981 SEC LEXIS 1940 (Feb. 28, 1981) .

(n5)Footnote 5. In a 2004 speech, the SEC's then-Director of Enforcement Stephen Cutler first emphasized the role of attorneys as "gatekeepers" to the securities markets--in the director's words, the "sentries of the marketplace" who "advise companies on disclosure standards and other securities law requirements." *See* S. Cutler, The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program, Speech at UCLA School of Law (September 20, 2004). That speech also noted that the SEC has "named lawyers as respondents or defendants in more than 30 of our enforcement actions in the past 2 years," and promised additional such actions in the future. *Id.*

(n6)Footnote 6. Remarks of Chairman Cox, Address to the 2007 Corporate Counsel Institute, March 8, 2007.

(n7)Footnote 7. Remarks of Linda Chatman Thomsen, SEC Director of Enforcement, speaking at the Practicing Law Institute, Corporate Accountability Report (BNS), Nov. 17, 2006.

(n8)Footnote 8. *See also* In the Matter of Stanley P. Silverstein, Release No. 34-49676, Administrative Proceeding File No. 3-11481 (May 11, 2007); SEC v. Tenet Healthcare Corporation et al., No. CV 07-2144 RGK, Litigation Release No. 20067, AAER No. 2591 (Apr. 2, 2007); In the Matter of Steven Woghin, Esq., Release No. 34-50653, AAER No. 2133, Administrative Proceeding File No. 3-11735 (Nov. 10, 2004); In the Matter of B. Roland Frasier, III, Release No. 34-48741, Administrative Proceeding File No. 3-11327 (Nov. 3, 2003); SEC v. Finkelstein, Lit. Rel. No. 18701, 2004 SEC LEXIS 958 (May 11, 2004); SEC v. Banks, Lit. Rel. No. 16251, 1999 SEC LEXIS 1604 (Aug. 12, 1999); SEC v. Toll, Lit. Rel. No. 17880, 2002 SEC LEXIS 3107, at *2 (Dec. 6, 2002).

(n9)Footnote 9. *In the Matter of John B. Zankowski*, Admin. Proceeding Fil No. 3-12053 (Sept. 21, 2005).

(n10)Footnote 10. *In the Matter of John B. Zankowski*, Release No. 52487, Admin. Proceeding Fil No. 3-12053 (Sept. 21, 2005).

(n11)Footnote 11. *Id.*

(n12)Footnote 12. *Id.*

(n13)Footnote 13. *SEC v. Craig Scott*, Lit. Release No. 19077 (February 14, 2005).

(n14)Footnote 14. *Id.*

(n15)Footnote 15. *Id.*

(n16)Footnote 16. *SEC v. Leboe and Rasmussen*, Lit. Rel. No. 19623 (Mar. 27, 2006).

(n17)Footnote 17. *Id.*

(n18)Footnote 18. *Id.*

(n19)Footnote 19. *SEC v. Jacob Alexander, David Kreinberg, and William F. Sorin*, Lit. Release No. 19796 (Aug. 9, 2006).

(n20)Footnote 20. *Id.*

(n21)Footnote 21. *Id.*

(n22)Footnote 22. *SEC v. Jacob Alexander, David Kreinberg, and William F. Sorin*, Lit. Release No. 19964 (Jan. 10, 2007).

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CHAPTER 5B Attorney Liability Under the 1934 Act *

1-5B Federal Securities Exchange Act of 1934 § 5B.07

§ 5B.07 Attorney Liability Under the Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act, signed into law on July 30, 2002 n1, made sweeping changes in accounting and auditor oversight, corporate governance, and executive responsibility which apply to all public companies. Section 307 of Sarbanes-Oxley requires that the SEC set "minimum standards of professional conduct for attorneys appearing and practicing before [it] in any way in the representation of issuers." n2 On January 23, 2003, after much debate and comment over the proposed rule, the SEC adopted a final rule concerning professional conduct by attorneys. n3 The final rule, which became effective on August 5, 2003, requires that attorneys who "appear and practice" before the SEC "in the representation of an issuer" n4 report evidence of material violations of law to the chief legal officer (the "CLO") or chief executive officer (the "CEO") of the issuer. n5 If the CLO or CEO does not respond appropriately to the report, the rule requires the attorney to report the evidence "up the ladder" to the issuer's audit committee, another committee of independent directors, or the full board of directors. n6 This reporting requirement is triggered when the attorney becomes aware of evidence such that "it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." n7 If the reporting attorney believes that the CLO or the CEO has provided an appropriate response, then the reporting attorney has no further obligations. If, however, this does not occur, the attorney must report the evidence of the violation "up the ladder" to the issuer's audit committee, or, if no such committee exists, another committee of independent directors or the full board. n8 Exclusive authority to enforce the rule is vested with the SEC--the rule explicitly provides that it creates no private right of action against an attorney, law firm, issuer, or any other entities having responsibilities under the rule. n9 The SEC also proposed a "noisy withdrawal" provision in November 2002 which would, in certain circumstances, have permitted or required attorneys who become aware of possible violations to withdraw from representation of an issuer, to notify the SEC of the withdrawal, and to disaffirm documents filed with or submitted to the SEC on behalf of the issuer. After receiving extensive comments on its original proposal, the SEC advanced an alternative proposal in January 2003 merely requiring attorneys who become aware of possible violations to withdraw from representation in writing and cease participation in the matter. Neither version of the proposed rule has yet been adopted by the SEC in final form.

FOOTNOTES:

(n1)Footnote 1. H.R. 3763, 107th Cong. (2002) (enacted).

(n2)Footnote 2. H.R. 3763, § 307.

(n3)Footnote 3. SEC Press Release No. 2003-13 (Jan. 13, 2003). The SEC released the text of the final rule shortly

thereafter. *See SEC Release Nos. 33-8185, 34-4726, IC-25919, 2003 SEC LEXIS 256 (Jan. 29, 2003)* .

(n4)Footnote 4. Under this rule, a lawyer is "appearing and practicing" before the SEC when transacting any business with the SEC; representing an issuer in an SEC administrative proceeding or in connection with an SEC investigation, inquiry, information request, or subpoena; providing advice concerning U.S. securities laws or SEC rules or regulations regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed or submitted to, the SEC; or advising an issuer as to whether information is required to be filed with or submitted to the SEC. An attorney acts "in the representation of an issuer" when providing legal services for the issuer, regardless of whether the attorney is employed or retained by the issuer. *See 2003 SEC LEXIS 256, at **167-168, 170.*

(n5)Footnote 5. *See 2003 SEC LEXIS 256, at **174-75*

(n6)Footnote 6. *See 2003 SEC LEXIS 256, at **175-176* .

(n7)Footnote 7. *See 2003 SEC LEXIS 256, at *170* .

(n8)Footnote 8. *See 2003 SEC LEXIS 256, at **176-177.*

The rule also allows for an alternative reporting procedure, under which an issuer may establish a qualified legal compliance committee (a "QLCC"), which would be responsible for carrying out the requirements of the rule. A QLCC must consist of at least one audit committee member (or, in the absence of an audit committee, one member of a committee of independent directors), and two or more independent directors. The QLCC changes the reporting duties of attorneys and CLOs by relieving them of any further obligation under the rule once they have reported to the QLCC. *See 2003 SEC LEXIS 256, at **180-181.*

(n9)Footnote 9. *See 2003 SEC LEXIS 256, at *186.*

The SEC has alleged that an issuer filed false reports with the SEC that failed to disclose related party transactions, despite the advice of its U.S. counsel. *SEC v. TV Azteca S.A.C.V., et al.* (Civil Action No. 1:05-CV-00004, D.D.C.), Litigation Release No. 19022 (January 4, 2005). TV Azteca's U.S. counsel read a newspaper article discussing a TV Azteca officer's false denials about the reports and advised the CEO and then the issuer's board to take corrective action. *Id.* The issuer did not take any corrective action, causing the U.S. counsel to resign, stating that its resignation was pursuant to the Rule. *Id.* The U.S. counsel did not report the matter outside the issuer to the SEC. There is no SEC allegation of any violation of the Rule by the U.S. counsel. *Id.*

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CHAPTER 5C Broker-Dealers' Liabilities Under the Securities Exchange Act *

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CHAPTER 5C Broker-Dealers' Liabilities Under the Securities Exchange Act *

1-5C Federal Securities Exchange Act of 1934 § 5C.01

§ 5C.01 Introduction

This chapter discusses the special issues that arise in connection with claims by private parties under the Exchange Act when the defendant is a broker-dealer. Other parts of this treatise deal with (1) the liabilities of underwriters and other broker-dealers under the Securities Act n1 and (2) issues relating to claims under the Exchange Act against participants in the securities markets generally, whether or not they are broker-dealers. n2 This chapter also does not discuss the panoply of requirements that broker-dealers must comply with under the Exchange Act and implementing regulations, but which may only be enforced by the SEC, the SROs, or in criminal proceedings. n3

Beginning with *Cort v. Ash*, n4 the federal courts stopped authorizing new private rights of action under federal statutes, including the Exchange Act. In *Cort v. Ash*, the Supreme Court established four factors for consideration in determining whether a private remedy is implicit in a statute that does not expressly provide for one:

- (1) whether the plaintiff is a member of the class for whose benefit the statute was enacted;
- (2) whether the legislative history indicates any legislative intent, explicit or implicit, either to create or deny such a remedy;
- (3) whether the implication of a private remedy would frustrate the underlying purposes of the legislative scheme; and
- (4) whether the cause of action is one traditionally relegated to state law. n5

Applying *Cort v. Ash* to the Exchange Act, the Supreme Court later stated that the "central inquiry remains whether Congress intended to create, either expressly or by implication, a private cause of action." n6 As a result of these standards and the addition of subsection (f) to Section 7 of the Exchange Act, prohibiting borrowers from violating the margin rules, the courts no longer recognize a private right of action for violations of Section 7. n7

Since *Cort v. Ash*, courts generally have agreed that there is no private right of action under the Exchange Act based on violation of SRO rules. n8 However, this chapter discusses certain SRO rules and guidance in some detail because they are an important source for establishing standards for broker-dealers' conduct and may be relevant to private claims asserted under the Exchange Act. n9

The tendency to afford relief under the Exchange Act using more liberal standards than state law slowed or even reversed itself after *Ernst & Ernst v. Hochfelder*, n10 and Congress imposed new restrictions on *Rule 10b-5* claims in the Private Securities Litigation Reform Act ("PSLRA"). n11 Moreover, as a result of the Supreme Court's decision in *Shearson/American Express v. McMahon*, n12 claims under the Exchange Act are subject to compulsory arbitration to the same extent as state law claims, with the additional effect of making federal court jurisdiction useless to a customer who has signed an arbitration agreement. Finally, Section 107 of the PSLRA n13 amended the Racketeer Influenced and Corrupt Organizations Act n14 to preclude claims for treble damages based on *Rule 10b-5* violations unless the defendant has been convicted for the violations.

For these reasons, the Exchange Act does not offer anything resembling a comprehensive set of private remedies against broker-dealers. n15 This chapter does not discuss any of the remedies available against broker-dealers under state law, notably the principles of agency, bailment and misrepresentation.

FOOTNOTES:

(n1)Footnote 1. 2 Matthew Bender's Securities Regulation Series: Federal Securities Act of 1933, ch. 9 (2005).

(n2)Footnote 2. *See* ch. 5, *supra.*).

(n3)Footnote 3. *See* ch. 3, *supra.*). Section 15 of the Exchange Act (1) requires broker-dealers to register with the SEC and (2) authorizes the SEC to adopt regulations having the force of law to prohibit certain types of conduct, such as fraud, and to promote certain objectives, such as financial responsibility. Section 15(b)(8) subjects broker-dealers to additional regulation by requiring them to belong to a securities association or national securities exchange (collectively, "self-regulatory organizations" or "SROs"). Sections 6(b)(5)-(6) and 15A(b)(6)-(7) require SROs to adopt rules, among other things, (1) to prevent fraudulent and manipulative practices, (2) to promote just and equitable principles of trade, and (3) to discipline members for violations of the Exchange Act, the rules and regulations thereunder, and SRO rules. Section 19(b) requires SROs to obtain the SEC's approval to amend their rules, and Section 19(c) authorizes the SEC itself to adopt rules for the SROs.

(n4)Footnote 4. 422 U.S. 66 (1975) .

(n5)Footnote 5. *Id.*

(n6)Footnote 6. *Touche Ross & Co. v. Redington*, 442 U.S. 560, 575 (1979) (no private right of action under Exchange Act § 17(a)). The Supreme Court also has cautioned that, "the breadth of the right once recognized should not, as a general matter, grow beyond the scope congressionally intended." *Va. Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1102 (1991) .

(n7)Footnote 7. 422 U.S. 66 (1975) .

(n8)Footnote 8. *See, e.g., Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 493 (6th Cir. 1990) (no private right of action for violation of NYSE "know your customer" rule); *Thompson v. Smith Barney, Harris Upham & Co.*, 709 F.2d 1413, 1419 (11th Cir. 1983) (no private right of action for violation of NYSE "know your customer" rule or NASD suitability rule); *Jablon v. Dean Witter & Co.*, 614 F.2d 677, 681 (9th Cir. 1980) (same); *Porter v. Shearson Lehman Bros.*, 802 F. Supp. 41, 63 (S.D. Tex. 1992) (no private right of action for violation of NASD suitability rule); *Charter House, Inc. v. First Tenn. Bank Inc.*, 693 F. Supp. 593, 597 (M.D. Tenn. 1988) (no private right of action for violation of Municipal Securities Rulemaking Board's suitability and "know your customer" rule); *SSH Co., Ltd. v. Shearson Lehman Bros., N.A.*, 678 F. Supp. 1055, 1058 (S.D.N.Y. 1987) (no private right of action for violation of NASD and NYSE rules); *Shahmirzadi v. Smith Barney, Harris Upham & Co.*, 636 F. Supp. 49, 52 (D.D.C. 1985) (reasoning that NASD and NYSE rules do not create private rights of action, because Congress did not intend to delegate authority to create private rights of action); *Colman v. D.H. Blair & Co.*, 521 F. Supp. 646, 653-55 (S.D.N.Y. 1981) (no private right

of action for violation of NASD and NYSE rules). *But see Cook v. Goldman Sachs & Co.*, 726 F. Supp. 151, 156 (S.D. Tex. 1989) (finding an implied private cause of action for violation of SRO rules, but relying on precedent that predated *Cort v. Ash*).

(n9)Footnote 9. *See, e.g., Miley v. Oppenheimer & Co.*, 637 F.2d 318, 333 (5th Cir. Unit A Feb. 1981) (stating, with respect to a churning claim under *Rule 10b-5*, that SRO rules were properly included as one factor for jury's consideration and were "excellent tools against which to assess in part the reasonableness or excessiveness of a broker's handling of an investor's account"); *Fed. Sav. and Loan Ins. Corp. v. Shearson-American Express, Inc.*, 658 F. Supp. 1331, 1344 (D.P.R. 1987) (citing NYSE rules imposing suitability obligations and duty to supervise, and stating, "Although it is acknowledged that the mere failure to comply with New York Stock Exchange Rules does not constitute fraud *per se*, in the present context it may serve as evidence to support such claims."); *Kirkland v. E.F. Hutton and Co.*, 564 F. Supp. 427, 443 (E.D. Mich. 1983) (granting summary judgment for defendants where claims were based solely on violation of SRO rules, but stating that "[t]he violations of these rules may be probative of plaintiff's claims under the antifraud provisions of the securities laws").

(n10)Footnote 10. 425 U.S. 185 (1976) .

(n11)Footnote 11. Pub. L. No. 104-67, 109 Stat. 737 (1995).

(n12)Footnote 12. 482 U.S. 220 (1987) .

(n13)Footnote 13. 18 U.S.C. § 1964(c).

(n14)Footnote 14. 18 U.S.C. § 1961-1968.

(n15)Footnote 15. For example, unless there is an allegation of fraud, deceit, misappropriation, or willful or reckless disregard of the client's best interests, unauthorized trading does not amount to a violation of § 10(b) or *Rule 10b-5*. *See Messer v. E.F. Hutton & Co.*, 833 F.2d 909, 917 (11th Cir. 1987) , amended, 847 F.2d 673 (11th Cir. 1988) ; *Pross v. Baird, Patrick & Co.*, 585 F. Supp. 1456, 1460 (S.D.N.Y. 1984) . Similarly, failure to execute a customer's order, though it may breach the contract between the broker and customer, does not rise to the level of a 10b-5 violation, unless all elements of a 10b-5 violations can be shown. *See Kravetz v. Brukenfeld*, 591 F. Supp. 1383, 1388 (S.D.N.Y. 1984) (no showing of intent to deceive or defraud, or of a purchase or sale of securities).

* This chapter was prepared by partners in the Broker-Dealer Group of Wilmer Cutler Pickering Hale and Dorr LLP ("WilmerHale"). This chapter is for general information purposes only and does not represent WilmerHale's legal advice as to any particular set of facts, nor does this chapter represent any undertaking to keep recipients advised as to all relevant legal developments. Unless indicated otherwise, the information contained in this chapter is current as of June 2008. Portions of this chapter have appeared previously in various WilmerHale outlines and presentations.



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CHAPTER 5C Broker-Dealers' Liabilities Under the Securities Exchange Act *

1-5C Federal Securities Exchange Act of 1934 § 5C.02

§ 5C.02 Investment Recommendations

[1] Suitability

A suitability claim is a claim that a broker-dealer made a recommendation to a customer to make an investment that was not suitable in terms of the customer's financial circumstances and stated investment objectives. A classic example is recommending volatile stocks that do not pay any regular dividends and present a significant risk of loss of principal to an elderly person who depends on a regular return on investments for financial support. It is equally unsuitable to recommend such securities to a customer whose stated investment objectives are regular income and conservation of principal, regardless of the customer's financial circumstances. n1

Self-regulatory organization ("SRO") rules require a broker-dealer to take affirmative steps to learn about both the securities it recommends and its customers' financial circumstances and investment objectives. n2 None of these requirements, however, are directly relevant to a private claim for damages under the Securities Exchange Act of 1934 ("Exchange Act"). The courts are unlikely to authorize a private right of action for damages based on the SRO rules. n3 The only claim that the courts recognize under the Exchange Act based on an alleged recommendation of an unsuitable investment is a claim under *Rule 10b-5*. n4

A *Rule 10b-5* claim, of course, requires proof of *scienter*, i.e., intent to defraud or, at a minimum, recklessness. The scienter requirement is inconsistent with holding a broker-dealer liable for a lack of care in making recommendations. As a result, and as described in detail below, relief for unsuitable investments under *Rule 10b-5* is quite restricted.

In *Hanly v. SEC*, a 1969 opinion affirming the grant of an injunction to the SEC prohibiting unsuitable recommendations by a broker-dealer, Judge Timbers wrote:

A securities dealer occupies a special relationship to a buyer of securities in that by his position he implicitly represents he has an adequate basis for the opinions he renders. While this implied warranty may not be as rigidly enforced in a civil action where an investor seeks damages for losses allegedly caused by reliance upon his unfounded representations, its applicability in the instant proceedings cannot be questioned.

[The security that petitioners recommended] was an over the counter stock. Those who purchased through petitioners could not readily confirm the information given them. In Charles Hughes & Co., Inc.

v. SEC ... this Court recognized the difficulties involved in over the counter stocks and the special duty imposed upon those who sell such stocks not to take advantage of customers in whom confidence has been instilled.

In summary, the standards by which the actions of each petitioner must be judged are strict. He cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation. Where the salesman lacks essential information about a security, he should disclose this as well as the risks which arise from his lack of information.

A salesman may not rely blindly upon the issuer for information concerning a company, although the degree of independent investigation which must be made by a securities dealer will vary in each case. Securities issued by smaller companies of recent origin obviously require more thorough investigation.
n5

As the quoted language indicates, Judge Timbers recognized that the same standard might not apply to a private action for damages. More importantly, *Hanly's* emphasis on duties to inquire concerning the security and the customer was premised on a negligence standard. n6 Accordingly, the standard enunciated in that case could not survive the Supreme Court's decisions requiring scienter for *Rule 10b-5* claims. n7 In *Clark v. John Lamula Investors, Inc.* n8 the plaintiff sought damages based on a broker's alleged recommendation of unsuitable securities pursuant to *Rule 10b-5*, Section 17(a) of the Securities Act of 1933, and provisions of the NASD's rules of fair practice, and the district court had entered judgment in her favor based on the jury's special written findings. n9

The court of appeals affirmed on the basis that the jury's findings established liability under the standards of *Rule 10b-5*, including the scienter requirement confirmed by the Supreme Court. The court explained:

It is clear from the jury's answers to the interrogatories, that appellants violated *Rule 10b-5*. The jury specifically found that the debentures were unsuited to appellee's needs, that appellant Lamula knew or reasonably believed they were unsuitable, but that he recommended them to her anyway. In addition, the jury found that Lamula failed to inform her (1) how the leading rating services rated the debentures, (2) that she could not expect to acquire \$12,000 annual income from her investments unless she bought speculative securities involving great financial risk, and (3) the extent of the risks involved in purchasing the securities. The jury found further that had appellant Lamula informed her of these matters, including other investment opportunities, she would not have purchased the securities. Thus, there can be no doubt but that appellant Lamula engaged in an act, practice or course of business which operated as a fraud or deceit upon Mrs. Grupe and omitted to state facts material to an informed purchase by her. n10

In the following decade, at least two district judges apparently concluded that the references to nondisclosures in *Lamula* were inessential and held that a suitability claim under *Rule 10b-5* required a showing that "(1) the investment was incompatible with the plaintiff's investment objectives; and (2) the broker recommended the investment although (3) the broker knew or reasonably believed the investment was inappropriate." n11 In 1992 the Tenth Circuit interpreted *Lamula* in the same way, and adopted that test with an additional requirement that "the broker exercised control over the investor's account." n12 In that case the broker had exercised discretion over the account and had simply purchased the securities it selected, rather than recommending them to the customer. n13 Although the broker's conduct did not involve anything that could be considered a misrepresentation, the court held that it violated *Rule 10b-5* as "fraud by conduct," by analogy to churning. n14 In this context, the court explained that the additional requirement that the investor show that the broker controlled the account "is essential to satisfy the causation/reliance requirement of a § 10(b), *Rule 10b-5* violation." n15

When the Second Circuit revisited the issue in *Brown v. E.F. Hutton Group, Inc.*, n16 however, it indicated that to establish a *Rule 10b-5* claim based on an unsuitable recommendation, the plaintiff must show:

(1) that the securities purchased were unsuited to the buyer's needs; (2) that the defendant knew or reasonably believed the securities were unsuited to the buyer's needs; (3) that the defendant recommended or purchased the unsuitable securities for the buyer anyway; (4) that, with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information relating to the suitability of the securities); and (5) that the buyer justifiably relied to its detriment on the defendant's fraudulent conduct. n17

The Fourth Circuit adopted the same standard in *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.* n18

Since a plaintiff who proves that he or she incurred damages as a result of purchasing securities in reliance on a broker-dealer's misrepresentation will have established all the elements of a *Rule 10b-5* claim by proving the items listed in *Brown* as (4) and (5), it is not clear why items (1) through (3) are relevant. However, in *GMS Group, LLC v. Benderson*, the Second Circuit seems to have accepted that the plaintiff must also prove that the defendant made a "recommendation" of a security that was not "suitable." n19

Both *Brown* and *Banca Cremi* also indicate that a suitability claim is subject, like other *Rule 10b-5* claims, to the defense that the plaintiff could not have justifiably relied on the broker-dealer's misrepresentation. n20 These holdings may preclude a suitability claim relating to a security for which complete and current information is publicly available, such as a recent prospectus, if the customer is capable of understanding that information and making an independent investment decision.

Where the broker has not made a recommendation and the transaction is customer-driven, most courts have held that there is no basis for a suitability claim. n21 Nevertheless, at least one court has suggested that a broker-dealer may have the obligation to refuse a transaction where it is clearly unsuitable for the customer and the broker-dealer is aware (or should be aware) that the customer lacks capacity to make independent investment decisions. n22

In 1996 the NASD adopted an interpretation concerning a broker-dealer's suitability obligations when making recommendations to institutional customers. The interpretation defined an "institutional" customer as "any entity other than a natural person," but added that the interpretation was "more appropriately applied to an institutional customer with at least \$10 million invested in securities." n23 The interpretation states that a broker-dealer's responsibility to determine that a recommendation is suitable for a particular institutional customer is fulfilled if the broker-dealer has reasonable grounds for concluding that: (1) the customer is making independent investment decisions, and (2) the customer is capable of evaluating investment risk.

The interpretation then provides guidance concerning when a broker-dealer has reasonable grounds for making these determinations, such as whether the customer is advised by one or more consultants, and its experience with financial markets and the type of instrument under consideration. n24

The NASD's interpretation seems to reflect the same principle as court decisions holding that a suitability claim is subject to a defense that the plaintiff did not justifiably rely on the defendant's recommendation. The "sophistication and expertise of the plaintiff in financial and securities matters" is one of the factors considered in determining whether an investor is justified in relying on a misstatement. n25 Accordingly, sophisticated customers like those meeting the criteria set forth in the NASD's interpretation have found it difficult to pursue suitability claims. n26

As a practical matter the adjudication of a suitability claim is most likely to occur through arbitration. n27 The Court's decision in *Shearson/American Express Inc. v. McMahon*, n28 held that pre-dispute arbitration agreements are an

enforceable part of a brokerage contract. Securities arbitration is normally conducted through the dispute resolution forum sponsored by the Financial Industry Regulatory Authority ("FINRA").ⁿ²⁹ In 2007, FINRA substantially amended and reorganized its Code of Arbitration Procedure into three separate procedural codes: (1) Code of Arbitration for Customer Disputes; (2) Code of Arbitration Procedure for Industry Disputes; and (3) Code of Mediation Procedure.ⁿ³⁰

Arbitration differs greatly in both substance and procedure from the courts,ⁿ³¹ and has minimal judicial oversight.ⁿ³² As a general matter, arbitration is more focused on hearing and resolving factual disputes than advancing competing legal theories. In addition, arbitration generally offers more limited discovery, limits opportunities for appeal, and does not rely on traditional rules of evidence. Arbitration also relies more heavily on the underlying substantive rules promulgated by the relevant sponsoring self-regulatory organization than those promulgated by the SEC.ⁿ³³

The structural differences between arbitration and the courts have resulted in a divergence in outcomes between judicial rulings and arbitration decisions in several areas of suitability claims. This divergence is pronounced in a series of suitability cases alleging that a broker negligently allowed an investor to commit "economic suicide."ⁿ³⁴ Plaintiffs in such cases allege that their brokers are liable for negligently failing to advise them against or otherwise restrain their destructive trading practices.ⁿ³⁵ Some have claimed that the arbitration process, by substituting equity and efficiency for legal sophistication, commonly uses negligence as a proxy for scienter and justified reliance when reaching a decision in such suitability disputes.ⁿ³⁶ While arbitration decisions are not binding as precedent and therefore do not create a new legal standard for broker liability, such cases illustrate a greater degree of uncertainty when suitability disputes are resolved through arbitration.

[2] Misleading Recommendations

Beginning in 2002, an investigation by the New York Attorney General gave rise to a large number of *Rule 10b-5* claims against broker-dealers based on allegations that they had recommended the purchase of shares in research reports that did not accurately reflect the analysts' true opinions, but instead were motivated by a desire to obtain future investment banking business from the subject companies. In general, such false opinion claims are subject to the usual requirements for *Rule 10b-5* claims.ⁿ³⁷ It is well established that a misrepresentation concerning an opinion may, under certain circumstances, satisfy *Rule 10b-5*'s requirement for a material misrepresentation.ⁿ³⁸

In 2005 the Second Circuit issued a decision identifying a potentially disabling obstacle to such false research claims in *Lentell v. Merrill Lynch & Co.*ⁿ³⁹ Merrill Lynch had issued research reports with four-part "Investment Opinions" that were presented using numerical codes for "Investment Risk Rating," intermediate and long-term "Appreciation Potential," and likely dividend payout. The analyst's opinion concerning Appreciation Potential was purportedly reflected in a number from one to six, with one representing "Buy," five representing "Sell," and six representing "No Rating." The plaintiffs asserted claims based on reports for two internet companies issued over a period of 21 months that almost all rated "Appreciation Potential" at one or two, and never below three.ⁿ⁴⁰ The Second Circuit emphasized, however, that they all gave the highest possible rating for "Investment Risk."ⁿ⁴¹

The plaintiffs alleged that Merrill Lynch's analysts did not actually believe that the recommended shares were, in fact, good investments, that the reports failed to disclose that the firm's true motivation for publishing the positive recommendations was to attract future investment banking business, and that the plaintiffs bought the shares as a result of the misstatements and omissions only to lose millions of dollars when the value of the shares later dropped.ⁿ⁴² Although none of the plaintiffs were alleged to have read the reports, Merrill Lynch's motion to dismiss did not assert that they had failed to plead "transaction causation," *i.e.*, that they would not have bought the securities but for the misrepresentations, and the Second Circuit assumed that they adequately pleaded transaction causation based on the fraud-on-the-market theory endorsed in *Basic Inc. v. Levinson*.ⁿ⁴³

The Second Circuit nonetheless affirmed the dismissal of the complaint because it failed to allege "loss causation." The

court explained, "Loss causation is the causal link between the alleged misconduct and the economic harm ultimately suffered by the plaintiff." n44 The court reviewed and reconciled its own precedents and held that loss causation requires both that the loss should be a foreseeable consequence of the misrepresentation or omission and "that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security." n45 It further held, "It is not enough to allege that a defendant's misrepresentations and omissions induced a 'purchase-time disparity' between the price paid for a security and its 'true "investment quality"' ." n46 The Court of Appeals specifically held that the plaintiffs' allegations that they bought the securities at prices that were artificially inflated by the alleged misrepresentations at most established transaction causation, but it did not show loss causation. n47 Rather, the court held that the complaint failed to allege loss causation because it did not allege that "the market reacted negatively to a corrective disclosure regarding the falsity of Merrill's 'buy' and 'accumulate' recommendations." n48

The court also rejected the plaintiffs' contention that they pleaded loss causation because they alleged that the market price of the shares fell when Merrill Lynch downgraded its recommendations for the two stocks, in one case from "buy" to "accumulate" and in the other case from "accumulate" to "neutral." "These allegations," the court explained, "do not amount to a corrective disclosure ... because they do not reveal to the market the falsity of the prior recommendations." n49

At the time of the Second Circuit's decision in *Lentell*, the Ninth Circuit apparently would have reached a different conclusion. In *Broudo v. Dura Pharmaceuticals, Inc.*, n50 the Ninth Circuit reversed a decision dismissing a *Rule 10b-5* claim based on the plaintiffs' failure to allege that the price of their shares dropped as a result of a corrective disclosure. The Court of Appeals followed its prior decisions holding that "[i]n a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price *on the date of purchase* was inflated because of the misrepresentation." n51 Three months after the Second Circuit's decision in *Lentell*, however, the Supreme Court reversed the Ninth Circuit's decision in *Broudo v. Dura Pharmaceuticals, Inc.* Writing for a unanimous Court, Justice Breyer held that "as a matter of pure logic, at the moment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase price is offset by ownership of a share that *at that instant* possesses equivalent value." n52

Under *Lentell*, a *Rule 10b-5* claim based on false and misleading research cannot survive a motion to dismiss unless there are adequate allegations demonstrating that the market price of the recommended shares declined once the true information that was the subject of the research was disclosed. n53 *Lentell* has been interpreted to give rise to broader causes of action than merely corrective disclosure. n54

FOOTNOTES:

(n1)Footnote 1. Suitability is discussed frequently in secondary materials. *See, e.g.*, Blair H. Wallace, Note, *A Proposal to Refine the Suitability Standard by Quantifying Recommendation Risk and Client Appropriate Risk Levels*, 1 BROOK J. CORP. FIN. & COM. L. 231, 232, 246-47, 261 (2006) (arguing current suitability standard is vague and offering an alternative); Frederick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability*, 37 ARIZ. ST. L.J. 535, 537-46 (2005) (noting lack of liability for discount broker-dealers who make no recommendations and proposing solution); Roger W. Reinsch et al., *Trust Your Broker?: Suitability, Modern Portfolio Theory, and Expert Witnesses*, 17 ST. THOMAS L. REV. 173, 173 (2004) (examining suitability and suitability litigation); Barbara Black & Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 991-95 (2002) (discussing differences between suitability claims brought in court and arbitration); Matthew J. Benson, *Online Investing and the Suitability Obligations of Brokers and Broker-Dealers*, 34 SUFFOLK U. L. REV. 395, 398 (2001) (examining role of suitability in online trading); Nancy C. Libin & James S. Wrona, *The Securities Industry and the Internet: A Suitable Match?*, 2001 COLUM. BUS. L. REV. 601, 608 (2001) (same); Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations to Institutional Investors*, 2001 BYU L. REV. 1493, 1501-24 (2001) (examining interaction between suitability and institutional investors); Renee Barnett, Comment, *Online Trading and the National Association of Securities Dealers' Suitability Rule: Are Online Investors Adequately Protected?*, 49 AM. U. L. REV. 1089, 1095 (2000) (examining role of suitability

in online trading); Lewis D. Lowenfels & Alan R. Bromberg, *Suitability in Securities Transactions*, 54 BUS. LAW. 1557 (1999) (discussing suitability generally); Willa E. Gibson, *Investors, Look Before You Leap: The Suitability Doctrine is Not Suitable for OTC Derivatives Dealers*, 29 LOY. U. CHI. L.J. 527, 531-32 (1998) (arguing against suitability standard for over-the-counter ("OTC") derivatives); Robert N. Rapp, *Rethinking Risky Investments for that Little Old Lady: A Realistic Role for Modern Portfolio Theory in Assessing Suitability Obligations of Stockbrokers*, 24 OHIO N.U. L. REV. 189, 189-94 (1998) (discussing suitability in light of evolving theory of stock portfolio management); Geoffrey B. Goldman, Note, *Crafting a Suitability Requirement for the Sale of Over-the-Counter Derivatives: Should Regulators "Punish the Wall Street Hounds of Greed"?*, 95 COLUM. L. REV. 1112, 1115 (1995) (arguing for the imposition of suitability standards in OTC derivatives market); Daniel G. Schmedlen, Jr., *Broker-Dealer Sales Practice in Derivatives Transactions: A Survey and Evaluation of Suitability Requirements*, 52 WASH & LEE L. REV. 1441, 1441-45 (1995) (examining role of suitability in OTC derivatives market); David C. Sienko, *The Aftermath of Derivatives Losses: Can Sophisticated Investors Invoke The Suitability Doctrine Against Dealers Under Current Law?*, 8 DEPAUL BUS. L.J. 105, 106-07 (1995) (arguing against liability for dealer when sophisticated institutional investor loses money unless dealer also provides advice and recommendations); Stuart D. Root, *Suitability - the Sophisticated Investor - and Modern Portfolio Management*, 1991 COLUM. BUS. L. REV. 287, 289 (1992) (arguing courts should not consider the sophistication of investors who relied on broker-dealers); Janet E. Kerr, *Suitability Standards: A New Look at Economic Theory and Current SEC Disclosure Policy*, 16 PAC. L.J. 805, 805-06, 822-32 (1985) (examining conflicts arising from suitability, evolving theory of stock portfolio management and SEC disclosure policy); Richard M. Baker & Gregory K. Lawrence, *Actions Against Broker-Dealers for the Sale of Unsuitable Securities*, 13 STETSON L. REV. 283 (1984) (discussing suitability generally); Kathy Connelly, Note, *The Suitability Rule: Should a Private Right of Action Exist?*, 55 ST. JOHN'S L. REV. 493, 495-96 (1981) (arguing against suitability as an implied private cause of action under federal law); Arvid E. Roach II, *The Suitability Obligations of Brokers: Present Law and the Proposed Federal Securities Code*, 29 HASTINGS L.J. 1069, 1071 (1978) (examining sources of suitability doctrine); Stephen B. Cohen, *The Suitability Rule and Economic Theory*, 80 YALE L.J. 1604, 1606-07 (1971) (describing and arguing for use of economic criteria in defining suitability); Gerald L. Fishman, *Broker-Dealer Obligations to Customers--The NASD Suitability Rule*, 51 MINN. L. REV. 233, 233-35 (1966) (arguing NASD (now known as the Financial Industry Regulatory Authority ("FINRA")) suitability rule is not sufficient and SEC should promulgate robust suitability rule); Robert H. Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L.J. 445 (1965) (discussing suitability generally).

(n2)Footnote 2. NYSE Rule 405 requires members to use "due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization." NASD Conduct Rule 2310 states:

[p]rior to the execution of a transaction recommended to a non-institutional customer ... a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member ... in making recommendations to the customer.

In addition, NASD Rule 2360 requires broker-dealers that promote day-trading to make a determination that day-trading is suitable for a customer, based on his or her financial situation, tax status, investment experience, and investment objectives, before approving the account for a day-trading strategy. NASD Rule 2860(b)(19) imposes a suitability requirement for recommendations for purchases and sales of options. NASD IM-2310-3 also imposes specific suitability requirements for institutional customers. FINRA has provided specific suitability guidance regarding, among other topics, structured products (see FINRA Notice to Members ("NTM") 05-59 (Sept. 2005)), online communications (see FINRA NTM 01-23 (April 2001)), and speculative and low-priced securities (see FINRA NTM 96-60 (Sept. 1996)). Municipal Securities Rulemaking Board ("MSRB") Rule G-19 provides suitability standards for dealers in municipal securities.

Regardless of whether the broker-dealer makes a recommendation, SEC Rule 15c2-11, 17 C.F.R. § 240.15c2-11, provides that, prior to publishing or submitting for publication an initial quotation for certain OTC securities in a quotation medium, or upon the occurrence of enumerated events (such as a suspension of trading), a broker-dealer must: (A) review specified information about the issuer and the security; (B) determine that it has a reasonable basis for believing that the information is accurate and current in all material respects and is obtained from reliable sources; and (C) record the date it reviewed the specified information, the sources of the information, and the person at the firm responsible for the broker-dealer's compliance with the rule. The Rule does not apply to broker-dealers publishing quotations for securities listed and traded on a national securities exchange or quoted on NASDAQ.

A 1991 amendment eliminated the so-called "piggyback provision" of the previous version of the rule, which permitted broker-dealers to publish quotations for a security without complying with the Rule's requirements if any other broker-dealer published regular and frequent quotations for that security. Finally, the rule requires any broker-dealer that publishes quotations for covered OTC securities to make the Rule 15c2-11 information promptly available upon request by any person.

(n3)Footnote 3. *See supra* § 5.03[2].

(n4)Footnote 4. *See, e.g., O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893, 897 (10th Cir. 1992) . In *GMS Group, LLC v. Benderson* , 326 F.3d 75 (2d Cir. 2003) , the Court of Appeals stated that a violation of the NASD's suitability rules "may be considered relevant for purposes of § 10(b) unsuitability claims," even though the court noted that "arguably there is no right of action simply for a violation of NASD rules." *Id. at 82* . The Court then cited its decision in *Brown v. E.F. Hutton Group, Inc.* , 991 F.2d 1020 (2d Cir. 1993) , discussed below, as "describing the nature of [an] 'unsuitability' claim under § 10(b)." *Id.* *Brown* makes clear that such a claim must satisfy the usual requirements for a fraud claim under *Rule 10b-5*. The opinion in *GMS Group* refers to the NASD rules in the context of a discussion of whether the claimant had proved that the respondents had made a recommendation and that the recommended security was not suitable. *Id. at 81-82* . This suggests that the NASD rules are relevant to factors that the plaintiff asserting suitability claim must establish *in addition* to the elements of a *Rule 10b-5* claim. *See also Malhorta v. Equitable Life Assurance Soc'y of the United States*, 364 F. Supp. 2d 299, 308 (E.D.N.Y. 2005) ("[E]ven if NASD Conduct Rule 2310 establishes an affirmative duty to disclose the alleged omission, the Court finds that no Section 10(b) or *Rule 10b-5* claim was sufficiently alleged."); *infra* note 15.

(n5)Footnote 5. *Hanly v. SEC*, 415 F.2d 589, 596-97 (2d Cir. 1969) (citations omitted).

(n6)Footnote 6. *Id. at 596* ; *SEC v. Paro*, 468 F. Supp. 635, 648 (N.D.N.Y. 1979) . Before the Supreme Court's decision in *Aaron v. SEC*, 446 U.S. 680, 695 (1980) , the Second Circuit took the position that the SEC could obtain an injunction under *Rule 10b-5* based on negligence, without a showing of scienter. *See SEC v. Aaron*, 605 F.2d 612, 620-21 (2d Cir. 1979) , *vacated*, 446 U.S. 680 (1980) .

(n7)Footnote 7. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) . In 1980 the Supreme Court held that the SEC also must show scienter to obtain an injunction under *Rule 10b-5*. *Aaron*, 446 U.S. at 695 . The SEC still may be able to obtain an injunction against a broker-dealer that sells securities under the *Hanly* standard pursuant to subsections 17(a)(2)-(3) of the Securities Act of 1933, 15 U.S.C. §§ 77q(a)(2)-(3), which do not require scienter, *see Aaron*, 446 U.S. at 702 . In addition, while acknowledging the scienter requirement, some courts seemingly have continued to apply the *Hanly* standard to SEC proceedings under *Rule 10b-5*. *See SEC v. Shainberg*, No. 06-0384-cv, 2008 U.S. App. LEXIS 5935, at *6 (2d Cir. Mar. 20, 2008) ; *Abbondante v. SEC*, No. 06-0558-ag, 2006 U.S. App. LEXIS 30982, at *3-4 (2d Cir. Dec. 12, 2006) ; *SEC v. Randy*, 38 F. Supp. 2d 657, 670 (N.D. Ill. 1999) ; *SEC v. Hasho*, 784 F. Supp. 1059, 1107 (S.D.N.Y. 1992) . Of course, under the standards applicable to injunctions generally, it is harder to justify an injunction based on negligent misconduct. *See SEC v. Pros Int'l, Inc.*, 994 F.2d 767, 769 (10th Cir. 1993) ("A knowing violation of §§ 10(b) or 17(a)(1) will justify an injunction more readily than a negligent violation of § 17(a)(2) or (3)").

(n8)Footnote 8. 583 F.2d 594 (2d Cir. 1978) .

(n9)Footnote 9. *Id.* at 597 , 599.

(n10)Footnote 10. *Id.* at 600 .

(n11)Footnote 11. *Keenan v. D.H. Blair & Co.*, 838 F. Supp. 82, 86-87 (S.D.N.Y. 1993) ; accord, *Eickhorst v. E.F. Hutton Group, Inc.*, 763 F. Supp. 1196, 1200 (S.D.N.Y. 1990) . In *Keenan* the court did not cite, and presumably was unaware of, the Second Circuit's decision rendered four months earlier in *Brown v. E.F. Hutton Group, Inc.*, discussed below.

(n12)Footnote 12. *O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893, 898 (10th Cir. 1992) .

(n13)Footnote 13. *Id.* at 895.

(n14)Footnote 14. See *infra* § 5C.03.

(n15)Footnote 15. *O'Connor*, 965 F.2d at 898.

(n16)Footnote 16. 991 F.2d 1020, 1031 (2d Cir. 1993) .

(n17)Footnote 17. *Id.*; SEC v. Solow, No. 06-81041- CV-Middlebrooks/Johnson, 2007 U.S. Dist. LEXIS 34712, at *7-8 (S.D. Fla. May 10, 2007) . In addition, since a suitability claim under the Exchange Act is simply "a subset of the ordinary § 10(b) fraud claim," *id.*, the plaintiff must prove loss causation. See *Louros v. Kreicas*, 367 F. Supp. 2d 572, 592 n.145 (S.D.N.Y. 2005) ("The Second Circuit's formulation of an unsuitability claim in *Brown* ... does not mention loss causation. *Brown*, however, was rendered before the Private Securities Litigation Reform Act codified the causation requirement for Section 10(b) cases. In any case, *Brown* does require that 'the buyer justifiably relied to its detriment on the defendant's fraudulent conduct.' This element comprehends a requirement of causation, and with it the jurisprudence on loss causation in securities fraud cases." (quoting *Brown*, 991 F.2d at 1031)).

(n18)Footnote 18. 132 F.3d 1017, 1032 (4th Cir. 1997) ; accord, *Rowe v. Morgan Stanley Dean Witter*, 191 F.R.D. 398, 410-11 (D.N.J. 1999) .

(n19)Footnote 19. 326 F.3d 75, 81-83 (2d Cir. 2003) . See also *Louros*, 367 F. Supp. 2d at 585 ("An unsuitability claim ... is similar to an ordinary Section 10(b) fraud claim, except that the unsuitability claim requires (a) proof of the knowing purchase or recommendation of unsuitable securities, and (b) that the misrepresentations and omissions in question relate to the suitability of the securities, rather than that they be in connection with their purchase or sale.").

In *Keenan v. D.H. Blair & Co.*, 838 F. Supp. 82 (S.D.N.Y. 1993) , the court dismissed a *Rule 10b-5* suitability claim but went on to sustain a claim of breach of fiduciary duty under New York law based on the same facts. *Id.* at 87-89 . The court quoted the opinions in *Hanly* and a number of other SEC injunctive proceedings and, without citing any New York law decisions directly on point, assumed that the New York law of fiduciary duty would authorize an award of damages based on the same standards. *Id.* at 88-89 . A similar effort to assert a suitability claim based on the fiduciary duty law of Massachusetts was rejected in *Lefkowitz v. Smith Barney, Harris Upham & Co.*, 804 F.2d 154, 155 (1st Cir. 1986) (per curiam).

(n20)Footnote 20. *Banca Cremi*, 132 F.3d at 1032-33; *Brown*, 991 F.2d at 1031-32 .

(n21)Footnote 21. See, e.g., *Podgoretz v. Evans & Co., Inc.*, No. 86 CV 2681, 1994 U.S. Dist. LEXIS 6670 (E.D.N.Y. Mar. 23, 1994) .

A broker-dealer may use "data-mining technology" (the electronic collection of information about customers) to analyze a customer's financial or online activity. If it then provides specific investment suggestions to a customer based on this analysis, the NASD has taken the position that it is making a recommendation subject to a suitability obligation.

See NASD NTM 01-23, at 3 (April 2001).

(n22)Footnote 22. *Board of Trustees v. Chicago Corp.*, No. 88-C-3855, 1988 U.S. Dist. LEXIS 14031, at *3 (N.D. Ill. Dec. 8, 1988) (under certain circumstances, broker may have duty to monitor investment decisions made by customer).

(n23)Footnote 23. *NASD Conduct Rule IM-2310-3*; approved, 61 Fed. Reg. 44,100 (Aug. 20, 1996) .

(n24)Footnote 24. *Id.*

(n25)Footnote 25. *Banca Cremi*, 132 F.3d at 1028; *Myers v. Finkle*, 950 F.2d 165, 167 (4th Cir. 1991) .

(n26)Footnote 26. See, e.g., *Banca Cremi v. Alex. Brown*, 955 F. Supp. 499, 515-16 (D. Md. 1997) , *aff'd*, 132 F.3d 1017 (4th Cir. 1997) . Nevertheless, "[i]t is well established that wealth of the customer (however accumulated) and sophistication are not bases for recommending risky investments, nor are they defenses to claims of unsuitability." *Strobel v. Morgan Stanley Dean Witter*, No. 04cv1069-BEN, 2006 U.S. Dist. LEXIS 89673, at *17 (S.D. Cal. Dec. 11, 2006) . Thus, sophistication is only relevant for proving the elements of suitability claim, it cannot be used as a defense in the event that the elements are otherwise proven.

(n27)Footnote 27. See, e.g., *Black*, *supra* note 1, at 991 (2002) (noting that SROs have become "virtually the only playing field[] for resolving customer's disputes with their brokers"); See also, *Gedicks*, *supra* note 1, at 546 n.33 (noting a greater than three fold increase in claims made by NASD members to their insurance providers related to unsuitability claims since 2000).

(n28)Footnote 28. 482 U.S. 220 (1987) .

(n29)Footnote 29. *Black*, *supra* note 1, at 991-92.

(n30)Footnote 30. Exchange Act. Release No. 55,158 (Jan. 24, 2007); 72 Fed. Reg. 4574 (Jan. 31, 2007) .

(n31)Footnote 31. *Black*, *supra* note 1, at 1027 (noting that NASD arbitrators need not be lawyers or have any formal legal training, are given minimal formal training in the substantive area of law they preside over, and are not strictly required to follow legal precedent or statutory law).

(n32)Footnote 32. *Dennis v. Wachovia Sec.*, 429 F. Supp. 2d. 281, 287 (D. Mass. 2006) (applying the manifest disregard standard of judicial review to a securities arbitration decision).

(n33)Footnote 33. *Lowenfels*, *supra* note 1, at 1557, 1584 (1999).

(n34)Footnote 34. *Black*, *supra* note 1, at 1042; *Lowenfels*, *supra* note 1, at 1594 (noting an analogy between this line of suitability cases and "dram shop" cases where bartenders and drinking establishments were held liable for failing to cut-off a willing customer's supply of alcohol).

(n35)Footnote 35. See generally, Rebecca Buckman, *Student Awarded \$40,000 From Firm in Trading Case* WALL ST. J., Jan. 17, 2000, at C16 (a highly publicized case where a medical student recovered damages for his broker's failure to warn or stop him from high risk margin trading).

(n36)Footnote 36. *Lowenfels*, *supra* note 1, at 1584.

(n37)Footnote 37. See *supra* § 5.04.

(n38)Footnote 38. See *Eisenberg v. Gagnon*, 766 F.2d 770, 775-76 (3d Cir. 1985) , *cert. denied*, 474 U.S. 946 (1985) ; *infra* § 5C.06[2]. See also *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 1090-95 (1991) (claim under §

14(a)).

(n39)Footnote 39. 396 F.3d 161 (2d Cir. 2005) , cert. denied, 546 U.S. 935 (2005) .

(n40)Footnote 40. *Id.* at 165-66 .

(n41)Footnote 41. *Id.* at 176 .

(n42)Footnote 42. *Id.* at 172 .

(n43)Footnote 43. 485 U.S. 224, 241-47 (1988) ; *Lentell*, 396 F.3d 161, 172.

(n44)Footnote 44. *Lentell*, 396 F.3d at 172 (quoting *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 343 F.3d 189, 197 (2d Cir. 2003)) .

(n45)Footnote 45. *Id.* at 173 .

(n46)Footnote 46. *Id.* at 174 (quoting *Emergent Capital*, 343 F.3d at 198).

(n47)Footnote 47. *Id.* at 175 .

(n48)Footnote 48. *Id.*

(n49)Footnote 49. *Id.* at 161 n.4 .

(n50)Footnote 50. 339 F.3d 933 (9th Cir. 2003) , rev'd, 544 U.S. 336 (2005) .

(n51)Footnote 51. *Broudo*, 339 F.3d at 938 (quoting *Knapp v. Ernst & Whinney*, 90 F.3d 1431, 1438 (9th Cir. 1996)) .

(n52)Footnote 52. *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 342 (2005) .

(n53)Footnote 53. *See also Lattanzio v. Deloitte & Touche LLP*, 476 F.3d 147, 157-58 (2d Cir. 2007) (holding awareness of risk was sufficient, even when financial data was misleading, to overcome finding of loss causation).

(n54)Footnote 54. *See e.g., Liu v. Credit Suisse First Boston Corp.*, 399 F. Supp. 2d 298 (S.D.N.Y. 2005) ("Where the alleged misstatement conceals a condition or event which then occurs and causes the plaintiff's loss, it is the materialization of the undisclosed condition or event that causes the loss. By contrast, where the alleged misstatement is an intentionally false opinion, the market will not respond to the truth until the falsity is revealed--i.e. a corrective disclosure."); accord, *In re Initial Pub. Offering Sec. Litig.*, 544 F. Supp. 2d 277, 289 (S.D.N.Y. 2008) . *In re Motorola Sec. Litig.*, 505 F. Supp. 2d 501, 540, 545-46, 552 n.42 (N.D. Ill. 2007) (noting additionally a difference between *Lentell* and the Seventh Circuit's interpretation of loss causation). Moreover, a corrective disclosure can come from any source and need not be of a particular form or quality. *In re Initial Pub. Offering Sec. Litig.*, 544 F. Supp. 2d at 289.

* This chapter was prepared by partners in the Broker-Dealer Group of Wilmer Cutler Pickering Hale and Dorr LLP ("WilmerHale"). This chapter is for general information purposes only and does not represent WilmerHale's legal advice as to any particular set of facts, nor does this chapter represent any undertaking to keep recipients advised as to all relevant legal developments. Unless indicated otherwise, the information contained in this chapter is current as of June 2008. Portions of this chapter have appeared previously in various WilmerHale outlines and presentations.



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Federal Securities Exchange Act of 1934

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CHAPTER 5C Broker-Dealers' Liabilities Under the Securities Exchange Act *

1-5C Federal Securities Exchange Act of 1934 § 5C.03

§ 5C.03 Churning

[1] In General

Churning refers to the practice of excessive trading in an account by a broker for the purpose of generating commission income, n1 or excessive trading in an account by a broker in light of the investor's objectives. n2 A churning claim is typically a claim under *Rule 10b-5*. A churning claim consists of three elements:

- (1) trading that is excessive in light of the customer's investment objectives;
- (2) control over the account by the broker; and
- (3) scienter, e.g., the broker's intent to defraud the customer or his willful or reckless disregard of the customer's interests. n3

[2] Excessive Trading

Evaluation of the frequency of trading in the account generally requires the calculation of the "turnover rate." The turnover rate has been described as "a measure of the volume of trading that changes the holdings of a portfolio without changing its size." n4 One method of calculating it is to divide the total amount of purchases over the relevant period by the average equity in the account, net of any debt, for that period. The result is then annualized. For example, where average monthly equity is \$10,000 and a total of \$30,000 in purchases has been made in six months, the turnover for the six-month period is three and the annualized turnover rate would equal six. n5 Courts generally state that no particular turnover rate, without more, is conclusive evidence of churning, n6 but a turnover rate in excess of six is considered very strong evidence that the account is being churned. n7

Appropriate turnover rates vary with the type of account and the objectives of the customer. A turnover rate of two may be excessive for an account with non-speculative investment objectives. n8 When an investor has aggressive investment goals, it is easier to conclude that trading is not excessive. n9 Apart from turnover rate, courts have cited a pattern of in-and-out trading (sale of part or all of a customer's portfolio with the proceeds immediately reinvested in other securities followed shortly by a sale of the newly acquired securities), and high commissions relative to the size of the account, as evidence of excessive trading. n10

[3] Control By Broker

Whether a broker has control over an account is a question of fact. A power of attorney or other document giving the broker discretionary authority to make trades in the account is obviously strong evidence that the broker controls the account. However, the fact that no power of attorney has been executed and the customer retains formal authority over the account is not dispositive of the question of control. The broker may have control if the customer acted on its recommendations and lacked the financial acumen to "adequately determine his own best interests and to independently evaluate his broker's suggestions." n11 Generally, the greater the financial sophistication of the customer, and the more frequently he or she is kept informed of the status of the account and the frequency of the trades, the less likely the customer will be able to establish a churning claim. n12

Courts have cited many factors relevant to the determination of the issue of control. One list of factors includes "(1) the identity, age, education, intelligence, and investment and business experience of the customer; (2) the relationship between the customer and the account executive, that is, whether it is an arms-length one or a particularly close relationship; (3) knowledge of the market and the account; (4) the regularity of discussions between the account executive and the customer; (5) whether the customer actually authorized each trade; and (6) who made the recommendations for trades." n13

[4] Scienter

Like every *Rule 10b-5* claim, a claim for churning requires proof of scienter. Once excessive trading and control are established, however, scienter has sometimes been found to be "implicit in the nature of the conduct." n14

FOOTNOTES:

(n1)Footnote 1. See *Carras v. Burns*, 516 F.2d 251, 258 (4th Cir. 1975); *Manela v. Garantia Banking Ltd.*, 5 F. Supp. 2d 165, 173 (S.D.N.Y. 1998) .

(n2)Footnote 2. *O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893, 898 (10th Cir. 1992) .

(n3)Footnote 3. See, e.g., *M&B Contracting Corp. v. Dale*, 795 F.2d 531, 533 (6th Cir. 1986); *Franks v. Cavanaugh*, 711 F. Supp. 1186, 1191 (S.D.N.Y. 1989) .

(n4)Footnote 4. *Carras*, 516 F.2d at 255 n.2 (4th Cir. 1975) .

(n5)Footnote 5. There are several methods of calculating a turnover rate. See Philip J. Hoblin, Jr., *Securities Arbitration* 9-18 to 9-23 (2d ed. 1992) (discussing the Looper, asset turnover, equity turnover, and weighted turnover methods).

(n6)Footnote 6. See *Mitchell v. Sperrazza*, No. 94 Civ. 0266, 1995 U.S. Dist. LEXIS 6157, at *4 (S.D.N.Y. May 8, 1995) ("there is no such thing as churning as a matter of law based simply on the turnover rate of an account without regard to other factors").

(n7)Footnote 7. See, e.g., *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 490 (6th Cir. 1990); *Siegel v. Tucker, Anthony & R.L. Day, Inc.*, 658 F. Supp. 550, 554 (S.D.N.Y.1987) ("Although there is no clear demarcation between excessive and non-excessive trading, excessive trading generally is thought to exist by courts and commentators when there is an annual turnover rate in an account in excess of six.")

(n8)Footnote 8. *In re Thomson McKinnon Sec., Inc.*, 191 B.R. 976, 983-84 (Bankr. S.D.N.Y. 1996) (turnover ratio of 2.22 created fact question for jury to decide if trading was excessive).

(n9)Footnote 9. See, e.g., *Hotmar v. Lowell H. Listrom & Co.*, 808 F.2d 1384, 1386 (10th Cir. 1987); *Trustman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, No. CV 82-6701-ER(Px), 1985 U.S. Dist. LEXIS 23154, at *36 (C.D. Cal.

Jan. 24, 1985) .

(n10)Footnote 10. *See Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 435-36 (N.D. Cal. 1968) , modified, 430 F.2d 1202 (9th Cir. 1970) .

(n11)Footnote 11. *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 464 F. Supp. 528, 534 (D. Md. 1978) .

(n12)Footnote 12. *See, e.g.*, (plaintiff with financial acumen to understand transactions and aware of frequency of trades could not establish excessive trading), *Thompson v. Smith Barney, Harris Upham & Co.*, 539 F. Supp. 859, 863 (N.D. Ga. 1982) , *aff'd*, 709 F.2d 1413 (11th Cir. 1983) .

(n13)Footnote 13. *M&B Contracting Corp. v. Dale*, 601 F. Supp. 1106, 1111 (E.D. Mich. 1984) , *aff'd*, 795 F.2d 531 (6th Cir. 1986) .

(n14)Footnote 14. *See Armstrong v. McAlpin*, 699 F.2d 79, 91 (2d Cir. 1983) ; *Franks*, 711 F. Supp. at 1191 (S.D.N.Y. 1989) .

* This chapter was prepared by partners in the Broker-Dealer Group of Wilmer Cutler Pickering Hale and Dorr LLP ("WilmerHale"). This chapter is for general information purposes only and does not represent WilmerHale's legal advice as to any particular set of facts, nor does this chapter represent any undertaking to keep recipients advised as to all relevant legal developments. Unless indicated otherwise, the information contained in this chapter is current as of June 2008. Portions of this chapter have appeared previously in various WilmerHale outlines and presentations.



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Federal Securities Exchange Act of 1934

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CHAPTER 5C Broker-Dealers' Liabilities Under the Securities Exchange Act *

1-5C Federal Securities Exchange Act of 1934 § 5C.04

§ 5C.04 Excessive Mark-Ups/Mark-Downs

[1] Introduction

Broker-dealers are obligated to deal fairly with their customers in pricing securities. This duty of fair dealing includes the implied representation that the prices they charge to customers bear a "reasonable relationship" to the prevailing market price. n1 The SEC and the SROs have recognized a special regulatory need to protect investors from excessive charges in securities transactions. One focus of that concern has been on principal transactions in the over-the-counter (OTC) market for which a dealer charges a mark-up or mark-down from the prevailing market price instead of a commission.

Generally, a mark-up is the difference between the price charged to a customer for a security and the prevailing market price for the security when the broker-dealer, acting in a principal capacity and holding ownership of the security, sells the security to the customer. n2 Conversely, a mark-down is the difference between the price charged to a customer for a security and the prevailing market price for the security when the broker-dealer, acting in a principal capacity and taking ownership of the security, buys the security from the customer. In contrast to principal transactions, brokers' compensation in agency transactions, whether executed on an exchange or in the OTC market, is an agency "commission." A commission is the fee paid to a broker for executing a trade based on the number of shares traded or the dollar amount of the trade.

The SEC and SROs prohibit undisclosed excessive and fraudulent mark-ups and mark-downs on principal transactions between broker-dealers and their customers. In general, a mark-up is "excessive" if it bears no reasonable relationship to the prevailing market price. n3 Broker-dealers that charge excessive, undisclosed mark-ups violate the antifraud provisions of the federal securities laws. n4 Additionally, broker-dealers that charge excessive mark-ups, whether or not disclosed, may violate SRO and state rules and interpretations. n5

Both the SEC and SROs have refused to state a specific percentage of the market price which would make a mark-up of that percentage presumptively reasonable or unreasonable. For equity securities, both case law and an NASD guideline suggest that a mark-up under 5% is reasonable. n6 A mark-up of over 10%, on the other hand, has been described as fraudulent as a matter of law. n7

[2] Liability Under Federal Securities Laws

No specific statute, SEC rule or regulation proscribes excessive mark-ups or mark-downs. Nevertheless, section 10(b) of the Exchange Act, and *Rule 10b-5* thereunder prohibit deceptive practices in connection with the purchase or sale of securities. Charging customers excessive mark-ups or mark-downs without proper disclosure has been held to constitute such a deceptive practice. In addition, under Rules 10b-10 and 15g-4 of the Exchange Act, the SEC requires broker-dealers to disclose the mark-up on various transactions. Further, under section 15(b)(4)(E), the SEC has brought actions against broker-dealers that have failed to reasonably supervise for excessive mark-ups.

[a] Antifraud Provisions Under the Securities Laws

Under section 10(b) of the Exchange Act, it is unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. n8

A securities fraud claim under section 10(b) and *Rule 10b-5* thereunder requires a private plaintiff to prove the following elements:

- (1) a misstatement or omission of a material fact,
- (2) made with scienter,
- (3) in connection with the purchase or sale of a security,
- (4) upon which the plaintiff relied,
- (5) which caused the plaintiff injury. n9

A plaintiff typically must prove that a defendant acted with scienter in order to recover under section 10(b) and *Rule 10b-5* thereunder. n10 Scienter is established by showing that the defendant acted intentionally, willfully, or recklessly. n11 In the past, however, the SEC has argued that the scienter requirement is not at issue in mark-up cases. For example, in *Elysian Federal Savings Bank v. First Interregional Equity Corp.*, the SEC argued that the scienter issue in mark-up cases is not often addressed because the facts relevant to this issue usually are not in dispute and the scienter determination is usually straightforward. n12 Specifically, the SEC argued that it is not necessary to determine whether the dealer acted recklessly if the dealer:

- (1) knows the prevailing inter-dealer market price for the securities,
- (2) knows the retail price that it is charging the customer, and'
- (3) is aware that its mark-up exceeds industry norms.

In such circumstances, the dealer's knowing conduct satisfies the scienter requirement. n13 The SEC has long held that broker-dealers violate *Rule 10b-5* when they charge excessive mark-ups without proper disclosure. n14 The SEC consistently has held that undisclosed mark-ups in excess of 10% of "prevailing market price" are fraudulent per se. n15 Mark-ups of less than 10%, particularly for debt securities, also may be fraudulent, although they are not fraudulent per se. n16

The SEC's policy on mark-ups is based on the so-called "shingle theory," which is the view that the "relationship of a

securities dealer to his clients is not that of an ordinary merchant to his customers." n17 Instead, it is a relationship in which dealers impliedly represent, by hanging out their "shingles," that they will treat their customers fairly and honestly. This implied representation is deemed to include a promise that the prices a dealer charges customers will bear a reasonable relationship to the prevailing market. n18

The SEC's mark-up policy has been regularly affirmed by reviewing courts. Federal courts consistently have held that it is a violation of Section 10(b) and *Rule 10b-5* thereunder for a broker-dealer to charge excessive mark-ups on the sale of securities and fail to disclose this compensation to the customer. n19 As the Second Circuit explained in its landmark opinion in *Hughes*:

[a]n over-the-counter firm which actively solicits customers and then sells them securities at prices ... far above the market ... must be deemed to commit a fraud. It holds itself out as competent to advise in the premises, and it should disclose the market price if sales are to be made substantially above that level. n20

In *Hughes*, a broker-dealer sold securities to widows and unsophisticated buyers at 16% to 40% above market value. n21 The court found that "the failure to reveal the mark-up pocketed by the firm was both an omission to state a material fact and a fraudulent device." n22

[b] Mark-Up Disclosure Requirements: SEC Rules 10b-10 and 15g-4

Until 1978, SEC rules did not address the disclosure requirements applicable to mark-ups in principal transactions, in contrast to the requirements applicable to brokerage commissions in agency transactions. Since then, Rule 10b-10 has required disclosure of mark-ups for broker-dealers acting in a principal capacity. Rule 10b 10 generally requires that broker-dealers provide customers with a written confirmation of a transaction disclosing certain information. It is important to emphasize, however, that compliance with Rule 10b-10's disclosure requirements will not relieve a broker-dealer of its obligations to disclose excessive mark-ups to customers. The SEC consistently has taken the position that Rule 10b 10 is not a safe harbor from *Rule 10b-5* liability for failure to disclose excessive mark-ups, and this position has received judicial support. n23

The SEC has adopted special disclosure requirements for mark-ups and mark-downs on penny stock transactions. n24 Section 15(g) of the Exchange Act and the rules promulgated thereunder provide the basis for the disclosure requirements applicable to low-priced securities that have been the source of much fraudulent activity. Generally, Rule 15g-3 requires broker-dealers to make certain disclosures to customers regarding quotations and other pricing information relating to the penny stock market. n25 These disclosures must be made both at or before the time of a penny stock transaction and at or before the time that a written confirmation is sent or provided to the customer. Rule 15g-4 generally requires broker-dealers to disclose the compensation they receive in connection with the execution of the penny stock transaction. "Compensation" is defined to include mark-ups that the broker-dealer receives in connection with a principal transaction. n26 Due to the complex definition of penny stock and the numerous transaction exemptions, any questionable transaction needs to be evaluated to determine if such requirements are applicable.

[c] Liability for Failure to Supervise

Section 15(b)(4)(E) of the Exchange Act provides for the imposition of sanctions on a person who has:

[F]ailed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. n27

Under section 15(b)(4)(E), the SEC may bring actions against broker-dealers for failure to supervise for excessive mark-ups. For example, in *In re W.J. Nolan & Co.*, the SEC sanctioned a broker-dealer and its Chief Executive Officer

(CEO) for, among other things, failing to reasonably supervise the firm's registered representatives with a view to preventing mark-up violations. n28 In its order, the SEC found that the broker-dealer's registered representatives charged excessive mark-ups. n29

Furthermore, firms are required to have procedures in place, even for securities that trade off computerized terminals, which identify personnel entrusted with determining the total mark-up charged the customer based upon prevailing market price, the appropriate range of mark-ups, and the facts to be weighed for each transaction. n30

[3] Guidelines for Determining Whether a Mark-Up Is "Excessive"

[a] General Principles

The determination of whether a mark-up is "excessive" must be conducted on a case-by-case basis. n31 Indeed, a broker-dealer's failure to perform this determination on a case-by-case basis, focusing on the particular facts of a situation, may result in sanctions. n32 In calculating the mark-ups relating to a single customer, individual transactions are probative of the mark-ups, not the average mark-up per customer. n33 In this regard, the fact that a broker-dealer lost money on other transactions for the same clients or that some of the mark-ups paid the firm's costs in other transactions does not justify an excessive mark-up in any one transaction. n34 Furthermore, unreasonable mark-ups may not be justified by excessive expenses or "extraordinary retail sales efforts." n35 In the context of equity securities, the SEC consistently has held that mark-ups in excess of 10% over the prevailing market price are, absent disclosure, fraudulent per se. n36 In certain circumstances, however, mark-ups less than 10% or 5% are unreasonable and mark-ups greater than these figures may be reasonable (for example, a minimum ticket charge). A broker-dealer always has the right to produce evidence to demonstrate that unusual circumstances may justify mark-ups that are higher than ordinarily accepted. n37

[b] Mark-Ups on Equity Securities

As stated above, the SEC and courts consistently have held that, at the least, mark-ups in excess of 10% over the prevailing market price are, absent disclosure, fraudulent per se in the sale of equity securities. n38 Under SRO Mark-Up Policy, mark-ups for equity securities greater than 5% above the prevailing market price are presumed to be unreasonable and thus violative of NASD rules. n39 For certain low-priced securities (that is, penny stocks), the SEC has permitted mark-ups higher than 5%, but the 10% ceiling applies to low-priced securities as well. n40 Therefore, while the SEC and the NASD have been willing to set a ceiling for mark-ups, they have refused to set a floor, below which a mark-up can never be found excessive. n41 There is no safe harbor for mark-ups below 5%.

[c] Mark-Ups on Debt Securities

The SEC and courts consistently have found that mark-ups on debt securities, including municipal securities, generally are expected to be lower than mark-ups on equity securities. n42 SRO Mark-Up Policy, NASD IM-2440-1, states that mark-ups on debt securities usually will be smaller than those on equity securities: "[A] higher percentage of mark-up customarily applies to a common stock transaction than to a bond transaction of the same size." n43

The SEC and SROs rely on both quantitative and qualitative standards when assessing mark-ups on debt securities. Particularly when debt securities are involved, not only may mark-ups over 5% be subject to sanction, mark-ups under 5% may also be subject to sanction in certain circumstances. n44 Nevertheless, some courts have been willing to recognize a limit on the percentage amount of a mark-up that is excessive. The Second Circuit in *Press v. Chemical Investment Services Corp.*, affirmed a lower court summary judgment dismissal on the grounds that the mark-ups involved (1/6 of 1% on six-month straight Treasury bills) were *not excessive as a matter of law*. n45

FOOTNOTES:

(n1)Footnote 1. See *Charles Hughes & Co. v. SEC*, 139 F.2d 434 (2d Cir. 1943) . "[A dealer] should disclose the

market price if sales are to be made substantially above that level." *Id.* at 437 .

(n2)Footnote 2. See *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 533 n.2 (2d Cir. 1999) (citing *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1469 (2d Cir. 1996) , cert. denied, 118 S. Ct. 57 (1997)) . See also *In re Lehman Bros., Inc.*, Exchange Act Rel. No. 37,673, 62 S.E.C. Docket 2324 (Sept. 12, 1996), and *Zero-Coupon Securities*, Exchange Act Rel. No. 24,368, 38 S.E.C. Docket 158 (Apr. 21, 1987).

(n3)Footnote 3. See *Bank of Lexington & Trust Co. v. Vining-Sparks Sec., Inc.*, 959 F.2d 606 (6th Cir. 1992) ; *Grandon v. Merrill Lynch & Co.*, No. 95 Civ. 10742 (SWR), 2001 U.S. Dist. LEXIS 10169 (S.D.N.Y. July 20, 2001) .

(n4)Footnote 4. See 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.

(n5)Footnote 5. See NASD Conduct Rule 2440; IM-2440-1; MSRB Rule G-30 (Prices and Commissions).

(n6)Footnote 6. See *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1469 (2d Cir. 1996) , cert. denied, 522 U.S. 812 (1997) ; NASD Conduct Rule 2440, IM-2440.

(n7)Footnote 7. See *First Jersey Sec., Inc.*, 101 F.3d at 1469 ; *In re Powell & Assocs.*, 47 S.E.C. 746, 748 (1982) .

(n8)Footnote 8. See 15 U.S.C. § 78j(b).

(n9)Footnote 9. See *Grandon v. Merrill Lynch & Co.*, 147 F.3d 184, 189 (2d Cir. 1998) .

(n10)Footnote 10. See *Aaron v. SEC*, 446 U.S. 680 (1980) .

(n11)Footnote 11. See *Coleco Indus., Inc. v. Berman*, 567 F.2d 569, 574 (3d Cir. 1977) ; *In re Leslie Fay Cos. Sec. Litig.*, 871 F. Supp. 686, 691-94 (S.D.N.Y. 1995) .

(n12)Footnote 12. *Supplemental Amicus Curiae Brief of the Securities and Exchange Commission in Elysian Fed. Sav. Bank v. First Interregional Equity Corp.*, 713 F. Supp. 737 (D.N.J. 1989) .

(n13)Footnote 13. See *id.* See also *In re James Ryan*, Exchange Act Rel. No. 18,617 (Apr. 5, 1982).

(n14)Footnote 14. See, e.g., *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017 (4th Cir. 1997) ; *Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 835 F.2d 1031 (3rd Cir. 1987) ; *Barnett v. United States*, 319 F.2d 340, 344 (8th Cir. 1963) ; *Samuel B. Franklin & Co. v. SEC*, 139 F.2d 434, 437 (2d Cir. 1943) ; *SEC v. Rauscher Pierce Refsnes, Inc.*, 17 F. Supp. 2d 985, 996 (D. Ariz. 1998) ; *SEC v. Great Lakes Equities Co.*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,685, at 98,201, 98,211 (E.D. Mich. Sept. 4, 1990).

(n15)Footnote 15. See, e.g., *SEC v. Great Lakes Equities Co.*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,685, at 98,201, 98,211-12 (E.D. Mich. Sept. 4, 1990); *In re Alstead, Dempsey & Co.*, 47 S.E.C. 1034 (1984) ; *In re Peter J. Kisch*, Exchange Act Rel. No. 19,005, 25 S.E.C. Docket 1242, 1246 (Aug. 24, 1982); *In re James Ryan*, Exchange Act Rel. No. 18,617 (Apr. 5, 1982); *In re Powell & Assocs., Inc.*, 47 S.E.C. 746 (1982) .

(n16)Footnote 16. See *In re Staten Sec. Corp.*, 47 S.E.C. 766, 768 (1982) ; *In re Powell & Assocs., Inc.*, 47 S.E.C. 746 (1982) .

(n17)Footnote 17. *In re William H. Keller, Jr.*, 38 S.E.C. 900, 905 (1959) (footnote omitted).

(n18)Footnote 18. See, e.g., *In re Duker & Duker*, 6 S.E.C. 386 (1939) ; *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 436 (2d Cir. 1943) .

(n19)Footnote 19. *See, e.g., Grandon v. Merrill Lynch & Co.*, 147 F.3d 184, 193 (2d Cir. 1998) ; *Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 835 F.2d 1031 (3d Cir. 1987) ; *Barnett v. United States*, 319 F.2d 340, 344 (8th Cir. 1963) ; *In re Trost & Co.*, 12 S.E.C. 531, 535 (1942) .

(n20)Footnote 20. *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 436-37 (2d Cir. 1943) (footnote omitted).

(n21)Footnote 21. *Id.*

(n22)Footnote 22. *Id.* at 437 .

(n23)Footnote 23. *See* Zero-Coupon Securities, Exchange Act Rel. No. 24,368, 38 S.E.C. Docket 158 (Apr. 21, 1987); *Ettinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 835 F.2d 1031 (3d Cir. 1987) . *See also* *Grandon v. Merrill Lynch & Co.*, 147 F.3d 184 (2d Cir. 1998) ; *Shivangi v. Dean Witter Reynolds, Inc.*, 107 F.R.D. 313 (S.D. Miss. 1985) , *aff'd*, 825 F.2d 885 (5th Cir. 1987) ; *Krome v. Merrill Lynch & Co.*, 637 F. Supp. 910 (S.D.N.Y. 1986), vacated in part on other grounds, 110 F.R.D. 693 (S.D.N.Y. July 11, 1986), and *In re Meyer Blinder*, 50 S.E.C. 1215 (1992). In *Krome* the court held that Rule 10b-10 was intended to provide additional protection to securities customers, and stated that it would "not interpret this rule to reduce the protection afforded purchasers under other provisions of the securities laws." 637 F. Supp. at 916 .

(n24)Footnote 24. *See* Penny Stock Disclosure Rules, Exchange Act Rel. No. 30,608, 51 S.E.C. Docket 415 (Apr. 20, 1992). The term "penny stock" is defined in Rule 3a51-1 under the Exchange Act.

(n25)Footnote 25. For example, under Rule 15g-3 the broker-dealer must disclose the inside bid quotation and the inside offer quotation for a penny stock appearing on a Qualifying Electronic Quotation System as well as the number of shares to which the bid and offer prices apply. *See* 17 C.F.R. § 240.15g-3.

(n26)Footnote 26. 17 C.F.R. § 240.15g-4(c).

(n27)Footnote 27. 15 U.S.C. § 78o(b)(4)(E).

(n28)Footnote 28. *In re W.J. Nolan & Co. et al.*, Exchange Act Rel. No. 44,833, 75 S.E.C. Docket 1972 (Sept. 24, 2001).

(n29)Footnote 29. The SEC also found that the firm neither had a reasonable system of supervision that would have detected such violations nor procedures for follow-up if red flags were detected. Finally, the SEC found that the CEO, as head of the firm, was responsible for establishing firm procedures for mark-ups, which he failed to do. *See also* *In re Todd J. Cohen*, Exchange Act Rel. No. 54,108, Admin. Proc. File No. 3-12358, 2006 SEC LEXIS 1552 (July 6, 2006) (settlement of alleged failure to supervise based on respondent's failure to detect excessive mark-ups and mark-downs charged by trader subject to his supervision). In *Cohen*, the SEC concluded that the supervisor, who was responsible for reviewing trading activity to ensure that mark-ups were consistent with the firm's policies and based upon prevailing market prices, failed to investigate red flags.

(n30)Footnote 30. *In re Lehman Bros., Inc.*, Exchange Act Rel. No. 37,673, 62 S.E.C. Docket 2324 (Sept. 12, 1996).

(n31)Footnote 31. *See, e.g., Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 535 (2d Cir. 1999) ; *Grandon v. Merrill Lynch & Co.*, 147 F.3d 184, 190 (2d Cir. 1998) ; *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1033 (4th Cir. 1997) ; *Bank of Lexington & Trust Co. v. Vining-Sparks Sec., Inc.*, 959 F.2d 606, 613 (6th Cir. 1992) ; *SEC v. Rauscher Pierce Refsnes, Inc.*, 17 F. Supp. 2d 985, 997 (D. Ariz. 1998) ; *SEC v. Feminella*, 947 F. Supp. 722, 729 (S.D.N.Y. 1996) .

(n32)Footnote 32. *See* *In re Lehman Bros., Inc.*, Exchange Act Rel. No. 37,673, 62 S.E.C. Docket 2324 (Sept. 12,

1996).

(n33)Footnote 33. See *F.B. Horner & Assocs. v. SEC*, 994 F.2d 61, 63 (2d Cir. 1993) ; *In re W.N. Whelen & Co.*, 50 S.E.C. 282 (1990) .

(n34)Footnote 34. See *F.B. Horner & Assocs.*, 994 F.2d at 63 ; *In re Inv. Planning, Inc.*, 51 S.E.C. 592 (1993) .

(n35)Footnote 35. See NASD Mark-Up Policy, IM-2440-1(a)(2); *In re Inv. Planning, Inc.*, 51 S.E.C. 592 (1993) (citing *In re Gen. Investing Corp.*, 41 S.E.C. 952, 957 (1964)) .

(n36)Footnote 36. See *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1469 (2d Cir. 1996) , cert. denied, 118 S. Ct. 57 (1997) . In matters involving excessive mark-down allegations, the SEC has noted that "mark-downs generally are lower than mark-ups." *In re Mark David Anderson*, Exchange Act Rel. 48,352 n.39 (Aug. 15, 2003) (citing *In re Shamrock Partners, Ltd.*, 53 S.E.C. 1008, 1011 (1998); *In re Hamilton Bohner*, 50 S.E.C. 125 (Sept. 9, 1989) (mark-downs ranging from 5.3% to 10.2% determined to be far in excess of permissible levels); *In re Thill Sec. Corp.*, 42 S.E.C. 89, 92-95 (1964) (mark-downs ranging from 2% to 6% determined to violate NASD rules) and The Report of the Special Study of the Securities Markets of the SEC, H.R. Doc. No. 95, Pt. 2, 88th Cong., 1st Sess. 649 (1963)).

(n37)Footnote 37. See, e.g., *In re Strathmore Sec., Inc.*, 42 S.E.C. 993 (1966) .

(n38)Footnote 38. See *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1469 (2d Cir. 1996) , cert. denied, 118 S. Ct. 57 (1997) ; *SEC v. Rauscher Pierce Refsnes, Inc.*, 17 F. Supp. 2d 985 (1998) ; *SEC v. Great Lakes Equities Co.*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,685, at 98,201, 98,211-12 (E.D. Mich. Sept. 4, 1990); *In re D.E. Wine Invs., Inc.*, Exchange Act Rel. No. 43,929, 74 S.E.C. Docket 763-11 (Feb. 6, 2001); *In re Richard R. Perkins*, 51 S.E.C. 380 (1993); *In re W.N. Whelen & Co.*, 50 S.E.C. 282 (1990) ; *In re Alstead, Dempsey & Co.*, 47 S.E.C. 1034 (1984) ; *In re Peter J. Kisch*, 47 S.E.C. 802, 808 (1982) ; *In re James E. Ryan*, 47 S.E.C. 759 (1982) ; *In re Powell & Assocs., Inc.*, 47 S.E.C. 746, 748 (1982) ; *In re J.A. Winston & Co.*, 42 S.E.C. 62 (1964) . See also NASD Notice to Members 92-16 (Apr. 1992), Mark-ups/Mark-downs in Equity Securities.

(n39)Footnote 39. See *Lehl v. SEC*, 90 F.3d 1483, 1487 (10th Cir. 1996) ; *Samuel B. Franklin & Co. v. SEC*, 290 F.2d 719 (9th Cir. 1961) ; *SEC v. Rauscher Pierce Refsnes, Inc.*, 17 F. Supp. 2d 985, 996 (D. Ariz. 1998) ; *In re Michael Alan Leeds*, 51 S.E.C. 500 (1993); *In re Voss & Co., Inc.*, 48 S.E.C. 39 (1984) .

(n40)Footnote 40. See *In re LSCO Sec., Inc.*, 50 S.E.C. 518 (1991) ; Cf. *In re Gerald M. Greenberg*, 40 S.E.C. 133 (1960) ; *In re NASD*, 17 S.E.C. 459 (1944) .

(n41)Footnote 41. See *SEC v. Rauscher Pierce Refsnes, Inc.*, 17 F. Supp. 2d 985, 998 (D. Ariz. 1998) .

(n42)Footnote 42. See, e.g., *Grandon v. Merrill Lynch & Co.*, 147 F.3d 184, 191 (2d Cir. 1998) ; *SEC v. Rauscher Pierce Refsnes, Inc.*, 17 F. Supp. 2d 985, 998 (D. Ariz. 1998) ; *SEC v. Feminella*, 947 F. Supp. 722, 729 (S.D.N.Y. 1996) ; *SEC v. Charles A. Morris & Assocs.*, 386 F. Supp. 1327, 1334 n.5 (W.D. Tenn. 1973) ; *In re Lehman Bros., Inc.*, Exchange Act Rel. No. 37,673 (Sept. 12, 1996); *In re First Honolulu Sec., Inc.*, Exchange Act Rel. No. 32,933, 55 S.E.C. Docket 63 (Sept. 21, 1993); *In re Inv. Planning, Inc.*, 51 S.E.C. 592 (1993) ; *In re Donald T. Shelton*, 51 S.E.C. 59 (1992); *In re Codispoti*, 48 S.E.C. 842, 843-44 (1987) ; *In re Crosby & Elkin, Inc.*, 47 S.E.C. 526, 530 (1981) ; *In re Edward J. Blumenfeld*, 47 S.E.C. 189, 192 (1979) .

(n43)Footnote 43. NASD Conduct Rule IM-2440-1.

(n44)Footnote 44. See *In re Lehman Bros., Inc.*, Exchange Act Rel. No. 37,673, 62 S.E.C. Docket 2324 (Sept. 12, 1996) (holding mark-ups of 3.5% to 4.7% excessive); *In re Inv. Planning, Inc.*, 51 S.E.C. 592 (1993) (determining that mark-ups of over 4% represented extraordinary charges for ordinary transactions); *In re First Honolulu Sec., Inc.*, Exchange Act Rel. No. 32,933, 55 S.E.C. Docket 63 (Sept. 21, 1993).

(n45)Footnote 45. *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529 (2d Cir. 1999) ; but see *SEC v. Zwick*, File No. 03-CV-2742, 2007 U.S. Dist. LEXIS 19045 (S.D.N.Y. Mar. 16, 2007) (unreported) (declining to set aside jury verdict finding of excessive mark-ups, where mark-ups in riskless principal trades involving Treasury and mortgage-backed securities ranged from 2.5 ticks to 43 ticks (where a "tick" is 1/32 of one percent); *SEC v. Rauscher Pierce Refsnes, Inc.*, 17 F. Supp. 2d 985, 998 (D. Ariz. 1998) (denying a summary judgment motion and noting that Press was not controlling in the present case involving zero-coupon bonds); *SEC v. Feminella*, 947 F. Supp. 722, 729 (S.D.N.Y. 1996) ("[T]he fact finder must determine whether, under all the circumstances of the transaction, the price charged for the security was reasonably related to the prevailing market price. This determination cannot reasonably be made upon a motion to dismiss").

* This chapter was prepared by partners in the Broker-Dealer Group of Wilmer Cutler Pickering Hale and Dorr LLP ("WilmerHale"). This chapter is for general information purposes only and does not represent WilmerHale's legal advice as to any particular set of facts, nor does this chapter represent any undertaking to keep recipients advised as to all relevant legal developments. Unless indicated otherwise, the information contained in this chapter is current as of June 2008. Portions of this chapter have appeared previously in various WilmerHale outlines and presentations.



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Federal Securities Exchange Act of 1934

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CHAPTER 5C Broker-Dealers' Liabilities Under the Securities Exchange Act *

1-5C Federal Securities Exchange Act of 1934 § 5C.05

§ 5C.05 Frontrunning, Interpositioning, and Trading Ahead

This section describes the potential for certain trading violations--which are regulated most closely by the SROs--to give rise to private claims under the Exchange Act. Private claims, however, rarely are made pursuant to the Exchange Act based on conduct that allegedly constitutes frontrunning, trading ahead of customer orders, interpositioning, or trading ahead of research. Rather, plaintiffs may be more likely to pursue other remedies--such as those stemming from a broker-dealer's agency obligations under state law.

[1] Frontrunning

The SEC relies primarily on the SROs to enforce the prohibition on frontrunning. As a general matter, the SROs define "frontrunning," which they consider inconsistent with just and equitable principles of trade, as "the practice of trading a security while in possession of material, non-public information regarding an imminent block transaction in the same or a related security." n1

Notwithstanding this reliance on the SROs to promulgate and enforce rules against frontrunning, the SEC also has indicated that, in some instances, frontrunning may constitute insider trading in violation of Section 10(b) of the Exchange Act and *Rule 10b-5*. In adopting Rules 10b5-1 and 10b5-2, the SEC commented that *Rule 10b-5* could be implicated if a broker-dealer trades for its own account while in possession of "unusually significant information regarding a customer order." n2 In this context, the SEC provided the following analysis of how the misappropriation theory may apply in this situation:

We believe that ordinary market making does not present insider trading concerns if a customer who places an order with a broker-dealer has an understanding that the broker-dealer may continue to engage in market making while working the order. Thus, a broker-dealer's ordinary market making would not be considered a "misappropriation" of the customer's information because it would not involve trading on the basis of the information in a manner inconsistent with the purpose for which it was given to the broker. *If, however, a broker-dealer engaged in extraordinary trading for its own account when aware of unusually significant information regarding a customer order, it is possible, based on the facts and circumstances, that the broker-dealer would be held liable for insider trading or for front-running as defined by SRO rules.* n3

[a] Possession of Material Non-Public Information

To prevail on a *Rule 10b-5* claim based on a frontrunning violation, the plaintiff would have to show that the broker-dealer traded while in possession of material non-public information. n4 Under *Rule 10b-5*, information is "material" if there is a substantial likelihood a reasonable investor would consider it important in making an investment decision. n5 Similarly, in the context of frontrunning, the SROs generally consider information to be material if it "reasonably can be expected to have an immediate, favorable impact in relation to" the transaction at issue. n6 The SROs' frontrunning policies generally apply to a customer's imminent block transaction. However, the SROs also take the position that a series of smaller transactions may be within the scope of the frontrunning prohibition, if the transactions together reasonably may be expected to have an immediate market impact. n7 In addition, frontrunning may be based upon knowledge of less than all of the terms of the block transaction, "so long as there is knowledge that all of the material terms of the transaction have been or will be agreed upon imminently." n8

A broker-dealer may limit the potential for frontrunning claims by employing information barriers to prevent persons with knowledge of material, non-public information from sharing that information with others within the broker-dealer firm. n9 The degree of information flow among persons within a firm and the timing of the relevant transactions are important aspects of the fact-specific inquiry into whether frontrunning has occurred. n10 Of course, a private plaintiff asserting a violation of *Rule 10b-5* for frontrunning also would have to prove that the broker-dealer acted with scienter. n11 An information barrier may be an important means by which a broker-dealer can show scienter was lacking.

Under the SRO rules, information about a trade is considered "publicly available" when it has been disseminated via the tape or high speed communications line of a last sale reporting system. n12 When a block transaction is executed in a series of executions, it is publicly available only when the entire transaction has been completed and publicly reported. n13

[b] Loss Causation

It may be possible for a frontrunning violation to occur under the SRO rules even if the relevant transactions do not affect the market price of the security. n14 A private plaintiff, however, would need to demonstrate loss causation in order to prevail on a *Rule 10b-5* claim. n15 Thus, the plaintiff would have to show that the broker-dealer's trading on the basis of material non-public information had an impact on the market price and caused the plaintiff to obtain an inferior price.

[c] Intermarket Frontrunning

As noted above, the SROs define frontrunning as trading a security while in possession of material non-public information regarding an imminent transaction in the "same or related" security. For example, frontrunning may involve a stock transaction while in possession of material non-public information regarding an imminent transaction in the same stock, n16 or an option transaction while in possession of such information regarding an imminent option transaction. n17

However, the SROs also have articulated a variety of other possible permutations. For example, trading an option or security future may constitute frontrunning where the relevant imminent transaction involves the underlying security, n18 or vice versa. n19 Frontrunning also may occur if a broker-dealer trades a stock index option when such broker-dealer has knowledge of an imminent transaction in a component security or securities of the index, if that transaction may affect the value of the index. n20 Trading a stock index futures contract or option on a stock index future may cause a violation where the broker-dealer knows of an imminent stock program transaction, or vice versa. n21 Under the Exchange Act, liability for trading a security while in possession of material non-public information also applies to the same conduct involving trading "a put, call, straddle, option, privilege or security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) with respect to such security or with respect to a group or index of securities including such security." n22

[2] Trading Ahead of Customer Orders

A broker-dealer may be liable to a customer for trading ahead of the customer's order. Trading ahead, which is prohibited by SRO rules, occurs when a broker-dealer trades for its own account with the knowledge that it holds an unexecuted customer order on the same side of the market that could be executed at the same price. n23 Certain exceptions apply to this general prohibition. n24 This conduct may violate *Rule 10b-5*. n25 Unlike frontrunning, trading ahead does not necessarily involve a customer order that is expected to have a material impact on the market price of the security. Rather, the violation arises out of the broker-dealer's obligation, as the customer's agent, to disclose information the broker-dealer possesses that is relevant to execution of its agency obligation. If the broker-dealer fails to disclose that it will violate its duty of loyalty and trade for its own account prior to executing the customer's trade, it may be withholding information material to the customer's decision to enter into the transaction. n26 Thus, a customer could have a claim against a broker-dealer that trades ahead of the customer's order, and the remedy typically would be the amount of price advantage obtained by the broker-dealer.

Under applicable FINRA policy regarding trading ahead, desks that trade only for proprietary accounts may trade even when the broker-dealer holds customer orders for the same securities, provided the broker-dealer has in place adequate information barriers to prevent the proprietary trading desks from having knowledge of customer orders. n27 The corresponding NYSE rule also allows broker-dealers that implement appropriate procedures to avoid a presumption that the person entering the proprietary trade knew of a customer order. n28 Similarly, adequate information barriers would negate the scienter necessary to maintain a 10b-5 claim.

[3] Interpositioning

Interpositioning, which the SROs consider conduct inconsistent with just and equitable principles of trade, refers to the practice of trading as principal with two customer agency orders (one to buy and one to sell) that should have been matched. By positioning itself between the two orders, the broker-dealer takes additional profit from the trades, while each customer receives a less favorable price than if the orders had been matched.

Interpositioning also may be challenged as fraud under *Rule 10b-5*. n29 For example, in settlements with broker-dealer specialist firms for alleged conduct involving trading ahead and interpositioning, the SEC and the NYSE asserted that individual specialists who filled certain orders by trading on a proprietary basis, rather than matching them with corresponding orders on the other side of the market, violated Section 10(b) and *Rule 10b-5*. The regulators reasoned that "certain specialists at [the broker-dealer firm] engaged in unlawful proprietary trades with *scienter*, violating their implied representations to public customers that they were limiting dealer transactions to those reasonably necessary to maintain a fair and orderly market. In those instances, individual specialists at [the firm] violated Section 10(b) of the Exchange Act and *Rule 10b-5* thereunder." n30 In contrast, the U.S. District Court for the Southern District of New York ruled in a related criminal case against an individual specialist that interpositioning did not constitute fraud without specific evidence to demonstrate that "customers were misled or defrauded or otherwise deceived." n31

According to the SEC and NYSE settlements with the specialist firms, these broker-dealers failed to reasonably supervise the specialists whose conduct violated Section 10(b) and *Rule 10b-5*. n32 The settlements did *not* state that the broker-dealer firms had violated Section 10(b) and *Rule 10b-5*.

Following the settlements, however, shareholders of a broker-dealer's parent asserted claims against one of the specialist firms, LaBranche LLC, and its parent, LaBranche & Co., as well as certain individuals, under *Rule 10b-5*. The plaintiffs argued that certain of the parent company's public filings and press releases were misleading because they failed to disclose that the broker-dealer subsidiary was engaged in interpositioning and trading ahead of customer orders in connection with its specialist operations on the New York Stock Exchange, and that the broker-dealer derived substantial profits from these impermissible trading practices. Thus, the plaintiffs alleged that the defendants' misleading statements caused the parent company's stock price to be artificially inflated. The broker-dealer subsidiary

argued that it could not be held liable for the alleged misstatements of its parent. The district court refused to dismiss the case against the subsidiary, however, reasoning that the relevant information could only have been provided by the subsidiary itself. n33 A similar lawsuit against Van der Moolen Holding NV and Van der Moolen Specialists USA, LLC, was settled in late 2006, with Van der Moolen Holding NV and its liability insurer agreeing to pay \$8 million to a proposed class of holders of the holding company's American Depositary Receipt shares. n34 A separate class action lawsuit involving similar claims is still pending against a group of broker-dealers based on their conduct as NYSE specialists, as well as certain affiliated companies. n35

[4] Trading Ahead of Research

Another problematic trading practice involves trading a security prior to issuing research about that security. This practice is sometimes referred to as trading ahead of research, and the SROs have prohibited it. n36 The practice of purchasing a security prior to recommending it, and then selling the security after the recommendation has caused the price to rise, also has been called scalping. n37

In settled charges against Banc of America Securities LLC ("BAS"), the SEC alleged that BAS failed to maintain adequate policies and procedures to prevent the misuse of material non-public information regarding the firm's research activities, as required by Exchange Act Section 15(f). n38 The settlement stated that the lack of adequate procedures resulted in at least two instances when the firm traded for its proprietary account in advance of releasing research reports about the relevant securities. n39

Although the SEC has taken the position that information relating to anticipated upgrades or downgrades of securities may be material non-public information, n40 it may be difficult for an investor who claims injury as a result of a broker-dealer's trading on research information before its dissemination to demonstrate that the broker-dealer misappropriated its own research information in violation of *Rule 10b-5*. n41 If, however, a broker-dealer issued misleading research with the intent of affecting the value of the subject securities, a subsequent purchaser of the recommended securities may have a 10b-5 claim based on the misrepresentation in the research report. n42 Moreover, if a broker-dealer issuing the research has a proprietary position in the security that is sufficiently large, failure to disclose this fact may render the report misleading. n43

As with frontrunning and trading ahead of customer orders, information barriers and related policies and procedures are an important means by which broker-dealers may prevent the potential for trading ahead of research. Similarly, information barriers are likely to be an important defense in potential private claims asserted in connection with proprietary trading that occurs in advance of research reports.

FOOTNOTES:

(n1)Footnote 1. Exchange Act Release No. 25,233 (Dec. 30, 1987), *53 Fed. Reg.* 296 (Jan. 6, 1988) (approving SRO frontrunning policies). *See also* NASD IM-2110-3; NYSE Info. Memos: 80-38 (Sept. 11, 1980), 85-36 (Nov. 6, 1985), 88-9 (Apr. 13, 1988), 89-34 (Aug. 14, 1989), 89-35 (Aug. 14, 1989), 89-53 (Nov. 27, 1989), 95-28 (July 10, 1995); AMEX Info. Circulars: 79-12 (Feb. 27, 1979), 80-36 (Apr. 17, 1980), 85-115 (Nov. 29, 1985), 90-147 (Sept. 14, 1990); CBOE Educ. Circular 23 (Oct. 10, 1978), CBOE Regulatory Circulars RG99-224 (Dec. 7, 1999) and 99-225 (Dec. 7, 1999); PHLX Circular 85-82 (Dec. 3, 1985). For a more detailed discussion of the SRO rules prohibiting frontrunning, see Brandon Becker, Yoon-Young Lee, Christie Farris Oberg, and Imran Javaid, *Restrictions and Obligations of Broker-Dealers Engaged in Proprietary Trading*, ALI-ABA Course of Study, SL047 ALI-ABA 115, 139-45 (2006).

(n2)Footnote 2. Exchange Act Release No. 43,154 (Aug. 15, 2000), *65 Fed. Reg.* 51,715, 51,729 n. 125 (Aug. 24, 2000).

(n3)Footnote 3. *Id.* (emphasis added).

(n4)Footnote 4. As defined by the SROs, frontrunning can occur if a member or a person associated with a member

has possession of material, non-public information while placing an order or while causing an order to be executed. *See* NASD IM-2110-3; NYSE Info. Memo 89-53.

(n5)Footnote 5. *See Basic Inc. v. Levinson*, 485 U.S. 224, 231-232 (1988) .

(n6)Footnote 6. *See* NYSE Info. Memo 89-53.

(n7)Footnote 7. *See* NASD IM-2110-3; NYSE Info. Memo 80-38; AMEX Info. Circular 80-36; CBOE Regulatory Circular RG99-224.

(n8)Footnote 8. NASD IM-2110-3. *See also* NYSE Info. Memo 80-38; NYSE Info. Memo 89-34 (Aug. 14, 1989) (stating that "knowledge of the material terms of such imminent transaction" is sufficient); AMEX Info. Circular 80-36; AMEX Info. Circular 79-12 (stating that the "knowledge" requirement is met "if the basic facts concerning the order are known, i.e. approximate size of order, buy or sell, etc."); CBOE Regulatory Circular RG99-224.

(n9)Footnote 9. NYSE Info. Memo 89-34. *See also* § 5C.08 (discussing information barriers as a preventive measure and a defense).

(n10)Footnote 10. *Id.*

(n11)Footnote 11. *See* Chapter 5 section on scienter and *Rule 10b-5, supra*.

(n12)Footnote 12. *See* NASD IM-2110-3; NYSE Info. Memo 80-38; AMEX Info. Circular 80-36; CBOE Regulatory Circular RG99-224. FINRA's frontrunning policy also states that information may become publicly available through "a similar system of a national securities exchange under Section 6 of the [Securities Exchange Act of 1934], an alternative trading system under Regulation ATS, or by a third-party news wire service." NASD IM-2110-3.

(n13)Footnote 13. *See* NASD IM-2110-3; NYSE Info. Memo 80-38; AMEX Info. Circular 80-36; CBOE Regulatory Circular RG99-224.

(n14)Footnote 14. *See* Amex Info. Circular 79-12.

(n15)Footnote 15. *See* § [Chapter 5 section on loss causation in 10b-5 claim], *supra*.

(n16)Footnote 16. NYSE Info. Memo 89-53; CBOE Regulatory Circular RG99-224; NYSE Arca Rule 11.6; NYSE Arca Equities Rule 6.6.

(n17)Footnote 17. NYSE Arca Rule 11.6; NYSE Arca Equities Rule 6.6.

(n18)Footnote 18. NASD IM-2110-3; NYSE Info. Memo 89-53; AMEX Info. Circular 80-36; AMEX Info. Circular 79-12; CBOE Regulatory Circular RG99-224; NYSE Arca Rule 11.6; NYSE Arca Equities Rule 6.6;

(n19)Footnote 19. NASD IM-2110-3; NYSE Info. Memo 80-38; AMEX Info. Circular 80-36; NYSE Arca Rule 11.6; NYSE Arca Equities Rule 6.6.

(n20)Footnote 20. NYSE Info. Memo 85-36; AMEX Info. Circular 85-115; AMEX Info. Circular 90-147.

(n21)Footnote 21. NYSE Info. Memo 89-53.

(n22)Footnote 22. Exchange Act § 20(d).

(n23)Footnote 23. *See, e.g.*, NASD IM-2110-2 (customer limit orders), NASD Rule 2111 (customer market orders and marketable limit orders); NYSE Rule 92; NSX Rule 12.6; NYSE Arca Equities Rule 6.16; CHX Art. 9, Rule 17.

(n24)Footnote 24. For a more detailed (though not fully updated) discussion of the restrictions under NASD IM-2110-2, NASD Rule 2111, and NYSE Rule 92, see Brandon Becker, Yoon-Young Lee, Christie Farris Oberg, and Imran Javaid, *Restrictions and Obligations of Broker-Dealers Engaged in Proprietary Trading* at 121-38.

(n25)Footnote 25. See *Opper v. Hancock Sec. Corp.*, 250 F. Supp. 668, 673-74 (S.D.N.Y. 1966) (holding broker-dealer liable under New York agency law, as well as Rule 10b-5, for selling securities for its own account before filling the plaintiff customer's sell order for the same security). The *Opper* court did not, however, provide an element-by-element analysis of why the conduct violated Rule 10b-5. See also *United States v. Hunt*, No. 05 CR 395, 2006 U.S. Dist. LEXIS 64887 (S.D.N.Y. Sept. 6, 2006) (refusing to dismiss indictment alleging that NYSE specialist violated Rule 10b-5, because trading ahead and interpositioning could constitute violations of Rule 10b-5(a) and/or (c)); *United States v. Bongiorno*, No. 05 CR 390, 2006 U.S. Dist. LEXIS 24830 (S.D.N.Y. May 1, 2006) (same). These criminal cases and other related litigation followed SEC and NYSE settlements with certain NYSE specialist firms based on allegations stemming from individual specialists' trading. See *infra*.

(n26)Footnote 26. Under NASD Rule 2111, a broker-dealer may not trade ahead of a customer market order or marketable limit order unless it immediately executes the customer order at the same price or better. NASD Rule 2111(b). However, the broker-dealer may negotiate terms and conditions that permit it to trade ahead of or alongside a customer order, with respect to orders that are for institutional accounts or that are for at least 10,000 shares and at least \$100,000, if the broker-dealer discloses and explains the terms and conditions to the customer. See NASD Rule 2111(d); NASD Notice to Members 06-03 (Jan. 2006). The same provision applies to customer limit orders, and FINRA no longer recognizes a safe harbor for market-making firms that fully disclose that they trade ahead of customer limit orders. See *id.* Presumably, however, such disclosure would affect a customer's ability to assert a 10b-5 claim for trading ahead. Similarly, NYSE Rule 92 permits trading ahead or alongside an institutional customer's order in certain circumstances, if the customer has provided its affirmative consent to such trading. See NYSE Rule 92(b).

(n27)Footnote 27. NASD Notice to Members 06-03. NASD Notice to Members 03-74 (Nov. 2003).

(n28)Footnote 28. NYSE Rule 92.10 (stating that knowledge of a customer order is presumed, unless the member firm has "a reasonable system of internal policies and procedures to prevent the misuse of information about customers orders by those responsible for entering such proprietary orders").

(n29)Footnote 29. See, e.g., *Hunt*, 2006 U.S. Dist. LEXIS 64887 (refusing to dismiss indictment alleging that NYSE specialist violated Rule 10b-5, because trading ahead and interpositioning could constitute violations of Rule 10b-5(a) and/or (c)); *Bongiorno*, 2006 U.S. Dist. LEXIS 24830 (same).

(n30)Footnote 30. *In re LaBranche & Co. LLC*, Exchange Act Release No. 49,500, P 3 (Mar. 30, 2004) ("SEC LaBranche Settlement"); *LaBranche & Co. LLC*, NYSE Disciplinary Decision 2004-52, P 6 (Mar. 29, 2004) ("NYSE LaBranche Settlement"). With respect to the scienter requirement, the settlements stated, "The interpositioning conduct by certain [] specialists with respect to certain transactions in the above six stocks evidences scienter." SEC LaBranche Settlement at P 43; NYSE LaBranche Settlement at P 43. Other settlements tracked this analysis and language. See, e.g., *In re Fleet Specialist, Inc.*, Exchange Act Release No. 49,499 (Mar. 30, 2004); *In re Van Der Moolen Specialists USA, LLC*, Exchange Act Release No. 49,502 (Mar. 30, 2004); *In re Spear, Leeds & Kellogg Specialists, LLC*, Exchange Act Release No. 49,501 (Mar. 30, 2004); *Fleet Specialist, Inc.*, NYSE Hearing Panel Decision 04-49 (Mar. 29, 2004); *Van Der Moolen Specialists USA, LLC*, NYSE Hearing Panel Decision 04-50 (Mar. 29, 2004); *Spear, Leeds & Kellogg Specialists, LLC*, NYSE Hearing Panel Decision 04-53 (Mar. 29, 2004). The settlements also described instances of trading ahead of customer orders, but the regulators did not assert that this conduct violated Section 10(b) and Rule 10b-5. See also SEC Press Release 2004-42, Settlement Reached with Five Specialist Firms for Violating Federal Securities Laws and NYSE Regulations (Mar. 30, 2004); SEC Press Release 2004-99, Settlement Reached with Two Specialist Firms for Violating Federal Securities Laws and NYSE Regulations (July 26, 2004).

(n31)Footnote 31. *United States v. Finnerty*, 474 F. Supp. 2d 530, 532 (S.D.N.Y. 2007) (overturning jury's

conviction of defendant for securities fraud). The court reasoned that the prosecution had failed to provide evidence of customer expectations that interpositioning would not occur, and that such expectations were a necessary aspect of proving deception. *Id.* at 538-42 .

(n32)Footnote 32. See SEC LaBranche Settlement at PP 3, 36 (stating that the firm violated NYSE Rule 342 and Exchange Act Section 15(b)(4)(E)); NYSE LaBranche Settlement at P 45 (same). Among other violations, the settlements also stated that the firms violated their specialist obligations under Exchange Act Section 11(b) and Rule 11b-1 to limit their dealings to those reasonably necessary to maintain a fair and orderly market. SEC LaBranche Settlement at P 20; NYSE LaBranche Settlement at P 29.

(n33)Footnote 33. *In re LaBranche Sec. Litig.*, 405 F. Supp. 2d 333 (S.D.N.Y. 2005) . The court ordered the parties in October 2007 to attempt mediation. The court docket for the case includes no further entries since that time. S.D.N.Y. Docket for 1:03-CV-08201, Entry No. 69 (Oct. 15, 2007) (docket current through June 24, 2008).

(n34)Footnote 34. See *In re Van der Moolen Holding N.V. Sec. Litig.*, 405 F.Supp.2d 388 (S.D.N.Y. 2005) (denying motions to dismiss Section 10(b) and Section 20(a) claims against the broker-dealer and its holding company); Van der Moolen Holding NV, Annual Report, at 88 (2006) (describing litigation and settlement).

(n35)Footnote 35. The district court dismissed claims against the NYSE. See *In re NYSE Specialists Sec. Litig.*, 405 F. Supp. 2d 281, 302-08 (S.D.N.Y. 2005) , cert. denied sub nom *California Pub. Employees Ret. Sys. v. NYSE*, 128 S. Ct. 1707 (2008) .

(n36)Footnote 36. See, NASD IM-2110-4 (prohibiting trading ahead of research reports); NYSE Info. Memo 91-08 (Mar. 18, 1991) (stating that it is inconsistent with just and equitable principles of trade to accumulate a position in a security in anticipation of issuing a favorable research report).

(n37)Footnote 37. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 181 (1963) (interpreting section 204 of Investment Advisors Act).

(n38)Footnote 38. *In re Banc of America Securities LLC*, Exchange Act Release No. 55,466, at 4 (Mar. 14, 2007).

(n39)Footnote 39. *Id.* at 5. The SEC also brought charges under Section 15(c) and Rule 15c1-2(a), alleging that the firm's investment bankers improperly influenced the firm's research analysts and that the firm published research reports that did not accurately reflect the views of its analysts. *Id.* at 12.

(n40)Footnote 40. *Id.* at 4.

(n41)Footnote 41. There have been insider trading claims against individuals, however, for trading on the basis of material, non-public information about pending research that the individuals misappropriated from the broker-dealer. See *SEC v. Guttenberg*, *Litigation Release 20022*, 2007 SEC LEXIS 383 (Mar. 1, 2007) (alleging that Guttenberg, an executive director in a broker-dealer's equity research department, tipped co-defendants about upgrades and downgrades in upcoming research reports, and that these and subsequent tippees traded on this information). A related criminal case also was filed. See *United States v. Guttenberg and Tavdy* No. 07 Cr. 141 (S.D.N.Y. 2007) (denying defendants' motions, including Guttenberg's motion to dismiss). See also *SEC v. Scherer*, *Litigation Release No. 13340*, 1992 SEC LEXIS 1960 (S.D.N.Y. Aug. 20, 1992) (alleging that high yield analyst misappropriated his employer's proprietary information in violation of Section 10(b) and Rule 10(b)-5 by holding an interest in bonds that were the subject of research reports he was preparing).

(n42)Footnote 42. See, e.g. *In re Banc of America Securities LLC*, Exchange Act Release No. 55,466 (where the allegedly fraudulent conduct was the publication of the misleading research reports about three companies, rather than the firm's proprietary transactions prior to releasing research reports about two other companies).

(n43)Footnote 43. See *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1267 (9th Cir. 1979) ; *SEC v. Blavin*, 557 F. Supp. 1304, 1311-12 (E.D. Mich. 1983) . In *SEC v. Blavin*, the court accepted the SEC's contention that an unregistered investment adviser had violated *Rule 10b-5* by failing to disclose in his recommendations that he had purchased large amounts of the stock he was recommending, but the SEC apparently did not contend that he violated the rule in purchasing the stock before issuing the research. In these cases the individual who bought the shares was the same person who wrote the recommendation, and they are to that extent distinguishable from a case in which a research department prepares research and the firm's trader subsequently attempts to profit from the research by buying the shares before the research is published. The NYSE and FINRA rules regarding research reports include, among their various disclosure requirements for research reports, disclosure if the NYSE or FINRA member issuing the research or its affiliates beneficially own 1% or more of any class of common equity securities of the subject company. NYSE Rule 472(k)(1)(i)(c); NASD Rule 2711(h)(1)(B).

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CHAPTER 5C Broker-Dealers' Liabilities Under the Securities Exchange Act *

1-5C Federal Securities Exchange Act of 1934 § 5C.06

§ 5C.06 Fairness Opinions

[1] In General

A broker-dealer that provides investment banking services may at times provide a fairness opinion at the request of a client company. A fairness opinion typically summarizes a proposed major corporate transaction, such as a merger or acquisition, and states (1) that the broker-dealer has reviewed certain information provided by the company, (2) that it has assumed the accuracy of that information without independent verification and (3) that on the basis of that information the broker-dealer has formed the opinion that the proposed transaction is fair from a financial point of view to the company's stockholders.

A fairness opinion is typically addressed to the company's directors and its principal function is to assist the directors in exercising their business judgment in deciding whether to approve the transaction. There is no statute or rule that specifically requires that a company's board of directors obtain a fairness opinion from a broker-dealer prior to approving a major corporate transaction. Following a 1985 Delaware Supreme Court decision, however, in which the court held that a corporate board had breached its fiduciary duty of care by approving a merger without having sufficient information about the transaction, boards routinely obtain fairness opinions from broker-dealers. n1

Although addressed to a company's board of directors, a fairness opinion also may be provided to stockholders. If the transaction involves a registered distribution of securities, the opinion may be included in the registration statement. n2 If the transaction requires the approval of stockholders, the opinion may be included in the proxy statement soliciting proxies for the stockholder vote. n3 A broker-dealer that issues a fairness opinion may expose itself to liability if shareholders later challenge the fairness of the transaction. A stockholder who believes an opinion that was included in the proxy statement was materially misleading might attempt to assert a claim pursuant to SEC Rule 14a-9. In addition, any person who purchases or sells a security in reliance on the fairness opinion may attempt to assert a claim under *Rule 10b-5*. The potential plaintiffs may include "forced" purchasers or sellers whose securities were automatically converted to cash or other securities pursuant to the relevant corporate transaction. n4 Finally, stockholders may be able to assert a claim pursuant to Section 14(e) for "fraudulent, deceptive or manipulative acts or practices" in connection with tender offers. n5

[2] The Debate about Fairness Opinions' Value

The value of fairness opinions has been hotly contested. Some have reasoned that the lack of a standard definition of

"fairness" calls into question the very premise of the fairness opinion. n6 Various commentators have examined the variability of how broker-dealers determine fairness and value for purposes of fairness opinions. n7

Another aspect of fairness opinions that has received considerable attention is the potential for conflicts of interest in connection with their production. A fairness opinion typically is just one aspect of a broker-dealer's work on a transaction, and some or all of the broker-dealer's compensation may be contingent on the successful completion of the transaction. The broker-dealer also may have an ongoing business relationship with the company. n8 In addition, a broker-dealer may have business interests involving both sides of the transaction. n9 Indeed, some view fairness opinions as nothing more than pricey statements of what a board of directors wants to hear. n10 Others view this critique as overblown and unsupported by empirical evidence. n11

Skepticism towards and criticism of fairness opinion practices, of course, does not necessarily mean that investment banks should be held liable to shareholders for the opinion they write. Judge Easterbrook cautioned in a recent opinion that broker-dealers are fulfilling a market demand and that, even if the cost of fairness opinions exceeds their utility, this conclusion would not be a basis for damages against a broker-dealer that provides a fairness opinion according to market norms. n12 Indeed, for some, the inherent subjectivity in fairness opinions, and the fact that directors rather than shareholders are their intended audience, are reasons to limit broker-dealers' liability. n13

[3] FINRA's Response

To address the concern that public shareholders may lack sufficient information regarding potential conflicts of interest between the broker-dealer authoring a fairness opinion and the recipient company, FINRA implemented a new rule in late 2007. Under new NASD Rule 2290, a FINRA member must make certain disclosures when it provides a fairness opinion that it knows or has reason to know will be provided to a company's shareholders, and a member that provides fairness opinions must have written procedures for their approval. n14

As adopted, new NASD Rule 2290 includes two sets of requirements relating to, respectively, disclosures in fairness opinions and written procedures for the approval of such opinions. The disclosure requirements apply where the member firm knows or has reason to know that the fairness opinion will be provided or described to the company's public shareholders. A firm has reason to know that the fairness opinion will be provided or described to the company's public shareholders if, for example, the structure of the transaction requires a shareholder vote. n15 The rule requires several types of disclosures, some of which are descriptive and others of which are quantitative.

The second part of Rule 2290 requires any member issuing a fairness opinion to have written procedures for their approval. Specifically, these procedures must address two topics. First, they must address the types of transactions and circumstances in which the member will use a fairness committee to approve or issue a fairness opinion. Second, the written procedures must address how the member will determine whether the valuation analyses used in the fairness opinion are appropriate. n16

NASD Rule 2290, of course, does not directly affect Exchange Act liability, which is the focus of this chapter, although it does articulate certain disclosure and procedural standards for a practice otherwise not directly regulated by the SEC or the SROs. n17 On the other hand, claims under the Exchange Act must satisfy the standards under that law's applicable provisions. n18

[4] Applicability of Rule 14a-9

Rule 14a-9 prohibits, in proxy solicitations, any false or misleading statement with respect to a material fact, or omission of any material fact necessary to prevent a statement from being false or misleading. n19 To succeed in a 14a-9 claim, a plaintiff must show that: (1) the proxy statement included a material misrepresentation or omission of fact made by the defendant; (2) the misrepresentation caused injury to the plaintiff; and (3) the proxy solicitation was an

essential link in the completion of the transaction. n20 If the defendant is not the issuer of the proxy statement, the plaintiff must show a substantial connection between the use of the defendant's name and the solicitation effort. n21 Courts have disagreed as to whether, when the only connection between the proxy solicitation and the author of a fairness opinion is the inclusion of the fairness opinion in the proxy statement, a substantial connection exists.

In *Mendell v. Greenberg*, n22 the district court found that the mere inclusion of the fairness opinion in a proxy statement did not result in the financial advisor that wrote the opinion being substantially connected to the solicitation effort. n23 In dismissing the claims against the financial advisor, the *Mendell* court also stated that "the fact that [the financial advisor] may have participated in drafting the proxy statement, as plaintiff alleges, is insufficient to constitute a solicitation." n24

Other courts, however, have held that the inclusion of a fairness opinion in a proxy statement is sufficient to establish a substantial connection to the solicitation. In *Lazzaro v. Manber*, n25 for example, the court declined to dismiss a claim under Section 14(a) against a financial advisor. The joint proxy statement soliciting shareholders' approval for a merger included the advisor's opinion that the merger was fair to the merging company's shareholders. In contrast with *Mendell*, the plaintiffs alleged that the financial advisor, in cooperation with the other defendants, had included knowing misrepresentations in its opinion with the object of obtaining the shareholders' approval. The court reasoned that the term "solicitation" includes any communication to shareholders that is part of a continuous plan intended to end in solicitation and to prepare the way for its success. n26 Other courts, too, have held that a broker-dealer may be held liable under Rule 14a-9 based on the inclusion of its fairness opinion in the proxy statement. n27

[5] Misrepresentation or Omission

A claim under Rule 14a-9, *Rule 10b-5*, or Section 14(e) requires a showing of a false or misleading statement or omission of a material fact. With respect to a statement of opinion, a plaintiff must show both (a) that the defendant did not in fact hold the opinion stated and (b) that an objective basis for the opinion was lacking. n28

In the Supreme Court's decision in *Virginia Bankshares v. Sandberg*, a minority shareholder in a "freeze-out" merger claimed that the directors had disseminated false and misleading proxy materials in violation of Rule 14a-9. The plaintiff challenged as false and misleading the portions of the proxy materials stating that the acquired company's directors believed that the terms of the proposed merger were "fair" to the public shareholders and would provide the shareholders with an opportunity to achieve a "high" value for their shares. n29 The Court rejected the argument that statements of "reasons, opinions or belief" were not misstatements of fact, holding that they were factual (1) as statements that defendants held the opinion stated and (2) as statements about the underlying subject matter of the opinion. The Court nevertheless held that to establish liability, a plaintiff must demonstrate both (1) that the defendant did not in fact hold the asserted opinion or belief and (2) that the statement of opinion or belief was materially false or misleading as to its subject. n30 Proof of one element without the other is insufficient. n31 The standard enunciated in *Virginia Bankshares* has also been applied to *Rule 10b-5* and Section 14(e). n32

Another body of cases has dealt with alleged misrepresentations or omissions concerning the broker-dealer's relationship with the company, its compensation for rendering the opinion, and other facts that might influence the weight that an investor would give to the opinion. n33

In addition to a misrepresentation or omission of fact, a claim under the relevant provisions of the federal securities laws requires a showing that the fact was material. n34 Courts are likely to consider a broker-dealer's conclusion that the transaction is fair to be material. n35

[6] Standard of Liability

While a *Rule 10b-5* claim requires a showing of scienter, there is some uncertainty regarding whether a Rule 14a-9

claim requires scienter or may be based on a negligence standard. In *Virginia Bankshares*, the Supreme Court specifically declined to rule on whether scienter is required under Rule 14a-9. n36

The Third Circuit has applied a negligence standard to 14a-9 claims based on fairness opinions. In *Herskowitz v. Nutri/System, Inc.*, n37 a financial advisor had provided an opinion in which it stated that a leveraged buyout was fair to the stockholders based on an assumption that the then-existing 46% corporate tax rate would prevail for the next five years. The plaintiffs asserted claims pursuant to *Rules 10b-5* and 14a-9. Relying upon its earlier decision in *Eisenberg v. Gagnon*, n38 in which the court held that projections are actionable under the securities laws if "issued without a genuine belief or reasonable basis," the court stated:

Given that the test is intended to identify deviations from the appropriate standard of care in expressions of opinions by professionals "with greater access to information or having a special relationship to investors making use of the information," the more reasonable interpretation of the rule is that it permits recovery when an expert, in making a projection, adopts an assumption which the factfinder concludes was objectively unreasonable in the circumstances. n39

The Third Circuit determined that there was some evidence that selection of the 46% tax rate was unreasonable and held that the district court had erred in granting defendants a directed verdict on this claim. In addition, the court stated that a negligence standard applies to management under Rule 14a-9, and that a broker-dealer knowingly assisting in preparation of proxy materials should be subject to the same standard. n40

While *Virginia Bankshares* precludes liability based on a negligently--but honestly--held opinion, courts have continued to apply a negligence standard to Rule 14a-9 claims. n41 One court, applying a negligence standard to a broker-dealer, reasoned that *Virginia Bankshares* requires a plaintiff to show that a statement of opinion was both subjectively and objectively false, but cautioned that this standard applies only to statements of opinion, stating parenthetically that "any purely factual assertions in the fairness opinion, such as [a broker-dealer's] statements that it reviewed certain materials during its due diligence inquiry, would be held to a negligence standard." n42

A minority of courts have required a showing of scienter for Rule 14a-9 claims. n43 Even if courts require a showing of scienter, however, broker-dealers should be mindful that allegations of conflicts of interest may affect the scienter analysis. In one case, for example, a district court held that plaintiffs had adequately pleaded scienter in a Section 10(b) claim against a broker-dealer that issued a fairness opinion in connection with a merger, where plaintiffs alleged motives for compensation and reputation, along with facts to suggest that the broker-dealer approved an unreasonable exchange ratio according to "various objective metrics." n44

In considering claims against broker-dealers, courts have been mindful of the intended scope of a fairness opinion, both as a matter of general practice and as expressed in the relevant contracts. For example, in *City Partnership Co. v. Lehman Brothers, Inc.*, the district court dismissed a 14a-9 claim against the broker-dealer, stating that "Lehman's actions were consistent with what it saw as its duties under the engagement letter and to the limited partners." n45 In addition, courts tend to approach with skepticism plaintiffs' attempts to hold broker-dealers liable for not subjecting information to closer scrutiny, because the engagement letter typically stipulates that the broker-dealer is to rely on certain information provided by the company. n46

[7] Effect of Disclaimer

As discussed above, a broker-dealer typically agrees to provide a fairness opinion based upon information provided to it by the company requesting the opinion, and the broker-dealer generally is not expected to verify such information. The engagement letter typically states these expectations. FINRA has acknowledged that the contractual terms control and that a member firm has no general obligation to verify the information supplied to it for purposes of preparing a fairness opinion. n47 NASD Rule 2290, which took effect in December 2007, permits the use of a general disclosure to the

effect that the broker-dealer preparing the opinion has relied upon such information without independent verification.
n48

Such disclaimers generally should preclude the imposition of liability on the broker-dealer for relying in good faith on information provided by the company that turns out to be inaccurate. First, a number of courts have held that such a disclaimer has the effect that the broker-dealer has not made any representation concerning the accuracy of the company's information, and therefore cannot be held liable for inaccuracies in that information. n49 Other courts hold that disclaimers require dismissal of misrepresentation claims because the plaintiff could not have justifiably relied on any supposed representation concerning the accuracy of the information covered by the disclaimer. n50

Other decisions indicate, however, that the usual disclaimer in a fairness opinion may not be effective to avoid liability in every case. A disclaimer seems unlikely to afford any protection if the broker-dealer actually knows that the information on which its opinion is based is incorrect. In *Folger Adam Co. v. PMI Industries, Inc.*, the Second Circuit refused to dismiss a claim under *Rule 10b-5* against a broker-dealer that assisted in the preparation of an offering memorandum containing allegedly deceptive projections. n51 The Second Circuit observed that the plaintiff alleged that the broker-dealer had "affirmatively misled" the plaintiff about the accuracy of the projections. n52 In *Kline v. First Western Government Securities, Inc.*, n53 the Third Circuit analyzed the effect of disclaimers in an attorney's tax opinion. The court refused to hold that the disclaimers immunized the law firm from liability under the securities laws, and while observing that "the presence and character of disclaimers has clear relevance to that determination" of reasonable reliance, it also held that the disclaimers did not preclude the plaintiffs from relying on the opinion's description of the underlying transactions. n54

FOOTNOTES:

(n1)Footnote 1. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) ; Steven M. Davidoff, Fairness Opinions, 55 AM. U. L. REV. 1557, 1598-1603 (2006) (discussing Delaware courts since *Van Gorkom* as continually treating fairness opinions as "virtually required" in the context of a corporate control transaction and as valuable and reliable in aiding the board of directors in fulfilling its duty of care); Daniel R. Fischel, The Business Judgment Rule and the Trans Union Case, 40 BUS. LAW. 1437, 1453 (1985) (stating that, following the *Van Gorkom* decision, "no firm considering a fundamental corporate change will do so without obtaining a fairness letter"). Throughout this chapter, we use the term "broker-dealer" to refer to a broker-dealer that provides fairness opinions as part of its investment banking services. At times, particularly for consistency with the vocabulary of court opinions we discuss, we also use the terms "financial advisor" and "investment bank" to refer to authors of fairness opinions.

(n2)Footnote 2. Someone who acquires the securities that are the subject of the registration statement and believes the fairness opinion was inaccurate could assert a claim pursuant to Section 11(a)(4) of the Securities Act of 1933 under the standards described elsewhere in this treatise. 2 Matthew Bender's Securities Regulation Series: Federal Securities Act of 1933, ch. 9 (2001). Section 11(a)(4), 15 U.S.C. 77k(a)(4), provides that a person who acquires the security that is the subject of a registration statement may sue "every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement" if that part of the registration statement "contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

(n3)Footnote 3. For a discussion of the SEC's disclosure requirements applicable to fairness opinions in the context of going private transactions and proxy solicitations, see Davidoff, *supra* note 1 at 1590-94.

(n4)Footnote 4. See *Grace v. Rosenstock*, 228 F.3d 40 (2d Cir. 2000) . In *Grace* the Second Circuit extended to *Rule 10b-5* the Supreme Court's holding that a party may not assert a claim based on an allegedly misleading proxy statement under *Rule 14a-9* if the transaction would have been approved regardless of the accuracy of the proxy statement, see *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991) . See 228 F.3d at 48 . The continued

validity of the forced seller doctrine was questioned in *Howe v. Bank for Int'l Settlements*, 194 F. Supp. 2d 6, 26-27 (D. Mass. 2002).

(n5)Footnote 5. See *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985); *Lewis v. McGraw*, 619 F.2d 192, 195 (2d Cir.), cert. denied, 449 U.S. 951 (1980) (per curiam).

(n6)Footnote 6. See, e.g., Davidoff, *supra* note 1, at 1566-67 (discussing the variability and subjectivity of what constitutes "fairness" for purposes of a fairness opinion, and describing as "startling" the lack of agreement regarding what is "fair"); Charles M. Elson, Fairness Opinions: Are They Fair or Should We Care?, 53 OHIO ST. L.J. 951, 953 (1992) (calling "fairness" a misnomer, and stating that "price acceptability" is a more accurate description of what a fairness opinion considers).

(n7)Footnote 7. Davidoff, 55 AM. U. L. REV. at 1573-85 (also arguing that particular valuation methodologies in turn may suffer from subjectivity and a lack of uniform standards); Elson, *supra* note 6 at 960-64; Lucian Arye Bebchuk & Marcel Kahan, Fairness Opinions: How Fair Are They and What Can Be Done About It?, 1989 DUKE L.J. 27, 29-37 (1989); Steven J. Cleveland, An Economic and Behavioral Analysis of Investment Bankers when Delivering Fairness Opinions, 58 ALA. L. REV. 299, 302-06 (2006). See also William J. Carney, Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It, 70 WASH. U. L.Q. 523, 526-27 (1992) (criticizing Van Gorkom as assuming that stock has an intrinsic value independent of market price).

(n8)Footnote 8. See Davidoff, *supra* note 1 at 1586-87.

(n9)Footnote 9. See *id.* at 1587-88 (describing "stapled financing," in which an investment bank provides a fairness opinion to the board of an acquiree company, and then provides financing for the acquirer to complete the transaction). See also Elson, *supra* note 6 at 965-70 (discussing potential conflicts of interest, and stating that fairness opinions inherently lack objectivity because they are a product investment banks actively seek to sell); Bebchuk and Kahan, *supra* note 7 at 37-45 (also rejecting arguments that reputation concerns and internal procedures and guidelines encourage unbiased opinions).

(n10)Footnote 10. See, e.g., Bernard Black and Reinier Kraakman, Delaware's Takeover Law: The Uncertain Search for Hidden Value, 96 NW. U. L. REV. 521, 556 (2002) ("The uncomfortable truth is that investment banker fairness opinions often say almost whatever their client wants them to, the facts be damned.").

(n11)Footnote 11. One empirical study argues that fairness opinion practices are the product of competitive forces and provide valuable information to investors, and that concerns regarding conflicts of interest are exaggerated. Charles W. Calomiris and Donna M. Hitscherich, Banker Fees and Acquisition Premia for Targets in Cash Tender Offers: Challenges to the Popular Wisdom on Banker Conflicts, 4 J. EMPIRICAL LEGAL STUD. 909 (2007).

(n12)Footnote 12. *The HA2003 Liquidating Trust v. Credit Suisse Secs (USA) LLC*, 517 F.3d 454, 457 (7th Cir. 2008). ("The possibility that judges, regulators, or legislators have caused 'too much demand' for a particular service, inducing firms to buy something worth less than its price, is no reason to mulct the service's provider."). The opinion affirmed a district court's ruling that an investment bank did not act with gross negligence when it provided a company's board of directors with a fairness opinion that relied upon the company's projections, which an auditor determined were unrealistic, because contractual terms required the investment bank to rely upon the company's projections. Judge Easterbrook observed that the plaintiff's brief "reflects a view that fairness opinions are worthless (but expensive) paper." *Id.*

(n13)Footnote 13. See, e.g., Carney, *supra* note 7 at 525 (1992) (arguing that fairness opinions have served an important role in "assuring the continued application of the business judgment rule during an era when it has been under severe attack" and stating that courts and investors should recall that fairness opinions are intended for directors rather than investors, treat fairness opinions as having only limited value, and impose liability only in the event of fraud); Elson, *supra* note 6 (discussing variability in valuation processes, and arguing against application of the tort of

negligent misrepresentation in cases against investment bankers that provide fairness opinions).

(n14)Footnote 14. Exchange Act Release No. 56,645 (Oct. 11, 2007), 72 Fed. Reg. 59,317 (Oct. 19, 2007) (approving new Rule 2290, hereafter "Rule 2290 Adopting Release"); FINRA Regulatory Notice 07-54 (Nov. 2007) (discussing the new rule and announcing an effective date of Dec. 8, 2007).

The rule's origin extends back to 2004, when the NASD solicited comment regarding whether it should propose a new rule to regulate the identification and disclosure of conflicts of interest relating to members' fairness opinions in connection with corporate control transactions. See NASD Notice to Members 04-83 (Nov. 2004). The Notice to Members raised the possibility of a requirement that, when a member provides a fairness opinion to be included in a proxy statement, it disclose a "complete description" of its conflicts of interest (such as whether it has been an advisor on the transaction, and the nature of its compensation in connection with the transaction), as well as the extent to which it relied upon information supplied by a company or its management or independently verified certain information. In addition, the NASD sought comment on whether it should propose requirements to guard against conflicts of interest in connection with fairness opinions, such as the process for approving fairness opinions, the process to determine appropriate valuation analyses, and the process for evaluating the degree to which the amount and nature of the transaction's compensation to individual officers, directors or employees--relative to shareholders' benefits--is a factor in determining fairness. See *id.* As discussed below, the final rule's disclosure requirements are narrower than this early suggestion of a "complete description" of conflicts of interest, and the rule as adopted also does not mandate an evaluation of insiders' compensation relative to shareholders' compensation.

(n15)Footnote 15. See FINRA Regulatory Notice 07-54 (Nov. 2007).

(n16)Footnote 16. NASD Rule 2290(b)(2).

(n17)Footnote 17. There is no express or implied private cause of action based on a violation of Rule 2290. See § 5C.01, *supra*.

(n18)Footnote 18. See § 5C.06[5], n. 28 & accompanying text, *infra*.

(n19)Footnote 19. Rule 14a-9(a), 17 C.F.R. § 240.14a-9(a), provides:

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

(n20)Footnote 20. *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 384-85 (1970) .

(n21)Footnote 21. See, e.g., *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 68-69 (D.C. Cir.) , cert. denied, 449 U.S. 1012 (1980) (holding that substantial connection existed with respect to company's chairman and controlling shareholder, who was "pivotal" to the transaction, which would result in his taking control of the company); *Yamamoto v. Omiya*, 564 F.2d 1319, 1322-23 (9th Cir. 1977) (finding no substantial connection between purchaser of a building and solicitation of shareholders' approval of the sale, where purchaser had no control over contents of the proxy statement and purchaser's identity likely had little bearing on shareholders' votes).

(n22)Footnote 22. 612 F. Supp. 1543 (S.D.N.Y. 1985) , *aff'd in part, rev'd in part on other grounds*, 927 F.2d 667 (2d Cir.) , *amended*, 938 F.2d 1528 (2d Cir. 1991) .

(n23)Footnote 23. *Mendell*, 612 F. Supp. at 1551-52.

(n24)Footnote 24. *Mendell*, 612 F. Supp. at 1552.

(n25)Footnote 25. 701 F. Supp. 353 (E.D.N.Y. 1988) .

(n26)Footnote 26. *Lazzaro*, 701 F. Supp. at 366-67.

(n27)Footnote 27. See, e.g., *City Partnership Co. v. Lehman Bros.*, 344 F. Supp. 2d 1241, 1246-47 (D. Colo. 2004) ; *Graham v. Taylor Capital Group (In re Reliance Sec. Litig.)*, 91 F. Supp. 2d 706, 728 (D. Del. 2000) ("Third Circuit law, however, permits a finding of liability under Rule 14a-9 by those who make material misstatements or omissions in proxy statements, regardless if the defendant is an outside expert that does not benefit from the outcome of the solicitation.").

(n28)Footnote 28. *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991) . See also, e.g., *In re AOL Time Warner, Inc. Sec. and "ERISA" Litig.*, 381 F. Supp. 2d 192, 243-44 (S.D.N.Y. 2004) (dismissing claims under Rule 14a-9 and Securities Act §11 against investment bank because plaintiff had not alleged that investment bank did not believe the statements expressed in its fairness opinion).

(n29)Footnote 29. *Virginia Bankshares*, 501 U.S. at 1084-94 .

(n30)Footnote 30. *Virginia Bankshares*, 501 U.S. at 1095-96 .

(n31)Footnote 31. *Id.*; see also *Freedman v. Value Health, Inc.*, 958 F. Supp. 745, 753 (D. Conn. 1997) ; *In re McKesson HBOC, Inc. Secs. Litig.*, 126 F. Supp. 2d 1248, 1265 (N.D. Cal. 2000) ("The teaching of *Virginia Bankshares* is that an opinion is only false if the speaker does not in fact hold that opinion.").

(n32)Footnote 32. See, e.g., *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1428 (3d Cir. 1997) (*Virginia Bankshares* applies to Rule 10b-5 claims); *In re PHLCORP*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,808, at 93,189-93 (S.D.N.Y. 1992) (*Virginia Bankshares* applies to tender offers under Exchange Act § 14(e)); *In re JPMorgan Chase & Co. Sec. Litig.*, No. 06-C-4674, 2007 U.S. Dist LEXIS 93877 (N.D. Ill. Dec. 18, 2007) (applying *Virginia Bankshares* to Section 10(b) fraud claim against investment bank). In *JPMorgan Chase*, the court held that the pleadings had alleged both objective and subjective falsity with respect to the investment bank's fairness opinion, because plaintiffs alleged that the bank endorsed a merger with an unreasonable exchange ratio, and that "JPMSI knew of the unfair ratio but endorsed the merger in an effort to collect compensation and further its own ranking amongst its competitors." *Id.*

(n33)Footnote 33. *Goldstein v. Bear, Stearns & Co.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,037 (E.D.N.Y. Aug. 15, 1988), involved an exchange offer by defendant Compact Video to shareholders of defendant Four Star International. The complaint asserted that the broker-dealer that had provided a fairness opinion failed to disclose that it had a prior relationship with the ultimate owner of Compact Video. The court held that whether the relationship "would be a factor in the reasonable investor's decision making process is a question of fact to be decided by a jury." *Id.* at 90,861. See also, e.g., *City Partnership Co. v. Lehman Bros.*, 344 F. Supp. 2d at 1252 (finding that conflicts of interest were adequately disclosed, and that evidence did not indicate potential or actual conflicts affected the fairness opinion); *Maywalt v. Parker & Parsley Petroleum Co.*, 808 F. Supp. 1037, 1057 (S.D.N.Y. 1992) (adequate disclosure of contingent fee arrangement); *Mendell v. Greenberg*, 612 F. Supp. 1543, 1552 n.10 (S.D.N.Y. 1985) (alleged conflict of interest fully and fairly disclosed).

(n34)Footnote 34. An omission is material under Rule 14a-9 if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. Put another way, materiality is established when "the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Indus., Inc. v. Northway Inc.*, 426 U.S. 438, 449 (1976) ; accord,

Virginia Bankshares, 501 U.S. 1083, 1090-91 (1991) . The same standard applies to *Rule 10b-5*. See *SEC v. Maio*, 51 F.3d 623, 637 n.17 (7th Cir. 1995) (same standard for both *Rule 10b-5* and § 14(e)); *Kramas v. Security Gas & Oil Inc.*, 672 F.2d 766, 768-69 (9th Cir.) , *cert. denied*, 459 U.S. 1035 (1982) ; *First Eastern Corp. v. Mainwaring*, No. 92 Civ. 1176, 1992 U.S. Dist. LEXIS 16979, *11-12 (E.D. Pa. Nov. 4, 1992) . In order to be material, a misrepresentation or omission need not be "outcome determinative" in the sense that it actually would have caused a reasonable investor to have acted differently. See *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 162 (2d Cir. 2000) ; *Folger Adam Co. v. PMI Indus., Inc.*, 938 F.2d 1529, 1533 (2d Cir.) , *cert. denied* , 502 U.S. 983 (1991) .

(n35)Footnote 35. See *Flake v. Hoskins*, 55 F. Supp. 2d 1196, 1225 (D. Kan. 1999) ; *Denison Mines Ltd. v. Fibreboard Corp.*, 388 F. Supp. 812, 822 (D. Del. 1974) (opinion of investment bank as to valuation of corporation of "signal importance" under circumstances of case); see also *Caruso v. Metex Corp.*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,967 (E.D.N.Y. July 30, 1992) (valuation of company's subsidiary); *Dowling v. Narragansett Capital Corp.*, 735 F. Supp. 1105 (D.R.I. 1990) ; *SEC v. Parklane Hosiery Co.*, 422 F. Supp. 477 (S.D.N.Y. 1976) , *aff'd*, 558 F.2d 1083 (2d Cir. 1977) .

(n36)Footnote 36. 501 U.S. at 1091 n.5 .

(n37)Footnote 37. 857 F.2d 179, 184 (3d Cir. 1988) , *cert. denied*, 489 U.S. 1054 (1989) .

(n38)Footnote 38. 766 F.2d 770, 776 (3d Cir.) , *cert. denied*, 474 U.S. 946 (1985) .

(n39)Footnote 39. *Herskowitz*, 857 F.2d 179, 185 (citation omitted).

(n40)Footnote 40. *Id.* at 190 ("Moreover since an investment banker rendering a fairness opinion in connection with a leveraged buyout knows full well that it will be used to solicit shareholder approval, and is well paid for the service it performs, we see no convincing reason for not holding it to the same standard of liability as the management it is assisting.").

(n41)Footnote 41. See, e.g., *In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1263-64 (N.D. Cal. 2000) (applying a negligence standard and discussing contrary authority); *In re Reliance Sec. Litig.*, 91 F. Supp. 2d at 729 ("Under Third Circuit law, negligence, not scienter, is the standard of liability under Rule 14a-9. ... While the PSLRA, 15 U.S.C.A. § 78u-4(b)(2), might be interpreted as raising the pleading requirements for alleging violations of Rule 14a-9, the court will await direction from the Third Circuit before contravening express precedent on this issue. Accordingly, the court will not apply the heightened pleading requirements of the PSLRA to plaintiffs' claims under Rule 14a-9."). See also *In re JPMorgan Chase & Co. Sec. Litig.*, 2007 U.S. Dist LEXIS 93877 (assuming in discussion of pleading requirements that negligence standard applies to 14a-9 claims).

(n42)Footnote 42. *In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d at 1265-66.

(n43)Footnote 43. See *Adams v. Standard Knitting Mills, Inc.*, 623 F.2d 422, 428-31 (6th Cir. 1980) , *cert. denied*, 449 U.S. 1067 (1980) (applying a scienter standard to outside accountants in a Section 14(a) action); *Zatkin v. Primuth*, 551 F. Supp. 39, 45 (S.D. Cal. 1982) (citing *Adams*, adopting a scienter standard, and dismissing 14(a) claim against independent auditor).

(n44)Footnote 44. *In re JPMorgan Chase & Co. Sec. Litig.*, 2007 U.S. Dist LEXIS 93877 (denying motion to dismiss Section 10(b) claim against broker-dealer).

(n45)Footnote 45. 344 F. Supp. 2d 1241, 1249 (D. Colo. 2004) .

(n46)Footnote 46. For instance, Judge Easterbrook stated in a recent opinion: "Separating number-creation from number-evaluation is not illegal and may make business sense. The division of labor between number verifiers (Ernst & Young) and number crunchers (CSFB) is not to be sneezed at; the division of labor has large benefits for an economy,

as it allows specialists to do what they are best at." HA2003 *Liquidating Trust v. Credit Suisse Securities (USA) LLC*, 517 F.3d 454, 457 (7th Cir. 2008) (affirming district court's ruling that investment bank did not act with gross negligence when it provided board of directors with a fairness opinion that relied upon the company's projections, which an auditor determined were unrealistic, because contractual terms required the investment bank to rely upon the company's projections). *See also* *In re AOL Time Warner, Inc. Securities and "ERISA" Litig.*, 381 F. Supp. 2d at 244 ("Put simply, it was not Morgan Stanley's job to independently investigate AOL's accounting; indeed, Morgan Stanley explicitly disclosed this by disavowing any such independent investigation in the fairness opinion itself.").

(n47)Footnote 47. *See* Rule 2290 Proposing Release, 71 Fed. Reg. at 18398 (discussing commenters' views that engagement letters generally do not call for independent verification and that other professionals are better-equipped to perform such verification); FINRA Regulatory Notice 07-54 (stating that independent verification is not required but that a member must describe information that it has verified).

(n48)Footnote 48. NASD Rule 2290(a)(4).

(n49)Footnote 49. *See In re AOL Time Warner, Inc. Sec. and "ERISA" Litig.*, 381 F. Supp. 2d at 244 ("Put simply, it was not Morgan Stanley's job to independently investigate AOL's accounting; indeed, Morgan Stanley explicitly disclosed this by disavowing any such independent investigation in the fairness opinion itself."); *In re Reliance Secs. Litig.*, 135 F. Supp. 2d 480, 516 (financial advisors stated they would rely on management representations, no showing that doing so was reckless); *Maywalt v. Parker & Parsley Petroleum Co.*, 808 F. Supp. 1037, 1048, 1058 (S.D.N.Y. 1992) ; *Goldstein v. Bear Stearns & Co.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,037, at 90,860 (E.D.N.Y. 1988); *Devaney v. Chester*, [1986-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,747, at 93,648-49 (S.D.N.Y. Apr. 30, 1986), *aff'd in part and rev'd in part on other grounds*, 813 F.2d 566 (2d Cir. 1987) ; *Ince & Co. v. Silgan Corp.*, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,842 at 99,126 (Del. Ch. Feb. 7, 1991) (fairness opinion was not misleading because of disclosures that it was relying on director's valuations); *see also Sable v. Southmark/Envicon Capital Corp.*, 819 F. Supp. 324, 335-37 (S.D.N.Y. 1993) (tax counsel not liable for any misrepresentation in a private placement memorandum when it merely accepted representations of sponsors as true and rendered its opinion in reliance thereon); *Haberkamp v. Steele*, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. P 96,606 at 92,855 (S.D.N.Y. Apr. 15, 1992) (accountant's disclaimers that it had relied on unverified information undermine claim that its statements were misleading).

(n50)Footnote 50. *See Devaney v. Chester*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,747, at 93,949 (S.D.N.Y. Apr. 30, 1986) (investment bank's confidential memorandum, "with its broad disclaimers as to the source of information contained therein, does not support an allegation of reliance"), *aff'd in part and rev'd in part on other grounds*, 813 F.2d 566 (2d Cir. 1987) ; *see also Sable v. Southmark/Envicon Capital Corp.*, 819 F. Supp. 324, 338-39 (S.D.N.Y. 1993) (law firm's disclaimers make reliance on disclaimed material unreasonable); *Buford White Lumber Co. v. Octagon Properties, Ltd.*, 740 F. Supp. 1553, 1566 (W.D. Okla. 1989) (reliance unreasonable as a matter of law in light of accountant's disclaimer that supplied information was unverified).

(n51)Footnote 51. 938 F.2d 1529 (2d Cir.) , *cert. denied*, 502 U.S. 983 (1991) .

(n52)Footnote 52. *Folger Adam Co.*, 938 F.2d at 1534 .

(n53)Footnote 53. 24 F.3d 480 (3d Cir.) , *cert. denied*, 513 U.S. 1032 (1994) .

(n54)Footnote 54. *Kline*, 24 F.3d 480, 487-90.

* This chapter was prepared by partners in the Broker-Dealer Group of Wilmer Cutler Pickering Hale and Dorr LLP ("WilmerHale"). This chapter is for general information purposes only and does not represent WilmerHale's legal advice as to any particular set of facts, nor does this chapter represent any undertaking to keep recipients advised as to all relevant legal developments. Unless indicated otherwise, the information contained in this chapter is current as of

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Federal Securities Exchange Act of 1934

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CHAPTER 5C Broker-Dealers' Liabilities Under the Securities Exchange Act *

1-5C Federal Securities Exchange Act of 1934 § 5C.07

§ 5C.07 Private Placements

An investor seeking compensation from an underwriter for misrepresentations relating to a securities offering that was registered under the Securities Act of 1933 will normally assert claims pursuant to that Act, n1 but plaintiffs seeking remuneration in unregistered private placements face unique challenges. n2 Because the Supreme Court has held that a writing delivered in connection with a private sale of securities, such as an offering circular or a private placement memorandum, is not a "prospectus" subject to liability under Section 12(a)(2) of the Securities Act, *Rule 10b-5* of the Exchange Act is the most common approach to seeking liability against broker-dealer placement agents or initial purchasers in a private placement transaction. n3 Although such claims are subject to all the requirements discussed elsewhere with respect to *Rule 10b-5* claims in general, n4 they present two distinctive issues relating to (1) whether the purchaser may justifiably rely on the offering circular as a representation by the placement agent or initial purchaser and (2) whether the complaint satisfies the requirements of the Private Securities Litigation Reform Act for pleading scienter. These two issues represent the two main hurdles plaintiffs face when attempting to impose *Rule 10b-5* liability on a broker-dealer in a private placement transaction. The third main issue facing private placement broker-dealers is potential liability under Section 12(a)(2) if a court determines that a private placement had sufficient public aspects to fall under Section 12(a)(2) notwithstanding the Supreme Court's limitation.

[1] The Offering Circular as a Representation by the Placement Agent

The first hurdle facing plaintiffs seeking to impose liability on broker-dealer private placement agents under *Rule 10b-5* is demonstrating misrepresentation in and reliance on the offering circular or the private placement memorandum. Since the Supreme Court held that there is no private right of action for aiding and abetting a violation of *Rule 10b-5*, n5 the pleading and proof of a *Rule 10b-5* claim must satisfy the requirements of the rule with respect to each separate defendant. Since most of the information in an offering circular or private placement memorandum relates to and presumably originates with the issuer, a question may arise concerning whether the offering circular should be regarded as a statement by the initial purchaser or placement agent and whether it was justifiable for the plaintiff to rely on it as such. n6 There are two key cases that address these issues, *Gabriel Capital, L.P. v. NatWest Finance, Inc.* n7 and *GSC Partners CDO Fund v. Washington*. n8 Both of the cases demonstrate the difficulty plaintiffs experience when attempting to impose *Rule 10b-5* liability on broker-dealers engaged in private placement transactions.

In *Gabriel Capital, L.P. v. NatWest Finance, Inc.*, purchasers in a private placement asserted *Rule 10b-5* claims against the placement agents based on a variety of alleged misrepresentations, including alleged misrepresentations in the

offering memorandum. The offering memorandum contained the following disclaimer:

NO REPRESENTATION OR WARRANTY, EXPRESS OR IMPLIED, IS MADE BY THE INITIAL PURCHASERS AS TO THE ACCURACY OR COMPLETENESS OF THE INFORMATION SET FORTH HEREIN, AND NOTHING CONTAINED IN THIS OFFERING MEMORANDUM IS, OR SHOULD BE RELIED UPON AS, A PROMISE OR REPRESENTATION, WHETHER AS TO THE PAST OR THE FUTURE. THE INITIAL PURCHASERS DO NOT ASSUME ANY RESPONSIBILITY FOR THE ACCURACY OR COMPLETENESS OF SUCH INFORMATION. n9

The placement agents moved to dismiss on the grounds, *inter alia*, that in light of this disclaimer, the complaint did not properly allege either that they had made a misrepresentation or that the plaintiffs justifiably relied on any such misrepresentation. n10 The district court ruled against them on the first argument solely on the basis that, on its reading, "This disclaimer does not state that the initial purchasers have made no representations; rather, it states that the initial purchasers make no warranty about the accuracy or completeness of the representations." n11 Presumably, it would be possible to draft a disclaimer that would not permit the court to draw such a conclusion. n12 The placement agents also argued on the basis of the disclaimer that the plaintiffs had not properly pleaded justifiable reliance. The court may have believed this argument to have some merit, but it did not rule on it. Instead, it denied the motion to dismiss on the ground that the plaintiffs adequately pleaded justifiable reliance on other alleged misrepresentations by the initial purchasers, outside the placement memorandum. n13

By contrast, in *GSC Partners CDO Fund v. Washington*, n14 the Third Circuit subsequently affirmed the dismissal of a *Rule 10b-5* claim against a placement agent, based on alleged misstatements in the offering circular for a private placement, on the alternate ground that "the plaintiffs have failed to attribute any false statement or omissions to" the placement agent. n15 The Court of Appeals distinguished *Gabriel Capital* by pointing out that in that case "the plaintiffs alleged that the defendants, in addition to being the initial purchasers, also drafted the offering memorandum as well as distributed it during sale pitches" whereas "[t]he plaintiffs here do not allege that [the placement agent] drafted or distributed the circular." n16 The Court of Appeals also noted that unlike the disclaimer in *Gabriel Capital*, which stated that the initial purchasers made "no warranty" concerning the statements in the offering circular, the circular in *GSC* stated that "the initial purchasers made 'no representations' at all." n17

These cases illustrate the uncertainty faced by plaintiffs and defendants alike when involved in actions alleging material misrepresentations or omissions under *Rule 10b-5* against broker-dealer private placement agents.

[2] Pleading Scierter Under the PSLRA

The second issue facing plaintiffs seeking *Rule 10b-5* liability against broker-dealer private placement agents relates to the pleading standards of the Private Securities Litigation Reform Act ("PSLRA"). The PSLRA requires plaintiffs that seek to assert federal securities law claims to "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." The "required state of mind" for a *Rule 10b-5* claim is scierter. n18 Some courts have indicated that plaintiffs may "establish this strong inference" that defendants acted with scierter "either (a) by alleging facts to show that defendants had both motive and opportunity to commit fraud, or (b) by alleging facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness." n19

In the context of a private placement, this standard remains high. The broker-dealer's role as placement agent, including the performance of due diligence, is most likely not enough in itself to support the necessary inference because pleading of scierter "may not rest on a bare inference that the defendant 'must have had' knowledge of the facts." n20 Instead, courts have held that a placement agent should be entitled to the benefit of the same principle that protects members of the issuer's management from allegations of scierter based on their presumed access to information concerning the issuer. n21

Courts also have rejected contentions that investors may satisfy the PSLRA's requirements for pleading scienter by alleging a "motive" consisting solely of a placement agent's interest in earning fees from an offering. If such an allegation could sustain the plaintiffs' burden, all underwriters would, by definition, have the requisite mental state to commit securities fraud, rendering the PSLRA's scienter pleading requirement meaningless as applied to underwriter defendants. n22 In fact, the courts have recognized that an underwriter's predominant motivation with respect to the accuracy of disclosures relating to the offering is to ensure that they are accurate, because the enormous liability associated with misleading statements in connection with a securities offering dwarfs the underwriters' compensation for the offering. As the court observed in *Wenger v. Lumisys, Inc.*, "no rational underwriter would market an IPO to customers knowing that the stock would soon decline in value." n23 Courts have similarly found that the failure of a broker-dealer to uncover fraud during due diligence in a private placement transaction alone did not meet the strong inference of scienter standard. n24 These cases demonstrate that meeting the PSLRA standards for pleading, especially in the context of private placements, remains difficult for plaintiffs seeking to impose *Rule 10b-5* liability on broker-dealers and underwriters.

[3] Potential Section 12(a)(2) Liability

Although the Supreme Court held in *Gustafson* that a writing delivered in connection with a private sale of securities, such as an offering circular or a private placement memorandum, is not a "prospectus" subject to liability under Section 12(a)(2) of the Securities Act of 1933, n25 some courts have nevertheless found a way to impose Section 12(a)(2) liability on private placement broker-dealers notwithstanding this limitation. At the same time, it is important to keep in mind that there are many circumstances in which there is no disclosure in connection with a private placement, so private placement broker-dealers are able to escape the risk of Section 12(a)(2) liability altogether. n26

Simultaneous private and public offerings raise especially complex issues, as some courts have held that a private placement occurring concurrently or subsequently to a public offering is not subject to Section 12(a)(2), n27 whereas other courts have considered that a private offering may be "integrated" with the public offering and come under Section 12(a)(2). n28 In *Sloane Overseas Fund Ltd. v. Sapiens Int'l Corp., N.V.* the court imposed Sec. 12(a)(2) liability on a combined Rule 144A private placement to U.S. qualified institutional buyers and Regulation S offering to purchasers outside of the U.S. by emphasizing the role of the Regulation S offering and holding that it constituted a "public offering" due to the "wide distribution" of the offering memorandum. n29 On the other hand, in *Yung v. Lee*, the court refused to impose liability on broker-dealers even though the private placement investor plaintiffs proved that they relied on a fraudulent prospectus provided in a simultaneous public offering. n30

Some commentators have pointed to these decisions to demonstrate that the nature of the offering, rather than the existence of a prospectus, will determine whether or not a distribution is subject to Section 12(a)(2) liability. n31 However, this has resulted in additional complexity as courts have pointed to different factors to determine the private or public nature of the offering. Some courts emphasize the language of the private placement memorandum as evidence of the sellers' intent to retain the private nature of the offering, n32 whereas other courts look to the conduct of the parties, such as the size of the offering or the number of offerees, n33 and yet others simply consider whether the plaintiff alleged that the offering was made pursuant to a "prospectus" or whether the offering was registered. n34

The legal uncertainty of Section 12(a)(2) liability in the context of private placements in close proximity to public offerings has resulted in significant criticism from the securities bar and the academic community. Some commentators have argued that the *Gustafson* decision leaves more questions than answers, casting doubt on its statutory construction methods and citing economic reasons for a contrary outcome. n35 Others have criticized *Gustafson* arguing that even sophisticated investors participating in private placements also need protection from misrepresentations by broker-dealers beyond *Rule 10b-5*. n36 Thus, although *Gustafson* clearly remains the standard in negating the application of Section 12(a)(2) claims in connection with private offering materials, there likely will continue to be a certain degree of uncertainty on this front in the context of contemporaneous private placement transactions and public offerings.

FOOTNOTES:

(n1)Footnote 1. 2 Matthew Bender, *Federal Securities Act of 1933* § 9.02 (Lexis 2007).

(n2)Footnote 2. Some commentators have argued that broker-dealers that work solely as private placement intermediaries should be subject to modified registration requirements or escape registration completely, but these efforts have met with minimal success. *Report and Recommendations of the Task Force on Private Placement Broker-Dealers*, 60 *Bus. Law.* 959, 961-61 (2005); Robert Connolly, *Legitimizing Private Placement Broker-Dealers Who Deal With Private Investment Funds: A Proposal for a New Regulatory Regime and a Limited Exception to Registration*, 40 *J. Marshall L. Rev.* 703, 723-30 (2007).

(n3)Footnote 3. In *Gustafson v. Alloyd Co.*, 513 U.S. 561, 568-69 (1995), the Supreme Court held that a writing delivered in connection with a private sale of securities is not a "prospectus" subject to Section 12(a)(2) of the Securities Act of 1933, 15 U.S.C. § 77l(a)(2) (2007), unless it relates to an offering that was required to be registered under Section 5 of the Act, 15 U.S.C. § 77e (2007), or was exempt under Section 3 of the Act, 15 U.S.C. § 77c (2007).

(n4)Footnote 4. See § 5.04, *supra*.

(n5)Footnote 5. *Cent. Bank v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). For additional discussion of *Rule 10b-5*, see § 5.04, *supra*.

(n6)Footnote 6. To prevail on a *Rule 10b-5* claim the plaintiff must have "justifiably" relied on a misleading statement by the defendant. *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1032 (2d Cir. 1993); *Tracinda Corp. v. Daimlerchrysler A.G.*, 197 F. Supp. 2d 42, 64 (D. Del. 2002).

(n7)Footnote 7. *Gabriel Capital, L.P. v. Natwest Fin., Inc.* 94 F. Supp. 2d 491 (S.D.N.Y. 2000).

(n8)Footnote 8. *GSC Partners CDO Fund v. Washington*, 368 F.3d 228 (3d Cir. 2004).

(n9)Footnote 9. *Gabriel Capital*, 94 F. Supp. 2d at 501-02.

(n10)Footnote 10. When a complaint asserts a *Rule 10b-5* claim based on alleged misrepresentations in a written document like an offering circular, the document is taken into account in deciding a motion to dismiss the complaint. *E.g.*, *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1426 (3d Cir. 1997).

(n11)Footnote 11. *Gabriel Capital*, 94 F. Supp. 2d at 502.

(n12)Footnote 12. In another recent case, *Wafra Leasing Corp. 1999- A-1 v. Prime Capital Corp.*, 192 F. Supp. 2d 852 (N.D. Ill. 2002), the court reached a similar conclusion where a private placement memorandum disclaimed any representations by its agents when it stated that "[n]o person has been authorized to give any information or to make any representations other than those contained in this [private placement memorandum] and, if given or made, such information or representations must not be relied upon." *Id.* at 865-66. The court compared this disclaimer with the disclaimer used in *Gabriel Capital*, which stated "[n]o dealer, salesperson or other person has been authorized [by the note issuer] ... to give any information or to make any representation not contained in this Offering Memorandum." *Gabriel Capital*, 94 F. Supp. 2d at 507. Even though the *Gabriel Capital* disclaimer was narrower than the *Wafra* disclaimer, the court emphasized that a private placement memorandum or a company's agents cannot disclaim their statements no matter its scope. *Id.* In addition, a private placement memorandum cannot disclaim statements made in the memorandum itself. *Wafra Leasing Corp.* 192 F. Supp. 2d 852, 865-66. *But see* *Saltzberg v. TM Sterling/Austin Assoc.*, 45 F.3d 399 (11th Cir.1995) (per curiam) (holding that explicit cautionary language in private placement memorandum rendered alleged misstatements immaterial and made them not actionable under "bespeaks caution" doctrine).

(n13)Footnote 13. *Gabriel Capital*, 94 F. Supp. 2d at 507.

(n14)Footnote 14. *GSC Partners CDO Fund*, 368 F.3d at 246 .

(n15)Footnote 15. *GSC Partners CDO Fund*, 368 F.3d at 246 (alternate holding).

(n16)Footnote 16. *Id.*

(n17)Footnote 17. *Id.*

(n18)Footnote 18. 15 U.S.C. § 78u-4(b)(2) (2007); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) . For a discussion of the definition of scienter, see § 5.04[2][b], *supra*.

(n19)Footnote 19. *Oran v. Stafford*, 226 F.3d 275, 288-89 (3d Cir. 2000) (quoting *In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1418 (3d Cir. 1997)) ; see also *Novak v. Kasaks*, 216 F.3d 300, 307-11 (2d Cir.) , *cert. denied*, 531 U.S. 1012 (2d Cir. 2000) . For a discussion of what is required to satisfy the "strong inference" test, see § 5.04[2][b][iii], *supra*.

(n20)Footnote 20. *E.g.*, *Greenstone v. Cambex Corp.*, 975 F.2d 22, 26 (1st Cir. 1992) (quoting *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 497 (7th Cir. 1986) and using a pre-PSLRA requirement of "reasonable" rather than "strong" inference of scienter); see also *GSC Partners CDO Fund*, 368 F.3d at 239 .

(n21)Footnote 21. *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 539 (3d Cir. 1999) ("A]llegations that [a defendant] because of [its] position within the company, 'must have known' a statement was false or misleading' are precisely the types of inferences which [courts], on numerous occasions, have determined to be inadequate to withstand Rule 9(b) scrutiny.") See also *Kennilworth Partners L.P. v. Cendant Corp.*, 59 F. Supp. 2d 417, 428 (D.N.J. 1999) (cannot infer scienter from the defendants' positions as directors or officers).

(n22)Footnote 22. *Melder v. Morris*, 27 F.3d 1097, 1104 (5th Cir. 1994) (holding that mere allegation that underwriter-defendant's motive in participating in fraud was to collect fees "would make a mockery of Rule 9(b) by effectively eliminating the scienter requirement as to securities underwriters since all underwriters are, of course, fee seekers"), In *Sherleigh Assocs., L.L.C. v. Windmere-Durable Holdings, Inc.*, 178 F. Supp. 2d 1255 (S.D. Fla. 2000) , the court states: "It is well-settled, however, that a court may not infer fraudulent intent from an allegation that "a defendant's due diligence investigation 'should have turned up the asserted improprieties in the offering materials.'" *Id.* at 1279 ; *Wenger v. Lumisys, Inc.*, 2 F. Supp. 2d 1231, 1251-52 (N.D. Cal. 1998) ; *In re WRT Energy Sec. Litig.*, Nos. 96 Civ. 3610, 96 Civ. 3611, 1997 U.S. Dist. LEXIS 14009 at *24 (S.D.N.Y. Sept. 15, 1997) .

(n23)Footnote 23. *Wenger*, 2 F. Supp. 2d at 1252 .

(n24)Footnote 24. *American High-Income Trust v. Allied Signal*, 329 F. Supp. 2d 534 (S.D.N.Y. 2004) . On the other hand, some have stated that most broker-dealers believe their internal business and reputational concerns require them to have high standards of due diligence for all private placements, so their standard of care always exceeds the "recklessness" standard. John C. Cocchiarella & Robert S. Risoleo, *Private Placements, resales and Rule 144A and Regulation S Offerings*, in *Securities Filings 2008*, at 717, 810 (PLI Corp. Law and Practice, Course Handbook Series No. 13988, 2008).

(n25)Footnote 25. *Supra* note 3. For example, a claim may not be maintained under Section 12(a)(2) based on alleged misstatements in a private placement memorandum. *Glamorgan Coal Corp. v. Ratner's Group PLC*, No. 93-CIV-7581, 1995 U.S. Dist. LEXIS 9548 (S.D.N.Y. July 10, 1995) at *3 ; *Laser Mortgage Mgmt. Inc. v. Asset Securitization Corp.*, No. 00-Civ-8100, 2001 U.S. Dist. LEXIS 13746 (S.D.N.Y. Sept. 6, 2001) , *aff'd*, *Steed Fin. LDC v. Nomura Sec. Int'l, Inc.*, No. 00-Civ-8058, 2005 U.S. App. LEXIS 19947 (2d Cir. Sept. 14, 2005) ; *American High-Income Trust v. Allied Signal*, *Fed. Sec. L. Rep. (CCH)* 92,889, 329 F. Supp. 2d 534, 543 (S.D. N.Y. 2004) ("[O]fferings memoranda distributed in connection with [non-public] offerings cannot give rise to Section 12(a)(2) liability."); *Endo v. Albertine*, No. 88-C-1815, 1995 U.S. Dist. LEXIS 4517 (N.D. Ill. Apr. 7, 1995) ("[A]ny class

member in this case who purchased securities pursuant to a private sale agreement no longer has a § 12(2) right of action against any of the defendants."); *ESI Montgomery County, Inc. v. Montenay Int'l Corp.*, 899 F. Supp. 1061, 1065 (S.D. N.Y. 1995) ("In light of the Supreme Court's holding that § 12(2) covers only public offerings, private offering memoranda can no longer be considered prospectuses within the meaning of § 12(2)."); *In re Worldcom, Inc. Sec. Lit.*, 294 F. Supp. 2d 431, 454 (S.D.N.Y. 2003) (stating that offering of debt securities is "private placement" because it is "personal to each person to whom it has been delivered" and therefore not subject to liability provisions of the Securities Act of 1933), *vacated and remanded on other grounds.*, 496 F. 3d 245 (2d. Cir. 2007) .

(n26)Footnote 26. Although a disclosure document is often provided in a private placement because of market demands and antifraud considerations, and some information is required by Rule 144A(d) and Rule 144(c), there is no such requirement for secondary trades in restricted securities. John C. Cocchiarella & Robert S. Risoleo, *Private Placements, Resales and Rule 144A and Regulation S Offerings*, in Securities Filings 2008, at 717, 811-12 (PLI Corp. Law and Practice, Course Handbook Series No. 13988, 2008). In addition, Regulation FD requires another kind of disclosure for private placements if there is communication of material nonpublic information in connection with any offering (such as a private placement) unless all recipients of the information agree not to disclose or trade on the basis of that information. *Id.* at 812-13.

(n27)Footnote 27. *Laser Mortgage Mgmt., Inc. v. Asset Securitization Corp.*, No. 00 Cir. 8100, U.S. Dist. LEXIS 13746 (S.D.N.Y. Sept. 6, 2001); *In re Refco, Inc. Sec. Litig.*, 503 F. Supp. 2d 611, 626-27 (S.D.N.Y. 2007) ; *In re Levi Strauss & Co. Sec. Litig.*, 527 F. Supp. 2d 965,980-83 (N.D. Cal. 2007) .

(n28)Footnote 28. *Steed Finance LDC v. Nomura Sec. Int'l Inc.*, N. 00 Cir. 8058, 2001 U.S. Dist. LEXIS 14761 (S.D.N.Y. Sept. 20, 2001) , *aff'd*, 148 Fed. Appx. 66 (2nd Cir. 2005) ; *Goodwin Prop., LLC v. Acadia Group, Inc.*, No. 01-49-P-C., 2001 U.S. Dist. LEXIS 9975 (D. Me. July 17, 2001) .

(n29)Footnote 29. *Sloane Overseas Fund Ltd. v. Sapiens Int'l Corp., N.V.*, 941 F.Supp. 1369, 1376-77 (S.D.N.Y. 1996) .

(n30)Footnote 30. *Yung v. Lee*, 432 F.3d 142, 148-49 (2d Cir.) , *aff'd in part*, 160 Fed. Appx. 37 (2d. Cir. 2005) .

(n31)Footnote 31. John C. Cocchiarella & Robert S. Risoleo, *Private Placements, Resales and Rule 144A and Regulation S Offerings*, in Securities Filings 2008, at 717, 808 (PLI Corp. Law and Practice, Course Handbook Series No. 13988, 2008); David A. Lipton, *Broker Dealer Regulation* § 3.53 (West 2007).

(n32)Footnote 32. *Fisk v. Superannuities, Inc.*, 927 F. Supp. 718, 729-31 (S.D.N.Y. 1996) ; *AUSA Life Ins. Co. v. Dwyer.*, 928 F.Supp. 1239, 1259 (S.D.N.Y. 1996) ; *Vannest v. Sage, Ruddy & Co.* , 960 F.Supp 651 (W.D.N.Y. 1997) , *cert. denied*, 8 F. Supp. 2d 243 (W.D.N.Y. 1998) ; *Kainos Labs., Inc. v Beacon Diagnostics, Inc.* , No. C-97-4618, 1998 U.S. Dist. LEXIS 23473 (N.D. Cal Sept. 14, 1998) ; *Pacholder High Yield Fund v. Cucuz*, 271 F. Supp. 2d 1007, 1028-29 (E.D. Mich. 2003) .

(n33)Footnote 33. *Lewis v. Fresne*, 252 F.3d 352, 357-58 (5th Cir. 2001) ; *AIG Global Sec. Lending Corp. v. Banc of America Sec., LLC*, 254 F. Supp. 2d 373, 389 (S.D.N.Y. 2003) ; *ESI Montgomery County*, 899 F.Supp. at 1065; *Premier Capital Mgmt. v. Cohen*, No. 02-C-5368, 2003 U.S. Dist. LEXIS 14137 at *10 (N.D. Ill. Aug. 14, 2003) ; *Newby v. Enron Corp.*, 310 F. Supp. 2d 819, 859-66 (S.D. Tex. 2004) ; *West v. Innotrac Corp.*, 463 F. Supp. 2d 1169, 1174-79 (D. Nev. 2006) .

(n34)Footnote 34. *Whirlpool Fin. Corp. v. GN Holdings., Inc.*, 67 F.3d 605, 609 fn. 2 (7th Cir. 1995) , *reh'g denied*, 67 F.3d 605 (7th Cir. 1995) ; *In re Musicmaker.com Sec. Litig.*, No. CV00-2018 CAS, 20012 U.S. Dist. LEXIS 25118 (C.D. Cal. June 4, 2001) ; *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.*, 165 F. Supp. 2d 615, 622 (S.D.N.Y. 2001) ; *Walltree Ltd. v. ING Furman Selz LLC*, 97 F. Supp. 2d 464, 470 (S.D.N.Y. 2000) ; *Liberty Ridge LLC v. Realtech Sys. Corp.*, 173 F. Supp. 2d 129, 135 (S.D.N.Y. 2001) ; *In re Worldcom, Inc. Sec. Litig.*, 294 F. Supp. 2d at 453-56 , *vacated and remanded on other grounds in In re Worldcom Sec. Lit.*, 496 F.3d 245 (2d. Cir. 2007)

; *Faye L. Roth Revocable Trust v. UBS Painewebber, Inc.*, 323 F. Supp. 2d 1279, 1288-95 (S.D. Fla. 2004) .

(n35)Footnote 35. J. William Hicks, *Scope: Gustafson v. Alloyd --Open Questions*, 7B Exempted Trans. Under Securities Act of 1933 § 16.70 (West 2008). See also Edmund W. Kitch, *Gustafson v. Alloyd Co.: An Opinion That Did Not Write*, 1995 Sup. Ct. Rev. 99, 121-24 (1995); Laura K. Bancroft, *Gustafson v. Alloyd Co.: The Continued Shrinking of Private Plaintiff Remedies Under the 1933 Securities Act*, 27 Loy. U. Chi. L.J. 149, 178-89 (1995); Brian E. Burns, *Red Means Green: The Disruption of the Statutory Construction process in Gustafson to Harmonize Section 12(2) and Rule 10b-5 Private Liability Actions Under the Federal Securities Laws*, 57 Ohio St.L.J. 1365, 1389-98 (1996). J. Dormer Stephen, III, *Gustafson: One Small Step (Backward) for Private Plaintiffs, One Giant Step (Backward) for the Securities Bar*, 49 Okla. L. Rev. 425, 454 (1996); Krista R. Bowen, *A Cloudy Prospectus: The Supreme Court's Problematic Reasoning in Gustafson v. Alloyd Co.*, 53 Wash. & Lee L. Rev. 1041, 1086-98 (1996); Kimberly D. Krawiec, *Gustafson v. Alloyd Co.: The Wrong Decision, But It Is Still Business as Usual in the Securities Markets*, 31 Tulsa L.J. 509, 514-17 (1996); Peter V. Letsou, *The Scope of Section 12(2) of the Securities Act of 1933: A Legal and Economic Analysis*, 45 Emory L.J. 95, 124-33 (1996); Natasha S. Guinan, *Nearly a Decade Later: Resiviting Gustafson and the Status of Section 12(a)(2) Liability in the Courts - Creative Judicial Developments and a Proposal for Reform*, 72 Fordham L.Rev. 1053, 1067-71 (2004); David B. Gail, *Uncertain Future: Liability Concerns Surrounding the Application of Section 12(a)(2) of the Securities Act of 1933 to Free Writing Prospectuses After the Enactment of the SEC's Recently Reformed Offering Rules*, 60 SMU L. Rev. 609, 629-30 (2007).

(n36)Footnote 36. David A. Lipton, *Broker Dealer Regulation* § 3.53 (West 2007).

* This chapter was prepared by partners in the Broker-Dealer Group of Wilmer Cutler Pickering Hale and Dorr LLP ("WilmerHale"). This chapter is for general information purposes only and does not represent WilmerHale's legal advice as to any particular set of facts, nor does this chapter represent any undertaking to keep recipients advised as to all relevant legal developments. Unless indicated otherwise, the information contained in this chapter is current as of June 2008. Portions of this chapter have appeared previously in various WilmerHale outlines and presentations.



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Federal Securities Exchange Act of 1934

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CHAPTER 5C Broker-Dealers' Liabilities Under the Securities Exchange Act *

1-5C Federal Securities Exchange Act of 1934 § 5C.08

§ 5C.08 Information Barriers: An Important Defense

Effective information barriers, or "Chinese Walls," can provide an affirmative defense to certain private claims under the Exchange Act--most notably, those involving insider trading. Information barriers generally consist of policies, procedures and controls designed to restrict and monitor the flow of, and access to, information. In the last two decades, Congress, the SEC, and the SROs have encouraged, and even mandated, the use of information barriers within multiservice broker-dealer firms to prevent the misuse of material nonpublic information and to manage potential conflicts of interests. In light of the potential importance of information barriers as a defense to certain of the private claims discussed in this chapter, this section highlights some of the guidance regulators have provided with respect to information barriers, as well as their potential impact on private claims against broker-dealers under the Exchange Act.

[1] Information Barriers in the Context of Insider Trading

In 1984, Congress passed the Insider Trading Sanctions Act ("ITSA"), which sought to give the SEC more power to combat insider trading. n1 The legislative history of the ITSA reveals strong support for the idea that effective information barriers can provide a defense to alleged insider trading violations. The then-Chairman of the SEC stated in a letter to Congress that, "[I]t is ... important to recognize that, under both existing law and the bill, a multiservice firm with an effective Chinese wall [or information barrier] would not be liable for trades effected on one side of the wall, notwithstanding inside information possessed by firm employees on the other side." n2

In 1988, amid several insider trading scandals, Congress passed the Insider Trading and Securities Fraud Enforcement Act ("ITSFEA"), n3 creating Section 15(f) of the Exchange Act which imposed an affirmative duty on broker-dealers to "establish, maintain and enforce written policies and procedures reasonably designed ... to prevent the misuse ... of material, nonpublic information." n4 Section 15(f) requires broker-dealers not only to implement information barriers to prevent the misuse of material, nonpublic information, but also to regularly review and to vigorously enforce the barriers.

Although the ITSFEA does not expressly outline the types of procedures necessary to avoid liability, the House Committee report cited some examples, including: restraining access to files likely to contain material, nonpublic information; providing continuing education programs concerning insider trading regulations; restricting or monitoring trading in securities about which firm employees possess material, nonpublic information; and diligently monitoring trading for firm or individual accounts. n5

The ITSFEA gave the SEC broad authority to adopt rules "reasonably designed to prevent" misuse of information by requiring specific policies and procedures to be adopted by broker-dealers and investment advisers. It also expanded the enforcement power of the SEC by allowing it to seek sanctions against firms who fail to have adequate policies and procedures in place, even if no actual trading violations occur.

[2] Specific Provisions Providing Defenses

[a] Section 21A

ITSFEA amended the Exchange Act to expand the scope of civil penalties and to create a new ground for liability for "controlling persons" who fail to take adequate steps to prevent insider trading. See *15 U.S.C. § 78u-1(a)(1)(B)* (Exchange Act Section 21A(a)(1)(B)). Significantly, however, this expansion of "controlling person" liability was accompanied by a specific Chinese Wall defense:

Limitations on Liability ... Liability of controlling persons. No controlling person shall be subject to a penalty under subsection (a)(1)(B) of this section unless the Commission establishes that ... such controlling person knowingly or recklessly failed to establish, maintain, or enforce any policy or procedure required under section 78o(f) [15(f)] ... and such failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation.

15 U.S.C. § 78u-1(b)(1)(B) (Exchange Act Section 21A(b)(1)(B)). While this defense relates only to controlling person liability for insider trading, it is nonetheless noteworthy for providing an explicit Chinese Wall defense.

[b] Rule 10b5-1

Rule 10b5-1, promulgated in 2000, provides affirmative defenses to violations of *Rule 10b-5*, including a provision that a broker-dealer or other entity may "demonstrate that a purchase or sale of securities is not 'on the basis of' material nonpublic information" if the person making the investment decision was not aware of the information and the broker-dealer or other entity had implemented reasonable policies and procedures to ensure that investment decisions would not be based on such information. n6 In the release accompanying the rule, the SEC noted that a broker-dealer could reduce the risk that the person making the investment decision, such as a trading desk employee, would be aware of material, nonpublic information by "segregat[ing] its personnel and otherwise us[ing] information barriers so that the trader for the firm's proprietary account is not made aware of the material nonpublic information." n7

[c] Tender Offers: Rule 14e-3 and 14e-5

To the extent that Section 14(e) of the Exchange Act may provide a private right of action, the rules under that section also recognize a defense where an effective information barrier exists. n8 Rule 14e-3, promulgated under the Exchange Act by the SEC, prohibits any person from trading on the basis of material, nonpublic information with respect to tender offers. The rule expressly includes a defense for employees of a broker-dealer or other entity so long as those employees are walled off behind an effective information barrier. n9 For the defense to apply, the person making the investment decision must not have known the material, nonpublic information and the broker-dealer must have implemented "one or a combination of policies and procedures, reasonable under the circumstances" to prevent violations of the rule. n10 In the adopting release for Rule 14e-3, the SEC indicated that reasonable procedures may include, but are not limited to, those that restrict the purchase or sale of the security, such as the use of restricted and watch lists, or those that prevent an individual from knowing the material, nonpublic information, such as the implementation of an information barrier. n11

Rule 14e-5 prohibits fraudulent, deceptive or manipulative acts in connection with tender offers for equity securities. n12 Specifically, the rule states that "no covered person n13 may directly or indirectly purchase or arrange to purchase

any subject securities or any related securities except as part of the tender offer." n14 The rule, however, contains an exception for purchases or arrangements to purchase by an affiliate of the dealer-manager as long as certain information barriers are implemented and enforced between the affiliate and the dealer-manager n15

[3] Minimum Elements Required for Information Barriers

Multiservice firms establish information barriers to restrict the flow of material, nonpublic information between employees who regularly acquire or develop such information, such as investment bankers, and employees who buy, sell, or recommend the securities to which the information relates. Although firms must tailor their information barriers to address the specific nature of their businesses, the SEC and the SROs have set forth certain minimum elements necessary to create an effective information barrier.

[a] SEC Regulation

Following the passage of ITSFEA, the SEC's Division of Market Regulation published a report of its review and analysis of broker-dealers' information barrier policies and procedures. n16 Throughout its report, the Division emphasized the importance of a firm's compliance department to the proper functioning of the firm's information barrier, and it outlined the following minimum elements for an adequate information barrier:

- Substantial control, preferably via a compliance department, of relevant interdepartmental communications;
- Reviews of employee trading through the effective use of some combination of watch, restricted and rumor lists;
- Adequate memorialization of information barrier procedures and documentation of all actions taken pursuant to those procedures; and
- Heightened reviews of or restrictions on proprietary trading while the firm is in possession of material, nonpublic information.

[b] SRO Regulation

In June 1991, the NASD and the NYSE issued a Joint Memo on Chinese Wall Policies and Procedures, setting forth the minimum elements necessary to formulate an adequate information barrier. n17 While reiterating that information barriers may vary from firm to firm, the SROs, following guidance from the SEC's 1990 report, set forth the following minimum requirements:

- Information barrier policies and procedures must be "formalized, organized and incorporated within a firm's procedural/policy manuals." Such documentation must be sufficient to allow the recreation of actions taken pursuant to the information barrier procedures, including documentation of policies, analyses and investigations.
- Firms that conduct both investment banking and research or arbitrage activities must maintain some combination of restricted and watch lists and must conduct reviews of proprietary and employee trading in securities appearing on the lists. The SROs set forth specific minimum documentation standards concerning such lists.
- All firms must investigate possible misuses of material, nonpublic information, including any transactions in restricted or watch list securities. In addition, each investigation initiated must be properly

documented.

- Information barriers must include policies and procedures designed to restrict material, nonpublic information only to employees who have a "need to know." These procedures include: policy statements, restrictions on access to records and support systems for sensitive departments, and supervision of all interdepartmental communications ("wall-crossing") involving material, nonpublic information.
- Information barriers must include physical separation of the trading and sales departments from departments that regularly receive confidential information.
- Every firm must establish and maintain adequate training and education programs regarding material, nonpublic information.
- Every firm must require each employee to sign an attestation of his or her knowledge of the insider trading rules and regulations at least once during the course of employment.

Several SROs rules also specifically provide for the use of information barriers to manage potential conflicts of interest in connection with proprietary trading activities. n18

[4] Information Barriers in the Context of Conflicts of Interest

Regulators have also endorsed the use of information barriers to address conflicts of interest. In 1988, the SEC spoke on this issue when a regulated entity was sued for non-disclosure of material nonpublic information when acting in two capacities on the same transaction. In a letter response to the court's request for comment, the SEC's General Counsel acknowledged that the firm had a conflict of interest. n19 He opined, however, that "violations of the federal securities laws stemming from these conflicts can be avoided through the use of well-established preventive policies and procedures, such as Chinese Walls, restricted lists and watch lists." n20

In recent years, concerns about research analysts' activities and perceived conflicts of interest between a firm's investment banking and research activities have prompted action by Congress, the SEC, the SROs, the states, other jurisdictions, and the industry itself. Among the many new research-related requirements are those imposing information barriers and restricting interaction between investment bankers and research analysts. While these requirements do not specifically provide for or relate to potential private claims, they may be relevant to a private claim, particularly an allegation of a misleading recommendation n21

[a] Global Research Analyst Settlements

In April 2003, the SEC and SROs, along with state regulators, announced a global settlement of enforcement actions against ten firms to resolve conflict of interest issues relating to equity research analysts ("Global Research Settlement"). The SEC and SROs alleged that the firms "created or maintained inappropriate influence by investment banking over research analysts, thereby imposing conflicts of interest on research analysts that the firms failed to manage in an adequate or appropriate manner." n22 As part of the Global Research Settlement, the firms agreed to an extensive set of undertakings that impose detailed changes on the firms' equity research and investment banking activities. n23 While the Global Research Settlement is a court-issued injunction and therefore applies only to the settling firms, state regulators and other third parties have looked to its terms to define a set of "best practices" to supplement the SRO Rules. n24

The major provisions regarding structural and organizational separation between investment banking and equity research cover various aspects of the two businesses including the following: n25

- Separate reporting lines for equity research and investment banking within the firm;
- Physical separation between equity research and investment banking;
- Separate dedicated legal/compliance staff;
- Determination of the research budget, research analyst compensation, and research analyst evaluations without input from investment bankers;
- Restrictions on communications between investment bankers and research analysts; and
- Restrictions on research analysts' participation in investment banking activities.

[b] Section 15D of the Exchange Act and SRO Rules

In an effort to "foster greater public confidence in securities research and to protect the objectivity and independence of securities analysts," Congress passed the Sarbanes-Oxley Act, which added a new section 15D to the Exchange Act. n26 Without specifically imposing an "information barrier" requirement on broker-dealers, section 15D requires the SEC and SROs to adopt rules designed to "establish structural and institutional safeguards within registered brokers or dealers to assure that securities analysts are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision." n27

Both before and after the passage of section 15D, the SROs adopted new rules to address equity research analyst conflicts of interest. NASD Rule 2711 and NYSE Rule 472 address an extensive set of equity research analyst and research report issues, including information barriers between research analysts and investment bankers. These rules impose requirements similar to those set forth in the Global Research Settlement.

[5] Effectiveness in Litigation

Information barriers have become an important part of multiservice broker-dealers' internal policies and procedures. However, the effectiveness of information barriers as a defense against private claims is largely untested. There is a surprisingly small number of cases that address the issue of the conflicting duties of a multiservice financial firm and whether an effective Chinese Wall policy would provide a defense against a claim that such duties had been breached.

Arguably, the strongest case for the effectiveness of a Chinese Wall defense is *Connell v. Chase Manhattan Bank National Association*, a state law breach of duty case that predates ITSA and ITSFEA. n28 In *Connell*, a pension fund alleged that it purchased stock in a company based on Chase's positive recommendation even though, at the same time, Chase's investment services department was in possession of negative, nonpublic financial information about the company. The Court denied the pension fund's motion for summary judgment, declining to impute one department's knowledge of the issuer to another. The Court found that the "potential for conflict was foreseen and controlled by the regulations of the SEC and the Comptroller of the Currency" and "[t]he establishment of the 'Chinese Wall,' which resulted in a separation of the knowledge of the investment officers from that of the other departments, was the result." n29

The Ninth Circuit's decision in *Cooper v. Pickett* is also helpful. n30 In *Cooper*, plaintiffs alleged that analysts issued false research reports in light of information known by investment bankers. In considering this question, the court quoted Section 15(f) and then stated: "If [defendants] have established [Chinese Wall] policies and followed them in this case, *they may raise that as a defense*." n31 The court went on to state that there was a question of fact whether such a wall was effective: "The existence of such policies does not, however, preclude plaintiffs from asserting in their

complaint that inside information was misused." n32

In *Nelson v. Craig-Hallum, Inc.*, investors alleged that Craig-Hallum violated Section 10(b) of the Exchange Act and *Rule 10b-5* when it issued misleading statements and recommendations in various research reports regarding one of its investment banking clients at the same time that its investment banking department had material, nonpublic financial information about the client. n33 Although Craig-Hallum moved to dismiss the claim based on its unwritten Chinese Wall procedure that precluded its investment banking division from sharing the information with its research department, the Court refused to dismiss because a material factual dispute existed as to whether the Chinese Wall procedure was followed. The Court raised the question of whether an unwritten Chinese Wall procedure could be a complete defense, and whether it should have been reinforced through the use of a restricted list. n34

Finally, in *Cotton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, investors alleged that Merrill Lynch violated *Rule 10b-5* when its investment banking division failed to share nonpublic information about an impending merger with the firm's brokerage customers. n35 While the magistrate judge's analysis did not use the vocabulary of the "Chinese Wall," the judge reasoned that the multiservice financial firm was caught in a situation of dual loyalty, *i.e.*, an obligation to its investment banking client to keep confidential information secret and to its retail customers to reveal all it knew. In balancing these two demands, the magistrate judge concluded that plaintiffs had failed to show that Merrill had any duty to tell the confidential information to its retail clients. n36 *Cotton* has been interpreted by some commentators as implicitly endorsing the Chinese Wall defense. n37

FOOTNOTES:

(n1)Footnote 1. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264 (1984).

(n2)Footnote 2. Letter from John S. R. Shad to Rep. Timothy E. Wirth (June 29, 1983), reprinted in H.R. Rep. No. 98-355, at 28 n.52 (1983) (hereinafter 1984 Act Report), reprinted in 1984 U.S.C.C.A.N. 2274, 2301 n.52. This position was reiterated by the House Committee, which stated in its report that, "[T]here should be certain limits on the liability of a multiservice firm ... where one employee possesses information but another employee, not knowing of the information, trades for the firm's account before the information is made public. [S]uch a firm with an effective 'Chinese wall' would not be liable" for such trades. 1984 Act Report at 11, 1984 U.S.C.C.A.N. at 2284.

(n3)Footnote 3. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988).

(n4)Footnote 4. Securities Exchange Act of 1934, 15 U.S.C. § 78o(f) (Section 15(f)).

(n5)Footnote 5. ITSFEA House Report at 22 (1988), *as reprinted in* 1988 U.S.C.C.A.N. 6043, 6059.

(n6)Footnote 6. 17 C.F.R. § 240.10b5-1(c)(2) (2000). For detailed discussion of *Rule 10b-5*, see Chapter 5, *supra*.

(n7)Footnote 7. *Selective Disclosure and Insider Trading*, Exchange Act Release No. 43,154, 65 Fed. Reg. 51,716, 51,729 n.125, (Aug. 24, 2000) .

(n8)Footnote 8. For a discussion of the unresolved issue of whether there is an implied right of action under Section 14(e), see § Chapter 5 section on 14(e), *supra*.

See also § 5C.06[4] , (discussing potential liability under Section 14(e) in connection with fairness opinions).

(n9)Footnote 9. 17 C.F.R. § 240.14e-3(b) (1980).

(n10)Footnote 10. *Id.*

(n11)Footnote 11. Tender Offers, Exchange Act Release No. 17,120 (Sept. 4, 1980), 45 Fed. Reg. 60,410, 60,415

(Sept. 12, 1980) .

(n12)Footnote 12. 17 C.F.R. § 240.14e-5 (1999).

(n13)Footnote 13. The term "covered person" includes the offeror and its affiliates, the dealer-manager and its affiliates, any adviser to the offeror or dealer-manager whose compensation is dependent on completion of the tender offer, and any person acting, directly or indirectly, in concert with any of the persons specified above. *Id.* § 240.14e-5(c)(3).

(n14)Footnote 14. *Id.* § 240.14e-5(a).

(n15)Footnote 15. *Id.* § 240.14e-5(b)(8).

(n16)Footnote 16. Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Non-Public Information, Fed. Sec. L. Rep. (CCH) P 84,520 (Mar. 1, 1990). *See also* Broker-Dealer Internal Control Procedures for High Yield Securities, Fed. Sec. L. Rep. (CCH) P 85,251 (Jan. 01, 1993) (reporting on a follow-up review of information barriers relating to non-investment grade securities). Although the ITSFEA explicitly granted the SEC broad powers to mandate specific policies to be adopted by broker-dealers, the SEC determined that the SROs are best equipped to test the adequacy of current broker-dealer policies and procedures and to formulate any required improvements or modifications.

(n17)Footnote 17. NASD/NYSE Joint Memo on Chinese Wall Policies and Procedures, NASD Notice to Members 91-45 (June 21, 1991), NYSE Information Memo 91-22 (June 28, 1991).

(n18)Footnote 18. *See* § 5C.05[2], *supra*, for a discussion of SRO rules regarding trading ahead of customer orders. *See also* NYSE Rule 98 (providing an exemption from certain restriction for approved persons associated with specialist organizations, if the organization implements an "organizational separation" that has been approved by the NYSE).

(n19)Footnote 19. *Koppers Co. v. Am. Express Co.*, 689 F. Supp. 1408, 1413 (W.D. Pa. 1988) (order) (attaching letter as App. A); *see also* 689 F. Supp. 1371 (opinion).

(n20)Footnote 20. *Id.* at 1416.

(n21)Footnote 21. *See* § 5C.02[2], *supra*, (describing private 10b-5 claims against broker-dealers for misleading recommendations).

(n22)Footnote 22. *SEC v. Bear, Stearns & Co.*, *Litigation Release No. 18438*, 2003 SEC LEXIS 2601 (Oct. 31, 2003) .

(n23)Footnote 23. The undertakings are set forth in Addendum A to their respective final judgments, which were entered in October 2003. Addendum A is available at www.sec.gov/spotlight/globalsettlement.htm. *See also* Joint Press Release, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), *available at* www.sec.gov/news/press/2003-54.htm.

(n24)Footnote 24. *See, e.g.*, News Release, Treasurer Angelides Announces Tough New Requirements for Investment Banks That Do Business With State of California (May 8, 2003), *available at* www.treasurer.ca.gov/news/releases/2003/20030508ips.pdf.

(n25)Footnote 25. *See* Addendum A.

(n26)Footnote 26. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 501(a), 116 Stat. 745 (*codified at* 15 U.S.C. § 78o-6).

(n27)Footnote 27. *Id.* § 78o-6(a)(3).

(n28)Footnote 28. 1981 N.Y. Misc. LEXIS 3519 (N.Y. Sup. Ct. Jan. 5, 1981) .

(n29)Footnote 29. *Id.* at *4-*5 .

(n30)Footnote 30. 137 F.3d 616 (9th Cir. 1998) .

(n31)Footnote 31. *Id.* at 628-29 (emphasis added).

(n32)Footnote 32. *Id.* at 629 .

(n33)Footnote 33. Fed. Sec. L. Rep. P 94,500 (D. Minn. June 26, 1989).

(n34)Footnote 34. Note that in *In re Federated Department Stores, Inc., 1991 Bankr. LEXIS 288 at *3 (Bankr. S.D. Ohio. 1991)* , the Bankruptcy Court ruled that Fidelity Management & Research Company would not be violating its duties as an Official Bondholders' Committee member by trading in the securities of the debtors and a non-debtor while the proceeding was pending if it adopted Chinese Wall procedures, among other things, to block its traders from misusing any material, nonpublic information in its possession.

(n35)Footnote 35. 699 F. Supp. 251 (N.D. Okla. 1988) . In addition to acting as an investment banking advisor to a merger, Merrill had also, acting as a broker, executed a sale of the plaintiffs' stock in one company just before the company merged with another (and, after the merger, the price of the stock surged). The plaintiffs alleged that since Merrill was aware of the pending merger, it had a fiduciary duty to pass this information on to its brokerage customers.

(n36)Footnote 36. *Id.* at 256 .

(n37)Footnote 37. *But see* Slade v. Shearson, Hammill & Co., No. 72-Civ. 4779 (RC), 1974 U.S. Dist. LEXIS 13000 (S.D.N.Y. Jan. 2, 1974) (remanding for resolution of factual issues and declining to answer the question of whether a broker-dealer with an information barrier between its retail sales and investment banking departments may solicit transactions in securities with respect to which its investment banking department has material, negative, nonpublic information). The district court had denied the defendants' motion for partial summary judgment and certified the question to the appellate court. Several factors suggest, however, that courts and regulators would not follow *Slade* because it predates Congressional and regulatory endorsement of the use of Chinese Wall procedures to address conflicts of interest at multi-service financial institutions.

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Federal Securities Exchange Act of 1934

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CHAPTER 5C Broker-Dealers' Liabilities Under the Securities Exchange Act *

1-5C Federal Securities Exchange Act of 1934 § 5C.09

§ 5C.09 Voidness Under Section 29(b)

Section 29(b) provides generally that any contract made in violation of the Exchange Act or any rule or regulation thereunder, as well as any contract whose performance would involve such a violation, is voidable (at the option of the innocent party) against (1) any person who has made or engaged in the performance of the contract and (2) any person, not a party to the contract, who acquires any right under the contract with actual knowledge of the facts resulting in the violation. n1 In order to void a contract under Section 29(b), a plaintiff must show (1) that the contract was illegal or involved a prohibited transaction, (2) that the plaintiff is in contractual privity with the defendant, and (3) that the plaintiff is within the "class of persons the [Exchange] Act was designed to protect." n2 For an agreement to be declared void under Section 29(b) it must be incapable of being performed without violating the securities laws, not merely tangential to a violation of those laws. n3

The distinctive danger that Section 29(b) poses for broker-dealers is that if an entity whose business requires it to register as a broker-dealer under Section 15 fails to do so, every contract it enters into in the course of that business may be voidable at the option of the other party. n4 Section 15 of the Exchange Act requires any non-exempt person who acts as a "broker" or "dealer" to register with the SEC. n5 No properly advised company will make the mistake of failing to register before engaging in traditional broker-dealer activities like acting as a broker or market maker in stocks and bonds. However, the evolution of new markets and new ways of doing business can create traps for the unwary. n6

For example, questions have arisen concerning whether an operator of a website designed to facilitate communications among registered broker-dealers, between registered broker-dealers and their customers, or otherwise between buyers and sellers of securities, is itself required to register as a broker-dealer. In responses to requests for no-action letters, the SEC staff has provided some guidance concerning the limits with which a website's operations must comply to avoid the need for registration, and has concluded in several cases that the operator of such a website would be required to register. n7 This raises the possibility that transactions effected through an unregistered website might be voidable under Section 29(b).

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 78cc(b). Section 29(b) also is discussed in *Section 5.03[2][c] supra*. Although the statute uses the word "void," the courts read Section 29(b) to render a contract "merely voidable at the option of the innocent party." See, e.g., *Berkeley Inv. Group, Ltd. v. Colkitt*, 455 F.3d 195, 205 (3d Cir. 2006) (quoting *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 387-88 (1970)).

(n2)Footnote 2. See *Regional Props., Inc. v. Fin. Real Estate Consulting Co.*, 678 F.2d 552, 559 (5th Cir. 1982) (quoting *Eastside Church of Christ v. Nat'l Plan, Inc.*, 391 F.2d 357, 362 (5th Cir. 1968)) .

(n3)Footnote 3. See, e.g., *Berkeley Inv. Group*, 455 F.3d at 206-07 (contract requiring seller of convertible debentures to convert them into unregistered shares of stock was not subject to rescission based on allegation that buyer's downstream securities transactions would violate securities laws).

(n4)Footnote 4. See *Lawrence v. Richman Group of Conn., LLC*, 407 F. Supp. 2d 385, 389 (D. Conn. 2005) , aff'd, 2006 U.S. App. LEXIS 25613 (2d. Cir. 2006) (stockbroker could not sue syndicator for breach of mutual exclusivity marketing contract because syndicator was not a properly registered securities broker or dealer and therefore marketing contract was unenforceable under Section 29(b)); *Couldock & Bohan, Inc. v. Societe Generale Secs Corp.*, 93 F. Supp. 2d 220, 232 (D. Conn. 2000) (improperly unregistered broker-dealer could not sue clearing broker for breach of clearing agreement, which was unenforceable under § 29(b)).

(n5)Footnote 5. A "broker" is defined under the Exchange Act as "any person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(a)(4)(A). A "dealer" is defined as "any person engaged in the business of buying and selling securities for such person's own account," but only if the person does so "as a part of a regular business." 15 U.S.C. § 78c(a)(5)(A)-(B). The definition of a dealer would literally apply to an investor who supported himself by investing in the stock market, but the courts typically have distinguished such "traders" from dealers, whose characteristic attributes include transacting with a regular clientele, transacting in substantial part directly with investors rather than with other dealers or through exchange members, and holding themselves out to the public as being engaged in dealer activities. See Louis Loss & Joel Seligman, *Fundamentals of Securities Regulation* 812-15 (5th ed. 2004). Banks are excluded from the definitions of "broker" and "dealer" if they only engage in certain enumerated securities-related activities. See 15 U.S.C. §§ 78c(a)(4)(B)-(D), 78c(a)(5)(C); *Definitions of Terms and Exemptions Relating to the "Broker" Exceptions for Banks*, Exchange Act Release No. 56501, 72 Fed. Reg. 56,514 (Oct. 3, 2007) . In addition, a contract with a bank that has failed to register properly as a broker under the Exchange Act is not void or voidable under Section 29(b) when the bank acted in good faith, had reasonable policies and procedures in effect to comply with registration requirements and the violation did not cause significant harm, financial loss or cost to the person seeking to void the contract. Exchange Act Release No. 56501, 72 Fed. Reg. at 56,546.

(n6)Footnote 6. A firm that is unsure whether it must register may request an informal administrative interpretation from the SEC staff. 17 C.F.R. § 202.2.

(n7)Footnote 7. See, e.g., *Swiss American Securities, Inc.*, SEC No-Action Letter, 2002 SEC No-Act. LEXIS 597 (June 4, 2002); *BondGlobe, Inc.*, SEC No-Action Letter, 2001 SEC No-Act. LEXIS 140 (Feb. 6, 2001); *MuniAuction, Inc.*, SEC No-Action Letter, 2000 SEC No-Act. LEXIS 359 (Mar. 13, 2000); *Charles Schwab & Co.*, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 976 (Nov. 27, 1996).

* This chapter was prepared by partners in the Broker-Dealer Group of Wilmer Cutler Pickering Hale and Dorr LLP ("WilmerHale"). This chapter is for general information purposes only and does not represent WilmerHale's legal advice as to any particular set of facts, nor does this chapter represent any undertaking to keep recipients advised as to all relevant legal developments. Unless indicated otherwise, the information contained in this chapter is current as of June 2008. Portions of this chapter have appeared previously in various WilmerHale outlines and presentations.



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CHAPTER SA-6 Special Update to Chapter 6 -- Market Manipulation *

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CHAPTER SA-6 Special Update to Chapter 6 -- Market Manipulation *

2- Federal Securities Exchange Act of 1934

Regulators, legislators and the media continue to focus on the issue of market manipulation. This Special Update highlights some of the recent developments in the law of market manipulation under the Federal Securities Exchange Act of 1934, which will be addressed in the next update of the Chapter.

Following rapid and dramatic fluctuations in the equity markets, and the sale of Bear Stearns and the failure of Lehman Brothers, regulators launched a number of investigations into possible market manipulation. and @_)_and_footnotes(n2);.vk n1 A particular focus of these investigations is whether short sellers spread false rumors about certain issuers to drive down the price of those issuers' securities. Although the regulators have announced no charges arising out of these investigations, they have continued to seek additional information from market participants and have served additional "waves" of subpoenas in connection with these investigations.

The market fluctuations of 2008 also lead to a series of rules and regulations imposing unprecedented limitations on short selling. The SEC adopted a new anti-fraud rule expressly aimed at abusive short selling, and eliminated the market-maker exception to Regulation SHO. and @_)_and_footnotes(n3);.vk n2 For a period of twenty days in September-October 2008, the SEC imposed an outright ban on short selling the securities of 799 specified financial firms. and @_)_and_footnotes(n4);.vk n3 A temporary rule was adopted in late 2008 imposing a hard "T+3 close out requirement," mandating that short sellers and their broker-dealers deliver securities and close out the short sale transaction by the close of business on the settlement date, three days after the transaction date. and @_)_and_footnotes(n5);.vk n4 The SEC adopted as a final rule the hard "T+3 close out requirement" on July 27, 2009 and @_)_and_footnotes(n6);.vk n5. Also in late 2008, the SEC adopted a temporary rule requiring that institutional investment managers who manage accounts with an aggregate value of \$100 million per year file a "Form SH" report on a weekly basis reporting to the SEC on short sale activity and positions. and @_)_and_footnotes(n7);.vk n6 Although the rule expired on August 1, 2009, without being renewed or extended, the SEC identified new efforts underway to "substantially increase the public availability of short sale-related information" including by increased reporting by the self-regulatory organizations. and @_)_and_footnotes(n8);.vk n7 Three specific initiatives identified by the SEC are:

- Daily publication by the SRO's of aggregate short-selling volume in individual equities;
- Publication by the SRO's of individual short sale transactions on a one-month delayed basis; and

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- Publication by the SEC on a twice monthly basis of data on "fails to deliver."

The SEC also announced it will host a roundtable on September 30, 2009, to further consider disclosure of individual short sale positions, as well as issues related to securities lending and pre-borrowing.
n8

One area of particular media attention has been the "uptick" rule. Prior to June 2007, Rule 10a-1 imposed a "price test" on short selling.
n9 In a declining market, no short sale could be executed at a price at or below the last reported sale. Following the market fluctuations of 2008, there have been repeated cries in the media, and by some legislators, for reinstatement of the uptick rule.
n10 Indeed, certain legislators wrote to SEC Chair Schapiro to communicate that if the SEC does not regulate in this area then legislation will be enacted to address the perceived short sale abuses.
n11

On April 10, 2009, the SEC published a release seeking comment on two alternatives for reinstating short sale price restrictions, and three versions of a possible "circuit breaker" rule which would impose restrictions only upon a significant intra-day price decline in a stock and only for the impacted stock.
n12

- The "Modified Uptick Rule" would limit short selling to the price above the current bid in a declining market, and at or above the current bid in a rising market. While the former uptick rule focused on the last reported *sale* price, the Modified Uptick looks at the current national best bid ("NBB"). If the last differently priced NBB was higher than the current NBB--in other words, if the market is declining--then short sale orders could only be displayed or executed if they are higher than the current NBB. If the market is rising, then short sale orders could be displayed or executed if they are equal to the current NBB.

- The "Uptick Rule" would reinstate former SEC Rule 10a-1. In a declining market, short sales would be limited to a price above the last reported sale. In a rising market, short sales would be limited to a price at or above the last reported sale.

- The "Circuit Breaker Halt Rule" would be triggered by a 10% or more decrease in the price of a covered security from the price of the previous day's last reported trade, and would prohibit selling short the covered security for the remainder of the trading day.

- The "Circuit Breaker Modified Uptick Rule" also would be triggered by a 10% or more decrease in the price of a covered security from the price of the previous day's last reported trade, and would require adherence to the "Modified Uptick Rule" for that covered security for the remainder of the trading day.

- The "Circuit Breaker Uptick Rule" also would be triggered by a 10% or more decrease in the price of a covered security from the price of the previous day's last reported trade, and would require adherence to the "Uptick Rule" for that covered security for the remainder of the trading day.

In addition to the range of possible rules described above, the SEC noted the range of possible exemptions to apply to any such rule. The SEC also sought comment with respect to derivative transactions, noting that such transactions would not be subject to the proposed rules. To discuss the proposed rules and exemptions, the SEC held a "Roundtable to Examine Short Sale Price Test and Circuit Breaker Restrictions" on May 5, 2009, involving academics, broker-dealers, public companies, hedge funds and self-regulatory organizations. Comments on the proposed rules were due on June 19, 2009, and the SEC received almost 4,000 unique comment letters.

The SEC announced on August 17, 2009, that it was re-opening the comment period with respect to the proposals, and

highlighted a possible "Alternative Uptick Rule." _and_@_)_and_footnotes(n14);vk n13 Under this rule, short selling would only be allowed at a price above the current national best bid. The Alternative Uptick Rule would not allow short sales to get immediate execution, and therefore would impose a greater restriction on short selling than the prior proposals. The SEC acknowledged that under the Alternative Uptick Rule, the benefits of short selling--market liquidity and pricing efficiency--might be reduced. _and_@_)_and_footnotes(n15);vk n14 The SEC has sought comment on the proposed "Alternative Uptick Rule" by September 21, 2009, and can be expected to adopt some version of an uptick rule and/or circuit breaker test sometime thereafter.

The Chapter on Market Manipulation will be updated over the coming months to address all of these developments in detail, in addition to other developments with respect to market manipulation.

FOOTNOTES:

(n2)Footnote 1. SEC Press Release July 13, 2008, "Securities Regulators to Examine Industry Controls Against Manipulation of Securities Prices Through Intentionally Spreading False Information"; *see also* David Scheer, *SEC Subpoenas Wall Street in Hunt for 'Manipulators'*, BLOOMBERG.COM, July 16, 2008.

(n3)Footnote 2. *See* 73 Fed. Reg. at 61,678 .

(n4)Footnote 3. *See* Louise Story, *A Debate as a Ban on Short-Selling Ends: Did It Make Any Difference?*, N.Y. TIMES, Oct. 7, 2008.

(n5)Footnote 4. *See* 73 Fed. Reg. at 61,706 .

(n6)Footnote 5. Release 34-60388 "Rule 204 -- Amendments to Regulation SHO."

(n7)Footnote 6. *See* 73 Fed. Reg. at 55,557 .

(n8)Footnote 7. SEC Press Release July 27, 2009, "SEC Takes Steps to Curtail Abusive Short Sales and Increase Market Transparency."

(n9)Footnote 8. *Id.*

(n10)Footnote 9. "Amendments to Regulation SHO," SEC Release No. 34-59748 (April 10, 2009).

(n11)Footnote 10. Representative Barney Frank, head of the House Financial Services Committee, was reported to have said "I've spoken with Chair Schapiro of the SEC, and I am hopeful the uptick rule will be reinstated within a month." Frank Ahrens, *Washington Post*, March 10, 2009.

(n12)Footnote 11. Letter to Mary Schapiro dated April 1, 2009, from Senators Chambliss, Isakson, Kaufman, Levin, Specter and Tester, indicating that if the SEC does not demonstrate an unambiguous commitment to ending abusive short selling, then "Congress will need to consider legislation that directs the SEC to do so."

(n13)Footnote 12. "Amendments to Regulation SHO," SEC Release No. 34-59748 (April 10, 2009).

(n14)Footnote 13. Release no. 34-60509 "Amendments to Regulation SHO." 74 Fed. Reg. at 42,033 .

(n15)Footnote 14. *Id.*

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CHAPTER 6 Regulation of Market Manipulation

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FOOTNOTES:

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CHAPTER 6 Regulation of Market Manipulation

2-6 Federal Securities Exchange Act of 1934 § 6.01

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§ 6.01 Introduction

When Congress passed the Securities Exchange Act of 1934 (the "Exchange Act"), it sought to address many of the problems that had contributed to the stock market crash of 1929 by proscribing conduct designed to create fictitious market forces that have an artificial impact on the price of a security. Yet many of the manipulation schemes that existed in 1929 are still a problem today. With advances in technology and the increased popularity of investing in securities, market manipulation has become more widespread than ever before, and the need to address manipulative schemes has become more urgent. In this chapter, we will describe the most common types of manipulation schemes, explain the complex web of rules and regulations governing market manipulation, and discuss contemporary contexts that have made market manipulation such an important issue today.

The Securities and Exchange Commission ("SEC" or "Commission") and self-regulatory organizations ("SROs") have promulgated a wide array of rules and regulations designed to detect and prosecute persons engaged in and profiting from fraudulent practices in the marketplace. These rules and regulations address two types of practices that harm investors--deception and manipulation--both of which were captured in the broad language of Section 10(b) of the Exchange Act, which prohibits "any manipulative or deceptive device or contrivance." n1 Deception generally involves the misrepresentation or omission of a material fact concerning a company, or the improper use of inside information to conduct stock transactions (insider trading). Manipulation generally involves the creation of fictitious market forces for the purpose of artificially impacting the price of a security. There is no neat division between these two categories. For example, in "pump and dump" schemes, stock promoters employ both deception and manipulation by obtaining a significant block of shares in a struggling business, disseminating false information about that stock to create a false picture of buying momentum (and often paying others to recommend the stock), then selling their shares before the stock collapses.

In addition to Section 10(b), which Congress passed to combat fraudulent activities generally, Congress also sought to prohibit manipulative acts on national securities exchanges through Section 9, and to prohibit fraudulent acts by brokers

and dealers in the over-the-counter markets through Section 15(c). Manipulative activities considered to have no redeeming value for the securities market were banned outright. Other activities that were particularly susceptible to manipulation, but perceived as essential to the smooth functioning of the marketplace, were made subject to strict SEC oversight. Thus, for example, the Exchange Act contains provisions that prohibit wash sales and matched orders, which serve no beneficial purpose, while authorizing SEC regulation of transactions designed to stabilize stock prices which, under certain circumstances, may be appropriate, but are prone to abuse.

Market manipulation has proven difficult to police because it continually evolves with developing market trends. In the mid-1980s, enforcement efforts focused on junk bond and other high risk transactions, resulting in a much publicized series of prosecutions against Boyd Jefferies, Ivan Boesky and Michael Milken. In the 1990s, the media for manipulation greatly expanded, as the explosive growth of Internet stock trading was accompanied by widespread dissemination of fraudulent information. At the turn of the twenty-first century, financial fraud cases, such as Enron and WorldCom, involved fraud on a massive scale and attempted to extend primary actor liability to accountants, investment banks, attorneys, and others, who allegedly participated in a scheme to inflate corporate earnings by providing services in connection with complex structured finance transactions and hedging techniques. And in the wake of the 2008-2009 financial crisis that resulted in credit markets seizing up, dramatic falls in the stock market, and the exposing of old fashioned Ponzi schemes on a scale previously unimagined, regulators and courts have found themselves confronted with a wide array of issues relating to market manipulations.

Like the methods of manipulation, the law is always evolving to deal with new cases of market manipulation. As the capital markets continue to evolve, both courts and regulators will be required to apply and adapt the securities laws to new forms of manipulative conduct.

FOOTNOTES:

(n1)Footnote 1. *15 U.S.C.A. § 78j(b) (2004)* (Sec. Ex. Act § 10(b)).



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CHAPTER 6 Regulation of Market Manipulation

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§ 6.02 Common Types of Market Manipulation

There is no shortage of ways to manipulate the securities markets. It is not possible to capture the universe of manipulative devices, and the specific ways in which markets may be manipulated constantly evolves with changes in technology. There are, however, a number of manipulative practices that occur with some degree of regularity. We describe those practices in this section.

[1] Mediums Used to Perpetrate Market Manipulation

The Securities and Exchange Act of 1934 was enacted to respond to manipulative and deceptive practices in the securities market. In the late 1920s and early 1930s, congressional investigations into the securities market exposed an increase in pool operations where investors would fictitiously increase stock prices through a series of well-timed purchases, then unload their holdings on the unsuspecting public before prices dropped. n1

Traditional, non-electronic forms of market manipulation often required a "boiler room" network of promoters and brokers who participated in phone banking and made hundreds of unsolicited calls a day to potential customers. n2 These broker-dealers applied high-pressure tactics, providing inadequate financial information to investors or not cautioning them as to the risk involved in purchasing the stock without such information.

Technologies changed the way that investment information is disseminated and stocks are traded. Now, enormous quantities of financial data, analyses and other information are instantaneously available to millions of people who can quickly trade on that information. Those who seek to manipulate the markets have exploited these developments. n3 An individual stock promoter working from a single computer can create websites and use on-line newsletters, e-mail, blogs, instant messages, and social networking sites to create a false picture of interest in a stock. Because these communications reach a large audience, manipulators can create enormous demand that can dramatically alter stock prices in a short time period. n4 The Internet allows manipulators to retain their anonymity, presenting themselves as

sophisticated stock analysts, or impersonating company officials or famous commentators. n5

While the mediums used to manipulate the market have changed over time, the same general manipulation schemes are consistently perpetrated. These schemes can be broken down into two categories: demand-side and supply-side manipulation.

[2] Demand-Side Manipulation (Purchase of Securities)

Cross Trading and Circular Trading allow brokers to raise stock prices by creating a misleading appearance of increased market activity, or to prevent a decrease in price by keeping sold shares off the market. Cross Trading occurs where a broker arranges for transfers of stock between two customer accounts. n6 Circular trading involves trades that rotate stock through a series of accounts until the initial buyer or seller ends the series as the ultimate seller or buyer respectively. n7 The SEC has enjoined broker-dealers and/or revoked their registrations after reviewing evidence that brokers kept shares off the market by crossing them back and forth between customer accounts or created false market activity by selling shares only to buy them back for the same customers. n8

Domination and Control of Market is a generic term referring to manipulative practices designed to dominate the market in a particular stock and thereby control its price. One of the most common indicia of domination and control is the percentage of transactions in a stock attributable to a particular person or entity. n9 However, domination alone is not unlawful; there must also be proof of manipulation. n10 For example, in *Trane Co. v. O'Connor Securities*, the court denied a corporation's motion to enjoin a securities firm from further trading in the corporation's securities. The court rejected plaintiff's claim that the corporation had dominated and manipulated the sale of plaintiff's stock, reasoning that defendant traded the securities openly and was not involved in any fictitious transactions, and that there was no collapse in the market of that stock once defendant's trading activities subsided. n11 The court concluded that "[i]f what defendants did constituted manipulation within the meaning of [Exchange Act] Section 9(a), most large scale transactions in a single security would be prohibited. That was clearly not the purpose of Congress. It sought to protect the small investor by maintaining a market controlled by natural forces rather than by intervention of artificial manipulative devices which would distort the market to the detriment of the investing public." n12

Courts are more likely to entertain a claim of market manipulation when, in addition to dominating the trading of a particular security, the defendant: kept increasing its bids; n13 was often the highest bidder; n14 could have purchased below the bid price, but instead raised its bid; n15 controlled customer accounts on both the buy-side and the sell-side; n16 or increased its bids even though it could fill buy orders from its inventory. n17

In a recent case regarding manipulation of natural gas futures contracts pricing, a court found that instant messages ("IMs") between two defendants gave rise to a strong inference of scienter to drive up a contract spread price. n18 The defendants argued that the IMs were merely reflections of real-time observations of the market and discussions of how many contracts to purchase and at what price. The court noted that it is difficult to decipher the meanings of IMs because of various abbreviations. However, it was skeptical that instructions, such as "drive out," "push the spread" and "take the spread to certain prices," were merely directions regarding the prices at which trades should be executed. n19

Free Riding occurs when a trader buys securities with the intention of paying only if the stock price rises between the transaction and settlement dates, n20 or buys securities "without sufficient funds to pay for these purchases and then us[es] the proceeds of the sale of that same stock to cover the purchase price." n21 In either case, the purchase order is not a true reflection of market demand for the stock.

Front-Running n22 is "[t]rading a stock, option or future while in possession of non-public information regarding an imminent block transaction that is likely to affect the price of the stock, option or future." n23 One clearly prohibited scenario involves a broker selling or buying stock for its own account before executing its customer's order. In that instance, the broker may receive a more favorable price than its customer, as the broker's transaction may adversely

affect the price of the stock at the time of the customer's transaction. n24

Marking the Close is a means of creating false pressure on the market, in which the manipulator increases or decreases the quoted bid for a security, or purchases or sells stock at or near the close of the market to either increase or decrease the closing price of the security. n25 The closing price is significant because it is the price reported in the press as the final price for that trading session and influences the next day's market. The closing price is also generally used by brokerage firms to set their margin requirements for customers. n26

Painting the Tape is conduct that creates a false picture of increased trading activity through a series of transactions initiated by the manipulator. It refers to a time when stock transactions were recorded on ticker tape and the manipulator created buying activity among nominee accounts at increasingly higher prices, or caused other fictitious transaction reports to appear on the ticker tape. n27 For example, in *Crane Co. v. Westinghouse Air Brake Co.*, American Standard painted the tape in order to defeat the tender offer of its competitor Crane, by driving up the price of Air Brake stock through purchasing a large number of shares on the last day of the tender offer to make Crane's tender offer for Air Brake appear less attractive to Air Brake shareholders, then selling a significant number of shares in private sales to conceal its actions. n28

Parking and Warehousing are often used interchangeably to connote transferring shares to a customer or other broker and holding them there, either to take the shares off the market to reduce supply in order to maintain or raise the stock price, or to conceal the identity of the true owner. Parking often involves the creation of a sham sale where the seller sells stock to a purchaser who holds the stock until it is repurchased at a later date by the seller, with the seller assuming the economic risk. n29 Parking may be used to avoid net capital restrictions by transferring securities outside the brokerage firm, n30 or to raise prices after an initial public offering, by placing stock in nominee accounts and then selling the stock into the market at much higher prices post-initial public offering ("IPO"). n31 It also has been used to hide an underwriter's failure to sell the required number of shares in a "best efforts all or none" offering, by putting stocks in accounts to create a false appearance of sales, with the underwriter eventually repurchasing the stock. n32 The term "warehousing" also is often used in the context of a corporate takeover, where the acquirer purchases more than five percent of the stock of the acquired corporation and keeps the stock with another person or entity to avoid the need to file a schedule 13D, which would alert the target and the market to the buyer's position. n33

Reaching Across the Market entails a broker or dealer "taking out" or purchasing shares at the ask price of other market makers in order to raise the manipulator's bid and inflate the stock price. The manipulator can also sell shares at the bid price of other market makers to depress the stock price. n34

Reducing the Floating Supply n35 is a means of inflating the price of a security by purchasing a sufficient quantity of a company's outstanding shares to place pressure on the buy-side of the market. Manipulators can accomplish this by tying up large blocks of stock, either contractually or by obtaining an option, or refusing to execute customer sell orders. n36

Squeezing the Shorts refers to a variety of techniques designed to drive up stock prices so as to force short sellers to purchase stocks at inflated prices to cover their short sales. Strategies may include calling in shares to force sellers to cover their short positions, n37 or purchasing a large quantity of stock to make fewer shares available to cover short positions. As the stock price rises, those with short positions must post additional margin collateral or buy stock to cover their positions (which further bids up the price of the security). The manipulator then sells the stock at an inflated price to those covering their positions. n38 In *Jeffrey Weissman et al.*, the SEC imposed sanctions against a broker-dealer for manipulating the market through, among other practices, enforcing a no-net-selling policy for Health Professional Inc. ("HPI") stock and asking the clearing agent to call in a large number of HPI shares that had been loaned out, forcing various short sellers to cover their positions. The manipulation resulted in an increase in the stock price of 44% in two and a half weeks. n39

Touting consists of recommending a stock without disclosing the touter's financial interest in the stock. n40 When touting is perpetrated through the Internet, a stock promoter recommends a stock on-line without revealing that he has been compensated for the recommendation. In *Kenneth W. Schilling*, the defendant, president of iBIZ Technology Corp., provided false financial statements to an analyst, and then placed several press releases on the iBIZ website containing hyperlinks to the analyst's report. The release claimed the analyst was independent, when he had been promised company stock in exchange for writing the report. Defendant consented to entry of a permanent injunction against further violations of the antifraud provisions of the federal securities laws, and agreed to pay a civil penalty of \$20,000. n41

In a similar case, defendant James Sheret, Jr. created spam e-mails with a fictitious "AOL Investment Snapshot" banner, recommending stock in fifty-seven thinly traded companies. The e-mails stated that stock prices of the companies had recently increased without disclosing that, in many instances, the price increase was due to Sheret's prior stock purchases. The e-mails spurred wide-scale buying, and Sheret then sold his personal holdings, realizing substantial profits. The SEC filed a complaint charging Sheret with violating Section 10(b) of the Exchange Act. The court entered a permanent injunction and ordered Sheret to disgorge approximately \$378,000 in profits and to pay a civil penalty of \$110,000. The U.S. Attorney for the Southern District of New York also filed a criminal complaint against Sheret, who pled guilty to securities fraud. n42

One of the most consistently sanctioned forms of touting is "scalping," which occurs when a person purchases a security for his own account before recommending that security, then sells the security at a profit upon the rise in the market price following the recommendation. n43 Scalping often occurs when stock manipulators pose as investment advisers on the Internet and simultaneously induce a large number of investors to purchase high risk or otherwise unsuitable stock. n44

Wash Sales and Matched Orders are two of the most common means of creating a false appearance of market activity. n45 A wash sale is a sale of stock where there is no change in beneficial ownership. A matched order entails offsetting orders to buy and sell securities by placing the orders at substantially the same time, for substantially the same price and for substantially the same quantity. n46 For example, in *Edward J. Mawod & Co. v. SEC*, the court affirmed an SEC order revoking the registration of a broker-dealer and its principal for driving up the stock price of a corporation during a three month period from twenty cents to \$10.00 on the basis of trades in which the buyers and sellers were identical, or the buyers and sellers worked together to match trades. As soon as the broker-dealer stopped directing the wash sales and matched orders, the stock price dropped precipitously. n47

[3] Supply-Side Manipulation (Distribution of Securities)

Pump and Dump is a scheme where stock promoters gain a significant block of shares in a struggling business and inflates the stock price to attract investment. When the price reaches a certain level, the promoters sell or dump their shares and the market for that stock collapses. The promoters often pay brokers to recommend the stock. n48

In an Internet "pump and dump" scheme, the manipulator purchases stock, promotes it on-line through false information as to the promoter's investment track record and/or the investment itself, then dumps the stock at a profit before the market correction. In *Jonathan G. Lebed*, a fifteen year old purchased large blocks of micro cap stocks, posted false or misleading messages under multiple fictitious author names, which praised the stock on the Yahoo! Finance message board, then sold the stock as the price rose. n49 Lebed settled with the SEC and disgorged approximately \$273,000 in profits. n50

Yet another scheme attracting media attention involved a false announcement launching "Pinkmonkey," a website service that purportedly could "quickly reach a significant market share" in the study aids market. At the time of the press release, the website already had operated for 14 months, however, and had generated only \$30 in sales. Within one hour of the false release, Pinkmonkey stock climbed from \$1.50 to \$4.375 per share, peaking at \$17 two days later. The

stock plummeted once the company corrected its misrepresentations. Defendant consented to entry of a permanent injunction against further violations of the antifraud provisions of the federal securities laws, and payment of a \$20,000 civil penalty. n51

Distort and Short is a "pump and dump" scheme in reverse. n52 *SEC v. Berliner* is an example of recent distort and short scheme. n53 In that case the SEC alleged that the respondent trader, Paul Berliner, knowingly sent an untrue rumor by instant message to thirty-one market participants and then benefited by shorting the shares of the company at issue. n54 In May 2007, Blackstone agreed to acquire Alliance Data Systems ("ADS") for \$81.75 per share. n55 Then, on November 29, 2007, Berliner sent an instant message to 31 traders and securities professionals stating that ADS's board of directors was meeting to consider a revised proposal from Blackstone to acquire ADS for \$70 per share. n56 The rumor spread through Wall Street and the news media picked up the false story, causing the stock to drop by 17% within 30 minutes after the first instant message and the NYSE to temporarily halt trading. n57 ADS issued a press release denying the rumor, and by the end of the day the stock recovered, n58 but by then over 33,000,000 shares had traded--more than twenty times the previous day's volume. n59 The SEC ultimately obtained a settlement from Berliner consisting of a \$130,000 fine, \$261,229 disgorgement, a permanent injunction and a bar from association with any broker or dealer. n60

An earlier example of a distort and short scheme is *Sean Edward St. Heart*. In that case, defendant posed as a CEO and posted a fictitious message on Yahoo! claiming he was joining twelve other companies in filing a \$20 million lawsuit against NCO Group, Inc. The message caused over a \$200 million drop in NCO Group's market capitalization and a 28% drop in its stock price. St. Heart consented to entry of a permanent injunction against further violations of the antifraud provisions of the federal securities laws, and the SEC waived any monetary penalty based on the defendant's inability to pay. n61

Sham offerings involve misrepresentations over the Internet with respect to initial public offerings or the future profitability of secondary offerings. A stock can be promoted through false announcements of imminent IPOs, including the offer of "free" stock in exchange for an administrative fee or the provision of personal information. n62 In *Web Works Marketing.com, Inc.*, a company claiming to provide extraordinary residential and business long distance telephone service offered free stock to persons who registered on its website, referred others to the site, subscribed to its long distance service or remained a customer for more than six months. Although the website boasted 10,000 to 12,000 satisfied customers and claimed that the company intended to go public and that each share of stock should be worth \$38.40, it had only 35 customers and a gross revenue of \$26. Defendant consented to an order to cease and desist from committing or causing any future violation of Section 10(b) of the Exchange Act and *Rule 10b-5* thereunder. n63 In November 2001, FINRA posted an investor alert regarding faxes, spam and junk e-mail recommending investment in stocks of companies manufacturing defense, anti-terrorism or biological detection products. n64

There also have been offerings involving non-existent stocks, including investments that would seem fairly questionable even if the stocks were real. The SEC has uncovered fictitious sales of interests in eel farms, coconut plantations and projects to explore near earth asteroids. n65

Withholding occurs when the underwriter retains some of the inventory of the stock not sold in an initial public offering to manipulate the price of that stock in the aftermarket. In *Halsey Stuart & Co.*, the SEC found that it constituted a violation of the anti-fraud provisions of the securities laws where the manager of a syndicate formed to underwrite bond issues withheld unsold allotments, and traded heavily in the post-syndicate market, often bidding and paying prices at increasingly higher levels. n66 FINRA Rules require FINRA members to distribute the entire public offering at the offering price, and not to withhold shares for registered representatives or their co-employees or families. As explained in the FINRA alert, the rules are meant to prohibit the underwriters from using such securities to reward persons who can direct future business to members, or from taking advantage of their "insider" position to purchase shares for their own benefit. n67

FOOTNOTES:

(n1)Footnote 1. Norman S. Poser, *Stock Market Manipulation and Corporate Control Transactions*, 40 U. Miami L. Rev. 671, 691-97 (1986). In an early case, *United States v. Brown*, the Second Circuit upheld mail fraud convictions in a case involving a scheme to artificially inflate the price of a stock. 79 F.2d 321, 329 (2d Cir. 1935). In *Brown*, the defendants had formed a "pool" that engaged in wash sales, issued false publicity and made untrue statements about the company's earnings, while bribing brokers, their managers, clerks and other personnel who directly dealt with customers to push the stock onto unsuspecting customers.

(n2)Footnote 2. Marcy Gordon, *States Are Cracking Down On 'Boiler Room' Operations*, Investment Scams Targeted by States, Philadelphia Inquirer, July 24, 1998.

(n3)Footnote 3. The SEC has sought to deal with these challenges in a variety of ways. The SEC formed the Office of Internet Enforcement ("OIE") in July 1998 to administer the Enforcement Division's Internet program. See www.sec.gov/divisions/enforce/internet/enforce.htm (last modified Sept. 12, 2008). OIE also has developed surveillance systems to monitor web sites, message boards and chat groups for violations of securities laws, searching for suspicious phrases such as "get rich quick." See Saul S. Cohen, *Electronic/Internet Compliance*, SF51 ALI-ABA 1, 4 (Jan. 11, 2001). The OIE also oversees Cyberforce, an Internet surveillance group that works with federal agencies, the North American Securities Administration Association and various SROs to coordinate investigations into Internet fraud. See SEC Charges 23 Companies and Individuals in Cases Involving Broad Spectrum of Internet Securities Fraud, SEC Rel. No. 2000-24 (Mar. 1, 2001), available at www.sec.gov/news/headlines/internet5.htm. In addition, the SEC and FBI have formed Operation InvestNet, a nationwide joint project to combat Internet fraud. See Linda C. Quinn, *Securities Regulation and the Use of Electronic Media --Year 2000*, 1243 PLI/CORP. 127, 171 (2001). As of February 2009, the SEC maintains three Twitter feeds, including an "Investor Ed" feed, to publicize its enforcement actions and share other financial news with the public. See http://twitter.com/SEC_Investor_Ed.

(n4)Footnote 4. Joseph Conahan et al., *Securities Fraud*, 40 Am. Crim. L. Rev. 1041, 1103 (2003); Richard H. Walker & David M. Levine, *You've Got Jail: Current Trends in Civil and Criminal Enforcement of Internet Securities Fraud*, 38 AM. CRIM. L. REV. 405, 408 (2001).

(n5)Footnote 5. See Stuart R. Cohn, *Securities Counseling for New and Developing Companies* § 19:21--Internet Fraud (2004).

(n6)Footnote 6. See, e.g., *Norris & Hirshberg v. SEC*, 177 F.2d 228, 232 (Fed. Cir. 1949) ("[T]he heart of [petitioner's] business was the continual shuffling of securities back and forth in its customers' accounts."); *SEC v. Sayegh*, 906 F. Supp. 939, 945 (S.D.N.Y. 1995), *aff'd*, *SEC v. Militano*, 101 F.3d 685 (2d Cir. 1996).

(n7)Footnote 7. See, e.g., *Shultz v. SEC*, 614 F.2d 561, 564-65 (7th Cir. 1980).

(n8)Footnote 8. *Sayegh*, 906 F. Supp. at 945; *Shultz*, 614 F.2d at 564-65.

(n9)Footnote 9. See, e.g., *Wright v. SEC*, 112 F.2d 89, 92 (2d Cir. 1940) ("Wright's purchases represented 79 per cent of all purchases on the Los Angeles Exchange during the active buying or 'mark-up' phase of his operations ..."); *Sayegh*, 906 F. Supp. at 944 ("During this period, Moore & Schley's trading in ICP accounted for 90% of all NASDAQ volume in ICP ADRs. This trading volume demonstrates Moore & Schley's domination, control and manipulation of the market in ICP.").

(n10)Footnote 10. See *United States v. Mulheren*, 938 F.2d 364, 370-71 (2d Cir. 1991):

While we agree, as a general proposition, that market domination is a factor that supports a manipulation charge, the extent to which an investor controls or dominates the market at any given period of time cannot be viewed in a vacuum. For example, if only ten shares of a stock are bought or sold in a given hour and only by one investor, that investor has created 100 percent of the activity in that

stock in that hour. This alone, however, does not make the investor a manipulator. The percent of domination must be viewed in light of the time period involved and other indicia of manipulation. See also *In the Matter of H.J. & Co.*, 78 SEC Dock. 718, 2002 SEC LEXIS 2075, at *98-99 (Aug. 9, 2002) .

(n11)Footnote 11. *Trane Co. v. O'Connor Securities*, 561 F. Supp. 301, 305 (S.D.N.Y. 1983) .

(n12)Footnote 12. *Trane Co. v. O'Connor Securities*, 561 F. Supp. 301, 305 (S.D.N.Y. 1983) .

(n13)Footnote 13. See, e.g., *Pagel, Inc. v. SEC*, 803 F.2d 942, 943 (8th Cir. 1986) .

(n14)Footnote 14. See, e.g., *Pennaluna & Co. v. SEC*, 410 F.2d 861, 869 (9th Cir. 1969) .

(n15)Footnote 15. See, e.g., *Advanced Research Assocs., Inc., Sec. Ex. Act Rel. No. 7113*, 41 SEC 579, 605 (Aug. 16, 1963) .

(n16)Footnote 16. See, e.g., *SEC v. Commonwealth Chem. Sec., Inc.*, 410 F. Supp. 1002, 1011-12 (S.D.N.Y. 1976) , modified, 574 F.2d 90 (2d Cir. 1978) .

(n17)Footnote 17. See, e.g., *Pagel, Inc.*, 803 F.2d at 943 .

(n18)Footnote 18. See *In re Amaranth Natural Gas Commodities Litig.*, 612 F. Supp. 2d 376, 387 (S.D.N.Y. 2009) .

(n19)Footnote 19. See *In re Amaranth Natural Gas Commodities Litig.*, at 388 .

(n20)Footnote 20. See *United States v. Tager*, 788 F.2d 349, 350 (6th Cir. 1986) ; *United States v. Smith*, 727 F.2d 214, 215-16 (2d Cir. 1984) ; *SEC v. Hansen*, 726 F. Supp. 74, 75 (S.D.N.Y. 1989) .

(n21)Footnote 21. *SEC v. Leslie, Litig. Rel. No. 19000*, 2004 SEC LEXIS 2946, at *2 (D.D.C. Dec. 15, 2004) ; *SEC v. Margolin*, No. 92 Civ. 6307, 1992 U.S. Dist. LEXIS 14872, at *1-2 (S.D.N.Y. Sept. 30, 1992) . See also *SEC v. Sendo*, No. 91 Civ. 4408, 1991 U.S. Dist. LEXIS 12864, at *3 (S.D.N.Y. July 18, 1991) .

(n22)Footnote 22. There are many other scenarios that might meet the SEC's general description of front-running, including certain hedging practices and index-related trading, but which do not so directly penalize the investor.

(n23)Footnote 23. SEC Division of Market Regulation, Memorandum accompanying letter dated May 13, 1988, from SEC Chairman David S. Ruder to Congressmen John D. Dingall and Edward J. Markey.

(n24)Footnote 24. See, e.g., *Dreyfus Aggressive Growth Mutual Fund Litig.*, No. 98 Civ. 4318, 2001 U.S. Dist. LEXIS 8418, at *4 (S.D.N.Y. June 22, 2001) (manager of mutual funds bought securities for funds after buying them for his own account); *United States v. Frayler*, No. 98 CR. 670, 2000 U.S. Dist. LEXIS 1389, at *5-6 (S.D.N.Y. Feb. 15, 2000) (floor broker obtained a better price for his own account than for his customers' accounts); *Pirelli Armstrong Tire Corp. v. Labranche & Co.*, No. 03 Civ. 8264 RWS, 2004 U.S. Dist. LEXIS 9571, at *2-3 (S.D.N.Y. May 27, 2004) (New York Stock Exchange specialist traded for its own firm accounts, took advantage of its confidential knowledge to trade ahead of public investors' orders and engaged in "freezing" the specialist firm's Display Book so that it could engage in trades for its own account prior to entering and executing the orders of public investors).

(n25)Footnote 25. See, e.g., *U.S. Commodity Futures Trading Comm'n v. Amaranth Advisors, L.L.C.*, 554 F. Supp. 2d 523, 527-28 (S.D.N.Y. 2008) (using instant messages to coordinate sales before close); *SEC v. Edgar, Litig. Rel. 19033*, 2005 SEC LEXIS 86 (C.D. Ill. Jan. 13, 2005) (increasing and decreasing price); *R.J. Koeppe & Co. v. SEC*, 95 F.2d 550, 552 (7th Cir. 1938) (increasing price); *In the Matter of U.S. Bancorp Piper Jaffray, Sec. Ex. Act Rel. No. 46770*, 2002 SEC LEXIS 2807, at *2 (Nov. 5, 2002) (same); *Vigue, Litig. Rel. No. 16,912*, 74 SEC Dock. 1063-64 (Feb.

28, 2001) (same); *T.H.C., Inc. v. Fortune Petroleum Corp.*, No. 96 Civ. 2690-91, 1999 U.S. Dist. LEXIS 4039, at *4-5, (S.D.N.Y. Mar. 31, 1999) (same); *In the Matter of Baron Capital, Inc., et al.*, Sec. Ex. Act Rel. No. 47741, 80 SEC Dock. 202 (Apr. 29, 2003) (increasing price during period when closing price determined the consideration paid by the buyer in a pending corporate acquisition); *Zico Investment Holding, Inc.*, Litig. Rel. No. 11,763, 41 SEC Dock. 262, 263 (June 13, 1988) (decreasing price).

(n26)Footnote 26. See *Adrian C. Havill*, Initial Decision No. 74, 60 SEC Dock. 310, 314 (Aug. 31, 1995).

(n27)Footnote 27. See, e.g., *R.J. Koeppe & Co.*, 95 F.2d at 552 ; *SEC v. Torr*, 22 F. Supp. 602, 606 (S.D.N.Y. 1938) .

(n28)Footnote 28. *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 792 (2d Cir. 1969) .

(n29)Footnote 29. See, e.g., *United States v. Russo*, 74 F.3d 1383, 1387 (2d Cir. 1996) (brokerage firm places stock with customers and promises to buy it back within several weeks at small profit for customer); *United States v. Corr*, 543 F.2d 1042, 1046 (2d Cir. 1976) (parking stock with other brokers to keep shares from being sold in the market); *Magna Technologies, Inc.*, Litig. Rel. No. 12,227, 44 SEC Dock. 686, 688 (Aug. 21, 1989) (as defendants learned that customers were about to sell shares, they parked them in nominee and controlled accounts to avoid a fall in stock price).

(n30)Footnote 30. Under Rule 15c3-1 of the Exchange Act, broker-dealers are required to maintain a certain level of net capital to ensure there are sufficient liquid assets to meet the obligations to customers and other dealers. See *Sayegh*, 906 F. Supp. at 947 (S.D.N.Y. 1995) (broker-dealer warehoused stock from its account in different customer accounts until a buyer could be found to alleviate the firm's net capital requirements); see also *Boyd L. Jefferies*, Litig. Rel. No. 11,370, 37 SEC Dock. 1286, 1287 (Mar. 19, 1987); *Jeffrey Weissman*, Sec. Ex. Act Rel. No. 37,661, 62 SEC Dock. 2165, 2169 (Sept. 9, 1996).

(n31)Footnote 31. See *SEC v. Wexler*, No. 92 Civ. 2902, 1993 U.S. Dist. LEXIS 12656, at *5-7 (S.D.N.Y. Sept. 14, 1993) ; *SEC v. Commonwealth Chemical Sec., Inc.*, 410 F. Supp. 1002, 1009-11 (S.D.N.Y. 1976) , *aff'd in part, modified in part*, 574 F.2d 90 (2d Cir. 1978) .

(n32)Footnote 32. *Commonwealth Chemical Sec., Inc.*, 410 F. Supp. at 1007 ; *SEC v. Blinder, Robinson & Co.*, 542 F. Supp. 468, 477-78 (D. Colo. 1982) , *aff'd*, No. 82-1954, 1983 U.S. App. LEXIS 16806 (10th Cir. Sept. 19, 1983) .

(n33)Footnote 33. See, e.g., *SEC v. Drexel Burnham Lambert, Inc.*, 837 F. Supp. 587, 591 (S.D.N.Y. 1993) ; *SEC v. First City Fin. Corp.*, 688 F. Supp. 705, 723 (D.D.C. 1988) ; *SEC v. Bilzerian*, 814 F. Supp. 116, 118 n.2 (D.D.C. 1993) .

(n34)Footnote 34. See, e.g., 1990 NYSE Disc. Action LEXIS 143, at *5-6 (N.Y.S.E. Jul. 31, 1990) (NYSE hearing panel found that trader accused of reaching across the market bought from NYSE specialist at specialist's offer and sold to him at his bid, but that trader was merely inexperienced, and did not intend to reach across the market); see also Order Approving Proposed Rules Changes, Sec. Ex. Rel. No. 17,568, 22 SEC Dock. 167, 170 (Feb. 24, 1981).

(n35)Footnote 35. The floating supply has been defined by the SEC as "that part of the issue which is outstanding and which is held by dealers and the public with a view to resale for a grading profit, as distinguished from that part of the stock held for investment." *Barrett & Co.*, 9 SEC 319, 327 (May 26, 1941) .

(n36)Footnote 36. See, e.g., *Sayegh*, 906 F. Supp. at 944 (to support price of stock in light of poor corporate earnings, trader artificially withheld supply from the market by refusing to execute customer sell orders).

(n37)Footnote 37. See, e.g., *Jeffrey Weissman*, 62 SEC Dock. at 2168; *Wexler*, 1993 U.S. Dist. LEXIS 12656, at

*4 .

(n38)Footnote 38. *See, e.g., Peter E. Butler*, Litig. Rel. No. 12,536, 46 SEC Dock. 963, 963 (S.D.N.Y. July 9, 1990); *United States v. Deeb*, 175 F.3d 1163, 1165-66 (9th Cir. 1999) .

(n39)Footnote 39. *Jeffrey Weissman*, 62 SEC Dock. at 2168. *See also In re Sterling Foster & Co.*, 222 F. Supp.2d 216 (E.D.N.Y. 2002) (broker sold short millions of shares during IPO and subsequently covered those sales through a previously undisclosed arrangement to buy additional shares from inside shareholders who had been released from their lockup agreements).

(n40)Footnote 40. *United States v. Haddy*, 134 F.3d 542, 544-45 (3d Cir. 1998) .

(n41)Footnote 41. *Kenneth W. Schilling*, Litig. Rel. No. 16,914, 74 SEC Dock. 1064, 1064-65 (Feb. 28, 2001). *See also SEC v. Calandra*, Litig. Rel. No. 19028 (Jan. 10, 2005) (scalping by columnist for Internet website CBS MarketWatch.com); *SEC v. Simmons, et al.*, Litig. Rel. No. 18968 (Nov. 15, 2004) (touting through posting of Internet messages using different identities); *SEC v. Mandaci*, Litig. Rel. No. 18924 (Oct. 7, 2004).

(n42)Footnote 42. *James Sheret, Jr.*, Litig. Rel. No. 16,451, 71 SEC Dock. 1787, 1787 (Feb. 24, 2000); *United States v. Sheret*, No. 00-CR-864-ALL (S.D.N.Y. 2000); *see also SEC v. Sneiderman*, Litig. Rel. No. 17945 (Jan. 22, 2003) (permanently enjoining respondent from future violations and ordering \$60,000 in civil penalties for posting phony press release n Internet bulletin board announcing an acquisition after purchasing shares of the company allegedly being acquired).

(n43)Footnote 43. *See, e.g., SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180, 183 (1963) ; *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1266-67 (9th Cir. 1979) ; *SEC v. Blavin*, 557 F. Supp. 1304, 1311 (E.D. Mich. 1983) ; *Peter E. Butler*, 46 SEC Dock. at 963; *In the Matter of Wolfson, Sec. Ex. Act Rel. No. 50041*, 2004 SEC LEXIS 1525, at *3-4 (July 20, 2004) . Under § 10(b) of the Exchange Act and *Rule 10b-5* thereunder, scalpers assume a duty to disclose their interest in the targeted stock. *See § 6.03[4][e]* (below); *SEC v. Gane*, No. 03-61553, 2005 U.S. Dist. LEXIS 607, at *26-27 (S.D. Fla. Jan. 4, 2005) ; *SEC v. Park*, 99 F. Supp. 2d. 889, 900 (N.D. Ill. 2000) .

(n44)Footnote 44. In *SEC v. Lindberg*, Mark Lindberg along with attorneys, stock promoters and financiers worked together to acquire shares of three issuers and then sold those shares after manipulating the prices by organizing "blast" email/fax campaigns about the issuers. *See Complaint*, Civil Action No. 08CV-402CVE SAJ (D. Okla. Jul. 14, 2008). Some of these blasts exploited the devastating effects of Hurricane Katrina by stating: "Katrina means National Storm (NLST) is poised for a massive run up as demand to repair homes skyrockets." During these promotional campaigns, the price and trading volumes significantly increased and Lindberg personally obtained a profit of over \$6 million. The SEC obtained a judgment against Lindberg, permanently enjoining him from future violations and barring him from participating in an offering of penny stock. *See Judgment*, Civil Action No. 08-CV-0402-CVE-SAJ (D. Okla. Jul. 22, 2008).

(n45)Footnote 45. In *SEC v. Georgiou*, the SEC alleged that Georgiou regularly used wash sales and matched trades through nominee trading accounts thereby creating a false appearance of an active and liquid market for the purpose of artificially inflating stock prices. *See Complaint*, Civil Action No. 2:09-cv-00616-MMB (E.D. Penn. Feb. 12, 2009). To conceal his communications coordinating the trades, Georgiou used cell phones, Blackberry Messenger, and disguised email accounts. He also allegedly used the marking-the-close technique and illegal kickbacks to control the trading volume.

(n46)Footnote 46. *See, e.g., In the Matter of Rajan Moondrai, Ex. Act Rel. No. 48260*, 2003 SEC LEXIS 1804, at *3-4 (July 31, 2003) ; *SEC v. Lybrand*, 200 F. Supp.2d 384, 389-90 (S.D.N.Y. 2002) ; *Leslie*, 2004 SEC LEXIS 2946 ; *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588, 591-92 (10th Cir. 1979) ; *SEC v. Malenfant*, 784 F. Supp. 141, 143 (S.D.N.Y. 1992) ; *Harvey Rubenstein*, Litig. Rel. No. 11,945, 42 SEC Dock. 732, 732-733 (Dec. 20, 1988).

(n47)Footnote 47. *Edward J. Mawod & Co.*, 591 F.2d at 591-92 .

(n48)Footnote 48. *See, e.g., Sunrise Fin., Inc. v. Paine Webber, Inc.*, 4 F. Supp. 2d 1035, 1037 (D. Utah 1998) ; *Vandenberg v. Adler*, No. 98 Civ. 3544, 2000 U.S. Dist. LEXIS 4050, at *24 (S.D.N.Y. Mar. 31, 2000) ; *SEC v. Calvo*, 378 F.3d 1211, 1213-14 (11th Cir. 2004) ; *Glaser v. Enzo Biochem, Inc.*, 303 F. Supp.2d 724, 731 (E.D. Va. 2003) ; *DeMarco v. Robertson Stephens, Inc.*, 318 F. Supp.2d 110, 117 (S.D.N.Y. Jan. 9, 2004) .

(n49)Footnote 49. *Jonathan G. Lebed*, 73 SEC Dock. at 741-42.

(n50)Footnote 50. In another notorious pump and dump case, defendant Gary D. Hoke Jr. created a web page that appeared to be an official Bloomberg News Service page, announcing that a NASDAQ-traded corporation was acquired by an Israeli company. Under an assumed name, Hoke posted a message reporting the acquisition with a link to the fictitious Bloomberg News Service. The publication of the false report caused the market price of the acquired company to increase substantially, then decline drastically once the hoax was exposed. Hoke consented to entry of a permanent injunction against further violations of the antifraud provisions of the federal securities laws. The SEC waived a monetary penalty based on the Hoke's demonstrated inability to pay. Criminal fraud charges also were brought against Hoke, and he pled guilty to violations of *Rule 10b-5*. Hoke was sentenced to five years probation, restitution of approximately \$93,000, and a \$200 fine. *Gary D. Hoke, Jr.*, Litig. Rel. No. 16,266, 70 SEC Dock. 1187, 1187 (Aug. 30, 1999); *United States v. Hoke*, Dock. 99-CR-411-ALL (C.D. Cal.).

(n51)Footnote 51. *SEC v. Pinkmonkey*, Litig. Rel. No. 16,919, 74 SEC Dock. 1068, 1068 (Feb. 28, 2001). Another plot, involving defendant Leszek Zbierajewski, used a false screen name to post a message on the Yahoo! Finance message board that included a doctored press release announcing a fictitious strategic alliance between Bid.com International, Inc. and America Online, Inc. Trading in Bid.com increased dramatically in response to the release, pushing the share price up from \$8.50 to \$9. Zbierajewski consented to entry of a permanent injunction against further violations of the antifraud provisions of the federal securities laws. The SEC waived a monetary penalty based on defendant's demonstrated inability to pay. *Leszek Zbierajewski*, Litig. Rel. No. 16,363, 71 SEC Dock. 217, 217 (Nov. 18, 1999). *See also, SEC v. One or More Unknown Traders in the Common Stock of Certain Issuers*, Complaint, Civil No. 1:07CV00431 (D.D.C. Mar. 6, 2007) (hacking into online brokerage accounts and placing unauthorized trades for defendant's pecuniary benefit); *SEC v. New Energy Corp.*, Litig. Rel. No. 19160 (Mar. 29, 2005) (posting misleading press releases and a research report on the Internet); *SEC v. Am. Healthcare Providers, Inc.*, Litig. Rel. No. 19124 (Mar. 8, 2005) (extensive campaign of false press releases and Internet message board postings for fictitious start-up company); *SEC v. Kirkpatrick et al.*, Lit. Rel. No. 48748 (Nov. 5, 2003) (driving up price through restriction of supply, then using high-pressure sales tactics and misrepresentation to profit from sale); *SEC v. SG Limited et al.*, Litig. Rel. No. 18181 (June 9, 2003) (operating website as "virtual stock exchange," unilaterally reducing share price and refusing to redeem shares).

(n52)Footnote 52. *See* Christopher Cox (SEC Chairman), What the SEC Really Did on Short Selling (July 24, 2008), available at <http://www.sec.gov/news/speech/2008/spch072408cc.htm>.

(n53)Footnote 53. *See* Section 6.06[1][a], *infra*.

(n54)Footnote 54. *SEC v. Paul S. Berliner* (S.D.N.Y. 2008) (No. 08 Civ. 3859), Complaint at 13, 14, 19.

(n55)Footnote 55. *Id.* at 12.

(n56)Footnote 56. *Id.* at 13.

(N57)Footnote 57. *Id.* at 14, 16, 17.

(n58)Footnote 58. *Id.* at 17, 18.

(n59)Footnote 59. *Id.* at 18.

(n60)Footnote 60. *See* Sec. Litig. Rel. No. 20,537 (Apr. 24, 2008), available at <http://www.sec.gov/litigation/litreleases/2008/lr20646.htm>.

(n61)Footnote 61. *Sean Edward St. Heart*, Litig. Rel. No. 16,947, 74 SEC Dock. 1434, 1434-35 (Mar. 29, 2001).

(n62)Footnote 62. *See, e.g., Chidwhite Enterprises*, Litig. Rel. No. 16,918, 74 SEC Dock. 1067, 1067 (W.D. Tex. Feb. 28, 2001); *Joe Loofbourrow*, Sec. Ex. Act Rel. No. 41,631, 70 SEC Dock. 306, 307 (July 21, 1999). The SEC has taken the position that the issuance of free stock is a sale, finding adequate consideration when the person is required to register or merely visit the website in order obtain the free stock. SEC Brings First Actions to Halt Unregistered Online Offerings of So-Called Free Stock, Rel. No. 99-83 (July 22, 1999), available at www.sec.gov/news/headlines/webstock.htm.

(n63)Footnote 63. *Web Works Marketing.com, Inc.*, Sec. Ex. Act Rel. No. 41,632, 70 SEC Dock. 312, 313-15 (July 21, 1999). *See also In the Matter of Oliver*, Sec. Ex. Act Rel. No. 50565 (Oct. 20, 2004) (sham private offering for shares in company producing catalytic converter falsely claiming reduction in toxic emissions).

(n64)Footnote 64. *Fears of Anthrax and Terrorism Spawning Investment Scams*, available at <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScams/P006039>

(n65)Footnote 65. Richard Walker (SEC Director of Enforcement), Remarks at the National Press Club (April 5, 1999), available at www.sec.gov/news/speech/speecharchive/1999/spch265.txt.

(n66)Footnote 66. *Halsey, Stuart & Co.*, 30 SEC 106, 109-11 (Sept. 21, 1949) .

(n67)Footnote 67. FINRA Rule 5130 provides, in relevant part:

(a) General Prohibitions: (1) A member or a person associated with a member may not sell, or cause to be sold, a new issue to any account in which a restricted person has a beneficial interest, except as otherwise permitted herein. (2) A member or a person associated with a member may not purchase a new issue in any account in which such member or person associated with a member has a beneficial interest, except as otherwise permitted herein. (3) A member may not continue to hold new issues acquired by the member as an underwriter, selling group member, or otherwise, except as otherwise permitted herein.



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Federal Securities Exchange Act of 1934

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CHAPTER 6 Regulation of Market Manipulation

2-6 Federal Securities Exchange Act of 1934 § 6.03

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§ 6.03 Government Regulation of Market Manipulation

[1] Regulation Before the Exchange Act

The federal government did not comprehensively monitor or regulate market manipulation prior to passage of the Exchange Act in 1934. However, the common law recognized that the manipulation of stock prices was a form of deception and provided a variety of remedies in law and equity. This was based on the view that the securities markets could not prosper unless they reflected true market forces. As one court explained in 1933:

When an outsider, a member of the public, reads the price quotations of a stock listed on an exchange, he is justified in supposing that the quoted stock is an appraisal of the value of the stock due to a series of actual sales between various persons dealing at arm's length in a free and open market on the exchange, and so represents a true chancering [sic] of the market value of that stock thereon under the process of attrition due to supply operating against demand. n1

State courts entertained damages actions on the ground of fraud where there was evidence of price manipulation. For example, the New York State Court of Appeals sustained a private action in fraud and deceit where corporate directors declared a dividend payable out of capital and not out of net profits, as required by state statute, thus giving a false picture of profitability and inducing the purchase of that company's stock. n2 In another pre-Exchange Act case, a New York State appellate court held a bank liable for the actions of an officer who was authorized to sell stock on the bank's behalf and who misrepresented the bid and ask prices of the stock. n3

Courts in pre-Exchange Act cases also held that contracts made for the purpose of manipulating stock prices were voidable and not enforceable between the parties. For example, the Supreme Judicial Court of Massachusetts held that a party to a contract to corner the market in a stock to force short sellers to settle at a higher price could not recover funds expended in pursuit of the contract, as the agreement was illegal and void. n4 Similarly, stock purchases based on price manipulation were held to be fraudulent and subject to rescission. n5

Federal and state governments also found ways to address stock market manipulation, mainly through the Federal Mail Fraud Act and state Blue Sky laws. Several federal circuit courts upheld convictions of market manipulators under the Mail Fraud Act, 18 U.S.C. § 338. In *United States v. Brown*, for example, the Court of Appeals for the Second Circuit upheld the conviction under the Mail Fraud Act of a president of a corporation and his business associates who drove up the stock prices of the corporation by using wash sales, bribing brokers to recommend the stock, and releasing false earning statements. n6

Wash sales and touting also could be prosecuted under various state Blue Sky laws prior to passage of the Exchange Act. n7 False or misleading statements within a prospectus also were considered fraudulent practices falling under most state Blue Sky laws. n8

Pre-Exchange Act jurisprudence, whether based on common law theories of fraud and deceit or statutory provisions regulating fraudulent business and securities practices, reflected the belief that stock prices should represent an accurate picture of the market for that stock. The courts recognized that use of investment pools, wash sales, matched orders and other manipulative devices to impact price skewed that picture to the disadvantage of the investor. Prohibitions against such devices were adopted and expanded under the Exchange Act. Several sections of the Exchange Act, such as 9(a)(2), 10(b) and 15(c), were drafted with broad wording prohibiting manipulative and deceptive devices, empowering the SEC and self-regulatory organizations the flexibility to respond to ever-changing methods of market manipulation.

[2] Legislative History of Market Manipulation Provisions of the Exchange Act

The Securities Act of 1933 and Securities Exchange Act of 1934 were in part a reaction to the speculation and market volatility that led to the stock market crash of 1929. n9 The committee reports supporting that legislation reveal that Congress perceived manipulative devices, in their broadest sense, to be a dangerous source of market instability. For example, the House Report in support of the Exchange Act stated:

[T]he most subtle manipulating device employed in the security markets is not simply the crude form of a wash sale or a matched order. It is the conscious marking up of prices to make investors believe that there is a constantly increasing demand for stocks at higher prices, or the conscious marking down of stocks to make investors believe that an increasing number of investors are selling as prices recede.

There is plenty of room for legitimate speculation in the balancing of investment demand and supply, in the shrewd prognostication of future trends and economic directions; but the accentuation of temporary fluctuations and the deliberate introduction of a mob psychology into the speculative markets by the fanfare of organized manipulation menace the true functioning of the exchanges, upon which the economic well-being of the whole country depends. n10

Congress noted that the exchanges had not sufficiently acknowledged or discouraged the full universe of harmful practices. The Senate Report in support of the Exchange Act found:

The true function of an exchange is to maintain an open market for securities, where supply and demand may freely meet at prices uninfluenced by manipulation and control. In the past this function has been fulfilled most imperfectly. The exposure of the extent and effect of manipulative practices upon organized exchanges was one of the most salutary and important accomplishments of the investigation. Stock exchange representatives have consistently minimized the extent of manipulative activities upon exchanges and, provided there were no technical wash sales or matched orders, they have not regarded manipulative devices in general use as pernicious or violative of the principles of fair, free, and open trading. The tendency has been to belittle reports of manipulative activities as unfounded rumors, unworthy of serious attention. The evidence adduced before the subcommittee has thoroughly discredited

this attitude. n11

Congress erected a two-tiered system to protect investors against market manipulation, prohibiting practices that serve no beneficial purpose and closely monitoring other practices that, while necessary to market efficiency, were often prone to abuse. n12 Thus, wash sales, matched orders and various other transactions that create actual or apparent active trading in a security, or raise or depress the price of a security for the purpose of inducing the purchase or sale of the security, were flatly prohibited under Section 9. At the same time, other practices, which were part of the normal functioning of the markets but prone to manipulation, such as transactions by persons with an interest in the outcome of a stock offering, the pegging, fixing or stabilizing of stock prices, short selling and transactions involving options, were not banned outright but were placed under the watchful eye of the SEC.

[3] Definition of Market Manipulation

The Supreme Court has avoided any bright line test or definition of practices constituting market manipulation. The Court has stated that manipulation "is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." n13 In a later case, the Court added that "[t]he term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity." n14

The SEC also has defined market manipulation broadly. In one proceeding, the Commission wrote: "A manipulation may be accomplished without wash sales, matched orders, or other fictitious devices. Actual buying with the design to create activity, prevent price falls, or raise prices [operates] to distort the character of the market as a reflection of the combined judgment of buyers and sellers and to make of it a stage-managed performance." n15 In another proceeding, the SEC stated, more generally: "In essence, manipulation is the intentional interference with the free forces of supply and demand." n16

Under the Exchange Act, manipulation and fraud are separate forms of dishonest practices that harm investors. While fraud normally involves misstatements or omissions with respect to substantive information concerning a corporation (or non-disclosure of inside information by a fiduciary during a stock transaction), manipulation entails the creation of artificial appearances of market activity. Both have the purpose of inducing a purchase or sale of securities, but a manipulator does so with the express goal of impacting the market price of the security. Thus, whereas an action in fraud under Section 10(b) of the Exchange Act requires a showing of scienter, i.e., commission of a knowingly wrongful act (normally a material misstatement or omission), a manipulation case under Section 9(a) not only requires a showing of scienter, but adds the more specific element of manipulative purpose--normally interpreted by courts as a purpose to induce the purchase or sale of a security in order to raise or depress the market price. n17

Both fraud and manipulation, however, share the theme of misleading the investor through non-disclosure.

Section 10(b)'s general prohibition of practices deemed by the SEC to be 'manipulative'--in this technical sense of artificially affecting market activity in order to mislead investors--is fully consistent with the fundamental purpose of the [Exchange] Act to 'substitute a philosophy of full disclosure for the philosophy of caveat emptor ... ' "Indeed, nondisclosure is usually essential to the success of a manipulative scheme ... No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices." n18

Some courts have adopted a wider definition of manipulative device or scheme beginning with the Enron debacle and initial public offering class actions described in more detail below. In those actions, the courts broadened the reach of typical securities fraud cases involving the alleged misrepresentation of a corporation's financial condition by corporate insiders, and brought in as primary actors accountants, lawyers, and investment banks underwriting stock issues and disseminating analyst reports, and others, grouping those actors as part of a general manipulative scheme to mislead the

market. Thus, at least some courts now appear to apply the definition of market manipulation to actors who may not be directly responsible for the misrepresentations or omissions at issue, but who are described as being part of a larger pattern of deception artificially influencing stock price. n19 However, more recently some courts have expressed discomfort with this trend. n20

[4] Prohibited Practices

[a] Section 9 Generally. Section 9 is entitled "Prohibition Against Manipulation of Securities Prices," and addresses manipulative activity on the national securities exchanges. n21 It prohibits wash sales and matched orders, n22 manipulative transactions generally, n23 touting, tipster sheets and other misrepresentations on a national securities exchange, n24 and it regulates stabilization measures, n25 options n26 and practices affecting market volatility. n27

Although Section 9 applies solely to stocks listed for trading on a national securities exchange, the SEC and courts traditionally have relied on Section 9 jurisprudence when analyzing manipulation cases in the over-the-counter market under Section 17 of the Securities Act, Section 10(b) of the Exchange Act and *Rule 10b-5* thereunder, and Section 15(c) of the Exchange Act and Rules 15c1-2 et seq. thereunder. n28 It also has been argued that Section 9 applies to manipulation of exchange-registered securities in the over-the-counter market. n29

Unlike the general anti-fraud provisions of the Exchange Act, activity proscribed under Section 9 is not limited to the purchase or sale of a security. n30 Section 9 also is one of the few sections of the federal securities laws that explicitly provides both for SEC enforcement and a private right of action with respect to securities fraud. n31 However, since an implied right of action was found in Section 10(b) of the Exchange Act, Section 10(b) has been more commonly invoked, as its applicability is not formally limited to securities sold on an exchange and does not require proof of manipulative purpose. n32

[b] Section 9(a)(1)--Wash Sales and Matched Orders. Section 9(a)(1) prohibits wash sales and matched orders effected "[f]or the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security ... " n33 The full text reads:

a. It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange--

1. For the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security,

A. to effect any transaction in such security which involves no change in the beneficial ownership thereof, or

B. to enter an order or orders for the purchase of such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the sale of any such security, has been or will be entered by or for the same or different parties, or

C. to enter any order or orders for the sale of any such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the purchase of such security, has been or will be entered by or for the same or different parties. n34

The elements of a claim under Section 9(a)(1) are: (1) a wash sale or matched orders in a security; (2) done with scienter; (3) for the purpose of creating a false or misleading appearance of active trading in that security. n35 The scienter and purpose to induce requirements are considered separate state of mind requirements. Scienter involves intent to commit a fraudulent act, while purpose to induce specifically addresses the objective of the fraudulent act, which in the context of Section 9, means purpose to induce the purchase or sale of a security by others. n36 Although manipulative purpose or intent must be shown, intent can be inferred through motive, such as a financial interest in raising or depressing the price of the security. n37

[c] Section 9(a)(2)--Manipulative Transactions. The SEC deemed Section 9(a)(2) "the very heart of the [Exchange Act]." n38 It prohibits manipulative activity on the national securities exchanges. The provision makes it unlawful:

To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange ... creating actual or apparent active trading in such security, or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others. n39

Congress included Section 9(a)(2) to outlaw "every ... device used to persuade the public that activity in a security is the reflection of a genuine demand instead of a mirage." n40

The elements of a claim under Section 9(a)(2) are: (1) a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security, or raising or depressing the price of such security; (2) carried out with scienter; (3) for the purpose of inducing the purchase or sale of such security by others. n41

Like the general anti-fraud provision of Section 10(b), the elements of Section 9(a)(2) have been interpreted broadly. The "series of transactions" element can include bids, purchases, sales and short sales, including purchases or sales in small lots. n42 As few as three transactions has been considered a series of transactions under Section 9(a)(2). n43

Instead of pleading a change in stock price, plaintiff can alternatively plead the creation of "actual or apparent active trading." n44 Actual active trading requires activity greater than the security's customary trading volume or price fluctuations. Apparent active trading denotes an artificial appearance of active trading, such as when a broker-dealer induces other broker-dealers to quote the security, or itself places increasingly higher bids. n45 Another method of creating an artificial appearance of activity entails a broker-dealer inducing the purchase of a security by other broker-dealers through the use of nominee accounts or guarantees against loss. n46

To establish the "raising or depressing price of a security" element, there must be proof that the manipulator caused the change in price. n47 A substantial price change is not necessary. n48 Evidence of causation can include "a) price leadership by the manipulator; b) dominion and control of the market for the security; c) reduction in the floating supply of the security and d) the collapse of the market for the security when the manipulator ceases his activity." n49

In *SEC v. Resch-Cassin & Co.*, for example, an underwriter involved in a best efforts, all-or-nothing initial public offering created interest in the stock by promising a certain aftermarket price. n50 The underwriter then induced a number of traders to become market-makers in the stock, making large purchases at increasingly higher bids. The market-makers often purchased at the price offered by the other traders, without negotiating a better price, and the high bidder during a particular period continually raised the bid price, even as it was purchasing below its own quoted price. The lead bidder purchased more shares than the aggregate of all other market-makers during the period in question, enabling it to control the market in that stock. n51 After obtaining an injunction against the underwriter, the SEC obtained an injunction against the market makers working with the underwriter, which the Court upheld, finding ample evidence that the group had dominated and controlled the market of that stock and thereby caused the rise in price. n52

Not every series of transactions that causes a change in market price is necessarily manipulative. The House Report supporting Section 9(a)(2) explained:

Paragraph (2) makes it unlawful to effect any series of transactions in a security. Of course, any extensive purchases or sales are bound to cause changes in the market price of the security. If a person is merely trying to acquire a large block of stock for investment, or desires to dispose of a big holding, his knowledge that in doing so he will affect the market price does not make his action unlawful. His transactions become unlawful only when they are made for the purpose of raising or depressing the market price. n53

Ultimately, the issue in Section 9(a)(2) proceedings is often one of intent. As mentioned above, Section 9 requires a showing of manipulative intent or purpose. n54 Generally, plaintiffs do not have access to direct evidence of purpose, and courts allow proof of intent or purpose to be established by circumstantial evidence of motive combined with evidence that the defendant effectively raised or lowered stock prices. As one court noted, if an individual purchases a large number of shares which drives up the stock price, the question often becomes "the purpose and motive behind such extensive acquisition. And such 'requisite purpose and willfulness is normally inferred from the circumstances of the case.' " n55 This includes analyzing the content of e-mails for evidence of intent or motive. n56

Similarly, the SEC has stated that "[s]ince it is impossible to probe into the depths of a man's mind, it is necessary in the usual case (that is, absent an admission) that the finding of manipulative purpose be based on inferences drawn from circumstantial evidence." n57 At least one court has implied that once the SEC shows circumstantial evidence of a motive to manipulate and a series of transactions resulting in a price change, the burden shifts to the defendant to provide alternate explanations for the transactions. n58

[d] Sections 9(a)(3), (4) & (5)--Touting, Tipster Sheets and Other Misrepresentations. In passing the Exchange Act, Congress was concerned with "touting," where the individual recommending stock does not disclose his financial interest in the transaction and other manipulative devices in connection with recommendations or predictions of stock performance. The Senate investigation that preceded passage of the Exchange Act uncovered many instances of touting:

In one instance a financial writer on a great New York newspaper was discovered to have been a regular participant in the profits of a freelance trader, without obligation except to publicize the stocks of the trader Still other cases were observed where persons were employed to broadcast over the radio, ostensibly as economists tendering gratuitous advice, but in reality as publicity agents of stock-exchange firms. n59

Congress included Sections 9(a)(3), (4) and (5) to ban the inducement to purchase or sell stock when the recommender does not disclose their personal interest in the stock, or makes misleading statements with respect to price predictions or other information regarding that stock. Section 9(a)(3) addresses price predictions made with the purpose of influencing the stock price. It prohibits: (1) a broker, dealer or other person selling, offering to sell, purchasing or offering to purchase; (2) any security registered on a national securities exchange; (3) from inducing the purchase or sale of the security; (4) by circulating stock predictions about future anticipated prices; (5) for the purpose of affecting the stock price. n60

Section 9(a)(4) has an even broader reach, addressing any false or misleading statement for the purpose of inducing the purchase or sale of a security. It prohibits: (1) a broker, dealer or other person selling, offering to sell, purchasing or offering to purchase; (2) any security registered on a national securities exchange; (3) from inducing the purchase or sale of the security; (4) by making any false or misleading statement with respect to any material fact; (5) which the person knew or had reasonable ground to believe was false or misleading. n61 The SEC has invoked Section 9(a)(4) where a broker made misleading or unsubstantiated price predictions to customers as part of a market manipulation scheme.

In Jeffrey Weissman and Martin Weissman, the SEC alleged a scheme whereby Jeffrey Weissman, a broker employed by a market-maker of HPI stock, effected a large price increase through misleading marketing, a no-net-selling policy (i.e., execution of sale orders could not exceed execution of buy orders), and selective placement of buy orders on the American Stock Exchange. n62 Among other misleading marketing techniques, Weissman directed his network of brokers to pursue high-pressure selling tactics and make unsubstantiated price predictions to customers. n63 The SEC charged Weissman with violations of Sections 9(a)(2), 9(a)(4), 10(b) of the Exchange Act, and *Rules 10b-5* and 15c1-2 thereunder, among other provisions. n64

To establish a violation of Section 9(a)(4), the misleading statement must be made directly between a buyer and seller. For example, in *Robbins v. Banner Industries, Inc.*, a stockholder claimed that the corporation had issued stock to the directors without fair consideration, and without disclosing the details of the issuance to shareholders. n65 The court dismissed plaintiff's Section 9(a)(4) claim against the individual defendant who was charged only as an aider and abettor, when plaintiff failed to allege facts constituting a false or misleading statement and did not allege that the individual defendant was either a purchaser or seller of any securities. n66

Section 9(a)(5) addresses touting. It prohibits: (1) any person receiving consideration from a broker, dealer or other person selling, offering to sell, purchasing or offering to purchase; (2) any security registered on a national securities exchange; (3) from inducing the purchase or sale of the security; (4) by circulating stock predictions about future anticipated prices; (5) for the purpose of affecting the stock price. n67

[e] Section 10(b) and Rules Relevant to Market Manipulation. Section 10(b) n68 and *Rule 10b-5* thereunder n69 bar fraud and deception in the purchase or sale of securities whether done face to face, through a national securities exchange or in over-the-counter markets. n70 This section contains a very limited review of Section 10(b) and *Rule 10b-5* within the context of market manipulation. Section 10(b) and *Rule 10b-5* are covered, in depth, in Chapter 5.

The elements of a manipulation claim under Section 10(b) are: (1) fraudulent conduct; (2) in connection with the purchase or sale of securities; (3) through the means or instruments of transportation or communication in interstate commerce or the mails; and (4) with the requisite scienter. n71

To state a market manipulation claim under *Rule 10b-5(a)* or (c), plaintiffs must allege: (1) that they were injured; (2) in connection with the purchase or sale of securities; (3) by relying on a market for securities; (4) controlled or artificially affected by the defendant's deceptive and manipulative conduct; and (5) that the defendant engaged in the manipulative conduct with scienter. n72

There is an implied private right of action under Section 10(b) and *Rule 10b-5*. n73 To bring a private action for damages under 10(b), the plaintiff must be a purchaser or seller of the security at issue, n74 within a time period relevant to the manipulative act. n75 For example, where a corporation moved for a temporary injunction to stop a takeover attempt, claiming that defendant's alleged "buy-me-out-or-face-a-takeover" ultimatum constituted a manipulative and deceptive device under Section 10(b) and *Rule 10b-5*, the court denied plaintiff's request, in part because it deemed it unlikely that plaintiff would prevail on the issue of whether sales of its stock as a defensive measure occurred during the period that defendant allegedly was manipulating the market by amassing plaintiff's stock. n76

Aside from the purchaser or seller restraint, application of Section 10(b) is quite broad, allowing suit by a purchaser or seller of "any security" against "any person" who has used "any manipulative or deceptive device or contrivance," "in connection with" the purchase or sale of a security. n77 Moreover, it is commonly held that Section 10(b) has more lenient evidentiary requirements than its Section 9(a) counterpart. For example, one court has commented that "*Rule 10b-5* require[s] no additional proof of facts creating a higher burden of proof when compared to subsection 9(a)(1), (2) and (6). In fact, *Rule 10b-5* create[s] a lower burden of proof." n78

Significantly, Section 10(b) manipulation claims, unlike claims under Section 9(a), do not include the element of purpose to manipulate. Instead, it is sufficient to show that defendant engaged in a knowingly wrongful act involving a significant risk of effecting the violation that has occurred. n79 For example, one court held that a broker may be liable under Section 10(b) for following a stock promoter's directions to execute stock trades that he knew, or was reckless in not knowing, were manipulative, even if he did not share the promoter's intention to manipulate the price of those stocks, and may simply have sought compensation for his cooperation. n80

After *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, plaintiffs who seek to bring a claim under Section 10(b) must plead an inference of scienter that is "cogent and at least as compelling as any opposing inference of non-fraudulent intent." n81 This has been interpreted to mean that for allegations of Section 10(b) violations, courts must look at the allegations as a whole, rather than focusing on the sufficiency of particular allegations. n82 This holistic approach likely makes it harder for plaintiffs to allege scienter in market manipulation cases under 10(b). n83

In certain contexts, however, the distinction between the manipulative purpose element of Section 9(a) and the scienter requirement of Section 10(b) may have little practical import. With Section 10(b) pleadings, scienter is often expressed in terms of an inference of fraudulent intent. n84 And, as with the manipulative purpose element of Section 9(a), fraudulent intent can be shown through some combination of evidence of motive and/or manipulative activity. n85

Manipulative acts prosecuted under Section 10(b) and *Rule 10b-5* are also very broad. They include matched orders and wash sales, n86 cross trading and circular trading, n87 painting the tape, n88 domination and control of the market, n89 marking the close, n90 manipulative short selling, n91 undisclosed stabilization, n92 and undisclosed purchase of securities by an underwriter while still participating in a distribution. n93

Plaintiffs bringing a number of large securities fraud class actions since 2002 have also successfully utilized subsections (a) and (c) of *Rule 10b-5* to pursue market manipulation claims against additional categories of actors traditionally sheltered from primary liability under *Central Bank*.

In the 1994 case *Central Bank v. Denver, N.A.*, the Supreme Court held that there was no private cause of action against mere aiders and abettors of section 10(b) violations. n94 Thus, secondary actors, such as lawyers, accountants, investment bankers and others who counseled corporations or facilitated financial transactions were, subsequent to *Central Bank*, generally immune from private suit. *Central Bank*, however, contained the important caveat that

[a]ny person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under *Rule 10b-5* are met ... In any complex securities fraud ... there are likely to be multiple violators. n95

Prior to the Enron era, it was difficult to show direct involvement by secondary actors in securities fraud under the traditional basis of a material misstatement or omission. Two basic standards for the primary liability of secondary actors had emerged in such cases: the "bright-line" test followed in the Second, Tenth and Eleventh Circuits, and the "substantial participation" test, followed in the Ninth Circuit. n96 While the "bright-line" test establishes primary liability on the part of secondary actors only when an investor has relied on a misstatement or omission made by and attributable to the defendant at the time of the investment, the "substantial participation" test establishes such liability when the actor "substantially participates" or plays a "significant role" in making the representation, even if it is not publicly attributed to the actor at the time of the investment. n97 Despite the looser standard in the Ninth Circuit, private securities fraud actions against secondary actors were still difficult to maintain post-*Central Bank*. n98

Starting with the Enron motion to dismiss, however, several courts expanded the potential liability of secondary actors through their application of two lesser-used provisions of *Rule 10b-5*, *Rule 10b-5(a)* and (c), to deny motions to dismiss

suits against secondary actors when they are alleged to be an integral part of a broad scheme to deceive investors.

As stated above, *Rule 10b-5* establishes liability under subsection (a) and (c) for any person who, through use of interstate commerce, the mails or any facility of any national securities exchange: "(a) employs any device, scheme, or artifice to defraud," or "(c) engages in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person," in connection with the purchase or sale of any security. n99

In *Enron*, plaintiffs brought suit against the corporation, individual executives, and secondary actors such as accounting firms, law firms and investment banks, claiming that all the defendants had collectively and directly participated in a manipulative scheme to artificially inflate Enron's earnings and conceal its debt using off-balance sheet special purpose entities. In denying the secondary defendants' motion to dismiss and holding that they could be primarily liable under *Rules 10b-5(a)* and (c), the Court reasoned that "[n]ovel or atypical methods [of deception] should not provide immunity from the securities laws." n100

Whereas courts traditionally held liable those directly misstating corporate prospects through misstatements or omissions in such routine issuances as financial statements, prospectuses and road shows, here the court noted allegations that defendant investment banks made loans disguised as trades, participated in a phony IPO, participated in the creation of fraudulent special purpose entities, and contributed to Enron's misleading accounting methods, among other acts. The court noted further allegations that one of the defendant law firms helped create the special purpose entities, drafted sales opinions and drafted false SEC filings and press releases, and that defendant accounting firm violated accounting standards, destroyed documents and participated in Enron's scheme despite knowledge of the fraud. The Court recognized such allegations as falling under a special category:

Market manipulation, employment of a manipulative device, and engaging in manipulative schemes such as a scheme to artificially inflate or deflate stock prices, falsifying records to reflect non-existent profits, and creating and distributing false research reports favorably reviewing a company are other types of conduct prohibited by § 10(b) and *Rule 10b-5* that do not fall within the category of misleading statements and omissions. n101

Other courts continued the trend, acknowledging applications of *Rules 10b-5(a)* and (c) to secondary actors involved in alleged tie-in agreements, undisclosed compensation and analyst conflicts with respect to initial public offerings, n102 the creation of "phantom revenue" through the structuring of transactions to circumvent standard accounting practices, n103 the creation, funding and operating of sham entities to artificially inflate company profits, n104 and the directing and funding by a clearing broker of the introducing broker's sham trades on behalf of investors. n105

The Supreme Court's decision in *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, however, limited the arsenal available to securities plaintiffs in market manipulation cases. n106 Relying on *Central Bank*, the Court held *Rule 10b-5(a)* and (c) liability can exist only when plaintiffs can prove reliance on the deceptive conduct. n107 This "ensures that, for liability to arise, the 'requisite causal connection between a defendant's misrepresentation and a plaintiff's injury' exists as a predicate for liability." n108 The Court rejected the argument that a presumption of reliance on the deceptive acts exists under *Rule 10b-5(a)* and (c), thereby limiting the possible secondary actors who may be held liable under section 10(b). n109

The *Stoneridge* holding reiterates the notion that Section 10(b) "does not incorporate common-law fraud into federal law," and "should not be interpreted to provide a cause of action against the entire marketplace in which the issuing company operates." n110 Allowing such an expansion under the securities laws, among other things, invites litigation in areas already protected by state law. n111 Furthermore, the Court noted an expansion of the implied private right of action under Section 10(b) is unnecessary considering secondary actors are subject to criminal penalties and civil enforcement by the SEC. n112

This limitation of scheme liability under *Rule 10b-5(a)* and *(c)* significantly affected the Enron litigation. Because those plaintiffs could no longer argue liability existed under 10(b) based on deceptive conduct absent reliance on such conduct by the investors, the *Stoneridge* decision foreclosed much of the litigation arising from the Enron scandal. n113

In addition to *Rule 10b-5*, the SEC promulgated two other rules under Section 10(b) that relate directly to market manipulation, and address the more specific claims of market manipulation of exempt securities and market manipulation by brokers and dealers of over-the-counter securities. Under *Rule 10b-1*, entitled "Prohibition of Use of Manipulative or Deceptive Devices or Contrivances with Respect to Certain Securities Exempted from Registration," n114 plaintiff must show that defendant: (1) employed a manipulative or deceptive device or contrivance as used in Section 10(b); (2) with respect to any security exempted from the operation of Section 12(a); (3) if such act or omission would have been unlawful under Section 9(a) or rules thereunder; (4) through the use of any means or instrumentality of interstate commerce, the mails or any facility of a national securities exchange; (5) in connection with the purchase or sale of any such security. n115

Rule 10b-1 has successfully been used in civil suits alleging market manipulation of exempt securities. In *Box v. Northrop Corp.*, a minority shareholder brought suit, alleging that a merging corporation had been organized solely for the purpose of effecting a scheme to eliminate the minority shareholder's interest, by diluting his holdings and inducing him to sell his exempt shares at a greatly reduced valuation. n116 The court found that these allegations stated a cause of action under Section 10(b) and Rules 10b-1 and 10b-3 thereunder. n117

Rule 10b-3, entitled "Employment of Manipulative and Deceptive Devices by Brokers and Dealers," addresses market manipulation by brokers or dealers of over-the-counter securities. n118 To make out a *Rule 10b-3* claim, plaintiff must show: (1) a broker or dealer; (2) using any means or instrumentality of interstate commerce, the mails or any facility of any national securities exchange; (3) committed any act, practice or course of business defined by the SEC to be a 'manipulative, deceptive, or other fraudulent device or contrivance' for purposes of Section 15(c) of the Exchange Act; (4) in connection with the purchase or sale of any security in the over-the-counter market. n119

The SEC often invokes Sections 10(b) and 15(c) and Rules 10b-3 and 15c1-2 together to address market manipulation generally. For instance, in *U.S. Environmental*, an action brought by the SEC, the Court found violations of sections 10(b) and 15(c) and *Rules 10b-5*, *10b-3* and 15c1-2 thereunder, where a broker established a blind pool, worked with a group of investors to buy the majority of stock in the blind pool, and merged the blind pool with a private company the investors controlled to make it a public company. The broker then effected trades to manipulate the stock of the merged company through wash sales, matched sales, trades involving undisclosed nominees and other manipulative devices to inflate the stock and sell it to the public in the aftermarket. n120 More specifically, *Rule 10b-3* also is used in conjunction with *Rules 10b-5* and 15c1-2 to prosecute the failure of brokers and dealers to disclose a financial interest in recommended stocks, n121 and in conjunction with *Rule 15c1-4* to prosecute the failure to disclose that the dealer is acting as a broker or principal with respect to that stock. n122

[f] Section 15(c)--Brokers and Dealers Engaged in Transactions in Over-the-Counter Markets. Section 15(c) of the Exchange Act is the general provision addressing deception and manipulation by brokers and dealers engaging in securities transactions in the over-the-counter market. n123 The SEC and federal courts apply Sections 15(c)(1) and 15(c)(2), along with Section 10(b), to prohibit the types of manipulative conduct in the over-the-counter market that Section 9(a) prohibits with respect to trading on the securities exchanges. Section 15(c) is interpreted as broadly as Section 9(a) within that context. n124 In *Barrett & Co.*, the SEC reasoned:

We think that there is no reasonable distinction in this respect between manipulation of over-the-counter prices and manipulation of prices on a national securities exchange, and that both are condemned as fraudulent by the Securities Exchange Act, and, in fact, were fraudulent at common law We believe that the Securities Exchange Act contemplates that Section 15(c)(1) affords to the over-the-counter market at least as great a degree of protection against manipulation or attempted control

as is afforded to the exchange market by Section 9(a). n125

The SEC has applied the same reasoning with respect to Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act. n126 Conceptually, both the SEC and the courts base application of Sections 10(b) and 15(c) on nondisclosure to the market of the manipulative activity. n127 However, while Section 10(b) applies to all persons and all securities, and Section 9(a) applies to all persons with respect to securities listed on a national securities exchange, Section 15(c)(1) is limited to brokers and dealers trading securities not listed on a national exchange. Moreover, no private right of action exists under Section 15(c). n128 The legislative history is silent on creation of a private cause of action and courts have uniformly reasoned that such a right would not further the purposes of the statute, since a broader private right already exists under Section 10(b). n129

[i] Section 15(c)(1) and Rules Relevant to Market Manipulation. Section 15(c)(1) prohibits brokers and dealers from inducing or attempting to induce the purchase or sale of any over-the-counter, municipal or government security "by means of any manipulative, deceptive, or other fraudulent device or contrivance" n130 It gives the SEC authority to adopt rules defining the prohibited practices. n131

There are several rules under Section 15(c) that specifically combat broker and dealer market manipulation in the over-the-counter markets. Like *Rule 10b-5*, Rule 15c1-2, entitled "Fraud and Manipulation," is a catch-all provision for manipulative or deceptive devices. n132 That provision defines "manipulative, deceptive or other fraudulent device or contrivance" as used in Section 15(c)(1) as "any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading ... ," but adds that the section is not limited by any specific definitions of the above terms. n133

The SEC has charged violations of Section 15(c)(1), and Rule 15c1-2 thereunder, often in conjunction with Section 10(b) and *Rule 10b-5* thereunder, to address a wide array of conduct. This includes domination and control of the market in a particular stock, n134 artificial raising of prices through misrepresentations, n135 undisclosed stabilization n136 and undisclosed purchase of securities by an underwriter while still participating in a distribution, n137 among other manipulative practices. n138 In recent years, the SEC has increasingly used Section 15(c) to file enforcement actions against mutual fund administrators and broker-dealers for market timing and late trading activities. n139

There are other rules under Section 15(c) which require brokers and dealers to make particular disclosures at or before completion of stock transactions, where failure to make such disclosure is considered price manipulation. In particular, Rule 15c1-5, entitled "Disclosure of Control," obligates brokers and dealers to disclose in writing that they are controlled by, controlling, or under common control with the issuer of the stock involved in the transaction. n140

In *Richard D. Wheeler, Sr. et al.*, the SEC, citing Section 10(b) and *Rule 10b-5* thereunder, and Section 15(c) and Rules 15c1-2 and 15c1-5 thereunder, barred two employees of a broker-dealer from the securities industry, after they allegedly defrauded the public through the sale of two blind pool offerings. n141 The SEC alleged that the corporation that was the subject of one of the blind pool offerings was under the undisclosed control of Ronald D. Wheeler Sr., and that Mr. Wheeler manipulated the price of the security by buying back shares in the aftermarket to the financial benefit of the broker-dealer, dominating and controlling the market and driving up prices through misleading press releases and false SEC filings containing unrealistic sales and earnings estimates. n142

Rule 15c1-6, entitled "Disclosure of Interest in Distribution," obligates written disclosure by a broker or dealer to a customer participating in a distribution of the broker or dealer's own participation, or other financial interest in the distribution. n143 In *Rooney, Pace Inc.*, the SEC accepted an offer of settlement by a broker-dealer after charging it with various violations under the Exchange Act for abuses in connection with three public offerings. n144 With respect to one of the offerings, Rooney, Pace was charged with violation of Rule 15c1-6 for failing to disclose its role as underwriter, as well as with other violations, after it distributed the stock prior to the effective date of the secondary

offering. As a result, Rooney, Pace substantially reduced the supply of the stock publicly available, thereby artificially supporting its price. n145

Finally, Rule 15c1-8, entitled "Sales at the Market," prohibits any representation by a broker or dealer to a customer that the price of a security is "at the market," or a price related to the market, i.e., not a result of market manipulation, unless the broker or dealer has reasonable grounds for that belief. n146 In *Lawrence J. Penna*, the SEC cited a broker-dealer for a violation of Section 15(c) and Rule 15c1-8, among other violations, when it allegedly discovered a scheme among broker-dealers to manipulate the market price of a number of securities to a predetermined target level that was twice that of the offering price. n147 The broker-dealers filled customer orders at the artificial price that had been solicited before the offering and then covered their positions through securities they had previously arranged to purchase at a substantial discount. n148

[ii] Section 15(c)(2) and Rules Relevant to Market Manipulation. Section 15(c)(2) prohibits brokers and dealers from inducing or attempting to induce the purchase or sale of any over-the-counter or municipal security "in connection with which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation." n149 It is broader than Section 15(c)(1) in its prohibition of fraudulent, deceptive or manipulative acts or practices that are in connection with the purchase or sale of an over-the-counter or municipal security, and explicitly forbids the entering of a fictitious quotation. n150 Section 15(c)(2) also gives the SEC broad authority to adopt rules to define fraudulent practices and to "prescribe means reasonably designed to prevent ... such acts and practices" n151

Rule 15c2-7 is one such rule relevant to market manipulation. n152 It makes it unlawful for a broker or dealer to furnish quotations for a security to an inter-dealer-quotation system unless there is disclosure, if applicable, of the submission by a correspondent broker-dealer on behalf of another broker-dealer or of any other arrangement between or among broker-dealers, n153 and disclosure of the identity of each broker-dealer participating in such arrangement, among other requirements. n154 For example, in *Paul I. Comi*, the SEC brought enforcement proceedings against a broker-dealer under Rule 15c2-7 when the broker-dealer failed to disclose a profitable arrangement between it and another broker. n155 Comi and the other broker each provided the high bid quotations to the NASDAQ system over a certain period, giving the impression of competition between them, and driving up the price of the stock, when Comi had no customer orders for the stock, but sold its excess inventory at the end of the day back to the other broker at a profit. n156

Another rule under Section 15(c)(2) used to address market manipulation is Rule 15c2-11, which makes it unlawful for any broker or dealer to initiate or resume quotations in a security without maintaining in their records and furnishing to the inter-dealer quotation system information concerning the issuer and certain other matters, unless otherwise exempted. n157 The broker-dealer also must have a reasonable basis to believe the information is accurate and was obtained from a reliable source. n158 Rule 15c2-11 was adopted as a means of curbing activities of brokers and dealers submitting quotations in the pink sheets "without making diligent inquiry concerning the issue or obtaining sufficient information to justify their activity in the security." n159

Rule 15c2-11 has been used to sanction broker-dealers for failing to disclose information concerning issuers that might artificially affect price. In *General Bond & Share Co. v. SEC*, the court upheld the SEC's affirmance of the NASD's ruling that a member firm had violated an NASD Rule by continuing to accept issuer-paid compensation for making a market in a certain security after informing the NASD that it would cease the practice. n160 The court further affirmed the SEC's sanction of the broker-dealer for violation of Rule 15c2-11, among other violations, for failing to maintain in its files certain information concerning the issuer that was "reasonably current" in relation to the day its quotations were submitted. n161

[5] Restricted Practices

When Congress passed the Securities Exchange Act of 1934, it recognized that there were particular trading practices

that, while prone to manipulation, if properly conducted, were necessary for the functioning of healthy and efficient markets. Congress chose to restrict those practices instead of banning them outright. It therefore included provisions in Sections 9 and 10 of the Exchange Act that enable the SEC to oversee restricted practices, such as securities transactions by persons with an interest in a distribution (including stabilization of stock prices), short sales, options trading and practices affecting market volatility.

[a] Regulation of Distributions: Regulation M. The SEC has a long history of regulating the scope of permissible activities of underwriters, broker-dealers, and others participating in the distribution of securities during the course of securities offerings. n162 The goal has been to "prevent participants in a distribution from artificially conditioning the market for the securities in a distribution" and to "protect the integrity of the securities trading market as an independent pricing mechanism during the distribution period." n163 The first rulemaking in this area occurred in 1955, when the SEC adopted Rules 10b-6, 10b-7 and 10b-8 to codify the "principles which historically have been applied in considering questions relating to manipulative activity and stabilization in connection with a distribution." n164

Rule 10b-6 prohibited persons participating in a distribution from "bidding for or purchasing, or inducing others to purchase the securities being distributed, or any security of the same class and series as the security being distributed, or any rights to purchase that security, until they have completed their participation in the distribution." n165 Rule 10b-7, addressing pegging, fixing or stabilizing, regulated "stabilizing for the purpose of facilitating a distribution, and prohibit[ed] any person from making any stabilizing bid or purchase in connection with a distribution except in compliance with that rule. In general, the rule require[d] that such purchases be limited to those necessary to prevent or retard a decline in the open market price of the security, that they be made at price levels restricted as provided in the rule, that purchasers be given notice that the market [was] being stabilized, and that the Commission receive[d] appropriate notice and reports." n166

Rule 10b-8 restricted bids for and purchases of stock rights. It applied in two situations:

(1) when the price of the security underlying the rights [was] being stabilized; or (2) when any syndicate member, dealer-manager, soliciting dealer, or other distribution participant ha[d] purchased rights, as principal, without having sold the underlying securities obtainable upon exercise (*i.e.*, when any member of the syndicate ha[d] a net long position in the underlying security, assuming the exercise of all rights owned by the syndicate members) Rule 10b-8 also limit[ed] the price at which the underlying securities, or securities of the same class and series, [could] be offered or sold during the rights offering. n167

In 1988, the SEC promulgated Rule 10b-21, which was an effort to prevent manipulation by institutional investors by regulating short selling in anticipation of a public offering. n168 Rule 10b-21 prohibited investors from covering short sales of a security that were the subject of a public offering with securities purchased in the offering. n169

Regulation M, entitled, "Manipulative Conduct by Persons with Interest in Outcome of an Offering," was adopted in December 1996 and took effect in March 1997, replacing Rules 10b-6, 10b-6A (NASD passive market making), 10b-7, 10b-8 and 10b-21. n170 Regulation M applies to all distributions, including unregistered distributions. Rule 101 of Regulation M governs the securities transactions of participants in a distribution; Rule 102 governs the transactions of issuers and selling security holders; Rule 103 regulates NASDAQ passive market making; Rule 104 regulates stabilizing and other syndicate activities during a distribution; and Rule 105 codifies former Rule 10b-21 and governs short selling in relation to a public offering. Rule 100 is the definitional section explaining relevant terms. n171 It is important to note that, in addition to Regulation M, the general anti-fraud and anti-manipulation provisions of the federal securities laws, including Section 17(a) of the Securities Act, and Sections 9(a), 10(b) and 15(c) of the Exchange Act, also govern all activities with respect to public offerings. n172

Regulation M was an attempt by the SEC to clarify and streamline regulation of restricted practices, and to relax those restrictions "in cases where either the risk of manipulation is small or the costs of the restrictions are disproportionate to the purposes they serve." n173 The SEC cited significant changes in the securities markets as the impetus for the reconceptualization. It commented that institutional investors had become major participants in securities offerings and that their greater sophistication and bargaining power created strong barriers to manipulation by offering participants. n174

The SEC also noted that secondary markets were more transparent and liquid, making manipulation more detectable. It pointed to the effective real-time surveillance technologies developed by SROs, and the availability of transaction audits, which had lessened the need for regulatory restrictions. The SEC also discussed the growth in the use of shelf-registered offerings, the reduction in rights offerings and globalization of equity and debt offerings as examples of significant changes in securities offerings that necessitated regulatory revisions. n175 The SEC concluded:

These developments have outpaced the current structure of anti-manipulation regulation of securities offerings and have reduced the need for broad prophylactic restrictions. Moreover, the Commission has been advised by market participants that the application of the trading practices rules in the present environment has become needlessly complex and involves substantial compliance costs. n176

The SEC has monitored implementation of Regulation M since its adoption in 1996. In 2004, it proposed amendments to the rule that changed the definition of "restricted" period for purposes of IPOs. n177 The amendments also sought to adjust the average daily trading volume ("ADTV") and public float values for purposes of the definition of "restricted" period under Rule 100(b), actively-traded securities under Rule 101(c)(1) and actively traded reference securities under Rule 102(d)(1) to account for inflation of the dollar since 1996. In response to manipulative activity in the area of IPO allocations, the SEC also proposed a new Rule 106, which would have prohibited distribution participants, issuers and their affiliated purchasers from inducing or accepting any consideration from their customers in addition to the stated offering price of the security. n178 This proposal was meant to counter the practice alleged by the SEC whereby firms expect higher commissions from customers during a "hot IPO" in order to obtain an allocation of those shares, or to "tie" allocation of shares in a "hot IPO" to the purchase of shares, usually from a "cold" offering. n179 While these proposals were not adopted in the 2007 amendments to Rule 105, the SEC responded to increasing manipulative activity by prohibiting entities from covering a short sale with securities purchased from an underwriter or broker dealer participating in the relevant offering on a firm commitment basis. n180

[i] Rule 101: Activities by Distribution Participants (Underwriters, Brokers, Dealers). Rule 101 governs activities by underwriters and other participants in a distribution. It provides, in pertinent part:

... In connection with a distribution of securities, it shall be unlawful for a distribution participant or an affiliated purchaser of such person, directly or indirectly, to bid for, purchase, or attempt to induce any person to bid for or purchase, a covered security during the applicable restricted period; Provided, however, that if a distribution participant or affiliated purchaser is the issuer or selling security holder of the securities subject to the distribution, such person shall be subject to the provisions of [Rule 102], rather than this section. n181

Rule 100 defines distribution participants as "an underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in a distribution." n182 Rule 101 applies only to a "covered security," which is the security that is the subject of a distribution or any security into which it can be converted, exchanged or exercised or which may determine the value of the subject security. n183 The rule also applies only during a restricted period that lasts either one or five business days before the pricing of the offered security and continues until completion of the distribution.

The length of the restricted period depends on the trading volume and public float value of the offered security: under the definition of "restricted period" in Rule 100, for any security with an average daily trading volume ADTV of at least \$100,000 and a public float value of at least \$25 million, the restricted period is the later of one business day prior to determination of the offering price or the date the person becomes a distribution participant, and ending on that person's completion of participation in the distribution. n184 For all other securities, the restricted period begins on the later of five business days prior to determination of the offering price or the date the person becomes a distribution participant and ends on that person's completion of participation in the distribution. n185

There are a number of exemptions from Rule 101, which allow distribution participants and their affiliated purchasers to engage in a variety of activities during the restricted period, including: the routine dissemination of research reports; n186 odd-lot transactions; n187 exercises of options, warrants, rights or any convertible securities; n188 unsolicited transactions; n189 transactions in baskets of securities involving an offered security; n190 and certain transactions involving Rule 144A securities of foreign and domestic issuers. n191 Rule 101 also excepts de minimis transactions, defined as bids that are not accepted or purchases during the restricted period that total less than 2% of the ADTV of the security, provided that the person making the purchases or unaccepted bids has maintained and enforces written policies and procedures designed to achieve compliance with Regulation M. n192

In addition to activity exemptions, there are a variety of securities that are excepted from Rule 101: actively traded securities, defined as securities that have an ADTV value of at least \$1 million, have a public float value of at least \$150 million and are not issued by the distribution participant or an affiliate; n193 investment grade nonconvertible and asset-backed securities; n194 exempted securities under § 3(a)(12) of the Exchange Act; n195 and face-amount certificates, or securities issued by an open-end management investment company or unit investment trust. n196 Rule 101(d) permits the Commission, upon written application or its own motion, to grant an exemption from Rule 101, either unconditionally or on special terms and conditions, to any transaction or class of transaction, any security or class of securities.

The SEC has invoked Rule 101 against brokers allegedly manipulating the market for distributions, or even significant blocks of stock, as part of securities fraud enforcement actions. For example, the SEC settled with two registered representatives who had purchased a significant block of securities at a discount, placed it in their personal accounts and sold it to their customers at market price without disclosing their personal interest or the fact that their customers could have bought the stock directly from them at a lower price. The SEC considered their selling activities a distribution for purposes of Regulation M and violation of Rule 101, as well as section 10(b) and *Rule 10b-5* thereunder, among other violations. n197 In another SEC action under Rule 101, a brokerage settled charges that it had induced certain customers who received allocations of IPOs to place orders for additional shares in the aftermarket, and induced at least one customer to purchase shares in a "cold" IPO with the promise that they would be allocated shares in an upcoming "hot" IPO. n198

[ii] Rule 102--Activities by Issuers and Selling Securities Holders During a Distribution. Rule 102 reads, in pertinent part:

... In connection with a distribution of securities effected by or on behalf of an issuer or selling security holder, it shall be unlawful for such person, or any affiliated purchaser of such person, directly or indirectly, to bid for, purchase, or attempt to induce any person to bid for or purchase, a covered security during the applicable restricted period; Except that, if an affiliated purchaser is a distribution participant, such affiliated purchaser may comply with Rule 101, rather than this section. n199

The SEC distinguished between underwriters (covered by Rule 101) and issuers/securities holders (covered by Rule 102) because it reasoned that issuers and securities holders have a greater interest in an offering, engage in different types of securities transactions and are not monitored by SROs as closely as are member firms. n200 Regulation M therefore contains fewer exceptions under Rule 102 than under Rule 101.

Activities excepted from Rule 102 include: odd lot transactions; n201 repurchases by closed-end investment companies in compliance with Investment Company Act Rule 23c-3; n202 security redemptions by commodity pools or limited partnerships; n203 exercises of options, warrants, rights or any convertible securities; n204 offers to sell or the solicitation of offers to buy; n205 unsolicited purchases; n206 and transactions in Rule 144A securities. n207

Most transactions in connection with dividend reinvestment and stock repurchase plans, including securities distributions made to employees or shareholders of the issuer, are also excluded from Rule 102. n208 Only plan distributions to persons other than employees or shareholders, involving securities obtained directly from the issuer, fall under the rule. n209

There is no general exception for actively-traded securities, as with Rule 101, but reference securities with an ADTV value of at least \$1 million and public float value of at least \$150 million are excepted if they are not issued by the issuer, or affiliate of the issuer, of the offered security. n210 As under Rule 101, Rule 102 exempts investment grade nonconvertible and asset-backed securities; n211 exempted securities under § 3(a)(12) of the Exchange Act; n212 and face-amount certificates or securities issued by an open-end management investment company or unit investment trust. n213 Rule 102(e) contains the identical exemptive authority by the SEC as Rule 101(d). n214

The SEC has also brought enforcement actions against issuers and securities holders under Rule 102. In one such case, the SEC barred from the securities industry brokers who had made misstatements to investors to artificially manipulate the price and demand for securities in the aftermarket so that they could sell their undisclosed holdings at a profit. n215

[iii] Rule 103--Nasdaq Passive Market Making. Because Nasdaq market makers are often distribution participants or their affiliates, regulators have expressed concern that their prohibition from trading during the restricted period would have a negative impact on the market. n216 Nasdaq market makers are therefore permitted to conduct limited trades during the restricted period which could not, for example, amount to price stabilization. n217 This so-called "passive market-making" is also subject to certain notification, identification and disclosure requirements. n218

Rule 103 generally limits a passive market maker's bids and purchases to the highest current independent bid (i.e., a bid by a non-participant in the distribution). n219 The rule limits net purchases of passive market makers to the greater of either 30% of the ADTV of the market maker or 200 shares for less active market makers. n220

Passive market making is prohibited when a stabilizing bid pursuant to Rule 104 is in effect. n221 As with former 10b-6A, passive market-making is prohibited for best efforts and at-the-market offerings. n222

[b] Regulation of Stabilization Measures: Section 9(a)(6) and Rule 104 of Regulation M. The SEC has defined stabilization broadly as "the buying of a security for the limited purpose of preventing or retarding a decline in its open market price in order to facilitate its distribution to the public" n223 Some measure of stock price maintenance is not only accepted, but is an open practice during initial public offerings. Underwriters often inform stockholders in the prospectus that they may effect transactions that stabilize the market price of the stock. Underwriters also often authorize a "representative" underwriter to make purchases and sales on behalf of all the underwriters, which can include efforts at price stabilization, pursuant to an agreement limiting the amount to a fixed percentage of each underwriter's commitment to the entire offering. n224

Section 9(a)(6) of the Exchange Act makes it unlawful to effect any series of transactions for the purchase or sale of any security registered on a national securities exchange for the purpose of pegging, fixing or stabilizing the price of the security in contravention of any rules or regulations of the SEC. n225 In 1939, the SEC promulgated its first rules regulating price-stabilizing activities. The rules permitted such activities, but required notice in the prospectus that the underwriters intended to engage in price stabilization, as well as disclosure through reports of such activity. n226 In

1940, the SEC issued its first release analyzing its policy concerns with respect to the regulation of stabilization activities. n227 The Commission acknowledged that stabilization was considered a form of manipulation, but one that was necessary for the building and maintenance of vibrant capital markets. n228

In 1955, the SEC adopted Rule 10b-7 to regulate stabilization activities. n229 The rule established the price level at which a stabilizing bid could be entered and rules of priority for the execution of independent bids at times when a stabilizing bid had been entered. In addition, the rules regulated the number of stabilizing bids that an underwriting syndicate could enter in any one market at any one time, and the entry of stabilizing bids on markets other than the principal market for the security being stabilized. n230 Rule 10b-7 was replaced in 1996 with Rule 104 of Regulation M.

[i] Rule 104 of Regulation M--Stabilizing and Other Activities in Connection with an Offering. With adoption of Regulation M, the Commission recognized significant changes in the practice of distributions, pointing out the increase in flipping and the shift in stabilizing practices to the aftermarket period. n231 Rule 104 attempted to replace the old trading practice rules with "a more flexible framework for stabilizing transactions." n232

Rule 104 governs stabilizing and certain aftermarket syndicate transactions, including transactions to cover syndicate short positions and penalty bids. n233 Rule 104 reads in pertinent part:

... It shall be unlawful for any person, directly or indirectly, to stabilize, to effect any syndicate covering transaction, or to impose a penalty bid, in connection with an offering of any security, in contravention of the provision of this section ... n234

Under the rule, stabilizing bids may be increased to the level of the highest independent bid in the principal market, or, if the principal market is closed, to the highest independent bid in that market at the previous close, provided that the bid price does not exceed the maximum caps provided in the rule, i.e., the lower of the offering price or the stabilizing bid for the security in the principal market. n235

It is unlawful to place a stabilizing bid in more than one market at the same price and same time. n236 Anyone entering a bid for the purpose of stabilization must notify the market on which the bid is placed and disclose the purpose of the bid to the person to whom the bid is entered (e.g., the specialist or executing broker-dealer). n237 Anyone effecting a syndicate covering transaction or placing or transmitting a penalty bid also must disclose the transaction to the SRO with oversight over the principal market for that security. n238 Public disclosure is not required. n239 Rule 104(k) contains the identical exemptive authority by the SEC as Rules 101 and 102. n240

[c] Regulation of Short Sales: Section 10(a), Old Rules 10a-1, 10a-2, and 3b-3, New Rule 201 of Regulation SHO and Rule 105 of Regulation M. As described above, a short sale is the sale of a security that the seller does not own or that is consummated through the seller borrowing the security. While short selling is not necessarily harmful, concentrated short-selling historically has been used to manipulate the market downward. The SEC responded in 1938 by adopting Rule 10a-1 to restrict short selling in a declining market. n241 More recently, there was an increase in "naked" short selling, n242 which led to calls for updated regulation in this area.

Section 10(a) of the Exchange Act makes it unlawful for any person to effect a short sale or use any stop-loss order in connection with the purchase or sale of a security registered on a national securities exchange, in contravention of any rule or regulation by the SEC. n243 The Commission conducted a study of the effect of concentrated short-selling during the market break of 1937, and in 1938 issued Rule 10a-1 to restrict short selling in a declining market. n244 After the SEC issued related Rules 10a-2 and 3b-3, regulation of short sales remained relatively constant for approximately 60 years, with periodic reviews of its effectiveness. n245

In 1999, the SEC issued a release requesting public comment on the current regulatory system for short sales and

received an overwhelming response. In addition to reviewing those comments and reexamining Rules 10a-1, 10a-2 and 3b-3, the SEC considered recent market changes, including the increase in "naked" short selling, decimalization, the development of securities futures trading and the growing proportion of Nasdaq securities that are traded away from the Nasdaq market, removing them from application of the short sale price test. n246 As a result of that analysis, on October 28, 2003, the SEC released Proposed Rule, Regulation SHO, which it finalized after public comment on July 29, 2004. The Final Rule of Regulation SHO replaced Rule 10a-2 in its entirety, replaced Rule 3b-3 by amending and then integrating it into the definitional section of Regulation SHO, amended Rule 105, the short sale provision of Regulation M, and authorized a pilot program that would test potential amendment or replacement of Rule 10a-1. n247

In June 2007, the SEC amended Regulation SHO to replace Rule 10a-1 with new Rule 201 of Regulation SHO. n248 Specifically, the SEC eliminated any price test that prohibits short selling in a "down" market including the so-called "uptick test." In eliminating the "uptick" test, the SEC also hoped market participants would benefit from increased liquidity and more pricing efficiency. n249 As part of its 2007 amendments, the SEC also eliminated Regulation SHO's grandfather exception (Rule 203(b)(3)(i)). n250 As a result, all fail-to-deliver positions in threshold securities must be closed out within 13 consecutive settlement days regardless of whether any of those days occurred before the security became a threshold security. n251

Furthermore, in the midst of the financial crisis in 2008, the SEC made more changes. Initially, the SEC halted short selling in 799 financial institutions. n252 After issuing an emergency order requiring traders to borrow or arrange to borrow stock before shorting securities of specified financial services companies, the SEC announced three changes to the short sale rules: 1) a hard T+3 close-out requirement; 2) a new anti-fraud rule addressing deceptive conduct in connection with abusive short selling; and 3) elimination of the options market-maker exception to Regulation SHO. n253 The SEC also instituted disclosure requirements whereby investment managers had to submit a Form SH report with the SEC on the first business day of every calendar week immediately following a week in which the manager effected short sales. n254

[i] Rule 3b-3--Definition of "Short Sale". Rule 3b-3 of the Exchange Act contained the definition of "short sale" under the Exchange Act, including for purposes of Rules 10a-1 and 10a-2. n255 The rule defined short sale as "any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller." n256 Under Rule 3b-3(e), a seller of an equity security subject to Rule 10a-1 was obligated to aggregate all positions in that security in order to determine whether the seller maintained a "net long position" in the security. n257

[ii] 10a-1--Short Sales. The now-repealed Rule 10a-1 regulated short selling on a national securities exchange. n258 Generally, the rule established that, except in special circumstances, if an order had been marked "long," the broker was prohibited from making delivery with a borrowed security or delay delivery of the stock. Rule 10a-1 provided that, subject to certain exceptions, short sales of securities covered by the rule could be effected only (1) at a price above the price at which the immediately preceding sale was effected ("plus tick" or "uptick"), or (2) at the last sale price if it was higher than the last different price ("zero-plus tick"). n259 Short sales on minus ticks or zero-minus ticks were not permitted, with narrow exceptions. n260 The applicable price was either the last transaction price reported under an effective transaction reporting plan or on a particular exchange. n261 These rules were collectively referred to as the "tick test." The tick test was established to allow relatively unrestricted short selling in an advancing market, but to prevent short selling at successively lower prices or exhausting all remaining bids at one price level, which would cause successively lower prices, and therefore drive the market price down. n262

Rule 10a-1(c) provided that every order for the sale of a security on a national securities exchange was required to be marked either "long" or "short" to indicate whether the security being sold was owned and deliverable by the seller. n263 There were various exceptions to application of Rule 10a-1, including arbitrage undertaken to profit from a current difference between a convertible security and the underlying common stock; n264 and arbitrage undertaken to profit from a current difference between the price of a security in the United States and its price abroad. n265

Most courts found that there was no private right of action to enforce Rule 10a-1. n266

[iii] Rule 10a-2--Requirements for Covering Purchases. Before it was replaced by Regulation SHO, Rule 10a-2 governed the lending of securities traded on a national securities exchange. n267 The rule provided that, with narrow exceptions, no broker or dealer was permitted to lend any security traded on a national securities exchange or fail to deliver a security on the date of delivery, if such broker or dealer knew or had reasonable grounds to believe that the sale was effected as a long sale. n268

[iv] 10b-21--Naked Short Selling Antifraud Rule. In 2008, the SEC promulgated Rule 10b-21 in response to deceptive conduct in connection with short selling. The new rule overlaps with the SEC's general antifraud rules, and expressly states that it is "not intended to limit, or restrict, the applicability of the general antifraud provisions ... " n269 In finalizing the rule, the SEC noted concerns pertaining to misrepresentations by Regulation SHO's locate requirement and mischaracterization of short sales as long sales. n270 The new rule imposes liability on any seller--including a broker-dealer trading for its own accounts--that makes misrepresentations to broker-dealers, clearing firms, or purchasers in connection with any long or short sale that resulted in a delivery failure. n271 In addition, broker-dealers may be liable for aiding and abetting selling customers that violate the rule. n272 As with 10b-5 liability standards, the SEC must prove that the putative defendant acted with scienter in order to establish a violation. n273

In its release amending the adoption of Rule 10b-21 the SEC notes that a seller could potentially violate Rule 10b-21 by failing to deliver the securities on settlement date and the broker-dealer about the validity of the seller's locate source by failing to contact the purported source to determine whether shares were available. n274 A seller can also violate the rule if it deceives the broker-dealer by contacting the source and learning that it could not borrow sufficient shares for timely delivery. n275 Finally, it may constitute deception under the new rule if a seller contacts a source that has which had sufficient shares for a pre-settlement delivery but fails to instruct the source to deliver the shares in time for settlement which results in the source not delivering the shares and then refuses to deliver shares on settlement date, resulting in a fail to deliver. n276

[v] Rule 105 of Regulation M--Short Selling in Connection with a Public Offering. As originally promulgated, Rule 105, which replaced the 1988 version of Rule 10b-21, prohibited certain short sales from being covered with securities purchased from an underwriter, broker or dealer who is participating in an offering. n277 Rule 105 "is prophylactic and prohibits the conduct irrespective of the short seller's intent." n278 Its purpose is "to promote offering prices that are based upon market prices determined by supply and demand rather than artificial forces." n279 The rule applies during the shorter of the period spanning the initial filing of the registration statement or five business days before pricing of the offered security, until the pricing of the security. n280

Rule 105 originally excepted Rule 415 shelf offerings and offerings that are not conducted on a firm commitment basis (such as all-or-none or best efforts offerings) n281 (see below for amendment of Rule 105(c) under Regulation SHO). Rule 105(d) provides the SEC with the same exemptive authority as established by Rules 101, 102 and 104. n282

Between promulgation of Regulation M and Regulation SHO, the SEC brought enforcement actions under Rule 105, section 10(a) and Rule 10a-1 for short sales during public offerings. For example, in *SEC v. Weitz and Altman*, brokers agreed to settle charges that they made short sales within five days of the pricing of securities offered in fifteen repeat and secondary offerings, and covered their short sales with securities they purchased in the offerings, consenting to disgorgement, prejudgment interest and civil penalties of over \$1 million. n283

In 2007, the SEC adopted several amendments to Rule 105. n284 The amendments were motivated by the SEC's belief that there was widespread use of trading strategies designed to evade the rule. As the SEC explained in the adopting release:

In recent years, the Commission has become aware of non-compliance with Rule 105, and in some

cases, strategies used to disguise Rule 105 violations. In particular, the Commission has become aware of attempts to obfuscate the prohibited covering. Due to continued violations of the rule, including a proliferation of trading strategies and structures attempting to accomplish the economic equivalent of the activity that the rule seeks to prevent, the Commission published proposed amendments to Rule 105 for notice and comment.

The Commission proposed to eliminate the covering requirement in order to end the progression of trading strategies designed to hide activity that violated the rule. In particular, the Commission proposed to make it unlawful for a person to effect a short sale during the Rule 105 restricted period and then purchase, including enter into a contract of sale for, such security in the offering. In effect, the proposal imposed an absolute prohibition against purchasing offered securities in firm commitment offerings by any person that effected a restricted period short sale(s). n285

Therefore, the amendments to Rule 105 did away with the requirement that the SEC prove that the short position was covered using stock acquired in the public offering. Instead, a new bright line rule was established requiring an investor to choose between shorting or participating in the offering. Thus, under the new rule, a person may *either* short an equity security within the restricted period *or* purchase shares in the public offering, but may not do both. n286 In other words, while the old Rule 105 prohibited covering under certain specified circumstances, new Rule 105 prohibits participation in the offering, except under certain specified circumstances. New Rule 105 includes three categories of excepted activity from the short-selling requirements: 1) bona fide purchases; 2) short selling in separate accounts; and 3) short selling by investment companies.

In connection with the first exception, to qualify as a "bona fide purchase," the purchase must be: (a) equivalent in quantity to the amount of the restricted period short sale(s); (b) effected during regular trading hours; (c) reported pursuant to an effective transaction reporting plan; (d) made after the last Rule 105 restricted period short sale; (e) made no later than the business day prior to the day of pricing; and (f) the purchaser must not have effected a short sale within the 30 minutes prior to the close of regular trading hours on the business day prior to the day of pricing. n287 Still, even where these criteria are satisfied, the SEC also will look to the surrounding facts and circumstances to determine whether a purchase is bona fide. The SEC stressed that transactions that are part of a plan or scheme to evade the rule would not be bona fide even if made in technical compliance with the exception. As an example, the SEC referred to transactions that do not include the "economic elements of risk associated with a purchase for value." n288

The second exception permits a purchase of the offered security in an account of a person where such person sold short during the restricted period in a separate account, "if decisions regarding securities transactions for each account are made separately and without coordination of trading or cooperation among or between accounts ... even though the accounts may be affiliated or otherwise related." n289 The SEC enumerated a list of indicia of separate accounts:

- The accounts have separate and distinct investment and trading strategies and objectives;
- Personnel for each account do not coordinate trading among or between the accounts;
- Information barriers separate the accounts, and information about securities positions or investment decisions is not shared between accounts;
- Each account maintains a separate profit and loss statement;
- There is no allocation of securities between or among accounts; and
- Personnel with oversight or managerial responsibility over multiple accounts in a single entity or affiliated entities, and account owners of multiple accounts, do not have authority to execute trades in

individual securities in the accounts and in fact do not execute trades in the accounts, and do not have the authority to pre-approve trading decisions for the accounts and, in fact do not pre-approve trading decisions for the accounts. n290

As with the bona fide purchase exception, the SEC stressed that these conditions are not necessarily determinative. Rather, the entire facts and circumstances must be considered. n291

The third exception relates to registered investment companies, which are already subject to the provisions of the Investment Company Act, which prohibits concerted action between funds in a complex and between different series of the same fund. Section 17(d) of the Investment Company Act and Rule 17d-1 prohibit an affiliated person of a registered investment company, and the affiliates of that affiliated person, acting as principal, from participating in any joint enterprise, or other joint enterprise or arrangement with their affiliated investment company. n292 Under these provisions, an arrangement by which one fund sells short while another affiliated fund intentionally goes long in the same security to cover the short position would generally be the type of coordinated strategy that is prohibited. Accordingly, for registered investment companies, amended Rule 105 provides that "an individual within a fund complex, or a series of a fund, is not prohibited from purchasing the offered security if another fund within the same complex or a different series of the fund sold short during the Rule 105 restricted period." n293

[vi] Regulation SHO. Regulation SHO was issued, among other reasons, to establish a uniform standard for all short sellers to locate securities for borrowing. It modifies the definitions of a short sale and owning a security and it also addresses the problems of naked short selling and extended failure to deliver securities. Regulation SHO replaces Rules 3b-3, Rule 10a-1, and 10a-2 of the Exchange Act. It also amended Rule 105 of Regulation M by eliminating the shelf exception and, in June 2007, shifting Rule 105's focus from covering to with prohibited securities to participation in an offering.

Rule 200 replaces Rule 3b-3, adopting that rule's basic definition of short sale, but broadening the ownership of a security under the definition to include unconditional contracts to purchase securities and securities futures contracts, n294 and amending it to explicitly allow multi-service broker-dealers to aggregate their positions by separate trading units. n295 Under this provision, all sales of equity securities must be marked "long," "short," or "short exempt." n296 It provides that a person owns a security only to the extent that he has a net long position in the security. n297

Rule 200 incorporates the block-positioner exception from Rule 10a-1(e)(13). Under the block-positioner exception, a broker or dealer is considered to own a security, even if it is not net long, if the broker acquired the security while acting as a block positioner and if the broker's short position is the subject of offsetting positions in the course of arbitrage, risk arbitrage or hedging activities. n298 The broker or dealer is also considered to own a security, even if it is not net long, if: (1) he is unwinding an index arbitrage position involving a long basket of stock and one or more short index futures traded on a board of trade or one or more standardized options contracts; and (2) the broker's or dealer's short position is the subject of offsetting positions created in the course of arbitrage, risk arbitrage or hedge activities; and (3) the sale does not occur during a period starting with the time the NYSE Composite Index has declined two or more percent from the close on the previous day and ending with the establishment of the closing value on the next trading day. n299

The SEC has brought enforcement actions against broker-dealers who have allowed their customers to sell securities short while falsely marking their sales "long." For example, in 2007 the SEC brought cease-and-desist proceedings against a subsidiary of Goldman Sachs, alleging that certain customers using the firm's automated trading system unlawfully sold securities short in advance of follow-on and secondary offerings while marking their orders to sell "long," and that the firm's failure to detect and prevent these violations was unreasonable. n300 Although the conduct in question took place before the promulgation of Regulation SHO, the SEC's order required the firm to cease and desist from violations of Rules 200 and 203 of Regulation SHO. n301

Similarly, in *In the Matter of Sandell Asset Management Corp.* the SEC brought cease-and-desist proceedings against

an unregistered investment advisor, Sandell Asset Management ("SAM") and certain of its principals and traders for improper order marking. n302 "SAM established long positions of approximately nine million shares in Hibernia Corporation, a financial holding company, the first half of 2005 in response to an announced business combination between Hibernia and Capital One Financial Corporation." n303 As part of a risk arbitrage transaction, SAM then sold its shares to third parties and entered into swap transactions whereby the fund managed by SAM no longer owned the shares, but retained the economic risk of the loss should the price decline. The combination of Hibernia and Capital One was expected to close on September 1, 2005 and the strategy, if successful, would permit the fund to profit from the difference between the market price for Hibernia shares at the time of the purchase and the higher anticipated deal price at closing. Hurricane Katrina struck on Sunday August 28, 2005, and by Tuesday August 30, 2005, many analysts were concluding the deal would not close as scheduled until Capital One and Hibernia could assess the damage to their assets in New Orleans. On August 31, 2005, SAM began attempting to hedge its risk by shorting Hibernia stock. However, they were unable to locate sufficient stock to borrow. It was determined, incorrectly, and without seeking the advice of either in house or outside counsel, that they could simply mark the sales as "long," thereby "alleviating the need to locate shares to borrow and the trading restrictions of the 'tick test.'" n304 Additional marking violations occurred even after counsel for SAM informed SAM that a number of trades had been mis-marked. Had they correctly marked the shares as "short," the broker-dealer's direct access trading system that SAM was using would have "automatically blocked executions of the trades because of the unavailability of shares to borrow." n305 By the end of August 31, over 3.5 million shares had been mismarked as "long" and over two million shares had been shorted on a down tick or a zero minus tick in violation of the "tick test."

When Regulation SHO was drafted in 2004, implementation of Rule 201 was deferred until evaluation of the results of pilot program created under Rule 202T. Specifically, Rule 202T authorized the SEC to establish a pilot program under which it could exclude designated securities from application of the tick test of Rule 10a-1 and any short sale price test rule of any exchange or national securities association. n306 As of May 2, 2005, the pilot program suspended the short sales price test for a subset of securities from a broad-based index, to study the impact on market quality, price changes caused by short selling, costs imposed by the tick test, and the use of alternative means to establish short positions. n307 In the Preamble to Regulation SHO, the SEC set forth the possible results of the pilot with respect to the new short sale price test under Rule 201: (1) to eliminate a price test for some or all securities; (2) to adopt the uniform bid test with exceptions, and possibly extend that test to securities which are not currently subject to a price test; or (3) to retain the current price tests. n308

Based on the information gathered during the pilot program, the SEC repealed Rule 10a-1 and adopted Rule 201 in 2007. n309 The SEC concluded that existing price test regulation was "inconsistent across markets," "potentially create[d] an unlevel playing field," "allow[ed] for regulatory arbitrage," and failed to "k[ee]p pace with the types of trading systems and strategies currently used in the marketplace." n310 Rule 201 not only eliminates the Rule 10a-1 "tick rule," n311 but also prohibits self-regulatory organizations from having their own "tick rule." n312 Because Rule 201 eliminated all price test restrictions, the SEC also amended Rule 200 to remove the requirement that a broker-dealer mark a sell order of an equity security as "short exempt" if the seller was relying on an exception to the new-defunct price test of Rule 10a-1 or any other price test. n313 However, the SEC confirmed that broker-dealers would, notwithstanding its June 2007 amendments, continue to be required to mark sell orders as either "long" or "short" in compliance with Rule 200. n314

In April 2009, the SEC sought public comment on whether a short sale price test requirement should be re-instituted. n315 The SEC "decided to re-evaluate the issue due to extreme market conditions and the resulting deterioration in investor confidence." n316 On February 24, 2010 the SEC announced a new Rule 201 alternative uptick rule, effective as of May 10, 2010. n317 The alternative uptick rule set forth in Rule 201(b) of Regulation SHO combines a price test and a circuit breaker, "such that when triggered, short selling will be permitted only at a price above the current national best bid." n318 In other words, new Rule 201(b) is a "short sale-related circuit breaker that, if triggered, will impose a restriction on the prices at which securities may be sold ('short sale price test' or 'short sale price test restriction')." n319 Specifically, Rule 201(b) provides that:

(1) trading center shall establish, maintain, and enforce written policies and procedures reasonably designed to:

(i) Prevent the execution or display of a short sale order of a covered security at a price that is less than or equal to the current national best bid if the price of that covered security decreases by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day; and

(ii) Impose the requirements of paragraph (b)(1)(i) of this section for the remainder of the day and the following day when a national best bid for the covered security is calculated and disseminated on a current and continuing basis pursuant to an effective national market system plan.

The SEC adopted new Rule 201(b) "because, when triggered, it will prevent short selling, including potentially manipulative or abusive short selling, from driving down further the price of a security that has already experienced a significant intra-day price decline, and will facilitate the ability of long sellers to sell first upon such a decline." n320 According to the SEC, "[t]his approach establishes a narrowly-tailored Rule that will target only those securities experiencing significant intra-day price declines." n321 Rule 201(a)(1) defines "covered security" to mean any "NMS stock" as defined under Rule 600(b)(47) of Regulation NMS. "Thus, Rule 201 will apply to any security or class of securities, except options, for which transaction reports are collected, processed, and made available pursuant to an effective transaction reporting plan. As a result, Rule 201 generally will cover all securities, except options, listed on national securities exchanges whether traded on an exchange or in the OTC market ... [but] will not include non-NMS stocks quoted on the OTC Bulletin Board or elsewhere in the OTC market." n322

According to the SEC, "combining the alternative uptick rule with a circuit breaker will strike the appropriate balance between our goal of preventing short selling, including potentially manipulative or abusive short selling, from being used as a tool to exacerbate a declining market in a security and the need to allow for the continued smooth functioning of the markets, including the provision of liquidity and price efficiency in the markets." n323 At the same time, however, the SEC recognizes "the benefits to the market of legitimate short selling, such as the provision of liquidity and price efficiency. Thus, by imposing a short sale price test restriction only when an individual security is undergoing significant downward price pressure, the short sale price test restrictions of Rule 201 will apply to a limited number of securities, rather than to all securities all the time." n324

There are, however, several exemptions that will permit trading centers to display or execute short sales at or below the national best bid under certain circumstances even when a circuit breaker is in effect. Rule 201(d)(1) exempts a seller who owns the stock but is experiencing a delivery delay. Rule 201(d)(2) exempts a market maker attempting to "offset customer odd-lot order or to liquidate an odd-lot position that changes such broker's or dealer's position by no more than a unit of trading." Rules 201(d)(3) and (d)(4) exempt short sales that are part of domestic or international arbitrage transactions. Rule 201(d)(5)(i)-(ii) exempts an underwriter executing short sales in connection with an "over-allotment" or "lay-off sales" as part of a distribution of securities. Rule 201(d)(6) exempts short sales that facilitate a "riskless principal" trade. And Rule 201(d)(7) exempts transactions involving volume weighted average pricing. Under Rule 201(c), broker dealers routing such orders to trading centers must mark them as "short exempt."

Before addressing the provisions regulating the transaction of short sales, Rule 203 sets forth the requirements for designating and effecting a sale that is "long." If a broker-dealer knows or should know that a sale of an equity security is marked long, the broker-dealer must make delivery when due and cannot use borrowed securities to do so. n325

The requirement does not apply: (1) when there is a loan of a security through the medium of a loan to another broker or

dealer; (2) where the broker or dealer knows or has been reasonably informed by the seller that the seller owns the security and will deliver it to the broker or dealer prior to the scheduled settlement of the transaction and the seller fails to make such delivery; or (3) where an exchange or securities association finds, prior to the loan or arrangement to loan any security for delivery, or failure to deliver, that the sale resulted from a good-faith mistake, the broker-dealer exercised due diligence, and either that requiring a buy-in would result in undue hardship or that the sale had been effected at a permissible price. n326

The rule then focuses on short sale transactions. Broker-dealers, prior to effecting short sales in all equity securities, are required to "locate" securities for borrowing. The rule imposes additional delivery requirements on broker-dealers with a history of failures to deliver. n327

The rule also provides that a broker-dealer cannot accept a short sale order or effect a short sale order for the broker-dealer's own account unless it has (1) borrowed the security, or entered into an arrangement to borrow the security; or (2) has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due. n328 This provision acts as a restriction on "naked" short selling. n329

Rule 203(b) further requires any participant in a clearing agency to take action on all failures to deliver threshold securities within 10 days after the normal settlement date, i.e., for thirteen consecutive settlement days, by closing out the failure to deliver position and purchasing securities of like kind and quantity. n330 There are several exceptions to this obligation. n331 The participant, and any clearing broker, is prohibited from effecting further short sales in the threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the fail to deliver position is closed out. n332

On September 17, 2008, the SEC eliminated the options market-maker exception to Rule 203, which allowed designated options market makers to hedge existing options by selling short the underlying security even if the market maker had no ability to deliver the shorted security on the settlement date. n333 As a result of the elimination of this exception, options market makers had to comply with new interim Rule 204T. n334

In addition to amending Rule 203, the SEC changed the short sale rules with its implementation of Rule 204T. Rule 204T required broker-dealers to deliver the equity securities that are the subject of a long or short sale by the close of business on the third business day after the transaction date or "T+3." If there has been a delivery failure, no later than the beginning of regular trading hours on the next settlement date following T+3, subject to certain exceptions noted below, broker-dealers must either borrow or purchase the subject securities or they are subject to a penalty whereby offending broker-dealers and their clearing firms will be barred from effecting further short sales in the subject security on behalf of any client unless the shares are pre-borrowed. n335 If there is a delivery failure and the clearing firm can document that the failure was in connection with a long position, then it has until the start of trading on the third settlement day following T+3 to close out the position through a buy-in. n336 If there is delivery failure with respect to securities sold pursuant to Rule 144, then the broker-dealer has until the beginning of regular trading hours on the 36th settlement day after T+3 to close out the position through a buy-in. n337

On April 10, 2009, the SEC released proposed amendments to Regulation SHO that sought to impose new restrictions on short sales. Specifically, the SEC proposed restricting short sales either by a modified uptick rule, an uptick rule similar to former Rule 10a-1 or a circuit breaker that would either (i) ban short selling in a particular security for the remainder of the day if there is a severe decline in the price of that security or (ii) impose a short sale price test. A roundtable was held on May 5, 2009 and comments regarding the proposals were encouraged through June 19, 2009.

On July 27, 2009, the SEC adopted Rule 204T. n338 Like the Temporary Rule, the new permanent Rule 204 seeks to enhance the delivery requirements of Regulation SHO by requiring that broker-dealers deliver securities by the settlement date or, if they have not delivered securities by the settlement date, resulting in a fail to deliver, that they immediately purchase or borrow securities to close out the fail to deliver position by no later than the beginning of

regular trading hours on the settlement date following the day they incurred the fail to deliver position. n339 Participants that do not comply with the close-out requirement, and any broker-dealer from which they receive trades for clearance and settlement, will not be able to sell short the security either for itself or for the account of another, unless it has previously arranged to borrow or borrowed the security, until the fail to deliver position is closed out. n340

Rule 204 aims to reduce fails to deliver and address potentially abusive "naked" short selling. Sudden and unexplained declines in prices of equity securities and deterioration of investor confidence served as additional impetus for Rule 204, which serves as a powerful disincentive to those who engage in potentially abusive practices of naked short selling. n341 Analysis conducted by the SEC's Office of Economic Analysis, after the adoption of the close-out requirement under Temporary Rule 204T, showed significant declines in the number of fails to deliver, confirming the Rule's effectiveness. n342

Regulation SHO also amends Rule 105 of Regulation M, "Short Sales in Connection with a Public Offering." n343 Rule 105, described in more detail in the previous section, prohibits pre-pricing short sales, effected within five days of pricing of an offering, from being covered with offering securities acquired from an underwriter or other broker-dealer participating in the offering. The SEC explains that pre-pricing short sales that are covered with offering shares distort the market, as offering prices are normally based on the stock's closing price just prior to pricing for the offering, and short sales during that period that reduce the market price can lower the offering price. n344 Regulation SHO also eliminates the previous exception under Rule 105, which allowed short sales during a restricted period prior to a shelf offering. n345 The SEC explains that shelf offerings have become more common, are often subject to the same marketing efforts as non-shelf-offerings, and therefore should be treated similarly for purposes of the rule. n346

[vii] Short Sale Reporting Requirements. When it issued an emergency ban on short-selling stock of certain financial firms in September 2008, the SEC also promulgated Temporary Rule 10a-3T, which required any issuer filing a Form 13F for the period ended June 30, 2008 to report certain information about short positions in all Section 13(f) securities on a new Form SH. n347 Each issuer was required to file the form electronically and include the number and value of the securities sold short, except for short sales in options, and the opening short, closing short, and gross number of short sales. Originally, this requirement was set to expire on October 2, 2008, but was later extended and remain in place until August 1, 2009. n348

After its adoption of Rule 204, the SEC allowed Rule 10a-3T to expire. n349 In lieu of Rule 10a-3T, the Commission is working with self-regulatory organizations to increase the public availability of short sale-related information. n350 Specifically, self-regulatory organizations will now begin publishing on their websites the aggregate short selling volume in each individual equity security for that day, along with information regarding individual short sale transactions in all exchange-listed equity securities on a one-month delayed basis. n351 The Commission will also enhance publication on its website of fail to deliver data so that fails to deliver information is provided twice per month for all equity securities, regardless of their fail level. n352

[d] Regulation of Options: Sections 9(b)-(d) and (g).

[i] Section 9(b) and Rule 9b-1. The legislative history of the Exchange Act clearly reveals Congress' distrust of options trading. In 1934, Congress found:

The granting of options to pools and syndicates has been found to be at the bottom of most manipulative operations, because the granting of these options permits large-scale manipulations to be conducted with a minimum of financial risk to the manipulators. The bill, therefore, gives the administrative commission power to regulate dealing in options or trading in options. n353

Section 9(b) grants the SEC the authority to regulate stock options. n354 It makes it unlawful for any person, through a national securities exchange, in contravention of any rule or regulation by the SEC, to effect any transaction in connection with a security in which any party to the transaction: acquires any put, call, straddle or other option or

privilege of buying or selling a security without being bound to do so; has, directly or indirectly, any interest in any such put, call, straddle, option or privilege; conducts the transaction for the account of any person who the party has reason to believe has, and who actually has, directly or indirectly, any interest in any such put, call straddle, option or privilege.

The SEC has interpreted Section 9(b) as granting it "plenary authority to regulate all aspects of options trading on exchanges and to assure that such trading occurs in a manner calculated to eliminate the manipulative and fraudulent uses of options." n355 Despite its broad delegation of authority with respect to options, there currently are no SEC rules specifically addressing market manipulation of options. Regulation of options trading has principally become the province of self-regulatory organizations, which have issued numerous rules regulating such practices. n356

There is only one current SEC rule governing options trading generally: Rule 9b-1, promulgated in 1982, which requires an options disclosure document ("ODD") to accompany any options transaction. n357 Rule 9b-1 requires a broker-dealer to file an ODD with the SEC and to furnish the ODD to the customer prior to approving the customer's account for trading in options. n358 The ODD must contain, among other items, a discussion of the mechanics of buying, writing or exercising the option; the risks of trading the option; the market for the option; and a reference to the transaction costs, margin requirements, and tax consequences of options trading. n359

Following adoption of Rule 9b-1, an options disclosure document was prepared jointly by the American Stock Exchange, the Chicago Board Options Exchange, the Pacific Exchange, the Philadelphia Stock Exchange and the Options Clearing Corporation. n360 The Financial Industry Regulatory Authority ("FINRA") n361 and The New York Stock Exchange ("NYSE") have also joined in submitting jointly-prepared ODDs. n362 Individual and joint amendments are made periodically to adapt to the evolving options markets. n363

Several courts have recognized private rights of action under the Exchange Act for improprieties with respect to the options disclosure document. The Court of Appeals for the Fifth Circuit recognized an action under Section 9(e) for failure to provide an options disclosure document, but affirmed the district court's order granting a motion for a directed verdict with respect to plaintiff's Section 9 claim, for failure to plead and prove the violation's effect on the market or on the purchase price, as required under Section 9 claims in other contexts. n364 The United States District Court for the Southern District of New York also entertained a cause of action under Section 10(b) for alleged false and misleading statements in an ODD, but dismissed the count for failure to allege scienter. n365

[ii] Sections 9(c), 9(d) and 9(g). Section 9(c) prohibits members of national securities exchanges from violating SEC rules in connection with endorsing or guaranteeing the performance of puts, calls, straddles, options or privileges in relation to securities that are registered on national securities exchanges. n366 Section 9(d) excludes warrants, rights or convertible securities registered under the Exchange Act from the Section 9 prohibitions with respect to puts, calls, straddles, options and privileges. n367

Section 9(g) makes explicit the scope of the SEC's rule-making power and jurisdiction to regulate transactions involving options. Congress passed the provision in response to a 1982 decision by the United States Court of Appeals for the Seventh Circuit, n368 where the Court found that the Commodities Futures Trading Commission, which had exclusive jurisdiction for regulatory "accounts, agreements ... and transactions involving contracts of sale of a commodity for future delivery," n369 had exclusive jurisdiction to regulate options trading on Government National Mortgage Association pass-through certificates that were backed by mortgages (GNMAs). The Seventh Circuit had noted that, under the Exchange Act, the SEC had the authority to regulate securities, but found that the definition of "security" under the Act did not include the word "option." Congress therefore passed Section 9(g) to preserve the jurisdiction of the SEC over options trading. n370

Section 9(g) grants the SEC the authority to regulate the trading of any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities ... or any put, call, straddle, option or privilege entered

into on a national securities exchange related to foreign currency (but not, with respect to any of the foregoing, an option on a contract for future delivery). n371

[e] Regulation of Practices Affecting Market Volatility: Section 9(h). Section 9(h), which was added by the Market Reform Act of 1990, n372 prohibits or constrains certain trading practices during periods of extraordinary market volatility. It prohibits any act or practice in connection with the purchase or sale of any equity security in contravention of rules or regulations adopted by the Commission to prevent manipulation of price levels of the equity securities market. It also prohibits or constrains, during periods of extraordinary market volatility, any trading practice in connection with the purchase or sale of a security that the Commission determines has previously contributed significantly to extraordinary levels of volatility and is reasonably certain to engender such levels of volatility if not prohibited or constrained. n373

Section 9(h) provides the basis for recent measures curtailing transactions particularly prone to wide market fluctuations. For example, the section was cited as one of the provisions supporting promulgation of proposed Rules 41.1, 41.25(a)(2) and 41.25(b) under the Commodity Exchange Act and Rule 6h-1 under the Exchange Act, which establish certain criteria for listing futures products on national securities exchanges and national securities associations and call for a halt in trading when a regulatory halt is instituted by a national securities exchange or national securities association listing the underlying security. These rules were intended primarily to reduce susceptibility of the futures markets to manipulation of the price of the futures product, or the underlying security or option. n374

[f] Rule 10b-18 Safe Harbor for Issuer Repurchases. Corporations buy back their stock for a variety of purposes, including to facilitate mergers or other corporate reorganizations, provide increased liquidity or earnings per share, support falling stock prices or otherwise raise investor confidence in the stock. However, when an issuer, or an affiliate or agent of the issuer, bids for or repurchases the issuer's own stock in the open market, its activities can be falsely perceived as market interest, thereby raising the specter of market manipulation. Rule 10b-18 represents the SEC's attempt to balance the interest in maintaining a "market that is set by independent market forces and not influenced in any manipulative manner by the issuer or persons closely related to the issuer" with the interest in "avoid[ing] complex and costly restrictions that impinge on the operation of issuer repurchase programs." n375

Rule 10b-18 provides a "safe harbor" from liability for manipulation under Sections 9(a)(2) and 10(b) of the Exchange Act and *Rule 10b-5* thereunder, when an issuer or affiliated purchaser of the issuer bids for or purchases shares of its common stock in compliance with the rule's conditions limiting the time or price at which its Rule 10b-18 bids or purchases are made, the amount of such bids or purchases, and the number of brokers or dealers used. n376 The safe harbor is limited: it protects an issuer from a violation based on the time, price or amount of bids or purchases made, or number of brokers or dealers used, but will not shield it from liability if there is other evidence of manipulative conduct. n377

In November 2003, the SEC issued a rule entitled "Purchases of Certain Equity Securities by the Issuer and Others," which comprised amendments to the 10b-18 safe harbor. n378 The 2003 amended rule clarified and revised certain aspects of the safe harbor in light of recent issues and developments in the securities industry. The 2003 amended rule also adopted amendments to other regulations and forms to require disclosure of all issuer repurchases, with respect to both open market and private transactions, regardless of whether the repurchases are effected under the safe harbor rule. n379 The amendments require issuers to disclose, among other things, the total number of shares repurchased, the average price paid per share, and the number of shares repurchased.

The preliminary notes to the amended rule explain that compliance with Rule 10b-18 is voluntary. n380 In order to gain the protection of the safe harbor, the issuer must comply with all four conditions on a daily basis. n381 Any repurchase outside the safe harbor removes all other repurchases from the safe harbor for that day. n382 The Rule 10b-18 safe harbor is available to issuers and their affiliated purchasers. n383 A "Rule 10b-18 purchase" is defined as a purchase (or any bid or limit order that would effect such purchase) of the issuer's common stock by or for the issuer or an affiliated

purchaser, including riskless principal transactions, so long as the acquisition does not fall under a listed exclusion. n384

On September 18, 2008, the SEC suspended Rule 10b-18 in an effort to provide issuers with a source of liquidity during times of market volatility. n385 Generally, issuers were reluctant to undertake repurchases without the certainty that they would be covered by the safe harbor. n386 As such, the emergency order altered the timing and volume conditions in the safe harbor, which provided issuers with additional flexibility and certainty when executing repurchases in the backdrop of dire market conditions. n387

Prior to the 2008 emergency order suspending and modifying Rule 10b-18, there were four elements that had to be met if an issuer was to rely on the safe harbor. They concern (1) the one broker or dealer requirement; (2) time of purchase; (3) price of purchase; and (4) volume of purchase: n388

(1) One Broker or Dealer--The issuer and its affiliated purchasers may use only one broker or dealer to solicit purchases or to make bids on a single day, n389 but may use more than one broker or dealer if the transaction has not been solicited by or for the issuer. n390 Issuers can effect repurchases through an electronic communication network (ECN) or alternative trading system (ATS) directly to qualify. Issuers cannot use an ECN or ATS directly and a broker-dealer on a single day. n391 This condition is designed to prevent an exaggerated appearance of market interest in the stock.

(2) Time of Purchase--An issuer bid or purchase may not constitute the day's opening transaction for any security reported in the consolidated system. n392 This requirement prevents the issuer from setting the tone for the day's trading by establishing the opening price. n393 Similarly, no issuer purchases can be made within ten minutes before the close of the primary trading session in the principal market for the security or the market where the purchase is effected, for securities with an ADTV value of \$1 million or more and a public float value of \$15 million or more. n394 For all other securities, purchases cannot be made within 30 minutes before the close of the primary trading session in the principal market for the security or the market where the purchase is effected. n395 The distinction is based on the relative liquidity of the security and therefore the likelihood of the issuer's repurchase impacting the closing price, which is the most widely disseminated to investors by the media. n396 The 2002 amended rule also added a provision allowing an issuer to purchase securities after the close of the primary trading session until the last sale prices are reported in the consolidated system, so long as the purchases are not the opening transaction of the session following the close of the primary session and are not effected at a price that exceeds the lower of the closing price of the primary trading session and any lower bids or sale prices subsequently reported in the consolidated system. The issuer may use a different broker or dealer to effect purchases in the aftermarket. n397

(3) Price of Purchase--The bid or price paid by the issuer or its affiliate cannot exceed the highest independent published bid or the last independent transaction, whichever is higher, quoted or reported in the consolidated system. n398 For securities for which bids and prices are not quoted or reported in the consolidated system, the same rule applies for the independent bid or last independent transaction price displayed on any national securities exchange or any inter-dealer quotation system that displays at least two priced quotations for the security. n399 For all other securities, the purchase must be effected at a price no higher than the highest independent bid obtained from three independent dealers. n400 This requirement limits 10b-18 purchases to the prevailing price in order to prevent artificial price increases through issuer stock purchases.

(4) Volume of Purchases--The volume of shares purchased by an issuer or its affiliate on a particular day cannot exceed 25 percent of the ADTV in its security, which includes any block-size purchases when calculating the security's four-week ADTV. n401 The 2002 amended rule also allows issuers to make

one block purchase per week under the safe harbor so long as no other Rule 10b-18 purchases are effected that day and the block purchase is not included in the issuer's calculation of the security's four-week ADTV for purposes of the safe harbor. n402

In 1999, the SEC promulgated an amendment to Rule 10b-18, which loosened 10b-18's time of purchase condition following a market-wide suspension of trading due to extreme market volatility. n403 The SEC intended to encourage issuers to participate in reestablishing equilibrium between buying and selling interests and to facilitate short-term liquidity during severe market downturns. n404 Under the amendment, the time of purchase requirement would not apply from the reopening of trading until the close of trading on the same day as the imposition of the market-wide trading suspension, or at the next day's opening, if the market-wide trading suspension was in effect at the scheduled close of trading. n405 The amendment retained the other Rule 10b-18 conditions governing the manner, price, and volume of market purchases of an issuer's common stock. n406 The 2002 amended rule increased the volume of purchase limitation of the 1999 amendment from 25% of the security's ADTV to 100% for that session. n407

The safe harbor is not available for repurchases during the restricted period under Rule 102 of Regulation M, which specifically forecloses an issuer or affiliated purchaser from bidding for or purchasing shares during the restricted period surrounding a distribution of the company's common stock or a distribution for which the common stock is a reference security. n408 The Regulation M and other specific issuer repurchases are listed as exclusions within the definition of a 10b-18 purchase. They include:

- (1) Purchases by the issuer or an affiliated purchaser during the Regulation M restricted period, *i.e.*, during a distribution period of the issuer's common stock or a distribution for which such common stock is a reference security. n409 Whereas the other exclusions are intended to facilitate issuer repurchases within the specified categories, this exclusion is meant to preclude issuer purchases during distributions.
- (2) Purchases effected by or for an issuer plan by an agent independent of the issuer. n410 The SEC does not consider transactions by agents independent of the issuer attributable to the issuer. n411
- (3) Purchases that represent a fractional interest in a security, evidenced by a script certificate, order form or similar document. n412 The SEC considers these purchases sufficiently *de minimis* that they do not to present a risk of manipulation. n413
- (4) Purchases pursuant to a merger, acquisition, or similar transaction involving a recapitalization. n414 The 2003 amended rule narrows the exclusion so that it now applies to the period from the public announcement until the earlier of the completion of the transaction or the completion of the vote by target shareholders (including during any period where the market price of a security will be a factor in determining the consideration to be paid). n415 The SEC has excluded these transactions because they present less opportunity for manipulation. n416
- (5) Purchases subject to Rule 13e-1 under the Exchange Act. n417 Rule 13e-1 applies to an issuer's purchases of its own stock after a third party has filed a tender offer for its securities. n418 The SEC has excluded these transactions, as they already are subject to other regulatory safeguards. n419
- (6) Purchases pursuant to a tender offer that is subject to Rule 13e-4 under the Exchange Act or specifically exempted therefrom. n420 Rule 13e-4 applies to issuer self-tender offers and was excluded from the safe harbor because such offers are subject to other regulatory safeguards. n421
- (7) Purchases pursuant to a tender offer subject to Section 14(d) of the Exchange Act and the rules and regulations thereunder. n422 Section 14(d) applies to certain tender offers by bidders other than the issuer, and such tenders are likewise excluded from the safe harbor because they are subject to other

regulatory safeguards. n423

The SEC has emphasized that the 10b-18 safe harbor "is not mandatory nor the exclusive means of effecting issuer purchases without manipulating the market." n424 The safe harbor is not necessary, for example, for issuer repurchases that are otherwise permitted, in limited circumstances, by alternate provisions of the Exchange Act. The SEC explicitly provided that there is no presumption of a violation of the anti-manipulation provisions simply because an issuer or affiliated purchaser failed to meet all the conditions under Rule 10b-18. n425 Conversely, for a person or securities for which the safe harbor is not explicitly available, there is no obligation to attempt to conform with the requirements of the safe harbor. n426

In September 2008, the SEC issued an emergency order altering the timing and volume conditions of Rule 10b-18. n427 The purpose of the order was to provide issuers with added flexibility and certainty in light of poor market conditions. Specifically, the SEC was concerned about sudden and unexplained declines in the prices of securities, which decreases confidence without a fundamental underlying basis. n428 Thus, the emergency order (1) suspended the time of purchases condition in paragraphs (b)(2)(i), (b)(2)(ii), and (b)(2)(iii) of the rule; and (2) modified the volume of purchases condition in paragraph (b)(4) so that the amount of 10b-18 purchases must not exceed 100% of the ADTV for the security. n429 The manner and price purchase conditions remain in place.

FOOTNOTES:

(n1)Footnote 1. *United States v. Brown*, 5 F. Supp. 81, 85 (S.D.N.Y. 1933) , *aff'd on other grounds*, 79 F.2d 321 (2d Cir. 1935) .

(n2)Footnote 2. *Ottinger v. Bennett*, 203 N.Y. 554, 554 (1911) .

(n3)Footnote 3. *Singleton v. Harriman*, 272 N.Y.S. 905, 905 (Sup. Ct. 1933) , *aff'd per curiam*, 271 N.Y.S. 996 (App. Div. 1st Dep't 1934) .

(n4)Footnote 4. *Thomas Sampson, Jr. v. Samuel S. Shaw*, 101 Mass. 145, 1869 Mass. LEXIS 163, at *4 (Jan. Term, Mass. 1869) . *See also Ridgely v. Keene et al.*, 119 N.Y.S. 451, 453-54 (App. Div. 2d Dep't 1909) (contract between stockbrokers and writer of circular letter to compensate writer for recommending particular stock was illegal and voidable).

(n5)Footnote 5. *Willcox v. Harriman Sec. Corp.*, 10 F. Supp. 532, 535 (S.D.N.Y. 1933) ("If persons boost the quoted price of a stock above its real value by fictitious sales in order to induce the public to take over their stock at the artificial levels, one who acquires stock for value from the manipulators may treat the transaction as one infected by fraud and may rescind.").

(n6)Footnote 6. *United States v. Brown*, 79 F.2d 321, 322-23 (2d Cir. 1935) . *See also Harris v. United States*, 48 F.2d 771 (9th Cir. 1931) (conviction under Mail Fraud Act upheld where defendant engaged in wash sales and made false reports and statements concerning value of stock in order to manipulate market price of stock); *Goddard v. United States*, 86 F.2d 884 (10th Cir. 1936) (conviction under Mail Fraud Act upheld where defendants set up fictitious brokerage and engaged in wash sales and false representations of offers to buy stock in order to induce purchases and drive up price of stock for which defendants possessed option).

(n7)Footnote 7. *See People v. Rice*, 223 N.Y.S. 566, 568-69 (App. Div. 1st Dep't 1927) .

(n8)Footnote 8. *See People v. Federated Radio Corp.*, 244 N.Y. 33, 38 (1926) ("The purpose of the law is to prevent all kinds of fraud in connection with the sale of securities and commodities and to defeat all unsubstantial and visionary schemes in relation thereto whereby the public is fraudulently exploited."). Most state Blue Sky laws still prohibit a variety of manipulative and fraudulent devices. Sara Beth Brody & Ted F. Angus, *Securities Litigation in State Court*, 1070 PRAC. LAW INST./ CORP. LAW AND PRAC. COURSE HANDBOOK SERIES 413, 416, 421,

424-25 (1998). *See also* 1 MATTHEW BENDER, *Blue Sky Regulation*, § 6.03 [iii].

(n9)Footnote 9. *See* 1 MATTHEW BENDER, *FEDERAL SECURITIES EXCHANGE ACT OF 1934*, § 1.01[1] n.10 (2002); S. REP. NO. 73-792, at 3-5 (1934) ("Excessive speculation" by those deprived of complete information, coupled with "unfair methods of speculation" by those in a position to control artificially the market price of stock were important causes of the crash of 1929, and are the "principal problems with which the [Exchange Act] deals."); *Hundahl v. United Benefit Life Ins. Co.*, 465 F. Supp. 1349, 1360 (N.D. Tex. 1979) .

(n10)Footnote 10. H.R. REP. NO. 73-1383, at 10-11 (1934).

(n11)Footnote 11. S. REP. NO. 73-1455, at 30 (1934).

(n12)Footnote 12. "The Securities Exchange Act of 1934 has erected certain safeguards around the exchanges in order that their legitimate function of furnishing a free and honest market may no longer be defeated by manipulative practices. Certain devices employed for the purpose of artificially raising or depressing security prices are specifically prohibited by the act. Others have not been forbidden outright but have been placed under the control of the Securities and Exchange Commission." *Id.* at 54-55.

(n13)Footnote 13. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976) .

(n14)Footnote 14. *Santa Fe Indus. Inc. v. Green*, 430 U.S. 462, 476 (1977) . Fifth Circuit Judge Patrick Higginbotham, formerly of the Northern District of Texas, defined market manipulation as follows: "Practices in the marketplace which have the effect of either creating the false impression that certain market activity is occurring when in fact such activity is unrelated to actual supply and demand or tampering with the price itself are manipulative." *Hundahl*, 465 F. Supp. at 1360 .

(n15)Footnote 15. *Halsey, Stuart & Co.*, 30 SEC at 112 .

(n16)Footnote 16. *Pagel, Inc.*, Sec. Ex. Act. Rel. No. 22,280, 33 SEC Dock. 1003, 1005 (August 1, 1985), *aff'd*, *sub. nom.*, *Pagel, Inc. v. SEC*, 803 F.2d 942 (8th Cir. 1986) ; *See also*, In the Matter of John Roger Faherty, Sec. Ex. Act Rel. No. 47402, 79 SEC Dock. 2381 (Mar. 14, 2003) (same definition); *Gurary v. Winehouse*, 190 F.3d 37, 45 (2d Cir. 1999) (similar definition by Second Circuit).

(n17)Footnote 17. *See* § 6.03[4][a] (below).

(n18)Footnote 18. *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 6-7 (1985) . *See also* *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963) .

(n19)Footnote 19. *Lautenberg Foundation v. Madoff*, No. Civ. A. 09-816 (SRC), 2009 U.S. Dist. LEXIS 82084 (D.N.J. Sep. 09, 2009) ; *In re Pfizer Inc. Sec. Litig.*, 584 F.Supp.2d 621 (S.D.N.Y. 2008) ; *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 310 F. Supp.2d 819 (S.D. Tex. 2004) ; *In re Initial Public Offering Litig.*, 241 F. Supp.2d 281 (S.D.N.Y. 2003) ; *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp.2d 319 (S.D.N.Y. 2004) . *See also*, *In re Lernout & Hauspie Sec.*, 236 F. Supp.2d 161 (D. Mass. 2003) .

(n20)Footnote 20. *See In re Refco, Inc. Sec. Litig.*, 609 F. Supp. 2d 304 (S.D.N.Y. 2009) ; *In re Converium Holding AG Sec. Litig.*, No. 04 Civ. 7897 (S.D.N.Y. Dec. 28, 2006).

(n21)Footnote 21. Manipulation of Security Prices, 15 U.S.C.A. § 78i (2004) (Sec. Ex. Act § 9). *See* MATTHEW BENDER Securities Primary Law Sourcebook Volume B for the complete text of § 9.

(n22)Footnote 22. Sec. Ex. Act § 9(a)(1).

(n23)Footnote 23. Sec. Ex. Act § 9(a)(2).

(n24)Footnote 24. Sec. Ex. Act §§ 9(a)(3), (4) & (5).

(n25)Footnote 25. Sec. Ex. Act § 9(a)(6).

(n26)Footnote 26. Sec. Ex. Act §§ 9(b), (c), (d) and (g).

(n27)Footnote 27. Sec. Ex. Act § 9(h).

(n28)Footnote 28. *See, e.g., SEC v. Competitive Techs. Inc.*, No. 3:04-cv-1331 (JCH), 2005 WL 1719725, at *1 (D. Conn. July 21, 2005); *SEC v. Resch-Cassin & Co.*, 362 F. Supp. 964, 975 (S.D.N.Y. 1973) ("It is well settled that the manipulative activities expressly prohibited by § 9(a)(2) of the Exchange Act with respect to a listed security are also violations of § 17(a) of the Securities Act and § 10(b) of the Exchange Act when the same activities are conducted with respect to an over-the-counter security."); *Halsey, Stuart & Co.*, 30 SEC at 124-25 (applying reasoning of 9(a)(2) to enforcement actions under Exchange Act §§ 10(b) and 15(c) and Securities Act § 17(a)); *Sec. Ex. Act Rel. No. 3505*, 1943 SEC LEXIS 162, at *4-5 (Nov. 16, 1943) ("[T]he Commission has consistently expressed the view that transactions which would violate 9(a)(2), if effected in a registered security, would be in violation of § 15 of the Securities Exchange Act and § 17(a) of the Securities Act of 1933, if effected in a security which is not so registered."); *see also Paine Webber, Inc.*, 4 F. Supp. 2d at 1043 ; *Sayegh*, 906 F. Supp. at 946 .

(n29)Footnote 29. *Charles C. Wright*, 3 SEC 190, 213 (Feb. 28, 1938) , *rev'd on other grounds, Wright v. SEC*, 112 F.2d 89 (2d Cir. 1940) .

(n30)Footnote 30. *See Harold T. White*, *Sec. Ex. Act Rel. No. 1745*, 3 SEC 466 (June 22, 1938) .

(n31)Footnote 31. *See Niss v. NASD, Inc.*, 989 F. Supp. 1302, 1305 (S.D. Cal. 1997) (noting §§ 9(e), 16(b), and 18 of the Securities Exchange Act expressly provide for a private cause of action); *see also Jablon v. Dean Witter & Co.*, 614 F. 2d 677, 681 (9th Cir. 1980) (same).

(n32)Footnote 32. *See § 6.03[4][e]* (below) for a discussion of § 10(b).

(n33)Footnote 33. *See § 6.02[1]* (above) for descriptions of wash sales and matched orders.

(n34)Footnote 34. Sec. Ex. Act § 9(a)(1).

(n35)Footnote 35. *Chemetron Corp. v. Business Funds, Inc.*, 682 F.2d 1149, 1163-64 (5th Cir. 1982) . The Supreme Court has defined scienter to be "a mental state embracing intent to deceive, manipulate, or defraud." *Hochfelder*, 425 U.S. at 193 n.12 . *See also* DAVID M. BRODSKY AND DANIEL J. KRAMER, *FEDERAL SECURITIES LITIGATION: COMMENTARY AND FORMS*, Ch. 1, 1-18 (Data Trace 1997 & 2002 Supp.) (hereinafter "BRODSKY AND KRAMER.")

(n36)Footnote 36. *See Chemetron Corp.*, 682 F.2d at 1162-63 .

(n37)Footnote 37. *See § 6.03[4][c]* (below) for a discussion of manipulative purpose regarding § 9(a)(2).

(n38)Footnote 38. SEC, Report on Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934, House Comm. on Interstate & Foreign Commerce, 77th CONG., 1st SESS. 50 (Comm. Print 1941).

(n39)Footnote 39. Sec. Ex. Act § 9(a)(2).

(n40)Footnote 40. S. REP. NO. 73-1455, at 54.

(n41)Footnote 41. *Chemetron Corp.*, 682 F.2d at 1164 ; *Davis v. Pennzoil Co.*, 264 A.2d 597, 602-03 (Pa. 1970) .

See also *Fezzani v Bear, Stearns & Co.*, 384 F. Supp. 2d 618, 637 (S.D.N.Y. 2004) (explicitly adding two additional elements: (4) was relied on by the plaintiff; and (5) affected plaintiff's purchase or selling price); *SEC v. Competitive Techs., Inc.*, No. 3:04-cv-1331 (JCH), 2005 WL 1719725, at *6 (D. Conn. July 21, 2005).

(n42)Footnote 42. *Kidder Peabody & Co.*, 18 SEC 559, 569-70 (1945) (bids); *Adams & Co.*, 33 SEC 444, 450 n.7 (1952) (entering listings in the sheets or orders on an exchange); *SEC v. Awdisho*, Litig. Rel. No. 18926, 83 SEC Dock. 2851, 2004 SEC LEXIS 2310 (N.D. Ill. Oct. 7, 2004) ("small lot baiting" or "spoofing" on options exchange); *United States v. Stein*, 456 F.2d 844, 846 (2d Cir. 1972) (purchase of small lots).

(n43)Footnote 43. *Kidder Peabody & Co.*, 18 SEC at 568 .

(n44)Footnote 44. *Stein*, 456 F.2d at 850 .

(n45)Footnote 45. See *Resch-Cassin & Co.*, 362 F. Supp. at 976.

(n46)Footnote 46. See *SEC v. Schiffer*, No. 97 Civ. 5853, 1998 U.S. Dist. LEXIS 8579, at *18-19 (S.D.N.Y. June 11, 1998) (use of nominee accounts by brokers); *William Lowe*, Sec. Ex. Act Rel. No. 41,308, 69 SEC Dock. 1337, 1337-38 (Apr. 19, 1999).

(n47)Footnote 47. See *Jolley v. Welch*, 904 F.2d 988, 993 (5th Cir. 1990) ; *Shull v. Dain, Kalman & Quail, Inc.*, 561 F.2d 152, 159 (8th Cir. 1977) ; *Resch-Cassin & Co.*, 362 F. Supp. at 976; *Richardson v. Shearson/American Express Co.*, 573 F. Supp. 133, 136 (S.D.N.Y. 1983) .

(n48)Footnote 48. See *Russell Maguire & Co.*, Sec. Ex. Act Rel. No. 3046, 1941 SEC LEXIS 195, at *35 n.22 (Oct. 18, 1941) .

(n49)Footnote 49. *Resch-Cassin & Co.*, 362 F. Supp. at 976.

(n50)Footnote 50. *Resch-Cassin & Co.*, at 970.

(n51)Footnote 51. *Resch-Cassin & Co.*, at 971.

(n52)Footnote 52. *Resch-Cassin & Co.*, at 978. See also *Stein*, 456 F.2d at 845 (broker made series of small purchases with different brokers and paid brokers to recommend stock); *J. Newman & Co.*, Sec. Ex. Act Rel. No. 14,384, 13 SEC Dock. 1401, 1402-03 (Jan. 17, 1978) (brokers with short position on option manipulated a decrease in stock price by selling short significant number of shares so that option holders would not exercise their options); *Zico Investment Holdings, Inc.*, Litig. Rel. No. 11,763, 41 SEC Dock. 262, 263 (June 13, 1988) (broker arranged a series of sales of stock through another broker in order to depress the stock price before a tender offer).

(n53)Footnote 53. H.R. REP. NO. 73-1383, at 20.

(n54)Footnote 54. *United States v. Minuse*, 114 F.2d 36, 39 (2d Cir. 1940) ("To convict the defendants, it was necessary to prove that they intended to manipulate the stock market. The crossing of orders resulting from active buying and selling without such intention would not violate the law."). In *Trane Co. v. O'Connor Securities*, Trane sought to enjoin O'Connor Securities from any further purchases of Trane securities, under Exchange Act §§ 9(a)(2) and 10(b), among other provisions, as O'Connor had purchased 15% of the outstanding stock in Trane during a nine month period. The Federal District Court for the Southern District of New York denied plaintiff's 9(a)(2) claim on the ground of lack of manipulative purpose:

This level of trading activity undoubtedly affected the price of the stock and induced purchase by others ... [However, defendant] purchased and sold stock through open market channels. There is no evidence that defendants were responsible for any simulated pink sheet activity, nor has there been any evidence of the collapse of the market after O'Connor's active trading subsided ... If what defendants did

constituted manipulation within the meaning of § 9(a), most large scale transactions in a single security would be prohibited. That was clearly not the purpose of Congress. It sought to protect the small investor by maintaining a market controlled by natural forces rather than by intervention of artificial manipulative devices which would distort the market to the detriment of the investing public.

Trane Co., 561 F. Supp. at 304-05.

(n55)Footnote 55. *Seagoing Uniform Corp. v. Texaco, Inc.*, 705 F. Supp. 918, 934 (S.D.N.Y. 1989) , citing *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 794 (2d Cir. 1969) .

(n56)Footnote 56. *U.S. v. Futch*, 278 Fed. Appx. 387, 391-92 (5th Cir. 2008); *U.S. Commodity Futures Trading Com'n v. Johnson*, 408 F.Supp.2d 259, 268-69 (S.D. Tex. 2005) .

(n57)Footnote 57. *The Federal Corp.*, 25 SEC 227, 230 (Jan. 29, 1947) . See also Adrian C. Havill, Initial Decision No. 74, 60 SEC Dock. 310, 316 (Aug. 31, 1995) ("[A]bsent an admission, an inference of manipulative intent may be drawn, and a prima facie case shown when a person with substantial pecuniary interest in achieving a price change engages in the type of market activity proscribed by §§ 9(a)(1) and 9(a)(2).") (citations omitted). For examples of discussion of motivation, see, e.g., *Thornton & Co.*, 28 SEC 208, 223 (July 14, 1948) , *aff'd per curiam sub. nom.*, *Thornton v. SEC*, 171 F.2d 702 (2d Cir. 1948) (lack of satisfactory explanation for series of stock purchases, including wash and matched sales, resulting in rise of stock price, followed by profit from sale of stock); *Resch-Cassin & Co.*, 362 F. Supp. at 977-78 (incentive to artificially raise price to facilitate distribution as underwriter, as well as personal profit motive of individual defendants); *Minuse*, 114 F.2d at 38 (manipulators held options by which they could only profit through rise in stock price); *Stein*, 456 F.2d at 845 (manipulators bought small amounts of stock from different brokers and offered them secret compensation to promote stock); *Crane Co.*, 419 F.2d at 792-94 (motive to defeat competitor's tender offer by increasing the price of the target's stock).

Courts also accept as circumstantial evidence of manipulative purpose evidence of the impact of the manipulative activity. *Pagel, Inc. v. SEC*, 803 F.2d 942, 946 (8th Cir. 1986) ("We believe the Commission could reasonably have inferred from the evidence of price movement, trading activity, and other factors that the manipulation was undertaken for the purpose of securing financial and tax benefits for petitioners and thus was intentional."); *R.J. Koeppe & Co. v. SEC*, 95 F.2d 550, 553 (7th Cir. 1938) ("Not only does the evidence of disinterested witnesses condemn the action and the motive and intent of the defendants, but the transactions themselves, unsupported by oral testimony of witnesses, leave no doubt as to the defendants' intentions."); *R.A. Holman & Co. v. SEC*, 366 F.2d 446, 450 (2d Cir. 1966) ("The record supports the conclusions of the Commission. The interval between purchase by the affiliates and repurchase and sale to the public was so short that it seems likely that it was part of a preconceived plan with manipulative effects ... ").

(n58)Footnote 58. *Alabama Farm Bureau Mut. Casualty Co. v. American Fidelity Life Ins. Co.*, 606 F.2d 602, 616-17 (5th Cir. 1979) . In a 1941 opinion of the General Counsel, the SEC took intent one step further by holding that, in the absence of a satisfactory explanation, an inference of manipulative purpose arises from the mere fact that "one who has purchased stock in a series of transactions and raised its price disposes of the stock before the true effect of his purchases has been dissipated by other market factors." *Thornton & Co.*, 28 SEC at 223 . The General Counsel thus advised that a person who effects a series of transactions for the purpose of later sale at a profit, and whose transactions themselves impact the price of the stock, should not sell that stock until the market impact of those transactions has worn off.

If the broker begins to sell the security at a time when the market still reflects the effects of his activity, the natural inference would be that he had raised the market price for purposes of manipulation. However, where the broker refrains from selling for a sufficient length of time after his purchases so that the market price of the security no longer represents a price for which he is responsible, his failure to take advantage of the market price resulting from his buying would tend to show that he had not caused the rise in market prices for a manipulative purpose.

Opinion of General Counsel Relating to the Anti-Manipulation Provisions of Section 9(a)(2), 10(b) and 15(c)(1) of the Securities Exchange Act of 1934, as well as § 17(a) of the Securities Act of 1933, *Sec. Ex. Act Rel. No. 3056, 1941 SEC LEXIS 1827, at *1 (Oct. 27, 1941)* . However, this appears to be an isolated opinion, which the SEC has not since actively enforced.

(n59)Footnote 59. S. REP. NO. 73-792, at 8.

(n60)Footnote 60. § 9(a)(3) makes it unlawful:

If a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security ... to induce the purchase or sale of any security registered on a national securities exchange ... by the circulation or dissemination in the ordinary course of business of information to the effect that the price of any such security will or is likely to rise or fall because of market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.

Sec. Ex. Act § 9(a)(3).

(n61)Footnote 61. § 9(a)(4) makes it unlawful:

If a dealer or broker, or the person selling or offering for sale or purchasing or offering to purchase the security ... to make, regarding any security registered on a national securities exchange ... for the purpose of inducing the purchase or sale of such security ... any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and which he knew or had reasonable ground to believe was so false or misleading.

Sec. Ex. Act § 9(a)(4).

(n62)Footnote 62. *Weissman*, 62 SEC Dock. at 2166-67. HPI was thinly traded both on Amex and over-the-counter, and Weissman allegedly was able to direct transactions involving HPI by a number of brokers at his firm, controlling where the shares would be traded. Weissman allegedly increased the price of HPI stock traded on Amex by directing to the Amex buy orders that were large enough to deplete the supply, causing the specialist to increase the offer price. Weissman then allegedly directed that the next trades be executed over-the-counter at the increased Amex price. *Id.* at 2167.

(n63)Footnote 63. *Weissman*, at 2170.

(n64)Footnote 64. *Weissman*.

(n65)Footnote 65. *Robbins v. Banner Indus., Inc.*, 285 F. Supp. 758, 760 (S.D.N.Y. 1966) .

(n66)Footnote 66. *Robbins v. Banner Indus., Inc.* at 761 , citing *Elfenbein v. Yaeger*, CCH 64-66 Fed. Sec. L. Rep. P 91, 368 (S.D.N.Y. 1964); *Schoenbaum v. Firstbrook*, 268 F. Supp. 385, 396 (S.D.N.Y. 1967) , *aff'd in part, reversed in part on other grounds*, 405 F.2d 215 (2d Cir. 1968) .

(n67)Footnote 67. § 9(a)(5) makes it unlawful:

For a consideration, received directly or indirectly from a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security ... to induce the purchase of any security registered on a national securities exchange ... by the circulation or dissemination of information to the effect that the price of any such security will or is likely to rise or fall because of the market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.

Sec. Ex. Act § 9(a)(5).

(n68)Footnote 68. § 10(b) of the Exchange Act (15 U.S.C.A. § 78j(b) (2004)), provides in pertinent part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange ...

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Sec. Ex. Act § 10(b).

(n69)Footnote 69. *Rule 10b-5* (17 CFR § 240.10b-5 (2001)), provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Id.

(n70)Footnote 70. For a more detailed discussion of § 10(b) and *Rule 10b-5* as the basis for civil causes of action, see BRODSKY AND KRAMER, *supra* n.33 at § 6.03[4][b], at Ch.6, 6-3 to 6-22.

(n71)Footnote 71. *SEC v. Graystone Nash, Inc.*, 820 F. Supp. 863, 870-71 (D. N.J. 1993) , *rev'd on other grounds*, 25 F.3d 187 (3d Cir. 1994) . For discussion of the scienter element, see *Aaron v. SEC*, 446 U.S. 680, 695 (1980) ; *Hochfelder*, 425 U.S. at 196 .

(n72)Footnote 72. *In re Genesisintermedia, Inc. Sec. Litig.*, No. CV 01-9024-SVW VBKX, 2007 WL 1953475, at *9 (C.D. Cal. Jun. 28, 2007); *Leykin v. AT & T Corp.*, 423 F.Supp.2d 229 (S.D.N.Y. 2006) ; *In re Initial Public Offering Sec. Litig.*, 241 F. Supp.2d 281, 385 (S.D.N.Y. 2003) ; *Stephenson v. Deutsche Bank AG*, 282 F. Supp.2d 1032, 1056 (D. Minn. 2003) ; *In re Sterling Foster & Co., Inc. Sec. Litig.*, 222 F. Supp.2d 216, 269 (S.D.N.Y. 2002) ; *In re Enron Corp. Sec. Derivative & ERISA Litig.*, 235 F. Supp.2d 549, 580 (S.D. Texas 2002) ; *In re Blech Sec. Litig.*, 961 F. Supp. 569, 582 (S.D.N.Y. 1997) .

(n73)Footnote 73. *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13, n.9 (1971) . There is an implied private remedy under 10(b) even when an express remedy is afforded under other provisions of the *Securities Act and Exchange Act*. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 387 (1983) ; *Chemetron Corp. v. Business Funds, Inc.*, 718 F.2d 725, 728 (5th Cir. 1983) (express remedy under § 9 of Exchange Act does not preclude relief under § 10(b)).

2-6 Federal Securities Exchange Act of 1934 § 6.03

(n74)Footnote 74. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731-32 (1975) .

(n75)Footnote 75. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 731-32 (1975) .

(n76)Footnote 76. *Dan River v. Icahn*, 701 F.2d 278, 284-85 (4th Cir. 1983) . See also *Bosio v. Norbay Sec., Inc.*, 599 F. Supp. 1563, 1566 (E.D.N.Y. 1985) (as applied both to § 10(b) and 15(c)(1)).

(n77)Footnote 77. See *Herman & MacLean*, 459 U.S. at 382 . For examples of the breadth of the "in connection with" element, see *Bankers Life and Casualty Co.*, 404 U.S. at 12 ; *United States v. Russo*, 74 F.3d 1383, 1391-92 (2d Cir. 1996) ; *In re Ames Dep't Stores, Inc. Stock Litig.*, 991 F.2d 953, 962 (2d Cir. 1993) ; County of Nevada, Initial Decision No. ID-153, 70 SEC Dock. 2535, 2545-46 (Oct. 29, 1999).

(n78)Footnote 78. *Chemetron Corp.*, 682 F.2d at 1165 .

(n79)Footnote 79. *United States v. Charnay*, 537 F.2d 341, 350-52 (9th Cir. 1976) (it is sufficient for the person to engage in a course of business which operates as a fraud or deceit as to the nature of the market for the security); *Michael Batterman*, 46 SEC 304, 305 (1976) ; *Adrian Havill*, 60 SEC Dock. at 317-18.

(n80)Footnote 80. *SEC v. U.S. Environmental, Inc.*, 155 F.3d 107, 112 (2d Cir. 1998) :

[A]s long as Romano [the broker], with scienter, effected the manipulative buy and sell orders, Romano's personal motivation for manipulating the market is irrelevant in determining whether he violated § 10(b). Even if Romano were motivated by a desire to obtain compensation rather than by a desire to change USE's market price, as [the stock promoter] was, Romano is liable under § 10(b) if, with scienter, he effected the manipulative trades.

(n81)Footnote 81. 551 U.S. 308 (2007) .

(n82)Footnote 82. *Institutional Investors Group v. Avaya, Inc.*, 564 F.3d 242, 253 (3d Cir. 2009) .

(n83)Footnote 83. *Globis Capital Partners, L.P. v. Stonepath Group, Inc.*, No. 06-2560, 2007 WL 1977236, at *3 n.1 (3rd Cir. July 10, 2007)

(n84)Footnote 84. See *Tuchman v. DSC Communications Corp.*, 14 F.3d 1061, 1068 (5th Cir. 1994) ("To plead scienter adequately, a plaintiff must set forth specific facts that support an inference of fraud.").

(n85)Footnote 85. Under § 10(b), "[t]he factual background adequate for an inference of fraudulent intent can be satisfied by alleging facts that show a defendant's motive to commit securities fraud. Where a defendant's motive is not apparent, a plaintiff may adequately plead scienter by identifying circumstances that indicate conscious behavior on the part of the defendant, though the strength of the circumstantial allegations must be correspondingly greater." *Id.* See also *United States v. Mulheren*, in which the Second Circuit reasoned that an investor may be convicted under *Rule 10b-5* where "the purpose of his transaction is solely to affect the price of a security. The issue then becomes one of [the defendant's] subjective intent. The government was obligated to prove beyond a reasonable doubt that when Mulheren purchased 75,000 shares of G & W common stock ... he did it with the intent to raise its price, rather than with the intent to invest." 938 F.2d 364, 368-69 (2d Cir. 1991) .

(n86)Footnote 86. See *Edward J. Mawod & Co. v. SEC*, 591 F.2d 588, 595 (10th Cir. 1979) .

(n87)Footnote 87. See *Norris & Hirshberg v. SEC*, 177 F.2d 228, 232 (D.C. Cir. 1949) .

(n88)Footnote 88. See *Crane Co.*, 419 F.2d at 792-93 .

(n89)Footnote 89. *See Pagel, Inc.*, 33 SEC Dock. at 1006; Litig. Rel. No. 11,973, 42 SEC Dock. 1066, 1066 (Jan. 25, 1989).

(n90)Footnote 90. *See SEC v. Edgar*, Litig. Rel. No. 19033, 2005 SEC LEXIS 86 (C.D. Ill. Jan. 13, 2005); *Zico Investment Holdings, Inc.*, 41 SEC Dock. at 263.

(n91)Footnote 91. *See Charnay*, 537 F.2d at 344 .

(n92)Footnote 92. *See J. Newman & Co*, Sec. Ex. Act Rel. No. 14,384, 13 SEC Dock. 1401, 1402 (Jan. 17, 1978); *Alan Bennett Harp*, Sec. Ex. Act Rel. No. 22,511, 34 SEC Dock, 344, 344 (Oct. 5, 1985); *Kidder Peabody & Co.*, 18 SEC at 570-71 .

(n93)Footnote 93. *See R.A. Holman & Co.*, 366 F.2d 446, 449 (2d Cir. 1966) .

(n94)Footnote 94. 511 U.S. 164 (1994) .

(n95)Footnote 95. 511 U.S. at 191 .

(n96)Footnote 96. *See Osrecovery, Inc. v. One Group Int'l, Inc.*, 354 F. Supp.2d 357, 369 (S.D.N.Y. 2005) ; *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) ; *Anixter v. Home-Stake Production*, 7 F.3d 1215, 1225 (10th Cir. 1996) ; *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) ; *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000) ; *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994) .

(n97)Footnote 97. At least one court has adopted a third test, recommended by the SEC, which is sometimes referred to as the "creation test" and would establish liability of a secondary actor involved in the creation of a misstatement. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp.2d 549, 587-88 (S.D. Texas 2002) . For more detail as to the liability of secondary actors post-Central Bank in the context of misrepresentations or omissions, see chapter 5.

(n98)Footnote 98. *See, e.g., Freeman v. DirecTV, Inc.*, 457 F.3d 1001, 1006 (9th Cir. 2006) ; *In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp.2d 1018, 1041 and 1045 (9th Cir. 2003) (granting motion to dismiss 10(b) claim against business partners and outside vendors involved in allegedly fraudulent revenue enhancing measures, but denying motion with respect to outside auditors); *In re Cylink Sec. Litig.*, 178 F. Supp.2d 1077, 1084-85 (N.D. Cal. 2001) (granting motion to dismiss 10(b) claim against sales and marketing executive and CEO of company filing allegedly fraudulent financial statements). *But see In re Software Toolworks, Inc.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994) (denying summary judgment for outside auditors involved in alleged financial misstatements).

(n99)Footnote 99. 17 C.F.R § 240.10b-5 (2004).

(n100)Footnote 100. *In re Enron* at 577.

(n101)Footnote 101. *In re Enron*, 235 F. Supp.2d at 579.

(n102)Footnote 102. *In re Initial Public Offering Sec. Litig.*, 241 F. Supp.2d 281, 293 (S.D.N.Y. 2003) .

(n103)Footnote 103. *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp.2d 319, 335 (S.D.N.Y. 2004) .

(n104)Footnote 104. *In re Lernout & Hauspie Sec.*, 236 F. Supp.2d 161, 173-74 (D. Mass. 2003) .

(n105)Footnote 105. *In re Blech Sec. Litig.*, No. 94 Civ. 7696 RWS, 2002 U.S. Dist. LEXIS 19835 at *42-43 (S.D.N.Y. Oct. 17, 2002).

(n106)Footnote 106. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 128 S. Ct. 761 (2008)

(n107)Footnote 107. *Id. at 769-70* .

(n108)Footnote 108. *Id. at 769* .

(n109)Footnote 109. *Id. at 770* .

(n110)Footnote 110. *Id. at 771* .

(n111)Footnote 111. *Id. at 770-71* .

(n112)Footnote 112. *Id.*

(n113)Footnote 113. *In re Enron Corp. Sec., Deriv. & ERISA Litig.*, 610 F.Supp.2d 600, 612-16 (S.D. Tex. 2009) .

(n114)Footnote 114. 17 C.F.R. § 240.10b-1 (2004) (Rule 10b-1) provides:

The term *manipulative or deceptive device or contrivance*, as used in § 10(b), is hereby defined to include any act or omission to act with respect to any security exempted from the operation of section 12(a) pursuant to any section in this part which specifically provides that this section shall be applicable to such security if such act or omission to act would have been unlawful under section 9(a), or any rule or regulation heretofore or hereafter prescribed thereunder, if done or omitted to be done with respect to a security registered on a national securities exchange, and the use of any means or instrumentality of interstate commerce or of the mails or of any facility of any national securities exchange to use or employ any such device or contrivance in connection with the purchase or sale of any such security is hereby prohibited.

Id. (emphasis added).

(n115)Footnote 115. See *Smith v. Oppenheimer and Co., Inc.*, 635 F. Supp. 936, 942 (W.D. Mich. 1985) (Dismissing plaintiff's 10b-1 claim on alleged churning of brokerage account: "The complaint contains no allegations that defendants' activities were in any way intended to alter the market price of securities in which plaintiff was trading. In fact, plaintiff has not claimed that defendants' conduct had any effect upon the market at all. Further, plaintiff has nowhere asserted that stock purchased by him or on his account was priced artificially because of defendants' acts.").

(n116)Footnote 116. *Box v. Northrop Corp.*, 423 F. Supp. 4, 5 (S.D.N.Y. 1976) .

(n117)Footnote 117. *Id. at 6* .

(n118)Footnote 118. 17 C.F.R. § 240.10b-3 (Rule 10b-3) provides:

It shall be unlawful for any broker or dealer, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, to use or employ, in connection with the purchase or sale of any security otherwise than on a national securities exchange, any act, practice, or course of business defined by the Commission to be included within the term 'manipulative, deceptive, or other fraudulent device or contrivance', as such term is used in section 15(c)(1) of the Act

Id.

(n119)Footnote 119. See § 6.03[4][f] (below) regarding Sec. Ex. Act § 15(c).

(n120)Footnote 120. *SEC v. U.S. Environmental, Inc.*, No. 94 Civ. 6608, 2003 U.S. LEXIS 12580 at *49-50 (S.D.N.Y. July 21, 2003) . See also, *Thornton & Co.*, Sec. Ex. Act Rel. No. 4246, 1949 SEC LEXIS 53, at *1-2 (Apr. 26, 1949) (SEC revoked the registration of a broker for having employed wash sales and matched orders. Court cited sections 10(b) and 15(c)(1), as well as Rules 10b-3 and 15c1-2, for non-disclosure of over-the-counter sales based on prices artificially raised on a national securities exchange); *James F. Vigue et al.*, Sec. Ex. Act Rel. No. 44,016, 74 SEC Dock. 1024-25 (Feb. 28, 2001) (price manipulation scheme including inflating corporate assets on financial statements, a no-net-sale policy for the stock, matched trades and wash sales, purchasing stock for nominee accounts, unauthorized purchases, improper margin loan and marking the close).

(n121)Footnote 121. See *Dudley Mihran Freeland*, Sec. Ex. Act Rel. No. 44,242, 74 SEC Dock. 1889, 1890 (May 1, 2001) (failure to disclose receiving compensation for recommending stock); *Suppes Sec. Inc.*, Sec. Ex. Act Rel. No. 38,172, 63 SEC Dock. 1533, 1535 (Jan. 15, 1997) (same).

(n122)Footnote 122. See *Monness, Crespi, Hardt & Co.*, Sec. Ex. Act Rel. No. 37,712, 62 SEC Dock. 2422, 2423 (Sept. 23, 1996) (broker-dealer who executed trades for investment bank failed to disclose that it acted as "riskless principal" in trades, whereby it temporarily acquired the securities into its proprietary account and then added mark-ups or mark-downs beyond its commission before completing transaction); *Taylor v. Smith, Barney & Co.*, 358 F. Supp. 892, 894 (D. Utah 1973) . See also *Straub v. Vaisman and Co.*, 540 F.2d 591, 594 (3d Cir. 1976) (private suit bringing action under §§ 10(b), 15(c)(1) and 15(c)(2) of the Exchange Act and Rules 10b-3, 10b-5, 15c1-1, 15c1-2 and 15c1-4).

(n123)Footnote 123. 15 U.S.C.A. § 78o(c) (2004) (Sec. Ex. Act § 15(c)).

(n124)Footnote 124. See *Sec. Ex. Act Rel. No. 3505*, 1943 SEC LEXIS 162, at *4-5 (Nov. 16, 1943) . For a broader discussion of regulation of broker-dealer fraud under § 15(c), including application of the "shingle theory," see 2 MATTHEW BENDER, *FEDERAL SECURITIES EXCHANGE ACT OF 1934*, §§ 3.06-3.08 (2002).

(n125)Footnote 125. *Barrett & Co.*, 9 SEC 319, 328 (May 22, 1941) .

(n126)Footnote 126. *SEC v. Resch-Cassin & Co.*, 362 F. Supp. 362, 975 (S.D.N.Y. 1973) ("It is well settled that the manipulative activities expressly prohibited by § 9(a)(2) of the Exchange Act with respect to a listed security are also violations of § 17(a) of the Securities Act and § 10(b) of the Exchange Act when the same activities are conducted with respect to an over-the-counter security.").

Courts also apply the same scienter requirement to actions under Section 15(c)(1) as under Sections 17(a)(1) and 10(b). See *SEC v. Dowdell*, No. CIV.A. 3:01CV00116, 2002 U.S. District LEXIS 4522 at *708 (D. Va. Mar. 14, 2002) .

(n127)Footnote 127. See, e.g., *Adams & Co.*, 33 SEC 444, 457 (May 28, 1952) ("Respondents sold Mohawk stock over the counter and on the exchange ... at price levels brought about by their manipulative activity without disclosing that fact to the purchasers. Their omission to inform such purchasers of the material facts relating to their manipulation of the market operated as a fraud upon them, and accordingly, we find that each of the respondents willfully violated the antifraud provisions of § 17(a) of the Securities Act and § 10(b) of the Exchange Act and Rule [10b-5] thereunder."); *Thornton & Co.*, Sec. Ex. Act Rel. No. 4246, 1949 SEC LEXIS 53, at *1-2 (failure of a broker to disclose that he has artificially influenced and manipulated the market price constitutes fraud under §§ 10(b) and 15(c)(1)); *Crane Co.*, 419 F.2d at 796 (same); *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1471 (2d Cir. 1996) (failure to disclose excessive markups constitutes fraud and is a violation of §§ 17(a), 10(b) and Rule 10b-5); *Alstead, Dempsey & Co.*, 47 SEC 1034, 1035 (Apr. 5, 1984) (same); *Richfield Sec., Inc.*, Sec. Ex. Act Rel. No. 33,188, SEC Dock. 1219, 1220 n.22 (Nov. 12, 1993) (failure to disclose excessive markups constitute violation of NASD rules).

(n128)Footnote 128. *Asch v. Philips, Appel & Walden, Inc.*, 867 F.2d 776, 777 (2d Cir. 1989) ; *Admiralty Fund v. Hugh Johnson & Co.*, 677 F.2d 1301, 1313-14 (9th Cir. 1982) ; *Beres v. Thomson McKinnon Sec., Inc.*, No. 85 Civ.

6674, 1989 U.S. Dist. LEXIS 10385, at *13-15 (S.D.N.Y. Sept. 1, 1989) ; *Prester v. Shearson Lehman Bros., Inc.*, Civ. A. No. 86-1528-MA, 1986 U.S. Dist. LEXIS 22111, at *6-8 (D. Mass. Jul. 30, 1986) ; *Roberts v. Smith Barney, Harris Upham & Co.*, 653 F. Supp. 406, 413-14 (D. Mass. 1986) ; *Corbey v. Grace*, 605 F. Supp. 247, 251 (D. Minn. 1985) ; *Wagman and Pliskow v. FSC Sec. Corp.*, No. 85C2037, 1985 U.S. Dist. LEXIS 17610, at *10-13 (N.D. Ill. July 23, 1985) ; *Chapman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, Civ. No. H-82-2286, 1983 U.S. Dist. LEXIS 15349, at *8 (D. Md. Jul. 19, 1983) ; *Pierson v. Dean, Witter, Reynolds, Inc.*, 551 F. Supp. 497, 502-03 (C.D. Ill. 1982) .

(n129)Footnote 129. See *Asch*, 867 F.2d at 777 ; *Roberts*, 653 F. Supp. at 414 ; *Corbey*, 605 F. Supp. at 251 ; *Pierson*, 551 F. Supp. at 502-03 .

(n130)Footnote 130. Sec. Ex. Act § 15(c)(1).

(n131)Footnote 131. Sec. Ex. Act § 15(c)(1)(D).

(n132)Footnote 132. 17 C.F.R. § 240.15c1-2 (2004) (Rule 15c1-2) provides:

a. The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in Section 15(c)(1) of the Act, is hereby defined to include any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

b. The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in Section 15(c)(1) of the Act, is hereby defined to include any untrue statement of a material fact and any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, which statement or omission is made with knowledge or reasonable grounds to believe that it is untrue or misleading.

c. The scope of this section shall not be limited by any specific definitions of the term 'manipulative, deceptive, or other fraudulent device or contrivance' contained in other rules adopted pursuant to Section 15(c)(1) of the Act.

Id.

(n133)Footnote 133. 17 C.F.R. § 240.15c1-2(b) & (c).

(n134)Footnote 134. In the Matter of EKN Fin. Servs. Inc., et al, SEC Rel. No. 34-57934 (June 6, 2008); In the Matter of Salomon Grey Fin. Corp., Sec. Ex. Act Rel. No. 53928 (June 1, 2006); *Thornton & Co.*, Sec. Ex. Act Rel. No. 4246, 1949 SEC LEXIS 53, at *1-2 ; *Emacio & Co.*, Sec. Ex. Act Rel. No. 4880, 1953 SEC LEXIS 319, at *20, 26 (June 16, 1953) ; H.J. Meyers & Co., Sec. Ex. Act Rel. No. 43,946, 74 SEC Dock. 822, 822-23 (Feb. 9, 2001); U.S. *Environmental*, 2003 U.S. Dist. LEXIS 12580 at *49-51 ; In the Matter of the Application of John Roger Faherty, SEC Rel. No. 34-47402, 79 SEC Dock. 2381, 2003 SEC LEXIS 605, at *18 (Mar. 14, 2003) .

(n135)Footnote 135. SEC v. Fareri, No. 09-80360-CIV, 2009 WL 563819 (S.D. Fla. Mar. 3, 2009) (enforcement action by the SEC against a broker alleging a scheme to create an artificial market for two stocks using arranged matched orders to move up the price and create the illusion of market demand); FINRA News Release, *FINRA Expels Meeting Street Brokerage, Bars Broker, Sanctions Firm's Owner for Market Manipulation, Other Violations*, available at <http://www.finra.org/Newsroom/NewsReleases/2009/P120509> (Dec. 8, 2009) (announcing settlement for market manipulation involving, *inter alia*, placing matched orders); *SEC v. Lorin*, 877 F. Supp. 192, 200 (S.D.N.Y. 1995) , *aff'd in part, vacated in part*, 76 F.3d 458 (2d Cir. 1996) (broker involved in scheme to artificially raise stock prices through quoting excessive prices and effecting wash sales, among other devices); *Singer v. Olympia Brewing Co.*, 878 F.2d 596, 598 (2d Cir. 1989) (artificial price increase through spreading false rumors of imminent takeover, among other devices); N.B.: sometimes price manipulation is not attempted in order to directly profit from an artificially inflated

price of a security, but rather for the purpose of attempting to stay compliant with other rules or regulations. *See., e.g., In re Dep't of Enforcement v. Kirlin Securities, Inc.*, Compl. No. EAF0400300001, FINRA NAC Decision, *available at* <http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/nacdecisions/p118029.pdf> (Feb. 25, 2009) (expelling brokerage and brokers for artificially inflating the price of their holding company over a \$1.00 for over ten consecutive trading days in order to avoid delisting from the Nasdaq); *NYSE Arca Equities, Inc. v. Schonfeld Sec., LLC*, Equities Decision Nos. 08-AE-04 and 08-AE-05, *available at* <http://www.nyse.com/pdfs/08-AE-04%20&%2005.pdf> (Dec. 31, 2008) (firm and its chairman and principal entered into prearranged "round trip securities transactions" for the purpose of increasing the firms net capital position in order to stay compliant with SEC Rule 15c3-1).

(n136)Footnote 136. *SEC v. Peabody & Co.*, 18 SEC 559, 570-71 (Apr. 2, 1945) .

(n137)Footnote 137. *R.A. Holman & Co. v. SEC*, 366 F.2d 446, 449 (2d Cir. 1966) .

(n138)Footnote 138. *See also* In the Matter of Wolfe & Hurst Bond Brokers, Inc., Sec. Ex. Act Rel. No. 59913, 2009 WL 1323408 (May 13, 2009) (broker-dealer manipulated auctions for municipal bonds by lowering the price of highest bidders and entering cover-bids that were represented as bids by other broker-dealers); In the Matter of Scottrade, Inc., Sec. Ex. Act Rel. 58012 (June 24, 2008) (broker-dealer fraudulently failed to give best execution to customer's orders and misrepresented its practices to its customers); In the Matter of Morgan Stanley & Co., Inc., Sec. Ex. Act Rel. No. 55726 (May 9, 2007) (same); In the Matter of Banc of America Sec. LLC, Sec. Ex. Act Rel. No. 55466 (Mar. 14, 2007) (company's analysts produced research reports that, although purportedly objective, were unduly influenced by the company's investment banking efforts); *In the Matter of Knight Sec.*, Sec. Ex. Act Rel. No. 50867, 2004 SEC LEXIS 2938 (Dec. 16, 2004) (broker-dealer fraudulently failing to give best execution to "not held" orders from institutional customers and generating excess profits for firm); James F. Vigue, 74 SEC Dock. at 1024-25 (price manipulation scheme including inflating corporate assets on financial statements, a no-net-sale policy for the stock, matched trades and wash sales, purchasing stock for nominee accounts, unauthorized purchases, improper margin loan and marking the close); *SEC v. Wexler*, No. 92 Civ. 2902, 1993 U.S. Dist. LEXIS 12656, at *4-6 (S.D.N.Y. Sept. 14, 1993) (broker drove up price of OTC stock by squeezing short sellers, engaging in unauthorized transactions, parking stocks, among other manipulative devices).

(n139)Footnote 139. In the Matter of Trautman Wasserman & Co., Inc., 92 SEC Dock. 1156 (Jan.14, 2008) (registered broker-dealer fraudulently time-stamped mutual fund trade orders to give the appearance that the trades were executed while the market was open, while engaging in late trading on behalf of clients); In the Matter of Regional Brokers, Inc., et al, Sec. Ex. Act Rel. No. 56542 (Sept. 27, 2007) (registered broker dealer operating bids-wanted auctions knowingly accepted late winning bids and otherwise manipulated its auctions by entering cover bids); In the Matter of Mutuals.com, Inc., et al., Sec. Ex. Act Rel. No. 56539 (Sept. 26, 2007) (registered broker dealer and investment advisor provided market timing and late trading services involving mutual funds to clients); In the Matter of Kaplan & Co. Sec., Inc., Sec. Ex. Act Rel. No. 54954 (Dec. 18, 2006) (two representatives of broker-dealer defrauded hundreds of mutual funds and their investors over several years through measures to disguise the identities of the firm's clients so that they could circumvent rules on market timing); *In the Matter of Banc of America Capital Management*, Sec. Ex. Act Rel. No.51167, 2005 SEC LEXIS 291, at *54-55, 57 (Feb. 9, 2005) (distributor allowed mutual fund market timing by certain clients; related brokerage firm facilitated market timing and late trading by its hedge fund clients); *In the Matter of Columbia Management Advisors, Inc.*, Sec. Ex. Act Rel. No. 51164, 2005 SEC LEXIS 289, at *41-42 (Feb. 9, 2005) (underwriter and distributor of mutual fund allowed certain customers to engage in short-term excessive trading); *In the Matter of Lawrence S. Powell*, Sec. Ex. Act Rel. No. 51017, 2005 SEC LEXIS 60 (Jan. 11, 2005) (registered representative of broker-dealer aided the market timing and late trading activities of clients).

(n140)Footnote 140. 17 C.F.R. § 240.15c1-5 (2004) (Rule 15c1-5) provides:

The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in section 15(c)(1) of the Act, is hereby defined to include any act of any broker, dealer or municipal securities

dealer controlled by, controlling, or under common control with, the issuer of any security, designed to effect with or for the account of a customer any transaction in, or to induce the purchase or sale by such customer of, such security unless such broker, dealer or municipal securities dealer, before entering into any contract with or for such customer for the purchase or sale of such security, discloses to such customer the existence of such control, and unless such disclosure, if not made in writing, is supplemented by the giving or sending of written disclosure at or before the completion of the transaction.

Id.

(n141)Footnote 141. Ronald D. Wheeler, Sr. *et al.*, Sec. Ex. Act Rel. No. 29,982, 50 SEC Dock. 392, 392-94 (Nov. 25, 1991).

(n142)Footnote 142. *Id.* at 392-93.

(n143)Footnote 143. 17 C.F.R. § 240.15c1-6 (2004) (Rule 15c1-6) provides:

The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in section 15(c)(1) of the Act, is hereby defined to include any act of any broker who is acting for a customer or for both such customer and some other person, or of any dealer or municipal securities dealer who receives or has promise of receiving a fee from a customer for advising such customer with respect to securities, designed to effect with or for the account of such customer any transaction in, or to induce the purchase or sale by such customer of, any security in the primary or secondary distribution of which such broker, dealer or municipal securities dealer is participating or is otherwise financially interested unless such broker, dealer or municipal securities dealer, at or before the completion of each such transaction gives or sends to such customer written notification of the existence of such participation or interest.

Id.

(n144)Footnote 144. Rooney, Pace, Inc., Sec. Ex. Act Rel. No. 25,125, 39SEC Dock. 804, 804 (Nov. 16, 1987).

(n145)Footnote 145. *Id.* at 804-05.

(n146)Footnote 146. 17 C.F.R. § 240.15c1-8 (2004) (Rule 15c1-8), provides:

The term 'manipulative, deceptive, or other fraudulent device or contrivance,' as used in Section 15(c)(1) of the [Exchange] Act, is hereby defined to include any representation made to a customer by a broker, dealer or municipal securities dealer who is participating or otherwise financially interested in the primary or secondary distribution of any security which is not admitted to trading on a national securities exchange that such security is being offered to such customer 'at the market' or at a price related to the market price unless such broker, dealer or municipal securities dealer knows or has reasonable grounds to believe that a market for such security exists other than that made, created, or controlled by him, or by any person for whom he is acting or with whom he is associated in such distribution, or by any person controlled by, controlling or under common control with him.

Id.

(n147)Footnote 147. Lawrence J. Penna, Sec. Ex. Act Rel. No. 42,106, 70 SEC Dock. 2507, 2508 (Nov. 4, 1999); Lawrence J. Penna, Litig. Rel. No. 16,270, 70 SEC Dock. 1189, 1189-90 (Sept. 2, 1999).

(n148)Footnote 148. Lawrence J. Penna, 70 SEC Dock. at 2508; Lawrence J. Penna, 70 SEC Dock. at 1190. *See also* Sterling Foster & Co., Sec. Ex. Act Rel. No. 41,942, 70 SEC Dock. 1568, 1569 (Sept. 29, 1999); Thomas J. Dalton, Sec. Ex. Act Rel. No. 41,566, 70 SEC Dock. 71, 72-73 (June 28, 1999); *Theodore A. Landau, Sec. Ex. Act Rel. No. 6792, 40 SEC 1119, 1122-24 (Apr. 30, 1962)* .

(n149)Footnote 149. Sec. Ex. Act § 15(c)(2).

(n150)Footnote 150. *See* Adoption of Rule 15c2-5 Under the Securities Exchange Act of 1934, *Sec. Ex. Act Rel. No. 6851, 1962 SEC LEXIS 274, at *2 (July 17, 1962)* .

(n151)Footnote 151. Sec. Ex. Act § 15(c)(2)(D).

(n152)Footnote 152. *17 C.F.R. § 240.15c2-7 (2004)*.

(n153)Footnote 153. This includes a joint account, guarantee of profit, guarantee against loss, commission, markup, markdown, indication of interest or accommodation arrangement. *17 C.F.R. § 240.15c2-7(b)*.

(n154)Footnote 154. *See also* Adoption of Rule 15c2-7 Under the Securities Exchange Act of 1934, *Sec. Ex. Act. No. 7381, 1964 SEC LEXIS 153, at *1-2 (Aug. 6, 1964)* .

(n155)Footnote 155. Paul I. Comi, Sec. Ex. Act Rel. No. 39,968, 67 SEC Dock. 209, 210 (May 6, 1998).

(n156)Footnote 156. *Id. See also* Order Instituting Administrative Proceedings Pursuant to §§ 15(b)(6) and 19(h) of the Securities Exchange Act of 1934, Sec. Ex. Act Rel. No. 40,256, 67 SEC Dock. 1338, 1339 (July 23, 1998); Certain Market Making Activities on Nasdaq, Sec. Ex. Act Rel. No. 40,913, 68 SEC Dock. 2739, 2740-41 (Jan. 11, 1999); Sec. Ex. Act Rel. No. 12,083, 8 SEC Dock. 1239, 1239 (Feb. 9, 1976); *cf. In re ICAP Sec. USA LLC, Sec. Ex. Act Rel. No. 61200, 2009 SEC LEXIS 4281, at *3 (Dec 18, 2009)* (enforcement action by SEC against inter-dealer broker for, inter alia, displaying fictitious "flash" trades on ICAP's screen seen by its customers "who took that information into account in making their trading decisions").

(n157)Footnote 157. *17 C.F.R. § 240.15c2-11 (2004)*.

(n158)Footnote 158. *See Securities Uniformity; Annual Conference on Uniformity of Securities Laws, Sec. Ex. Act Rel. No. 7964, 66 FR 17207 -02, at *17210 n.21 (March 29, 2001)*.

(n159)Footnote 159. Submission of Price Quotations, Sec. Ex. Act Rel. No. 12,630, 10 SEC Dock. 1114, 1115 (July 15, 1976). *See also* Adopting Release, Sec. Ex. Act Rel. No. 9310 (Sept. 13, 1971); Publication or Submission of Quotations without Specified Information, Sec. Ex. Act Rel. No. 39,670, 66 SEC Dock. 1142, 1142-43 (Feb. 17, 1998). "Until the Rule was adopted, the Commission encountered difficulty in establishing that those broker-dealers were culpable participants in such manipulations because the broker-dealers asserted that they were unaware that the issuers involved were shell corporations. By requiring broker-dealers to obtain information about the securities in which they initiate quotations, the Rule provides a source which the Commission could use to rebut such assertions." Kidder Peabody & Co., Sec. Ex. Act Rel. No. 21,914, 32 SEC Dock. 1091, 1094 (Apr. 1, 1985).

(n160)Footnote 160. *General Bond & Share Co. v. SEC, 39 F.3d 1451, 1460 (10th Cir. 1994)* .

(n161)Footnote 161. *Id. at 1461* . *See also* Sec. Ex. Act Rel. No. 44,038, 74 SEC Dock. 1092, 1092-93 (Mar. 5, 2001) (one of many releases by the SEC temporarily suspending over-the-counter trading of a security due to alleged misrepresentations affecting the value of the security, accompanied by a warning that brokers and dealers, at termination of the suspension, cannot make quotations without compliance with the rule, alluding to up-to-date and accurate information concerning the issuer).

(n162)Footnote 162. A "distribution participant" is "an underwriter, prospective underwriter, broker, dealer, or

other person who has agreed to participate or is participating in a distribution." 17 C.F.R. § 242.100(b).

(n163)Footnote 163. Review of Anti-Manipulation Regulation of Securities Offerings, Sec. Ex. Act Rel. No. 33,924, 56 SEC Dock. 1302, 1307 (Apr. 19, 1994), *citing* Prohibitions Against Trading by Persons Interested In a Distribution, Sec. Ex. Act Rel. No. 18,528, 24 SEC Dock. 1444, 1445 (Mar. 10, 1982). *See* Review of Anti-Manipulation Regulation of Securities Offerings, 56 SEC Dock. at 1303 for a history of SEC regulation of securities offerings.

(n164)Footnote 164. 17 C.F.R. §§ 240.10b-6 (repealed 1996), 240.10b-7 (repealed 1996), & 240.10b-8 (repealed 1996). *See* Review of Anti-Manipulation Regulation of Securities Offerings, 56 SEC Dock. at 1304, *citing* Proposal to Adopt Rules and to Rescind a Regulation Under the Securities Exchange Act of 1934, *Sec. Ex. Act Rel. No. 5040, 1954 SEC LEXIS 257 (May 18, 1954)* .

(n165)Footnote 165. Review of Anti-Manipulation Regulation of Securities Offerings, 56 SEC Dock. at 1307.

(n166)Footnote 166. Notice of Proposed Amendment of Rule 10b-7 Under the Securities Exchange Act of 1934, *Sec. Ex. Act Rel. No. 6127, 1959 SEC LEXIS 212, at *2 (Nov. 30, 1959)* .

(n167)Footnote 167. Review of Anti-Manipulation Regulation of Securities Offerings, 56 SEC Dock. at 1318.

(n168)Footnote 168. 17 C.F.R. § 240.10b-21 (repealed 1996). *See* Review of Anti-Manipulation Regulation of Securities Offerings, 56 SEC Dock. at 1305.

(n169)Footnote 169. Trading Practices Rules Concerning Securities Offerings, Sec. Ex. Act Rel. No. 37,094, 61 SEC Dock. 1713, 1741 (Apr. 11, 1996) (hereinafter "Reg. M Proposing Rel."). *See* § 6.03[5][c][4] (below) for an explanation of Rule 105.

(n170)Footnote 170. The SEC recognized no further need to address regulation of rights offerings in Regulation M and simply rescinded Rule 10b-8. Reg. M Proposing Rel., *supra* n.140, at 1713.

(n171)Footnote 171. Reg. M Adopting Rel., *supra* n. 142, at 1143-44.

(n172)Footnote 172. Reg. M Proposing Rel., *supra* n. 140, at 1717.

(n173)Footnote 173. Anti-Manipulation Rules Concerning Securities Offerings, Sec. Ex. Act Rel. No. 38,067, 63 SEC Dock. 1141, 1142 (Dec. 20, 1996) (hereinafter "Reg. M Adopting Rel."). *See* Appendix H for the complete text of Regulation M, which includes 17 C.F.R. §§ 242.100 through 242.105 (2004).

(n174)Footnote 174. Reg. M Proposing Rel., *supra* n.140, at 1714-15.

(n175)Footnote 175. *Id.* at 1715.

(n176)Footnote 176. *Id.* The proposing release listed the ways in which Reg. M streamlined and simplified the trading practices rules: eliminating restrictions on actively-traded securities; reducing the period of trading restrictions for many other securities and focusing that period on the pricing of the offering; eliminating trading restrictions on derivative securities during a distribution of an underlying security; narrowing substantially the restrictions on debt securities; deregulating rights offerings; allowing routine dissemination of research reports, transactions in baskets of securities, exercise of call options, and transactions complying with Rule 144A under the Securities Act; creating a *de minimis* exception for transactions that are unlikely to have market impact; narrowing the scope of persons subject to the rules; allowing greater flexibility for issuer plans and odd-lot programs; expanding the scope of Nasdaq passive market making; creating a more flexible framework for stabilizing transactions; and shortening the regulated period for short sales in connection with a public offering. *Id.* at 1714.

(n177)Footnote 177. 69 Fed. Reg. 75774 (Dec. 17, 2004) .

(n178)Footnote 178. 17 C.F.R. § 242.106 (proposed rule).

(n179)Footnote 179. 69 Fed. Reg. at 75,783.

(n180)Footnote 180. Short Selling in Connection with a Public Offering, Exchange Act Release No. 5206, Fed Sec. L. Rep. (CCH) P 87,940 (Aug. 6, 2007).

(n181)Footnote 181. 17 C.F.R. § 242.101(a) (2004).

(n182)Footnote 182. 17 C.F.R. § 242.100(b) (2004) (definition of "Distribution Participant"), defines "affiliated purchaser" as:

(1) A person acting, directly or indirectly, in concert with a distribution participant, issuer, or selling security holder in connection with the acquisition or distribution of any covered security; or

(2) An affiliate, which may be a separately identifiable department or division of a distribution participant, issuer, or selling security holder, that, directly or indirectly, controls the purchases of any covered security by a distribution participant, issuer, or selling security holder, whose purchases are controlled by any such person, or whose purchases are under common control with any such person; or

(3) An affiliate, which may be a separately identifiable department or division of a distribution participant, issuer, or selling security holder, that regularly purchases securities for its own account or for the account of others, or that recommends or exercises investment discretion with respect to the purchase or sale of securities

Id. (definition of "Affiliated Purchaser"). The definition includes exceptions for affiliates who: maintain and enforce written policies and procedures to prevent the flow of information to or from the affiliate; obtain an annual independent assessment of the operation of such policies and have no officers or employees in common with the distribution participant, issuer or selling security holder that direct, effect or recommend securities transactions; and do not, during the restricted period, act as a market maker (other than as a specialist in compliance with the rules of a national securities exchange) or engage as a broker or dealer in solicited transactions or proprietary trading. *Id.*

(n183)Footnote 183. *Id.* (definitions of "Covered Security" and "Reference Security.")

(n184)Footnote 184. *Id.* (definition of "Restricted Period"). "ADTV" is defined as the worldwide average daily trading volume during the two full calendar months immediately preceding, or any 60 consecutive calendar days ending within the 10 calendar days preceding, the filing of the registration statement; or, if there is no registration statement or if the distribution involves the sale of securities on a delayed basis pursuant to § 230.415 of this chapter, two full calendar months immediately preceding, or any consecutive 60 calendar days ending within the 10 calendar days preceding, the determination of the offering price.

Id. (definition of "ADTV").

(n185)Footnote 185. *Id.*

(n186)Footnote 186. 17 C.F.R. § 242.101(b)(1).

(n187)Footnote 187. 17 C.F.R. § 242.101(b)(3).

(n188)Footnote 188. 17 C.F.R. § 242.101(b)(4).

(n189)Footnote 189. "Unsolicited transactions" are defined as "Unsolicited brokerage transactions; or unsolicited purchases that are not effected from or through a broker or dealer, on a securities exchange, or through an inter-dealer quotation system or electronic communications network." 17 C.F.R. § 242.101(b)(5).

(n190)Footnote 190. "Basket transactions" are defined as bids or purchases in connection with a basket of 20 or more securities in which the security does not comprise more than 5% of the value of the basket purchased or adjustments to a basket as a result of a change in the composition of a standardized index. 17 C.F.R. § 242.101(b)(6).

(n191)Footnote 191. 17 C.F.R. § 242.101(b)(10). 144A is an exemption for the resale of restricted securities. It permits issuers of Rule 144A securities (it does not include securities listed on NASDAQ or a U.S. stock exchange) to privately place a large offering with an institutional investor who can make an unlimited offering to qualified institutional buyers, using a public offering and general solicitation. Rule 144A is available, for instance, for securities listed on a foreign stock exchange and for all debt securities. The SEC has explained the basis for the exemption as follows: "The Commission considers it appropriate to reduce the scope of Rule 101's prophylactic protections in the case of [qualified institutional buyers], because [qualified institutional buyers] have considerable ability to obtain, consider, and analyze market information, and the Commission is not aware of complaints of manipulation in this context." Reg. M Adopting Rel., *supra* n.142, at 1158.

(n192)Footnote 192. 17 C.F.R. § 242.101(b)(7). The December 2004 proposed rules would require firms to create a record of each bid or purchase made under the *de minimis* exception, including specifying the security, the day the restricted period started, the ADTV and the bids or purchases that would otherwise violate Reg M, in order for the SEC and SROs to be able to uncover potential abuse of the exception, or policies and procedures that result in inadequate compliance. 69 Fed. Reg. at 75, 779.

(n193)Footnote 193. 17 C.F.R. § 242.101(c)(1). The SEC explained that "[t]he costs of manipulating such securities generally are high. In addition, because actively-traded securities are widely followed by the investment community, aberrations in price are more likely to be discovered and quickly corrected. Moreover, actively-traded securities are generally traded on exchanges or other organized markets with high levels of transparency and surveillance." Reg. M Adopting Rel., *supra* n.142, at 1153.

(n194)Footnote 194. 17 C.F.R. § 242.101(c)(2). The definition of "asset-backed security" was amended in January 2005 to adopt the meaning contained in 17 C.F.R. § 229.1101.

(n195)Footnote 195. 17 C.F.R. § 242.101(c)(3).

(n196)Footnote 196. 17 C.F.R. § 242.101(c)(4).

(n197)Footnote 197. In the Matter of Harvey M. Burstein and James D. Loeffelbein, Sec. Ex. Act Rel. No. 45715, 77 SEC Dock. 817, 2002 SEC LEXIS 862 (Apr. 9, 2002) .

(n198)Footnote 198. SEC v. J.P. Morgan Sec., Litig. Rel. No. 18385 (D.D.C. Oct. 1, 2003). *See also* In the Matter of Morgan Stanley & Co., Lit. Rel. No. 19050 (Jan. 25, 2005) (settlement of injunctive action regarding Rule 101 violations based on SEC allegations that broker-dealer had induced customers purchasing shares in IPO to place purchase order for additional shares in the aftermarket).

(n199)Footnote 199. 17 C.F.R. § 242.102 (2001).

(n200)Footnote 200. Reg. M Adopting Rel., *supra* n.142, at 1158.

(n201)Footnote 201. 17 C.F.R. § 242.102(b)(1).

(n202)Footnote 202. 17 C.F.R. § 242.102(b)(2).

(n203)Footnote 203. 17 C.F.R. § 242.102(b)(3).

(n204)Footnote 204. 17 C.F.R. § 242.102(b)(4).

(n205)Footnote 205. 17 C.F.R. § 242.102(b)(5).

(n206)Footnote 206. 17 C.F.R. § 242.102(b)(6).

(n207)Footnote 207. 17 C.F.R. § 242.102(b)(7).

(n208)Footnote 208. 17 C.F.R. § 242.102(c). See Reg. M Adopting Rel., *supra* n.142, at 1161-62. "Plan" is defined under Rule 100 as: "[A]ny bonus, profit-sharing, pension, retirement, thrift, savings, incentive, stock purchase, stock option, stock ownership, stock appreciation, dividend reinvestment or similar plan; or any dividend or interest reinvestment plan or employee benefit plan as defined in Rule 405 of this chapter." 17 C.F.R. § 242.100(b).

(n209)Footnote 209. 17 C.F.R. § 242.102(c)(1).

(n210)Footnote 210. 17 C.F.R. § 242.102(d)(1).

(n211)Footnote 211. 17 C.F.R. § 242.102(d)(2).

(n212)Footnote 212. 17 C.F.R. § 242.102(d)(3).

(n213)Footnote 213. 17 C.F.R. § 242.102(d)(4).

(n214)Footnote 214. 17 C.F.R. § 242.102(e).

(n215)Footnote 215. *In the Matter of Fiore, Salmonese, Deceglie and Lavender*, Sec. Ex. Act Rel. No. 48,905, 2003 SEC LEXIS 2916 (Dec. 11, 2003). See also SEC v. Faceprint Global Solutions, Inc., 92 S.E.C. Dock. 1881 (Feb. 8, 2008) (SEC obtained consent judgment disgorging defendants of more than \$1.5 million in profits based on improperly-registered securities offering involving sales to public through nominee accounts that the CEO of the issuer secretly controlled); *In the Matter of Vincent Napolitano*, Sec. Ex. Act Rel. No. 55090 (Jan. 11, 2007) (SEC barred broker who had profited from sale of large blocks of stock in a pump-and-dump scheme from participating in offerings of penny stocks and ordered disgorgement); *In the Matter of Jordan I. Shamah*, Sec. Ex. Act Rel. No. 54341 (Aug. 21, 2006) (same).

(n216)Footnote 216. See Reg. M Proposing Rel., *supra* n.140, at 1164.

(n217)Footnote 217. 17 C.F.R. § 242.103 (2004). The purpose of Rule 103 is to "alleviate special liquidity problems that may exist in the Nasdaq market during the restricted period, when distribution participants or their affiliates that are Nasdaq market makers otherwise must withdraw from the market. In general, exchange-traded securities are not similarly affected because independent specialists are assigned to provide depth and liquidity in listed securities." Reg. M Adopting Rel., *supra* n.142, at 1164.

(n218)Footnote 218. 17 C.F.R. §§ 242.103(b)(5)-(7).

(n219)Footnote 219. Reg. M Adopting Rel., *supra* n.142, at 1164.

(n220)Footnote 220. 17 C.F.R. § 242.103(b)(2). "The 30% ADTV limitation is designed to prevent an amount of purchasing activity that could produce the price effects of stabilization, while generally permitting a level of activity associated with normal market making." Reg. M Adopting Rel., *supra* n.142, at 1164.

(n221)Footnote 221. Reg. M Adopting Rel., *supra* n.142, at 1164.

(n222)Footnote 222. *Id.* at 1166.

(n223)Footnote 223. Statement of the Commission and Commissioner Healy on ' *Pegging, Fixing, and Stabilizing* ' of Security Prices, Sec. Ex. Act Rel. No. 2446, 1940 SEC LEXIS 653, at *5 (Mar. 18, 1940) . The release contains detailed pros and cons regarding stabilization and its effect on market price.

(n224)Footnote 224. See Jonathan A. Shayne & Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 48 VAND. L. REV. 965, 977-78 & *Supra* n.7 at § 6.03[1] (May, 1995).

(n225)Footnote 225. 15 U.S.C.A. § 78i(a)(6) (2004) (Sec. Ex. Act § 9(a)(6)). After investigating the effects of stabilization, the Senate Committee on Banking and Currency concluded: "The impropriety of practices such as 'pegging,' or fixing or stabilizing the price of a security received most careful consideration by the committee. The committee recommends that such practices not be abolished by statute but subjected to regulation by the Commission." S. REP. NO. 73-792, at 8-9 (1934).

(n226)Footnote 226. 17 C.F.R. § 240.17a-2 (2004); 17 C.F.R. § 230.426 (2004).

(n227)Footnote 227. Statement of the Commission and Commissioner Healy on ' *Pegging, Fixing, and Stabilizing* ' of Security Prices, 1940 SEC LEXIS 653, at *1 .

(n228)Footnote 228. "The Commission is unanimous in recognizing that stabilizing is a form of manipulation. The statute itself so recognizes. The Commission also agrees that stabilizing in many respects is undesirable." *Id.* at *2 . However, it continued: "Stabilization ... is now an integral part of the American system of fixed-price security distribution." *Id.* at *23.

(n229)Footnote 229. 17 C.F.R. § 10b-7 (repealed 1996). See Sec. Ex. Act Rel. No. 5194 (Aug. 15, 1955).

(n230)Footnote 230. Review of Anti-Manipulation Regulation of Securities Offerings, 56 SEC Dock. at 1315.

(n231)Footnote 231. *Id.* at 1315-16. See also *Friedman v. Salomon Smith Barney, Inc.*, 313 F.3d 796, 802 (2d Cir. 2002) . Flipping occurs when a subscriber (purchaser of shares in an initial public offering) purchases shares, then quickly sells the shares in the secondary market for a profit.

(n232)Footnote 232. Reg. M Adopting Rel., *supra* n.142, at 1141.

(n233)Footnote 233. Penalty bids are used to combat flipping. Underwriters enter a contractual arrangement whereby the underwriting manager reclaims underwriting fees from syndicate members when the securities originally sold by the syndicate member are re-purchased by the manager in connection with the distribution. Penalty bids make it unprofitable for syndicate members to sell public offering shares to retail customers who flip because the syndicate members will have to remit their fees. See also proposed NYSE Rule 470 (IPO Allocations and Distributions) and NASD Rule 2712, both designed to more specifically prohibit certain practices in the allocation and distribution of shares in IPOs. The rules would limit the use of penalty bids. Sec. Ex. Act Rel. No. 50896 (Dec. 28, 2004).

(n234)Footnote 234. 17 C.F.R. § 242.104(a) (2004). See also Rule 17a-2 (Recordkeeping Requirements Relating to Stabilizing Activities--requiring underwriters to maintain information regarding stabilizing activities under Rule 104). 17 C.F.R. § 240.17a-2 (1004).

(n235)Footnote 235. 17 C.F.R. § 242.104(f)(1).

(n236)Footnote 236. 17 C.F.R. § 242.104(d).

(n237)Footnote 237. 17 C.F.R. § 242.104(h)(1).

(n238)Footnote 238. 17 C.F.R. § 242.104(h)(2).

(n239)Footnote 239. *Id.* However, under the December 2004 proposed rules, any person placing a syndicate covering bid would be required to identify or designate it as a syndicating bid wherever it is communicated. 17 C.F.R. § 242.104(h)(2) (proposed rule). The SEC believes such notification would help investors by providing contemporaneous information regarding the market impact of the bid. 69 Fed. Reg. at 75,781-82.

The proposed rule also would add a subparagraph to Rule 104 that would prohibit the assessment of penalty bids as part of an offering and would eliminate the existing references to penalty bids in subparagraph (2) of the rule. 17 C.F.R. § 242.104(a) (proposed rule). The SEC also proposed that Rule 17a-2(c) of the Exchange Act (which requires certain record keeping and notification) and Rule 481(d) (which requires the inclusion of certain information in prospectuses), as well as Item 508(l) of Regulations S-K and S-B (which impose certain disclosure requirements for the "plan of distribution" section of a prospectus) be amended to eliminate all references to penalty bids. *See* 69 Fed. Reg. at 75,783.

(n240)Footnote 240. 17 C.F.R. § 242.104(k) (2004).

(n241)Footnote 241. *See Proposed Rule, Regulation SHO*, 68 Fed. Reg. 62,972, 62,973 (Nov. 6, 2003) .

(n242)Footnote 242. Naked short selling for purposes of the securities regulations is selling short without borrowing the security for delivery.

(n243)Footnote 243. 15 U.S.C.A. § 78j(a)(1) (2004) (Sec. Ex. Act § 10(a)).

(n244)Footnote 244. *Sec. Ex. Act Rel. No. 1548*, 1938 SEC LEXIS 474, at *1 (Jan. 24, 1938) .

(n245)Footnote 245. *See* 68 Fed. Reg. 62,972, 62,972 (Nov. 6, 2003) .

(n246)Footnote 246. *Proposed Rule, Regulation SHO*, 68 Fed. Reg. 62,972, 62,973 (Nov. 6, 2003) .

(n247)Footnote 247. *Final Rule, Regulation SHO*, 69 Fed. Reg. 48,008 (Aug. 6, 2004) ; 69 Fed. Reg. 70,480 (Dec. 6, 2004) .

(n248)Footnote 248. *Sec. Ex. Act Rel. No. 55,970* (June 28, 2007); 17 C.F.R. § 242.201.

(n249)Footnote 249. *Regulation SHO and Rule 10a-1*, Exchange Act Release No. 34-55970, Fed. Sec. L. Rep. (CCH) P 87,918 (June 28, 2007).

(n250)Footnote 250. *Id.*

(n251)Footnote 251. 17 C.F.R. 242.203(b)(3)(i) (2007).

(n252)Footnote 252. *Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments*, Sec. Ex. Act Rel. No. 58,592 (Sep. 18, 2008).

(n253)Footnote 253. "Naked" Short Selling Anti-Fraud Rule, Exchange Act Release No. 34-58774, Fed. Sec. L. Rep. (CCH) P 88,295 (Oct. 14, 2008).

(n254)Footnote 254. *Disclosure of Short Sales and Short Positions by Institutional Investment Managers*, Exchange Act Release No. 58785, P 88,298 (Oct. 15, 2008).

(n255)Footnote 255. 17 C.F.R. § 240.3b-3 (2004).

(n256)Footnote 256. *Id.* 17 C.F.R. § 240.3b-3 provided:

A person shall be deemed to own a security if (a) he or his agent has title to it; or (b) he has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it but has not yet received it; or (c) he owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; or (d) he has an option to purchase or acquire it and has exercised such option; and (e) he has rights or warrants to subscribe to it and has exercised such rights or warrants: *Provided, however*, That a person shall be deemed to own securities only to the extent that he has a net long position in such securities.

Id.

(n257)Footnote 257. See Liquidation of Index Arbitrage Positions, Sec. Ex. Act Rel. No. 27,938, 46 SEC Dock. 105, 105 (Apr. 23, 1990).

(n258)Footnote 258. 17 C.F.R. §§ 240.10a-1 (2004) (Rule 10a-1); 72 Fed. Reg. 36,348-01 (July 6, 2007) . Short sales of securities not registered on an exchange and transactions in securities covered by paragraph (b) that were effected in the over-the-counter market are not subject to the Rule. Short Sales, Sec. Ex. Rel. Act No. 42,037, 70 SEC Dock. 2090, 2092 (Oct. 20, 1999). However, NASD Rule 3350 prohibits short sales by NASD members in Nasdaq National Market System (NMS) securities at or below the current best (inside) bid as shown on the Nasdaq screen when that bid is lower than the previous best (inside) bid (referred to as the "bid test."). See "SRO Regulation of Market Manipulation," § 6.05[1] (below).

(n259)Footnote 259. 17 C.F.R. § 240.10a-1(a); Liquidation of Index Arbitrage Positions, Sec. Ex. Act Rel. No. 27,938, 46 SEC Dock. 105, 105 (April 23, 1990). An example: "[I]f there were two successive sales of a stock at a price of \$100 on an exchange, you may sell short at \$100 only if the third preceding sale was at a price less than \$100. If that third preceding sale was at \$100 or over, you cannot sell short at \$100." *United States v. Mandel*, 296 F. Supp. 1038, 1039 (S.D.N.Y. 1969) .

(n260)Footnote 260. See Short Sales, 70 SEC Dock. at 2092.

(n261)Footnote 261. *Id.*

(n262)Footnote 262. 21468 Fed Reg. at 62,974.

(n263)Footnote 263. 17 C.F.R. § 240.10a-1(c). See Sec. Ex. Act Rel. No. 1548, 1938 SEC LEXIS 474, at *5 . See also J. Newman & Co., Sec. Ex. Act Rel. No. 14,384, 13 SEC Dock. 1401, 1402 n.5 (Jan. 17, 1978).

(n264)Footnote 264. 17 C.F.R. § 240.10a-1(e)(7).

(n265)Footnote 265. 17 C.F.R. § 240.10a-1(e)(8). See Short Sales, 70 SEC Dock. at 2097-98.

(n266)Footnote 266. See, e.g., *Hemispherx Biopharma v. Asensio*, No. Civ. A. 98-5204, 1999 U.S. Dist. LEXIS 2849, at *18-20 (E.D. Pa. Mar. 15, 1999) ; *Advanced Magnetics, Inc. v. Bayfront Partners, Inc.*, No. 92 Civ. 6879, 1997 U.S. Dist. LEXIS 8808, at *10 (S.D.N.Y. June 4, 1997) . But see *United States v. Mandel*, 296 F. Supp. 1038, 1039 (S.D.N.Y. 1969) (to plead a claim under Rule 10a-1, plaintiff must allege that the short sales were not "made at a price higher than the next preceding different price."); *Metzner v. D.H. Blair & Co.*, 989 F. Supp. 262, 267 n.7 (S.D.N.Y. 1988) .

(n267)Footnote 267. 17 C.F.R. § 240.10a-2 (Rule 10a-2) (repealed 2003).

(n268)Footnote 268. 17 C.F.R. § 240.10a-2(a). The exceptions to Rule 10a-2(a) were found in Rule 10a-2(b).

(n269)Footnote 269. 17 C.F.R. § 240.10b-21 (2008).

(n270)Footnote 270. "Naked" Short Selling Anti-Fraud Rule, Exchange Act Release No. 58774, P 88,295 (Oct. 14, 2008).

(n271)Footnote 271. "Naked" Short Selling Anti-Fraud Rule, Exchange Act Release No. 58774, P 88,295 (Oct. 14, 2008).

(n272)Footnote 272. "Naked" Short Selling Anti-Fraud Rule, Exchange Act Release No. 58774, P 88,295 (Oct. 14, 2008).

(n273)Footnote 273. "Naked" Short Selling Anti-Fraud Rule, Exchange Act Release No. 58774, P 88,295 (Oct. 14, 2008).

(n274)Footnote 274. "Naked" Short Selling Anti-Fraud Rule, Exchange Act Release No. 58774, P 88,295 (Oct. 14, 2008).

(n275)Footnote 275. "Naked" Short Selling Anti-Fraud Rule, Exchange Act Release No. 58774, P 88,295 (Oct. 14, 2008).

(n276)Footnote 276. "Naked" Short Selling Anti-Fraud Rule, Exchange Act Release No. 58774, P 88,295 (Oct. 14, 2008).

(n277)Footnote 277. 17 C.F.R. § 242.200(f).

(n278)Footnote 278. Sec. Ex. Act Rel. No. 56,212 (Aug. 14, 2007).

(n279)Footnote 279. Sec. Ex. Act Rel. No. 56,212 (Aug. 14, 2007).

(n280)Footnote 280. 17 C.F.R. § 242.105(a).

(n281)Footnote 281. 17 C.F.R. § 242.105(b).

(n282)Footnote 282. 17 C.F.R. § 242.105(c).

(n283)Footnote 283. *SEC v. Weitz and Altman*, Sec. Ex. Act Rel. No. 18121, 2004 SEC LEXIS 1036 (Apr. 30, 2003). See also *In the Matter of Perceptive Advisors LLC*, SEC Ex. Act. Rel. No. 60843 (Oct. 20, 2009); *In the Matter of First New York Sec., L.L.C.*, Sec. Ex. Act. Rel. No. 60842 (Oct. 20, 2009); *In the Matter of Diamondback Capital Mgmt., LLC*, Sec. Ex. Act Rel. No. 59428, 2009 SEC LEXIS 405 (Feb. 20, 2009); *Lion Gate Capital, Inc.*, SEC Litig. Rel. No. 20775, 2008 SEC LEXIS 2235 (Oct. 7, 2008); *Victoire Finance Capital LLC*, Sec. Ex. Act Rel. No. 58670, 2008 SEC LEXIS 2539 (Sept. 29, 2008); *Sirios Capital Management, L.P.*, Sec. Ex. Act Rel. No. 58634, 2008 SEC LEXIS 2803 (Sept. 24, 2008); *In the Matter of Moon Capital Mgmt., L.P.*, Sec. Ex. Act Rel. No. 58548, 2008 SEC LEXIS 2931 (Sept. 15, 2008); *In the Matter of DKR Oasis Mgmt. Co., L.P.*, Sec. Ex. Act Rel. No. 57961, 2008 SEC LEXIS 1347 (June 12, 2008); *In the Matter of Quogue Capital LLC*, Sec. Ex. Act Rel. No. 57804, 2007 SEC LEXIS 1065 (May 8, 2008); *SEC v. Armstrong Capital Ltd*, Sec. Litig. Rel. No. 20361, 2007 SEC LEXIS 2601 (Nov. 8, 2007); *In the Matter of Swiss Re Financial Products Corp.*, Sec. Ex. Act Rel. No. 56450, 2007 SEC LEXIS 2092 (Sept. 18, 2007); *In the Matter of GLG Partners, LP*, Sec. Ex. Act Rel. No. 55956, 2007 SEC LEXIS 1372 (June 26, 2007); *In the Matter of Amaranth Advisors L.L.C.*, Sec. Ex. Act Rel. No. 55728, 2007 SEC LEXIS 983 (May 9, 2007); *In the Matter of Imperium Advisors, LLC*, Sec. Ex. Act Rel. No. 55483A, 2007 SEC LEXIS 504 (Mar. 15, 2007); *In the Matter of Goldman Sachs Execution & Clearing, L.P.*, Sec. Ex. Act Rel. No. 55465, 2007 SEC LEXIS 491 (Mar. 14, 2007); *SEC v. Graycort Financial, LLC*, Sec. Litig. Rel. No. 19851, 2006 SEC LEXIS 2176 (Sept. 28, 2006); *SEC v. Compania Internacional Financiera S.A.*, Sec. Litig. Rel. No. 19501, 2005 SEC LEXIS 3246 (Dec. 20, 2005); *SEC v. Galleon Management, L.P.*, Sec. Ex. Act Rel. No. 51708, 2005 SEC LEXIS 1174 (May 19, 2005); *In the Matter of*

Oaktree Capital Management, LLC, Sec. Ex. Act Rel. No. 51709, 2005 SEC LEXIS 1175 (May 19, 2005) ; In the Matter of DB Investment Managers, Inc., Sec. Ex. Act Rel. No. 51707, SEC LEXIS 1173 (May 19, 2005); *In the Matter of Ascend Capital*, Sec. Ex. Act. Rel. No. 48188, 2003 SEC LEXIS 1659 (July 17, 2003) ; *In the Matter of JC Mgmt.*, Sec. Ex. Act Rel. No. 50092, 2004 SEC LEXIS 1580 (July 27, 2004) .

(n284)Footnote 284. Short Selling in Connection with a Public Offering, Exchange Act Release No. 56206, P 87940 (Aug. 6, 2007).

(n285)Footnote 285. Short Selling in Connection with a Public Offering, Exchange Act Release No. 56206, at 3.

(n286)Footnote 286. The SEC has actively sought to enforce amended Rule 105. *See, e.g., In the Matter of Palmyra Capital Advisors LLC*, Sec. Ex. Act Rel. 61421, 2010 SEC LEXIS 396 (Jan. 26, 2010) ; *In the Matter of AGB Partners LLC*, Sec. Ex. Act Rel. 61422, 2010 SEC LEXIS 397 (Jan. 26, 2010) .

(n287)Footnote 287. 17 CFR 242.105(b)(1)(i)-(ii).

(n288)Footnote 288. Short Selling in Connection with a Public Offering, Exchange Act Release No. 56206, at 13.

(n289)Footnote 289. *Id.* at 18-19.

(n290)Footnote 290. *Id.* at 19.

(n291)Footnote 291. One example noted by the SEC of separate accounts that may fit into the exemption would be an adviser providing capital to two private investment funds that are separate legal entities with different accounts and profit and loss statements, and without any coordination of trading or sharing of information or allocating securities between accounts. Other examples of accounts possibly eligible for the "separate accounts" exemption noted by the SEC would be: (a) an individual investor with multiple accounts with full discretionary authority in separate managers; (b) a money manager that provides capital to separate advisers where there is no coordination between the advisers; and (c) black box trading, if each black box is separate. *See* Short Selling in Connection with a Public Offering, Exchange Act Release No. 56206, at 22. The SEC also indicated that it is more likely to view accounts as separate if there are policies and procedures in place to ensure the separateness of the accounts, in addition to regular reviews to make sure that the policies and procedures are updated and implemented.

(n292)Footnote 292. *Id.* at 24.

(n293)Footnote 293. *Id.* at 25.

(n294)Footnote 294. 17 C.F.R. § 242.200(b)(2) and (6) (2004). A person is deemed to own a securities futures contract if he holds the contract and has received notice that the position will be physically settled and is irrevocably bound to receive the underlying security. 17 C.F.R. § 242.200(b)(6).

(n295)Footnote 295. 17 C.F.R. § 242.200(f).

(n296)Footnote 296. 17 C.F.R. § 242.200(g); *see also* In re Tradebot Sys., Inc., NYSE Arca, Inc. Hearing Board Decision 09-ARCA-10 (Oct. 15, 2009), *available at* <http://www.nyse.com/pdfs/09-ARCA-10.pdf>.

(n297)Footnote 297. 17 C.F.R. § 242.200(c).

(n298)Footnote 298. 17 C.F.R. § 242.200(d).

(n299)Footnote 299. 17 C.F.R. § 242.200(e).

(n300)Footnote 300. *In the Matter of Goldman Sachs Execution & Clearing, L.P.*, Sec. Ex. Act Rel. No. 55465,

2007 SEC LEXIS 491 (Mar. 14, 2007) .

(n301)Footnote 301. *See id.*

(n302)Footnote 302. Admin. Proc. File No. 3-12865, 2007 SEC LEXIS 2377 (Oct. 10, 2007) .

(n303)Footnote 303. Admin. Proc. File No. 3-12865, 2007 SEC LEXIS 2377 (Oct. 10, 2007) at *2-*3 .

(n304)Footnote 304. Admin. Proc. File No. 3-12865, 2007 SEC LEXIS 2377 (Oct. 10, 2007) at *9 .

(n305)Footnote 305. Admin. Proc. File No. 3-12865, 2007 SEC LEXIS 2377 (Oct. 10, 2007) at *10 .

(n306)Footnote 306. 17 C.F.R. § 242.202T (2004).

(n307)Footnote 307. 69 Fed. Reg. at 48,013; Order Delaying Pilot Period for Suspension of the Operation of Short Sale Price Provisions, Sec. Ex. Act Rel. No. 50747 (Nov. 29, 2004).

(n308)Footnote 308. 69 Fed. Reg. 48,008, 48,010 (Aug. 6, 2004) .

(n309)Footnote 309. Regulation SHO and Rule 10a-1, Exchange Act Release No. 55970, P 87,918 (June 28, 2007).

(n310)Footnote 310. Sec. Ex. Act Rel. No. 55,970 (June 28, 2007); 17 C.F.R. § 242.201.

(n311)Footnote 311. 17 C.F.R. § 242.201(a) (2009).

(n312)Footnote 312. *Id.* § 242.201(b).

(n313)Footnote 313. Sec. Ex. Act Rel. No. 55,970 (June 28, 2007); 17 C.F.R. § 242.200(g).

(n314)Footnote 314. *Id.*

(n315)Footnote 315. Sec. Ex. Act Rel. No. 59,748 (Apr. 8, 2009).

(n316)Footnote 316. Sec. Press Rel. No. 2009-76 (Apr. 8, 2009).

(n317)Footnote 317. Sec. Press Rel. No. 2010-26 (Feb. 24, 2010).

(n318)Footnote 318. Amendments to Regulation SHO, Final Rule, Sec. Ex. Act Rel. No. 34-61505, at 55.

(n319)Footnote 319. *Id.* at 1 .

(n320)Footnote 320. *Id.* at 2 .

(n321)Footnote 321. *Id.*

(n322)Footnote 322. *Id.* at 45-46.

(n323)Footnote 323. *Id.* at 9-10 .

(n324)Footnote 324. *Id.* at 10 .

(n325)Footnote 325. 17 C.F.R. § 242.203(a)(1) (2004).

(n326)Footnote 326. 17 C.F.R. § 242.203(a)(2). *See also*, 69 Fed. Reg. at 48,019.

2-6 Federal Securities Exchange Act of 1934 § 6.03

(n327)Footnote 327. The rule defines such prospective security sales as "threshold securities," and defines them as any equity security of an issuer that is registered under Section 12, or that is required to file reports pursuant to Section 15(d) of the Exchange Act where, for five consecutive settlement days: there are aggregate fails to deliver at a registered clearing agency of 10,000 shares or more per security; the level of fails is equal to at least one-half of one percent of the issuer's total shares outstanding; and the security is included on a list published by an SRO. 17 C.F.R. § 242.203(c)(6).

(n328)Footnote 328. 17 C.F.R. § 242.203(b) (2004).

(n329)Footnote 329. *In the Matter of TJM Proprietary Trading, LLC, Sec. Ex. Act Rel. 60440, 2009 SEC LEXIS 2721 (Aug. 5, 2009)* (order instituting administrative and cease-and-desist proceedings that found a market-maker violated Rules 203(b)(1) and 203(b)(3) of Reg. SHO by failing to locate securities and by engaging in a series of transactions involving FLEX options that created the illusion of closing out a 'fail-to-deliver' position); *In the Matter of Hazan Capital Mgmt., LLC, Sec. Ex. Act Rel. 60441, 2009 SEC LEXIS 2722 (Aug. 5, 2009)* (same).

(n330)Footnote 330. 17 C.F.R. § 242.203(b)(3).

(n331)Footnote 331. 17 C.F.R. § 242.203(b)(3)(i) (ii) and (iii).

(n332)Footnote 332. 17 C.F.R. § 242.203(b)(3)(iv).

(n333)Footnote 333. Amendments to Regulation SHO, Exchange Act Release No. 58775, P 88,296 (Oct. 14, 2008).

(n334)Footnote 334. 17 C.F.R. § 242.204T (2008).

(n335)Footnote 335. 17 C.F.R. § 242.204T(a).

(n336)Footnote 336. 17 C.F.R. § 242.204T(a)(1).

(n337)Footnote 337. 17 C.F.R. § 242.204T(a)(2).

(n338)Footnote 338. Amendments to Regulations SHO, Exchange Act Release No. 34-60388, P 88,662 (July 27, 2009).

(n339)Footnote 339. 17 C.F.R. § 242.204(a).

(n340)Footnote 340. 17 C.F.R. § 242.204(b).

(n341)Footnote 341. Amendments to Regulations SHO, Exchange Act Release No. 34-60388, P 88,662 (July 27, 2009).

(n342)Footnote 342. Id.

(n343)Footnote 343. 17 C.F.R. § 242.105.

(n344)Footnote 344. 69 Fed. Reg. at 48,026-27.

(n345)Footnote 345. 17 C.F.R. § 242.105(b) (amended). See 69 Fed. Reg. at 48,029.

(n346)Footnote 346. 69 Fed. Reg. at 48,027.

(n347)Footnote 347. 17 C.F.R. § 240.10a-3T (2008).

(n348)Footnote 348. Disclosure of Short Sales and Short Positions by Institutional Investment Managers,

Exchange Act Release No. 58785, P 88,298 (Oct. 15, 2008). In September 2008, the United Kingdom's Financial Services Authority (FSA), introduced a temporary ban on the creation or increase of net short positions in UK financial sector companies and accompanied this with a new disclosure regime for significant short positions. *See* FSA/PN/102/2008, FSA statement on short positions in financial stocks (Sept. 18, 2008) (*available at* <http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/102.shtml>). Following a brief period of consultation in January 2009, the FSA allowed the ban on short sales to lapse, but extended the disclosure regime until June 30, 2009. *See* FSA/PN/009/2009, FSA Confirms extension of short selling disclosure regime (Jan. 14, 2009) (*available at* <http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/009.shtml>). On June 26, 2009, the FSA announced that it was extending the disclosure regime indefinitely. *See* FSA/PN/084/2009, UK short selling disclosure regime extended (June 26, 2009) (*available at* <http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/084.shtml>). The FSA disclosure rule requires disclosure once a net short "position exceeds 0.25% of a company's issued share capital," but further disclosure is only required "if a short position changes by a further 0.1% of issued share capital." FSA/PN/009/2009; *see also* FSA Policy Statement 09/10, Extension of the short selling disclosure obligation, Feedback to CP09/15 (*available at* http://www.fsa.gov.uk/pubs/policy/ps09_10.pdf)

(n349)Footnote 349. SEC Takes Steps to Curtail Abusive Short Sales and Increase Market Transparency, Exchange Press Release No. 2009-172 (July 27, 2009).

(n350)Footnote 350. *Id.*

(n351)Footnote 351. SEC Takes Steps to Curtail Abusive Short Sales and Increase Market Transparency, Exchange Press Release No. 2009-172 (July 27, 2009).

(n352)Footnote 352. *Id.*

(n353)Footnote 353. H.R. REP. NO. 73-1383, at 10-11 (1934).

(n354)Footnote 354. 15 U.S.C.A. § 78i(b) (4) (Sec. Ex. Act § 9(b)).

(n355)Footnote 355. Termination of the Options Moratorium, Sec. Ex. Act Rel. No. 16,701, 19 SEC Dock. 998, 998 (Mar. 26, 1980).

(n356)Footnote 356. *See* "SRO Regulation of Market Manipulation," § 6.05[2], *below*. For a recent case synopsis of SEC regulation of options trading, see *Stock Exchanges Options Trading Antitrust Litigation*, No. 1283, M-21-79, 99 Civ. 962, 2001 U.S. Dist. LEXIS 1381, at *9-11 (S.D.N.Y. Feb. 15, 2001) .

(n357)Footnote 357. 17 C.F.R. § 240.9b-1 (2004) (Rule 9b-1). Rule 9b-1 went into effect on Oct. 25, 1982. *See* Registration Statement and other Disclosure Documents Related to Standardized Options, Sec. Ex. Act Rel. No. 19,055, 26 SEC Dock. 136, 138-39 (Sept. 16, 1982) (hereinafter "9b-1 Adopting Rel."); Amendment Relating to the Options Disclosure Document, Sec. Ex. Act Rel. No. 23,115, 35 SEC Dock. 595, 595-96 (Apr. 10, 1986); Amendments to Rule 9b-1, Sec. Ex. Act Rel. No. 43,461, 73 SEC Dock. 1301, 1301 (Oct. 19, 2000); Exemption for Standardized Options from Provisions of the Securities Act of 1933 and from the Registration Requirements of the Securities Exchange Act of 1934, Sec. Ex. Act Rel. 47082 (Dec. 23, 2002).

(n358)Footnote 358. 17 C.F.R. § 240.9b-1(b) and (d). *See* Amendments to Rule 9b-1, 73 SEC Dock. at 1301.

(n359)Footnote 359. 17 C.F.R. § 240.9b-1(c). *See* Registration Statement and Other Disclosure Documents Related to Standardized Options, Sec. Ex. Act Rel. No. 18, 836, 25 SEC Dock. 694, 699-00 (June 24, 1982); Amendment to 9b-1 Under the Securities Exchange Act Relating to Options, Sec. Ex. Act Rel. No. 40,129, 67 SEC Dock. 855, 857 (June 25, 1998) (hereinafter "9b-1 Proposing Rel."). The 9b-1 Adopting Release indicates the rule is intended "to foster better investor understanding of standardized options trading and to reduce compliance costs by shifting much of the information currently set forth in the registration statement into a new disclosure document containing a simplified

explanation of options trading, which would be subject only to anti-fraud liability." Registration Statement and Other Disclosure Documents Related to Standardized Options, 25 SEC Dock. at 694-95.

(n360)Footnote 360. See Amendments to Rule 9b-1, 73 SEC Dock. at 1302.

(n361)Footnote 361. See FINRA Regulatory Notice, "SEC Approves New Consolidated FINRA Rules," 09-60, October 2009, available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p120229.pdf>

(n362)Footnote 362. See Self-Regulatory Organizations, Sec. Ex. Act Rel. No. 22,418, 33 SEC Dock. 1463, 1463 (Sept. 17, 1985).

(n363)Footnote 363. See, e.g., Self-Regulatory Organizations, Sec. Ex. Act Rel. No. 24,895, 39 SEC Dock. 175, 175-76 (Sept. 9, 1987); Self-Regulatory Organizations, Sec. Ex. Act Rel. No. 29,850, 49 SEC Dock. 1713, 1713 (Oct. 23, 1991); Self-Regulatory Organizations, Sec. Ex. Act Rel. No. 37,824, 63 SEC Dock. 37, 37-38 (Oct. 15, 1996); Self-Regulatory Organizations, Sec. Ex. Act Rel. No. 43,167, 73 SEC Dock. 80, 80 (Aug. 17, 2000).

(n364)Footnote 364. *Jolley v. Welch*, 904 F.2d 988, 993 (5th Cir. 1990). See also *Robbins v. PaineWebber Inc.*, Civ. A. No. 88-G-0978-S, 1988 U.S. Dist. LEXIS 12735, at *1 (N.D. Ala. Aug. 30, 1988) ("The allegations of the complaint relate to possible violations of Rule 9b-1 and, therefore, constitute claims under the '34 Act.").

(n365)Footnote 365. *Pompano-Windy City Partners v. Bear Stearns & Co.*, 794 F. Supp. 1265, 1282 (S.D.N.Y. 1992).

(n366)Footnote 366. 15 U.S.C.A. § 78i(c) (2004) Sec. Ex. Act. § 9(c).

(n367)Footnote 367. Section 9(e) addresses private rights of action under § 9 and is covered in "Remedies for Market Manipulation," § 6.04, below. Section 9(f) excepts exempted securities from the purview of § 9(a).

(n368)Footnote 368. *Board of Trade v. SEC*, 677 F.2d 1137 (7th Cir.), vacated as moot, 459 U.S. 1026 (1982).

(n369)Footnote 369. 7 U.S.C.A. § 2 (2004).

(n370)Footnote 370. See *Golden Nugget, Inc. v. American Stock Exchange, Inc.*, 828 F.2d 586, 589 (9th Cir. 1987).

(n371)Footnote 371. 15 U.S.C.A. § 78i(g) (2004) (Sec. Ex. Act. § 9(g)).

(n372)Footnote 372. Pub. L. 101-432, 104 Stat. 963 (1990).

(n373)Footnote 373. 15 U.S.C.A. § 78i(h) (2004) (Sec. Ex. Act § 9(h)).

(n374)Footnote 374. Cash Settlement and Regulatory Halt Requirements for Security Futures Product, Sec. Ex. Act Rel. No. 44,743, 75 SEC Dock. 1639, 1639-40 (Aug. 24, 2001).

(n375)Footnote 375. Purchases of Certain Equity Securities by the Issuer and Others, Sec. Act Rel. No. 6434, 26 SEC Dock. 868, 868-69 (Nov. 17, 1982) (hereinafter "10b-18 Adopting Rel."). The Commission has "recognized that issuer repurchase programs are seldom undertaken with improper intent, may frequently be of substantial economic benefit to investors, and that, in any event, undue restriction of these programs is not in the interest if investors, issuers or the marketplace. [Thus] ... any rule in this area must not be overly intrusive." *Id.* at 869.

(n376)Footnote 376. 17 C.F.R. § 240.10b-18 (2001). See 10b-18 Adopting Rel., *supra* n.247, at 868.

(n377)Footnote 377. *17 C.F.R. § 240.10b-18(b)*.

(n378)Footnote 378. *68 Fed. Reg. 64,952 (Nov. 17, 2003)*.

(n379)Footnote 379. Issuers, whether or not they seek the protection of the safe harbor, must comply with the new disclosure provisions: Item 703 of Regulations S-K and S-B (*17 C.F.R. § 229.703 and 228.703*) and Item 15(e) of Form 20-F (for foreign private issuers) (*17 C.F.R. § 249.220f*). Closed-end management investment companies registered under the Investment Company Act must comply with Item 8 of Form N-CSR (*17 C.F.R. § 249.331; 17 C.F.R. § 274.128*). *17 C.F.R. § 240.10b-18(2)*.

(n380)Footnote 380. *17 C.F.R. § 240.10b-18(1)* (Preliminary Notes).

(n381)Footnote 381. Preliminary Notes.

(n382)Footnote 382. Preliminary Notes.

(n383)Footnote 383. *17 C.F.R. § 240.10b-18(a)*; 10b-18 Adopting Rel., *supra* n.247, at 870. An "affiliated purchaser" is "[a] person acting, directly or indirectly, in concert with the issuer for the purpose of acquiring the issuer's securities; or an affiliate who, directly or indirectly, controls the issuer's purchases of such securities, whose purchases are controlled by the issuer or whose purchases are under common control with those of the issuer." *17 C.F.R. § 240.10b-18(a)(3)*. The definition includes an exclusion for brokers, dealers or others effecting a Rule 10b-18 bid or purchase on behalf of the issuer for its account, as well as officers or directors of the issuer participating in the decision to authorize Rule 10b-18 bids or purchases on behalf of the issuer. *Id.*

(n384)Footnote 384. *17 C.F.R. § 240.10b-18(a)(13)*. "Riskless Principal" is defined as "a transaction in which a broker or dealer after having received an order from an issuer to buy its security, buys the security as a principal in the market at the same price to satisfy the issuer's buy order. The issuer's buy order must be effected at the same price per-share at which the broker or dealer bought the shares to satisfy the issuer's buy order, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee. In addition, only the first leg of the transaction, when the broker or dealer buys the security in the market as principal, is reported under the rules of a [SRO] or under the [Exchange Act] ... " *17 C.F.R. § 240.10b-18(a)(12)*. The broker-dealer also must have certain policies and procedures in place that allow the broker-dealer easily to reconstruct the transaction.

In a June 2002 Commission Guidance, the SEC indicated that the Rule 10b-18 safe harbor did not apply to issuer repurchase transactions involving securities futures, including the receipt of the securities underlying the futures. "Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Rules Thereunder to Trading in Security Futures Products," Sec. Ex. Act Rel. No. 46101 (June 21, 2002).

(n385)Footnote 385. Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Sec. Ex. Act Rel. No. 58,588 (Sep. 18, 2008).

(n386)Footnote 386. *Id.*

(n387)Footnote 387. *Id.*

(n388)Footnote 388. For an example of an SEC No-Action Letter applying the Rule 10b-18 conditions, see OptiMark Tech., Inc., SEC No-Action Letter, 2000 SEC No-Act. LEXIS 130 (Feb. 10, 2000).

(n389)Footnote 389. *17 C.F.R. § 240.10b-18(b)(1)*.

(n390)Footnote 390. *17 C.F.R. § 240.10b-18(b)(1)(i)*. The term "solicit" has not been defined in the rule.

(n391)Footnote 391. However, if the purchaser uses a non-ECN or non-ATS broker to effect all its repurchases, that broker can place trades through an ECN or ATS on behalf of the issuer. *17 C.F.R. § 240.10b-18(b)(1)(iii)*.

(n392)Footnote 392. *17 C.F.R. § 240.10b-18(b)(2)(i)*. For purposes of the timing and price conditions, amended Rule 10b-18(a)(6) defines "consolidated system" as "a consolidated transaction or quotation reporting system that collects and publicly disseminates on a current and continuous basis transaction or quotation information in common equity securities pursuant to an effective transaction reporting plan (as defined in *17 CFR 240.11Aa3-1*) or a national market system plan (as defined in *17 CFR 240.11Aa3-2*)."

(n393)Footnote 393. Purchases of Certain Equity Securities by the Issuer and Others, Sec. Ex. Act Rel. No. 40, 617, 68 SEC Dock 790, 791 (Oct. 29, 1998).

(n394)Footnote 394. *17 C.F.R. § 240.10b-18(b)(2)(ii)*.

(n395)Footnote 395. *17 C.F.R. § 240.10b-18(b)(2)(iii)*. For purposes of the safe harbor, "ADTV" means "the average daily trading volume reported for the security during the four calendar weeks preceding the week in which the Rule 10b-18 purchase is to be effected." *17 C.F.R. § 240.10b-18(a)(1)*.

(n396)Footnote 396. See Eileen Smith Ewing, *Signaling Confidence: The SEC's Emergency Powers and the Easing of Rule 10b-18*, 4 No. 1 ESECURITY 1 (Sept. 2001).

(N397)Footnote 397. *17 C.F.R. § 240.10b-18(b)(2)(iv)*.

(n398)Footnote 398. *17 C.F.R. § 240.10b-18(b)(3)(i)*.

(n399)Footnote 399. *17 C.F.R. § 240.10b-18(b)(3)(ii)*.

(n400)Footnote 400. *17 C.F.R. § 240.10b-18(b)(3)(iii)*.

(n401)Footnote 401. *17 C.F.R. § 240.10b-18(b)(4)*. "Block" for purposes of this provision is a quantity that either (1) has a purchase price of at least \$200,000; or (2) is at least 5,000 shares and has a purchase price of at least \$50,000; or (3) is at least 20 round lots of the security and totals 150 percent or more of the trading volume of that security. In the event that trading volume data are unavailable, a block purchase is at least 20 round lots of the security and totals at least one-tenth of one percent (.001) of the outstanding shares of the security, exclusive of any shares owned by any affiliate. *17 C.F.R. § 240.10b-18(a)(5)*.

(n402)Footnote 402. *17 C.F.R. § 240.10b-18(b)(4)*.

(n403)Footnote 403. Purchases of Certain Equity Securities by the Issuer and Others, Sec. Ex. Rel. No. 41,905, 70 SEC Dock. 1375, 1375-76 (Sept. 23, 1999).

(n404)Footnote 404. *Id.* at 1379.

(n405)Footnote 405. *17 C.F.R. § 240.10b-18(c)*.

(n406)Footnote 406. *Id.*

(n407)Footnote 407. *17 C.F.R. § 10b-18(c)(2)*.

(n408)Footnote 408. *17 C.F.R. § 240.10b-18(a)(13)*.

(n409)Footnote 409. *17 C.F.R. § 240.10b-18(a)(13)(i)*.

(n410)Footnote 410. *17 C.F.R. § 240.10b-18(a)(13)(ii)*. "Plan means any bonus, profit-sharing, pension,

retirement, thrift, savings, incentive, stock purchase, stock option, stock ownership, stock appreciation, dividend reinvestment, or similar plan; or any dividend or interest reinvestment plan or employee benefit plan as defined in § 230.405 of this chapter." 17 C.F.R. 242.100(b) (2004).

(n411)Footnote 411. Purchases of Certain Equity Securities by the Issuer and Others; Adoption of Safe Harbor, Sec. Ex. Rel. No. 19,244, 26 SEC Dock. 868, 875 (Nov 11, 1982).

(n412)Footnote 412. 17 C.F.R. § 240.10b-18(a)(13)(iii).

(n413)Footnote 413. Purchases of Certain Equity Securities by the Issuer and Others; Adoption of Safe Harbor, 26 SEC Dock. at 874-75.

(n414)Footnote 414. 17 C.F.R. § 240.10b-18(a)(13)(iv).

(n415)Footnote 415. 17 C.F.R. § 240.10b-18(a)(13)(iv). The provision does not apply where: the purchase is in cash and there is no valuation period, or where: (1) the total amount of the issuers' Rule 10b-18 purchase on any single day does not exceed the lesser of 25% of the security's four-week ADTV or the issuer's average daily ADTV or the issuer's average daily Rule 10b-18 purchase during the three full calendar months preceding the date of the announcement of the merger or other covered transaction; (2) the issuer makes a block purchase that does not exceed the average size and frequency of block purchases effected under paragraph (b)(4) during the three full calendar months preceding the date of the announcement of the transaction; and such purchases are not otherwise restricted or prohibited. 17 C.F.R. § 240.10b-18(a)(13)(iv)(A)-(B).

(n416)Footnote 416. Purchases of Certain Equity Securities by the Issuer and Others, Sec. Ex. Act Rel. No. 17,222, 21 SEC Dock. 212, 234 (Oct 17, 1980).

(n417)Footnote 417. 17 C.F.R. § 240.10b-18(a)(3)(v).

(n418)Footnote 418. 17 C.F.R. § 240.13e-1 (2004). An issuer subject to the Exchange Act's registration and reporting requirements may not purchase its own securities following a third party tender offer without a disclosure statement identifying the securities to be purchased, the identification of the seller(s) and the market through which the securities will be purchased, the purpose of the purchase and intended use of the securities, and the source and amount of consideration for the purchase. 17 C.F.R. § 240.13e-1(a).

(n419)Footnote 419. See Purchases of Certain Equity Securities by the Issuer and Others, Sec. Ex. Act Rel. No. 17,222, 21 SEC Dock. at 234.

(n420)Footnote 420. 17 C.F.R. § 240.10b-18(a)(13)(vi).

(n421)Footnote 421. See Purchases of Certain Equity Securities by the Issuer and Others, 21 SEC Dock. at 216-17.

(n422)Footnote 422. 17 C.F.R. § 240.10b-18(a)(13)(vii).

(n423)Footnote 423. See Purchases of Certain Equity Securities by the Issuer and Others, 21 SEC Dock. at 235 n.81.

(n424)Footnote 424. Purchases of Certain Equity Securities by the Issuer and Others; Adoption of Safe Harbor, 26 SEC Dock. at 869.

(n425)Footnote 425. *Id.*

(n426)Footnote 426. "The safe harbor is not intended to define the appropriate limits to be observed by those persons not covered by the safe harbor nor the appropriate limits to be observed by anyone when purchasing securities

other than common stock." *Id.*

(n427)Footnote 427. Emergency Order Pursuant to 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release 58588, P 88,275 (Sep. 17, 2008).

(n428)Footnote 428. *Id.*

(n429)Footnote 429. *17 C.F.R. § 240.10b-18.*



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Federal Securities Exchange Act of 1934

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CHAPTER 6 Regulation of Market Manipulation

2-6 Federal Securities Exchange Act of 1934 § 6.04

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§ 6.04 Remedies for Market Manipulation

This section describes the various remedies available to private litigants and the SEC to enforce the anti-manipulation provisions of the Exchange Act and SEC rules and regulations prohibiting manipulative conduct.

[1] Civil Remedies

There are two sections of the Exchange Act--Sections 9(e) and 10(b)--that plaintiffs may use to seek relief for harm caused by market manipulation. In this subsection, we analyze particular evidentiary elements of Sections 9(e) and 10(b) for comparative purposes. For a more detailed description of the substantive elements of each cause of action, please consult §§ 6.03[4][a]-[d] for Section 9(e) and § 6.03[4][e] for Section 10(b).

[a] Section 9(e). As discussed in §§ 6.03[4][a] -[d] above, Section 9 prohibits wash sales, matched orders, touting, tipster sheets and other misrepresentations. n1 It also prohibits general manipulative transactions on national securities exchanges, and regulates stabilization measures, options, and practices affecting market volatility on national securities exchanges. n2 Section 9(e) expressly grants a private right of action for violations of subsections (a), (b) or (c) of Section 9: n3

Any person who willfully participates in any act or transaction in violation of subsection (a), (b), or (c) of this section, shall be liable to any person who shall purchase or sell any security at a price which was affected by such act or transaction, and the person so injured may sue in law or in equity in any court of competent jurisdiction to recover the damages sustained as a result of any such act or transaction ... n4

Following the Sarbanes-Oxley Act of 2002, the statute of limitations for bringing a claim under Section 9(e) is the same "two year/five year" rule applicable to claims under 10(b):

"[A] private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in

contravention of a regulatory requirement concerning the securities laws ... may be brought not later than the earlier of[] (1) 2 years after the discovery of the facts constituting the violation; or (2) 5 years after such violation." n5

When securities are sold on a national securities exchange, private plaintiffs can bring actions under both Sections 9(e) and 10(b), n6 but, Section 9(e) is used less frequently given its narrower applicability and higher pleading burden relative to Section 10(b). n7 Section 9(e) is limited to securities sold on a national securities exchange and requires proof that the plaintiff bought or sold at a price that was affected by the market manipulation. n8 Recovery is therefore limited to damages directly linked to that change in price. n9 Section 9(e) also adds the element of manipulative purpose, not present in 10(b) actions. n10

The Section 9(e) requirement of connecting defendant's manipulative acts to plaintiff's sale or purchase price can be daunting, as there are often intervening factors that impact the market price of a security. n11 For example, in *Chemetron Corp. v. Business Funds, Inc.*, Business Funds, Inc. was held liable under Section 10(b), but not under Section 9(a)(2), when a jury found that Business Funds acquired control of Westec and manipulated the price of Westec stock, which was then sold to Chemetron, in exchange for the stock of a Chemetron subsidiary. n12 The jury found all the elements of a manipulative stock scheme under 10(b), but did not find that the stock scheme "affected" the price Chemetron paid for the Westec stock, a necessary element under Section 9. n13

Plaintiffs suing under Section 9 also must prove that defendant "willfully" participated in the manipulation. n14 The mere act of influencing the market price is not sufficient--plaintiff must show that defendant intended to do so, *i.e.*, had a manipulative purpose. n15 In practice, however, willfulness and manipulative purpose often are inferred from the circumstances of the case, and do not require a separate evidentiary showing. n16 For example, in *Crane Co. v. Westinghouse Air Brake Co.*, the Court of Appeals for the Second Circuit found the requisite manipulative purpose and willfulness under Section 9(e) when a company bought a significant amount of stock of a corporation it wished to acquire, on the expiration date of a competitor's tender offer, thus driving up the price of the stock and fending off the takeover attempt. n17

[b] Section 10(b). Although there is no explicit private right of action under Section 10(b), federal courts have established the availability of a private right of action for securities fraud under Section 10(b) and *Rule 10b-5*. n18 To set forth a private right of action for market manipulation under Section 10(b) and *Rule 10b-5*, a plaintiff must allege: (1) a misrepresentation or omission of a material fact or a scheme by defendant to defraud; (2) in connection with the purchase or sale of securities; (3) made with scienter; (4) that plaintiff relied upon, and (5) which caused plaintiff's injury. n19 As part of the causation requirement, plaintiff must show both transaction causation and loss causation. n20 "Transaction causation" has been described as "the violations in question caused the plaintiff to engage in the transaction." n21 "Loss causation" has been described as "the misrepresentations or omissions caused the harm." n22

It is often difficult to establish the element of causation in market manipulation cases. First, a plaintiff can only establish transaction causation where the stock was purchased *after* the alleged manipulation. In market manipulation cases, a person who buys the stock after the alleged manipulation can establish transaction causation under the "fraud on the market" theory by showing that defendant's manipulative acts interfered with the free forces of the market. n23 Shareholders who bought the stock in question before the alleged manipulation cannot establish the element of transaction causation, because they cannot show that the manipulation caused them to engage in the securities transaction. n24

Second, with respect to loss causation, it may be difficult for a plaintiff to prove that the alleged manipulation was the cause of the change in market price. n25

Plaintiffs have used Section 10(b) and *Rule 10b-5* thereunder to obtain both damages and injunctive relief. For example, in *Crane Co. v. Westinghouse Air Brake Co.* (see above), the Court of Appeals ordered appropriate remedies, including

damages, prospective injunctive relief, and divestiture or separation of Air Brake, as necessary to compensate Crane for its lost merger opportunity. n26

[2] Enforcement Remedies

Section 21 of the Exchange Act establishes a wide array of enforcement remedies for violations of the Exchange Act. Through administrative proceedings or actions brought in federal court, the SEC can obtain injunctions, cease and desist orders, civil penalties, disgorgement of monies fraudulently obtained, and orders barring individuals from serving as directors or officers of public companies. n27 Section 15 establishes enforcement mechanisms against brokers and dealers, n28 which are covered in more detail in Chapter 9. The SEC can also refer matters to the Department of Justice for criminal prosecution. We will briefly review each remedy in the context of market manipulation.

[a] Injunctive Relief. Section 21(d)(1) of the Exchange Act enables the SEC to move before a United States District Court for preliminary and permanent injunctions against a person or persons committing any violation of the securities acts, SEC rules, rules of the national securities exchanges, registered securities associations or registered clearing agencies. n29 That section provides:

Whenever it shall appear to the Commission that any person is engaged or is about to engage in any acts or practices constituting a violation of any provision of this title, the rules or regulations thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or a person associated with a member, the rules of a registered clearing agency in which such person is a participant, or the rules of the Municipal Securities Rulemaking Board, it may in its discretion bring an action in the proper district court of the United States, ... to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. n30

To obtain injunctive relief, the SEC must demonstrate by a preponderance of the evidence a reasonable likelihood that the defendant will repeat the securities violation. n31 One court explained:

In deciding whether to issue the preliminary injunction the critical question before the Court is whether there is a reasonable expectation that the defendants will thwart the policies of the SEC and Congress as expressed in the '33 and '34 Acts and the rules and regulations promulgated pursuant thereto by engaging in activities proscribed thereby. And the court must also consider the fact that illegal past conduct gives rise to the inference that there is a reasonable likelihood of future violations. n32

The burden then shifts to the defendant, which must show there is no reasonable expectation that it will repeat the illegal activity. n33 For example, the United States District Court for the Southern District of New York granted a preliminary injunction against further violations of the securities laws where defendants issued 10,000 shares of a company's stock in the names of 100 fictitious persons, placed purchase orders with various brokerage firms for over 40,000 shares of company stock with no intention of paying for them, then misrepresented the value of the stock, failed to disclose the true identity of the beneficial owners of the stock and effected sham transactions which involved no change in the beneficial ownership of stock. n34 The court issued the injunction after finding that defendants had not sustained their heavy burden rebutting the inference that there was a reasonable likelihood of future securities law violations. n35

[b] Cease and Desist Orders. In 1990, Congress added to the SEC's enforcement powers by permitting the SEC to issue cease and desist orders after notice and opportunity for hearing. n36 Section 21C of the Exchange Act provides:

If the Commission finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of this chapter, or any rule or regulation thereunder, the Commission may publish its findings and enter an order requiring such person, and any other person that

is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation. n37

Section 21C also permits the SEC to impose conditions on defendants to assure future compliance with the federal securities laws. n38 The SEC may enter temporary cease and desist orders where the securities violation is likely to result in significant dissipation or conversion of assets, significant harm to investors or substantial harm to the public interest, including losses to the Securities Investor Protection Corporation. n39

The SEC's burden for obtaining a cease and desist order is lower than its burden in obtaining injunctive relief. The Commission has stated that "while Congress intended that cease-and-desist orders be forward-looking, like injunctions, it intended that the showing of risk of future violations be significantly less than that required for an injunction." n40 Accordingly, "[a]bsent evidence to the contrary, a finding of a violation raises a sufficient risk of future violation. To put it another way, evidence showing that a respondent violated the law once probably also shows a risk of repetition that merits our ordering him to cease and desist." n41 The SEC need not show scienter to invoke cease and desist authority. n42

The SEC considers the following factors, among others, in determining whether to issue a cease and desist order:

[T]he seriousness of the violation, the isolated or recurrent nature of the violation, the respondent's state of mind, the sincerity of the respondent's assurances against future violations, the respondent's recognition of the wrongful nature of his or her conduct, and the respondent's opportunity to commit future violations ... [W]hether the violation is recent, the degree of harm to investors or the marketplace resulting from the violation, and the remedial function to be served by the cease-and-desist order in the context of any other sanctions being sought in the same proceedings. n43

The SEC issued a cease and desist order where a law school student created a stock recommendation website called "Fast-Trades.com" to manipulate the price of stocks and involved two friends in posting false recommendations on the site after purchasing the stock. The SEC also ordered disgorgement and prejudgment interest, but waived payment upon a finding that the defendants were unable to pay. n44 The cease and desist order may well have reflected the SEC's assessment that there was minimal risk of future violations on the part of these relatively unsophisticated traders.

[c] Profit Disgorgement. Under Section 21(d)(3)(A), the Commission or other appropriate regulatory agency may enter an order requiring an accounting and disgorgement of profits defendant illegally gained, including reasonable interest. n45 Disgorgement is "intended to deter by depriving wrongdoers of any unjust enrichment, thereby making their violations unprofitable." n46 The disgorgement remedy also may be used against persons who did not violate the securities laws, who hold illegally obtained profits, and have no legitimate claim to the proceeds. n47

In determining whether prejudgment interest is appropriate, courts consider: the need to fully compensate the wronged party for actual damages suffered, the fairness and the relative equities of the award, and the remedial purposes of the statute. n48 The proper measure of disgorgement is the full extent of the defendant's actual illegal profit rather than the amount of loss to the investor. n49 The disgorged amount must be "causally connected to the violation, but it need not be figured with exactitude," nor need there be a "precise nexus" between the disgorgement amount and the violation. n50 Joint and several liability is permitted for securities violations, but "no more than the total amount of unlawful profits, plus interest on those amounts, is to be disgorged." n51 The district court also has broad discretion as to whether to grant prejudgment interest and the rate of interest. n52

The court's broad discretion in determining disgorgement and other penalties sought by the SEC was reflected in *SEC v. Rosenfeld*. In that case, defendant, the president, treasurer and director of Synpro Environmental Services, issued his company's stock for no consideration to nominees, then directed them to sell the shares into the market, generating

profits for himself. The court ordered disgorgement of \$1,093,189, the amount of profits generated, and added \$630,386.63 in prejudgment interest by calculating the IRS rate for underpayment of taxes between defendant's last sale and entry of judgment. It further awarded civil penalties in the amount of \$1,093,189. n53 Under Section 308 of the Sarbanes-Oxley Act of 2002, n54 a court can order that the civil penalties imposed become part of the disgorgement fund for the benefit of the victims of securities fraud. n55

[d] Civil Penalties. Under Section 21A, if it appears that a person has violated an SEC rule, regulation or cease and desist order, other than a violation that is subject to a penalty under the Insider Trading Sanctions Act of 1984, the SEC may bring a civil action seeking a civil penalty against the violator. n56 The amount of penalty is discretionary and is determined by whether the violation involved "fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement," or "whether the violation directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to other persons." n57

The courts view civil penalties as a means "[t]o achieve the dual goals of punishment of the individual violator and deterrence of future violations." n58 The legislative history of Section 21(d) indicates that such penalties are necessary because disgorgement merely requires the return of wrongfully obtained profits, it does not result in any actual economic penalty or act as a financial disincentive to engage in securities fraud ... [The] authority to seek or impose substantial monetary penalties, in addition to the disgorgement of profits, is necessary for the deterrence of securities law violations that otherwise may provide great financial returns to the violator. n59

For example, in *SEC v. Poirier*, defendants had engaged in an elaborate pump and dump scheme involving a number of false press releases regarding unregistered stocks, resulting in significant profits for the defendants. The court granted the SEC's request for a \$100,000 civil penalty as to each defendant, finding that "defendants' violations involving fraud and deceit were numerous and ongoing." n60

[e] Bar Orders. Under Section 21(d)(2) of the Exchange Act, where the SEC seeks an injunction or criminal prosecution, the court may prohibit conditionally or unconditionally, permanently or temporarily, any person who has violated Section 10(b) or any rules thereunder, from acting as an officer or director of any issuer that has a class of securities registered under the Exchange Act or any issuer that is required to file periodic reports under the Act, "if the person's conduct demonstrates substantial unfitness to serve as an officer or director of any such issuer." n61

In *Charles O. Huttoe*, defendant, formerly the Chairman and CEO of Systems of Excellence, Inc. (SOE), allegedly artificially inflated the price of SOE securities by issuing materially false press releases about nonexistent multimillion dollar sales of SOE products, filing false periodic reports with the SEC, and bribing individuals to tout SOE stock. As a final part of the scheme, defendant and several cohorts took advantage of the inflated market by dumping their shares. Huttoe settled the SEC action by consenting to an order permanently enjoining him from violating federal securities laws, barring him from acting as an officer and director of a public company, and requiring him to disgorge the monies he derived from the SOE manipulation. n62

[f] Criminal Penalties. Under Section 21(d)(1) of the Exchange Act, "[t]he Commission may transmit such evidence as may be available concerning such acts or practices as may constitute a violation of any provision of this chapter or the rules or regulations thereunder to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this chapter." n63 Section 32 of the Exchange Act describes the criminal penalties that may be imposed, including fines of no more than \$1,000,000 or imprisonment of not more than 10 years for individuals, and fines not exceeding \$2,500,000 for entities. n64

It is a criminal offense to "willfully" violate any of the provisions of the Exchange Act. Section 32 establishes that "no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation." n65 Courts have held, however, that " '[a] person can willfully violate an SEC rule even if he does not know of its existence ... ' The prosecution need only establish 'a realization on the

defendant's part that he was doing a wrongful act;' it is necessary ... only that the act be 'wrongful under the securities laws and that the knowingly wrongful act involve a significant risk of effecting the violation.' " n66

The burden prosecutors bear in establishing a criminal violation of the rules proscribing market manipulation is proof beyond a reasonable doubt. Prosecutors must also show willful behavior, which is a heightened form of scienter. Although some courts have stated that the elements of a securities fraud claim remain the same in both criminal and civil cases, at least one commentator has noted that many courts interpret the elements of securities fraud more narrowly in criminal actions in order to align them with the fundamental values of criminal law. n67

The SEC does not have formal guidelines for determining the circumstances under which it will make a criminal referral. It cites a variety of factors: egregiousness of the alleged misconduct; single occasion versus pattern of misconduct; length of time that the misconduct took place; efforts to conceal the substantive violation; impact of the violation; effect of the misconduct on shareholders, clients, the marketplace or the subject entity; magnitude of proof; recidivism; and misrepresentations to the SEC staff. n68 The SEC tends to refer cases for criminal prosecutions in areas which it prioritizes, where blatantly fraudulent conduct impacts or potentially impacts a large number of investors. Thus, market manipulation, micro cap fraud and fraud over the Internet are areas of increased focus, both in the criminal and civil realms. n69

[g] Regulation of Brokers and Dealers. Sections 15(b)(4) and 15(b)(6) of the Exchange Act enable the SEC to enforce the securities laws against broker-dealers and associated persons of the broker-dealers through a variety of mechanisms. n70 The SEC can censure; place limitations on activities, functions and operations; suspend registration for a period not exceeding 12 months; and deny or revoke registration of member firms and their associated persons. On finding that a broker-dealer has engaged in market manipulation, the SEC has invoked section 15(b)(4) to issue injunctions, censure and revoke the registration of broker-dealers, suspend individual brokers and otherwise limit the activities of broker-dealers. For example, the SEC permanently enjoined a broker-dealer on finding that the broker-dealer had engaged in non-bona fide transactions to give the false impression that it had met the required sale of shares in a "best efforts, all-or-none" offering. n71 In another matter, it censured and barred from the securities industry a broker-dealer that had engaged in domination and control of the market, wash sales, matched orders, marking the close and other forms of artificial inflation in the aftermarket of the IPO it underwrote. n72

Under section 15(b)(6), the SEC has barred broker-dealers from engaging in penny stock transactions when they were found to have manipulated the market for penny stock through pump and dump schemes and other forms of artificial inflation of the stock price. n73

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C.A. § 78i (2008) (Sec. Ex. Act § 9).

(n2)Footnote 2. 15 U.S.C.A. § 78i (2008) (Sec. Ex. Act § 9).

(n3)Footnote 3. Note that no private right of action is expressly granted with respect to subsection (h) regulating practices affecting market volatility. *Id.*

(n4)Footnote 4. 15 U.S.C.A. § 78i(e).

(n5)Footnote 5. 28 U.S.C.A. § 1658 (2008).

(n6)Footnote 6. See, e.g., *D.C. Perry v. Eastman Kodak Co.*, No. IP 87-1023-C, 1991 U.S. Dist. LEXIS 20914, at *17 (S.D. Ind. Apr. 22, 1991); *Atlantic Fed. Savings and Loan Assoc. v. Dade Savings and Loan Assoc.*, 592 F. Supp. 1089, 1092 (S.D. Fla. 1984); *Liberty Nat'l Ins. Holding Co. v. Charter Co.*, No. CV82-H-233-S, 1982 U.S. Dist. LEXIS 12794, at *10 (N.D. Ala. Apr. 27, 1982); *DuPont v. Wyly*, 61 F.R.D. 615, 629 (D. Del. 1973).

(n7)Footnote 7. See, e.g., *D.C. Perry v. Eastman Kodak Co.*, No. IP 87-1023-C, 1991 U.S. Dist. LEXIS 20914, at *17 (S.D. Ind. Apr. 22, 1991); *Atlantic Fed. Savings and Loan Assoc. v. Dade Savings and Loan Assoc.*, 592 F. Supp. 1089, 1092 (S.D. Fla. 1984); *Liberty Nat'l Ins. Holding Co. v. Charter Co.*, No. CV82-H-233-S, 1982 U.S. Dist. LEXIS 12794, at *10 (N.D. Ala. Apr. 27, 1982); *DuPont v. Wyly*, 61 F.R.D. 615, 629 (D. Del. 1973).

(n8)Footnote 8. 15 U.S.C.A. § 78i(e).

(n9)Footnote 9. *Jolley v. Welch*, 904 F.2d 988, 992-93 (5th Cir. 1990). See also *John P. Lowe v. Salomon Smith Barney, Inc.*, 206 F. Supp.2d 442, 445 (W.D.N.Y. 2002) (for 9(e) claim, must show that plaintiff was induced to purchase or sell securities at a price that was effected by defendant's actions; it is not enough that plaintiff continued to hold shares to his detriment); *Richardson v. Shearson/American Express Co.*, 573 F. Supp. 133, 136 (S.D.N.Y. 1983) (manipulation of the market which induces a person not to sell shares already owned is not sufficient).

(n10)Footnote 10. *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, 794 (2d Cir. 1969).

(n11)Footnote 11. See *Jolley*, 904 F.2d at 992-93; *Crane Co. v. American Standard, Inc.*, 603 F.2d 244, 251-53 (2d Cir. 1979); *Kerrigan v. Merrill Lynch*, 450 F. Supp. 639, 647 (S.D.N.Y. 1978).

(n12)Footnote 12. *Chemetron Corp.*, 682 F.2d at 1157.

(n13)Footnote 13. *Id.* Timing also is critical. Neither § 10(b) nor § 9(e) liability may be predicated on a purchase or sale that occurs *before* defendant allegedly manipulated the price of a stock. *DuPont*, 61 F.R.D. at 629-30 (dismissing § 9(a) and portions of 10(b) claims related to purchases made before alleged manipulative activities); *Atlantic Fed. Savings and Loan Ass'n*, 592 F. Supp. at 1092 (dismissing § 9 and 10(b) claims because plaintiff did not allege purchase of shares after the purported price manipulations).

(n14)Footnote 14. 15 U.S.C.A. § 78i.

(n15)Footnote 15. *Crane Co.*, 419 F.2d at 794; *Adrian C. Havill*, 60 SEC Dock. at 317-18. See § 6.03[4][c] (above).

(n16)Footnote 16. *Crane Co.*, 419 F.2d at 794.

(n17)Footnote 17. *Id.*

(n18)Footnote 18. BRODSKY AND KRAMER, *supra* n.33 in § 6.03[4][b], at Ch. 6, 6-2.

(n19)Footnote 19. *Dietrich v. Bauer*, 76 F. Supp. 2d 312, 338 (S.D.N.Y. 1999); *Cowen & Co. v. Merriam*, 745 F. Supp. 925, 929 (S.D.N.Y. 1990). See also BRODSKY AND KRAMER, *supra* n.33 in § 6.03[4][b], at Ch. 6, 6-3.

(n20)Footnote 20. See, e.g., *Dietrich*, 76 F. Supp. 2d at 340-42; *Wong v. Thomas Bros. Restaurant Corp.*, 840 F. Supp. 727, 730-31 (C.D. Cal. 1994).

(n21)Footnote 21. *Wong*, 840 F. Supp. at 730.

(n22)Footnote 22. See *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 173 (2d Cir. 2005) (a misstatement or omission is the "proximate cause" of investor loss when "the risk that caused the loss was within the zone of risk concealed by the misrepresentations and omissions alleged by a disappointed investor"); *In re Initial Public Offering Sec. Litig.*, 2005 U.S. Dist. LEXIS 2121 (S.D.N.Y. Feb. 15, 2005) (loss causation concept compared to the tort law concept of proximate cause). See also BRODSKY AND KRAMER, *supra* n.33 in § 6.03[4][b], at Ch. 6, 6-14 to 6-22 for a more detailed explanation of the causation element.

(n23)Footnote 23. "[A] plaintiff may also, subject to rebuttal establish transaction causation by means of the 'fraud

on the market' theory,' which permits a plaintiff to rely on the integrity of open, well-developed markets rather than requiring proof of direct reliance on a defendant's conduct ..." *Dietrich*, 76 F. Supp. 2d at 341, citing *Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb, Inc.*, 967 F.2d 742, 748 (2d Cir. 1992).

(n24)Footnote 24. *Dietrich*, 76 F. Supp. 2d at 341 ("Because the September 1991 and December 1992 purchases occurred prior to the alleged market manipulation, a market manipulation claim with respect to these two purchases must be dismissed. As the Defendants point out, any loss associated with those purchases could not have been caused by the market manipulation occurring after those purchases were made.").

(n25)Footnote 25. See above, n.10. See *Dura Pharmaceutical, Inc. v. Broudo*, 125 S. Ct. 1627, 2005 U.S. LEXIS 3478 (Apr. 19, 2005) (plaintiff cannot plead and prove loss causation simply by pleading/proving that the price on the date of purchase was inflated because of the misrepresentation).

(n26)Footnote 26. *Crane Co.*, 419 F.2d at 804-05. See also *Chemetron Corp.*, 718 F.2d at 728 (affirming order of damages to largest shareholder injured as result of complex stock manipulation scheme).

(n27)Footnote 27. 15 U.S.C.A. § 78u(d) (2004).

(n28)Footnote 28. 15 U.S.C.A. § 78o(b)(4) and (6) (2004).

(n29)Footnote 29. 15 U.S.C.A. § 78u(d)(1).

(n30)Footnote 30. 15 U.S.C.A. § 78u(d)(1).

(n31)Footnote 31. *SEC v. U.S. Environmental, Inc.*, No. 94 Civ. 6608, 2003 U.S. Dist. LEXIS 12580, at *67-68 (S.D.N.Y. July 21, 2003); *SEC v. Tome*, 638 F. Supp. 596, 628 (S.D.N.Y. 1986); *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 18 (2d Cir. 1977); *SEC v. William A. Calvo*, 378 F.3d 1211, 1216 (11th Cir. 2004).

(n32)Footnote 32. *Globus Int'l*, 320 F. Supp. at 160. Proof of scienter or intent to defraud is not required to show violations justifying injunctive relief under federal securities laws. See *Aaron v. SEC*, 446 U.S. 680, 700-01 (1980); *SEC v. Pearson*, 426 F.2d 1339, 1343 (10th Cir. 1970).

(n33)Footnote 33. *Id.* See also *SEC v. Senex*, 399 F. Supp. 497, 508 (E.D. Ky. 1975).

(n34)Footnote 34. *Globus Int'l*, 320 F. Supp. at 159.

(n35)Footnote 35. *Id.* at 160. See also *SEC v. Poirier*, 140 F. Supp. 2d 1033, 1046-48 (D. Ariz. 2001) (Court found that defendants engaged in "pump and dump" scheme, by forming a company, acquiring shares, and issuing press releases misstating company revenue and sales, with the intent to sell off the shares at an inflated price. Given the egregious nature of the violations then before it, and violations of identical provisions over ten years earlier, the court concluded there was strong evidence that defendants were likely to violate the securities laws in the future).

(n36)Footnote 36. 15 U.S.C.A. § 78u-3(a) (2004) (Sec. Ex. Act § 21C).

(n37)Footnote 37. *Id.*

(n38)Footnote 38. *Id.* "[The cease and desist] order may in addition require ... such person to comply, or to take steps to effect compliance, with [the] provision, rule, or regulation [such person is violating, has violated, or is about to violate], upon such terms and conditions and within such time as the Commission may specify in such order."

(n39)Footnote 39. *Id.*

(n40)Footnote 40. KPMG Peat Marwick, LLP, Sec. Ex. Act Rel. No. 43,862, 74 SEC Dock. 357, 382-83 (Jan. 19,

2001).

(n41)Footnote 41. *Id.* at 380.

(n42)Footnote 42. *Id.* at 374-75.

(n43)Footnote 43. *Id.* at 383.

(n44)Footnote 44. Douglas W. Colt, Litig. Rel. No. 16,461, 71 SEC Dock. 1951, 1951-52 (Mar. 2, 2000); Kenneth Terrell, Sec. Ex. Act Rel. No. 42,483, 71 SEC Dock. 1863, 1869 (Mar. 2, 2000). *See also* In the Matter of Bruce E. Straughn, Sec. Ex. Act Rel. No. 45939, 77 SEC Dock. 1726, 2002 SEC LEXIS 1304, at *8-9 (May 15, 2002) .

(n45)Footnote 45. 15 U.S.C.A. § 78u-2(e) (2004).

(n46)Footnote 46. *SEC v. Rosenfeld*, No. 97 Civ. 1467 WHPRLE, 2001 U.S. Dist. LEXIS 166, at *4 (S.D.N.Y. Jan. 9, 2001) .

(n47)Footnote 47. *SEC v. Seibald*, No. 95 Civ. 2081, 1997 U.S. Dist. LEXIS 14940, at *17-18, at *7 (S.D.N.Y. Sept. 29, 1997) (two entities holding proceeds from insider trading must disgorge profits); *SEC v. Egan*, 856 F. Supp. 401, 402 (N.D. Ill. 1993) (third parties to whom funds were improperly disbursed must disgorge profits following finding that defendants violated securities laws).

(n48)Footnote 48. *Id.*

(n49)Footnote 49. *SEC v. First Jersey Securities*, 101 F.3d. 1450, 1474-75 (2d Cir. 1996) ; *SEC v. Tanner*, No. 02 Civ. 0306, 2003 U.S. Dist. LEXIS 11410, at *1 (S.D.N.Y. July 3, 2003) . *See also* *U.S. Environmental* at *26; *SEC v. Martino*, 255 F. Supp.2d 268, 289 (S.D.N.Y. 2003) .

(n50)Footnote 50. *Rosenfeld*, 2001 U.S. Dist. LEXIS 166, at *5 (internal citations omitted); In the Matter of Daniel R. Lehl, et al., Sec. Act Rel. No. 8102, 77 SEC Dock. 1926, 2002 SEC LEXIS 1796, at *49 (May 17, 2002) . *See also* *SEC v. William A. Calvo*, 378 F.3d 1211, 1217 (11th Cir. July 27, 2004) .

(n51)Footnote 51. *SEC v. Risan*, No. 00-6244, 2001 U.S. App. LEXIS 5089, at *3 (2d Cir. Mar. 23, 2001) ; *First Jersey Securities*, 101 F.3d. at 1474 . Disgorged funds normally may not be distributed as payment for attorneys' fees or expenses incurred by litigants seeking distribution of disgorged funds. 15 U.S.C.A. § 78u(d)(4) (2004).

(n52)Footnote 52. *First Jersey Securities*, 101 F.3d. at 1476 .

(n53)Footnote 53. *Rosenfeld*, 2001 U.S. Dist. LEXIS 166, at *13-14 .

(n54)Footnote 54. Pub. L. No. 107-204, 116 Stat. 745 (2002).

(n55)Footnote 55. *See SEC v. Henke*, 275 F. Supp.2d 1075, 1086 (N.D. Cal. 2003) ; *SEC v. Peter C. Lybrand*, 281 F. Supp.2d 726, 733 (S.D.N.Y. 2003) .

(n56)Footnote 56. 15 U.S.C.A. § 78u(d)(3)(A).

(n57)Footnote 57. 15 U.S.C.A. § 78u(d)(3)(B)(i),(ii) and (iii).

(n58)Footnote 58. *Rosenfeld*, 2001 U.S. Dist. LEXIS 166, at *11 .

(n59)Footnote 59. H.R. REP. NO. 101-616, at 17 (1990).

(n60)Footnote 60. *SEC v. Poirer*, 140 F. Supp. 2d. 1033, 1048-49 (D. Ariz. 2001) . *See also SEC v. Robert D.*

Happ, 392 F.3d 12, 32 (1st Cir. 2004) (court imposes amount of loss avoided in insider trading case both as punishment and as general deterrent); *Lybrand*, 281 F. Supp.2d at 731 ; *Tanner*, 2003 U.S. Dist. LEXIS at *5-6 (setting forth the three tiers of civil penalties under the Securities Act and Exchange Act).

(n61)Footnote 61. 15 U.S.C.A. § 78u(d)(2). See also In the Matter of Mark S. Parnass, Sec. Ex. Act Rel. No. 50730 (Nov. 23, 2000) (reflects SEC's position that administrative bar orders remain in place indefinitely and are removed only in compelling circumstances).

(n62)Footnote 62. Charles O. Huttoe, Litig. Rel. No. 16,632, 72 SEC Dock. 2192, 2193-94 (July 20, 2000). Huttoe also was sentenced to a federal prison term of 46 months, followed by two years of supervised release and a \$10,000 fine, pursuant to a criminal information charging him with one count of securities fraud and one count of money laundering. *Id.* at 2193 .

(n63)Footnote 63. 15 U.S.C.A. § 78u(d)(1).

(n64)Footnote 64. 15 U.S.C.A. § 78ff(a) (2004).

(n65)Footnote 65. *Id.*

(n66)Footnote 66. *United States v. Dixon*, 536 F.2d 1388, 1395 (2d Cir. 1976) , citing, *United States v. Peltz*, 433 F.2d 48, 54-55 (2d Cir. 1970)) . See also *Criminal Law Aspects of the Securities Exchange Act of 1934*, 21 VA. L. REV. 139, 144-149 (1934).

(n67)Footnote 67. Compare *United States v. Charnay*, 537 F.2d 341, 348 (9th Cir. 1976) ("There is no reasonable basis for holding that some different interpretation (of Rule 10b-5) should apply to a criminal action than in a civil action.") (internal citations omitted) and *United States v. Chiarella*, 588 F.2d 1358, 1368 n.16 (2d Cir. 1978) with Margaret V. Sachs, *Harmonizing Civil and Criminal Enforcement of Federal Regulatory Statutes: The Case of the Securities Exchange Act of 1934*, 2001 U. ILL. L. REV. 1025, 1044-45 (2001).

(n68)Footnote 68. Lawrence J. Zweifach, *Current Developments and Issues in the Criminal Prosecution of Federal Securities Law Violations*, 1199 PLI/CORP. at 391. See also Joseph Conahan et al., *Securities Fraud*, 40 Am. Crim. L. Rev. 1041, 1098 (2003).

(n69)Footnote 69. Lawrence J. Zweifach, *Current Developments and Issues in the Criminal Prosecution of Federal Securities Law Violations*, 1269 PLI/CORP. at 599; Stanley S. Arkin and Mark S. Cohen, *The "Criminalization" of Securities Sales Practices: A New Trend*, 4 Bus. Crimes Bulletin: Compliance & Litig., No. 9, at 6 (Oct. 1997).

(n70)Footnote 70. 15 U.S.C.A. §§ 78o(b)(4) and (b)(6). For more detail, see 1 MATTHEW BENDER, FEDERAL SECURITIES EXCHANGE ACT OF 1934, Ch. 3 (2002).

(n71)Footnote 71. In the Matter of Blinder, Robinson & Co., Admin. Proc. File No. 3-6380, 1985 SEC LEXIS 2636 (Aug. 30, 1985) .

(n72)Footnote 72. See In the Matter of Richard E. Moyer, et al., Admin. Proc. File No. 3-6985, 1989 SEC LEXIS 5160 (Mar. 6, 1989) .

(n73)Footnote 73. In the Matter of Peter C. Lybrand, 80 S.E.C. Docket 2955, 2003 SEC LEXIS 2097, at *15-16 (Sept. 3, 2003) (matched trades); In the Matter of Edward J. Muller, Sec. Ex. Act Rel. No. 45646, 77 SEC Dock. 601, 2003 SEC LEXIS 2867, at *9-10 (Mar. 26, 2002) (dissemination of false information); In the Matter of Roger M. Detrano, 81 SEC Dock. 2416, 2003 SEC LEXIS 2867, at *12 (Dec. 4, 2003) (false press release).



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Federal Securities Exchange Act of 1934

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CHAPTER 6 Regulation of Market Manipulation

2-6 Federal Securities Exchange Act of 1934 § 6.05

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§ 6.05 SRO Regulation of Market Manipulation

[1] Manipulative Devices

As described in more detail in Chapter Two, self-regulatory organizations have assumed responsibility for the day-to-day monitoring and policing of securities transactions, subject to SEC oversight. The constitution, by-laws and rules of conduct, that are issued by the SROs, and approved by the SEC, regulate the activities of SRO members and are designed to ensure compliance with the federal securities laws. These provisions run the gamut of general standards of conduct, including rules bearing titles such as "Standard of Commercial Honor and Principles of Trade" n1 and "Business Conduct," n2 to general prohibitions against "Manipulative Operations" n3 or "Manipulation," n4 to rules addressing specific violative conduct, such as crossing orders n5 and excessive dealing by members. n6 Many of these rules bear upon manipulation of the securities markets. In disciplinary actions against members, SROs often reference relevant provisions of the securities laws as well as the applicable SRO rules, citing the more specific violations where appropriate. In this section, we highlight a few of the SROs' most salient anti-manipulation provisions.

[a] FINRA. The legislation authorizing the registration of FINRA as a national securities association requires that FINRA's rules be "designed to prevent fraudulent and manipulative acts and practices," among other requirements. n7 The two principle tools for disciplining members who have engaged in market manipulation are FINRA Rules 2010 and 2020.

FINRA Rule 2010, entitled "Standards of Commercial Honor and Principles of Trade," reads simply: "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." FINRA Rule 2010 and its predecessor--NASD Rule 2110--have often been cited when a member has manipulated the market price of a security through a mechanism that is not specifically addressed elsewhere in the rules. For example, when a broker at a member firm pre-sold the aftermarket in connection with sales of an initial public offering, he was charged with violating Section 10(b) of the Exchange Act and *Rule 10b-5*, and NASD Rules 2110 and 2120. n8

There are a number of specific prohibitions under FINRA Rule 2010. IM 2110-2 Trading Ahead of Customer Limit Ordersⁿ⁹ and IM 2110-3 Front Running Policyⁿ¹⁰ are anti-manipulation rules prohibiting members from using their informational or transactional advantages to trade ahead of the market, coordinate prices or otherwise impact the market price of a security.ⁿ¹¹

FINRA Rule 2020, entitled "Use of Manipulative, Deceptive or Other Fraudulent Devices," is another all-purpose anti-manipulation rule, which states that "[n]o member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance." The NASD described Rule 2020's predecessor--NASD Rule 2120--as the "equivalent of SEC Rule 10b-5."ⁿ¹²

Rule 2020 has been cited in many instances in which a market maker paints a false picture of market interest in a security. For example, when a broker entered fictitious limit orders and later cancelled them to avoid executing particular customer limit orders as required under IM 2110-2, an NASD hearing panel found the broker had engaged in a manipulative act in violation of both Rule 2010 and Rule 2020.ⁿ¹³ The panel reasoned that the broker had deceived customers expecting limit orders to be honored, and created a false picture of activity because the trades had been reported on the Nasdaq tape prior to cancellation.ⁿ¹⁴

Other disciplinary actions under Rule 2020 have sanctioned brokers for "marking the open" by upticking bids in the pre-opening market in order to minimize losses on impending short positions,ⁿ¹⁵ dominating and controlling the aftermarket in warrants,ⁿ¹⁶ violating Regulation M by unlawfully bidding for and purchasing securities in the secondary market during the restricted period during distribution,ⁿ¹⁷ and failing to disclose the broker's beneficial interest in the majority of a float while engaging in a massive effort to sell and charging excessive mark-ups.ⁿ¹⁸

Four other FINRA rules directly address price manipulation. NASD Rule 2780, "Solicitation of Purchases on an Exchange to Facilitate a Distribution of Securities," forbids any member who is participating in a distribution, or has any other financial interest in the distribution, from compensating or offering to compensate another for soliciting a transaction involving the offering security, other than for the account of the member involved in the compensation arrangement.ⁿ¹⁹ The rule is designed to prevent artificial stimulation of the market for that offering.

NASD Rule 3310, "Publication of Transactions and Quotations," prohibits any member from publishing or circulating any communication which purports to report any transaction as a purchase, sale, bid or ask price unless the member believes that bid, offer or transaction to be bona fide.ⁿ²⁰ When, for example, one broker sold a stock almost exclusively between the firm's inventory and its customers, maintaining a high bid price even as it was long on the stock with a growing inventory, the NASD found that the principals of the broker had violated Rules 2010, 2020 and 3310.ⁿ²¹

Reflecting the regulatory settlements with major investment banks regarding the potential conflicts of interest of research analysts and subsequent SEC rulemaking (*see* "Contemporary Contexts of Market Manipulation," *infra*), the NASD adopted Rule 2711, "Research Analysts and Research Reports," which places restrictions on the relationships and communications among investment banking departments, research departments and the subject companies, and imposes new disclosure requirements on research reports.ⁿ²² More specifically, among other provisions, communications with the public must now disclose any potential conflicts of interest in research reports and public appearances and research department personnel engaged in the preparation of research reports may not be subject to the supervision or control of anyone in the investment banking department.

FINRA Rule 4560, "Short-Interest Reporting," is an OTC counterpart to the SEC's Rule 201 of Regulation SHO, which addresses reporting of short sales of exchange-listed securities.ⁿ²³

[b] New York Stock Exchange. There are also several New York Stock Exchange ("NYSE") rules that forbid specific manipulative activities. Rule 76 prohibits cross orders,ⁿ²⁴ and Rule 77 prohibits offers to buy or sell "on stop"

above or below the market, to buy or sell securities at the close, to buy or sell dividends, to bet upon the course of the market or to buy or sell privileges to receive or deliver securities. n25 Rule 78 prohibits sell and buy orders coupled at the same price. n26

There are a number of other provisions often cited in NYSE disciplinary actions involving market manipulation. Rule 435 prohibits, among other activities, excessive trading by members for an account in which they have an interest, n27 successive transactions by members, n28 manipulative operations n29 and circulation of rumors n30--all commonly used to have an artificial impact on securities prices.

The NYSE has disciplined members under NYSE Rules 435(1) and (3) for marking the close, n31 and for making successive bids and purchases to drive up the price of a security in order to raise and stabilize the stock price and enable execution of a sale with the issuer, n32 and for failing to establish procedures to prevent employees from engaging in market manipulation. n33 The NYSE also has its own short sale rule, Rule 440B, which mirrors Regulation SHO.

Like the NASD, the NYSE also has issued more general rules that allow it to discipline members for acts that do not fit neatly into explicitly prohibited activities. For example, NYSE Rule 476(a) authorizes the NYSE to impose sanctions on members for, among other acts:

- (1) violating any provision of the Securities Exchange Act of 1934 or any rule or regulation thereunder;
- (2) violating any of his or its agreements with the Exchange;
- (3) violating any provision of the Constitution or any Rule adopted by the Board of Directors of the Exchange;
- (4) making a material misstatement to the Exchange;
- (5) fraud or fraudulent acts;
- ***
- (7) acts detrimental to the interest or welfare of the Exchange;
- (8) making a fictitious bid, offer or transaction or giving an order for the purchase or sale of a securities the execution of which would involve no change of beneficial ownership or executing such an order with knowledge of its character; and
- (9) making any purchases or sales or offers of purchase or sale of securities for the purpose of upsetting the equilibrium of the market or bringing about a condition in which prices will not fairly reflect market values, or assisting in making any such purchases or sales with knowledge of such purpose, or being, with such knowledge, a party to or assisting in carrying out any plan or scheme for the making of such purchases or sales or offers of purchase or sale n34

The NYSE has disciplined members under NYSE Rule 476 for making a series of fictitious transactions in order to artificially influence the price of the securities in the firm's favor, n35 trading for accounts in which the member had a financial interest, and using the accounts to trade ahead of customer orders. n36

The NYSE also amended Exchange Rule 472, "Communications with the Public," and Exchange Rule 251, "Reporting Requirements," to reflect the settlements and SEC rulemaking stemming from the issue relating to research analysts and potential conflicts of interest. The amendments substantially mirror the provisions of NASD Rule 2711, described above. In addition, in February 2004 the NYSE proposed, and in December 2004 the SEC approved, Exchange Rule

470, "IPO Allocations and Distributions," which, like NASD Rule 2712, governs the allocation and distribution of initial public offerings and attempts to address alleged abuses such as "laddering" and "tie-ins" additionally highlighted in the regulatory settlements with respect to research analysts and potential conflicts of interest. n37

[c] AMEX (NYSE Euronext). NYSE Euronext, who acquired the American Stock Exchange ("AMEX") in 2008, has a rule that is similar to NYSE's excessive dealing prohibition, n38 as well as a rule that bans attempts to influence the market through rumors. n39 This organization has often disciplined members under general provisions in its constitution requiring members to adhere to "just and equitable principles of trade." n40 For example, the AMEX disciplined a member for marking the close, n41 and for stopping or delaying execution of customer orders in order to increase or maintain the value of securities in its proprietary account. n42

[2] Options

Both Congress and the SEC have perceived options trading to be particularly prone to manipulation. n43 In its report on the securities markets prior to passage of the Exchange Act, the Committee on Banking and Currency listed options as the "indispensable concomitants of every pool operation designed to distribute stock at an increased price," as one basis for authorizing the SEC to regulate options trading. n44 In 1977, after a rapid growth in options trading volume, the SEC undertook a review of possible abuses in the trading and selling of options and in 1979 released a report following investigation of the standardized options markets. n45 The report indicated significant inadequacies in the SRO regulation of options, resulting in a series of SRO rule revisions. n46

Today, SROs that permit options trading have extensive surveillance mechanisms to detect fraudulent and manipulative activities. They also have implemented detailed rules with respect to disclosure and permissible transactions involving options. Position limits (*i.e.*, limits on the number of options contracts that are based on a particular security), and exercise limits (*i.e.*, limits on the number of puts or calls exercised with respect to a particular security), are two mechanisms designed to limit the potential profitability and market impact of options manipulation.

FINRA Rule 2360 n47 addresses options trading. Most disciplinary actions citing this rule, or its NASD predecessors, involve unauthorized trading and suitability issues.

The NYSE also has detailed rules regulating options trading. n48 As with FINRA Rule 2360 and its NASD predecessors, NYSE disciplinary decisions citing violations of the options rules primarily involve unauthorized trading and suitability.

FOOTNOTES:

(n1)Footnote 1. NASD Rule 2110.

(n2)Footnote 2. AMEX Rule 16.

(n3)Footnote 3. NYSE Rule 435(4).

(n4)Footnote 4. AMEX Rule 4.

(n5)Footnote 5. NYSE Rule 76.

(n6)Footnote 6. AMEX Rule 3.

(n7)Footnote 7. *15 U.S.C. 78o-3(b)(6)*.

(n8)Footnote 8. "Such [tie-in] arrangements artificially stimulate demand in the aftermarket, the net effect of which is to create the impression of greater aftermarket activity than actually exists Thus, the non-disclosure of this information operated as a fraud upon the market, and the tie-in arrangement amounted to a device or scheme that

perpetuated a fraud upon aftermarket purchasers." *Perles*, 2000 NASD Discip. LEXIS 24, at *36.

(n9)Footnote 9. IM 2110-2 requires member firms acting as market makers to handle their customer limit orders with all due care in order to avoid trading ahead of those limit orders. Market makers handling customer limit orders, whether received from their own customers or from another member, are prohibited from trading at prices equal or superior to that of the limit order without also executing their customer's limit order. NASD IM 2110-2.

(n10)Footnote 10. IM 2110-3 forbids a member or person associated with a member, for an account in which such person has an interest or exercises investment discretion, or for certain customer accounts, to execute an order to buy or sell an option or an underlying security when such person has material, non-public information concerning an imminent block transaction regarding either the underlying security (in the case of the option) or the option overlying that security (in the case of the security), prior to the time information concerning the block transaction has been made publicly available. NASD IM 2110-3.

(n11)Footnote 11. The NASD also brought many actions to enforce former IM-2110-1, which was replaced by NASD Rule 2790 in 2003 (see below), and was designed to prevent members involved in the distribution of hot issues from selling the offering securities other than at the public offering price, and to prevent any sales in which a member or person associated with a member had a beneficial interest. Thus, the NASD disciplined an individual for purchasing shares of a hot issue for an account in which he had an interest while he was registered with a member firm. John M.W. Crute, Jr., Complaint No. C05950018, 1997 NASD Discip. LEXIS 51, at *2-4 (N.A.S.D.R. Aug. 28, 1997). Additionally, IM-2110-1(f) requires any member firm selling hot issues to an investment partnership or corporation to obtain documentation that shows whether any restricted persons have a beneficial interest in the investment partnership or corporation that is purchasing the hot issue. The firm must maintain this documentation for at least three years following the sales. *See, e.g.*, L.H. Alton & Co., Complaint Nos. C01960003, C10960024, 1997 NASD Discip. LEXIS 60, at *15-16 (N.A.S.D.R. Dec. 17, 1997); Equity Sec. Trading Co., Complaint No. C04940053, 1996 NASD Discip. LEXIS 42, at *8-12 (N.A.S.D.R. Oct. 23, 1996).

On October 24, 2003, the SEC approved NASD Rule 2790, "Restrictions on the Purchase and Sale of Initial Equity Public Offerings," to replace IM-2001-1. The rule generally prohibits a member from selling shares in a distribution to restricted persons, *i.e.*, most associated persons of a member, most owners and affiliates of a broker-dealer and certain other classes of persons, such as individuals in a position to provide the member with future business, unless the member meets certain "preconditions for sale." *See also* "Initial Public Offerings (IPO's)," Notice to Members 03-79 (Dec. 2003). Previously, in August 2002, the NASD had proposed NASD Rule 2712, "IPO Allocations and Distributions," which addressed such IPO abuses as "tie-ins," "spinning" and "flipping." "Regulation of IPO Allocations and Distributions," Notice to Members 02-55 (Aug. 2002); *see also* 69 *Fed. Reg.* 77,804 (Dec. 28, 2004). As of the date of this writing, the SEC had not approved the rule.

(n12)Footnote 12. *Perles*, 2000 NASD LEXIS 24, at *30.

(n13)Footnote 13. Michael B. Jawitz, Complaint No. CMS960238, 1999 NASD Discip. LEXIS 24, at *1 (N.A.S.D.R. July 9, 1999), *findings and sanctions sustained* by Sec. Ex. Act Rel. No. 44,357, 75 SEC Dock. 205 (May 29, 2001). To comply with IM-2110-2, the broker-dealer had devised an internal order routing and execution system that automatically executed any existing customer limit order (other than an odd lot) if the firm executed a trade for its proprietary account at a price that would satisfy the limit order. By entering fictitious limit orders at higher prices than the customer limit orders, Jawitz avoided having to execute those limit orders, which negatively would have impacted his positions. *Id.*

(n14)Footnote 14. *Jawitz*, 1999 NASD Discip. LEXIS 24, at *19-23.

(n15)Footnote 15. Morgan Stanley & Co., Complaint No. CMS960235, 2000 NASD Discip. LEXIS 1, at *52-55 (N.A.S.D.R. Jan. 18, 2000).

(n16)Footnote 16. A.S. Goldmen & Co., Complaint No. C10960208, 1999 NASD Discip. LEXIS 18, at *2-3 (N.A.S.D.R. May 14, 1999), *sustained*, Sec. Ex. Act Rel. No. 44,328, 75 SEC Dock. 62 (May 21, 2001).

(n17)Footnote 17. Dep't of Enforcement v. D.L. Cromwell Investments, Disc. Proc. No. CAF 020007, 2003 NASD Discip. LEXIS 53 (N.A.S.D.R. Nov. 19, 2003).

(n18)Footnote 18. John Roger Faherty, Complaint No. CMS920005, 1998 NASD Discip. LEXIS 44, at *10-12 (N.A.S.D.R. Oct. 14, 1998). *See also Perles*, 2000 NASD Discip. LEXIS 24, at *28-36 (pre-selling the aftermarket of an initial public offering through tie-in arrangement); *Jawitz*, 1999 NASD Discip. LEXIS 24, at *5-8 (fictitious trade orders).

(n19)Footnote 19. NASD Rule 2780 forbids any member who is participating or otherwise has a financial interest in any distribution, from compensating or offering to compensate any person for soliciting another to purchase any security of the same issuer on a national securities exchange, or for purchasing any security of the same issuer on any such exchange for any account other than the account of the member who has paid or is to pay such compensation; or for selling, offering to sell, inducing an offer to buy such security, or delivering such security after sale, if, in connection with such distribution, such member has compensated or offered to compensate any person for soliciting another to purchase any security of the same issuer on any national securities exchange, or for purchasing any security of the same issuer for any account other than the account of the member who has paid or is to pay such compensation. NASD Rule 2780.

(n20)Footnote 20. IM-3310, Manipulative and Deceptive Quotations, explains that Rule 3310 derives from Rules 2010 and 2020.

(n21)Footnote 21. Michael J. Markowski, Complaint No. CMS920091, 1998 NASD Discip. LEXIS 35, at *46-47 (N.A.S.D.R. July 13, 1998).

(n22)Footnote 22. Rule 2711 went into effect starting July 2002 with certain provisions effective during subsequent dates. While the rule has been periodically amended, its substance remains the same.

(n23)Footnote 23. FINRA Rule 4650 is the modern successor to NASD Rule 3350, which "prohibit[ed] short sales by NASD members in NMS securities at or below the current best (inside) bid as shown on the Nasdaq screen when that bid is lower than the previous best (inside) bid (this is referred to as the 'bid test.')

It contain[ed] certain exemptions, including an exemption for qualified Nasdaq market makers, options market makers, and warrant market makers. Rule 3350 also include[d] exceptions similar to those provided under Rule 10a-1. The NASD also require[d] members to report regularly to the NASD their total short positions in all customer and proprietary firm accounts." Short Sales, Sec. Ex. Act Rel. No. 42,037, 70 SEC Dock. 2090, 2093 (Oct. 20, 1999). NASD Rule 3350 employed a bid test rather than a tick test because Nasdaq trades are not necessarily reported to the tape in chronological order. Self Regulatory Organizations, Sec. Ex. Act Rel. No. 44,497, 75 SEC Dock. 761, 762 (June 29, 2001). IM-3350 further defined and applied many of the short sale provisions, including explanation of exemptions for certain market making activity. In order to qualify for an exemption, one was required to be a "qualified" Nasdaq market maker and must engage in "bona fide" market making activity. NASD Rule 3350.

(n24)Footnote 24. "Crossing Orders" Rule 76: "When a member has an order to buy and an order to sell the same security, he or she shall offer such security at a price which is higher than his or her bid by the minimum variation permitted in such security before making a transaction with himself or herself. All such bids and offers shall be clearly announced to the trading Crowd before the member may proceed with the proposed 'cross' transaction." NYSE Rule 76.

(n25)Footnote 25. "Prohibited Dealings and Activities" Rule 77: "No member shall offer publicly on the Floor: (1) to buy or sell securities 'on stop' above or below the market; (2) to buy or sell securities 'at the close'; (3) to buy or sell dividends; (4) to bet upon the course of the market; or (5) to buy or sell privileges to receive or deliver securities." NYSE Rule 77.

(n26)Footnote 26. "Sell and Buy Orders Coupled at Same Price" Rule 78: "An offer to sell coupled with an offer to buy back at the same or at an advanced price, or the reverse, is a prearranged trade and is prohibited. This rule applies both to transactions in the unit of trading and in lesser and greater amounts." NYSE Rule 78. *See, e.g.,* Joseph M. Peters, Ex. Panel Decision 80-44-45, 1980 NYSE Disc. Action LEXIS 40 (N.Y.S.E. July 25, 1980).

(n27)Footnote 27. NYSE Rule 435(1) Excessive trading by members--prohibiting excessive trading by members for an account in which the member has a financial interest, in view of the financial resources of the member or the market for such security. NYSE Rule 435(1).

(n28)Footnote 28. NYSE Rule 435(3) Successive transactions by members--prohibiting purchases at successively higher prices or sales at successively lower prices for the purpose of creating a false appearance of activity in the stock, or unduly or improperly influencing the price of the security. NYSE Rule 435(3).

(n29)Footnote 29. NYSE Rule 435(4) Manipulative operations--prohibiting directly or indirectly participating in or having any interest in the profits of a manipulative operation or knowingly managing or financing a manipulative operation. NYSE Rule 435(4).

(n30)Footnote 30. NYSE Rule 435(5) Circulation of rumors--prohibiting the circulation of "rumors of a sensational character which might reasonably be expected to affect market conditions on the Exchange." NYSE Rule 435(5).

(n31)Footnote 31. Bateman Eichler, Hill Richards, Inc., Ex. Hearing Panel Decision 78-12 to 15, 1978 NYSE Disc. Action LEXIS 74 (N.Y.S.E. Feb. 23, 1978); Peter Marting Toczek, Ex. Hearing Panel Decision 90-146, 1991 NYSE Disc. Action LEXIS 93, at *5-6 (N.Y.S.E. Jan. 25, 1991).

(n32)Footnote 32. Albert Fried, Jr., Hearing Panel Decision 78-28 & 78-83, 1978 NYSE Disc. Action LEXIS 19, at *8-12 (N.Y.S.E. Nov. 1, 1978).

(n33)Footnote 33. Spear, Leeds & Kellogg, L.P., NYSE Disc. Action 2003-108, 2003 NYSE Disc. Action LEXIS 117 (June 9, 2003).

(n34)Footnote 34. NYSE Rule 476(a)(1)-(9).

(n35)Footnote 35. Stuart Scotto Cella Co., Ex. Hearing Panel Decision 93-21, 1993 NYSE Disc. Action LEXIS 98, at *3 (N.Y.S.E. Feb. 26, 1993).

(n36)Footnote 36. Steven J. Blandi, Ex. Hearing Panel Decision 98-147, 1998 NYSE Disc. Action LEXIS 149, at *2-4 (N.Y.S.E. Dec. 29, 1998).

(n37)Footnote 37. Rule 470 contains sections limiting or prohibiting "Quid Pro Quo Allocations," "Spinning," and "Flipping," among other potentially abusive practices. *See* 69 Fed. Reg. 77,804 (Dec. 28, 2004) .

(n38)Footnote 38. AMEX Rule 3(a)--Excessive Dealing: "No member or member organization shall effect on the Exchange purchases or sales for any account in which he or it is directly or indirectly interested, which purchases or sales are excessive in view of his or its financial resources or in view of the market for such security." AMEX Rule 3(a).

(n39)Footnote 39. AMEX Rule 3(c)--Rumors: "No member or member organization shall circulate, in any manner, rumors of a sensational character which might affect market conditions on the Exchange. A report shall be promptly made to the Exchange of any such rumors. This rule does not prohibit discussion of unsubstantiated information widely published or broadcast by public media, provided its source and unverified nature are disclosed." AMEX Rule (3)(c).

(n40)Footnote 40. *See* Restated Certificate of Incorporation of NYSE Regulation, Inc., Art. II(a) (Apr. 3, 2007); *see also* Constitution of the American Stock Exchange, Art. V, §§ 4(c) and (h), respectively (now defunct).

(n41)Footnote 41. In the Matter of Vincent Morano, Disciplinary Panel Decision 91-D-04 (AMEX Jan. 16, 1992).

(n42)Footnote 42. Specialist Unit of BPN & Co., Disciplinary Panel Decision 98-D-02 (AMEX May 17, 1993).

(n43)Footnote 43. S. REP. NO. 73-792, at 9 (1934); H.R. Rep. No. 73-1383, at 10-11 (1934); Termination of the Options Moratorium, Sec. Ex. Act Rel. No. 16,701, 19 SEC Dock. 998, 999 (Mar. 26, 1980). See § 6.03[5][d] (above).

(n44)Footnote 44. S. REP. NO. 73-792, at 9 ("[T]he subject of options has been left with the Commission for regulation. Many of the most flagrant abuses upon stock exchanges would not be possible without the aid of options. They are indispensable concomitants of every pool operation designed to distribute stock at an increased price. Enormous profits have been made by operators who traded against options without incurring the slightest risk or obligation."). The SEC is authorized to regulate options trading through § 9(b) of the Exchange Act. In 1982, the SEC issued Rule 9b-1, requiring an Options Disclosure Document to accompany options transactions. There currently are no SEC rules directly addressing market manipulation of options. See § 6.03[5][d] (above).

(n45)Footnote 45. Termination of the Options Moratorium, 19 SEC Dock. at 1000.

(n46)Footnote 46. *Id.*

(n47)Footnote 47. FINRA Rule 2360 (formerly NASD Rule 2860) regulates such topics as: (3) position limits; (4) exercise limits; (5) reporting of options positions; (6) liquidation of positions and restrictions on access; (7) limits on uncovered short positions; (8) restrictions on options transactions and exercises; (9) rights and obligations of holders and writers; (10) open order on "ex-date"; (11) delivery of current disclosure documents; (12) confirmations; (13) transactions with issuers, (14) restricted stock; (15) statements of account; (16) opening of accounts; (17) maintenance of records; (18) discretionary accounts; (19) suitability; (20) supervision of accounts; (21) violation of by-laws and rules of the Association or the Options Clearing Corporation; (22) stock transfer tax; (23) tendering procedures for exercises of options; (24) options transactions and reports by market makers in listed securities.

(n48)Footnote 48. See NYSE Rules 700-795.



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Federal Securities Exchange Act of 1934

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CHAPTER 6 Regulation of Market Manipulation

2-6 Federal Securities Exchange Act of 1934 § 6.06

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§ 6.06 Contemporary Contexts of Market Manipulation

[1] The Financial Crisis of 2008-2009

In 2008, market manipulation became the focus of unprecedented attention from the media, regulators and legislators. The equity markets experienced rapid and dramatic fluctuations in value. In particular, the price of publicly traded financial company stocks decreased dramatically, and the largest U.S. investment banks ceased doing business, were acquired by bank holding companies, or became bank holding companies themselves. Amidst these market gyrations, some issuers indicated that they believed their stocks were being unfairly attacked by rumor-mongers and short sellers.
n1

In response to the market turmoil, regulators launched a series of investigations and adopted a series of emergency, temporary and permanent rules attempting to address market manipulation. Many of the actions taken by regulators focused on perceived market manipulation by short sellers.

[a] Government Investigations Into Short Selling. After the sale of Bear, Stearns & Co. Inc. ("Bear Stearns") to JPMorgan Chase & Co., the SEC initiated a series of high-profile investigations into market manipulation involving the spreading of false rumors coupled with short selling. n2 During the spring and summer of 2008, rumors circulated regarding Lehman Brothers Holdings Inc. ("Lehman Brothers"), including a forced bankruptcy and sale to Barclays plc. n3 Coupled with these rumors were short bets against the company, which paid off as the stock plummeted, even though the rumors turned out to be wrong.

In July 2008, the SEC issued a series of subpoenas to Wall Street firms regarding potential manipulation of shares in Bear Stearns and Lehman Brothers. n4 State attorneys general and state securities regulators, as well as foreign securities regulators, also announced investigations into short selling and market manipulation. n5

At the same time, the SEC announced that it would investigate short selling by conducting "sweep" examinations of

broker-dealers and investment advisers, with the help of the securities industry's SROs, such as the FINRA and the New York Stock Exchange Regulation, Inc. n6 The SEC later announced that it had approved a formal order of investigation under which hedge fund managers, institutional investors and broker-dealers with significant trading activity in the swaps or securities of financial services companies would be required to disclose their positions under oath and would receive subpoenas requiring the production of additional documents. n7 The New York State Attorney General announced that his office had commenced a "wide-ranging investigation into short selling in the financial market," indicating that the investigation began as the result of complaints alleging false rumors being spread by short sellers. n8

The SEC also filed its "first-ever case against a trader for spreading knowingly false information designed to drive down the price of stock." n9 In *SEC v. Berliner*, the SEC alleged that the respondent trader had sent an untrue rumor by instant message to thirty-one market participants and then benefited by shorting the shares of the company at issue. n10 The SEC alleged that a Wall Street trader started a false rumor related to The Blackstone Group's acquisition of Alliance Data Systems Corp. ("ADS"). n11 In May 2007, Blackstone agreed to acquire ADS for \$81.75 per share. n12 Then, on November 29, 2007, Paul Berliner sent an instant message to thirty-one traders and securities professionals stating that ADS's board of directors was meeting to consider a revised proposal from Blackstone to acquire ADS for \$70 per share. n13 The rumor spread through Wall Street, and the news media picked up the false story shortly afterwards. n14 The rumor caused ADS's stock to plummet: within thirty minutes after Berliner's first instant message, it dropped 17 percent, from \$77 per share to \$63.65, and the NYSE temporarily halted trading in ADS stock. n15 ADS issued a press release denying the rumor, and by the end of the day the stock recovered to \$77. n16 Over 33,000,000 shares of ADS were traded on November 29--more than twenty times the previous day's volume. n17 The SEC ultimately obtained a settlement from Mr. Berliner consisting of a \$130,000 fine, \$261,229 disgorgement, a permanent injunction and a bar from association with any broker or dealer. n18

[b] Rule-Making Regarding Short Selling. In addition to its investigations and enforcement activity, the SEC took an aggressive approach to adopting rules regarding short selling.

By the third quarter of 2008, the SEC had become sufficiently concerned about market volatility--particularly with respect to financial company stocks, and particularly in connection with naked short selling n19--to engage in emergency rule-making. n20 On July 15, 2008, the SEC issued an order heightening the requirement that a trader, prior to entering into a short sale with respect to a particular security, have reason to know that it had shares of the relevant stock available for delivery. n21 Moreover, for the securities of nineteen specified financial companies, the SEC required a trader to borrow the company's shares before shorting them, and deliver the securities on the settlement date. n22 This rule, which was in place between July 21 and August 12, 2008, applied to all market participants, including those otherwise exempted from the "borrow or locate" requirement under the market-maker exception to Regulation SHO.

Although this emergency rule expired on August 12, 2008, the SEC soon resuscitated the rule and significantly expanded it. Effective September 18, 2008, the SEC issued an emergency order making three temporary changes to short sale rules. n23 First, the SEC adopted temporary Rule 204T, which implemented a "hard T+3 close out requirement," mandating that broker-dealers deliver securities that are the subject of a long or short sale by the close of business on the settlement date, three days after the transaction date. n24 Second, the SEC adopted anti-fraud Rule 10b-21, which imposes liability on anyone found to have engaged in deceptive conduct in connection with abusive short selling. n25 Third, the SEC approved a final rule, originally proposed in August 2007, eliminating the options market-maker exception to Regulation SHO. n26 On October 14, 2008, the SEC extended Rule 204T until July 31, 2009, n27 adopted, as a final rule, antifraud Rule 10b-21, n28 and adopted, as final amendments to Regulation SHO, the elimination of the options market maker exemption to the close out requirements. n29 On July 27, 2009, the SEC permanently adopted Rule 204T. n30

On September 19, 2008, the SEC imposed an immediately-effective ban on short sales of publicly traded securities of 799 specified financial firms. n31 The definition of "short sales" included any sale where the seller is net short or flat;

therefore, with respect to boxed positions, a sale of the long side constituted a short sale. n32 The ban lasted twenty days, expiring on October 8, 2008. During that time, it was expanded to include almost 1,000 issuers. n33

Also on September 19, 2008, the SEC issued a companion rule applying to institutional investment managers who manage accounts with an aggregate value of \$100 million per year (i.e. those who are required to file quarterly 13F reports of their holdings). Beginning September 29, 2008, such managers were required to file new Form SH reports on the first business day of a week following a week in which it engaged in short selling. n34 The order contained a de minimis exclusion for short positions less than 0.25% of the class of securities issued and outstanding *and* if the fair market value of the securities was less than \$1,000,000. This short position disclosure rule originally required public disclosure of such positions. But the subsequent rulemaking on the issue changed course and indicated that managers could seek to keep the Form SH filings non-public and that the SEC staff believed that Form SH filings would be protected from disclosure under the Freedom of Information Act. n35 On October 15, 2008, the SEC issued a new rule requiring disclosure of short sales and positions on Form SH until August 1, 2009. n36 Similar bans and disclosure rules were imposed by the Financial Services Authority in the United Kingdom, and by regulators in more than a dozen different countries around the world. n37

On April 10, 2009, after abolishing the almost 70-year-old uptick rule in 2007, the SEC proposed reinstating some form of short sale price restrictions. The SEC commented that "[d]ue to the extreme market conditions that we are currently facing and the resulting deterioration in investor confidence," it is "appropriate at this time to re-evaluate and seek comment on some form of short sale price test restriction." n38 The proposed amendments to Regulation SHO included two possible approaches: (1) a "short sale price test" either based on the national best bid (an uptick rule) or the last sale price (a modified uptick rule), that would apply on a market-wide, permanent basis; or (2) a "circuit breaker" approach that would apply only on a security-specific, temporary basis during severe market declines in that security. n39 With respect to the circuit breaker approach, the SEC proposed two basic alternatives: (1) a "halt" that would temporarily prohibit short selling in a particular security during a steep decline in price, which could operate in place of, or in addition to, a short sale price test rule; or (2) a circuit breaker rule that would trigger a short sale price test rule. n40

The SEC held a roundtable discussion regarding the proposed uptick rule on May 5, 2009. n41 On August 17, 2009, the SEC re-opened the comment period until September 21, 2009, specifically requesting additional feedback regarding an alternative price test that would allow short selling only at a price above the current national best bid. n42

SEC Chairman Mary Shapiro remarked that although the SEC was "not aware of specific empirical evidence that the 2007 elimination of short sale price tests contributed to [the recent] volatility in the U.S. markets, many members of the public have come to associate short selling with that volatility, and with a loss of investor confidence." n43 For example, Morgan Stanley CEO John Mack and former Lehman Brothers CEO Richard Fuld both accused short sellers of attacking their firms. n44 Traders and asset managers, however, say short sellers are being unfairly targeted for the drop in stock prices that occurred as the housing market bubble burst and exposed risky bets by financial institutions. n45

In April 2009, the SEC sought public comment on whether a short sale price test requirement should be re-instituted. n46 The SEC "decided to re-evaluate the issue due to extreme market conditions and the resulting deterioration in investor confidence." n47 On February 24, 2010 the SEC announced a new Rule 201 alternative uptick rule, effective as of May 10, 2010. n48 The alternative uptick rule set forth in Rule 201(b) of Regulation SHO combines a price test and a circuit breaker, "such that when triggered, short selling will be permitted only at a price above the current national best bid." n49 Under Rule 201(b)(1)(i), circuit breakers are triggered when "the price of [a] covered security decreases by 10% or more from the covered security's closing price as determined by the listing market for the covered security as of the end of regular trading hours on the prior day." And under Rule 201(b)(1)(ii) these restrictions are imposed "for the remainder of the day and the following [trading] day."

The SEC adopted, new Rule 201(b) "because, when triggered, it will prevent short selling, including potentially

manipulative or abusive short selling, from driving down further the price of a security that has already experienced a significant intra-day price decline, and will facilitate the ability of long sellers to sell first upon such a decline." n50 The rule seeks to strike a balance between the SEC's goal of preventing abusive short selling and the need to maintain liquid and price-efficient markets. n51 In adopting new Rule 201(b), the SEC acknowledged the benefits to the market of legitimate short selling, as the short sale price test restrictions of Rule 201 will apply only to securities experiencing significant downward price pressure, rather than to all securities all the time. n52

There are, however, several exemptions that will permit trading centers to display or execute short sales at or below the national best bid under certain circumstances even when a circuit breaker is in effect. n53

[c] Regulatory Actions Involving PIPE Transactions. Generally, a private investment in public equity ("PIPE") deal involves the sale of publicly traded securities to private investors in either a registered or unregistered transaction. During and after the credit crisis of 2008-2009, PIPE transactions increased as they provided quick access to capital markets at reasonable costs. Currently, 49% of PIPE investors expect this increase to continue over the next twelve to eighteen months and another 43% project the investment pace will stay at current levels. n54

The SEC has taken a hard stance with respect to investors with knowledge of an upcoming PIPE transaction who short the stock in anticipation of the price drop that likely will occur when stockholders realize their shares have been diluted. For example, in 2005, the SEC filed an enforcement action against Guillaume Pollet for violating antifraud laws by selling short the publicly traded securities of PIPE issuers prior to the close of the PIPE transaction. n55 In certain instances, his short-selling was contrary to specific representations that no short selling or trading in the issuer's securities had taken place. Pollet made at least \$5.75 million in profits. A final settlement was entered permanently enjoining Pollet from violating securities laws and ordering him to pay a civil penalty of \$150,000. n56 The SEC also instituted and settled administrative proceedings against Pollet barring him from association with any broker or dealer. Additionally, Pollet pled guilty to one count of securities fraud brought against him by the U.S. Attorney's Office for the Eastern District of New York. n57 He was sentenced to two months imprisonment, three months of home confinement and three years of supervised release.

More recently, the SEC filed a lawsuit against Brian D. Ladin, a former analyst for Bonanza Capital, Ltd., for violations of Section 10(b), *Rule 10b-5* and Section 17(a). n58 Ladin, after being informed about a PIPE offering, established a short position for Bonanza in the stock of the company making the offering. Ladin then signed a stock purchase agreement in which he represented that Bonanza did not hold a short position. When the PIPE was publicly announced, the stock price declined. The SEC seeks a judgment enjoining Ladin from violating securities laws, ordering him and Bonanza to disgorge ill-gotten gains and ordering Ladin to pay a civil monetary penalty. n59

[2] Alternative Trading Systems and Dark Pools

An Alternative Trading System ("ATS") is generally any organization or system that provides a market place for bringing together purchasers and sellers of securities or otherwise performs the functions of a stock exchange, but does not set rules governing subscribers' conduct, other than trading conduct, and does not discipline subscribers other than by excluding them from trading on the system. n60 Electronic Communication Networks ("ECNs") and other types of ATSs accounted for almost 50% of Nasdaq's value over the past several years.

In December 1998, the SEC adopted Regulation ATS, noting that ATSs have remained largely outside the national market system, yet impact the public securities markets. n61 The SEC further observed the potential for manipulation due to lack of surveillance and regulation of those markets. n62

Under Regulation ATS, alternative trading systems can choose whether to register as national securities exchanges, or to register as broker-dealers and comply with additional requirements under Regulation ATS, depending on their activities and trading volume. The regulation broadens the definition of "exchange" under the Exchange Act to include

any "organization, association, or group of persons [that]: (1) [b]rings together the orders for securities of multiple buyers and sellers; and (2) [u]ses established, non-discretionary methods ... under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade." n63 The rule specifically excludes those systems the SEC believes perform only traditional broker-dealer activities. n64

Regulation ATS requires those alternative trading systems not choosing to register as an exchange to register as a broker-dealer. Depending on the trading volume in any single security, the broker-dealer may also be required to maintain public displays and execution of orders, provide access and charge fees to investors in a non-discriminatory manner and establish procedures to ensure adequate systems capacity, integrity and contingency planning. n65

The SEC also has pursued corporate insiders and investors who have tried to manipulate market price through use of ECNs. The SEC reached a settlement with three officers who drove up the price of their company's stock by dominating the market and maintaining the high bid through use of an ECN, thereby disguising the source of demand. n66 Other enforcement actions have focused on the practice of "spoofing," whereby individual investors place limit orders through ECNs, which impact the National Best Bid or Offer ("NBBO"), then place limit orders on the opposite side of the market through brokers, enabling them to effect more favorable trades. They then cancel or attempt to cancel their initial order. n67

An area of recent attention by the SEC in connection with alternative trading are "dark pools" of liquidity, which are electronic-trading venues that do not display quotations to the public and allow investors, typically large institutions, to trade shares anonymously. n68 Essentially, investors are able to signal an interest in buying or selling a security, but this "indication of interest" or "IOI" is only communicated to a subset of market participants.

Dark pools serve two purposes: (1) enabling high volume trading without affecting the price in the public market; and (2) avoiding information leaks, which prevent investors from getting the best execution of their trades. n69 The concerns are that these trades should be affecting the publicly traded price and that the private nature of dark pools undermines transparency in the marketplace, particularly for individual investors. These concerns are likely to increase as the popularity of dark pools grows. In 2002, there were only about ten dark pools in existence; in contrast, by 2009, there were approximately twenty-nine dark pools operating. n70

Given the growth of dark pools, the SEC has become concerned that their lack of transparency could create a "two-tiered" market that deprives the public of information about stock prices and liquidity because they are "'lit' to a select group of market participants and dark with respect to the rest of the public." n71 Therefore, on October 21, 2009, the SEC voted unanimously to propose three measures: (1) requiring that IOIs be treated like other quotes and subject to the same disclosure rules; (2) lowering the trading volume threshold applicable to ATSs for displaying best-priced orders; and (3) creating the same level of post-trade transparency for dark pools (and other ATSs) that currently exist for registered exchanges, specifically, requiring real-time disclosure of the identity of the dark pool that executed the trade. n72 Public comments are being sought and must be received within 90 days after the proposals' publication in the Federal Register. The SEC Chairman commented that "[t]ransparency is the cornerstone of the U.S. securities market We should never underestimate or take for granted the wide spectrum of benefits that come from transparency Although dark liquidity always has existed in one form or another in the equity market, the Commission must assure that the public markets and non-public trading venues operate within a balanced regulatory framework." n73

FOOTNOTES:

(n1)Footnote 1. *See Self-Regulators Warn Against Spreading False Rumors and Other Abusive Activity*, Press Release, Financial Industry Regulatory Authority (Mar. 31, 2008), available at <http://www.finra.org/Newsroom/NewsReleases/2008/P038211>.

(n2)Footnote 2. *See* 73 Fed. Reg. at 42,379.

(n3)Footnote 3. See Andrew Ross Sorkin, *Psst! Hearing the Rumor of the Day?*, N.Y. TIMES, Jul. 8, 2008.

(n4)Footnote 4. David Scheer, *SEC Subpoenas Wall Street in Hunt for 'Manipulators'*. BLOOMBERG NEWS, Jul. 16, 2008.

(n5)Footnote 5. See Aaron Lucchetti, Amir Efrati, & Kara Scannell, *Cuomo Plans Short-Selling Probe*, WALL ST. J., Sept 18, 2008; Russell Hubbard, *Alabama securities cops probe short sales in Colonial BancGroup*, THE BIRMINGHAM NEWS, July 24, 2008; Tomoko Yamazaki, *Japan Financial Regulator to Ban Naked Short-Selling*, BLOOMBERG NEWS, Oct. 27, 2008; Dearbail Jordan, *FSA launches inquiry into HBOS shares plunge*, THE TIMES OF LONDON, Mar. 19, 2008.

(n6)Footnote 6. See *Securities Regulators to Examine Industry Controls Against Manipulation of Securities Prices Through Intentionally Spreading False Information*, SEC Press Release 2008-140 (July 13, 2008).

(n7)Footnote 7. See *SEC Expands Sweeping Investigation of Market Manipulation*, SEC Press Release 2008-214 (Sept. 19, 2008).

(n8)Footnote 8. Aaron Lucchetti, Amir Efrati, & Kara Scannell, *Cuomo Plans Short-Selling Probe*, Sept. 18, 2008.

(n9)Footnote 9. Testimony Concerning the Role of Federal Regulators: Lessons from the Credit Crisis for the Future of Regulation: Hearing Before the H. Comm. on Oversight and Gov't Reform, 110th Cong. (2008) (statement of SEC Chairman Christopher Cox).

(n10)Footnote 10. Complaint at 13, 14, 19, SEC v. Paul S. Berliner (S.D.N.Y. 2008) (No. 08 Civ. 3859).

(n11)Footnote 11. *Id.* at 13.

(n12)Footnote 12. *Id.* at 12.

(n13)Footnote 13. *Id.* at 13.

(n14)Footnote 14. *Id.* at 14.

(n15)Footnote 15. *Id.* at 16, 17.

(n16)Footnote 16. *Id.* at 17, 18.

(n17)Footnote 17. *Id.* at 18.

(n18)Footnote 18. See SEC Litig. Rel. No. 20,537 (Apr. 24, 2008), available at <http://www.sec.gov/litigation/litreleases/2008/lr20646.htm>.

(n19)Footnote 19. "Naked" short selling occurs when the short seller does not deliver the "located" stock at settlement. The Commission expressed concerns that "naked" shorting occurred because multiple investors were sourcing the same inventory of stock for the purpose of meeting the existing "locate" requirements.

(n20)Footnote 20. See *SEC Enhances Investor Protections Against Naked Short Selling*, SEC Press Release 2008-143 (July 15, 2008).

(n21)Footnote 21. See 73 Fed. Reg. at 42,379.

(n22)Footnote 22. See *id.*

(n23)Footnote 23. See Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934

Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 34-58572 (Sept. 17, 2008).

(n24)Footnote 24. *See id.* This rule applies to both long and short sales even though the target is short sales.

(n25)Footnote 25. *See id.*

(n26)Footnote 26. *See* 73 Fed. Reg. at 54,875.

(n27)Footnote 27. *See* Amendment to Regulation SHO, Exchange Act Release No. 34-58773 (Oct. 14, 2008).

(n28)Footnote 28. *See* "Naked" Short Selling Antifraud Rule, Exchange Act Release No. 34-58774 (Oct. 14, 2008).

(n29)Footnote 29. *See* Amendments to Regulation SHO, Exchange Act Release No. 34-58775 (Oct. 14, 2008).

(n30)Footnote 30. *See* Amendments to Regulations SHO, Exchange Act Release No. 34-60388 (Jul. 27, 2009).

(n31)Footnote 31. *See* 73 Fed. Reg. at 55,169.

(n32)Footnote 32. The SEC advised that bonds, convertible bonds and preferred stocks were not covered. Additionally, effective September 22, 2008, the SEC allowed exemptions for: (1) short sales occurring as a result of the automatic exercise or assignment of equity options or futures contracts held prior to the ban and short sales resulting from assignment of call options, including those written after the ban; (2) registered and over-the-counter ("OTC") market makers where the short sale is part of bona fide market making or hedging activity directly related to bona fide market making in derivatives, exchange traded funds ("ETFs") and exchange traded notes ("ETNs"); and (3) short sales of Rule 144 securities. *See* Amendment to Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 58,611 (Sept. 21, 2008).

(n33)Footnote 33. *See* Louise Story, *A Debate as a Ban on Short-Selling Ends: Did It Make Any Difference?*, N.Y. TIMES, Oct. 7, 2008.

(n34)Footnote 34. *See* 73 Fed. Reg. at 55,557.

(n35)Footnote 35. *See id.* at 58,987.

(n36)Footnote 36. *See* Disclosure of Short Sales and Short Positions by Institutional Investment Managers, Exchange Act Release No. 34-58785 (Oct. 15, 2008).

(n37)Footnote 37. *See* Press Release, Australian Securities & Investment Comm'n, *Update on ASIC's response to short selling*, Sept. 23, 2008 (Australia); Dara Doyle, *Financial Regulator bans short-selling of Irish banks*, THE IRISH INDEPENDENT, Sept. 19, 2008 (Ireland); Press Release, Commissione Nazionale per le Società e le Borse ("Consob"), *Short Sale: Consob Adopts New Provisions*, Sept. 22, 2008 (Italy); Press Release, Commission de Surveillance du Secteur Financier ("CSSF"), *Ban on Naked Short Sales*, Sept. 19, 2008 (Luxembourg); Press Release, Authority for Financial Markets ("AFM"), *Ban on Naked Short Selling*, Sept. 21, 2008 (Netherlands); Press Release, Comissão de Mercado de Valores Mobiliários ("CMVM"), *CMVM makes mandatory the daily reporting of short-selling transactions*, Sept. 19, 2008 (Portugal); Press Release, Singapore Exchange ("SGX"), *SGX enhances transparency and deters Jailed share delivery*, Sept. 22, 2008 (Singapore); Press Release, Comisión Nacional del Mercado de Valores ("CNMV"), *Agreement of the Executive Committee of the CNMV on naked short selling*, Sept. 22, 2008 (Spain); Financial Servs. Auth. ("FSA"), *Short Selling Instrument (Nos. 2 & 3) 2008* (United Kingdom).

(n38)Footnote 38. *See* Amendments to Regulation SHO, Exchange Act Release No. 59,748 (Apr. 10, 2009).

(n39)Footnote 39. *See id.*

(n40)Footnote 40. *See id.*

(n41)Footnote 41. *See SEC to Hold Roundtable on May 5 to Examine Short Sale Price Test and Circuit Breaker Restrictions*, SEC Press Release 2009-88 (Apr. 24, 2009), available at <http://www.sec.gov/news/press/2009/2009-88.htm>.

(n42)Footnote 42. *See Amendments to Regulation SHO*, Exchange Act Release No. 34-60509 (Aug. 17, 2009).

(n43)Footnote 43. *See Chairman Mary L. Shapiro, Opening Statement Before the Commission Open Meeting*, U.S. Securities and Exchange Commission (Apr. 8, 2009), available at <http://www.sec.gov/news/speech/2009/spch040809mls.htm>.

(n44)Footnote 44. *See Jesse Westbrook, SEC Looks for Feedback on Short-Selling Clampdown Rules*, BLOOMBERG NEWS, Apr. 9, 2009.

(n45)Footnote 45. *See Rachele Younglai, U.S. SEC Asks if Options can Undermine Short Curbs*, REUTERS UK, Apr. 10, 2009.

(n46)Footnote 46. Sec. Ex. Act Rel. No. 59,748 (Apr. 8, 2009).

(n47)Footnote 47. Sec. Press Rel. No. 2009-76 (Apr. 8, 2009).

(n48)Footnote 48. Sec. Press Rel. No. 2010-26 (Feb. 24, 2010).

(n49)Footnote 49. Amendments to Regulation SHO, Final Rule, Sec. Ex. Act Rel. No. 34-61505, at 55.

(n50)Footnote 50. *Id.* at 2.

(n51)Footnote 51. *Id.* at 9-10.

(n52)Footnote 52. *Id.* at 10.

(n53)Footnote 53. *See*, § 6.03, *supra*.

(n54)Footnote 54. *See Josh Beckerman, PIPE Investors Plan to Stay the Course*, THE WALL STREET JOURNAL, Sept. 29, 2009.

(n55)Footnote 55. *See In the Matter of SG Americas Sec., LLC*, Exchange Act Release No. 59401, Feb. 13, 2009.

(n56)Footnote 56. *See id.*

(n57)Footnote 57. *See id.*

(n58)Footnote 58. *See Complaint, SEC v. Ladin*, Case: 1:08-cv-01784 (D.D.C. Oct. 20, 2008)

(n59)Footnote 59. *See id.*

(n60)Footnote 60. Regulation ATS, 17 C.F.R. § 242.300 (2002) (definition of "alternative trading systems.").

(n61)Footnote 61. *See SEC Modernizes Regulations for Alternative Trading Systems*, SEC Press Release 98-127, December 2, 1998, available at www.sec.gov/news/press/pressarchive/1998/98-127.txt.

(n62)Footnote 62. The SEC cited its 1998 proceedings against Ian Fishman and Lawrence Fishman, in which it sanctioned these two investors for placing a series of limit orders designed to impact the National Best Bid or Offer ("NBBO") quotes in five securities. The Fishmans then traded at the affected prices, and cancelled the limit orders, thereby profiting from their artificial raising or lowering of the market price. *Ian Fishman*, Sec. Ex. Act Rel. No. 40,115, 67 SEC Dock. 783, 783 (June 24, 1998), *cited* in Regulation of Exchanges and Alternative Trading Systems, Sec. Ex. Act Rel. No. 40,760, 68 SEC Dock. 2045, at 2048 n.5 (Dec. 8, 1998). Under Rule 11Ac-4 of the Exchange Act, with respect to fifty Nasdaq listed securities, market makers are required to display customer limit orders that are priced better than the market maker's quote. If the order is also better than the NBBO, it is incorporated into the NBBO and therefore the public market price.

(n63)Footnote 63. 17 C.F.R. § 240.3b-16(a) (2004) (Rule 3b-16(a)).

(n64)Footnote 64. ATS Adopting Release, *supra* n.23.

(n65)Footnote 65. 17 C.F.R. § 242.301(b) (2004) (Rule 301(b)).

(n66)Footnote 66. *SEC v. Peter F. Paul, et al.*, Case No. CV 04-6613, 2004 SEC LEXIS 1732 (Aug. 11, 2004) .

(n67)Footnote 67. See *In the Matter of Cary R. Kahn*, Sec. Ex. Act Rel. No. 50046, 2004 SEC LEXIS 1530 (July 20, 2004) ; *In the Matter of Jason T. Frazee*, Sec. Ex. Act Rel. No. 47522, 2003 SEC LEXIS 632 (Mar. 18, 2003) ; *In the Matter of Leonard Sheehan*, Sec. Ex. Act Rel. No. 47521, 2003 SEC LEXIS 631 (Mar. 18, 2003) .

(n68)Footnote 68. See *Strengthening the Regulation of Dark Pools*, SEC Open Meeting, Oct. 21, 2009, available at <http://www.sec.gov/news/press/2009/2009-223-fs.htm>; see also See Regulation of Non-Public Trading Interest Sec. Ex. Act Rel. No. 34-60997, at 6.

(n69)Footnote 69. See David Bogoslaw, *Big Traders Dive Into Dark Pools*, BUSINESS WEEK, Oct. 3, 2007.

(n70)Footnote 70. See Regulation of Non-Public Trading Interest Sec. Ex. Act Rel. No. 34-60997, at 6-7. Dark pools are also increasingly popular in Europe, where, according to a recent report, they now account for about 4% of all European equity trading. See Steve Goldstein, *Study: 'Dark Pools' Account for 4% of European Trades*, THE WALL STREET JOURNAL, Nov. 2, 2009.

(n71)Footnote 71. See Regulation of Non-Public Trading Interest Sec. Ex. Act Rel. No. 34-60997, at 8-9; see also *Strengthening the Regulation of Dark Pools*, SEC open Meeting, Oct. 21, 2009, available at <http://www.sec.gov/news/press/2009/2009-223-fs.htm>.

(n72)Footnote 72. See Regulation of Non-Public Trading Interest Sec. Ex. Act Rel. No. 34-60997, at 9-11; see also SEC Press Release 2009-223, *SEC Issues Proposals to Shed Greater Lights on Dark Pools*, Oct. 21, 2009, available at <http://www.sec.gov/news/press/2009/2009-223.htm>.

(n73)Footnote 73. Chairman Mary Schapiro, *Speech by SEC Chairman: Statement on Dark Pool Regulation Before the Commission Open Meeting*, Oct. 21, 2009.



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CHAPTER SA-7A PUBLISHER'S SPECIAL ALERT TO CHAPTER 7A

2- Federal Securities Exchange Act of 1934

SEC Rulemaking Regarding Amendments to the Rules Governing Cross-Border Tender Offers_and_@_)_and_footnotes(n2);.vk n*

(As of November 24, 2008)

On September 19, 2008, the U.S. Securities and Exchange Commission (the "SEC") published changes to the rules governing cross-border tender offers and business combinations involving foreign private issuers_and_@_)_and_footnotes(n3);.vk n1 The amended rules became effective on December 8, 2008.

The SEC's amendments are intended to expand the scope of exemptions for cross-border transactions involving foreign private issuers from certain tender offer rules and regulations. The amendments will also allow certain non-U.S. institutions to report their share ownership on the less onerous Schedule 13G to the same extent as would be permitted for similar U.S. institutions.

Regulation 14D and Regulation 14E under the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), set forth a complex set of tender offer rules and requirements intended to ensure that all security holders in the context of a tender offer are treated equally and are provided with sufficient time and information in deciding whether or not to participate in the tender offer. The regulation of cross-border tender offers under the U.S. securities laws contains two tiers of exemptions and regulatory relief which are primarily based upon the ownership level by United States shareholders of the foreign target company's securities. The "Tier I" exemptions apply where U.S. holders own no more than 10 percent of the securities of the subject foreign company and exempt such offer from most of the rules and requirements under Regulation 14D and Regulation 14E. The "Tier II" exemptions apply when U.S. holders account for between 10 percent and 40 percent of the foreign target company's share ownership and provide more limited exemptions from certain tender offer regulations.

Under the SEC's new amendments, the underlying Tier I and Tier II exemption structure will remain in place. The amendments instead alter the process by which share ownership calculations are performed for the purposes of determining eligibility and further expand the scope of the exemptions to provide relief from additional regulatory requirements.

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Rule 14d-1 under the Exchange Act will be amended to alter the "look-through" analysis of target record holders to determine levels of U.S. beneficial ownership. Acquirors may now calculate U.S. ownership levels as of any date that is no more than 60 days before and no more than 30 days after public announcement of the offer. Prior rules required calculation as of the thirtieth day prior to the commencement of the offer. In addition, the SEC has abandoned its requirement that holders of more than 10 percent of the subject securities be excluded from the calculation. In the past, the exclusion of 10 percent or greater holders served to significantly inflate the calculated percentage of U.S. holders in the case of target companies whose shares were held by one or more significant shareholders. Lastly, in the case of hostile tender offers or tender offers for which look-through analysis of the subject company's record holders cannot be conducted, the amendments provide an alternative test based upon the average daily trading volume of the target securities in the United States and worldwide.

The SEC's amendments made a number of other modifications and adjustments to the regulatory requirements of cross-border offers designed to reduce conflict between U.S. tender offer regulation and common foreign regulatory structures and market practices, including, among other changes, the following:

- **Withdrawal Rights.** The amendments permit relief from Section 14(d)(5) and Rule 14d-7 withdrawal rights such that the bidder may terminate withdrawal rights at the end of the initial offering period while tendered shares are counted and the offeror determines whether a subsequent offering period will be necessary.
- **Multiple Non-U.S. Offers.** Prior rules permitted a bidder to separate its offer into only two separate offers, a U.S. offer and a non-U.S. offer. The amendments recognize the need of many bidders to comply with multiple non-U.S. jurisdictions by allowing multiple foreign offers to be conducted contemporaneously with the U.S. offer.
- **Tier II Subsequent Offering Periods.** The amendments permit Tier II cross-border offers to extend subsequent offering periods which last beyond 20 business days.
- **Foreign Holders of ADRs.** The amendments permit the inclusion of foreign holders of ADRs within a U.S. offer. In addition, under certain circumstances U.S. holders will be permitted to participate in foreign offers.

The SEC's amendments also modify the treatment of certain foreign entities under Sections 13(d) and 13(g) of the Exchange Act. Under existing Rule 13d-1(b), the class of institutional investors eligible to use Schedule 13G (rather than the more burdensome Schedule 13D) to report their beneficial ownership of registered securities, was limited to investment companies, investment advisors, brokers and dealers which were U.S. institutions registered with the SEC, as well as entities such as insurance companies, banks and pension plans funds which were regulated under the laws of the United States. The SEC's new regulations will permit comparable non-U.S. institutions to report their beneficial ownership of securities on Schedule 13G to the same extent as similar U.S. entities. Foreign institutions desiring to use Schedule 13G must (1) certify that they are subject to a home country regulatory scheme substantially comparable to the regulatory scheme applicable to functionally equivalent U.S. institutions, (2) assert that the subject securities are acquired and held in the ordinary course of business and without the purpose or effect of influencing control over the issuer, and (3) be willing to furnish to the SEC, upon request, information that would otherwise be disclosed in a Schedule 13D filing.

Recent Judicial Interpretations of Section 13(d) of the Exchange Act: Beneficial Ownership and Group Status

In *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*,¹ and *@_and_footnotes(n4);vk n2* the court ruled that The Children's Investment Fund ("TCI") and 3G Capital Partners ("3G"), two activist hedge funds engaged in a proxy contest with CSX, violated Section 13(d) of the Exchange Act by using total return equity swaps

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("TRs")_and_@_)_and_footnotes(n5);vk n3 to secretly acquire beneficial ownership of more than 5 percent of CSX's common shares without properly disclosing such ownership on Schedule 13D. The court held that, pursuant to Rule 13d-3(b) under the Exchange Act, where a party has entered into a TRS arrangement as part of a plan or scheme to evade the reporting requirements of Section 13(d), it is deemed to be the beneficial owner of the shares held by the counterparty to the swap arrangement for the purpose of hedging such company's exposure under the TRS arrangement. As the court's finding was based solely upon the anti-evasion provisions of Rule 13d-3(b), the court's decision did not affirmatively rule that Section 13(d) applies to shares held pursuant to otherwise passive or benign swap or derivative arrangements. Instead, the court specifically applied Section 13(d)'s reporting requirements to instances in which parties have entered into swap or derivative arrangements with the intent of creating a false appearance that there is not a large accumulation of issuer shares which might have a control shifting effect. The court also found that TCI and 3G violated Section 13(d) by acting for months in close coordination with each other but failing to timely disclose their formation of a group on Schedule 13D. The finding that a group had been formed significantly prior to its disclosure by TCI and 3G was based upon a pattern of circumstantial evidence, including a close prior relationship between TCI and 3G, multiple communications discussing CSX and a rough synchronization of the parties' trading in CSX's shares.

In *Roth v. Jennings, and @_)_and_footnotes(n6);vk n4* the Second Circuit further defined what constitutes a group for purposes of determining beneficial ownership of securities under Section 13(d) of the Exchange Act. In *Roth*, the plaintiff, suing derivatively on behalf of Metal Management, Inc. ("MMI"), sought disgorgement of defendant shareholder's "short-swing" (opposite way transactions made within a period of 6 months) profits under Section 16 of the Exchange Act on the grounds that, if its shares were properly aggregated with those of another larger shareholder, the selling shareholder would be categorized as a principal shareholder (a holder of 10 percent or more of an issuer's shares) and be subject to Section 16 of the Exchange Act. Section 16 requires the short-swing profits of directors, officers and 10 percent shareholders to be disgorged to the company. In addition, the rules under Section 16 provides that, solely for the purposes of determining whether a person is a principal shareholder beneficially owning 10 percent or more of an issuer's shares, the term "beneficial owner" means a person who is a beneficial owner pursuant to Section 13(d) of the Exchange Act. The defendant, Jennings, purchased 8.3 percent of MMI's shares through funds supplied by a loan agreement with an existing 14.8 percent shareholder ("EMR"). The plaintiff alleged that Jennings and EMR constituted a group under Section 13(d) because EMR's loan was made for the specific purpose of purchasing MMI shares and because the parties otherwise had an agreement regarding the acquiring, holding or disposing of MMI's shares. Both Jennings and EMR reported their beneficial ownership in Schedule 13D filings which disclosed their respective ownership levels and contained the terms of the loan agreement._and_@_)_and_footnotes(n7);vk n5 In addition, both the Schedule 13D filings and the loan agreement itself specifically disclaimed the existence of any arrangement regarding MMI's shares and disclaimed that Jennings and EMR constituted a group. The court ruled that such formal disclaimers of group status will not serve to preclude a finding that parties had a triggering arrangement regarding an issuer's securities and constitute a group under Section 13(d). The court noted that parties' self serving disclaimers of group status will not, in itself, prove the truth of such an assertion. Under Section 13(d), parties which act with the purpose of acquiring an issuer's shares will have formed a group regardless of their attempts to disclaim such joint action._and_@_)_and_footnotes(n8);vk n6

Conversely, the court in *Litzler v. CC Investments, L.D.C. _and_@_)_and_footnotes(n9);vk n7* found that three hedge funds investing in Data Race, Inc. ("Data Race") had not acted in concert so as to have formed a group._and_@_)_and_footnotes(n10);vk n8 Plaintiff argued that the three funds had formed a group in their acquisitions of Data Race shares because they acted through common counsel in the negotiation and drafting of the acquisition documents. The court found plaintiff's argument to be unconvincing and found that a group had not been formed. The court noted the SEC's position that business considerations, such as cost savings, "that generally lead to cooperative activity characteristic of an institutional placement" are not sufficient to demonstrate that "investors were motivated by a desire to affect control or by some other indicia of concerted activity."_and_@_)_and_footnotes(n11);vk n9 In addition, the court noted that the investing parties had separately conducted their own due diligence review of Data Race, had been separately advised by counsel in making their decision to pursue an investment in Data Race and had not maintained a pre-existing prior relationship.

Chapter 7A, *The Williams Act Amendments -- Controlling Shareholders and Tender Offers*, will be updated in the coming months. The rule amendments and case law developments discussed in this Special Report will be addressed within the updated release of the chapter.

FOOTNOTES:

(n2)Footnote *. This chapter was prepared by Morton A. Pierce and Chang-Do Gong with the assistance of Michael Clifton-Harter and Daniel Hackney. Messrs. Pierce and Gong are partners of Dewey & LeBoeuf LLP and Messrs. Clifton-Harter and Hackney are associates of Dewey & LeBoeuf LLP.

(n3)Footnote 1. Commission Guidance and Revisions to the Cross-Border Tender Offer, Exchange Offer, Rights Offerings, and Business Combination Rules and Beneficial Ownership Reporting Rules for Certain Foreign Institutions, Exchange Act Release No. 34-58597 (Sept. 19, 2008).

(n4)Footnote 2. 562 F.Supp.2d 511 (S.D.N.Y. 2008).

(n5)Footnote 3. Total return equity swaps are a type of derivative that gives its holder substantially all of the indications of share ownership other than formal voting rights and investment power in the underlying security.

(n6)Footnote 4. 489 F.3d 499 (2nd Cir. 2007).

(n7)Footnote 5. It was uncontroverted that both Jennings and EMR had Schedule 13D filing requirements due to the beneficial ownership by each of over 5 percent of MMI's shares.

(n8)Footnote 6. *Id.*, at 511.

(n9)Footnote 7. 411 F.Supp.2d 411 (S.D.N.Y. 2006).

(n10)Footnote 8. Had the investors been found to be a group, they would have held over 10 percent of Data Race's shares and, as a consequence of their subsequent sales, would have been liable for short-swing profit recovery under Section 16.

(n11)Footnote 9. *Id.* at 415.



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CHAPTER 7 Proxy Regulation

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Paul G. Hughes n*

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FOOTNOTES:

(n1)Footnote *. This chapter was prepared by Paul G. Hughes and Richard McGrath. Mr. Hughes is a Partner and Mr. McGrath is Counsel in the law firm of Murtha Cullina LLP in Stamford, Connecticut.



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CHAPTER 7 Proxy Regulation

1-7 Federal Securities Exchange Act of 1934

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Summary of This Chapter

Securities Exchange Act of 1934 ("Exchange Act") Section 14(a) governs the solicitation of proxies and requires companies whose securities are registered pursuant to Section 12 to disclose information to stockholders concerning matters to be acted upon at meetings of stockholders. The proxy rules, collected under the title "Regulation 14A," are supplemented by Schedules 14A and 14B, which set forth the information required to be included in proxy statements, in statements filed by or on behalf of non-issuer participants soliciting proxies, and in information statements required to be distributed when stockholder action is proposed but proxies are not solicited. *See § 7.01 infra.*

Section 14(a) is applicable to any proxy solicitation; Rule 14a-1 defines solicitation. Certain activities are exempt from the proxy rules under Rule 14a-2, including certain solicitations by a broker, bank, or other fiduciary involving securities carried in its own name or in street name and any nonmanagement solicitation of ten or fewer persons. The solicitation of proxies and the transmission of proxy material by exchange members or broker-dealers concerning securities held for their customer's accounts are regulated under Section 14(b) and also by rules of the national stock exchanges. Solicitations may be made prior to the time a written proxy statement is furnished to security holders only under certain conditions. *See § 7.02 infra.*

If the proxy solicitation is made on behalf of the issuer for an annual meeting involving election of directors, the proxy statement must be preceded or accompanied by an annual report containing financial data and other information. *See § 7.03 infra.*

The initial solicitation of proxies must be preceded or accompanied by a written proxy statement containing the information specified in Schedule 14A. Schedule 14A contains twenty-two items requiring disclosure of general information as well as information concerning the specific proposals for shareholder action. The use in a proxy statement of a false or misleading statement with respect to a material fact, or the omission of a material fact necessary to make the statement not false or misleading, is prohibited under Rule 14a-9. The form of the proxy statement is prescribed in Rule 14a-5, and the filing requirements for the proxy statement and any other soliciting material to be furnished to security holders are set forth in Rule 14a-6. *See § 7.04 infra.*

A proxy to be signed by a shareholder must be in a specific form and contain certain required information. *See § 7.05 infra*, which contains a sample form of proxy.

Issuers that do not solicit proxies in connection with a meeting of shareholders or propose to take action on written consent of fewer than all stockholders (if permitted under applicable state law) are required by Exchange Act Section 14(c) to transmit to record holders an information statement pursuant to Regulation 14C, providing substantially equivalent information as if a solicitation were being made. If directors are to be elected at an annual meeting, the issuer must furnish security holders with an annual report either before or at the same time the information statement is furnished. Regulation 14C contains an antifraud provision applicable to information statements. *See § 7.06 infra*.

A shareholder who wants to present a proposal for action at an upcoming stockholders' meeting may have the proposal included in the proxy statement, provided the shareholder complies with the requirements of Rule 14a-8 concerning such matters as eligibility of the proponent, notice and attendance at the meeting by the proponent or the proponent's representative, timeliness, number and length of proposals, and the furnishing to the issuer of a supporting statement. The registrant, however, may omit certain types of proposals and the related supporting statements. These include proposals that are not proper subjects for action under the laws of the issuer's domicile, proposals that would require the issuer to violate other laws or other proxy rules and regulations, proposals that are irrelevant or insignificant with respect to the interests of the issuer or the issuer's security holders as a group, proposals dealing with ordinary business operations, counter proposals, proposals relating to specific amounts of cash or stock dividends and moot, duplicative or previously made proposals. The issuer must follow a prescribed procedure if the issuer determines to omit a shareholder proposal from the proxy statement or to include in the proxy statement a statement in opposition to the shareholder proposal. *See § 7.07 infra*.

Proxy contests involving the election or removal of directors at any annual or special meeting of shareholders are subject to special requirements involving the identity of any "participant" in the contest and the disclosure of certain information regarding each participant in the solicitation outlined in Schedule 14B. A dissident stockholder may communicate views differing from those of the issuer by use of the stockholder list. *See § 7.08 infra*.

There is presently no administrative means available to the Commission to enforce compliance with the proxy and information statement rules. The usual means of dealing with a violation is by an action for injunctive relief in a federal district court. Such an action may be brought either by the Commission or by affected private parties, *i.e.*, dissident shareholders or, in the case of a proxy contest, by the issuer acting by its management against the materials prepared by the dissidents. The Commission may also make an investigation and publish its findings, suspend trading in the security, or take administrative action against persons, such as broker-dealers, who are otherwise subject to its direct discipline under other statutory provisions of the federal securities laws. In addition, it may take action under Rule 2(e) against accountants, attorneys and other experts. In the case of a willful violation, it may refer the matter for criminal prosecution. In addition to injunctive actions, there is the alternative, available to shareholders, of an action for damages to recoup monetary losses caused by violations of the statute and regulations. A federal court may set aside a consummated transaction to correct the effects of a violation, but such relief is rarely given in mergers and similar transactions. *See § 7.09 infra*.



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CHAPTER 7 Proxy Regulation

1-7 Federal Securities Exchange Act of 1934 § 7.01

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§ 7.01 Introduction

Section 14(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), n1 governs the solicitation of proxies and requires companies whose securities are registered pursuant to Section 12 of the Exchange Act n2 to disclose information to shareholders concerning matters for which proxies are being sought. The proxy rules, collected in Regulation 14A, n3 are supplemented by Schedule 14A, n4 which describes the information required to be included in the proxy statement and in statements filed by or on behalf of non-issuer participants in election contests as well as requirements relating to the form of proxy. Section 14(c) of the Exchange Act, n5 and Regulation 14C n6 and Schedule 14C n7 adopted thereunder, require that a company that proposes to request shareholder action but that is not soliciting proxies must provide substantially the same information as if proxies were being solicited.

[1] The Proxy

In ordinary usage, the word "proxy" n8 may have one of several meanings, including:

- the manner of voting through an agent;
- the grant of authority by a shareholder to another person to vote the shareholder's shares;
- the instrument granting the authority to vote by the shareholder to an agent; or
- the agent (known as a proxy holder) to whom the authority to vote is granted.

The relationship between a shareholder and the person the shareholder chooses to vote his or her shares is a principal-agent relationship; a shareholder will generally be bound by the vote of the designated proxy holder when the proxy holder acts within the scope of the proxy holder's authority. n9 Voting by proxy has become the primary method of shareholder voting in this country, since it allows geographically dispersed shareholders to vote on matters before a meeting without the need to be physically present. n10 The right of shareholders to vote by proxy is specifically recognized under state corporation laws. n11

[2] The Statute--Section 14

One conclusion reached by Congress as the result of the stock market investigations of 1933-1934 was that the machinery of proxy solicitation required extensive regulation to compel disclosure to shareholders of the matters on which their powers of attorney were being sought. n12 After some attempts to codify appropriate rules, Congress chose rather to authorize the Securities and Exchange Commission (the "Commission") to regulate the solicitation of proxies by adopting Section 14 n13 of the Exchange Act. n14

Section 14(a) makes it unlawful for any person, through the use of the mails or by any means of interstate commerce or any facility of a national securities exchange or otherwise, to solicit, or to permit the use of that person's name to solicit proxies concerning any security registered pursuant to Section 12 if the solicitation would contravene Commission rules and regulations.

Section 14(b) makes it unlawful for exchange members and registered broker-dealers, banks and other associations or entities that exercise fiduciary powers, to give or refrain from giving proxies concerning any security registered pursuant to Section 12 or any security issued by an investment company registered under the Investment Company Act of 1940 if the giving or withholding of such proxies would contravene Commission rules and regulations. n15

The primary purpose of Section 14 is to protect the investor by preventing management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure. n16 The constitutionality of Section 14 has been upheld. n17

[3] Solicitation

Not all actions that are intended to have an effect on the way a shareholder votes are "solicitations" subject to the requirements of the proxy rules. In the interest of facilitating communications among shareholders about matters of common interest, the Commission exempts certain types of activities from the proxy rules. n18 In general, however, actions that are intended to influence the way shareholders vote and that are accompanied by a request for a proxy are subject to the proxy rules.

[4] The Rules

[a] Regulation 14A. Regulation 14A n19 includes the rules generally applicable to the solicitation of proxies. These rules prescribe the requirements as to the contents of the proxy statement, the contents of the annual report to shareholders required to be distributed no later than the time the proxy material is distributed, the form of proxy that may be used and the filing of materials with the Commission. n20

[b] Schedule 14A. The specific requirements as to information that must be included in proxy material subject to Regulation 14A are contained in Schedule 14A, n21 which includes detailed descriptions of the specific facts that must be included. Responses are needed only to those items of Schedule 14A that are applicable to the matters to be considered at the meeting of shareholders. Following the adoption of integrated disclosure and Regulation S-K, n22 much of the information required under Schedule 14A is determined by reference to various items of Regulation S-K.

[c] Regulation 14C. In the event that a company does not solicit proxies in connection with action by shareholders, the company is nevertheless required under Regulation C n23 to distribute information to the holders of its voting securities in advance of the taking of action. n24 The information statement required to be provided in these circumstances is substantially equivalent to the information that is required under Regulation 14A.

[5] The Documents

In cases where proxies are solicited or where information statements are required, various documents are typically distributed to the shareholders of the company. The documents most typically required are those described below.

[a] The Annual Report to Shareholders. Whether proxies are solicited and therefore a proxy statement is required or an information statement is required because shareholder action is proposed to be taken without the solicitation of proxies, an annual report to shareholders is required under Rule 14a-3. n25 The annual report, providing information with respect to the company's most recent fiscal year, must be provided to the shareholders no later than the time the proxy statement or the information statement is first sent or given. n26 Much of the information required in the annual report to shareholders relates to the financial performance of the company.

[b] The Proxy Statement--Internet Delivery. The proxy statement, containing specific information about the matters to be acted upon at the meeting of shareholders, must be sent if proxies are being solicited to vote shares at the meeting. The information required for proxy statements is specified in Schedule 14A. n27 The proxy delivery rules allow the delivery of a single proxy statement to two or more security holders sharing a single address where the holders have expressly or impliedly consented to such delivery. Separate proxy cards must be provided for each shareholder. n28

The SEC has adopted amendments to the proxy rules mandating that issuers provide shareholders with a proxy statement and annual report via the Internet. Issuers would be required to send physical notice at least 40 days before the meeting directing shareholders to the dedicated Web site hosting the material or alternatively could physically deliver all proxy material to shareholders (before or after 40 days) but also post it on the Web site. Shareholders could request physical delivery of the materials for the meeting and also for all future meetings. n29

[c] The Form of Proxy. Rule 14a-4 n30 prescribes specific requirements concerning the form of proxy that may be used. Of particular importance is the requirement that the form of proxy state how the proxy will be voted if the proxy is signed but no voting instructions are given. n31 Assuming the requirements of this rule are followed, in most cases proxies that are signed but not otherwise marked will be voted in accordance with the recommendation of the board of directors. Unless certain information is provided to stockholders, the ability of the proxy to vote in the exercise of discretionary authority may be limited. n32

[d] The Information Statement. If action is proposed to be taken at a meeting of shareholders or by written consent and proxies are not solicited, Regulation 14C requires that substantially the same information be provided to shareholders as would be required if proxies were solicited. n33

[6] Required Filings

Whether proxy material or information statements are distributed, copies of such materials will need to be filed with the Commission. n34 Under some circumstances, only definitive materials must be filed; in others, preliminary copies will need to be filed. Rule 14a-6(b), which previously required that definitive proxy material be "filed with, or mailed for filing to, the Commission not later than the date such material is first sent or given to any security holders", has been amended effective January 24, 2000 to eliminate the mailing alternative since companies must file electronically. n35

[7] Enforcement

Failure to comply with the requirements of Regulation 14A or Regulation 14C can subject a company or other person to liability as a result of either action instituted by the Commission or private action. n36

[8] Historical Development of Proxy Rules

The 1970's and 1980's saw a heightened awareness on the part of institutional investors, the general public, and the Commission regarding a perceived lack of responsiveness on the part of corporate management to legitimate business and social concerns. n37 In what might be considered the first wave of proxy reform, the Commission in 1978 proposed and adopted rules intended to provide additional information to shareholders about the structure, composition, and functioning of boards of directors, including the existence and functioning of audit, nominating, and compensation

committees, attendance of directors at meetings, economic and personal relationships between directors or nominees and a company or its management, and resignations of directors. n38

The second wave of proxy reform was triggered by a formal announcement in a speech by then Commission Chairman Richard C. Breeden to the Council of Institutional Investors Annual Meeting (Washington, D.C. April 2, 1990) of the commencement of a comprehensive review of the efficacy of the proxy rules in light of significant changes in shareholder demographics that had resulted in a concentration of institutional equity ownership and voting power, and increasing shareholder activism with respect to matters of corporate or partnership governance.

Chairman Breeden's concerns were initially directed to proposals submitted to the Commission by CalPERS (the California Public Employees' Retirement System) and by the United Shareholders' Association and other shareholder organizations that had manifested deep dissatisfaction with existing restrictions on shareholder communications. Almost simultaneously, there was a rising ground swell of criticism in the media concerning current levels of executive compensation, leading to the issuance on June 23, 1992 of two separate sets of proposals, one regarding shareholder communication n39 and one concerning executive compensation. n40

A rising tide of dissatisfaction among institutional stockholders with perceived inadequacies in compensation disclosure has culminated in the adoption in 2006 of far more detailed disclosure requirements, not only as to compensation (including more forthright descriptions of "perks") but also as to transactions between related persons and more far-reaching disclosure of the personal interests of insiders in company activities. n41

Virtually every effort by activists and government to rein in corporate compensation seems to have failed or backfired. Far from restraining increases, disclosure rules imposed by federal regulators in 1993 apparently juiced executives' competitive instincts by revealing what their rivals were making and giving them leverage to negotiate bigger compensation packages, according to a *Wall Street Journal* review of efforts to contain executive pay. n42

[a] 1978 Rulemaking Initiatives. The 1978 reforms to the governance process were launched when the Commission, based on its review of comments and testimony at the corporate governance hearings and its experience in enforcing the securities laws, decided that additional information about the structure, composition and functioning of boards of directors should be made available to shareholders. Accordingly, in 1978, the Commission proposed and adopted rules intended to provide this information to shareholders. n43 The rules required disclosure of the existence and functioning of audit, nominating and compensation committees of the board of directors; attendance of directors at board and committee meetings; certain economic and personal relationships between directors or nominees and a company or its management; and resignation of directors.

In addition, the Commission proposed and adopted a second set of rules that required shareholders to be provided with a form of proxy that indicates whether the proxy is solicited by the company's board of directors; provides a means to vote for director nominees individually; and provides a means to abstain from voting on any matter other than elections to office. n44

The Commission stated that these rulemaking initiatives did not represent a concerted effort to prescribe the composition of boards of directors or influence corporate conduct, but were designed to improve the quality of disclosure to shareholders about the structure, composition and functioning of boards of directors and thereby to enable shareholders to make informed voting decisions in elections of directors. n45

[b] 1992 Rulemaking Initiatives. In October 1992, the Commission adopted far-reaching revisions in the proxy rules regarding executive compensation, as well as a broad exemption for communications among shareholders in the absence of a contested election or other vote. The executive compensation proposals called upon the compensation committee of the reporting company's board of directors to explain the basis for its compensation decisions in the last

fiscal year, the relationship of such compensation to company performance, and a graphic representation of the cumulative return on the company's common stock compared with the S&P 500 stock index and a nationally recognized industry index or peer group over the last five years. n46

In a major revision from prior rules, the 1992 shareholder communications rules exempt shareholder communications by persons who are not requesting proxies and who do not otherwise have a "substantial interest" in the matter being acted upon. The exemption covers the filing and disclosure requirements applicable to proxy material generally. Mere ownership of the company's stock does not constitute a substantial interest. Likewise, a substantial interest would not exist if the benefit to be received would be shared pro rata by shareholders or if the benefit would arise out of a person's employment with the company. Persons owning \$5 million in company stock must file a "Notice of Exempt Solicitation."

The exemption is not available to specified classes of persons. For example, it does not apply to communications by the company or by its officers or directors, nominees for election as directors, or any of their affiliates or associates. Officers and directors who personally finance a communication will, however, be permitted to rely on this exemption. Persons interested in opposing certain extraordinary transactions, such as mergers and sales of assets, are also excluded if an alternative transaction to which such person would be a party will be proposed. Communications by certain 5% shareholders (those whose Schedule 13D indicates an intention to engage in a control transaction or election contest) and investment companies are also not exempt under this provision.

Under the proxy rules as currently in effect and as in effect prior to adoption of the revised rules in 1992, solicitation of ten or fewer persons or the furnishing of proxy voting advice by financial advisors would not require the filing or distribution of proxy material and would be subject only to the antifraud provisions of the proxy rules. n47

A second major shift allows dissident shareholders seeking minority board representation to request proxies to vote for selected management nominees without the consent of those nominees.

The 1992 rules also revised the definition of "solicitation" to exclude public announcements by shareholders of how they intend to vote and their reasons therefor and to permit a solicitation to commence upon the delivery of preliminary proxy material that has been filed with the Commission (assuming that no proxy card is distributed until the filing and distribution of definitive proxy material). "Solicitation" would continue to encompass communications that are accompanied by a proxy card.

[c] 2006 Rulemaking Initiatives. On January 27, 2006 the Commission proposed further revisions in the disclosure rules on executive compensation to remedy shortcomings in the 1992 revisions, as well as rules governing related party transactions, director independence, security ownership and corporate governance. After receiving and considering an overwhelming number of comments (over 20,000), the Commission adopted the bulk of the proposed revisions with the comment that it was building on the strength of the 1992 revisions rather than discarding them. n48

In a speech regarding the proposed rules delivered to the Council of Institutional Investors on March 30, 2006, Commission Chairman Christopher Cox observed:

Executive compensation matters--not only because if moral hazards inherent in these conflicts of interest are unchecked, executives will be paid too much, but also because it can play a valuable role in disciplining management across the board, and in protecting the entire range of shareholder interests.

By restraining executives from self-indulgent behavior--and using salary, bonuses, options, long term benefits, and other financial incentives in very purposeful ways--compensation committees acting on behalf of the shareholders can increase management's incentives to improve corporate performance.

So our purpose in advancing a very aggressive executive compensation rule is very straightforward:

It's to protect and advance the interests of shareholders.

This is the first time in 14 years that the Commission has undertaken significant revisions of its rules for executive compensation. Simply put, our rules are out of date, and it's high time we updated them.

The 2006 executive compensation rules provide that:

- "Principal Executive Officer" and "Principal Financial Officer" compensation must be disclosed regardless of pay level;
- Disclosure of compensation for the three other highest paid executives is required subject to a \$100,000 threshold; the Commission has requested comment on whether disclosure should be required for up to 3 additional employees whose compensation exceeds that of the named executive officers;
- A new compensation discussion and analysis (CD&A) ("filed", not "furnished") describing all material elements of compensation paid to or earned by the named executive officers ("NEOs"), how they were determined, and how they fit into the overall compensation strategy of the company, including whether the company has a policy of timing option grants to the release of material nonpublic information. Subject to a confidentiality exemption, companies must describe any performance targets affecting compensation. n49 According to the Corporate Library, two-thirds of companies listed fuzzy performance targets in their discussion of compensation. "Companies are still failing to disclose the performance hurdles that trigger pay for performance, and that remains a hugely contentious issue for shareholders". Patrick McGurn, Special Counsel, RiskMetrics Group (formerly Institutional Shareholder Services), New York Times, April 6, 2008, page 7.
- A reorganized and expanded summary compensation table ("SCT") reflecting virtually every element of compensation, with a new "total compensation" number for each NEO.
- A new table for the fair value of all equity-based compensation (including stock, restricted stock units, options and stock appreciation rights) valued under FAS123R.
- Tabular and narrative disclosure of post-employment benefits (severance, change of control, deferred compensation, and present value of pension benefits).
- Tabular disclosure of directors' compensation.
- Disclosure of perquisites exceeding \$10,000 in the aggregate.
- Increase in the threshold for reporting related party transactions from \$60,000 to \$120,000, with disclosure of company policies for approval of such transactions. n50
- The traditional compensation committee report has been eliminated, but a new report ("furnished", not "filed") must verify the committee's review and approval of the CD&A.
- Plain English will be mandated for all information provided in response to Items 402, 403, 404 and 407 when required in reports filed under Exchange Act Sections 13(a) or 15(d).
- Unless otherwise provided in an annual report to security holders pursuant to Rule 14(a)-3, a line graph comparing the yearly percentage change in the Company's cumulative total shareholder return on a class of registered common stock with a broad equity market index (the S&P 500 stock index if the

company is in that index), and the cumulative total return of a published industry or line-of-business index, or peer issuers selected in good faith, or issuers with similar market capitalization.

Under the previous rules, disclosure of individual compensation was required for the CEO and the four most highly paid executive officers whose cash compensation exceeded \$100,000. Under the rules adopted in 2006, disclosure is required for the Principal Executive Officer ("PEO") and Principal Financial Officer ("PFO") (or persons acting in a similar capacity), and the three other most highly compensated executive officers whose compensation exceeds \$100,000. Compensation of the Principal Executive Officer and Principal Financial Officer must be disclosed irrespective of the level of compensation.

On December 22, 2006, the SEC announced a substantial liberalization of the rules referred to above governing the SCT and the Director Compensation Table, which it summarized as follows:

- "The dollar values required to be reported in the Stock Awards and Option Awards columns of the Summary Compensation Table and the Director Compensation Table are revised to disclose the compensation cost of those awards, before reflecting forfeitures, over the requisite service period, as described in FAS 123R. Forfeitures are required to be described in accompanying footnotes.
- "The Grants of Plan-Based Awards Table is revised to require disclosure of the grant date fair value of each individual equity award, computed in accordance with FAS 123R, and the Director Compensation Table required under Item 402 of Regulation S-K is revised to require footnote disclosure of the same information.
- "The Grants of Plan-Based Awards Table is revised to require disclosure of any option or stock appreciation right that was repriced or otherwise materially modified during the last completed fiscal year, including the incremental fair value, computed as of the repricing or modification date in accordance with FAS 123R, and the Director Compensation Table required under Item 402 of Regulation S-K is revised to require footnote disclosure of the same incremental fair value information."

n51

The Council of Institutional Investors has termed "questionable" the adoption by the Commission of these latest revisions to the executive compensation disclosure rules n52 without an open meeting or opportunity to comment, although CII strongly supports the Commission's initiative in reforming executive compensation disclosure generally. n53

Discussing the revised rules on disclosing related-person transactions, former Commission Corporation Finance Director John White observed that the Commission had taken a principles-based approach to the new disclosure rules that will require well designed disclosure controls and procedures and that related person disclosure will require information that can only be obtained from the related persons themselves, one source of which is through director and officer questionnaires which may need to be updated to insure that the right questions are covered. He noted that under the new rules even a charitable contribution might under appropriate circumstances be deemed to be a related person transaction. The term "transaction" has broad scope and should not be narrowly interpreted. n54

[d] Electronic Delivery. The SEC in 2007 adopted amendments to the proxy rules making it mandatory that issuers provide shareholders with a proxy statement and annual report via the Internet. n55 The requirement applies to large accelerated filers as defined in Rule 12b 2 (other than investment companies) with respect to proxy solicitations commencing on or after January 1, 2008. Solicitations by other issuers and soliciting parties became subject to the new requirements for solicitations commencing on or after January 1, 2009. Under the new rule a company can proceed in one of two ways:

1. Under the "notice only option", the company would post its proxy materials on a publicly-available internet Web site other than EDGAR. The company would be required to send a Notice of Internet Availability of Proxy Materials at least 40 days before the meeting.

The Notice must be written in plain English and contain a prominent legend that advises shareholders of the date, time, and location of the meeting with information about attending and voting in person; a list of the proxy materials being made available at a specified Web site address; a toll-free phone number, e-mail address and a Web site that shareholders may use to request copies of the proxy materials; any control/identification numbers needed to access the shareholder's proxy card; instructions on how to access the proxy card (but not to execute the proxy without access to the proxy statement); and a clear and impartial description of the matters to be considered at the meeting. The Notice may also contain any information required by state law to constitute a valid notice of the meeting.

The company must send a physical copy of the materials free of charge within three business days after receiving a request from a shareholder. A shareholder may make a permanent election to receive all proxy materials in paper or by e-mail with respect to future proxy solicitations conducted by the company or soliciting person.

Brokers, banks and similar intermediaries must prepare and send their own Notices designed for beneficial shareholders. A beneficial shareholder desiring a paper or e-mail copy of the proxy materials must request one from the intermediary.

A soliciting person other than the company must follow the notice and access model in substantially the same manner as a company. However, its Notice must be sent to shareholders by the later of 40 days before the meeting or ten days after the company filed its proxy materials. It may limit its solicitation to shareholders who have not previously requested paper copies. But if the soliciting person sends a Notice to a shareholder, it must send that shareholder a paper or e-mail copy upon request. It may elect the "notice only option" as to some shareholders and the "full set delivery option" as to others.

After ten days following such notice, the company could send a form of proxy (by e-mail or hard copy) if accompanied by a copy of the original notice.

2. A company may also adopt the "full set delivery option", under which it would physically deliver all proxy material to shareholders but must also post its proxy material on a Web site other than EDGAR. The physical delivery would be accompanied by the same notice required under the "notice only option" or provide the same information in the proxy material, but the 40-day notice period would not apply. n56

The results of the Notice and Access initiative have been disappointing thus far. In a speech by Commissioner Luis A. Aguilar at "The SEC Speaks in 2009" (February 6, 2009), the Commissioner lamented the decline in the shareholder voting in those companies which have adopted the notice and access model, stating:

"As many of you are aware, the number of shareholders who voted through companies using the notice and access model dropped dramatically. Retail investor voting, in particular, plummeted. Some reports indicated less than 5 percent of individual investors voted at meetings held by companies that used e-proxy in late 2007 and early 2008. Other statistics compared the level of participation by the same investors before and after the notice and access model was put in place, and found decreases of over 30% for large investors, and over 60% for smaller investors. For these investors, access clearly didn't equal delivery.

"I recognize that there are significant cost savings to issuers who use e-proxy, but we should make sure that cost savings come without compromising effectiveness and adversely impacting an investor's exercise of their rights. That seems to have happened here, and we need to fix e-Proxy or scrap it."

As Dominic Jones wrote in the Winter 2009 issue of Investor Relationships.com:

"In a recent survey among 1,000 retail investors commissioned by the SEC, fully 57% of investors said they rarely (28%), very rarely (13%) or never (16%) read annual reports when they receive them. For proxy statements, the results were somewhat better, with 44% saying they rarely (21%), very rarely (10%) or never (13%) read proxy statements.

"When it comes to web-based proxy materials, statistics collected by Broadridge during the first year of notice-and-access meetings also present a dismal picture. First, only 1.1% of notice recipients bothered to ask companies to mail them paper documents. Meanwhile, just 0.5% of all recipients viewed the materials when they visited the URL provided in the notices. According to Broadridge, notice-and-access has resulted in a 96% reduction in information access by investors, which arguably has led to greater levels of voting without viewing proxy information."

[e] Institutional Activism. In part as a result of these changes, and in part because of the growing muscle-flexing among institutions that have begun to appreciate the extent of their economic power, control of the public corporation may no longer be considered safely lodged in the hands of management in most cases. The huge increase in shareholdings by institutions has been accompanied by a significant change in the attitudes and degree of activism of trustees and fund managers who once seemed indifferent to involvement in corporate operations. Under the leadership of organizations such as CalPERS, trust and fund managers are calling members of management to account in ways that would have been unheard of only a few years ago. n57 The emergence of this trend could have profound significance for the future of business regulation since it represents a counterweight to movements in favor of federal legislation to curb perceived abuses by management.

Indicative of the new activist approach of institutional investors was the announcement by CalPERS in 1993 that it would combine the use of shareholder proposals to effect corporate governance changes with a vigorous program of direct negotiations with corporate executives. This announcement, following on the heels of CalPERS' successful negotiations with such companies as General Motors, TRW, and Texaco with regard to shareholder proposals relating to director independence, n58 represented a reversal of its decision in 1992 not to put forward shareholder proposals, based on the conclusion that the strategy undermined the fund's bargaining position with target companies.

Latest to join the activist fray are certain hedge funds which are taking positions in companies which they view as undervalued or mismanaged. In a study of Pirate LLC and its founder, Tom Hudson, by Anthony Effinger and Katherine Burton for Bloomberg News, n59 it is stated that: "Hudson is an extreme example of the shareholder activism that's ripped through corporate America since the 1980s. Public pension funds led the way. Then, mutual fund managers charged in. Now, so-called activist hedge fund managers have joined the fray."

A somewhat more charitable view of the Pirate Capital activities was taken by Mark Hulbert in his column "Strategies", n60 making note that Pirate Capital had made a number of proposals to Walter Industries designed to bolster the Company's stock, like spinning off certain of its divisions; that the management of the Company had put into effect many of Pirate Capital's proposals and that the stock price had outperformed that of the average stock in its industry. Hulbert reported on a recent study titled "Hedge Fund Activism, Corporate Governance and Firm Performance" by Brav, Jiang, Partnoy & Thomas. The authors examined nearly 900 instances of hedge fund activism from 2001 through 2005 and found that the stock of the average company targeted outperformed the overall market by 7% over a 4-week period (2 weeks before and 2 weeks after the public announcement of the hedge funds' targeting of the company), that an average target company's stock kept pace with the overall market in the following year and that the average operating performance over the following two years improved markedly.

Several commentators have remonstrated with activists for going too far and imperiling the successful management of a business. Martin Lipton observed:

The key issue for American business is whether the institution of the corporate board of directors, as

we know it today, can cope with shareholder activism and survive as the governing organ of the public corporation. Will the forced migration from director-centric governance to shareholder-centric governance overwhelm American business corporations? The fundamental questions are: (1) whether we will be able to attract qualified and dedicated people to serve as directors and (2) whether directors and the companies they serve will become so risk adverse that they lose the entrepreneurial spirit that has made American business great." n61

Gretchen Morgenson has suggested that such comments are an unjustified overreaction. n62

Institutional Shareholder Services, Inc. ("ISS") has adopted guidelines that it follows in making voting recommendations, based on its client "policy survey", its issues-based advisory roundtables and new policy review and comment. Foremost among its 2007 proxy voting policies are backdating of stock options (ranked by institutional investors as "most problematic" among paid practices). ISS is adopting a case-by-case analysis approach and may recommend withholding votes from compensation committee members depending upon the severity of the practices and the subsequent corrective actions by the Board. Majority voting in director elections gained in 2006 as more than 180 companies adopted new election policies and bylaws. At more than 85 companies the average level of support for it increased to 49%, compared to 44% at more than 55 company meetings in 2005. Given the strong level of shareholder support, ISS will generally support precatory and binding resolutions to change bylaws to stipulate that directors need to be elected with an affirmative majority of votes cast, where not in conflict with state law. Proposals should allow for plurality voting when there are more nominees than Board seats. ISS is updating its poor pay practices policy and may recommend a vote to withhold from the compensation committee where it identifies poor pay practices, and even withhold from the entire Board if the full Board was involved in and contributed to egregious compensation problems. n63

The American Federation of State, County and Municipal Employees ("AFSCME") submitted proposals for non-binding shareholder votes on executive compensation packages to eight companies in 2006, receiving over 40% affirmative votes (but less than a majority) at two companies; it plans to submit such proposals to numerous companies in 2007. The United Brotherhood of Carpenters and Joiners intends to submit at least 80 proposals requesting that executive bonuses be tied to peer performance. CalPERS is pressing for shareholder approval for companies to enter into executive severance agreements which would pay out more than 2.99 times the executive's base salary and bonus. Shareholder activists are hostile generally to classified boards and would like to see universal declassification. (Over half of companies in the S&P 1500 Composite Index or listed on the NYSE have staggered boards.) n64 A consortium of large institutional pension funds representing \$3.4 trillion in invested assets internationally have urged the SEC to allow shareholders access to the proxy for resolutions relating to the director electoral process. The SEC, in reaction to the Second Circuit's reversal of the Commission's no-action position allowing AIG to omit a shareholder access proposal n65 has announced that it will address the proxy access issue by new rule-making soon. Signatories to the letter to the Commission included California State Teachers Retirement System, London Pensions Fund Authority, PGGM in the Netherlands, and the Ontario Teachers Pension Fund. n66 Business Roundtable President John J. Castellani, in announcing opposition to any such rule changes, has raised the possibility of a lawsuit challenging the Commission's authority if the Commission does adopt a proxy access rule. n67

[f] State Law. While, in general, state law is superseded when it conflicts with the requirements of Section 14(a), such pre-emption may not be without its exceptions. In *Newcastle Partners, L.P. v. Vesta Insurance Group, Inc.*, n68 the Delaware Court of Chancery held that the defendant was obligated under Section 211(c) of the Delaware General Corporation Law to hold an annual meeting within thirteen months of its last Annual Meeting despite the fact that it was prohibited under Rules 14c-2 and 14c-3 promulgated under the Securities Exchange Act of 1934 from holding its annual meeting because the company did not have audited financials on file with the SEC. The Court stated that the state law requirement is not preempted by the Federal Rules, primarily on the ground that in the broader sense the state and federal laws are basically compatible. The Court noted:

None of Vesta's shareholders have had the opportunity to vote their shares in 18 months, and Vesta cannot provide reliable guidance on when the audited financial statements required to prepare an annual report may become available. Few circumstances could be more consistent with the federal law's purpose of protecting the shareholder's franchise than this Court's Order directing that Vesta's shareholders be allowed to vote and, if they choose, to replace one or more of the directors standing for re-election. The Court also notes that its Order is consistent with the important policies underlying the internal affairs doctrine that the power of the state of incorporation to mandate stockholder meetings in appropriate circumstances not be lightly overturned. n69

Interpreting a Florida statute, the Delaware Chancery Court ruled that a majority shareholder may have breached its fiduciary duty of disclosure in a freeze-out merger by giving minority shareholders only the 10-day minimum statutory notice of the meeting, where the ten days included only four business days (over the July 4 holidays). In denying a Motion to Dismiss, the Court held that the defendant may have breached its duty of candor even assuming the truthfulness of the proxy materials. *Berger v. Intelident Solutions, Int'l.*, n70

The Court stated:

Where a controlling stockholder purposefully manipulates the timing of the proxy process in a cash-out merger so as to preclude a minority stockholder from enjoying any realistic opportunity to exercise his statutory appraisal rights, a breach of the duty of disclosure occurs. Such a breach, as it plainly implicates the procedural fairness of a transaction, is properly addressed in an action outside an appraisal proceeding. n71

The Alaska Supreme Court has ruled in favor of corporate directors who violated the proxy disclosure requirements imposed by Alaska statute where the violations were inadvertent and made in good faith reliance on the advice of competent legal counsel. n72

Delaware has adopted changes to the Delaware General Corporation Law, effective August 1, 2009, permitting (but not requiring) Delaware corporations to adopt bylaws requiring the inclusion of nominees for election to the board of directors which are submitted by stockholders in addition to individuals nominated by the board of directors, subject to such conditions as may be provided in the bylaws, including a requirement as to a minimum level of stock ownership. The new law is summarized in Section 7.04[2][b][i], note 33.

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 78n(a).

(n2)Footnote 2. 15 U.S.C. § 78 l .

(n3)Footnote 3. 17 C.F.R. § 240.14a-1 *et seq.*

(n4)Footnote 4. 17 C.F.R. § 240.14a-101.

(n5)Footnote 5. 15 U.S.C. § 78n(c).

(n6)Footnote 6. 17 C.F.R. § 240.14c-1 *et seq.*

(n7)Footnote 7. 17 C.F.R. § 240.14c-101.

(n8)Footnote 8. Rule 14a n.1(f) under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G, 17 C.F.R. § 240.14a-1(f), states: "The term 'proxy' includes every proxy, consent or authorization within the meaning of section 14(a) of the Act. The consent or authorization may take the form of failure to object or to dissent."

(n9)Footnote 9. *McClellan v. Bradley*, 299 F. 379, 388 (6th Cir.) , *cert. denied*, 266 U.S. 619 (1924) .

(n10)Footnote 10. See Eisenberg, *Access To The Corporate Proxy Machinery*, 83 Harv. L. Rev. 1489, 1490-91, 1494 (1970).

(n11)Footnote 11. See, e.g., Del. Gen. Corp. Law, § 212(b).

(n12)Footnote 12. "Management of properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies. Insiders having little or no substantial interest in the properties they manage have often retained control without an adequate disclosure of their interest and without an adequate explanation of the management policies they intend to pursue. Insiders have at times solicited proxies without fairly informing the stockholders of the purposes for which the proxies are to be used and have used such proxies to take from the stockholders for their own selfish advantage valuable property rights." H. Rep. No. 1383, 73d Cong., 2d Sess., 13-14 (1934), reprinted in Pt. 2A *infra*. See also S. Rep. No. 792, 73d Cong., 2d Sess. (1934).

See also *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 444, 96 S. Ct. 2126, 2130, 48 L. Ed. 2d 757, 763 (1976) ; *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 381, 90 S. Ct. 616, 620, 24 L. Ed. 2d 593, 600 (1970) .

See Emerson & Latham, *SEC Proxy Regulation: Steps Toward More Effective Stockholder Participation*, 59 Yale L.J. 635 (1950). See Pennsylvania's Control Shares Act (15 Pa. Cons. Stat. Ann. § 2562 *et seq.* , relied on in *Committee for New Management of Guaranty Bancshares Corp. v. Dimeling*, 772 F. Supp. 230 (E.D. Pa. 1991) (to disenfranchise an insurgent group of proxy holders because the proxies conferred discretionary authority contrary to the statute).

State courts, exercising their equity jurisdiction, may act to prevent or remedy fraud or material misrepresentation occurring during the proxy solicitation process. Based on findings of fraud or misrepresentation, state courts have enjoined the holding of a meeting and have set aside an election or other corporate action. See *Lieferant v. Bartell*, 36 Misc. 2d 477, 232 N.Y.S.2d 1003 (N.Y. Sup. Ct. 1962) (action to undo a merger); *Skora v. Great Sweet Grass Oils, Ltd.*, 30 Misc. 2d 572, 205 N.Y.S.2d 98 (N.Y. Sup. Ct. 1960) (voting of proxies enjoined).

(n13)Footnote 13. 15 U.S.C. § 78n.

(n14)Footnote 14. Report of Special Study of Securities Markets of the Securities and Exchange Commission, H. Doc. No. 95, 88th Cong., 1st Sess., Pt. 3 pp. 3-4 (1963).

(n15)Footnote 15. 15 U.S.C. § 80a-1 *et seq.*

(n16)Footnote 16. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 381, 90 S. Ct. 616, 620, 24 L. Ed. 2d 593, 600 (1970) .

"The purpose of [Section 14] and the Commission rules and regulations thereunder is to provide shareholders with an opportunity to exercise their corporate franchise on the basis of accurate and adequate information."

S. Rep. No. 379, 88th Cong. 1st Sess. (1963), reprinted in the Primary Law Sourcebook, Volume C, Section I of the 1934 Act. *infra*.

1-7 Federal Securities Exchange Act of 1934 § 7.01

See also *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 444, 96 S. Ct. 2126, 2130, 48 L. Ed. 2d 757, 763 (1976) , discussed in § 7.09[5] *infra*.

(n17)Footnote 17. *SEC v. May*, 229 F.2d 123 (2d Cir. 1956) ; *United States v. Guterma*, 189 F. Supp. 265 (S.D.N.Y. 1960) .

(n18)Footnote 18. See § 7.02 *infra* for a discussion of what activities constitute a "solicitation" subject to the requirements of Regulation 14A.

(n19)Footnote 19. 17 C.F.R. § 240.14a-1 *et seq.*

(n20)Footnote 20. See § 7.04 *infra* for a discussion of Regulation 14A.

(n21)Footnote 21. 17 C.F.R. § 240.14a-101.

(n22)Footnote 22. 17 C.F.R. § 229.10 *et seq.*

(n23)Footnote 23. 17 C.F.R. § 240.14c-1 *et seq.*

(n24)Footnote 24. Such actions, although infrequent for public companies, can arise if action is to be taken by written consent of a small number of holders of the company's securities. For a discussion of Regulation 14C, See § 7.06 *infra*.

(n25)Footnote 25. 17 C.F.R. § 240.14a-3.

(n26)Footnote 26. Rule 14a-3 and Rule 14c-3, 17 C.F.R. § 240.14c-3.

(n27)Footnote 27. The specific requirements of Schedule 14A are described in § 7.04 *infra* .

(n28)Footnote 28. Sec. Exch. Act Rel. No. 34-43487 (Oct. 27, 2000).

(n29)Footnote 29. Shareholder Choice Regarding Proxy Materials, Sec. Exch. Act Rel. No. 34 56135 (July 26, 2007). The new requirements are discussed more fully in Section 7.01[8][d], *infra* .

(n30)Footnote 30. 17 C.F.R. § 240.14a-4.

(n31)Footnote 31. Rule 14a-4(b)(1).

(n32)Footnote 32. Rule 14a-4(c); 17 C.F.R. § 240.14a-4(c).

(n33)Footnote 33. Regulation 14C is discussed in § 7.06 *infra*.

(n34)Footnote 34. Rule 14a-6, 17 C.F.R. § 240.24a-6, and Rule 14c-5, 17 C.F.R. § 240.14c-5. See § 7.04[2], *infra*

(n35)Footnote 35. Sec. Exch. Act Rel. No. 42055, Fed. Sec. L. Rep. (CCH) P 86,215 [1999-2000 Transfer Binder] (Oct. 22, 1999).

(n36)Footnote 36. For a discussion of remedies for failure to comply with the requirements of Regulation 14A or Regulation 14C, See § 7.09 *infra*.

(n37)Footnote 37. See also Report of the Advisory Committee on Corporate Disclosure to the SEC, 95th Cong. 1st Sess. (Comm. Print 95-29) Vol. 1 p. 403 (1977) ["Advisory Report"]; Schwartz, *A Case for Federal Chartering of Corporations*, 31 *Bus. Law.* 1125 (1976); Moscow, *The Independent Director*, 28 *Bus. Law.* 9 (1972); Eisen berg, *Access to the Corporate Proxy Machinery*, 83 *Harv. L. Rev.* 1489 (1970).

Concerns about the increasingly widening gulf between management and shareholders gave rise to fears of legislative interference in the corporate process:

The estrangement of the public shareholder, so well articulated by Berle and Means [*See infra*] 50 years ago, continues today. Ownership of public companies has become broader and even more dispersed than in 1932. Control has correspondingly become more safely lodged in the hands of management. Although large shareholdings may be more common today than in 1932, they are in the hands of bank trust departments, pension funds, ESOPs, insurance companies and mutual funds. These types of institutions seem paralyzed, like Gulliver in Lilliputia [sic], by the threads of thousands of concerns and restraints which prevent them from seeking an active role in management. Public companies and their managers are thus cut off from the sources of their legitimacy--the corporate owners for whom they act. As the connection grows more tenuous, any mechanism which fosters accountability becomes more important to avoiding the final, unacceptable conclusion that public companies exercise unchecked power in our society. If, rightly or wrongly, that perception becomes accepted as true, society may be expected to react by imposing mandatory restraints on management's discretion.

"The SEC and Shareholder Proposals: Simplification in Regulation," speech by Commissioner Bevis Longstreth before the National Association of Manufacturers, Denver, Colorado, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,067, at 84,705 (Dec. 11, 1981); Berle & Means, *The Modern Corporation and Private Property* (1932).

(n38)Footnote 38. *See* n.41 *infra*.

(n39)Footnote 39. Sec. Act Rel. No. 33-6940 (June 23, 1992) as modified, Sec. Act Rel. No. 33-6941 (July 10, 1992), [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) PP 85,003, 85,008 (1992).

(n40)Footnote 40. Sec. Exch. Act Rel. No. 34-30849, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,002 (June 24, 1992).

(n41)Footnote 41. Executive Compensation and Related Person Disclosures, Sec. Act. Rel. No. 33-8732A, Sec. Exch. Act Rel. 34-54302A, 17 *Fed.Reg.* 35158 -53266 (Sept. 8, 2006), effective November 7, 2006 for proxy filings related to fiscal years ending on or after December 15, 2006.

(n42)Footnote 42. As reported in *The Wilson Quarterly*, Winter 2007, "The New Yacht Club" by Steven Lagerfeld, 38, 42.

(n43)Footnote 43. Sec. Exch. Act Rel. No. 34-14970, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,645 (July 18, 1978) (proposed); Sec. Exch. Act Rel No. 34-15384, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,766 (Dec. 6, 1978) (adopted).

(n44)Footnote 44. Sec. Exch. Act Rel. No. 34-16104, Fed. Sec. L. Rep. (CCH) P 82,176 (1979) (proposed); Sec. Exch. Act Rel. No. 34-16356, Fed. Sec. L. Rep. (CCH) P 82,358 (1979) (adopted).

(n45)Footnote 45. Sec. Exch. Act Rel. No. 34-15384, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,766 (Dec. 6, 1978).

(n46)Footnote 46. Sec. Act Rel. No. 33-6962, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,056 (Oct. 21, 1992); Sec. Exch. Act Rel. No. 34-31326, Fed. Sec. L. Rep. (CCH) P 85,052 (Oct. 22, 1992).

(n47)Footnote 47. *See Faber, et al. v. Parent, et al.*, 164 *Fed.Appx* 596, 2006 *U.S. App. LEXIS* 1704 (9th Cir. 2006), where the 9th Circuit Court of Appeals reversed the granting by the District Court for the District of Arizona of

a preliminary injunction against Parent, who controlled 50.8% of defendant Gold Spring, Inc., and had signed consent resolutions that purported to remove seven board members and thereby take control of Gold Spring. The District Court had granted the preliminary injunction to restrain Parent's takeover on the ground that Parent failed to file and disseminate a proxy statement before his group could sign the consent resolutions. Parent claimed in opposition that because he had solicited 10 or fewer shareholders to join the takeover, he was exempt from the proxy statement requirement of § 14(a)-3. The appeals court vacated the injunction effective 90 days after its decision and remanded to the District Court to provide the District Court with an opportunity to determine facts which would support the preliminary injunction, stating that the plaintiff must show as an "irreducible minimum" a "fair chance of success on the merits."

(n48)Footnote 48. Executive Compensation and Related Person Disclosures, Sec. Act. Rel. No. 33-8732A, Sec. Exch. Act Rel. 34-54302A, 17 Fed.Reg. 35158 -53266 (Sept. 8, 2006), effective November 7, 2006 for proxy filings related to fiscal years ending on or after December 15, 2006.

(n49)Footnote 49. In a speech before the 27th Annual Ray Garrett Jr. Corporate and Securities Law Institute on May 7, 2007, John White, then Director, Division of Corporation Finance of the SEC, agreed with critics that some companies appear to be incorrectly relying on the confidentiality exemption in providing disclosure about performance targets for executive compensation, and that some other companies may simply be failing to make the required disclosure. Companies which rely on the confidentiality exemption also in many cases are failing to provide investors with an adequate sense of how hard the targets are to achieve or how likely it is they will be met (even though the targets are not disclosed). Further rule making in this area, according to White, is very possible. Other areas being looked at in response to criticism are the use of negative numbers in reporting under the new tables; disclosures regarding the role of the CEO, with specific reference to specific activities by the CEO vis-a-vis the compensation committee; and disclosure about perquisites, where the new rules appear to be having a significant impact on the amount of disclosure currently as compared with prior years. He announced that the Commission has initiated a "review project" that will analyze compliance with the new rules which will be released in the fall of 2007. Director White followed this with a speech delivered to the American Bar Association Committee on Federal Regulation of Securities on August 14, 2007, in which he outlined the Commission's agenda for 2007, re-emphasizing his concerns about the adequacy of disclosure of executive compensation and performance targets, and the importance of the Commission's alternate proposals on shareholder director nominations, discussed in § 7.07, *infra*. In a speech given on March 23, 2007, before a corporate governance seminar at the University of Southern California's Marshall School of Business, then SEC Chairman Christopher Cox noted that "alarm bells are ringing" as the Staff is seeing examples of "over lawyering" that are leading to 30 to 40 page executive compensation sections in proxy statements, particularly the lack of adherence to a plain English standard in writing the sections.

(n50)Footnote 50. For smaller reporting companies, formerly known as small business issuers, Regulation S-K requires disclosure if the amount involved exceeds the lesser of \$120,000 or 1% of the average of the small business issuer's total assets at year end for the last three completed fiscal years.

(n51)Footnote 51. Release No. 33-8765, 34-55009.

(n52)Footnote 52. Dated Dec. 22, 2006.

(n53)Footnote 53. 39 Sec. Reg. Law Rep. 173 (Feb. 5, 2007).

(n54)Footnote 54. 2251 Fed. Sec. Law Rep. 3. (Nov. 6, 2006). See discussion in XXXI *The Corporate Counsel* (November-December 2006).

(n55)Footnote 55. Shareholder Choice Regarding Proxy Materials, Sec. Exch. Act Rel. No. 34 56135, effective January 1, 2008 (except Rules 14a-16(d)(3) and 14a-17(j)(3) are effective October 1, 2007).

(n56)Footnote 56. Rules 14a-3(a)(3)(i) and 14a-16(m) do not permit, or require, the use of the notice and access

model with respect to business combination transactions as defined in Rule 165, as well as transactions for cash consideration requiring disclosure under Item 14 of Schedule 14A. SEC Exchange Act Release 34-55146A (effective April 1, 2008).

(n57)Footnote 57. One factor contributing to this heightened activity could well have been the U.S. Department of Labor's Proxy Voting Project. The Proxy Voting Project was an enforcement project of the Labor Department, designed to monitor how investment managers with control over employee benefit plan assets exercise their stock voting responsibilities. The project was meant to provide guidance for fiduciaries in performance of their responsibilities and to discourage improper influence of other interested parties. 15 Pens. Rep. (BNA) 799 (May 16, 1988).

(n58)Footnote 58. *24 Sec. Reg. & L. Rep. (BNA) 13 (1992)* .

(n59)Footnote 59. Appearing on bloomberg.com, Feb. 12, 2007.

(n60)Footnote 60. *New York Times*, Feb. 18, 2007.

(n61)Footnote 61. Katz and McIntosh, Corporate Governance Update: Institutional Investors Ready Proxy Season "Wish Lists." Keynote address to the 25th Annual Institute on Federal Securities (Feb. 7, 2007); both texts are *available at* publications@wlrk.com.

(n62)Footnote 62. *New York Times Business Section*, p. 1 (Feb. 11, 2007).

(n63)Footnote 63. The ISS policy guidelines for 2007 are *available at* www.issproxy.com/policy/2007policy.jsp.

(n64)Footnote 64. *See* Corporate Governance Update, Institutional Investors Ready Proxy Season "Wish Lists", Katz and McIntosh, Wachtell, Lipton, Rosen & Katz, publications@wlrk.com.

(n65)Footnote 65. *AFSCME v. AIG*, Section 7.07[9], *infra* .

(n66)Footnote 66. Jim Hamilton's World of Securities Regulation, Saturday, October 28, 2006, p. 15.

(n67)Footnote 67. 38 Sec. Reg. Law Rep. 2046 (Dec. 11, 2006).

(n68)Footnote 68. 887 A.2d 975, 2005 Del. Ch. LEXIS 174 (Nov. 15, 2005) .

(n69)Footnote 69. 2005 Del. Ch. LEXIS 174, at **15 .

(n70)Footnote 70. 911 A.2d 1164, 2006 Del. Ch. LEXIS 178 (Oct. 12, 2006) .

(n71)Footnote 71. 2006 Del. Ch. LEXIS 178, at **31 .

(n72)Footnote 72. *Brown v. Dick*, 107 P.3d 260 (Alaska 2005).



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Federal Securities Exchange Act of 1934

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CHAPTER 7 Proxy Regulation

1-7 Federal Securities Exchange Act of 1934 § 7.02

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§ 7.02 Solicitation of Proxies

Section 14(a) n1 is applicable to proxy solicitations in respect of any security (other than an exempted security) registered under the Exchange Act. Rule 14a-1 n2 defines solicitation broadly; however, certain activities are exempt from the proxy rules. Exempt activities under Rule 14a-2 n3 include certain solicitations by a broker or bank involving securities carried in its own name or in street name; solicitations by persons if authority to vote is not sought and a form of proxy is not provided (unless such person falls within one of certain categories of persons); nonmanagement solicitations of ten or fewer persons; and certain solicitations by financial advisors. In addition to the exemptions carved out by Rule 14a-2, the court in *Schiller v. Tower Semiconductor, Ltd.*, n4 affirmed a lower court ruling that the SEC was within its authority in exempting foreign private issuers from the proxy solicitation rules pursuant to Rule 3a12-3.

The solicitation of proxies and the transmission of proxy material by exchange members or broker-dealers concerning securities held for their customers' accounts is regulated under Section 14(b) n5 and under rules issued by the stock exchanges. Solicitations may be made prior to the time a written proxy statement is furnished to security holders only under certain conditions.

[1] Introduction

A "solicitation" is defined in Rule 14a-1 as including:

- a request for a proxy, whether or not the request is accompanied by or included in a form of proxy;
- a request to execute or not to execute, or to revoke, a proxy; and
- the furnishing of a form of proxy or other communication to shareholders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.

The terms "solicit" and "solicitation," however, do not include the furnishing of a form of proxy to a shareholder upon the unsolicited request of the shareholder, a company's performance of the acts required by Rule 14a-7 n6 (mailing communications for shareholders), the performance by anyone of ministerial acts for a person soliciting a proxy and

certain public statements by shareholders concerning their intended vote. n7

Effective in 1992, the Commission adopted amendments to the proxy rules intended to facilitate communications among shareholders without requiring full compliance with the proxy rules. The principal means of accomplishing this goal were (i) to exclude certain actions from the definition of "solicit" and "solicitation" n8 and (ii) to provide that the proxy rules, other than Rule 14a-6(g) n9 and Rule 14a-9 n10 (the general antifraud rule applicable to proxy solicitations), would not apply to certain solicitations. n11

Effective January 24, 2000, the Commission further liberalized the proxy rules n12 to allow virtually unlimited oral and written communications with shareholders prior to filing of written proxy material so long as such communications are not false or misleading statements within the prohibition of Rule 14a-9 and *Rule 10b-5*, that they do not violate the selective disclosure rules set forth in Regulation FD n13 and, as to written communications, that they meet the requirements of Rule 14a-12 that they identify the participants in the solicitation and describe their interests (or state where such information can be obtained); are not accompanied by a form of proxy; and are filed the same day with the Commission with a prominent legend advising security holders to read the proxy statement. Any written communication to security holders must explain to investors that they can obtain the proxy statement and any other relevant documents free at the Commission's web site and describe which documents are available free from the participants. n14 The Commission makes it clear that the communications are permitted for an unrestricted length of time without a cooling-off period between the end of communications and the filing of proxy material (particularly with respect to merger and acquisition transactions).

Thus, the proxy rules are now intended to apply to oral communications only in a limited sense, in that false or misleading oral solicitations are still prohibited by Rule 14a-9, and written filing instructions relating to personal soliciting materials under Rule 14a-6(c) n15 continue to apply. Whether an oral solicitation not involving an instrumentality of interstate commerce or of a national securities exchange would be constitutionally subject to regulation is another matter. n16 There are, however, no reported decisions nor are there likely to be since the probability of a modern proxy solicitation that avoids all instrumentalities of interstate commerce is remote.

It is sometimes difficult to determine just when the process of solicitation begins. n17 The general rule is that any communication to shareholders that is a "part of a continuous plan ending in solicitation" is within the ambit of the Exchange Act. n18 The Commission has made its own general interpretation quite clear, saying:

Thus, statements made for the purpose of inducing security holders to give, revoke, or withhold a proxy by any person who has solicited or intends to solicit proxies, whether or not such statements are accompanied by an express request to give, revoke or withhold a proxy, may involve a solicitation within the meaning of the regulation, depending upon the particular facts and circumstances. n19

Obviously, this interpretation involves an inquiry into the motives and intent of the person sending out the material.

The sender of soliciting material does not necessarily have to be part of management or opposition. n20 It can be anyone, although an editorial reference in a newspaper is generally not intended to constitute a solicitation. n21 Furthermore, the solicitation may not necessarily be of a proxy to vote, as long as it is part of a soliciting campaign or is designed to affect the voting of shares. n22

It is not always clear whether dissemination of information would constitute a solicitation because it attempts to influence how a shareholder votes. In the view of the Commission, this uncertainty could inhibit shareholders from discussing matters relevant to their interest and the interest of other shareholders since the shareholder would have to choose between the considerable expense of preparing, filing and distributing proxy material meeting the requirements of Schedule 14A n23 or risking liability for having violated the proxy rules. In order to remove "unnecessary government interference in discussions among shareholders of corporate performance and other matters of direct

interest to all shareholders," n24 the Commission has adopted regulations removing from the definition of "solicitation" communications by certain persons and making most of the proxy rules inapplicable to certain types of solicitations. n25

[2] Excepted Activities--Rule 14a-2

Rule 14a-2(a) n26 provides that the proxy rules apply to any solicitation of proxies concerning securities registered pursuant to section 12, except for solicitations:

- by a person concerning securities carried in his or her own name or in the name of such person's nominee (otherwise than as voting trustee) or held in his or her custody provided such person (i) does not get paid, except for reasonable expenses; (ii) furnishes promptly to the person solicited all soliciting material received from any person for that purpose; and (iii) does no more than impartially instruct the beneficial owner to forward a proxy to the person, if any, to whom the beneficial owner wishes to give a proxy or impartially request from the beneficial owner instructions as to the authority to be conferred by the proxy and state that a proxy will be given if no instructions are received by a certain date; n27
- by a person concerning securities that such person beneficially owns; n28
- involved in the offer or sale of a security registered under the Securities Act, unless the securities are to be issued in a transaction specified in Rule 145(a) n29 under the Securities Act; n30
- relating to a plan of reorganization under Chapter 11 of the Bankruptcy Reform Act of 1978, as amended, if made after the entry of an order approving the written disclosure statement concerning the plan of reorganization and after, or concurrently with, the transmittal of such disclosure statement in accordance with the provisions of the Bankruptcy Reform Act of 1978, as amended; n31
- relating to transactions pursuant to Rule 62 under the Public Utility Holding Company Act of 1935; n32 and
- made through the medium of a newspaper advertisement that informs shareholders of a source from which they may obtain copies of a proxy statement, form of proxy and any other soliciting material and does no more than (i) name the company, (ii) state the reason for the advertisement, and (iii) identify the proposal or proposals to be acted upon by shareholders. n33

Rule 14a-2(b) exempts the following from the proxy rules, other than the filing requirements of Rule 14a-6(g) and the antifraud provisions of Rule 14a-9: n34

- certain communications in which the person making the solicitation does not seek the power to act as proxyholder or furnish a form of revocation, abstention, consent or authorization; n35
- any nonmanagement solicitation of 10 or fewer persons; n36 and
- the furnishing of proxy voting advice by any person (the advisor) n37 to any other person with whom the advisor has a business relationship n38 if (i) the advisor renders financial advice in the ordinary course of business; (ii) the advisor discloses to the recipient of the advice any significant relationship the advisor has with the company, any affiliate of the company, or a shareholder proponent of the matter on which the advice is given; and any material interest the advisor has in the matter to which the advice relates; (iii) the advisor is not paid for furnishing the advice by any person other than the recipient of the advice and other persons who receive similar advice under Rule 14a-2(b)(3); and (iv) the advisor is not

furnishing proxy voting advice on behalf of any person soliciting proxies or any participant in an election contest subject to Rule 14a-11; n39 and

- Any solicitation in connection with a limited partnership roll-up transaction as defined in Item 901(c) of Regulation S-K in which the holder of a security that is the subject of a proposed roll-up transaction engages in preliminary communications with other holders of securities that are the subject of the same limited partnership roll-up transaction for the purpose of determining whether to solicit proxies, consents, or authorizations in opposition to the proposed limited partnership roll-up transaction. This exemption does not apply (1) to a security holder who is an affiliate of the registrant or general partner or sponsor; or (2) to a holder of 5% or more of the outstanding securities of a class that is the subject of a proposed roll-up transaction who engages in the business of buying and selling limited partnership interests in the secondary market unless such holder discloses such ownership interest and any relations of the holder to the parties to the transaction or to the transaction itself. If the communication is oral, the disclosure may be oral. Whether written or oral, a notice must be filed with the Commission as required by Rule 14a-6(n) and the Notice of Exempt Preliminary Roll-up Communication. n40

Electronic Shareholder Forums. In February, 2008, the Commission adopted n41 amendments to Rule 14a-2 to clarify that participation in an electronic shareholder forum that could potentially constitute a solicitation subject to the proxy rules is exempt from most of the rules if all of the conditions to the exemption are satisfied. Rule 14a-2b(6) exempts any solicitation which does not seek the power to act as proxy for a shareholder and does not furnish or request a form of revocation, abstention, consent or authorization. The exemption only applies if the solicitation occurs more than sixty (60) days prior to the scheduled meeting date (if the company announces the meeting less than sixty (60) days before the meeting date, the solicitation may not occur more than two (2) days following the announcement). Persons relying on the exemption may make a solicitation of proxies at a later date without threatening the exemption's validity. Any communications that remain available on the forum after the sixty (60) day period must comply with the proxy rules if they constitute a solicitation unless otherwise exempt. The Commission also amended Rule 14A-17 to provide that persons establishing, maintaining or operating such a forum will not be liable under the federal securities laws for any statement or information provided by any other person participating in the forum.

Effective in October 1992, the Commission adopted rules exempting a broad range of activities from the proxy rules. n42 These rules, adopted largely as a result of increasing shareholder activism by institutional investors, n43 exclude from the definition of "solicit" and "solicitation" communications by a shareholder (other than a solicitation exempt under Rule 14a-2) stating how the shareholder intends to vote and the reasons therefor if the communication:

- is made by speeches in public forums, press releases, published or broadcast opinions, statements, or advertisements appearing in a broadcast media, newspaper, magazine or other bona fide publication disseminated on a regular basis;
- is directed to persons to whom the shareholder owes a fiduciary duty in connection with the voting of securities; or
- is made in response to unsolicited requests for additional information with respect to a prior communication described above. n44

Even the provisions of Rule 14a-9, the general antifraud rule applicable to proxy solicitations, would not apply to such communications.

Certain other communications are exempted from the rules requiring preparation and distribution of proxy soliciting material even if the communication is intended to influence how a shareholder will vote. This exemption is available for

any solicitation by or on behalf of any person who (i) does not, at any time during the solicitation, seek directly or indirectly, either on its own or another's behalf, the power to act as proxyholder for a shareholder and (ii) does not furnish or otherwise request, or act on behalf of a person who furnishes or requests, a form of revocation, abstention, consent or authorization. n45 A solicitation exempt under Rule 14a-2(b)(1) is nevertheless subject to the antifraud provisions of Rule 14a-9. In addition, if a solicitation to which Rule 14a-2(b)(1) applies is made by a shareholder who owns securities of the relevant class having a market value of over \$5 million, the shareholder making the solicitation is obligated to file material with the Commission. n46

The exemption provided for in Rule 14a-2(b)(1) for solicitations where the person making the solicitation does not request a form of revocation, abstention, consent or authorization is not available for solicitations made by certain classes of persons. The classes of persons for whom this exemption is not available are:

- the company or an affiliate n47 or associate n48 of the company (other than an officer or director or any person serving in a similar capacity); n49
- an officer or director of the company or any person serving in a similar capacity engaging in a solicitation financed directly or indirectly by the company; n50
- an officer, director, affiliate or associate of a person that is ineligible to rely on the exemption set forth in Rule 14a-2(b)(1) (other than a person specified in Rule 14a-2(b)(1)(i)), or any person serving in a similar capacity; n51
- any nominee for whose election as a director proxies are solicited; n52
- any person soliciting in opposition to a merger, recapitalization, reorganization, sale of assets or other extraordinary transaction recommended or approved by the board of directors of the company who is proposing or intends to propose an alternative transaction to which such person or one of its affiliates is a party; n53
- any person who is required to report beneficial ownership of the company's equity securities on a Schedule 13D, unless such person has filed a Schedule 13D and has not disclosed pursuant to Item 4 thereof an intent, or reserved the right, to engage in a control transaction, or any contested solicitation for the election of directors; n54
- any person who receives compensation from an ineligible person directly related to the solicitation of proxies, other than pursuant to Rule 14a-13; n55
- where the company is registered as an investment company under the Investment Company Act of 1940, n56 an "interested person" of the investment company; n57
- any person who, because of a substantial interest in the subject matter of the solicitation, is likely to receive a benefit from a successful solicitation that would not be shared pro rata by all other holders of the same class of securities, other than a benefit arising from the person's employment with the company; n58 and
- any person acting on behalf of any of the foregoing. n59

[3] Communications With Shareholders

Section 14(b) makes it unlawful for any member of a national securities exchange, or any broker or dealer registered

under the Exchange Act or any bank, association, or other entity that exercises fiduciary powers n60 to give, or to refrain from giving, a proxy, consent, authorization or information statement in respect of any security registered under Section 12 of the Exchange Act n61 or any security issued by a registered investment company and carried for the account of a customer. n62 Amendments to Section 14(b) to assure the dissemination of information to holders of securities registered under the Exchange Act in part resulted from the increasing use of "nominee" or "street name" registrations of securities. n63 To facilitate communications to shareholders and to assure dissemination of proxy material, information statements and annual reports, the Commission adopted Rule 14a-13 and Rule 14c-7, which impose certain obligations on a company with securities registered under the Exchange Act to identify the beneficial owners of securities held in nominee or street name. The Commission has also adopted Rule 14b-1 regulating the dissemination of information to beneficial owners by brokers and dealers and Rule 14b-2 regulating the dissemination of information to beneficial owners by banks, associations and other entities exercising fiduciary powers.

[a] Obligations of Companies in Facilitating Communications With Shareholders--Rule 14a-13. As part of its action to facilitate shareholder communications and to assure dissemination of information to beneficial owners, the Commission adopted Rule 14a-13. n64 Under this rule, if a company knows that any securities entitled to vote at a meeting for which the company intends to solicit proxies (or for which the company intends to solicit written consents or authorizations in lieu of holding a meeting), are held of record by a broker, dealer, voting trustee, bank, association or other entity that exercises fiduciary powers in nominee name or otherwise, the company must inquire of the record holder n65 by first-class mail or equally prompt means, requesting the following information:

- whether other persons are the beneficial owners n66 of the securities to which the solicitation relates and, if so, the number of copies of proxy and other soliciting materials needed to supply the materials to the beneficial owners; n67
- in the case of an annual meeting (or special meeting in lieu of an annual meeting) or written consents in lieu of such meeting, at which directors are to be elected, the number of copies of the annual report to shareholders necessary to supply such report to beneficial owners to whom such reports are to be distributed by such record holder or its nominee and not by the company; n68
- if the record holder has an obligation to provide beneficial owner information to the company n69 or to forward proxy soliciting and other materials, n70 whether the record holder has designated an agent to act on its behalf in fulfilling such obligation and giving the name and address of such agent; n71 and
- whether the record holder holds the company's securities on behalf of a respondent bank n72 and, if so, the name and address of each such respondent bank. n73

At the time the company makes an inquiry pursuant to Rule 14a-13(a)(1), the company must provide certain information to the record holder. The company must indicate to each record holder:

- whether the company intends to distribute its annual report directly to beneficial owners whose names, addresses and securities positions are disclosed by broker-dealers or banks, associations and other entities exercising fiduciary powers pursuant to Rule 14b-1 and Rule 14b-2;
- the record date; n74 and
- at the option of the company, any employee benefit plan established by an affiliate of the company that holds securities of the company that the company elects to treat as exempt employee benefit plan securities. n75

Rule 14a-13(a)(2) provides that within one business day of receipt by the company of a record holder's or respondent

bank's response indicating the names and addresses of its respondent banks, the company must make inquiry of and give notice to each such respondent bank. The contents of the inquiry and notice are the same as those required under Rule 14a-13(a)(1). An inquiry required by Rule 14a-13(a)(1) and (2) shall not cover beneficial owners of exempt employee benefit plan securities. n76

In general, the inquiry required under Rule 14a-13(a)(1) must be made at least 20 business days prior to the record date of the meeting of shareholders. n77 Exceptions to this general rule are:

- if such inquiry is impracticable 20 business days prior to the record date of a special meeting, as many days before the record date of such meeting as is practicable; n78
- if consents or authorizations are solicited, and such inquiry is impracticable 20 business days before the earliest date on which they may be used to effect corporate action, as many days before that date as is practicable; n79 or
- at such later time as the rules of a national securities exchange on which the class of securities in question is listed may permit for good cause shown. n80

If a record holder or respondent bank has informed the company under Rule 14b-1 or Rule 14b-2 that it has designated one or more offices or departments to receive requests for beneficial owner information, the inquiry made pursuant to Rule 14a-13(a)(1) must be made to such offices or departments in order for the inquiry to comply with the rule. n81

The company is required to supply, in a timely manner, n82 each record holder and respondent bank of whom the inquiries required by Rules 14a-13(a)(1) and 14a-13(a)(2) are made with copies of the form of proxy, proxy statement, other proxy soliciting material and annual report. These materials must be supplied in such quantities and assembled in such form and at such place(s) as the record holder or respondent bank may reasonably request in order to send such material to the beneficial owners. n83 Upon the request of any record holder or respondent bank that is supplied with proxy soliciting material or annual reports to be sent to beneficial owners, the company must pay the reasonable expenses of the record holder or respondent bank for completing the mailing of such material to beneficial owners. n84

[b] Obligations of Brokers and Dealers in Facilitating Communications With Shareholders--Rule 14b-1.

Rule 14b-1 n85 requires a registered broker-dealer: n86

(1) to respond, by first-class mail or equally prompt means, no later than seven business days after receiving an inquiry by or on behalf of a company soliciting proxies, consents or authorizations in accordance with Rule 14a-13(a) n87 or distributing an information statement in accordance with Rule 14c-7(a), n88 by providing a search card or otherwise that contains the following:

- (a) a statement of the approximate number of its customers who are beneficial owners n89 holding shares of the company in street name; n90
- (b) a statement of the number of its customers objecting to disclosure of their names, addresses and securities positions, if the company has indicated pursuant to Rule 14a-13(a) or Rule 14c-7(a) that it will distribute its annual report to beneficial owners who have not so objected; n91 and
- (c) the identity of the broker-dealer's agent, if any, for fulfilling its obligations under Rule 14b-1;

(2) to forward to its customers who are beneficial owners of the company's securities, the company's

annual report and proxy material or information statement not later than five business days after receipt of the materials from the company; n92 and

(3) to provide the company at the company's request the names, addresses and securities positions of its customers who are beneficial owners of the company's securities and who have not objected to such disclosure. n93

The date as of which information is to be provided may be any date specified by the company that is no earlier than five business days after receipt of the company's request. Where the broker-dealer employs a designated agent to carry out its obligations under Rule 14b-1, the five business day period runs from the date the agent receives the company's request. n94 Rule 14b-1(b)(2) contains the general obligation for a broker-dealer to forward proxy and other soliciting material, information statements and annual reports to shareholders to its customers who are beneficial owners of the company's securities upon receipt of such materials. The broker-dealer is obligated to forward such materials within five business days of their receipt by the broker-dealer.

There are exceptions to the obligations of a broker-dealer to provide information about beneficial owners pursuant to Rule 14b-1(b)(2). The first exception is that the broker-dealer may not include information in its response pursuant to Rule 14b-1(b)(1) or forward proxies (or in lieu thereof requests for voting instructions), proxy soliciting material, information statements or annual reports to shareholders where the beneficial owners of the securities are owners of exempt employee benefit plan securities. n95

The second exception to the obligations of a broker-dealer under Rule 14b-1(b)(2) is that the broker-dealer need not satisfy its obligations to provide lists of beneficial owners and to forward proxy and other material if the company does not provide assurance that the broker-dealer will be reimbursed for its direct and indirect expenses in performing the functions. n96 Further, a broker-dealer need not forward annual reports to non-objecting beneficial owners if the company informs the broker-dealer that the company will forward that material to those non-objecting beneficial owners identified by the broker-dealer, either directly or through its agent, in a list provided under Rule 14b-1(b)(3). n97

[c] Obligations of Banks, Associations and Other Fiduciaries in Facilitating Communications With Shareholders--Rule 14b-2. Rule 14b-2 n98 regulates the dissemination of proxy soliciting materials and information statements by banks, associations and other entities that exercise fiduciary powers. n99 Important in an understanding of Rule 14b-2 is the term "beneficial owner," which is defined for purposes of Rule 14b-2 as "any person who has or shares, pursuant to an instrument, agreement, or otherwise, the power to vote, or to direct the voting of a security." n100

Rule 14b-2 imposes obligations on a bank with respect to disseminating certain communications to beneficial owners and providing beneficial owner information to companies. Specifically, Rule 14b-2:

(1) requires a bank:

(a) to respond, by first class mail or other equally prompt means, directly to the company, no later than one business day after the date it receives an inquiry under Rule 14a-13(a) or Rule 14c-7(a), indicating the name and address of each of its respondent banks n101 that holds the company's securities on behalf of beneficial owners, if any; and

(b) to respond, by first class mail or other equally prompt means, directly to the company no later than seven business days after the date it receives an inquiry made in accordance with Rule 14a-13(a) or Rule 14c-7(a), by indicating, by means of a search card or otherwise:

(i) the approximate number of customers of the bank who are beneficial owners of the

company's securities that are held of record by the bank or its nominee; n102

(ii) if the company has indicated that it will distribute the annual report to shareholders to beneficial owners of its shares whose names, addresses and securities positions are disclosed pursuant to Rule 14b-2(b)(1)(ii); and

(iii) the number of beneficial owners of the company's securities who have not objected to disclosure of their names, addresses and securities positions; n103 and

(c) to provide the name of its designated agent, if any, acting on its behalf in fulfilling its obligations under Rule 14b-2(b)(1)(i) and (ii); n104

(2) requires a bank, within five business days after the record date for a meeting of shareholders:

(a) to execute an omnibus proxy, including a power of substitution, in favor of its respondent banks and forward such proxy to the company; n105 and

(b) to furnish a notice to each respondent bank in whose favor an omnibus proxy has been executed that the bank has executed such a proxy, including a power of substitution, in its favor pursuant to Rule 14b-2(b)(2)(i);

(3) requires a bank, upon receipt of proxy cards, proxy statements, other proxy soliciting material, information statements or annual reports to shareholders, to forward such materials to each beneficial owner on whose behalf the bank holds securities, no later than five business days after the date the bank receives such material n106 and, where a proxy is solicited, the bank must forward to the beneficial owner either:

(a) a properly executed proxy; n107 or

(b) a request for voting instructions; n108

(4) requires a bank:

(a) to respond, by first class mail or other equally prompt means, directly to the company, no later than one business day after the date it receives an inquiry made in accordance with Rule 14a-13(b)(1) or Rule 14c-7(b)(1) by indicating the name and address of each of its respondent banks that hold the company's securities on behalf of beneficial owners, if any; n109

(b) through its agent or directly, to provide the company, upon the company's request and within the time specified in Rule 14b-2(b)(4)(iii) with the names, addresses and securities positions, compiled as of a date specified in the company's request that is no earlier than five business days after the date the company's request is received of beneficial owners of the company's securities on whose behalf the bank holds securities; n110 and

(c) through its agent or directly, transmit the data specified in Rule 14b-2(b)(4)(ii) to the company no later than five business days after the date specified by the company. n111

With respect to customer accounts opened on or before December 28, 1986, n112 unless the bank has made a good faith effort to obtain affirmative consent to disclosure of beneficial ownership information, the bank must provide such information as to beneficial owners who do not object to disclosure of the information. n113

There are several exceptions to the requirement that a bank provide beneficial ownership information to a company and disseminate shareholder communications on behalf of a company.

(1) With regard to beneficial owners of exempt employee benefit plan securities, a bank may not:

(a) include information in its response pursuant to Rule 14b-2(b)(1) or forward proxies (or in lieu thereof requests for voting instructions), proxy soliciting material, information statements or annual reports pursuant to Rule 14b-2(b)(3) to such beneficial owners; n114 or

(b) include in its response pursuant to Rules 14b-2(b)(4) or (b)(5) data concerning such beneficial owners. n115

(2) The bank need not satisfy:

(a) its obligations under Rules 14b-2(b)(2) and (b)(3) if the company does not provide assurance of reimbursement of the bank's reasonable expenses, both direct and indirect, incurred in connection with performing the obligations imposed under those rules; n116

(b) its obligations under Rule 14b-2(b)(3) to forward annual reports to consenting and non-objecting beneficial owners identified to the company if the company notifies the record holder bank or respondent bank n117 that the company will mail its annual report to beneficial owners whose names, addresses and securities positions are disclosed.

(3) For purposes of determining the fees that may be charged by the bank to the company for providing beneficial owner information and for disseminating shareholder communications, fees are deemed reasonable if they do not exceed those permitted to be charged by brokers or dealers for reimbursement of their reasonable expenses, both direct and indirect, incurred in connection with their performing corresponding duties under Rules 14b-1(b)(2) and (b)(3).

[4] Solicitations Prior to Furnishing Proxy Statement--Rule 14a-12(a) and (b).

Rule 14a-12(a) and (b) n118 permits a solicitation to be made prior to the time a written proxy statement is furnished to shareholders if the following three conditions are met:

(1) each communication published, sent or given to shareholders must identify the participants in the solicitation n119 and describe their interests, direct or indirect, by security holdings or otherwise, or contain a prominent legend in clear, plain language advising security holders where they can obtain that information;

(2) no form of proxy is furnished to or requested from shareholders prior to the time the written proxy statement is furnished (but if a proxy statement has previously been furnished by the persons involved in the solicitation and it meets the requirements of Regulation 14A, including Rule 14a-3(a), n120 when furnished, the prohibition against furnishing forms of proxy is inapplicable; and

(3) all written communications must contain a prominent legend advising security holders to read the proxy statement when it is available because it contains important information, and must state that the proxy statement and any other relevant documents may be obtained free at the Commission's web site, and describe what documents are available free from participants.

The requirement of sending a written proxy statement meeting the requirements of Regulation 14A "at the earliest practicable date" has been eliminated to avoid the need to file such a statement after a merger has been abandoned prior to filing. n121 The written proxy statement must be sent if and when the proxy is solicited or form of proxy delivered.

If the solicitation relates to an election contest, the further requirements of Rule 14a-12(c) must be complied with. n122

Rule 14a-12(b) specifies that any soliciting material published, sent or given to shareholders prior to the furnishing of a written proxy statement must also be filed with the Commission no later than the date the material is published, sent or given to shareholders. At the same time, three copies of the material must be filed with, or mailed for filing to, each national securities exchange upon which any class of securities of the company is listed and registered. n123

[5] Payment of Compensation in Roll-up Transactions--Rule 14a-15.

Rule 14a-15 prohibits the payment of compensation to any person for soliciting proxies, consents or authorizations directly from security holders in connection with a roll--up transaction if the compensation is based on whether the person solicited either approves or disapproves the proposed roll--up transaction or is contingent on approval or disapproval or completion of the roll--up transaction. This limitation does not apply to finite--life entities that are not limited partnerships, or partnerships whose investors will receive new securities or securities in another entity that are not reported under a transaction reporting plan declared effective before December 17, 1993 by the Commission under Section 11A of the Exchange Act. In addition, this limitation does not apply to partnerships whose investors' securities are reported under a transaction reporting plan declared effective before December 17, 1993 by the Commission under Section 11A of the Exchange Act. n124

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 78n(a).

(n2)Footnote 2. 17 C.F.R. § 240.14a-1.

(n3)Footnote 3. 17 C.F.R. § 240.14a-2.

(n4)Footnote 4. 449 F.3d 286, 2006 U.S. App. LEXIS 13621 (June 1, 2006) .

(n5)Footnote 5. 15 U.S.C. § 78n(b).

(n6)Footnote 6. 17 C.F.R. § 240.14a-7.

(n7)Footnote 7. Rule 14a-1(l)(2), under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B Section G.

For a discussion of the requirements for mailing communications for shareholders pursuant to Rule 14a-7, See § 7.08[2] *infra*.

See *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 795 (8th Cir. 1967) (solicitation of membership in a voting trust fund was within the federal proxy rules).

See also *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715, 725-26 (8th Cir. 1974) , *cert. denied*, 419 U.S. 1107 (1975) (solicitation of consent to extend a voting trust agreement violated the proxy rules).

(n8)Footnote 8. Rule 14a-1(l)(2)(iv).

(n9)Footnote 9. 17 C.F.R. § 240.14a-6(g).

(n10)Footnote 10. 17 C.F.R. § 240.14a-9.

(n11)Footnote 11. Rule 14a-2(b).

(n12)Footnote 12. Sec. Exch. Act Rel. No. 42055 (Oct. 22, 1999), effective January 24, 2000.

(n13)Footnote 13. Sec. Exch. Act Rel. No. 42055 (Oct. 22, 1999); *see also* Sec. Exch. Act Rel. No. 43154 (Aug. 15, 2000) (adopting Regulation FD).

(n14)Footnote 14. Rule 14a-12(a)(1)(ii).

(n15)Footnote 15. 17 C.F.R. § 240.14a-6(c).

(n16)Footnote 16. *See* S. Bernstein & H. Fischer, *The Regulation of the Solicitation of Proxies*, 7 *U. Chi. L. Rev.* 226, 241 (1940).

(n17)Footnote 17. *Cf.*, for instance, *Union P. R. Co. v. Chicago & N.W. Ry.*, 226 *F. Supp.* 400 (N.D. Ill. 1964) (broker's report in the form of advisory was communication calculated to result in procurement, withholding or revocation of proxy) *with* *Brown v. Chicago, R.I. & P.R.R.*, 328 *F.2d* 122 (7th Cir. 1964) (newspaper advertisement by first railroad not accompanied by any proxy statement was not unlawful solicitation of stockholders of target second railroad where the advertisement was intended to counter the arguments of third railroad's application for approval of its proposal to acquire target railroad's stock).

See also *Smallwood v. Pearl Brewing Co.*, 489 *F.2d* 579, 600 (5th Cir.) , *cert. denied*, 419 *U.S.* 873 (1974) (a communication well in advance of any formal proxy request may be made under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy and thus be considered a solicitation within the proxy rules even though the letter does not itself request proxies).

(n18)Footnote 18. *SEC v. Okin*, 132 *F.2d* 784, 786 (2d Cir. 1943) ; *SEC v. Topping*, 85 *F. Supp.* 63 (S.D.N.Y. 1949) .

Under certain circumstances, "informational" letters can constitute solicitations of proxies. *Long Island Lighting Co. v. Barbash*, 779 *F.2d* 793 (2d Cir. 1985) ; *Sargent v. Genesco*, 492 *F.2d* 750 (5th Cir. 1974) .

In *Studebaker Corp. v. Gittlin*, 360 *F.2d* 692 (2d Cir. 1966) , a circularization of shareholders to obtain authorization to apply for inspection of the shareholders' list preparatory to solicitation was held to be a step in a proxy contest and thus to constitute a solicitation.

In *Suburban Elec. Sec. Co.*, 23 *S.E.C.* 5 (1946) , the mailing of a proxy with the notice of meeting was held to be a solicitation, though the notice stated that no proxies were being sought.

See also *Smallwood v. Pearl Brewing Co.*, 489 *F.2d* 579 (5th Cir.) , *cert. denied*, 419 *U.S.* 873 (1974) ; *Rosenblatt v. Northwest Airlines*, 435 *F.2d* 1121 (2d Cir. 1970) .

(n19)Footnote 19. Sec. Exch. Act Rel. No. 34-5276, Fed. Sec. L. Rep. (CCH) P 76,380 (1956).

(n20)Footnote 20. In *SEC v. Falstaff Brewing Corp.*, 629 *F.2d* 62 (D.C. Cir.) , *cert. denied sub nom. Kalmanovitz v. SEC*, 449 *U.S.* 1012 (1980) , the defendant was successful in acquiring control of a corporation by use of a proxy

solicitation. The court held him liable for a materially false and misleading proxy statement, although he was neither a shareholder, officer nor director of the corporation at the time of the solicitation. *Id.* at 68-69. The inaccuracies were found to have appeared with his knowledge and on his behalf, so his connection with the solicitation was pivotal. *Id.*

(n21)Footnote 21. Letter from the Division of Corporation Finance to the American Newspaper Publishers Association, Fed. Sec. L. Rep. (CCH) P 76,366 (Sept. 27, 1955).

(n22)Footnote 22. In *Studebaker Corp. v. Gittlin*, 360 F.2d 692 (2d Cir. 1966), the defendant was soliciting permission to represent the holders of the five percent stock interest necessary under New York law to compel access to the shareholders' list.

In *Dunning v. Rafton*, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,660 (N.D. Cal. Dec. 14, 1965), the defendant was circularizing the holders of voting trust certificates, urging them to join the defendant in terminating a voting trust, and enclosing a form for them to sign and file with the trustees.

However, *See* Rule 14a-1(l) for activities exempted from the definition of "solicit" and "solicitation."

(n23)Footnote 23. *See* § 7.04 *infra*.

(n24)Footnote 24. Sec. Exch. Act Rel. No. 34-31326, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 85,051, at 83,353 (Oct. 16, 1992).

(n25)Footnote 25. *See* Rule 14a-1(l)(2) and Rule 14a-2(b).

(n26)Footnote 26. 17 C.F.R. § 240.14a-2(a).

(n27)Footnote 27. Rule 14a-2(a)(1)(i)-(iii).

The provision of Rule 14a-2(a)(1)(iii) concerning the record owner's giving impartial instructions does not, however, prevent the record owner from giving requested advice to his or her principal, though the record owner may not give unsolicited advice. "A broker normally is not engaged in solicitation when responding, whether orally or in writing, to an unsolicited request from a customer for advice as to how to vote..." Sec. Exch. Act Rel. No. 34-7208, 3 Fed. Sec. L. Rep. (CCH) P 24,104 (1964).

Rules 450 through 460 of the New York Stock Exchange and Rules 701 through 726 of the American Stock Exchange Company Guide govern the transmission of proxy material by exchange members to beneficial owners.

Notwithstanding the provision in Rule 14a-2(a)(1)(iii), which would permit the record owner to give a proxy if no instructions are received by a specific date, the rules of the New York Stock Exchange and the American Stock Exchange limit the right of a member firm to vote shares which it holds in nominee name without specific instructions. Under Rule 452 of the New York Stock Exchange, a member organization generally may not vote securities that it holds in nominee name without specific instructions from the beneficial owner when the matter to be voted on:

(1) is not submitted to shareholders by means of a proxy statement comparable to that specified in Schedule 14A under the Exchange Act;

(2) is the subject of a counter-solicitation, or is part of a proposal made by a shareholder which is being opposed by management (*i.e.*, a proxy contest);

(3) relates to a merger or consolidation (except when the Company's proposal is to merge with its own wholly owned subsidiary, provided that dissenting shareholders do not have rights of appraisal);

1-7 Federal Securities Exchange Act of 1934 § 7.02

- (4) involves rights of appraisal;
- (5) authorizes mortgaging of property;
- (6) authorizes or creates indebtedness or increases the authorized amount of indebtedness;
- (7) authorizes or creates a preferred stock or increases the authorized amount of an existing preferred stock;
- (8) alters the terms or conditions of existing stock or indebtedness;
- (9) involves waiver or modification of preemptive rights (except when the company's proposal is to waive such rights with respect to shares being offered pursuant to stock option or purchase plans involving the additional issuance of not more than 5% of the company's outstanding common shares);
- (10) changes existing quorum requirements with respect to shareholder meetings;
- (11) alters voting provisions or the proportionate voting power of a class of stock, or the number of its votes per share (except where cumulative voting provisions govern the number of votes per share for election of directors and the company's proposal involves a change in the number of its directors by not more than 10% or not more than one);
- (12) authorizes issuance of stock, or options to purchase stock, to directors, officers or employees in an amount which exceeds 5% of the total amount of the class outstanding;
- (13) authorizes (a) a new profit-sharing or special remuneration plan, or a new retirement plan, the annual cost of which will amount to more than 10% of the company's average annual income before taxes for the preceding five years or (b) the amendment of an existing plan which would bring its cost above 10% of such average annual income before taxes, subject to certain exceptions;
- (14) changes the purposes or powers of a company to an extent which would permit it to change to a materially different line of business and it is the company's stated intention to make such a change;
- (15) authorizes the acquisition of property, assets or a company, where the consideration to be given has a fair value approximating 20% or more of the market value of the company's previously outstanding shares;
- (16) authorizes the sale or other disposition of assets or earning power approximating 20% or more of the company's existing assets or earning power prior to the transaction;
- (17) authorizes a transaction not in the ordinary course of business in which an officer, director or substantial shareholder has a direct or indirect interest; or
- (18) reduces earned surplus by 51% or more, or reduces earned surplus to an amount less than the aggregate of three years' common stock dividends of the company computed at the current dividend rate.

New York Stock Exchange, Supplementary Material to Rule 452. The American Stock Exchange imposes similar requirements on its member organizations. See American Stock Exchange, Commentary to Rule 577.

On February 26, 2009, the New York Stock Exchange filed an amended proposal with the SEC to amend its Rule 452 and Listed Company Manual Rule 402.08, to eliminate brokers' discretion to cast votes for shareholders who don't return voting instructions with respect to the election of directors where there is no proxy contest. The amended rule

would apply to shareholders' meetings held on or after January 1, 2010.

If not approved by the SEC by September 1, 2009, the effective date will be at least 4 months after the date of SEC approval but will not be a date within the first 6 months of a calendar year.

Thus far there appears to have been little public discussion of the impact that adoption of the proposed rule would have on those companies which have adopted the e-proxy notice and access model for shareholder voting, as well as those which have adopted majority voting for election of directors. At a minimum, one would expect such companies to incur substantially greater solicitation expenses in an effort to get out the vote in the face of apparent lethargy by shareholders.

New York Stock Exchange Rules are available at <http://rules.nyse.com/NYSE/NYSE%5FRules/>.

(n28)Footnote 28. Rule 14a-2(a)(2).

The solicitation of an irrevocable proxy in connection with an offer to purchase the security is exempt under this provision. *Mills v. Sarjem Corp.*, 133 F. Supp. 753 (D.N.J. 1955), based on Rule 14a-2(c), predecessor to Rule 14a-2(a)(2); *U.S. Smelting, Refining & Mining Co. v. Clevite Corp.*, Fed. Sec. L. Rep. (CCH) P 92,691 (N.D. Ohio 1968).

(n29)Footnote 29. 17 C.F.R. § 230.145(a).

(n30)Footnote 30. Rule 14a-2(a)(3).

The transactions specified in Rule 145(a) under the Securities Act are transactions where, pursuant to state law or the provisions contained in the company's certificate of incorporation or otherwise, there is submitted to the shareholders a plan or agreement generally involving the substitution or exchange of securities of the company (including a statutory merger or consolidation) or for the transfer of assets in consideration for securities of the transferee.

(n31)Footnote 31. Rule 14a-2(a)(4).

(n32)Footnote 32. Rule 14a-2(a)(5).

Rule 62, 17 C.F.R. § 250.62, under the Public Utility Holding Company Act, 15 U.S.C. § 79 *et seq.*, relates to reorganizations of registered public utility holding companies or subsidiaries thereof where the reorganization is subject to the approval of the Commission or to any other transaction which is or will be the subject of an application or declaration filed with the Commission under the Public Utility Holding Company Act.

(n33)Footnote 33. Rule 14a-2(a)(6).

(n34)Footnote 34. For a discussion of the filing requirements under Rule 14a-6(g), *see* § 7.04[3] *infra*.

For discussion of the antifraud provisions of Rule 14a-9, *see* § 7.04[4] *infra*.

(n35)Footnote 35. Rule 14a-2(b)(1).

This exemption is not available for solicitations made by certain persons. *See* the text accompanying ns. 41-47 *infra* for a more complete description.

(n36)Footnote 36. Rule 14a-2(b)(2).

This exception has been used to legitimize efforts to form a shareholders' committee and would apply to efforts to

form a control group in certain circumstances. The restriction is strictly construed to mean a solicitation by any person or group of persons of 10 persons in the aggregate whether or not they agree to participate in the solicitation.

At least where it is contemplated that other stock will be purchased, such a group is, however, subject to the provisions of Section 13(d)(1), 15 U.S.C. § 78m(d)(1) (requiring any person or group owning more than five percent of the equity securities of a company to file certain information with the Commission). Schedule 13D, required by Rule 13d-1, 17 C.F.R. § 240.13d-1, must also be filed. *Bath Indus., Inc. v. Blot*, 305 F. Supp. 526 (E.D. Wis. 1969), *aff'd*, 427 F.2d 97 (7th Cir. 1970).

The importance of Rule 14a-2(b)(2) exempting nonmanagement solicitations of not more than 10 persons is likely to decrease because of the exemption now contained in Rule 14a-2(b)(1) relating to solicitations where no form of proxy is requested. *See* text accompanying ns. 39-53 *infra* for a discussion of Rule 14a-2(b)(1).

This exception applies to the formation of a third contestant although there is already a proxy contest in progress. *Universal Container Corp. v. Slade*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,005 (S.D.N.Y. 1971).

(n37)Footnote 37. The term "advisor" includes financial analysts, investment advisors and broker-dealers. Sec. Exch. Act Rel. No. 34-16356, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,358 (1979). *See also* the discussion of Rule 14a-2(a)(1) *supra*.

(n38)Footnote 38. Under ordinary circumstances, the requirements of the proxy rules do not apply to the relationship between a client and his or her attorney or accountant. The proxy rules regulate the conduct only of participants in the solicitation of proxies. Sec. Exch. Act Rel. No. 34-16356, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,358, n.11 (1979).

(n39)Footnote 39. Rule 14a-2(b)(3)(i)-(iv).

For discussion of the requirements of Rule 14a-11, 17 C.F.R. § 240.14a-11, "Special Provisions Applicable to Election Contests," *see* § 7.08[1] *infra*.

(n40)Footnote 40. Rule 14a-2(b)(4)(i)-(ii).

For discussion of the requirements of Rule 14a-6, 17 C.F.R. § 240.14a-11, "Filing Requirements" with regard to Notice of Exempt Communications, *see* Section 7.04[3] *infra*.

(n41)Footnote 41. *Electronic Shareholder Forum*, Release 34-57172.

(n42)Footnote 42. Rule 14a-1(l)(2)(iv) and Rule 14a-2(b)(1).

(n43)Footnote 43. Suggestion has been made that the interest of institutional investors in being able to comment publicly on the performance of a company's management without the substantial expense of complying with the proxy rules is the result of the increasing percentage of the securities of public companies owned by institutional investors generally and pension plans in particular. Historically, the response by a shareholder dissatisfied with management's performance would be to sell the securities held. As the percentage of shares owned increases, the ability to sell such shares quickly without disrupting an orderly market decreases.

The effect of this exclusion is to require that activities that meet the requirements of Rule 14a-8(b)(1), but which arguably could be exempt from the definition of "solicitation" under Rule 14a-1(l)(2)(iv) must be treated as an exempt solicitation under Rule 14a-2(b)(1). As a result, such activities would be subject to the filing requirements of Rule 14a-6(g) and the antifraud provisions of Rule 14a-9.

(n44)Footnote 44. Rule 14a-1(l)(2)(iv).

(n45)Footnote 45. Rule 14a-2(b)(1).

(n46)Footnote 46. Rule 14a-6(g). *See § 7.04 infra.*

(n47)Footnote 47. "Affiliate" is defined in Rule 12b-2 as a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

(n48)Footnote 48. "Associate" is defined in Rule 14a-1(a). The term associate, used to indicate a relationship with any person, means (1) any corporation or organization (other than the company or a majority owned subsidiary of the company) of which such person is an officer or partner or is, directly or indirectly, the beneficial owner of 10 percent or more of any class of equity securities; (2) any trust or other estate in which such person has a substantial beneficial interest or as to which such person serves as trustee or in a similar fiduciary capacity; and (3) any relative or spouse of such person, or any relative of such spouse, who has the same home as such person or who is a director or officer of the company or any of its parents or subsidiaries.

(n49)Footnote 49. Rule 14a-2(b)(1)(i) under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G.

(n50)Footnote 50. Rule 14a-2(b)(1)(ii).

(n51)Footnote 51. Rule 14a-2(b)(1)(iii). Officers or directors of the company are not disqualified from this exemption because of the parenthetical in Rule 14a-2(b)(1)(iii). However, an officer or director of the company cannot rely on the exemption in Rule 14a-2(b)(1) if the solicitation is financed directly or indirectly by the company. *See* Rule 14a-2(b)(1)(ii).

(n52)Footnote 52. Rule 14a-2(b)(1)(iv).

(n53)Footnote 53. Rule 14a-2(b)(1)(v).

(n54)Footnote 54. Rule 14a-2(b)(1)(vi). For a discussion of the requirements of Schedule 13D, *see* § 7A.02[1][b][i] *infra*.

(n55)Footnote 55. Rule 14a-2(b)(1)(vii). Rule 14a-13, permits a record holder to request reimbursement from the company of the reasonable expenses for completing the mailing of proxy soliciting material to the beneficial owners.

(n56)Footnote 56. 15 U.S.C. § 80a-1 *et seq.*

(n57)Footnote 57. Rule 14a-2(b)(1)(viii). For a discussion of "interested person" of an investment company, *see* Lemke, "The Investment Company Act of 1940," § 83.06[3][a] in A.A. Sommer, Jr., gen. ed., *Securities Law Techniques* (Matthew Bender).

(n58)Footnote 58. Rule 14a-2(b)(1)(ix).

(n59)Footnote 59. Rule 14a-2(b)(1)(x).

(n60)Footnote 60. When Section 14(b) of the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section F, 15 U.S.C. § 78n(b), was amended in 1986 to authorize the Commission to regulate the giving or withholding of proxies, consents and authorizations by banks, associations and other entities exercising fiduciary powers, Section 14(b)(2) was added to the Exchange Act. Section 14(b)(2) provides that the Commission's authority under Section 14(b)(1) with respect to banks may not require the disclosure of the names of beneficial owners of securities in an account held by a bank on December 28, 1986, unless the beneficial owner consents to the disclosure.

However, the exception in Section 14(b)(2) does not apply to a bank which the Commission finds has not made a good faith effort to obtain the consent from such beneficial owners.

(n61)Footnote 61. For a discussion of the requirements for registration of securities under Section 12 of the Exchange Act, *see* § 4.01 *supra*.

(n62)Footnote 62. As amended to 1964, Section 14(b) of the Exchange Act applied only to the giving of proxies, consents or authorizations by members of registered stock exchanges and brokers or dealers who transacted a business in securities through a stock exchange member and applied only to securities registered on a national securities exchange. In 1964, Section 14(b) was amended to apply to any registered broker-dealer. The scope of Section 14(b) was again expanded in 1985 when the Commission's authority to issue regulations was expanded to include any bank, association or other entity that exercises fiduciary powers. (Shareholder Communications Act of 1985, Public Law 99-222, 99 Stat. 1737, § 2.) Finally, in 1990, the Commission's authority to issue regulations was expanded to include securities of a registered investment company. *See* the Shareholder Communications Improvement Act of 1990, Public Law 101-550, 104 Stat. 2721, § 302(a).

(n63)Footnote 63. The Commission's preliminary report on its "Street Name Study" pointed out problems presented by the practice of recording ownership in "street name," or in the name of a bank or other nominee, insofar as that form of registration inhibits shareholder communications:

The principal statutory provision designed to assure the transmission of information from issuers to their shareholders is Section 14. Section 14(a) makes it unlawful to solicit, in contravention of the Commission's rules and regulations, proxies to vote any security registered under Section 12. Section 14(b), which is designed to prevent brokers from unduly influencing corporate affairs, prohibits any broker-dealer from giving or refraining to give, in contravention of the Commission's rules and regulations, proxies with respect to any security registered pursuant to Section 12 and carried for the account of a customer.

In 1974 and 1975, the Commission sought commentary on the effectiveness of the communication process. The number of comments received was not substantial, and unfavorable comments appeared to relate to isolated breakdowns rather than to fundamental disorders.

For example, issuers described instances in which materials for beneficial owners were not requested at all or not requested promptly enough to permit timely transmission and instances in which materials provided to record holders were not transmitted to beneficial owners in a timely manner or were not transmitted at all. Some issuers and the American Society of Corporate Secretaries complained that persons who are not record holders of issuers' securities request sets of materials and bill the issuers for services purportedly performed in forwarding the materials to beneficial owners. Issuers also stated that banks and brokers request reimbursement for costs which often are substantially higher than the costs which issuers incur in direct mailing to shareholders, and one issuer suggested that issuers should not be required to reimburse intermediaries.

Brokers and banks complained that issuers failed to announce record dates early enough to permit proper handling of proxies and annual reports and sometimes failed to respond to requests for materials in a timely manner. Shareholders complained that they had not received issuer mailings or had not received proxies in time to permit them to be voted.

Preliminary Report of the Securities and Exchange Commission on the Practice of Recording the Ownership of Securities in the Records of the Issuer in Other Than the Name of the Beneficial Owner of Such Securities, Pursuant to Section 12(m) of the Securities Exchange Act of 1934, at 16, 17 (Dec. 4, 1975) (footnotes omitted).

(n64)Footnote 64. 17 C.F.R. § 240.14a-13.

(n65)Footnote 65. If the company's list of shareholders indicates that some of its securities are registered in the name of a clearing agency registered pursuant to Section 17A, 15 U.S.C. § 78q-1, of the Exchange Act (*e.g.*, "Cede & Co.," nominee for the Depository Trust Company), the company must also make appropriate inquiry of the clearing agency and thereafter of the participants in such clearing agency, who may hold securities on behalf of a beneficial owner or respondent bank, and must also comply with Rule 14a-1(i) with respect to any such participant. Note 1 to Rule 14a-13(a).

The rules are not clear as to when inquiry must be made of participants in registered clearing agencies. If the inquiry of participants in registered clearing agencies must be made in compliance with the timing requirements of Rule 14a-13(a)(3), the inquiry of the clearing agency, as a practical matter, would need to be made approximately two months before the record date for an annual meeting of shareholders.

(n66)Footnote 66. While neither Rule 14a-1 nor Rule 14a-13 contains a specific definition of "beneficial owner" for purposes of Rule 14a-13, it would be reasonable to assume that the definition in Rule 14b-2(a)(2) should apply. "Beneficial owner" is defined in Rule 14b-2(a)(2) to "include any person who has or shares, pursuant to an instrument, agreement or otherwise, the power to vote, or to direct the voting of a security." Because the purpose of Rules 14a-13 and 14b-2 is to facilitate communication and dissemination of information to beneficial owners, it would seem reasonable that "beneficial owner" for this purpose would not extend to persons who have or share investment power with respect to the securities but who do not have or share voting power.

(n67)Footnote 67. Rule 14a-13(a)(1)(i)(A).

(n68)Footnote 68. Rule 14a-13(a)(1)(i)(B).

(n69)Footnote 69. The obligation of broker-dealers and of banks, associations and other entities that exercise fiduciary powers to provide such information arises under Rule 14b-1(b)(3)(i) and Rule 14b-2(b)(4)(ii), respectively.

(n70)Footnote 70. The obligation of broker-dealers and of banks, associations and other entities that exercise fiduciary powers to transmit proxy soliciting and other materials arises under Rule 14b-1(b)(3)(ii) and Rule 14b-2(b)(e)(iii) respectively.

(n71)Footnote 71. Rule 14a-13(a)(1)(i)(C).

(n72)Footnote 72. "Respondent bank" is defined in Rule 14a-1(k), 17 C.F.R. § 240.14a-1(k), as "any bank, association or other entity that exercises fiduciary powers which holds securities on behalf of beneficial owners and deposits such securities for safekeeping with another bank, association or other entity that exercises fiduciary powers."

(n73)Footnote 73. Rule 14a-13(a)(1)(i)(D).

(n74)Footnote 74. Rule 14a-13(a)(1)(ii)(B).

(n75)Footnote 75. Rule 14a-13(a)(1)(ii)(C), 17 C.F.R. § 240.14a-13(a)(1)(ii)(C).

"Exempt employee benefit plan securities" is defined in Rule 14a-1(d), 17 C.F.R. § 240.14a-1(d), as:

(1) Securities of the company held by an "employee benefit plan," defined in Rule 14a-1(b) as any purchase, savings, option, bonus, appreciation, profit sharing, thrift, incentive, pension or similar plan primarily for employees, directors, trustees or officers (see Rule 14a-1(b)); or

(2) If the notice regarding the current solicitation has been given pursuant to Rule 14a-13(b)(3),

securities of the company held by an employee benefit plan where such plan is established by an affiliate of the company.

Under Rule 14b-1(c)(1) and Rule 14b-2(c)(1)(i), information is not to be provided by broker-dealers or banks with regard to beneficial owners of exempt employee benefit plan securities.

(n76)Footnote 76. Rule 14a-13(a)(2) under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G.

(n77)Footnote 77. Rule 14a-13(a)(3).

(n78)Footnote 78. Rule 14a-13(a)(3)(i).

The exemption in Rule 14a-13(a)(3)(i) applies only to special meetings and not to annual meetings. In scheduling annual meetings and preparing for them, a company should keep in mind that the inquiry required under Rule 14a-13(a)(1) must be made at least 20 business days prior to the record date and is not made in compliance with the rule if made 20 calendar days before the record date.

(n79)Footnote 79. Rule 14a-13(a)(3)(ii).

(n80)Footnote 80. Rule 14a-13(a)(3)(iii).

(n81)Footnote 81. Proviso to Rule 14a-13(a)(3).

(n82)Footnote 82. "Timely manner" is not defined for purposes of this requirement. However, it would be reasonable to assume that, at a minimum, the information would need to be delivered to record holders and respondent banks sufficiently in advance of the meeting that the record holder or respondent bank would have the time allowed to them under applicable rules for forwarding materials to the beneficial owners.

(n83)Footnote 83. Rule 14a-13(a)(4).

(n84)Footnote 84. Rule 14a-13(a)(5).

(n85)Footnote 85. 17 C.F.R. § 240.14b-1.

(n86)Footnote 86. *See* § 3.03 *supra* for a discussion of the requirements for the registration of broker-dealers.

(n87)Footnote 87. *See* § 7.02[3][a] *supra*.

(n88)Footnote 88. *See* § 7.06[4] *infra*.

(n89)Footnote 89. While Rule 14b-1 does not contain a specific definition of "beneficial owner" for purposes of Rule 14b-1 it would be reasonable to assume that the definition in Rule 14b-2(a)(2) should apply. *See* n.60 *supra*.

(n90)Footnote 90. Rule 14b-1(b)(1)(i).

(n91)Footnote 91. Rule 14b-1(b)(1)(ii).

(n92)Footnote 92. Rule 14b-1(b)(2).

(n93)Footnote 93. The information as to names, addresses and securities positions is to be given as of a date specified by the company in its request, provided that the date is no earlier than five business days after the date the company's request is received. *See* Rule 14b-1(b)(3)(i) In addition, the information so requested must be transmitted to

the company no later than five business days after the record date or other date specified by the company. *See* Rule 14b-1(b)(3)(ii).

If the broker or dealer employs a designated agent to act on its behalf in performing its obligations under Rule 14b-2(b)(3), the five business day time period for determining the date as of which the beneficial ownership information is to be compiled is calculated from the date the designated agent receives the company's request. *See* Note 1 to Rule 14b-1(b)(3).

Receipt of the request for information less than five business days before the requested compilation date does not excuse the broker-dealer from providing the information as to names, addresses and securities positions. Rather, the broker-dealer must compile the information as of a date which is no more than five business days after the receipt of the request and must transmit the information no less than five business days after the date of compilation. *See* Note 2 to Rule 14b-1(b)(3).

(n94)Footnote 94. Rule 14b-1(b)(3).

(n95)Footnote 95. Rule 14b-1(c)(1)(i).

"Exempt employee benefit plan securities" is defined in Rule 14a-1(d). *See* n.69 *supra*.

(n96)Footnote 96. Rule 14b-1(c)(2)(i).

(n97)Footnote 97. Under Rule 14b-1(c)(3), "reasonable expenses" may include a surcharge for each set of proxy materials of registered investment companies or of information statements mailed to beneficial owners at the rate of \$0.20 for each such set of proxy materials or information statements in the first year and \$0.185 for each such set of proxy materials or information statements in the second year following December 28, 1986 under paragraphs (b)(2) and (b)(3) of Rule 14b-1. While Rule 14b-1(c)(3) still refers to a permissible surcharge, it would appear that no such surcharge could be imposed now since the two--year period referred to has passed.

(n98)Footnote 98. 17 C.F.R. § 240.14b-2.

(n99)Footnote 99. As used in Rule 14b-2, "banks" is a collective reference to banks, associations and other entities that exercise fiduciary powers. *See* Rule 14b-2(a)(1).

(n100)Footnote 100. Rule 14b-2(a)(2).

Unlike "beneficial owner" as used in other contexts of the federal securities laws, "beneficial owner" for purposes of Rule 14b-2 is established by reference only to the sole or shared voting power over the securities.

If more than one person shares voting power, the provisions of the instrument creating that voting power governs the question of whether consent to disclosure of beneficial owner information has been given. *See* Note 1 to Rule 14b-2(a)(2).

Furthermore, if more than one person shares voting power or if the instrument creating that voting power provides that such power shall be exercised by different persons depending on the nature of the corporate action involved, all persons entitled to exercise such power are deemed beneficial owners. However, only one of the beneficial owners needs to be designated among the beneficial owners to receive proxies or requests for voting instructions, other proxy soliciting material, information statements and annual reports to shareholders, if the person so designated assumes the obligation to disseminate in a timely manner such materials to the other beneficial owners. *See* Note 2 to Rule 14b-2(a)(2). Neither the Rule nor the Note specifies the manner in which the designated person would assume the responsibility to disseminate the materials to the other beneficial owners.

(n101)Footnote 101. "Respondent bank" is defined in Rule 14a-1(k). *See* n.66 *supra*.

(n102)Footnote 102. Rule 14b-2(b)(1)(ii)(A).

(n103)Footnote 103. Rule 14b-2(b)(1)(ii)(B).

A different rule applies with respect to customer accounts opened by a bank on or before December 28, 1986. For such accounts, the bank is obligated to provide the number of beneficial owners of the company's securities who have affirmatively consented to the disclosure of their names, addresses and securities positions.

(n104)Footnote 104. Rule 14b-2(b)(1)(ii)(C).

If a bank or a respondent bank has informed the company that one or more designated offices or departments are to receive inquiries from the company under Rule 14a-13(a) or Rule 14c-7(a), then "receipt" for purposes of the one--and seven-business day requirements of Rule 14b-2(b)(1)(i) and (ii) means receipt by such designated offices or departments.

(n105)Footnote 105. Rule 14b-2(b)(2)(i).

(n106)Footnote 106. Rule 14b-2(b)(3).

(n107)Footnote 107. Any such proxy must (i) indicate the number of securities held by the bank for such beneficial owner; (ii) bear the beneficial owner's account number or other form of identification, together with instructions as to the procedures to vote the securities; (iii) briefly state which other proxies, if any, are required to permit the shares to be voted under the terms of the instrument creating that voting power or applicable state law; and (iv) be accompanied by an envelope addressed to the company or its agent, if not provided by the company.

(n108)Footnote 108. For the purpose of requesting voting instructions, the company's form of proxy may be used provided such proxy is voted in accordance with the instructions received. In addition, the request must be accompanied by an envelope addressed to the record holder bank or respondent bank. *See* Rule 14b-2(b)(3)(ii).

(n109)Footnote 109. Rule 14b-2(b)(4)(i).

(n110)Footnote 110. Rule 14b-2(b)(4)(ii).

(n111)Footnote 111. Rule 14b-2(b)(4)(iii).

If the bank employs a designated agent to act on its behalf in performing the obligations imposed on it by Rule 14b-2(b)(4)(i) and (ii), the five business day time period for determining the date as of which the beneficial owner information is to be compiled is calculated from the date the designated agent receives the company's request. In complying with the company's request for beneficial owner information under Rule 14b-2(b)(4)(ii), a bank need only supply the company with the names, addresses and securities positions of affirmatively consenting and non-objecting beneficial owners. *See* Note 1 to Rule 14b-2(b)(4).

If the bank receives a request from a company less than five business days before the requested compilation date, that fact does not excuse the bank from providing the requested information. However, the information may be compiled as of a date that is no more than five business days after receipt and the bank must transmit the information within five business days after the compilation date. *See* Note 2 to Rule 14b-2(b)(4).

(n112)Footnote 112. The obligation of a bank to provide information in response to an inquiry from a company is different for customer accounts opened on or before December 28, 1986. *See* Rule 14b-2(b)(1)(ii)(B)(1) and Rule 14b-2(b)(4)(ii)(A).

(n113)Footnote 113. Rule 14b-2(b)(5).

A bank will be deemed to have made a "good faith effort to obtain affirmative consent to disclosure of beneficial ownership information" if the bank makes an inquiry: (a) phrased in neutral language explaining the purpose of the disclosure and the limitations on the company's use thereof; (b) either in at least one mailing separate from other account mailings or in repeated mailings; and (c) in a mailing that includes as an enclosure a return card, postage paid. Rule 14b-2(b)(5) does not prescribe the exclusive method for a bank to make such good faith effort; rather, it provides a safe harbor for banks which choose to follow it. However, the rule does not specify what is required for an inquiry to be "phrased in neutral language." Since Rule 14b-2(b)(5)(ii) does not specify the number of mailings required to constitute "repeated mailings," a bank wishing to rely on Rule 14b-2(b)(5) would be prudent in making a separate mailing.

(n114)Footnote 114. Rule 14b-2(c)(1)(i).

(n115)Footnote 115. Rule 14b-2(c)(1)(ii).

(n116)Footnote 116. Rule 14b-2(c)(2)(i).

(n117)Footnote 117. Under Rule 14a-13(c) and Rule 14c-7(c), a company has the right to mail its annual report to shareholders directly to the beneficial owners identified pursuant to Rule 14b-2.

(n118)Footnote 118. 17 C.F.R. § 240.14a-12(a) and (b).

(n119)Footnote 119. The terms "participant" and "participant in a solicitation" are defined in Instruction 3(a) to Item 4 of Schedule 14A to include the following:

- (1) The company;
- (2) Any director of the company and any nominee for whose election as a director proxies are solicited;
- (3) Any committee or group which solicits proxies, any member of such committee or group, and any person whether or not named as a member who, acting alone or with one or more other persons, directly or indirectly, takes the initiative or engages in organizing, directing or arranging for the financing of any such committee or group;
- (4) Any person who finances or joins with another to finance the solicitation of proxies, except persons who contribute not more than \$500 and who are not otherwise participants;
- (5) Any person who lends money or furnishes credit or enters into any other arrangement, pursuant to any contract or understanding with a participant, for the purposes of financing or otherwise inducing the purchase, sale, holding or voting of securities of the company by any participant or other person, in support of or in opposition to a participant; except that such terms do not include a bank or a broker or dealer who, in the ordinary course of business, lends money or executes orders for the purchase or sale of securities and who is not otherwise a participant; and
- (6) Any person who solicits proxies.

Instruction 3(b) to Item 4 of Schedule 14A excludes from the terms "participant" and "participant in a solicitation" the following persons:

- (1) Any person or organization retained or employed by a participant to solicit shareholders and whose

activities are limited to the duties required to be performed in the course of such employment;

(2) Any person who merely transmits proxy soliciting material or performs other ministerial or clerical duties;

(3) Any person employed by a participant in the capacity of attorney, accountant or advertising, public relations or financial adviser, and whose activities are limited to the duties required to be performed in the course of such employment;

(4) Any person regularly employed as an officer or employee of the company or any of its subsidiaries and who is not otherwise a participant; or

(5) Any officer or director of, or any person regularly employed by, any other participant, if such officer, director or employee is otherwise a participant.

(n120)Footnote 120. For discussion of the requirements of Regulation 14A, *see* § 7.04[1] *infra*.

(n121)Footnote 121. *See* Sec. Exch. Act. Rel. No. 34-42055, effective January 24, 2000.

(n122)Footnote 122. *See* § 7.08[1][h], *infra*.

(n123)Footnote 123. While not specifically required by the Commission's rules, it is standard practice with respect to securities included in NASDAQ to provide to the National Association of Securities Dealers, Inc. information comparable to that which is required by the Commission's rules to be provided to a national securities exchange with respect to securities listed on such exchange.

(n124)Footnote 124. 17 C.F.R. § 240.14a-15.



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Federal Securities Exchange Act of 1934

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CHAPTER 7 Proxy Regulation

1-7 Federal Securities Exchange Act of 1934 § 7.03

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§ 7.03 Annual Report to Shareholders--Rule 14a-3(b); Smaller Reporting Companies

If the proxy solicitation is made on behalf of the issuer for the annual meeting involving election of directors, the material must be preceded or accompanied by n1 an annual report containing certain financial data. n2 Financial statements must be audited unless the corresponding statements included in the company's annual report filed or to be filed with the Commission for the same fiscal years are not required to be audited. n3 The annual report to shareholders, other than small business issuers and registered investment companies, must include the following financial information:

- audited balance sheets as of the end of the two most recent fiscal years and audited statements of income and cash flows for each of the three most recent fiscal years n4 prepared in accordance with Regulation S-X, n5 for the company and its subsidiaries on a consolidated basis;
- supplementary financial information required by Item 302 of Regulation S-K; n6
- information on changes in the disagreements between the company and its accountants concerning accounting and financial disclosure required by Item 304 of Regulation S-K; n7
- selected financial data required by Item 301 of Regulation S-K; n8
- management's discussion and analysis of financial condition and results of operations required by Item 303 of Regulation S-K; n9 and
- the quantitative and qualitative disclosures about market risk required by Item 305 of Regulation S-K. n10

The annual report to shareholders is also required to include the following information:

- a brief description of the general nature and scope of the business of the company and its subsidiaries during the most recent fiscal year; n11

- the company's industry segments, classes of similar products or services, foreign and domestic operations and export sales required by Item 101(b), (c)(1)(i) and (d) of Regulation S-K; n12
- the identity of each of the company's directors and executive officers, the principal occupation or employment of each director or executive officer, and the name and principal business of the organization by which such person is employed; n13 and
- the market price of and dividends on the company's common equity and related shareholder matters required by Item 201 of Regulation S-K. If the report precedes or accompanies a proxy statement or information statement relating to an annual meeting of security holders at which directors are to be elected (or a special meeting or written consents in lieu of such meeting), the performance graph required by Item 201(e) of Regulation S-K. n14

The Commission has provided less stringent disclosure requirements for "smaller reporting companies" (previously referred to as "small business issuers") n15 and changed the eligibility requirements to less than \$75,000,000.00 in public common equity float; where companies cannot calculate that float, eligibility will be based on whether the company had annual revenues of less than \$50,000,000.00 in their last fiscal year. The effect of the amendments is to make the reduced disclosure requirements for smaller companies available to a broader range of companies. The Commission has rescinded Regulation S-B and transferred to disclosure requirements applicable to "smaller reporting companies" to Regulation S-K. n16

Amended Regulation S-K will allow smaller reporting companies to:

- Provide three years rather than five years of business development activities, and not be required to provide segment disclosure under amended Item 101 of Regulation S-K;
- Not provide disclosure required by Items 301 and 302 relating to selected financial data and supplementary financial information;
- Provide more streamlined disclosure for management's discussion and analysis of financial condition and results of operations found in Item 303 by requiring only two years of analysis if the company is presenting only two years of financial statements, instead of the three years currently required of larger companies;
- Provide audited balance sheets, audited statements of income, cash flows and changes in stockholders' equity for each of the last two fiscal years in new Article 8 of Regulation S-X instead of an audited balance sheet as of the end of the last two fiscal years and audited statement of income, cash flows and changes in stockholders' equity for each of the last three fiscal years as required by other parts of Regulation S-X;
- Provide disclosure about the chief executive officer and two other highly compensated executive officers only, rather than the information for the Chief Executive Officer, Chief Financial Officer and three other executive officers required of larger registrants;
- Not provide a Compensation Discussion and Analysis required of larger reporting companies;
- Provide only three of the seven tables (Summary Compensation, Outstanding Equity Awards, and Director Compensation) required of larger reporting companies.

Smaller reporting companies will not be required to provide disclosure regarding the company's policies and procedures for approving related person transactions. They will be required, however, to provide disclosure regarding a transaction where the amount exceeds the lesser of 1% of a smaller company's total assets or \$120,000. They also will be required to provide additional specific information about underwriting discounts and commissions and corporate parents. Additionally, smaller reporting companies will be required to provide disclosure regarding promoters and certain control persons.

Either the company's proxy statement or its annual report to shareholders n17 must contain an undertaking in bold face or other reasonably prominent type face that the company will, upon written request, provide without charge to each person solicited a copy of the company's annual report filed with the Commission on Form 10-K n18 for the most recent fiscal year, including financial statements and financial statement schedules, as well as the name and address of the person to whom written requests are to be directed. n19 The request must contain a good faith representation that, as of the record date for the annual meeting, the person making the request was the beneficial owner of securities entitled to vote at the meeting. n20 If the company prepares an annual report to shareholders that meets all of the disclosure requirements of Form 10-K and files it with the Commission in satisfaction of its Form 10-K filing requirements, n21 the company is not also required to supply a Form 10-K to requesting shareholders who receive a copy of the integrated annual report to shareholders. n22

If the company is a registered investment company, the requirements of Rule 14a-3(b) are substantially different. A registered investment company's annual report need contain only the information required under Rule 14a-3(b)(1) (financial information), Rule 14a-3(b)(3) (supplementary financial information) and Rule 14a-3(b)(4) (information concerning changes in and disagreements with accountants on accounting and financial disclosure). For registered investment companies, the financial statements required by Rule 14a-3(b)(1) are financial statements only for the last fiscal year except for statements of changes in net assets, which are to be filed for the two most recent fiscal years. n23

The annual report to shareholders may be in any form deemed suitable by management. The information required by Rule 14a-3(b)(5) through (b)(10) may be included in an appendix or other separate section of the annual report as long as the attention of shareholders is called to that presentation. n24 Companies are encouraged to use tables, schedules, charts and graphic illustrations to present financial information in an understandable manner. Any presentation of financial information, however, must be consistent with the data in the financial statements contained in the annual report to shareholders, with cross-references to the financial statements and notes where appropriate. n25

The provisions of Rule 14a-3(b) are not applicable to company solicitations made before the financial statements are available if: (i) a solicitation is being made at the time in opposition to management; and (ii) the company's proxy statement includes an undertaking in bold face type to furnish the annual report to shareholders to all persons being solicited at least 20 days before the meeting. n26

If the company knows that securities of any class entitled to vote at a meeting are held of record by a broker, dealer, bank, voting trustee, other fiduciary or nominee, the company must inquire of the record holder, at least 20 business days prior to the record date for the meeting or such later time as the rules of the exchange on which the class of securities is listed may permit for good cause shown, whether other persons are the beneficial owners. If there are other beneficial owners, the inquiry must request information as to the number of copies of the proxy and other soliciting material, including an annual report to shareholders, necessary to supply these documents to the beneficial owners of the securities. n27 The company is then required to supply as many copies as are needed and to pay the record holder's reasonable mailing expenses. n28

In SEC Releases 33-7766 and 33-7912, the Commission adopted amendments to Rule 14a-3 to permit the delivery by issuers and brokers of one annual report and proxy statement (or information statement) to investors who share an address, (referred to by the Commission as "householding"), subject to receipt of express consent, or alternatively, implied consent subject to four conditions:

- (1) the investors must have the same last name, or the person relying on the rule must reasonably believe they are members of the same family;
- (2) at least sixty (60) days before householding begins, each investor must have received written notice (in plain English) with an opportunity to respond regarding the proposed householding, with a statement in bold face type: **"Important Notice Regarding Delivery of Security Holder Documents"** or similar statement, with a toll free telephone number disclosed in the notice, or a reply form accompanying the notice to object to householding;
- (3) the investors must not opt out of householding during this sixty (60) day period; and
- (4) the person relying on the rule must deliver the material to a residential street address or a post office box. n29

Companies which household must also include in their proxy statement or information statement:

- a statement that only one copy is being delivered to the household absent contrary instruction;
- a phone number and mailing address of a point of contact for canceling the householding;
- instructions on how to elect householding; and
- an undertaking to provide an additional copy of the annual report, proxy statement or information statement on request to any security holder who did not receive it.

Separate proxy cards must still be provided to each security holder.

Unless state law requires otherwise, a company is not required to send an annual report or proxy statement to a shareholder if either (i) a proxy statement and an annual report for two consecutive annual meetings, or (ii) all (but at least two) dividend or interest checks during a 12-month period, have been mailed to the shareholder's address and returned undelivered. n30

Seven copies of the annual report to shareholders must be mailed to the Commission when the report is first sent or given to shareholders, or when the preliminary proxy material (or definitive material if preliminary proxy material was not filed) is filed with the Commission pursuant to Rule 14a-6, n31 whichever is later. **The annual report to shareholders is filed for information purposes only and is not a part of the solicitation material. Its contents are not subject to the liability provisions of Section 18 of the Exchange Act, unless the company specifically requests that the annual report be treated as part of the proxy solicitation material or incorporates it in the proxy statement or other report by reference.** n32

FOOTNOTES:

(n1)Footnote 1. It is improper to send the proxy statement by first-class mail and the annual report by fourth-class mail. Sec. Exch. Act Rel. No. 34-7078, Fed. Sec. L. Rep. (CCH) P 24,103 (1963).

See also Ash v. GAF Corp., Fed. Sec. L. Rep. (CCH) P 99,591 (3d Cir. 1983), where, citing the construction given Rule 14a-3(b) by the Commission as well as the rule's purpose and legislative history, the Third Circuit, unlike the district court, held that the mailing of an annual report by third class mail, a few days before sending proxy materials by first class mail, violated Rule 14a-3(b) since it did not reasonably guarantee that the annual report would "accompany or precede" the proxy material. However, the court stated that as a prerequisite to recovery in an action brought under

Section 14(a) of the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section F for violation of Rule 14a-3(b), there must be proof of a violation, injury and a causal connection. In this case, appellant failed to prove that the annual report's late arrival damaged anyone's fundamental right to vote. In fact, there was evidence that appellant never voted at all. Furthermore, there was no proof that the integrity of the uncontested election was impaired by the improper mailing procedure. Rule 14a-3(b)(2)(ii) provides that where the annual report is delivered through an electronic medium, legibility requirements applicable to printed documents, such as type size and fonts, may be satisfied by presenting all information "in a format readily communicated to investors." Similar provisions apply to proxy statements (Rule 14a-5(d)(2)), and information statements (Rule 14c-4(d)).

(n2)Footnote 2. Rule 14a-3(b)(1) under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G.

As to annual meetings for which proxies are not solicited by management (in which case an information statement must be provided), Rule 14c-3 contains substantially the same requirements for furnishing annual reports to shareholders before or at the time the information statement is furnished. *See § 7.06 infra*.

(n3)Footnote 3. Rule 14a-3(b)(1).

(n4)Footnote 4. If a company other than a registered investment company has changed its fiscal year end, financial statements for two years plus a period of nine to twelve months will satisfy the three-year requirement for statements of income and cash flows. Note 2 to Rule 14a-3.

(n5)Footnote 5. 17 C.F.R. Part 210.

The provisions of Article 3 (General Instructions as to Financial Statements), other than Rules 3-03(e), 3-04 and 3-20, and Article 11 (Pro Forma Financial Information) of Regulation S-X are not applicable. Rule 14a-3(b)(1).

A separate report of predecessor accountants about financial statements for any period prior to the most recently completed fiscal year that were examined by them may be omitted from the annual report to shareholders if the company obtains a reissued report for the prior period from the predecessor accountants and the successor accountant states:

- (a) that the financial statements for the prior period were examined by the predecessor accountants;
- (b) the date of the predecessor accountants' report;
- (c) the type of opinion expressed by the predecessor accountants; and
- (d) the reasons for the opinion, if it was not unqualified.

However, the separate report of the predecessor accountant must be filed with the Commission as a financial statement schedule in the company's Form 10-K.

Note 1 to Rule 14a-3(b)(1).

For discussion of Regulation S-X, *see § 4A.01[3][a] supra*.

(n6)Footnote 6. Rule 14a-3(b)(3).

Item 302 of Regulation S-K, reprinted in the Primary Law Sourcebook, Volume D, Section K, "Supplementary

financial information" is discussed in § 4.03[4][b] *supra*.

(n7)Footnote 7. Rule 14a-3(b)(4).

Item 304 of Regulation S-K, "Changes in and disagreements with accountants on accounting and financial disclosure," is discussed in § 4.03[4][d] *supra*.

Disclosure of information concerning changes in and disagreements with accountants on accounting and financial disclosure is not required in an annual report to shareholders prepared in accordance with Rule 14a-3(b) if such information has been previously filed within the meaning of Rule 12b-2. Notwithstanding this general rule, the information required by Item 304(a) of Regulation S-K must be included in proxy material used in connection with a meeting of shareholders at which directors are to be elected or the selection of the company's accountants is to be approved or ratified. See Item 9 of Schedule 14A and Instruction 1 to Item 304 of Regulation S-K.

(n8)Footnote 8. Rule 14a-3(b)(5)(i).

Item 301 of Regulation S-K, "Selected financial data," is discussed in § 4.03[4][a] *supra*.

(n9)Footnote 9. Rule 14a-3(b)(5)(ii).

Item 303 of Regulation S-K, "Management's discussion and analysis of financial condition and results of operations," is discussed in § 4.03[4][c] *supra*.

(n10)Footnote 10. Rule 14a-3(b)(5)(iii).

(n11)Footnote 11. Rule 14a-3(b)(6).

Unlike other parts of Rule 14a-3(b) which refer specifically to corresponding disclosures required under Regulation S-K, Rule 14a-3(b)(6) does not specifically require a narrative description of the company's business which would provide the information required by Item 101(c)(1) of Regulation S-K.

(n12)Footnote 12. Rule 14a-3(b)(7).

Item 101(b), "Financial information about industry segments," (c)(1)(i), "Narrative description of business," and (d) "Financial information about foreign and domestic operations and export sales," of Regulation S-K is discussed in § 4.03[2][a][ii]-[iv] *supra*.

(n13)Footnote 13. Rule 14a-3(b)(8).

The phrase "executive officer" means the president, any vice president in charge of a principal business function, *e.g.*, sales, administration or finance, and any other officer who performs a policy-making function for the company. For these purposes, executive officers of a subsidiary may be deemed executive officers of the company if they perform policy-making functions for the company. Rule 3b-7.

(n14)Footnote 14. Rule 14a-3(b)(9).

Item 201 of Regulation S-K, "Market price of and dividends on the registrant's common equity and related stockholder matters," is discussed in § 4.03[3][a] *supra*.

(n15)Footnote 15. SEC Releases 33-8876, 34-56994 "Smaller Reporting Company Regulatory Relief and Simplification" (effective February 4, 2008).

(n16)Footnote 16. Item 10(f)(1) of Regulation 5-k.

(n17)Footnote 17. Many companies choose to include this undertaking in their proxy statement instead of their annual report to shareholders.

(n18)Footnote 18. The annual report on Form 10-K is discussed in § 4.02[1] *supra*.

(n19)Footnote 19. Rule 14a-3(b)(10).

The company is not required to furnish without charge copies of all exhibits to its Form 10-K if the annual report furnished to shareholders is accompanied by a list of all the exhibits not contained therein and the company indicates that it will furnish any exhibit upon payment of its reasonable expenses in providing the exhibit. *Id.*

(n20)Footnote 20. Note to Rule 14a-3(b)(10).

(n21)Footnote 21. An annual report to shareholders prepared on an integrated basis pursuant to General Instruction H to Form 10-K may be furnished in response to Rule 14a-3. Responses to items on Form 10-K are subject to the liability provisions of Section 18 notwithstanding the provisions of Rule 14a-3(c). Rule 14a-3(d). A company may combine and file annual reports to shareholders with the required information of Form 10-K if: (i) the combined report contains complete answers to all items required by Form 10-K; and (ii) the cover page and required signatures of the Form 10-K are included.

Electronic filers are instructed to file electronically only the portions of the integrated report which are filed in satisfaction of the requirements of the Form 10-K. General Instruction H to Form 10-K.

Section 18(a), discussed in § 5.03 *supra*, imposes civil liability for false or misleading statements contained in any application, report or document filed with the Commission pursuant to the Exchange Act.

(n22)Footnote 22. Rule 14a-3(b)(10).

(n23)Footnote 23. Rule 14a-3(b)(1) and (12).

(n24)Footnote 24. Rule 14a-3(b)(11).

(n25)Footnote 25. Note to Rule 14a-3(b)(11).

(n26)Footnote 26. Rule 14a-3(b)(13).

(n27)Footnote 27. Rule 14a-13, discussed in § 7.02[3] *supra*.

Note that the inquiry must be made a specified time prior to the record date, not the date of the shareholders' meeting. Also note that this requirement is based on business days rather than calendar days.

The company must also inquire of registered clearing agencies and thereafter of participants in such clearing agency whether the agencies or their participants hold securities for any beneficial owner, and, if so, to furnish them the appropriate proxy solicitation materials and annual reports pursuant to Rule 14a-13. Note 1 to Rule 14a-13.

The inquiry must be made by first-class mail or other equally prompt means; companies are exempt from the 20 business-day requirement in the case of special meetings where compliance is impracticable. *See* § 7.02[3] *supra*.

(n28)Footnote 28. Rule 14a-13(a)(4) and (5).

Companies are directed to the requirements of Rule 14b-1, discussed in § 7.02[3][b] *supra*, and applicable exchange rules for a discussion of the obligations of broker-dealers to obtain and promptly forward proxy solicitation materials and annual reports to beneficial owners for whom they hold securities.

(n29)Footnote 29. Rule 14a-3(e).

(n30)Footnote 30. Rule 14a-3(e)(2). A company's obligation to deliver annual reports or proxy statements is reinstated, however, if it obtains the shareholder's current address. *Id.*

(n31)Footnote 31. Rule 14a-6 is discussed in § 7.04[3] *infra*.

(n32)Footnote 32. Rule 14a-3(c)

For a discussion of the liability provisions of Section 18, *see* § 5.03 *supra*.



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Federal Securities Exchange Act of 1934

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CHAPTER 7 Proxy Regulation

1-7 Federal Securities Exchange Act of 1934 § 7.04

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§ 7.04 The Proxy Statement

The solicitation of proxies must be preceded or accompanied by a publicly-filed preliminary or definitive written proxy statement containing the information required by Schedule 14A. n1 Schedule 14A contains twenty-two items requiring disclosure of three categories of information: (i) information required regardless of the nature of the action to be taken at the shareholders' meeting; (ii) information required in connection with an annual meeting at which directors are to be elected; and (iii) information required only if specified proposals are to be voted upon by shareholders. The rules contain requirements as to the form of the proxy statement and its filing. The use in a proxy statement of a false or misleading statement with respect to a material fact or the omission of a material fact necessary to make such statement not false or misleading is prohibited.

[1] Content of Proxy Statement--Introduction

Solicitation of proxies is prohibited unless the person solicited has received a publicly-filed preliminary or definitive written proxy statement containing the information set forth in Schedule 14A. n2

The proxy statement must contain the information set forth in Schedule 14A. If a company (or other person) is not soliciting a proxy, reference should be made instead to Section 14(c) under the Exchange Act n3 and the regulations thereunder, which require preparation and dissemination of an information statement in lieu of a proxy statement. n4 Companies that meet the requirements of "smaller reporting companies" as defined in Item 10(f) of Regulation S-K n5 are subject to stringent disclosure requirements n6

Instead of including certain information in the proxy statement, a company may incorporate such information by reference to disclosures contained in other filings with the Commission but only to the extent specifically permitted by the items of Schedule 14A. n7 A company may not incorporate by reference a document that itself incorporates other material by reference or material that, if incorporated by reference, would render the proxy statement incomplete, unclear or confusing.

[2] Content of Proxy Statement--Schedule 14A

Schedule 14A is divided into 22 items; it is an integral part of the proxy rules. All information required by Schedule

14A must be included in the proxy statement, n8 unless incorporated by reference, although it is not necessary that the information appear in the order set forth in the schedule. n9 Information is required to be "clearly presented" and to be divided into groups according to subject matter. n10 Information that cannot be determined until some point in the future is permitted to be disclosed based upon present knowledge and intention. n11 The regulations also contain specific minimum requirements as to type size that must be used in the proxy statement, including any financial information. n12 All proxy statements are required to contain the date by which shareholder proposals for the next annual meeting are required to be received by the company for inclusion in its proxy statement for such meeting. n13 In addition, all proxy material is required to contain a statement of the date on which definitive copies have been or are intended to be released to shareholders. n14

It is not necessary to answer an item of Schedule 14A unless its subject matter is to be presented for a vote at the shareholders' meeting. n15 However, if an item to be voted upon also relates to the subject matter of a different item of Schedule 14A, disclosure under each of the items is required. n16 For example, in the case of a merger, often the transaction involves not only the merger but also the issuance of additional securities and perhaps also a charter amendment. In such case, disclosure under each of the applicable items of Schedule 14A would be required. In this example, disclosure under Item 11 (Authorization or Issuance of Securities Otherwise than for Exchange), Item 14 (Mergers, Consolidations, Acquisitions and Similar Matters) and Item 19 (Amendment of Charter, Bylaws or Other Documents) would be required.

The introductory Notes to Schedule 14A contain additional disclosure and other requirements applicable to proxy statements. If the proxy statement contains a shareholder proposal (i.e., a proposal by a party other than the company), the company is only required to include information with respect to its proposal (although it may choose to include disclosures required by items related to the shareholder's proposal). n17 In addition, the scope of information required about directors or executive officers of a company is also prescribed in the Notes to Schedule 14A. Note C requires that, except as otherwise specifically provided, information be given for all persons who held the applicable position with the company at any time during the period for which information is required to be disclosed in the proxy statement. Information may, however, be excluded for portions of the period during which the individual did not hold such position if the proxy statement so states.

The information to be included in a company's proxy statement can generally be divided into three categories: (i) information required regardless of the nature of the action to be taken at the shareholders' meeting; (ii) information required if action is to be taken regarding the election of directors (the typical annual meeting); and (iii) information required only if specified action is to be voted upon at the meeting.

Preliminary proxy materials, if required, must be filed with the Commission no later than 10 days prior to mailing definitive proxy materials to shareholders. Preliminary filing is not required if the only matters to be acted on are the election of directors; approval of accountants; a shareholder proposal; or the approval of a plan under Item 402 (a)(6)(ii) of Regulation S-K. n18 Companies which have obtained financial assistance from the Federal Government under the TARP program must submit to shareholders at each annual meeting a nonbinding proposal for approval of the company's executive compensation program; in such event, preliminary proxy materials with respect to such action must be filed with the Commission. n19

[a] General. Provisions--Cover Page; Items 1-6, 18, 20, 21. n20 Every proxy statement filed with the Commission is required to contain a cover page in the form specified in Schedule 14A. n21 The first six items of Schedule 14A are required regardless of the nature of the action to be taken at the shareholders' meeting. The items require a company to include in its proxy statement the information set forth below.

Item 1: the date, time and place of the shareholders' meeting, the address of the company's principal executive offices, the approximate date on which the proxy statement and proxy card are first distributed to shareholders and the date by which shareholder proposals intended to be presented at the next annual meeting must be received by the company for

inclusion in its proxy statement and form of proxy for such meeting;

Item 2: a statement as to the revocability of the proxy; n22

Item 3: a brief description of dissenters' appraisal rights if corporate action is proposed to be taken that would give rise to such rights, n23 and a statement as to whether a shareholder's failure to vote against the proposal constitutes a waiver of such rights (and whether a negative vote will be deemed to satisfy any state law notice requirements);

Item 4: disclosure in some detail of who is making the solicitation (*i.e.*, the company or participants in the solicitation), the manner in which it is being made and who is paying for it; n24

Item 5: disclosure of any substantial interest, by ownership of shares or otherwise, n25 of each person who has been a director or executive officer (including nominees) of the company, since the beginning of the last fiscal year, each participant in the solicitation and their associates, n26 in the matters to be acted upon at the meeting other than elections to office; n27

Item 6: (a) for each class of voting securities, a statement of the number of shares outstanding and the number of votes to which each class is entitled, n28

(b) the record date for the meeting, if any (or other criteria that is to determine the holders entitled to vote),

(c) if shareholders have cumulative voting rights with respect to the election of directors, a brief description of such rights, conditions precedent to the exercise thereof, and an indication whether discretionary authority to cumulate votes is being sought,

(d) the information required by Item 403 (security ownership of certain beneficial owners and management) of Regulation S-K, n29 to the extent known by the persons on whose behalf the solicitation is being made, and

(e) if a change in control of the company has occurred since the beginning of its last fiscal year, disclosure of the following: (i) the name of the person who acquired control; (ii) the amount and source of consideration used; (iii) the basis of control; (iv) the date and a description of the transaction resulting in the change of control; (v) the percentage of the voting securities of the company now beneficially owned by the person who acquired control; and (vi) the identity of the person from whom control was assumed. n30

Item 18 of Schedule 14A covers matters being presented at the meeting that are not required to be submitted to a vote of shareholders. If any such action is proposed to be taken, the proxy statement must state the nature of the matter, the reasons for submitting it to a vote and what action the company intends to take if the proposal is defeated.

Item 20 relates to any matter proposed to be submitted at the meeting that is not specifically covered by any of the other items of Schedule 14A. Disclosure of the substance of the matter must be in the same degree of detail as required by the other items of Schedule 14A.

Under Item 21, with respect to each matter submitted for shareholder action, the proxy statement must also include a statement of (i) the vote required for approval or election (other than approval of auditors), and (ii) the method by which votes will be counted, including the effect of abstentions and broker non-votes. n31

[b] Provisions Applicable to Annual Meetings--Items 7, 8 and 9.

The principal item of business conducted at annual meetings of shareholders is the election of directors. If action is to be taken regarding the election of directors, in addition to the information required by Items 1 through 6, 18, 20 and 21,

the disclosures required by Items 7, 8 and 9 of Schedule 14A must be included in the proxy statement.

[i] Item 7. Directors and Executive Officers. Item 7 requires disclosure of information about directors, n32 nominees for director n33 and executive officers. The information required to be disclosed includes their background and experience, transactions with the company and other business relationships involving the company, legal proceedings adverse to the company, and compliance with filing obligations under Section 16(a) under the Exchange Act. n34

Item 7 of Schedule 14A requires that the proxy statement contain the information required by Regulation S-K, n35 as follows:

- (1) Instruction 4 to Item 103 (Legal proceedings) of Regulation S-K with respect to directors and executive officers; n36
- (2) Item 401 (directors, officers, promoters and control persons). n37
- (3) Item 404(a) (transactions with related persons). n38
- (4) Item 404(b) (review, approval or ratification of transactions with related persons). n39
- (5) Item 405 (Compliance with Section 16(a) of the Exchange Act). n40
- (6) Item 407(a) Director Independence.
- (7) Item 407(b) Board meetings and committees.
- (8) Item 407(c) Nominating Committee.
- (9) Item 407(d) Audit Committee.
- (10) Item 407(e) Compensation Committee.
- (11) Item 407(f) Shareholder Communications.

In respect of registered investment companies, additional or different disclosure regarding directors and officers may be required. n41

Item 407(d) of Regulation S-K requires that the audit committee must state in the issuer's proxy statement whether it has (1) reviewed and discussed the audited financial statements with management; (2) discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61 as may be modified or supplemented; and (3) received certain disclosures and the letter from the auditors regarding the auditors' independence as required by the Independence Standards Board Standard No. 1, and discussed independence with the auditors. The audit committee must also state whether it has recommended to the board of directors that the audited financial statements be included in the company's annual report on 10-K. Companies would have to disclose whether their audit committee has adopted a written charter and if so to include a copy of it as an appendix to the proxy or information statement at least once every three years. Companies quoted on NASDAQ or listed on the American or New York Stock Exchanges would disclose in their proxy statements certain information regarding any director on the audit committee who is not "independent" as defined in the applicable listing standards (small business issuers would not be required to comply with this requirement). Companies which do not have a separately designated audit committee, or a committee performing similar functions, must provide such information with respect to every member of its board of directors. If

the board of directors decides to appoint a director to the audit committee who is not independent because of exceptional or limited or similar circumstances, the company must disclose the nature of the relationship that makes that individual not independent and the reasons for the board's determination. n42 All other companies, including small business issuers, must disclose whether the members are independent within the definition of the listing standards of the NASD, AMEX or NYSE. The rule creates "safe harbors" for the information required to be disclosed. The name of each member of the Audit Committee (or, in the absence of an audit committee, the board committee performing equivalent functions or the entire board of directors) must appear below the disclosure required by this item.

In *Girard v. Krug International Corp.*, n43 Krug refused to include plaintiff's nominees for Krug's board of directors in its proxy statement on two grounds: (1) notice of nomination did not comply with Krug's Code of Regulations governing nominations to the board, and (2) the notice constituted an "election-related" proposal excludible under the SEC's proxy rules. The district court ruled in plaintiff's favor and issued a temporary injunction against the use of the proxy material on the dual ground that the notice of nomination substantially complied with Krug's Code of Regulations and that failure to include plaintiff's nominees violated Section 14(a) of the Exchange Act. The appeals court reversed, holding that the board's determination that plaintiff's proposal failed to meet the requirements of the Code of Regulations was protected by Ohio's business judgment rule; it therefore determined that it was unnecessary to address the issue of the excludability of the proposal as a "shareholder proposal" but noted that the company would be obligated to comply with the proxy rules including notifying plaintiff of any problems with the proposal, affording an opportunity to correct any defects (unless they are incurable) and filing any reasons for exclusion of the proposal with the SEC.

The Commission has relocated from paragraph (d)(2) of Item 7 to Item 407(c) of Schedule S-K extensive disclosure requirements regarding the nomination process for the election of directors. n44 The rule provides that the issuer state whether it has a standing nominating committee or a committee performing a similar function, and if not, the proxy statement must state specifically why the board of directors deems it appropriate not to have such committee and identify each director who participates in the consideration of director nominees. If the board has a standing nominating committee, the proxy statement must provide the following information:

- (A) If the committee has a charter, describe its material terms and state whether a current copy is available on the company's website; if not available on the website, attach it as an appendix to the proxy statement at least once every three years, and if not attached, state the last year that it was attached;
- (B) If it has no charter, so state;
- (C) If listed on a national securities exchange or NASDAQ, disclose whether the members of the nominating committee are independent as defined in the independence requirements of the applicable listing standards;
- (D) If not a listed company, disclose whether the members of the nominating committee are independent, using a definition set forth in the listing standards of a national securities exchange or NASDAQ, consistent with the standards used for the audit committee of such company;
- (E) If there is a policy to consider candidates recommended by security holders, describe its material terms, including a statement whether the committee will consider candidates recommended by security holders.
- (F) If the issuer has no such policy, state that fact and the basis for the board's view that it is appropriate for the company not to have such a policy;
- (G) If the committee will consider candidates recommended by security holders, describe the procedures to be followed;
- (H) Describe the specific minimum qualifications that the committee feels must be met by a committee-nominated candidate, stating the specific qualities or skills the committee feels are necessary for one or more of the directors to

possess;

(I) Describe the committee's process for identifying and evaluating nominees, including nominees recommended by security holders, and any difference between that process and the process for the committee's own nominees;

(J) For each nominee (other than nominees who are executive officers or directors for re-election) approved by the committee for inclusion on the proxy card, a statement as to which one or more of the following recommended the nominee: security holder, non-management director, CEO, other executive officer, third-party search firm, or other specified source; n45

(K) If any fee is paid to a third party to find or evaluate or assist in finding or evaluating potential nominees, disclose the function performed by each such third party; n46

(L) If at least 120 days prior to release of the proxy statement for the prior year's meeting, the company received a recommended nominee from a holder or group of holders of more than 5% of the voting stock beneficially owned at least one year, identify the candidate and the security holders who recommended him or her and whether the committee chose to name the candidate as a nominee (subject to consent of such parties). n47

Any material changes to the company's nominating procedures should be reported on Forms 10Q or 10K. n48

The Commission has revised paragraph (14) of Item 22 (applicable to registered investment companies) to require funds to specifically identify any separately designated audit committee and nominating committee in addition to any other standing committees of the fund's board of directors, stating, in the case of a nominating committee, whether or not the members of that committee are "interested persons" of the fund as defined in § 2(a)(19) of the Investment Company Act of 1940. The Commission has deleted subparagraph (iv) of paragraph (b)(14) requiring a statement of whether the nominating or similar committee will consider nominees recommended by security holders and, if so, the procedures to be followed. n49

As directed by the Sarbanes-Oxley Act of 2002, the Commission on April 25, 2003 adopted a new rule 10a-3 and amendments to Item 7 and 22 of Schedule 14A to require that each member of a registrant's audit committee be independent in accordance with specified criteria (subject to exemptions therein noted); that the audit committee must be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged for the purpose of auditing; that such accounting firm must report directly to the audit committee; and that the audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls and other auditing matters, including procedures for handling confidential anonymous submissions by employees regarding questionable accounting or auditing matters; each audit committee must have the authority to engage independent counsel and other advisors as is determined necessary; and the registrant must provide appropriate funding for the audit committee.

Item 407(b) of Schedule S-K also requires information about committee meetings and director attendance. Item 407(b)(1) requires disclosure of the total number of meetings (both regular and special) of the board of directors held during the last full fiscal year and requires disclosure of any director who attended fewer than 75 percent of the aggregate number of meetings of the board and of the committees of the board on which that director served.

The Company must describe its policy, if any, with regard to Board members' attendance at annual meetings of security holders, stating the number of Board members who attended the prior year's annual meeting, either in the proxy statement or on the Company's website. n50

[ii] Item 8. Compensation of Directors and Executive Officers. Item 8 of Schedule 14A requires disclosure of the information set forth in Item 402 (Executive compensation) of Regulation S-K. n51 This information must be

furnished if action is to be taken concerning:

- the election of directors;
 - any bonus, profit-sharing or other compensation plan, contract or arrangement in which any director, nominee for election as a director, or executive officer of the company will participate;
 - any pension or retirement plan in which any person listed in the preceding paragraph will participate;
- or
- the grant or extension to any director, nominee for election as a director, or executive officer of the company of any options, warrants or rights to purchase any securities (other than if issued to shareholders on a pro rata basis).

In the case of non-issuer solicitations, the information in response to Item 8 of Schedule 14A need only be furnished for nominees (and their associates) of the persons making the solicitation. n52

In lieu of the information required by Item 402 of Regulation S-K with respect to compensation of directors and executive officers, registered investment companies must instead furnish the information required by Item 22(b)(13) of Schedule 14A. n53

New executive compensation standards are mandated by the American Recovery and Reinvestment Act of 2009 ("ARRA") n54 for companies which have accepted financial assistance from the Federal Government under the TARP program. n55 These mandated standards include:

1. limiting compensation of senior executive officers ("SEO"s) to exclude incentives to take unnecessary and excessive risks;
2. recovery of any bonus, retentions award or incentive compensation paid to an SEO or any of the next 20 most highly compensated employees if based on published earnings, revenues, gains or other criteria later found to be materially inaccurate (the "clawback" requirement);
3. prohibiting golden parachutes to an SEO or any of the next five most highly compensated employees, i.e. *any* payment to an SEO leaving a company for *any* reason except payments for services performed or benefits accrued;
4. prohibiting payment of bonuses, retention awards or incentive compensation except payment of long-term restricted stock that (a), doesn't fully vest until the end of the company's TARP obligation period, (b) does not exceed 1/3 of the recipient's annual salary, and (c) is subject to any other terms the Secretary of the Treasury may impose.

Lesser requirements apply to companies accepting less than \$500 million in TARP assistance. Also, the restrictions do not apply to any written employment contracts executed on or before February 11, 2009.

TARP recipients must establish a Board Compensation Committee of independent directors to review employee compensation plans for compliance with TARP standards (if the company is not registered with the SEC and has received less than \$25 million in TARP assistance, the full Board may make such reviews).

A nonbinding shareholder vote on executive compensation (commonly called "say on pay") is required of all TARP participants.

[iii] Item 9. Independent Public Accountants. Information in response to Item 9, independent public accountants, must be included in a proxy statement when a solicitation is made on behalf of the company and relates to the election of directors or the election, approval or ratification of the company's accountant. n56 Disclosure of information describing the company's relationship with its independent accountant is required.

Item 9(a) requires disclosure of the name of the principal accountant selected or being recommended to shareholders for election, approval or ratification for the current year or, if none has been selected, a brief statement of the reasons why no selection was made. n57 The name of the principal accountant for the prior fiscal year must be disclosed if it is different from the accountant selected or being recommended for the current year or if no accountant has yet been so selected or recommended. Proxy statements are required to disclose whether or not representatives of the principal accountants for both the current year and the most recently completed fiscal year will be present at the shareholders' meeting, and whether or not they will have an opportunity to make a statement and be available to respond to appropriate questions by shareholders. n58

Item 9(d) requires that if a change in accountants has occurred during the company's two most recent fiscal years (or any subsequent interim period), the company must provide the information required by Item 304(a) (Changes in and disagreements with accountants on accounting and financial disclosure) of Regulation S-K. n59

Item 9(e) requires the disclosure of aggregate fees billed in each of the last two fiscal years for (1) Audit Fees, (2) Audit-related Fees, not recorded under Audit Fees, with a description of the nature of the services, (3) Tax Fees (Tax Compliance, Tax Advice and Tax Planning, with a description of the nature of the services), (4) All Other Fees (describing the nature of the services). The company must disclose the Audit Committee's pre-approval policies and procedures, the percentage of services described in each of the above categories that were approved by the Audit Committee, the percentage of hours spent on the principal accountants engagement by other than full-time permanent employees, if greater than 50%, if the company is an investment company, disclosed the aggregate non-audit fees billed to the company's investment advisor and state whether the audit committee has considered whether such payments are compatible with maintaining the principal accountant's independence. n60

[c] Provisions Governing Specific Proposals--Items 10-17, 19.

In addition to the general information required to be included in all proxy statements, Items 10-17 and Item 19 require additional disclosure to be included in a company's proxy statement but only if the action specified in such items is to be voted on at the meeting.

[i] Item 10. Compensation Plans. The information required to be disclosed under Item 10 of Schedule 14A is required if action is proposed to be taken regarding any plan n61 under which cash or noncash compensation may be paid. Item 10(a) is applicable to all plans; Item 10(b) applies to specified types of plans. n62

Item 10(a) requires the company to describe the material features of each plan being acted upon, to identify each class of persons who will be eligible to participate, and to state the approximate number of members of such class and the basis of their participation. n63 Item 10(a) requires the company to disclose, in the specified tabular format, the benefits or amounts that will be received or allocated under each plan being submitted for a vote of shareholders by:

- each of the persons named in the Summary Compensation Table; n64
- all current executive officers as a group;
- all current directors who are not executive officers, as a group; and
- all employees as a group (including current officers who are not executive officers).

If the benefits or amounts cannot be determined, the company must state the benefits or amounts that would have been received or allocated for the company's last fiscal year, had the plan been in effect. n65

If the plan can be amended without shareholder action to increase the cost thereof to the company or to change the allocation of benefits among the persons and groups identified in the table, then a description of the nature of any amendments that can be so made must be included. n66

Information is required to be disclosed under Item 10(b)(1) of Schedule 14A with respect to any pension or retirement plan submitted for shareholder action. With respect to pension or retirement plans, Item 10(b)(1) requires that the proxy statement state the approximate amount necessary to fund the plan with respect to past services, the period over which the amount must be paid and the estimated annual payments required to pay such amount and the estimated annual payment to be made with respect to current services. n67

Item 10(b)(2) applies to a grant or plan submitted for shareholder action involving options, warrants or rights and requires the proxy statement to state:

- the title and amount of securities underlying the options, warrants or rights;
- the prices, expiration dates and other material conditions upon which they may be exercised;
- the consideration received or to be received by the company (or a subsidiary) for the granting or extension of the options, warrants or rights;
- the market value of the underlying securities as of the latest practicable date; and
- in the case of options, the federal income tax consequences of the issuance and exercise thereof, both to the company and to the optionees. n68

The proxy statement must also separately state, if determinable, the number of options received or to be received by: (i) the individuals named in the Summary Compensation Table; (ii) all current executive officers as a group; (iii) all current directors who are not executive officers, as a group; (iv) each nominee for election as a director; (v) associates of any such directors, executive officers or nominees; (vi) other persons who received or will receive five percent of the warrants, rights or options covered by the plan; and (vii) all employees as a group (including current officers who are not executive officers). n69

Item 10(c) applies to plans and other arrangements *not* subject to security holder action, n70 and requires registrants to furnish the information called for by Item 201(d) of Regulation S-K. n71

If information must be included in a proxy statement in response to Item 10, the company is subject to certain additional procedural requirements. At the time definitive proxy material is filed with the Commission, n72 three copies of the plan to be acted upon must be filed with the Commission if the plan is set forth in a written document. n73 In addition, the Commission should be informed on a supplemental basis when the proxy statement is first filed as to when the options, rights or warrants (and the shares called for thereby) will be registered under the Securities Act or, if such registration is not contemplated, the section of the Securities Act or the rule of the Commission under which exemption from registration is claimed and the facts relied upon to make the exemption available. n74

The proper interpretation of the scope of Item 10 was at issue in *Seinfeld v. Gray*, n75 where Boeing Co. submitted to shareholders for approval a proposed compensation plan involving the granting of options which could be settled in cash as well as stock, which might greatly exceed the number of shares to be issued under the plan. The plan specified

the maximum number of shares that could be issued but did not specify the number of options that might be issued, an omission which the plaintiff claimed was materially misleading. The court held that Boeing had satisfied item 10 of Rule 14a-101 by specifying the maximum number of shares that could be issued on exercise of options granted under the plan and made clear in the proxy statement that the number of options which could be settled in cash as well as stock might greatly exceed the number of shares issued.

[ii] Items 11-17 and Item 19. The specific proposals covered by Items 11-17 and Item 19 are ones that can generally be classified as extraordinary corporate actions. The disclosure requirements are detailed and require a close review of any applicable item's provisions. The following is a summary of the proposals governed by Items 11-17 and Item 19; it is not a summary of the requirements of each respective provision.

Items 11 to 17 and Item 19 contain the disclosure requirements if action is to be taken with respect to:

Item 11: authorizing or issuing securities otherwise than for exchange;

Item 12: modifying or exchanging securities;

Item 13: financial and other information if action is to be taken requiring disclosure pursuant to Item 11 or 12 (in such event, the proxy statement is required to contain financial statements required by Regulation S-X, n76 supplementary financial information required by Item 302 of Regulation S-K, n77 management's discussion and analysis of financial condition and results of operations required by Item 303 of Regulation S-K, n78 and information on changes in and disagreements with accountants required by Item 304 of Regulation S-K); n79

Item 14: mergers, consolidations, acquisitions and similar transactions; n80

Item 15: acquiring or disposing of any property;

Item 16: restating any asset, capital or surplus account;

Item 17: any report of the company or of its directors, officers or committees or any minutes of meetings of its shareholders; and

Item 19: any amendment of the company's charter, bylaws or other documents as to which information is not required by the other items of Schedule 14A.

[iii] Disclosure Required of TARP Participants. The SEC has issued guidance to financial firms participating in the Capital Purchase

Program of TARP regarding required proxy statement disclosure concerning that participation, where shareholder approval will be required (SEC Staff Guidance, November 25, 2008).

They should disclose *inter alia*:

- why they are participating in the program
- the status of any application filed
- the material terms of securities and warrants to be issued to the Treasury Department
- how participation will affect common stockholders and holders of senior securities

- whether the Board must be expanded to include Treasury participation
- whether the company must register any securities issued to the Treasury for resale
- the impact of participation on its operations
- the impact on liquidity, capital resources or results of operations if the application is denied
- any revisions to outstanding contracts required in order to comply with restrictions on executive compensation
- a textual discussion of any material effect on its pro-forma financial statements
- discussion of any material effect upon net interest margin, net income available to common shares, and impact on earnings per share.

Further guidance states that a description regarding the above as well as any "Say on Pay" proposal mandated by the American Recovery and Investment Act of 2009 ("ARRA") must be included in any preliminary proxy material filed after February 17, 2009 the date ARRA was enacted into law. n81

[d] Provisions Applicable to Registered Investment Companies--Item 22.

Item 22 was added to Schedule 14A and prescribes specific information which needs to be included in a proxy statement or information statement filed by an investment company registered under the Investment Company Act of 1940.

As of July 2003, investment companies that invest in voting securities are obliged to disclose in their registration statements the policies and procedures they use to determine how to vote proxies relating to securities held in their portfolios. Where the fund has delegated voting responsibility to the investment advisor or other third party, such parties' proxy voting policies and procedures must be described in the fund's registration statement, or a copy of the policies and procedures themselves must be provided. n82

[i] General. Item 22(a)(3) specifies the information generally needed in a proxy statement for a registered investment company. The required information includes

- the name and address of the fund's investment adviser, principal underwriter and Administrator; n83
- if a fund proxy statement solicits a vote on proposals affecting more than one fund or class of securities of the fund (unless the proposal or proposals are the same and affect all fund or class shareholders), a summary of all of the proposals in tabular form indicating which fund or class shareholders are solicited with respect to each proposal; if this table is required, it must appear on one of the first three pages of the proxy statement; n84
- unless the proxy statement is accompanied by a copy of the fund's most recent annual report, a prominent statement that the fund will furnish, without charge, a copy of the annual report and the most recent semi-annual report succeeding the annual report, if any, upon request of a shareholder; n85
- if action is to be taken which would, directly or indirectly, establish a new fee or expense or increase any existing fee or expense to be paid by the fund or its shareholders, a table showing the current and pro

forma fees (with the required examples) using the format prescribed in the appropriate registration form under the Investment Company Act of 1940; n86

- if action is to be taken with respect to the election of directors or the approval of an advisory contract, a description of any purchases or sales of securities of the investment advisor or its Parents, n87 or Subsidiaries n88 of either, since the beginning of the most recently completed fiscal year by any director or nominee for election as a director of the fund. n89

If action is to be taken with respect to any transaction described in Items 11, 12 or 14 of Schedule 14A, a financial data schedule must be included as an exhibit to the proxy statement or information statement filed electronically. n90 If action is to be taken with respect to any transaction described in Item 12, and if the acquiring company or the acquired company is a registered investment company or a business development company as defined by § 2(a)(48) of the Investment Company Act of 1940, new Item 14(d) specifies the information to be included in the proxy statement for that company in lieu of the information specified by paragraph (c) of Item 14.

[iii] Election of Directors. If action is to be taken with respect to the election of directors of the fund, the proxy statement must in addition to the information required by paragraphs (d)(3), (f) and (g) of Item 7 of Schedule 14A: n91

- provide the information required by a table set forth in Item 22(b)(1). n92 If the solicitation is made by a person other than the fund or an investment advisor of the fund, information need only be provided as to the nominees of such person. Information with respect to directors who are or would be "interested persons" within the meaning of Section 2(a)(19) of the Investment Company Act of 1940 must be provided separately from persons who are not or would not be "interested persons," including supplying separate tables for each category. Information need not be given about any director whose term of office does not continue beyond the meeting for which the solicitation is made.

- for each individual listed in column 1 of the table referenced above (other than a person who is not an "interested person"), describe any positions, including as an officer, employee, director, or general partner, held with affiliated persons or principal underwriters of the fund. n93

- describe briefly any arrangement or understanding between any director, nominee for such, officer, or person chosen to become an officer and any other person (naming such person) pursuant to which he or she was or is to be selected as a director, nominee or officer. n94

- describe any positions held by a director or nominee for election as director who is not an "interested person" during the past five years with the fund, or with an investment company having the same investment advisor, principle underwriter, or Sponsoring Insurance Company as the fund, or with an investment advisor, principle underwriter, Sponsoring Insurance Company or affiliated person of the fund, or with any person directly or indirectly controlling, controlled by or under common control with any of such entities. n95

- provide a table showing the dollar range of the equity securities beneficially owned by the director or nominee in the fund and (on an aggregate basis) in any registered investment companies overseen or to be overseen by the director or nominee within the same family of investment companies as the fund, as of the most recent practicable date, specifying such date by footnote or otherwise. n96

- disclose for each director or nominee who is not an "interested person" of the fund a table of information as to each class of securities owned beneficially or of record in an investment advisor, principal underwriter or Sponsoring Insurance Company of the fund or an affiliate of such entities, as of the most recent practicable date (specifying such date) stating the name of the company, title of class,

value of securities and percent of class. n97

Beneficial ownership is determined under Rule 13d-3 or Rule 16a-1(a)(2) of the Exchange Act. The information required by Columns 5 and 6 should be provided for each director (or nominee) and his or her immediate family members.

- unless disclosed under the preceding paragraph, disclose any direct or indirect interest valued at more than \$120,000 of each director or nominee who is not an "interested person" of the fund, or an immediate family member of the director or nominee during the past five years in an investment advisor, principle underwriter, or Sponsoring Insurance Company of the fund or a person other than a registered investment company controlling, controlled by or under common control with any such entity. n98

- describe any direct or indirect interest of a director or nominee who is not an "interested person" of the fund in any transaction or series of similar transactions since the beginning of the last two completed fiscal years of the fund, or in any proposed transaction or series of transactions, involving more than \$120,000 where any of the following persons was or is to be a party: the fund; an officer of the fund; an investment company having the same investment advisor, principle underwriter or Sponsoring Insurance Company as the fund, or which controls, is controlled by or is under common control with any such entity; any officer of such an investment company, an investment advisor, principle underwriter or Sponsoring Insurance Company of the fund, or any officer of any such entity, or any person controlling, controlled by or under common control with any such person or an officer of any such person. n99

- describe briefly any direct or indirect relationship, involving more than \$120,000, of any director or nominee for a director who is not an "interested person" of the fund since the beginning of the last two completed fiscal years of the fund or currently exists or is proposed, with any of the persons specified in the previous item, including (i) payments for property or services to or from such persons, (ii) provision of legal services to any such person, (iii) provision of investment banking services to any such person other than as a participating underwriter in a syndicate, or (iv) any consulting or any other relationship substantially similar to the foregoing. State the amounts involved, including all periodic payments; disclose indirect as well as direct relationships; include interests of immediate family members in determining if the amount exceeds \$120,000; and in the case of an indirect interest, give the information specified by Instruction 7. Payments that involve the rendering of services as a common carrier or public utility at rates or charges fixed in conformity with law or governmental authority, or payments that arise solely from the ownership of securities in which no extra or special benefit is received or routine retail relationships may be excluded. n100

- if an officer of an investment advisor, principle underwriter or Sponsoring Insurance Company of a fund, or an officer of an affiliate of any such entity serves or has served since the beginning of the last two full fiscal years of the fund on the board of directors of a company where a director of the fund or nominee for election as director who is not or would not be an "interested person" of the fund or immediate family member is, or was, since the last two completed fiscal years of the fund, an officer, identify: the company; the individual who serves or has served as a director of the company in the period of service as a director; the investment advisor, principal underwriter or Sponsoring Insurance Company or affiliate thereof and the director of the fund nominee, or immediate family member who is or was an officer of the company; the office held; and the period of holding the office. n101

- provide in tabular form, to the extent practicable, the information required by Items 401(f) and (g), 404(a) and (c) and 405 of Regulation S-K. n102

- describe briefly any material pending legal proceedings, other than ordinary routine litigation

incidental to the fund's business, to which any director or nominee or affiliated person of such director or nominee is a party adverse to the fund or any of its affiliated persons or has a material interest adverse to the fund or any of its affiliated persons. n103

- for all directors and for each of the three highest-paid executive officers that have aggregate compensation from the fund for the most recently completed fiscal year in excess of \$60,000 ("Compensated Persons"), furnish the information required by a table as set forth in Item 22(b)(13) of Schedule 14A. n104

- state whether the fund has a separately designated audit committee, or if not, that the entire board of directors acts as the audit committee. Give the disclosure required by Section 240.10A-3(d) regarding any exemption claim from the listing standards for audit committees. Identify all other standing committees of the board of directors, providing for each a concise statement of its functions, the names of its members, the number of committee meetings held during the last fiscal year, and, if the committee is a nominating or similar committee, whether it will consider nominees recommended by security holders and, if so, the procedures to be followed in submitting recommendations. n105

[iii] Approval of Investment Advisory Contract. If action is to be taken with respect to an investment advisory contract, an investment company must include the following information in the proxy statement or information statement: n106

- Information with respect to the fund's existing investment advisory contract:

- the date of the contract and the date on which it was last submitted to a vote of security holders of the fund, including the purpose of such submission; n107

- a brief description of the terms of the contract, including the rate of compensation of the investment advisor; n108

- the aggregate amount of the investment advisor's fee and the amount and purpose of any other material payments by the fund to the investment advisor, or any affiliated person of the investment advisor, during the last fiscal year of the fund; n109

- if any person is acting as an investment advisor of the fund other than pursuant to a written contract that has been approved by the security holders of the fund, the person must be identified and the nature of the services and arrangements must be described; n110

- a description of any action taken with respect to the investment advisory contract since the beginning of the fund's last fiscal year by the board of directors of the fund (unless a description is provided in response to Item 22(c)(1)(vi)); n111 and

- if an investment advisory contract was terminated or not renewed for any reason, the fund must state the date of such termination or non-renewal, identify the parties involved and describe the circumstances of such termination or non-renewal. n112

- the name, address and principal occupation of the principal executive officer and each director or general partner of the investment advisor; n113

- the names and addresses of all Parents of the investment advisor and the basis of control of the

investment advisor and each Parent by its immediate Parent; n114

- if the investment advisor is a corporation and, if to the knowledge of the persons making the solicitation or the persons on whose behalf the solicitation is made, the identity of any person not named in response to Item 22(c)(3) of Schedule 14A, who owns, of record or beneficially, ten percent or more of the outstanding voting securities of the investment advisor, including the name and address of each such person; n115

- the name of each officer or director of the fund who is an officer, employee, director, general partner or shareholder of the investment advisor; n116

- a brief description and a statement of the approximate amount of, where practicable, any material interest, direct or indirect, of any director of the fund in any material transaction since the beginning of the most recently completed fiscal year, or in any material proposed transactions, to which the investment advisor of the fund, and Parent or Subsidiary of the investment advisor (other than another fund), or any Subsidiary of the Parent of such entities was or is to be a party; n117

- disclosure of any financial condition of the investment advisor that is reasonably likely to impair the financial ability of the advisor to fulfill its commitment to the fund under the proposed investment advisory contract; n118

- a description of the nature of the action to be taken on the investment advisory contract and the reasons therefor, the terms of the contract to be acted upon and, if the action is an amendment to, or a replacement of, an investment advisory contract, the material differences between the current and the proposed contract; n119

- if a change in the investment advisory fee is sought, the following information needs to be included in the proxy statement or the information statement: n120

- the aggregate amount of the investment advisor's fee during the last year; n121

- the amount that the advisor would have received had the proposed fee been in effect; n122 and

- the difference between the aggregate amounts stated in response to Item 22(c)(9)(i) and (ii) of Schedule 14A as a percentage of the amount stated in response to Item 22(c)(9)(i) of Schedule 14A; n123

- if the investment advisor acts as such with respect to any other investment company having a similar investment objective, the identity and size of such other investment company and the rate of the investment advisor's compensation; n124

- a discussion in reasonable detail of the material factors and the conclusions with respect thereto which form the basis for the recommendation of the board of directors that the shareholders approve an investment advisory contract and, if applicable, a discussion of any benefits derived or to be derived by the investment advisor from the relationship with the fund such as soft dollar arrangements by which brokers provide research to the fund or its investment advisor in return for allocating fund brokerage; n125

- a description of any arrangement or understanding made in connection with the proposed investment

advisory contract with respect to the composition of the board of directors of the fund or the investment advisor or with respect to the selection or appointment of any person to any office with either the fund or the investment advisor; n126

- for the most recently completed fiscal year, a statement of (i) the aggregate amount of commissions paid to any Affiliated Broker n127 and (ii) the percentage of the fund's aggregate brokerage commissions paid to any such Affiliated Broker; n128 and

- the amount of any fees paid by the fund to the investment advisor, its affiliated persons or any affiliated person of such person during the most recent fiscal year for services provided to the fund (other than under the investment advisory contract or for brokerage commissions) and a statement as to whether these services will continue to be provided after the investment advisory contract is approved. n129

[iv] Approval of Distribution Plan. If action is to be taken with respect to a Distribution Plan, n130 an investment company must include the following information in the proxy statement or information statement: n131

- a description of the nature of the action to be taken on the Distribution Plan and the reasons therefor, the terms of the Distribution Plan to be acted upon and, if the action is an amendment to, or a replacement, of a Distribution Plan, the material differences between the current and the proposed Distribution Plan; n132

- if the fund has a Distribution Plan in effect:

- the date that the Distribution Plan was adopted and the date of the last amendment, if any; n133

- the persons to whom payments may be made under the Distribution Plan, the rate of the distribution fee and the purposes for which such fee may be used; n134

- the amount of distribution fees paid by the fund pursuant to the plan during its most recent fiscal year, both in the aggregate and as a percentage of the fund's average net assets during the period; n135

- the name of, and the amount of any payments made under the Distribution Plan by the fund during its most recent fiscal year to any person who is an affiliated person of the fund, its investment adviser, principal underwriter or Administrator, an affiliated person of such person, or a person that during the most recent fiscal year received 10% or more of the aggregate amount paid under the Distribution Plan by the fund; n136

- a description of any action taken with respect to the Distribution Plan since the beginning of the fund's most recent fiscal year by the board of directors of the fund; n137 and

- if a Distribution Plan was or is to be terminated or not renewed for any reason, the date or prospective date of such termination or non-renewal, the identity of the parties involved and a description of the circumstances of such termination or non-renewal; n138

- a brief description and statement of the approximate amount of, where practicable, any material interest, direct or indirect, of any director or nominee for election as a director of the fund in any material transactions since the beginning of the most recently completed fiscal year, or in any material proposed

transactions, to which any person identified in response to Item 22(d)(2)(iv) of Schedule 14A was or is to be a party. n139 and

- a discussion in reasonable detail of the material factors and the conclusions with respect thereto which form the basis for the conclusion of the board of directors that there is a reasonable likelihood that the proposed Distribution Plan (or amendment thereto) will benefit the fund and its shareholders. n140

[e] Delivery of Documents to Security Holders Sharing an Address--Item 23. If one annual report or proxy statement is being delivered to two or more security holders who share an address in accordance with § 240.14a-3(e)(1), furnish the following:

- state that only one annual report or proxy statement, as applicable, is being delivered to multiple security holders sharing an address (unless the registrant has received contrary instructions).
- undertake to deliver promptly upon written or oral requests a separate copy of the annual report or proxy statement, as applicable, to a security holder at such address and provide instructions as to how a security holder can notify the registrant that the security holder wishes to receive a separate copy.
- provide the phone number and mailing address to which a security holder can direct a notification to the registrant that the security holder wishes to receive a separate copy in the future.
- provide instructions how security holders sharing an address can request delivery of a single copy of such reports or statements if they are receiving multiple copies. n141

[3] Filing Requirements for Proxy Statements--Rule 14a-6

Rule 14a-6 contains the filing requirements applicable to proxy material to be filed with the Commission. Five preliminary copies of the proxy statement and proxy card must be filed with the Commission at least 10 days before definitive material is sent to shareholders. n142 Preliminary proxy statements, proxy cards and other soliciting material are *not* permitted to be filed where the solicitation relates to a meeting at which the only matters to be acted upon are the following: n143

- the election of directors;
- the election, approval or ratification of accountants;
- a shareholder proposal included under Rule 14a-8; n144 and/or
- the approval or ratification of a plan (as defined in Item 402(a)(7)(ii) of Regulation S--K) or an amendment to a plan.

The prohibition on filing preliminary proxy material does not apply if the company comments on or refers in its own proxy material to a solicitation being made in opposition in connection with the meeting. n145 While Rule 14a-6(a) permits acceleration of the 10-day period upon a showing of good cause, the Division of Corporation Finance will not do so except in the case of opposing solicitations.

In most cases, the filing of preliminary or definitive proxy material does not require the payment of a filing fee. However, if the proxy material involves an acquisition, merger, spin-off, consolidation or proposed sale or other disposition of substantially all the assets of the company, a fee established in accordance with Rule 0-11 under the Exchange Act n146 must be paid. n147

In October 1992, the Commission changed the rules regarding public availability of preliminary proxy material on file with the Commission. Prior to adoption of these rules, preliminary proxy material was not available for public inspection until definitive material was filed with the Commission. Rule 14a-6(e) now permits public inspection of preliminary proxy material unless confidential treatment is obtained or unless the proxy statement relates to a merger, consolidation, acquisition or similar transaction not involving either a going private transaction pursuant to Rule 13e-3 under the Exchange Act n148 or a rollup transaction pursuant to Item 901 of Regulation S-K. n149 The proxy material eligible for confidential treatment is required to be clearly marked as confidential and would be filed in paper format rather than electronically. n150

A company whose preliminary proxy statement has been on file with the Commission for the required 10 days may mail those materials to shareholders without awaiting any notice or comments from the staff of the Division of Corporation Finance. The staff should notify the company, however, prior to the tenth day that the materials have been on file, if the staff has, or will have, comments on the preliminary proxy materials. n151

If the Division of Corporation Finance notifies the company of possible deficiencies in a preliminary proxy statement, the company must amend the material to correct the deficiencies. n152 Unlike the situation resulting under Securities Act Section 8(a), n153 however, filing an amendment will not extend the 10-day period established in Rule 14a-6(a) n154 since it is treated as part of the preliminary proxy statement unless the amendment contains material revisions or material new proposals. If a solicitor amends the proxy material in a timely fashion, the solicitor would not be required to modify the proposed schedule if required changes can be made that bring the material into compliance with the rules and any comments of the Commission.

While there is no provision for administrative action comparable to stop-order proceedings under the Securities Act, n155 the solicitor who refuses to modify proxy material in accordance with the suggestions of a letter of comment may be faced with injunctive proceedings and may be subject to a suit claiming that the proxies, having been obtained without complying with the rules, are invalid. n156

Eight copies of the definitive proxy statement, proxy card and other soliciting material must be filed with the Commission not later than the date such material is first sent to shareholders. The requirement of filing multiple copies and the option of mailing for filing would not apply to filings being made with the Commission since Regulation S--T n157 requires that such material be filed electronically. n158 Three copies are also required to be filed or mailed for filing with each national securities exchange upon which any class of securities of the company is listed and registered. n159 If the definitive proxy material differs from the preliminary proxy material filed with the Commission, two of the copies (or three of the copies in the case of a registered investment company) must be marked to indicate clearly and precisely the changes made from the material previously filed. For filings with the Commission submitted electronically, the changes would be marked as prescribed in the EDGAR Filer Manual. n160

Filing of personal solicitation material, revised proxy material and additional soliciting material is also required. n161

Neither copies of replies to inquiries from shareholders requesting further information, nor copies of communications that request only that proxies already solicited be signed and returned, need be filed pursuant to Rule 14a-6. n162

In respect of rollup transactions (as defined in Item 901(c) of Regulation S-K) n163 that are to be registered on Form S-4 or Form F-4 under the Securities Act, the proxy statement must be distributed to security holders by the earlier of (i) 60 days prior to the date on which the action is proposed to be taken or (ii) the maximum number of days permitted for giving notice under applicable state law. n164

In respect of solicitations by persons owning over \$5 million of the company's securities where authority to act as a proxyholder is not being sought (and assuming certain additional requirements are met), a Notice of Exempt Solicitation

n165 is required to be prepared and filed. n166 The notice is required to contain the name of the company, the name and address of the person submitting the notice, and a copy of all written soliciting materials. n167 Five copies of the notice, together with copies of all written soliciting material, must be filed or mailed for filing with the Commission not later than three days after the written solicitation is sent to any shareholder. The requirement for filing multiple copies and the option of mailing for filing would not apply to filings being made with the Commission since Regulation S--T n168 requires that such material be filed electronically. n169 Three copies must be sent to each national securities exchange on which any class of securities of the company is listed and registered. n170 No fee is required to be paid in connection with the filing of a Notice of Exempt Solicitation. n171 No filings are required by persons engaged in solicitations exempt under Rule 14a-2(b)(1) n172 in connection with oral solicitations (excluding scripts), public speeches, press releases, published or broadcast statements appearing in a broadcast media, newspaper or magazine. n173

Where the solicitation involves a roll--up transaction, and the solicitor both owns 5% or more of the outstanding securities of a class that is the subject of the proposed roll--up transaction and also engages in the business of buying and selling limited partnership interests in the secondary market, the solicitor must furnish or mail to the Commission not later than three days after making, sending or providing an oral or written solicitation to any security holder, five copies of a statement containing the information specified in the Notice of Exempt Preliminary Roll--up Communication. Five copies of any amendment to such statement shall be furnished or mailed to the Commission not later than three days after a communication containing revised material is first made, sent or provided to any security holder. n174 The requirement for filing multiple copies and the option of mailing for filing would not apply to filings being made with the Commission since Regulation S--T n175 requires that such material be filed electronically. n176

Finally, Rule 14a-6 provides that any proxy statement, proxy card or other soliciting material included in a Form N-14, Form S-4 or Form F-4 registration statement under the Securities Act is deemed to satisfy the filing requirements of the Exchange Act. n177 Separate copies are not required to be filed under Section 14(a) n178 if no separate fee is required thereunder. If any additional soliciting material is used after the effective date of the Form N-14, Form S-4 or Form F-4 registration statement, then such material must be filed in accordance with Rule 14a-6. n179

[4] Inaccurate Material In Proxy Statements--Rule 14a-9

A broad prohibition on the use of false or misleading statements comparable to the prohibition contained in Section 10 of the Exchange Act (and the rules adopted thereunder) n180 and Section 17 of the Securities Act n181 is set forth in Rule 14a-9. n182 The prohibition contained in Rule 14a-9 applies to statements included in proxy statements, forms of proxy, notices of meetings and other communications, whether written or oral. n183 Rule 14a-9(a) prohibits solicitation material from including a false or misleading statement with respect to a material fact or the omission of a material fact necessary in order to make the statement not false or misleading. n184

Notwithstanding the fact that the provisions of the proxy rules are not generally applicable to certain types of solicitations, n185 the prohibition contained in Rule 14a-9 nonetheless will apply to the following three types of solicitations:

- solicitations of ten or fewer persons by an entity other than the company;
- proxy voting advice given by a financial adviser in the course of business to a person with whom the adviser has a business relationship; n186 and
- solicitations by persons not seeking authority to act as proxyholder. n187

Rule 14a-9 does not require that all possible facts be disclosed; n188 rather, only those facts material to shareholder action are required to be included in proxy material. n189 The test of materiality established by the Supreme Court in *TSC Industries v. Northway*, n190 is as follows: "[a]n omitted fact is material if there is a substantial likelihood that a

reasonable investor would consider it important in deciding how to vote." n191 Rule 14a-9 does not require that proxy solicitation materials contain perfect disclosure; the appropriate standard is fair accuracy. n192

In *State of New Jersey, et al. v. Sprint Corp., et al.*, n193 the court addressed the issue of whether a corporation has a duty to make full and prompt disclosure of material facts, both favorable and unfavorable, regarding its financial condition. It stated that such disclosure is plainly required where a failure to disclose would render its previously issued projections misleading.

There is no general duty to disclose arising out of the fiduciary relationship between a corporation and its stockholders unless a statute or rule requires disclosure, an insider is trading, or a previous disclosure becomes inaccurate, incomplete or misleading. In the absence of securities fraud claims relating specifically to official reports of financial performance, the mere fact that an individual defendant was the company's chief financial officer is unlikely to be enough to allege control for purposes of attempting to impose controlling person liability under § 20(a) of the Act. A similar conclusion applies as to an individual who is a member of the company's board of directors, with no allegation that the person exerted control or influence over the day-to-day operations of the company. This is not so regardless of whether such individual signed an SEC filing that contains a misleading or fraudulent statement, because it is common sense to presume that a person who signs his name to a report has some measure of control over those who write the report.

In an action based on Sprint's failure to disclose the possibility or inevitability that the employment of the chairman and president of the company would be terminated as a result of their utilizing tax shelters which were subsequently held by the I.R.S. to be improper, the Court observed that, while the alleged nondisclosures did not make the financial statements misleading, it did arguably render misleading a statement in Sprint's proxy statements that "Sprint entered into new employment contracts with Mr. Esrey and Mr. LeMay designed to insure their long-term employment with Sprint," which statements were made at a time when the company was contemplating the termination of both executives.

A defendant corporation is not held to a standard of strict liability; rather, some jurisdictions require knowing, reckless or negligent conduct before a finding of liability under Rule 14a-9 will be made. n194 There is no requirement that proxy solicitation materials state interpretations of facts not shared by the solicitor, n195 contemplated alternative transactions that are merely conjectural, n196 or management's desire to defeat a takeover attempt. n197

Proxy statements need not disclose the underlying motivations of directors or major shareholders as long as all material facts relating to the transaction are adequately stated. n198 Where statements of reasons, opinions or beliefs are given, plaintiffs will be permitted to prove that such statements are knowingly false or misleadingly incomplete in order to state a cause of action under Section 14(a). n199

Certain categories of statements have been proscribed by the Commission in the Note to Rule 14a-9 as examples of statements that, depending on the facts and circumstances, may be misleading within the meaning of Rule 14a-9. The Note to Rule 14a-9 prohibits predictions as to specific future market values, n200 baseless personal attacks, n201 claims made prior to the shareholders' meeting as to the outcome of the vote, n202 and proxy material that does not clearly identify the soliciting party. n203 By contrast, Rule 3b-6 under the Exchange Act n204 permits forward-looking statements in documents filed with the Commission if certain conditions are met. n205

Rule 14a-9(b) provides that the filing of soliciting material or its examination by the Commission shall not be deemed to constitute a finding by the Commission that the material is not false or misleading, that it is accurate and complete, or that the Commission has passed on the merits of any statement contained therein or any matter to be voted upon by shareholders. Statements in proxy material to the contrary are likewise prohibited. n206 Notwithstanding the express provisions of Rule 14a-9(b), the weight and effect to be given by the courts to "clearance" of proxy material by the Commission varies almost from case to case. n207

Whether a given statement is actually false or misleading depends upon the facts and circumstances of the particular case. n208 Even if the proxy statement is misleading, lack of irreparable harm to shareholders may defeat a request for injunctive relief. n209

Whether proxy material violates Rule 14a-9 must be determined in the context in which the statement is made, since misleading implications may arise "not from the words alone, but from the words as seen against the background of all the circumstances existing at the time the statement or question was published." n210 Furthermore, failure to give prominence to important facts and "burying" material adverse information may make a statement misleading. n211 While Rule 14a-9 does not require that either certain words or a certain form of language be used to express a material fact in a proxy statement, "the language used and the position and emphasis given to each statement, however, may be considered in determining whether there has been a fair and candid disclosure of a material fact." n212 In connection with the language used in a proxy statement, a complicated description of a complex transaction would not generally be prohibited by Rule 14a-9. n213

FOOTNOTES:

(n1)Footnote 1. 17 C.F.R. § 240.14a-101.

(n2)Footnote 2. Rule 14a-3(a), under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G, 17 C.F.R. § 240.14a-3(a), states that no solicitation may be made unless a proxy statement containing the information required by Schedule 14A, or a proxy statement included in a registration statement on Form S-4 under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section H or F-4 (or Form N-14 for investment companies) and containing the information required by such form is provided to the person solicited.

This provision is not applicable to certain communications in the form of public speeches, press releases, published or broadcast statements appearing in a broadcast media, newspaper or magazine, or other publication distributed on a regular basis as long as (i) a proxy card is not provided to the shareholder being solicited and (ii) a definitive proxy statement has been filed with the Commission. Rule 14a-3(f), 17 C.F.R. § 240.14a-3(f). *See also* § 7.02 *supra*.

The person preparing the proxy statement should also consult materials other than Schedule 14A, including the following: (i) the rules under Regulation 14A (Rule 14a-1 through Rule 14a-14, 17 C.F.R. § 240.14a-1 through 14a-14); (ii) the introductory Notes to Schedule 14A; and (iii) the definitions contained elsewhere in the Exchange Act, 15 U.S.C. § 78a-78jj, and Regulations, 17 C.F.R. § 240 *et seq.* (e.g., Rule 12b-2, 17 C.F.R. § 240.12b-2).

The failure to answer correctly any item required by Schedule 14A is actionable in a shareholder's derivative action under Rule 14a-3. *Lewis v. Dansker*, 357 F. Supp. 636 (S.D.N.Y. 1973), *modified*, 68 F.R.D. 184 (S.D.N.Y. 1975). However, proof of causation (*i.e.*, that the violation of Rule 14a-3(a), by omitting to provide information required by Schedule 14A, "reasonably could be thought to have effected the outcome of the vote") is essential to establish a violation of § 14(a) and Rule 14a-3(a), 17 C.F.R. § 240.14a-3(a). *Ash v. Brunswick Corp.*, 405 F. Supp. 234, 246 (D. Del. 1975).

See also SEC v. Falstaff Brewing Corp., 629 F.2d 62, 73-74 (D.C. Cir. 1980) (failure to provide in a proxy statement the information required by Schedule 14A, violated Section 14(a), 15 U.S.C. § 78n(a) and Rule 14a-3.

Compare with cases brought under Rule 14a-9, 17 C.F.R. § 240.14a-9; see § 7.09[2] infra.

(n3)Footnote 3. *15 U.S.C. § 78n.*

(n4)Footnote 4. *See § 7.06 infra* for discussion of information statements.

(n5)Footnote 5. 17 C.F.R. § 229 *et seq.* For a discussion of Regulation S-K, *see § 4.03 supra.*

(n6)Footnote 6. For a discussion of disclosure requirements for smaller reporting companies under Item 10(f) of Regulation S-K, *see § 7.03, supra.*

(n7)Footnote 7. Note D to Schedule 14A.

The proxy statement must include on the last page a list of documents incorporated by reference. If material incorporated by reference has not been given to shareholders, the company must include in the proxy statement an undertaking to provide without charge, upon the request of the shareholder, a copy of any material incorporated by reference. The company is not required to provide exhibits to documents incorporated by reference unless those exhibits are specifically incorporated by reference in the proxy statement.

With respect to companies that are filing material electronically with the Commission under the EDGAR system, if the proxy statement incorporates information required by Item 13 or 14 of Schedule 14A by reference to an annual or quarterly report to shareholders, such report (or portion of the report) so incorporated is required to be filed in electronic format with the proxy statement. This provision does not apply to registered investment companies. Note D(4) to Schedule 14A.

(n8)Footnote 8. It is not sufficient merely to provide the specific information explicitly required by Schedule 14A. *Lyman v. Standard Brands, Inc.*, 364 F. Supp. 794 (E.D. Pa. 1973) (although a company's proxy statement complied with requirements of Schedule 14A by disclosing any direct financial interest or any material indirect financial interest its auditors had in the company, the company was still held to the requirements of full disclosure and should have complied with the full and fair disclosure requirements of Rule 14a-9. The existence of Schedule 14A does not restrict the scope of Rule 14a-9, which is designed to prevent management from obtaining authorization for corporate action through deceptive or inadequate disclosure in proxy solicitations).

See also Franchard Corp., Sec. Act Rel. No. 33-4710, Fed. Sec. L. Rep. (CCH) P 74,113 (1964) (stop order proceeding under Securities Act of 1933; registrant failed to disclose encumbrance on controlling person's shares in registration statement and prospectus) (footnotes omitted):

The fact that such disclosures are not required of all issuers and their controlling persons in all cases does not negate their materiality in specific cases. The registration forms promulgated by us are guides intended to assist registrants in discharging their statutory duty of full disclosure. They are not and cannot possibly be exhaustive enumerations of each and every item material to investors in the particular circumstances relevant to a specific offering. The kaleidoscopic variety of economic life precludes any attempt at such an enumeration. The preparation of a registration statement is not satisfied, as registrant's position suggests, by a mechanical process of responding narrowly to the specific items of the applicable registration form. On the contrary, Rule 408 under the Securities Act makes clear to prospective registrants that: "In addition to the information expressly required to be included in a registration statement, there shall be added such further material information, if any, as may be necessary to make the required statements in the light of the circumstances under which they were made, not misleading."

(n9)Footnote 9. Rule 14a-5(a), 17 C.F.R. § 240.14a-5(a).

(n10)Footnote 10. Rule 14a-5(a). This rule also requires appropriate headings to be used and amounts to be stated in figures. Where appropriate, use of tables is encouraged. If disclosure is required of the same information by more than one item of Schedule 14A, the disclosure is not required to be repeated.

Rule 14a-5(c), 17 C.F.R. § 240.14a-5(c), provides that disclosures contained in other proxy soliciting material do not need to be repeated in the proxy statement if the proxy statement contains a clear reference to the place where such information can be found.

(n11)Footnote 11. Rule 14a-5(b), 17 C.F.R. § 240.14a-5(b).

(n12)Footnote 12. Rule 14a-5(d), 17 C.F.R. § 240.14a-5(d).

All printed proxy statements must be in roman type at least as large and as legible as 10-point modern type, except that, to the extent necessary for convenient presentation, financial statements and other tabular data, but not the notes thereto, may be in roman type at least as large and as legible as 8-point modern type. All such type must be leaded at least 2 points. Rule 14a-5-(d)(2)(ii) provides that where the proxy statement is delivered through an electronic medium, legibility requirements applicable to printed documents, such as type size and fonts, may be satisfied by presenting all information "in a format readily communicated to investors." Similar provisions apply to annual reports (Rule 14a-3(b)(2)(ii)), and information statements (Rule 14c-4(d)).

(n13)Footnote 13. Rule 14a-5(e), 17 C.F.R. § 240.14a-5(e).

The date by which proposals are to be received is to be calculated pursuant to Rule 14a-8(a)(3)(i), 17 C.F.R. § 240.14a-8(a)(3)(i), discussed in § 7.07 *infra*.

If the date of the next annual meeting is subsequently advanced by more than 30 calendar days or delayed by more than 90 calendar days from the date of the annual meeting to which the proxy statement relates, the company should, in a timely manner, inform shareholders of the change and the new deadline for shareholder proposals to be received by the company. Rule 14a-5(f), 17 C.F.R. § 240.14a-5(f).

(n14)Footnote 14. Rule 14a-6(a), 17 C.F.R. § 240.14a-6(a).

(n15)Footnote 15. Rule 14a-5(a) provides, in part: "No statement need be made in response to any item or subitem which is inapplicable."

(n16)Footnote 16. Note A to Schedule 14A.

Items 11, 14 and 19 of Schedule 14A are discussed in § 7.04[2][c] *infra*.

(n17)Footnote 17. Note B to Schedule 14A.

(n18)Footnote 18. Rule 14a-6, Rule 14c-5..

(n19)Footnote 19. SEC Guidance dated February 24, 2009.

(n20)Footnote 20. This information need not be included in the proxy statement if it is provided to shareholders in other material furnished to them with or preceding the proxy statement.

If action is to be taken by written consent, the company must also include the date by which the consents are to be submitted, if state law requires a date to be specified, or if the person soliciting proxies intends to set a date.

(n21)Footnote 21. The requirement for a cover page was first adopted by the Commission in February 1993 in the

release adopting rules regarding implementation of the operational EDGAR system. Nevertheless, the requirement for the cover page applies to both electronic and paper filers. Since all issuers obligated to file proxy material with the Commission must file electronically, the rules applicable to paper filers now apply only to issuers that file with agencies other than the Commission (*e.g.*, the Comptroller of the Currency and the Federal Deposit Insurance Corporation). Sec. Exch. Act Rel. No. 34-31905, Fed. Sec. L. Rep. (CCH) P 85,111 (1993).

(n22)Footnote 22. In addition to a statement as to whether or not the shareholder has the right to revoke the proxy, if such right is limited or subject to certain procedures, a description of such limitation or procedures is required by Item 2 of Schedule 14A.

(n23)Footnote 23. If appraisal rights are required to be described in response to Item 3 of Schedule 14A, a description of any state statutory procedures necessary in order to perfect such rights is required. If time constraints are placed on the exercise of such rights, a statement whether the shareholder will be notified of the expiration of the applicable time period is also required.

(n24)Footnote 24. In the case of a solicitation subject to Rule 14a-11, 17 C.F.R. § 240.14a-11 (Special Provisions Applicable to Election Contests, *see* § 7.08 *infra*), additional disclosure must be made of any class of regular employees of the company or any other participant in a solicitation employed to solicit shareholders and the manner and nature of their employment for such purpose, the material features of any contract or arrangement for such solicitation and the parties thereto, and the total amount estimated to be spent and total expenditures to date, in connection with or in furtherance of the solicitation of shareholders and who will bear the cost of solicitation. Item 4(b) of Schedule 14A.

In *Ostergren v. Kirby*, Fed. Sec. L. Rep. (CCH) P 90,820 (N.D. Ohio 1957), and *SEC v. May*, 229 F.2d 123 (2d Cir. 1956) 134 F. Supp. 247 (S.D.N.Y. 1955), injunctions were granted for failure to disclose participants. It does not matter if such participants are technically not members of the committee soliciting proxies if they have been instrumental in organizing it.

Item 4(a)(2) of Schedule 14A, which reads: "[i]f the solicitation is made otherwise than by the registrant, so state and give the names of the persons by whom and on whose behalf it is made," codifies the result of the *May* case, which had previously been an administrative position.

See also SEC v. Henwood, Fed. Sec. L. Rep. (CCH) P 91,125 (S.D. Cal. 1961), *modified and aff'd*, 298 F.2d 641 (9th Cir.), *cert. denied*, 371 U.S. 814 (1962); *Chris-Craft Indus., Inc. v. Independent Stockholders Comm.*, 354 F. Supp. 895 (D. Del. 1973).

"Participant" and "participant in a solicitation" are defined in Instruction 3(a) to Item 4 of Schedule 14A to include the following:

- (1) the company;
- (2) any director of the company and any nominee for whose election as a director proxies are solicited;
- (3) any committee or group which solicits proxies, any member of such committee or group, and any person whether or not named as a member who, acting alone or with one or more other persons, directly or indirectly, takes the initiative or engages in organizing, directing or arranging for the financing of any such committee or group;
- (4) any person who finances or joins with another to finance the solicitation of proxies, except persons who contribute not more than \$500 and who are not otherwise participants;

1-7 Federal Securities Exchange Act of 1934 § 7.04

(5) any person who lends money or furnishes credit or enters into any other arrangement, pursuant to any contract or understanding with a participant, for the purposes of financing or otherwise inducing the purchase, sale, holding or voting of securities of the company by any participant or other person, in support of or in opposition to a participant; except that such terms do not include a bank, broker or dealer who, in the ordinary course of business, lends money or executes orders for the purchase or sale of securities and who is not otherwise a participant; and

(6) any person who solicits proxies.

Instruction 3(b) to Item 4 of Schedule 14A excludes from the terms "participant" and "participant in a solicitation" the following persons:

(1) Any person or organization retained or employed by a participant to solicit security holders and whose activities are limited to the duties required to be performed in the course of such employment;

(2) Any person who merely transmits proxy soliciting material or performs other ministerial or clerical duties;

(3) Any person employed by a participant in the capacity of attorney, accountant or advertising, public relations or financial adviser, and whose activities are limited to the duties required to be performed in the course of such employment;

(4) Any person regularly employed as an officer or employee of the company or any of its subsidiaries and who is not otherwise a participant; or

(5) Any officer or director of, or any person regularly employed by, any other participant, if such officer, director or employee is otherwise a participant.

(n25)Footnote 25. Disclosure is not required under Item 5(a) if the interest arises from ownership of securities of the company if the shareholder receives no extra or special benefit not shared on a pro rata basis by all other shareholders of the same class. Instruction to Item 5(a) of Schedule 14A.

(n26)Footnote 26. An "associate" is defined in Rule 14a-1(a) as:

(1) any corporation or organization (other than the registrant or a majority owned subsidiary of the registrant) of which such person is an officer or partner or is, directly or indirectly, the beneficial owner of 10 percent or more of any class of equity securities; (2) any trust or other estate in which such person has a substantial beneficial interest or as to which such person serves as trustee or in a similar fiduciary capacity; and (3) any relative or spouse of such person, or any relative of such spouse, who has the same home as such person or who is a director or officer of the registrant or any of its parents or subsidiaries.

(n27)Footnote 27. If the solicitation is an election contest subject to Rule 14a-12(c), Item 5(b) requires a brief description of any substantial interest of the participants in any matter to be acted upon at the meeting, and detailed information with respect to each participant, including:

(i) name and business address,

(ii) principal occupation and employment and the name, principal business and address of the employer,

- (iii) criminal convictions, if any, during the past 10 years, with details specified,
- (iv) direct and indirect beneficial ownership of the company's securities,
- (v) amount of any class of equity security owned of record but not beneficially,
- (vi) as to securities purchased or sold within the past two years, the dates and amounts of each purchase or sale,
- (vii) if the purchase price or market value of shares so bought or sold are represented by funds borrowed or otherwise obtained for the purpose of acquiring or holding the securities, the amount of the debt as of the latest practical date if the funds were acquired other than pursuant to a margin account or bank loan in the regular course of business, describing the transaction and the names of the parties,
- (viii) any contracts, arrangements or understandings to which the participant is or was within the past year a party with any person with respect to any securities of the registrant, naming the parties and giving the details thereof,
- (ix) amount of securities owned beneficially, directly or indirectly, by the participant's associates, with the name and address of each,
- (x) amount of each class of securities of any parent or subsidiary of the registrant owned beneficially, directly or indirectly, by the participant,
- (xi) for the participant and his or her associates, the information required by Item 404(a) of Regulation S-K (discussed in § 4.03 [5][d], *supra*),
- (xii) any arrangement or understanding of the participant or any associate with any person with respect to any future employment by the registrant or its affiliates or with respect to any future transactions to which the registrant or any of its affiliates will or may be a party, describing such arrangement and stating the names of the parties thereto.

Item 5(b)(1) of Schedule 14A.

(n28)Footnote 28. For a discussion of certain "street name" issues and the Commission's response thereto under Rules 14b-1, 14b-2, and 14a-13, *see* § 7.02[3] *supra*.

(n29)Footnote 29. Item 403 of Regulation S-K, reprinted in the Primary Law Sourcebook, Volume D, Section K, 17 C.F.R. § 229.403, is discussed in § 4.03[5][c] *supra*. Item 403 was amended by Release 33-8732A to require tabular disclosure of beneficial ownership of each class of securities of the registrant or any of its parents or subsidiaries by directors, nominees, named executive officers, and directors and executive officers as a group.

(n30)Footnote 30. If a bank loan was the source of all or part of the funds used by the person acquiring control, the identity of the bank need not be disclosed provided:

- (1) the person acquiring control has requested confidentiality under Section 13(d)(1)(B) of the Exchange Act, 15 U.S.C. § 78m(d)(1)(B), discussed in § 7A.02[1], n.37 *infra*, at the time of filing; or
- (2) the material indicates that the bank's identity has been omitted and filed separately with the Commission; and
- (3) the loan was made in the ordinary course of business by the bank.

The terms of the loan or pledge obtained by the new control group to acquire control and the names of the lenders and pledgees must be disclosed. Instruction 1 to Item 6(e) of Schedule 14A.

Any arrangement or understanding among members of both the former and new control groups and their associates about election of directors or other matters should also be described. Instruction 2 to Item 6(e) of Schedule 14A.

(n31)Footnote 31. Broker non-votes are unvoted shares held by a nominee for a beneficial owner for which the nominee has not received voting instructions from the beneficial owner or for which the nominee may not exercise discretionary voting power. Sec. Exch. Act Rel. No. 30849, Fed. Sec. L. Rep. (CCH) P 85,002, at 82,838 (1992). The NYSE has proposed that brokers' discretionary voting for directors be abolished. *See* discussion at § 7.02[2], *supra*, m. 27. The proposal has generated concerns about the effect this may have on the ability of directors to obtain majority votes when that requirement has been adopted.

In the release proposing changes to the shareholder communications rules in 1992, the Commission recognized the existence of "diverse state law approaches to proxy tabulation, particularly with respect to abstentions and broker non-votes" and noted that some states permit companies to include in their certificate of incorporation or by-laws a provision which would have the effect of altering the state law approach to tabulation of proxies. Sec. Exch. Act Rel. No. 34-30849, Fed. Sec. L. Rep. (CCH) P 85,002, at 82,838 (1992).

(n32)Footnote 32. Information is required for directors whose term of office will continue after the meeting. Instruction 3 to Item 401(a) of Regulation S-K.

(n33)Footnote 33. In the case of a nonissuer solicitation, information pertaining only to the nominees of such person is required to be furnished. Item 6 of Schedule 14A.

The nominees must have consented to serve if elected, though the consent need not be in writing. Rule 14a-4(d), 17 C.F.R. § 240.14a-4(d).

Delaware has revised its General Corporation Law effective August 1, 2009 to permit corporations to adopt bylaws conferring on shareholders the right to have their own nominees for election to the board included in the corporation's proxy material. The following is the legislative synopsis of new sections 112 and 113:

" New Section 112 clarifies that the bylaws may require that if the corporation solicits proxies with respect to an election of directors, the corporation may be required to include in its proxy materials one or more nominees submitted by stockholders in addition to individuals nominated by the board of directors. Section 112 also identifies a non-exclusive list of conditions that the bylaws may impose on such a right of access to the corporation's proxy materials. In particular, and in the interest of avoiding election contests instituted by stockholders having little or no economic interest in the corporation, Section 112 authorizes the bylaws to prescribe a minimum level of stock ownership as a prerequisite to requiring inclusion of nominees in the corporation's proxy materials. In establishing such a minimum level of stock ownership, the bylaws may define beneficial ownership to take account of ownership of options or other rights in respect of or relating to stock (including rights that derive their value from the market price of the stock). Section 112 also permits the bylaws to limit a right of access according to whether or not a majority of board seats is to be contested, or whether nominations are related to an acquisition of a significant percentage of the corporation's stock. The bylaws may also prescribe any other lawful condition to the exercise of a right of access to the corporation's proxy materials.

" New Section 113 provides that a bylaw may require the corporation to reimburse proxy solicitation expenses incurred by a stockholder. Section 113 also identifies a non-exclusive list of conditions that the bylaws may impose on such a right to reimbursement."

(n34)Footnote 34. 15 U.S.C. § 78p(a).

(n35)Footnote 35. 17 C.F.R. § 229 *et seq.*

(n36)Footnote 36. Item 7(a) of Schedule 14A. Item 103 of Regulation S-K is discussed in § 4.03[2][c] *supra*.

(n37)Footnote 37. Item 401 of Regulation S-K is discussed in § 4.03[5][a] *supra*. The fact that directors determine and vote for their own compensation need not be disclosed, *Vides v. Amelio*, 265 F. Supp 2d 273 (S.D.N.Y. 2003) .

(n38)Footnote 38. Item 404(a) of Regulation S-K is discussed in § 4.03[5][d] *supra*. See discussion and extensive analysis of Related Person Transaction Disclosures under item 404(a) in *The Corporate Counsel*, Vol. XXXI, No. 6 (November-December 2006).

(n39)Footnote 39. Item 404(b) of Regulation S-K is discussed in § 4.03[5][d][ii] *supra*.

(n40)Footnote 40. Item 405 is discussed in § 4.03[5][e], *supra*. See *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 75 (D.C. Cir.) , *cert. denied sub nom. Kalmanovitz v. SEC*, 449 U.S. 1012 (1980) , in which the court found that the statement in the company's proxy statement about the existence of an audit committee was materially false and misleading since the audit committee never met nor functioned. The proxy statement thus falsely conveyed to shareholders the impression that effective oversight of the company's accounting functions was being exercised by the board of directors.

(n41)Footnote 41. Item 7(e) requires investment companies registered under the Investment Company Act of 1940 to furnish the information required by Item 22(b) of Schedule 14A in lieu of the information required by Item 7 of Schedule 14A.

(n42)Footnote 42. Item 407(d)(2) of Regulation S-K.

(n43)Footnote 43. 230 F. 3d 1366 (9th Cir. 2000) .

(n44)Footnote 44. Release No. 33-8732A, 34-54302A, IC 27444A, 2006 SEC LEXIS 2016 (Aug. 29, 2006) , effective for proxy and information statements filed on or after December 15, 2006 that are required to include Item 402 and 404 disclosure for fiscal years ending on or after December 15, 2006, for 8-Ks for events occurring on or after November 7, 2006, and for 10-Ks filed for fiscal years ending on or after December 15, 2006.

(n45)Footnote 45. Item 407(c)(2)(vii) of Schedule S-K.

(n46)Footnote 46. Item 407(c)(2)(viii) of Schedule S-K.

(n47)Footnote 47. Item 407(c)(2)(ix) of Schedule S-K.

(n48)Footnote 48. Item 407(c)(3) of Schedule S-K.

(n49)Footnote 49. Item 22(b)(14) of Schedule 14A.

(n50)Footnote 50. Item 407(b)(2) of Regulation S-K.

(n51)Footnote 51. Item 402, "Executive Compensation," of Regulation S-K, 17 C.F.R. § 229.402, is discussed in § 7.01[8][c], *supra*, and § 4.03[5][b], *supra*.

See also *Lewis v. Dansker*, 357 F. Supp. 636, 642-43 (1973) , *modified*, 68 F.R.D. 184 (S.D.N.Y. 1975) ; *SEC v. Kalvex, Inc.*, 425 F. Supp. 310 (S.D.N.Y. 1975) .

(n52)Footnote 52. Item 8 of Schedule 14A.

(n53)Footnote 53. Item 22 of Schedule 14A is discussed in § 7.04[2][d], *infra*.

(n54)Footnote 54. American Recovery and Reinvestment Act of 2009.

(n55)Footnote 55. Troubled Asset Relief Program, provided for in the Economic Emergency Stabilization Act of 2008.

(n56)Footnote 56. Item 9 of Schedule 14A.

(n57)Footnote 57. Item 9(a) of Schedule 14A.

In cases where the selection of accountants is being voted upon by shareholders but is not required to be submitted for shareholder action, it could be argued that the disclosure required by Item 18 of Schedule 14A would be required in addition to the disclosure required by Item 9 of Schedule 14A. Item 18 of Schedule 14A would require companies to disclose the reasons for submitting the selection of accountants to a vote of shareholders and the action intended to be taken by the company in the event of a negative vote.

(n58)Footnote 58. Item 9(c) of Schedule 14A.

(n59)Footnote 59. Item 304 of Regulation S-K, 17 C.F.R. § 229.304, is discussed in § 4.03[4][d] *supra*. Such disclosure in a proxy statement is required even if such information has been previously disclosed.

(n60)Footnote 60. Item 9(e)(1)-(8).

(n61)Footnote 61. Item 402(a)(6)(ii) of Regulation S-K, 17 C.F.R. § 229.402(a)(6)(ii), states that a plan includes, but is not limited to, "any plan, contract, authorization or arrangement, whether or not set forth in any formal documents A plan may be applicable to one person." This definition applies to Item 10 because of Instruction 1 to Item 10.

(n62)Footnote 62. If action is to be taken requiring disclosure under Item 10, the information prescribed in Item 8 (Compensation of Directors and Executive Officers) must also be included pursuant to Item 8(b), even if directors are not being elected.

(n63)Footnote 63. Item 10(a)(1) of Schedule 14A.

(n64)Footnote 64. See Item 402(a)(3) of Regulation S-K, 17 C.F.R. § 229.402(a)(3). See § 4.03[5][b][ii] *supra*.

(n65)Footnote 65. Item 10(a)(2)(iii) of Schedule 14A.

(n66)Footnote 66. Item 10(a)(3) of Schedule 14A.

(n67)Footnote 67. Item 10(b)(1) of Schedule 14A.

(n68)Footnote 68. Item 10(b)(2)(i) of Schedule 14A.

(n69)Footnote 69. Item 10(b)(2)(ii) of Schedule 14A.

(n70)Footnote 70. Item 10(c) of Schedule 14A.

(n71)Footnote 71. Item 201(d) of Regulation S-K is discussed in § 4.03[3][a][iv] *supra*.

(n72)Footnote 72. Instruction 3 to Item 10 of Schedule 14A.

(n73)Footnote 73. If proxy material is filed electronically, the requirement to provide three copies would not apply; however, a copy of the plan would need to be included in the electronic submission as an appendix to the proxy statement.

(n74)Footnote 74. Instruction 5 to Item 10 of Schedule 14A.

(n75)Footnote 75. *404 F.3d 645 (2d Cir. 2005)* , *cert. denied*, *126 S.Ct. 1464 (2006)* .

(n76)Footnote 76. *17 C.F.R. § 210 et seq.*

(n77)Footnote 77. *17 C.F.R. § 229.302.*

(n78)Footnote 78. *17 C.F.R. § 229.303.*

(n79)Footnote 79. *17 C.F.R. § 229.304.*

The proxy statement must also contain a statement as to whether or not accountants for the current and prior fiscal years are expected to attend the shareholders' meeting, make a statement if desired and be available to respond to appropriate questions. Item 13(a)(6) of Schedule 14A.

The financial information required by Item 13(a)(1), (2) and (3) may be incorporated by reference if certain conditions are met. Item 13(b) of Schedule 14A.

Item 302, "Supplementary financial information," of Regulation S-K, *17 C.F.R. § 229.302*, is discussed in § 4.03[4][b] *supra*.

Item 303, "Management's discussion and analysis of financial condition and results of operations," of Regulation S-K, *17 C.F.R. § 229.303*, is discussed in § 4.03[4][c] *supra*.

Item 304, "Changes in and disagreements with accountants on accounting and financial disclosure," of Regulation S-K, *17 C.F.R. § 229.304*, is discussed in § 4.03[4][d] *supra*.

(n80)Footnote 80. Item 14 requires proxy statements to include specified information if action is proposed to be taken with respect to "(i) the merger or consolidation of the registrant into or with any other person or of any other person into or with the registrant, (ii) the acquisition by the registrant or any of its security holders of securities of another person, (iii) the acquisition by the registrant of any other going concern business or of the assets thereof, (iv) the sale or other transfer of all or any substantial part of the assets of the registrant, or (v) the liquidation; or dissolution of the registrant" Information must be provided about the transaction, about the business of the company and the other party to the transaction and about the financial condition of the company and the other party to the transaction and pro forma financial information.

(n81)Footnote 81. See Winston & Strawn LLP Briefing, Global Financial Markets (December 2008). The guidance can be found at www.sec.gov/division/corpfin/cffilingguidance.htm.

(n82)Footnote 82. Company Act Release, 68 Fed. Reg. 6564, 6567 ; see discussion in Securities & Commodities Regulation, Vol. 36 No. 11 (June 11, 2003).

(n83)Footnote 83. "Administrator" is defined in Item 22(a)(1)(i) of Schedule 14A as any person or persons who provide significant administrative or business management services to the fund and includes any person that has been or would be identified in response to Item 15(h) of Form N-1A (*17 C.F.R. § 274.11A*).

(n84)Footnote 84. Item 22(a)(3)(ii) of Schedule 14A.

(n85)Footnote 85. Item 22(a)(3)(iii). The proxy statement must also contain the name, address and toll-free telephone number of the person to whom such a request is to be directed (or, if no toll-free telephone number is provided, a postage paid card for requesting the annual report.)

The fund must provide any requested report by first class mail or other means designed to assure prompt delivery, within three business days of the request.

(n86)Footnote 86. Item 22(a)(3)(iv).

For open end-management investment companies, the reference would be Item 3 of Form N-1A (17 C.F.R. § 239.15A). For closed-end management investment companies, the reference would be Item 3 of Form N-2 (17 C.F.R. § 239.14). For separate accounts that offer variable annuity contracts, the reference would be to Item 3 of Form N-3 (17 C.F.R. § 239.17a).

Where approval is sought only for a change in asset breakpoints for a pre-existing fee that would not have increased the fee for the previous year (or have the effect of increasing fees or expenses, but for any other reason would not be reflected in a pro forma fee table), the proxy statement must describe the likely effect of the change in lieu of providing pro forma fee information. Instruction 1 to Item 22(a)(3)(iv) of Schedule 14A.

If a fund offers its shares exclusively to one or more separate accounts and therefore is not required to include a fee table in its prospectus, that fund should nonetheless prepare a table showing current and pro forma expenses and disclose that the table does not reflect separate account expenses, including sales load. Instruction 4 to Item 22(a)(3)(iv) of Schedule 14A.

(n87)Footnote 87. "Parent" is defined in Item 22(a)(1)(vi) of Schedule 14A as "the affiliated person of a specified person who controls the specified person directly or indirectly through one or more intermediaries."

(n88)Footnote 88. "Subsidiary" is defined in Item 22(a)(1)(viii) of Schedule 14A as "an affiliated person of a specified person who is controlled by the specified person directly or indirectly through one or more intermediaries."

(n89)Footnote 89. Item 22(a)(3)(v) of Schedule 14A.

This item requires that the investment company identify the parties, state the consideration, the terms of payment and describe any arrangement or understanding with respect to the composition of the board of directors of the fund or the investment advisor or with respect to the selection or appointment of any person to any office with either such company. Instruction 1 to Item 22(a)(3)(v) of Schedule 14A.

Transactions involving securities in an amount not exceeding one percent of the outstanding securities of any class of the investment advisor or any of its Parents or Subsidiaries may be omitted. Instruction 2 to Item 22(a)(3)(v) of Schedule 14A.

(n90)Footnote 90. Item 22(a)(4) of Schedule 14A.

Any required financial data schedule must be prepared in accordance with the requirements of Rule 483 of Regulation C under the Securities Act (17 C.F.R. § 230.483).

(n91)Footnote 91. Information must be furnished with respect to a prospective investment advisor to the extent applicable. Instruction 1 to Item 22(b) of Schedule 14A.

If the solicitation is being made other than by or on behalf of the fund or by or on behalf of an investment advisor, the information need only be provided as to nominees of the person making the solicitation. Instruction 2 to Item 22(b) of

Schedule 14A.

(n92)Footnote 92. The following is the table specified in Item 22(b)(1):

(1)	(2)	(3)	(4)	(5)	(6)
Name	Position(s) Held With Fund	Term of Office And Length Of Time Served	Principal Oc- cupation(s) During Past 5 Years	Number of Portfolios In Fund Complex Overseen By Director or Nominee For Director	Other Director- ships Held By Director of Nominee For Director

The term "family relationship" means any relationship by blood, marriage, or adoption, not more remote than first cousin. Only persons who have consented to act as a director or officer may be named in response to this item. If there are fewer nominees named than the number fixed by or pursuant to the governing instruments, the reasons must be stated and the proxies cannot be voted for a greater number of persons than the number of nominees named. For each nominee who is an "interested person," describe in a footnote or otherwise the reasons for such classification. The principal business of any company named in column 4 must be stated unless implicit in its name. Include in column (5) the total number of separate portfolios that a nominee for election as director would oversee if elected.

(n93)Footnote 93. Item 22(b)(2) of Schedule 14A.

(n94)Footnote 94. Item 22(b)(3) of Schedule 14A.

(n95)Footnote 95. Item 22(b)(4) of Schedule 14A.

(n96)Footnote 96. Item 22(b)(5) of Schedule 14A. The ranges to be used are: None, \$1-\$10,000, \$10,001-\$50,000, \$50,001-\$100,000, or over \$100,000.

(n97)Footnote 97. The table specified by Item 22(b)(6) appears as follows:

(1)	(2)	(3)	(4)	(5)	(6)
Name of Dir- ector or Nom- inee	Name of Own- ers and Rela- tionships to Director or Nominee	Company	Title of Class	Value of Se- curities	Percent of Class

(n98)Footnote 98. Item 22(b)(7) of Schedule 14A.

(n99)Footnote 99. Item 22(b)(8) of Schedule 14A. State the nature of the interest (and the circumstances requiring it to be described), the approximate dollar amount involved and the approximate dollar amount of the interest where practicable, including all periodic payments. The interest of the person shall be computed without regard to the amount of profit or loss involved. If the transaction involves a purchase or sale of assets, state the cost to the purchaser and, if acquired by the seller within two years, the cost to the seller, describing the method used in determining the purchase or sale price and the name of the person making the determination. Materiality shall be determined on the basis of the significance of the information to investors in light of all the circumstances of the particular case, including the importance of the interest to the person having the interest, the relationships of the parties to the transaction with each other, and the amount involved. No information need be given where the interest arises solely from ownership of

securities of a person specified and the owner receives no extra or special benefit. Transactions include loans, lines of credit and other debt; for debt, indicate the largest aggregate amount of debt outstanding at any time during the period, its nature and the transaction in which it was incurred, the amount outstanding at the latest practicable date and the rate of interest paid or charged.

(n100)Footnote 100. Item 22(b)(9) of Schedule 14A.

(n101)Footnote 101. Item 22(b)(10) of Schedule 14A.

(n102)Footnote 102. Item 22(b)(11) of Schedule 14A. Information provided under Item 22(b)(8) may be omitted here.

(n103)Footnote 103. Item 22(b)(12) of Schedule 14A must include name of court where case is pending, date instituted, principal parties, factual basis alleged for action and relief sought.

(n104)Footnote 104. Item 22(b)(13) of Regulation 14A.

The following is the table specified in Item 22(b)(13):

(1)	(2)	(3)	(4)	(5)
Name	Aggregate	Pension	Estimated	Total
of	Compensation	or	Annual	Compensation
Person,	from	Retirement	Benefits	From Fund
Position	Fund	Benefits	Upon	and Fund
		Accrued	Retirement	Complex
		as Part of		Paid to
		Fund		Directors
		Expenses		

For column (1), indicate, if necessary, the capacity in which the remuneration was received. For Compensated Persons that are directors of the fund, compensation is amounts received for service as a director. Instruction 1 to Item 22(b)(13) of Schedule 14A.

If the fund has not completed its first full fiscal year since its organization, the fund must furnish the information for the current fiscal year, estimating future payments that would be made pursuant to an existing agreement or understanding. The fund must disclose in a footnote to the Compensation Table the period for which the information is provided. Instruction 2 to Item 22(b)(13) of Schedule 14A.

The fund must include in column (2) amounts deferred at the election of the Compensated Person, whether pursuant to a plan established under *Section 401(k) of the Internal Revenue Code* or otherwise, for the fiscal year in which earned. The fund must also disclose in a footnote to the Compensation Table the total amount of deferred compensation (including interest) payable to or accrued for any Compensated Person. Instruction 3 to Item 22(b)(13) of Schedule 14A.

The fund must include in columns (3) and (4) all pension or retirement benefits proposed to be paid under any existing plan in the event of retirement at normal retirement date, directly or indirectly, by the fund or any of its Subsidiaries, or by other companies in the same fund complex as the fund. If retirement benefits are not determinable, column (4) may be omitted. Instruction 4 to Item 22(b)(13) of Schedule 14A.

For any defined benefit or actuarial plan under which benefits are determined primarily by final compensation (or average final compensation) and years of service, the fund must provide the information required in column (4) in a separate table showing estimated annual benefits payable upon retirement (including amounts attributable to any

defined benefit supplementary or excess pension award plans) in specified compensation and years of service classifications. The fund must also disclose the estimated credited years of service for each Compensated Person. Instruction 5 to Item 22(b)(13) of Schedule 14A.

The fund should include in column (5) only aggregate compensation paid to a director for service on the board and other boards of investment companies in the same fund complex specifying the number of such other investment companies. Instruction 6 to Item 22(b)(13) of Schedule 14A.

(n105)Footnote 105. Item 22(b)(14) of Schedule 14A.

(n106)Footnote 106. Item 22(c) of Schedule 14A.

The required information needs to be included with respect to a prospective investment advisor to the extent applicable. Instruction to Item 22(c) of Schedule 14A.

(n107)Footnote 107. Item 22(c)(1)(i) of Schedule 14A.

(n108)Footnote 108. Item 22(c)(1)(ii) of Schedule 14A.

(n109)Footnote 109. Item 22(c)(1)(iii) of Schedule 14A.

(n110)Footnote 110. Item 22(c)(1)(iv) of Schedule 14A.

(n111)Footnote 111. Item 22(c)(1)(v) of Schedule 14A.

(n112)Footnote 112. Item 22(c)(1)(vi) of Schedule 14A.

(n113)Footnote 113. Item 22(c)(2) of Schedule 14A.

If the investment advisor is a partnership with more than ten general partners, the fund must identify (i) the general partners with the five largest economic interests in the partnership and, if different, those general partners comprising the management or executive committee of the partnership or exercising similar authority and (ii) the general partners with significant management responsibilities relating to the fund. Instruction to Item 22(c)(2) of Schedule 14A.

(n114)Footnote 114. Item 22(c)(3) of Schedule 14A.

If any person named in response to Item 22(c)(3) of Schedule 14A is a corporation, the fund must include the percentage of its voting securities owned by its immediate Parent. Instruction 1 to Item 22(c)(3) of Schedule 14A.

If any person named in response to Item 22(c)(3) of Schedule 14A is a partnership, the fund must name the general partners having the three largest percentage interests (computed by whatever method is appropriate in the particular case). Instruction 2 to Item 22(c)(3) of Schedule 14A.

(n115)Footnote 115. Item 22(c)(4) of Schedule 14A.

(n116)Footnote 116. Item 22(c)(5) of Schedule 14A.

As to any officer or director who is not a director or general partner of the investment advisor and who owns securities or has any other material direct or indirect interest in the investment advisor or any other person controlling, controlled by or under common control with the investment advisor, the nature of such interest must be described. Item 22(c)(5) of Schedule 14A.

(n117)Footnote 117. Item 22(c)(6) of Schedule 14A.

The proxy statement or information statement must include the name of each person whose interest in any transaction is described and the nature of the relationship by reason of which such interest is required to be described. Where it is not practicable to state the approximate amount of the interest, the fund must indicate the approximate amount involved in the transaction. Instruction 1 to Item 22(c)(6) of Schedule 14A.

As to any transaction involving the purchase or sale of assets by or to the investment advisor, the proxy statement or information statement must state the cost of the assets to the purchaser and the cost thereof to the seller if acquired by the seller within two years prior to the transaction. Instruction 2 to Item 22(c)(6) of Schedule 14A.

If the interest of any person arises from the position of the person as a partner in a partnership, the proportionate interest of such person in transactions to which the partnership is a party need not be set forth, but the amount involved in the transaction with the partnership must be included. Instruction 3 to Item 22(c)(6).

Item 22(c)(6) of Schedule 14A does not require disclosure of information with respect to any transaction that is not related to the business or operations of the fund and to which neither the fund nor any of its Parents or Subsidiaries is a party. Instruction 4 to Item 22(c)(6) of Schedule 14A.

(n118)Footnote 118. Item 22(c)(7) of Schedule 14A.

(n119)Footnote 119. Item 22(c)(8) of Schedule 14A.

(n120)Footnote 120. Item 22(c)(9) of Schedule 14A.

(n121)Footnote 121. Item 22(c)(9)(i) of Schedule 14A.

(n122)Footnote 122. Item 22(c)(9)(ii) of Schedule 14A.

(n123)Footnote 123. Item 22(c)(9)(iii) of Schedule 14A.

(n124)Footnote 124. Item 22(c)(10) of Schedule 14A.

The proxy statement or information statement must also indicate whether the investment advisor has waived, reduced or otherwise agreed to reduce its compensation under any applicable investment advisory contract.

The information furnished in response to Item 22(c)(10) of Schedule 14A is required to be given in tabular form. Instruction to Item 22(c)(10) of Schedule 14A.

(n125)Footnote 125. Item 22(c)(11) of Schedule 14A.

Conclusory statements or a list of factors will not be considered sufficient disclosure. The discussion should relate the factors to the specific circumstances of the fund and the investment advisory contract for which approval is sought. Instruction to Item 22(c)(11) of Schedule 14A.

(n126)Footnote 126. Item 22(c)(12) of Schedule 14A.

(n127)Footnote 127. "Affiliated Broker" is defined in Item 22(a)(1)(ii) of Schedule 14A as "any broker: (A) That is an affiliated person of the Fund; (B) That is an affiliated person of such person; or (C) An affiliated person of which is an affiliated person of the Fund, its investment adviser, principal underwriter, or Administrator." *17 C.F.R. § 240.14a-101*.

(n128)Footnote 128. Item 22(c)(13) of Schedule 14A.

Each Affiliated Broker must be identified together with the relationships that cause the broker to be an Affiliated Broker. Instruction to Item 22(c)(13) of Schedule 14A.

(n129)Footnote 129. Item 22(c)(14) of Schedule 14A.

(n130)Footnote 130. "Distribution Plan" is defined in Item 22(a)(1)(iii) of Schedule 14A as "a plan adopted pursuant to Rule 12b-1 under the Investment Company Act of 1940 [*17 C.F.R. § 270.12b-1*]."

(n131)Footnote 131. Information is to be provided on a prospective basis to the extent applicable. Instruction to Item 22(d).

(n132)Footnote 132. Item 22(d)(1) of Schedule 14A.

(n133)Footnote 133. Item 22(d)(2)(i) of Schedule 14A.

(n134)Footnote 134. Item 22(d)(2)(ii) of Schedule 14A.

(n135)Footnote 135. Item 22(d)(2)(iii) of Schedule 14A.

(n136)Footnote 136. Item 22(d)(2)(iv) of Schedule 14A.

(n137)Footnote 137. Item 22(d)(2)(v) of Schedule 14A.

(n138)Footnote 138. Item 22(d)(2)(vi) of Schedule 14A.

(n139)Footnote 139. Item 22(d)(3) of Schedule 14A.

The investment company must include the name of each person whose interest in any transaction is described and the nature of the relationship by reason of which such interest is required to be described. Where it is not practicable to state the approximate amount of the interest, the fund must indicate the approximate amount involved in the transaction. Instruction 1 to Item 22(d)(3) of Schedule 14A.

As to any transaction involving the purchase or sale of assets, the fund must state the cost of the assets to the purchaser and the cost thereof to the seller if acquired by the seller within two years prior to the transaction. Instruction 2 to Item 22(d)(3) of Schedule 14A.

If the interest of any person arises from the position of the person as a partner in a partnership, the proportionate interest of such person in transactions to which the partnership is a party need not be set forth. However, in that case, the fund must state the amount involved in the transaction with the partnership. Instruction 3 to Item 22(d)(3) of Schedule 14A.

No information needs to be given in response to Item 22(d)(3) of Schedule 14A with respect to any transaction that is not related to the business or operations of the fund and to which neither the fund nor any of its Parents or Subsidiaries is a party. Instruction 4 to Item 22(d)(3) of Schedule 14A.

(n140)Footnote 140. Item 22(d)(4) of Schedule 14A. Conclusory statement or a list of factors will not be considered sufficient disclosure. Instruction to Item 22(d)(4).

(n141)Footnote 141. Item 23 of Schedule 14A.

(n142)Footnote 142. Rule 14a-6(a) under the Securities Exchange Act of 1934, reprinted in the Primary Law

Sourcebook, Volume B, Section G.

The 10-day period is computed counting the day of filing of the preliminary material and ending on midnight of the last day of the period. Accordingly, the definitive material may not be sent out until the eleventh day. Rule 14a-6(k), 17 C.F.R. § 240.14a-6(k).

The filing of revised preliminary material does not recommence the 10-day period during which the material must be on file with the Commission, unless the revised material contains material revisions or material new proposals that constitute a fundamental change in the proxy material. Note 1 to Rule 14a-6(a).

If a company incorporates material by reference under Item 13(b) or 14(b) of Schedule 14A (other than an annual report sent to shareholders as required by Rule 14a-3), and the material relates to the same meeting as the proxy statement, the proxy statement must be sent to shareholders at least 20 business days prior to the meeting date. Note D to Schedule 14A.

(n143)Footnote 143. In respect of registered investment companies, different rules apply. No preliminary proxy material may be filed where the only action proposed to be taken is (i) in the case of either a registered investment company or a business development company, a proposal to continue without change any advisory or other agreement which was the subject of a prior solicitation for which proxy material was filed with the Commission and/or (ii) in the case of an open-end registered investment company, a proposal to increase the number of authorized shares.

(n144)Footnote 144. 17 C.F.R. § 240.14a-8. For a discussion of Rule 14a-8, *see* § 7.07 *infra*.

(n145)Footnote 145. Rule 14a-6(a).

A "solicitation in opposition" includes solicitations opposing a proposal that the company supports or supporting a proposal that the company does not expressly support, excluding shareholder proposals. Note 3 to Rule 14a-6(a).

In this case, the company's transmittal letter to the Commission should indicate that the preliminary material is being filed for the sole reason that the company is commenting on or referring to a solicitation in opposition in its proxy materials. Note 4 to Rule 14a-6(a).

(n146)Footnote 146. In general, Rule 0-11 under the Exchange Act, 17 C.F.R. § 240.0-11, requires fees to be paid to the Commission based upon the value of the securities and/or other property involved in the transaction.

(n147)Footnote 147. Rule 14a-6(i), 17 C.F.R. § 240.14a-6(i).

(n148)Footnote 148. 17 C.F.R. § 240.13e-3.

(n149)Footnote 149. 17 C.F.R. § 229.901.

(n150)Footnote 150. Proxy material would be required to be disclosed to federal governmental agencies or departments and to Congress and could be used by the Commission for its own investigatory purposes. Rule 14a-6(e)(2)(ii), 17 C.F.R. § 240.14a-6(e)(2)(ii).

(n151)Footnote 151. The Commission is not required to approve or disapprove proxy material, and a court has no jurisdiction to compel it to do so. *SEC v. Idaho Inv. Corp., Fed. Sec. L. Rep. (CCH) P 92,676* (D. Ida. 1970).

(n152)Footnote 152. Rule 14a-6(h) requires two copies (or three copies in the case of a registered investment company) of the amended material to be marked to show the changes. For filings with the Commission which are submitted electronically, the changes would be marked as prescribed in the EDGAR Filer Manual.

(n153)Footnote 153. 15 U.S.C. § 77h(a). Securities Act § 8(a) provides that if an amendment to a registration statement is filed prior to the effective date of the statement, the registration statement will be deemed to have been filed when the amendment was filed.

(n154)Footnote 154. Rule 14a-6(a) is discussed in n.72 *supra*.

(n155)Footnote 155. 15 U.S.C. § 77h(d). Securities Act § 8(d) permits the Commission to issue a stop order suspending the effectiveness of a registration statement if the Commission finds at any time that it contains an untrue statement of material fact or omits to state a material fact necessary to make the registration statement not misleading.

(n156)Footnote 156. See § 7.09[5] *infra* for a discussion of enforcement of proxy rules by private action.

(n157)Footnote 157. 17 C.F.R. Part 232.

(n158)Footnote 158. Rule 101 of Regulation S--T; 17 C.F.R. § 232.101.

(n159)Footnote 159. Rule 14a-6(b).

(n160)Footnote 160. Rule 14a-6(h), 17 C.F.R. § 240.14a-6(h).

(n161)Footnote 161. Rule 14a-6(b), (c), (h), 17 C.F.R. § 240.14a-6(b), (c), (h).

In respect of personal solicitations, copies of all written instructions or other material which discusses or comments on the merits of any proposal to be acted upon at the meeting and which is furnished to the individuals making the personal solicitation for use in connection with the solicitation is required to be filed with the Commission not later than the date such material is first given to such individuals. Rule 14a-6(c).

In respect of revised proxy material, two of the five copies are required to be filed (three of the five copies for registered investment companies), and must be clearly and precisely marked to indicate the changes thereto. Rule 14a-6(h). For filings with the Commission submitted electronically, the changes would be marked as prescribed in the EDGAR Filer Manual.

In respect of additional soliciting material, copies are required to be filed with the Commission not later than the date first sent to shareholders. Rule 14a-6(b).

(n162)Footnote 162. Rule 14a-6(f), 17 C.F.R. § 240.14a-6(f).

(n163)Footnote 163. 17 C.F.R. § 229.901(c).

(n164)Footnote 164. Rule 14a-6(l), 17 C.F.R. 240.14a-6(l).

(n165)Footnote 165. Rule 14a-103, 17 C.F.R. § 240.14a-103.

(n166)Footnote 166. Rule 14a-6(g), 17 C.F.R. § 240.14a-6(g). See also § 7.02[2] *supra*.

(n167)Footnote 167. Rule 14a-103.

(n168)Footnote 168. 17 C.F.R. Part 232.

(n169)Footnote 169. Rule 101 of Regulation S--T; 17 C.F.R. § 232.101.

(n170)Footnote 170. Rule 14a-6(g).

Five copies of any amendments to the notice prepared in connection with the distribution of additional communications to shareholders is also required to be filed. Rule 14a-6(g)(1)(ii), 17 C.F.R. § 240.14a-6(g)(1)(ii).

(n171)Footnote 171. Rule 14a-6(i)(5), 17 C.F.R. § 240.14a-6(i)(5).

(n172)Footnote 172. 17 C.F.R. § 240.14a-2(b)(1). *See* § 7.02 *supra*.

(n173)Footnote 173. Rule 14a-6(g)(2), 17 C.F.R. § 240.14a-6(g)(2).

(n174)Footnote 174. The contents of the Notice of Exempt Preliminary Roll--up Communication are set forth in Rule 14a--104, 17 C.F.R. § 240.14a-104.

(n175)Footnote 175. 17 C.F.R. Part 232.

(n176)Footnote 176. Rule 101 of Regulation S--T; 17 C.F.R. § 232.101.

(n177)Footnote 177. Rule 14a-6(j), 17 C.F.R. § 240.14a-6(j).

Form N-14 is available for the registration of securities issued pursuant to Securities Act Rule 145(a), 17 C.F.R. § 230.145(a), concerning registration of transactions involving business combinations, and Forms S-4 and F-4 are available for the registration of securities issued in business combination transactions.

(n178)Footnote 178. 15 U.S.C. § 78n(a).

(n179)Footnote 179. Rule 14a-6(j)(5), 17 C.F.R. § 240.14a-6(j)(5).

(n180)Footnote 180. For discussion of Section 10 of the Exchange Act, 15 U.S.C. § 78j and the rules thereunder, see ch. 5 *supra*.

(n181)Footnote 181. 15 U.S.C. § 77q.

(n182)Footnote 182. 17 C.F.R. § 240.14a-9.

(n183)Footnote 183. Rule 14a-9(a).

(n184)Footnote 184. Rule 14a-9(a), provides as follows:

No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

See also Mendell v. Greenberg, 927 F.2d 667, 670 (2d Cir. 1990) , modified on other grounds, 938 F.2d 1528 (2d Cir. 1991) , in which the court, citing Rule 14a-9(a), stated that "A proxy statement should honestly, openly and candidly state all the material facts, making no concealment of the proposals it advocates. Unlike poker where a player must conceal his unexposed cards, the object of a proxy statement is to put all one's cards on the table face-up. In this case only some of the cards were exposed; the others were concealed." *Lebhar Friedman, Inc. v. Movielab, Inc.*, Fed. Sec. L. Rep. (CCH) P 93,162 (S.D.N.Y. 1987), in which the court held that the defendant corporation's proxy statement, to be used in connection with a shareholder meeting involving the election of directors, violated Rule 14a-9 because it

omitted recommendations contained in a report by independent counsel that the court considered to be material regarding the capability of the directors. Although the final report was released after the time that the proxy statement had been issued, the defendant directors had received the report and had become aware of its recommendations before the voting date; *Central Foundry Co. v. Gondelman*, 166 F. Supp. 429 (S.D.N.Y.), modified sub nom. *Securities & Exchange Com. v. Central Foundry Co.*, 167 F. Supp. 821 (S.D.N.Y. 1958) (failure to state material facts necessary to make an oral solicitation not false or misleading violated the Exchange Act, 15 U.S.C. § 78a-78jj.)

(n185)Footnote 185. Rule 14a-2(b), 17 C.F.R. § 240.14a-2(b).

(n186)Footnote 186. The adviser may not receive any special commission or remuneration in connection with the furnishing of proxy voting advice from a third party and must disclose any significant relationship with the company (or shareholder proponent) and any material interest in the matter to which the proxy voting advice relates. Rule 14a-2(b)(3), 17 C.F.R. § 240.14a-2(b)(3).

(n187)Footnote 187. See discussion at § 7.02[2] *supra* with respect to exempt solicitations.

(n188)Footnote 188. See *Bolger v. First State Fin. Servs.*, 759 F. Supp. 182, 193 (D.N.J. 1991) (stating that "there is a limit to the amount of disclosure required by section 14(a). Section 14(a) does not require shareholders to be buried in 'an avalanche of trivial information' " (citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49, 96 S. Ct. 2126, 2132, 48 L. Ed. 2d 757 (1976)); *Perelman v. Pennsylvania Real Estate Inv. Trust*, 432 F. Supp. 1298 (E.D. Pa. 1977), in which the court held that even if certain information omitted from the proxy statement was material, Rule 14a-9, 17 C.F.R. § 240.14a-9, was not violated because the omission of the information did not make the proxy statement false or misleading.

See also *Ash v. Brunswick Corp.*, 405 F. Supp. 234 (D. Del. 1975) (it was not necessary that proxy statement soliciting votes for a stock option plan should advise shareholders of the terms of the plan that would cease to be effective upon the adoption of the new plan, because even if disclosure of the old plan would have been desirable, failure to include disclosures about such plan did not make the proxy statement false or misleading).

(n189)Footnote 189. See *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 111 S. Ct. 2749, 2753, 115 L. Ed. 2d 929 (1991) (holding that a statement of belief by corporate directors about a recommended course of action or why it was recommended may be materially significant since a shareholder would consider it important in deciding how to vote, causing it to fall under Section 14(a)); *Justin Indus., Inc. v. Choctaw Sec., L.P.*, 920 F.2d 262, 267 (5th Cir. 1990) (upon remanding the issue of materiality of failure to disclose amendments to bylaws that made it difficult to remove directors, court stated that changes in the relative power of shareholders and directors "bear a strong semblance of materiality"); *Landy v. Amsterdam*, 815 F.2d 925, 933 (3d Cir. 1987) (holding that failure of proxy statement to disclose the number of shares covered by an investment trust's call option was not a material misrepresentation, where there was no evidence to support the contention that the expired call option had any value to the investment trust); *Allyn Corp. v. Hartford Nat'l Corp.*, Fed. Sec. L. Rep. (CCH) P 98,646 (D. Conn. 1982) (bank involved in a merger misled shareholders with respect to a material fact by presenting an overly optimistic portrait of its financial condition in the proxy materials).

See also *Allen v. Penn Central Co.*, 350 F. Supp. 697 (E.D. Pa. 1972) (shareholder's claim that a proxy statement was incomplete was dismissed; while opposition to the plan by a nominee for director was a material fact, his reasons for opposing the plan need not be included to satisfy Section 14(a)).

See generally Hetzer, *Proxy Regulation: Ensuring Accurate Disclosure Through a Negligence Standard*, 50 *Fordham L. Rev.* 1423 (1982); Herzel & Hagan, *Materiality and the Use of SEC Forms*, 32 *Bus. Law.* 1177 (1977).

(n190)Footnote 190. 426 U.S. 438, 449, 96 S. Ct. 2126, 2133, 48 L. Ed. 2d 757 (1976)

(n191)Footnote 191. For a discussion of the standard for determining materiality under Rule 14a-9, see § 7.09[5][f] *infra*.

Also discussed in § 7.09[2] *infra* are the elements of a private cause of action pursuant to Rule 14a-9.

(n192)Footnote 192. *New England Anti-Vivisection Soc'y, Inc. v. United States Surgical Corp.*, 889 F.2d 1198, 1202 (1st Cir. 1989) (holding that "federal law is satisfied as long as the proxy materials fully and fairly set forth the relevant and material facts from which a reasonable shareholder may draw his own conclusions as to how to vote"); *Lessler v. Little*, 857 F.2d 866, 875, Fed. Sec. L. Rep. (CCH) P 94,020 (1st Cir. 1988) ; *Bolger v. First State Fin. Servs.*, 759 F. Supp. 182, 193 (D.N.J. 1991) ; *Wallerstein v. Primerica Corp.*, 701 F. Supp. 393, 396-97, Fed. Sec. L. Rep. (CCH) P 94,111 (E.D.N.Y. 1988) ; *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, 584 F.2d 1195, 1200, Fed. Sec. L. Rep. (CCH) P 96,565 at pp. 94,355-56 (2d Cir. 1978) (disclosure in a proxy statement that a participant in a contest for corporate control had not made a "detailed study of the consequences" of its program was sufficient to alert shareholders of the lack of a thorough investigation of the matter).

See also *Laurenzano v. Einbender*, 448 F.2d 1, 6 (2d Cir. 1971) .

(n193)Footnote 193. 314 F.Supp. 2d 1119 (U.S.D.C., D.Kan. 2004) .

(n194)Footnote 194. See, e.g., *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 777-78 (3d Cir. 1976) ; *United Paperworkers Int'l Union v. International Paper Co.*, 801 F. Supp. 1134, 1139-40 (S.D.N.Y. 1992) , modified, *aff'd*, 985 F.2d 1190 (2d Cir. 1993) ; *Bolger v. First State Fin. Servs.*, 759 F. Supp. 182, 193 (D.N.J. 1991) ; *Plant Indus., Inc. v. Bregman*, 490 F. Supp. 265, 269 (S.D.N.Y. 1980) ; *Bertoglio v. Texas International Co.*, 488 F. Supp. 630, 651-52 (D. Del. 1980) .

(n195)Footnote 195. *Unicorp Fin. Corp. v. First Union Real Estate Equity & Mortgage Inv.*, 515 F. Supp. 249, 261 (S.D. Ohio 1981) (proxy statement was not misleading simply because it did not describe what a shareholder believed to be the probable effect of a proposal to disqualify trustees).

(n196)Footnote 196. *Jewelcor, Inc. v. Pearlman*, 397 F. Supp. 221, 247-48 (S.D.N.Y. 1975) (failure of proxy material to disclose that the target company had considered a tender offer for its own stock to combat a threatened takeover did not violate Section 14(a), 15 U.S.C. § 78n(a) or Rule 14a-9, where the contemplated action was one of several alternatives being considered and not a concrete plan being actively implemented).

See also *Keyser v. Commonwealth Nat'l Fin. Corp.*, 644 F. Supp. 1130 (M.D. Pa. 1986) , in which the court denied a motion for summary judgment and failed to enjoin a merger, rejecting the plaintiff's assertion that the defendants had violated Rule 14a-9, *inter alia*, by not disclosing a rival offer. The court held that the rival offer need not be disclosed because it had been withdrawn and was thus no longer available for consideration by the shareholders. The court also stated that disclosure of the rival offer might have been misleading in itself since it was uncertain whether and to what extent it remained a possible avenue for the defendant company.

But cf. 4 L. Loss & J. Seligman, *Securities Regulation*, 2068-2074 (3d ed. 1990 & Supp. 1992) (discussing that "some facts are deemed material even though they concern a prospective and, therefore, contingent event as long as there appears to be a reasonable likelihood of its future occurrence").

(n197)Footnote 197. *Jewelcor, Inc. v. Pearlman*, 397 F. Supp. 221, 247-48 (S.D.N.Y. 1975) (failure of proxy material to state that proposed amendments to certificate of incorporation were designed to combat threatened takeover of target company or entrench its directors in office was not a material omission in violation of Section 14(a), 15 U.S.C. § 78n(a), or Rule 14a-9).

See also *Bertoglio v. Texas International Co.*, 488 F. Supp. 630 (D. Del. 1980) .

(n198)Footnote 198. See *Freer v. Mayer*, 796 F. Supp. 89 (S.D.N.Y. 1992) ("[t]here is no requirement that directors reveal the rationale for a business transaction described in a proxy"); *Wilson v. Great American Indus., Inc.*, 661 F. Supp. 1555, 1566 (N.D.N.Y. 1987) (failure to disclose unsubstantiated opinion of president of housing project's "true value" was not a material omission where shareholders were provided with detailed information on the financial condition of the project from which to draw their own conclusions), *rev'd*, 855 F.2d 987 (2d Cir. 1987) ; *Shapiro v. Belmont Indus., Inc.*, 438 F. Supp. 284 (E.D. Pa. 1977) (proxy statement was not misleading for not informing shareholders of the actual reasons for the resignation of two directors where there was no showing that the directors did not resign for the reasons stated in the proxy statement); *Mendell v. Greenberg*, 927 F.2d 667, 674 (2d Cir. 1990) ; *Lewis v. Potlatch Corp.*, 716 F. Supp. 807, 809 (S.D.N.Y. 1989) .

(n199)Footnote 199. See *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S.1083, 111 S. Ct. 2749, 115 L. Ed. 2d 929 (1991) , in which minority shareholders of the defendant bank challenged representations made by the bank's board regarding the fairness of a proposed merger. The Court held that conclusory statements that the merger was fair were actionable if plaintiffs proved that the board knowingly offered false reasons for its conclusions, stating that under Section 14(a), "a plaintiff is permitted to prove a specific statement of reason knowingly false or materially incomplete, even when stated in conclusory terms." 111 S. Ct. at 2759 .

(n200)Footnote 200. See *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1292-93 (2d Cir. 1973) .

See also *Allyn Corp. v. Hartford Nat'l Corp.*, Fed. Sec. L. Rep. (CCH) P 98,646 (D. Conn. 1982), in which a bank involved in a merger misled shareholders by inconsistently describing dividend projections in a transmittal letter to shareholders and in the proxy statement. The message conveyed by each of the two statements was not the same; the transmittal letter was optimistic and confident and the proxy statement was guarded and circumspect.

(n201)Footnote 201. See *United States v. Matthews*, 787 F.2d 38, 46 (2d Cir. 1986) stating that "[t]he SEC disapproves of attacks on character without complete and adequate supporting data, the Commission's position being that such attacks are contrary to the standards of fair disclosure unless they are in fact true."

(n202)Footnote 202. See *Mack v. Mishkin*, 172 F. Supp. 885, 888 (S.D.N.Y. 1959) , *Gould v. American Hawaiian S.S. Co.*, 331 F. Supp. 981, 990-92 (D. Del. 1971) (holding that statement that 64 percent of the shareholders were contractually committed to vote in defendant's favor falsely gave the impression that the election was decided and was therefore actionable under Rule 14a-9).

But see *Management Assistance Inc. v. Edelman*, 584 F. Supp. 1016, 1019-20 (S.D.N.Y. 1984) (holding that a statement that management group will win, which does not claim a present victory but merely predicts what results will be in future, is not proscribed by Rule 14a-9); *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, 449 F. Supp. 951, 960 (S.D.N.Y.), *aff'd in part, rev'd in part*, 584 F.2d 1195 (2d Cir. 1978) , (finding that a prediction of victory at a press conference was "an acceptable exclamation of confidence that would not divert a reasonable shareholder from the task of coolly determining how best to vote his shares in light of the opposing platforms").

(n203)Footnote 203. The Commission withdrew the reference in the Note to Rule 14a-9, to prediction of dividends as an example of a false or misleading statement, however, in connection with the Commission's adoption of a safe harbor for projections made in good faith and with a reasonable basis in filings with the Commission and in annual reports to shareholders. Sec. Exch. Act Rel. No. 15944, Fed. Sec. L. Rep. (CCH) P 82,117 (1979). Regarding the revision of this Note, see 4 L. Loss & J. Seligman, Securities Regulation 2054 n.351 (3d ed. 1990 & Supp. 1992) (citing *Walker v. Action Indus., Inc.*, 802 F.2d 703, 707-10 (4th Cir. 1986) , *cert. denied*, 479 U.S. 1065 (1987) ; *South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co.*, 669 F.2d 1265, 1271-72 n.3 (9th Cir. 1982)) .

In Sec. Exch. Act Rel. No. 16833, Fed. Sec. L. Rep. (CCH) P 24,117 (1980), the Commission presented its views with respect to disclosure in a proxy contest where a principal issue in contention is the liquidation of all or a part of the equity of a company with proceeds to be made available to shareholders. Those sponsoring a proposal often project the

dollar amount per share to be available to shareholders if such proposal is effected. These valuations in proxy soliciting material are appropriate and consonant with Rule 14a-9, when made in good faith and on a reasonable basis and when accompanied by disclosure which facilitates shareholders' understanding of the basis for and the limitations on the projected realization. Where material has been prepared and published by an independent party for purposes other than use in connection with the proxy contest and is offered as support for the valuation, the reasonableness of reliance on the material will be dependent on its original context and purpose, the qualifications of the author, and its currency.

(n204)Footnote 204. 17 C.F.R. § 240.3b-6.

(n205)Footnote 205. A forward-looking statement (as defined) made by a company in a document filed with the Commission, in Part 1 of Form 10-Q or in an annual report to shareholders is deemed not to be fraudulent unless such statement "was made or reaffirmed without a reasonable basis or was disclosed other than in good faith." Rule 3b-6 under the Exchange Act.

For a discussion of Rule 3b-6 with respect to annual reports to shareholders under Rule 14a-3(b) and (c) or Rule 14c-3(a) and (b), 17 C.F.R. § 240.14c-3(a) and (b), *see* § 4.04 *supra*.

(n206)Footnote 206. These provisions of Rule 14a-9(b), 17 C.F.R. § 240.14a-9(b), are consistent with Section 26 of the Exchange Act, 15 U.S.C. § 78z, which makes it unlawful to:

- (1) construe any act or omission by the Commission to mean that the Commission has passed on the merits of or approved a security or transaction;
- (2) consider any Commission action or failure to act upon a statement or report filed with or examined by it as a finding that the report or statement is true and accurate on its face or not false or misleading; or
- (3) represent to a prospective purchaser or seller of a security that the act or omission by the Commission should be construed to mean that the merits of the security or transaction has been approved or be considered as a finding that the statement or report is true and accurate on its face or not false or misleading.

(n207)Footnote 207. The Commission maintains that no inference at all is to be drawn from its clearance of proxy material. *See Klatorin v. Roth*, 353 F.2d 182, 183 (2d Cir. 1965). Furthermore, preparation of the proxy statement in consultation with the staff of the Commission "cannot affect the sufficiency as a matter of law of the allegations of the complaint." *Subin v. Goldsmith*, 224 F.2d 753, 774 (2d Cir.) (Medina, C.J. dissenting in part), *cert. denied*, 350 U.S. 883 (1955).

The opinion in *Millimet v. George F. Fuller Co.*, *Fed. Sec. L. Rep. (CCH) P 91,570*, at 95,156 (S.D.N.Y. 1965) makes the following observation:

Movant Fuller argues that "great deference should be paid" by this court to "clearance" of the Proxy Statement by the Commission (Reply Memorandum, page 7). This argument cannot be accepted. "Clearance" by the Commission, as I understand it, means merely an indication by the Commission that it will take no action under Section 21(e) of the Act (15 U.S.C. P 78u(e)) to enjoin (*sic*) use of the proxy statement. It is specifically provided in Section 26 of the Act (15 U.S.C. § 78z) that failure of the Commission to act shall not be construed to mean any approval. The Commission has apparently taken the position that no inference should be drawn from a failure by it to act. See 2 Loss, Securities Regulation (2d ed.) 953-4. In *J.I. Case Co. v. Borak*, above, the Commission filed a brief *amicus curiae* arguing ..., among other things, that examination by it of proxy material and its failure to object "should have no effect upon a subsequent private suit based upon the material." The Supreme Court appears to

have accepted this argument, for the opinion states (377 U.S. at 432):

The Commission advises that it examines over 2,000 proxy statements annually and each of them must necessarily be expedited. Time does not permit an independent examination of the facts set out in the proxy material and this results in the Commission's acceptance of the representation contained therein at their face value, unless contrary to other material on file with it.

Fed. Sec. L. Rep. (CCH) P 91,570, at 95,156.

Nevertheless, there is a definite inclination in some courts to attribute some significance to such clearance. *See Mack v. Mishkin*, 172 F. Supp. 885, 888 (S.D.N.Y. 1959) :

While I am aware that the action of the Securities and Exchange Commission is in no way binding on the Court, I must give some deference to both their action and inaction in the present case. All of the proxy material, including the press release and the newspaper advertisement, utilized by defendants was in accordance with the generally accepted procedure, submitted to the staff of the Securities and Exchange Commission for prior approval. Presumably, certain changes were required before issuance. I realize that the submission of the material is *ex parte* in nature; nevertheless, the fact that the staff of the Securities and Exchange Commission has presumably approved the issuance of the material must be given some weight. In addition, with full knowledge of all of the facts presented herein, the Securities and Exchange Commission, although it has jurisdiction to bring an action such as brought by plaintiffs, has not.

See also the following cases in which the courts deferred to such clearance:

Second Circuit: General Time Corp. v. Talley Indus., Inc., 283 F. Supp. 832 (S.D.N.Y. 1968) , *rev'd on other grounds*, 403 F.2d 159 (2d Cir. 1968) , *position reiterated in later appeal in same case*, 403 F.2d 159 (2d Cir. 1968) , *cert. denied*, 393 U.S. 1026 (1969) ; *Armour & Co. v. General Host Corp.*, 296 F. Supp. 470 (S.D.N.Y. 1969) ; *Sherman v. Posner*, 266 F. Supp. 871 (S.D.N.Y. 1966) ; *Shvetz v. Industrial Rayon Corp.*, 212 F. Supp. 308 (S.D.N.Y. 1960) ; *Dunn v. Decca Records, Inc.*, 120 F. Supp. 1 (S.D.N.Y. 1954) .

Tenth Circuit: Sunray DX Oil Co. v. Helmerich & Payne, Inc., 398 F.2d 447 (10th Cir. 1968) .

(n208)Footnote 208. *See* 4 L. Loss & J. Seligman, Securities Regulation 2052-85 (3d ed. 1990 & Supp. 1992) for cases and authorities on false and misleading statements under Rule 14a-9.

Second Circuit: Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973) (proxy statement seeking shareholder approval of a merger was misleading for failing to disclose management's intention of aggressively pursuing a policy of selling the assets of the other company after the merger); *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, 449 F. Supp. 951 (S.D.N.Y.) , *aff'd in part, rev'd in part*, 584 F.2d 1195 (2d Cir. 1978) (statement in proxy material by a participant in a contest for corporate control that it had not made a "detailed study of the consequences" of selling a corporate subsidiary did not mislead shareholders to believe that the feasibility of the proposed sale had been "thoroughly studied").

Ninth Circuit: South Coast Servs. Corp. v. Santa Ana Valley Irrigation Co., 669 F.2d 1265 (9th Cir. 1982) (a company's omission of its board of director's estimates of the fair market value of company property from a proxy statement did not violate Rule 14a-9); *SEC v. American Real Estate Inv. Trust*, 529 F. Supp. 1300 (C.D. Cal. 1982) (proxy solicitations that overstated a company's net worth, inflated the company's growth record, and included an annual report that contained misleading information violated Section 14(a), 15 U.S.C. § 78n(a) and Rule 14a-9).

(n209)Footnote 209. *Bolger v. First State Fin. Servs.*, 759 F. Supp. 182, 191-92 (D.N.J. 1991) (holding that shareholders alleging insufficient disclosure in proxy statements did not show an actual threat of irreparable harm and therefore injunctive relief was denied, where election could be voided and new election ordered, if necessary); *Wetter v. Caesars World, Inc.*, 541 F. Supp. 68 (D.N.J. 1982) (although proxy solicitations for the repurchase of stock from two major shareholders may have been misleading, injunctive relief was denied since any harm caused by the proxies was not irreparable; if the proxies were later found to be defective, the tainted transaction could be set aside and a resolicitation ordered).

(n210)Footnote 210. *SEC v. May*, 134 F. Supp. 247, 252 (S.D.N.Y. 1955) , *aff'd*, 229 F.2d 123 (2d Cir. 1956) . See also 4 L. Loss & J. Seligman, Securities Regulation 2057 n.362, 2052-85 (3d ed. 1990).

(n211)Footnote 211. The court in *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 774 (3d Cir. 1976) stated as follows:

The defendant-appellants argue, on the other hand, that the facts which were stated in various parts of the documents did constitute an adequate disclosure of the conflicting interests of the three directors in question. While we find ourselves in general accord with Judge Mansfield's statement in *Richland v. Crandall*, 262 F. Supp. 538, 554 (S.D.N.Y. 1967) , that "corporations are not required to address their stockholders as if they were children in kindergarten," we also bear in mind Judge Friendly's admonition in *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1297 (2d Cir. 1973) , who, after quoting Judge Mansfield's statement, said that "it is not sufficient that overtones might have been picked up by the sensitive antennae of investment analysts." In the present case many of the statements upon which the defendant-appellants rely are scattered through and rather buried in the lengthy proxy statement. There is nowhere a statement giving emphasis to the conflicts of interest similar to that given to the board's approval of the merger agreement. We conclude that the district court did not err in holding on summary judgment that the proxy materials were materially deficient in this respect. [Footnote omitted.]

See *United States v. Natelli*, 527 F.2d 311 (2d Cir. 1975) , *cert. denied*, 425 U.S. 934 (1976) (criminal conviction for "burying" earnings decrease in financial statements).

(n212)Footnote 212. *Richland v. Crandall*, 262 F. Supp. 538, 554 (S.D.N.Y. 1967) .

(n213)Footnote 213. "[C]orporations are not required to address their stockholders as if they were children in kindergarten." *Id.* See *Harner v. Prudential Sec.*, 785 F. Supp. 626, 641 (E.D. Mich. 1992) (holding, in the related context of actions under Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), that defendants were not required to condescend to the plaintiffs, as the law assumes a certain level of comprehension and judgment among investors).

See also *Consolidated Goldfields v. Anglo*, 713 F. Supp. 1457, 1470 (S.D.N.Y. 1989) ; *Shvets v. Industrial Rayon Corp.*, 212 F. Supp. 308 (S.D.N.Y. 1960) .

But see Fed. Sec. L. Rep. (CCH) P 82,236, at p. 85,221 (1982), in which the Commission stated the following in its release proposing Item 404 of Regulation S-K, 17 C.F.R. § 229.404: "To the extent that a proxy statement is overly complicated and difficult to read, it may not effectively perform its intended function of communicating meaningful information to security holders in order that they may make informed voting decisions."



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Federal Securities Exchange Act of 1934

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CHAPTER 7 Proxy Regulation

1-7 Federal Securities Exchange Act of 1934 § 7.05

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§ 7.05 Proxy Card

A proxy executed by a shareholder grants authority to a third party, the proxyholder, to vote the shares owned by the shareholder at the shareholders' meeting. The proxy card, or form of proxy, must be in a specific form and contain information required by Rule 14a-4.

A proxy card, or form of proxy, must indicate in bold face type whether or not it is being solicited on behalf of the company's board of directors. If it is not being solicited on behalf of the board of directors, the proxy card must state on whose behalf the solicitation is being made. n1 Many public companies use a computerized form of proxy card when soliciting proxies for shareholder meetings; however, as long as the form of proxy complies with the requirements of Rule 14a-4, it can be in any other form. The rules of the Commission do not regulate the color, size or other attributes of a proxy card. The proxy card must contain a blank space specifically designated for dating the proxy card. n2

The proxy card must "identify clearly and impartially each separate matter intended to be acted upon, whether or not related to or conditioned on the approval of other matters, and whether proposed by the registrant or by security holders." n3

Rule 14a-4(a)(3) and (b)(1) requires that the proxy card provide for a separate vote on each matter presented, whether or not the matter is conditioned upon approval of any other matter to be voted upon at the meeting. n4

In a case of first impression, it has been held that a private right of action exists under each of these rules where the security holder was improperly denied the opportunity to vote on each separate matter for which a proxy was solicited. n5

The proxy card is not required to contain a reference to matters as to which discretionary authority is granted. n6

A proxy card may grant the proxyholder discretion to vote on matters that are not identified in the proxy card. Rule 14a-4(c) specifies the following subjects about which discretionary authority may be granted:

- for an annual meeting of shareholders, if the company did not have notice of the matter at least 45

days before the date on which the company first mailed its proxy materials for the prior year's annual meeting of shareholders (or the date specified by an advance notice provision) and a specific statement to that effect is made in the proxy statement or form of proxy; n7

- in the case in which the company has received timely notice in connection with an annual meeting of shareholders (as determined under Rule 14a-4(c)(1)), if the company includes in its proxy statement advice on the nature of the matter and how the company intends to exercise its discretion to vote on each matter; n8

- for solicitations other than for annual meetings or for solicitations by persons other than the company, matters which the person making the solicitation do not know, a reasonable time before the solicitation, are to be presented at the meeting, if a specific statement to that effect is made in the proxy statement; n9

- approval of the minutes of the prior meeting of shareholders if such approval does not amount to ratification of the action taken at that meeting; n10

- the election of any person to any office for which a bona fide nominee is named in the proxy statement and such nominee is unable to serve or for good cause will not serve; n11

- any proposal omitted from the proxy statement and form of proxy pursuant to Rule 14a-8 or Rule 14a-9; n12 and

- matters incident to the conduct of the meeting. n13

Notwithstanding the general rule that a company may exercise discretion with respect to matters as to which it has received timely notice so long as it includes certain information in its proxy statement, n14 the company may not exercise discretionary authority if the proponent:

- provides the company with a written statement, within the time--frame determined under Rule 14a-4(c)(1), that the proponent intends to deliver a proxy statement and form of proxy to holders of at least the percentage of the company's voting shares required under applicable law to carry the proposal; n15

- includes the same statements in its proxy materials filed with the Commission; n16 and

- immediately after soliciting the percentage of shareholders required to carry the proposal, provides the company with a statement from any solicitor or other person with knowledge that the necessary steps have been taken to deliver a proxy statement and form of proxy to holders of at least the percentage of the company's voting shares required under applicable law to carry the proposal. n17

Discretionary authority may also be granted to the proxyholder to vote on matters that are identified in the proxy card but on which the shareholder has not specified a choice. In such case the proxy card must contain a statement, in bold face type, of how the proxyholder intends to vote the shares in each case. n18

If the meeting relates to an annual or special meeting at which directors are to be elected, Rule 14a-4(b)(2) requires that the names of the nominees be included in the proxy card. In addition, it contains specific requirements relating to the form and content of the proxy card. n19 For example, if the proxy card permits the shareholder to vote for a slate of directors as a group, similar means must be provided for the shareholder to withhold authority to vote for the group. n20 Rule 14a-4(b)(2) also contains specific requirements regarding the method by which a shareholder may withhold

authority to vote for specified nominees. n21 If state law gives legal effect to votes cast against a nominee (as compared to votes that withhold authority to vote for a nominee), then the proxy card must provide a means for the shareholder to vote against the nominee, either in addition to or in lieu of providing a means for the shareholder to withhold authority to vote for such nominee. n22 If, however, the shareholder executes the proxy card but does not withhold authority to vote for a specified nominee it will be deemed to constitute a vote for the election of such nominee, provided that the proxy card so states in bold face type. n23

In general, a proxy card may not confer authority to vote for the election of a person to any office if such person is not named in the proxy statement or such person has not consented to serve if elected. n24 However, the rules permit persons seeking to elect a minority of directors to the board (*i.e.*, dissident shareholders) to solicit authority to vote in favor of selected nominees from management's slate of directors, notwithstanding the fact that such persons are not named in the dissident's proxy statement. n25 In such case, the dissident must (i) seek authority to vote for the entire number of director positions then subject to election, (ii) represent that it will vote for management's nominees other than those named by the dissident, and (iii) provide a means by which the shareholder may withhold authority to vote for any of management's nominees who would be elected to office with the dissident's nominees. n26 The dissident's proxy card and proxy statement must, however, include a statement to the effect that no assurance can be given that management's nominees will serve as directors with the dissident's nominees if elected to the company's board of directors. n27

For all matters other than elections to office, the proxy card is required to contain boxes that may be marked by the shareholder to specify his or her vote. A shareholder is required to be provided with three boxes for each such matter: (i) a box indicating approval; (ii) a box indicating disapproval; and (iii) a box indicating that the shareholder is abstaining from voting on the matter. n28

The rules prohibit companies from soliciting proxies that relate to more than one annual meeting of shareholders, or that relate to a meeting of shareholders that is subsequent to the next scheduled meeting. A proxy card would, however, be valid at a reconvened meeting of shareholders if the originally scheduled meeting were adjourned. n29 Rule 14a-4(d)(4) prohibits a proxy from conferring authority to authorize any action that is not described in the proxy statement, other than action that is taken pursuant to discretionary authority.

The company's proxy statement or proxy card is required to contain a representation that the shares covered by the proxy will be voted and that, if the shareholder specifies a choice on how to vote, the shares will be voted in accordance with such specifications. n30

A proxy card is not permitted to be distributed to shareholders unless the shareholder has previously received (or concurrently receives) a definitive proxy statement that has been filed or mailed for filing with the Commission. n31

A proxy card that contains a simple statement that the company recommends a vote FOR or AGAINST a certain proposal is permitted, but electioneering or obscurative or similar material may not be included. n32

Some proxy cards contain a statement to the effect that any shareholder who wishes to attend the meeting may revoke his proxy and vote in person. The rights and responsibilities of a shareholder who revokes a proxy and wishes to vote in person are subject to state law. n33

An example of a proxy card for an annual meeting of shareholders at which directors are to be elected and ratification of the selection of independent accountants is to be voted upon is set forth below.

SAMPLE PROXY

WHAT FOLLOWS IS NOT AN ACTUAL PROXY

(Side One)**[NAME OF COMPANY]**

**PROXY SOLICITED ON BEHALF OF BOARD OF DIRECTORS
FOR THE ANNUAL MEETING OF SHAREHOLDERS OF
(NAME OF COMPANY)**

TO BE HELD ON _____

The undersigned hereby appoints _____, _____ and _____, and each of them, as proxies for the undersigned with full powers of substitution to vote all shares of the Common Stock of (Name of Company) (the "Company") which the undersigned may be entitled to vote n34 at the Annual Meeting of Shareholders of the Company to be held at (address) at (time) [a.m.] [p.m.], local time, on (date), or at any adjournments thereof as follows:

(TO BE SIGNED AND DATED ON REVERSE SIDE)**SAMPLE PROXY****WHAT FOLLOWS IS NOT AN ACTUAL PROXY****(Side Two)**

THIS PROXY WHEN PROPERLY EXECUTED WILL BE VOTED IN THE MANNER DIRECTED HEREIN BY THE UNDERSIGNED SHAREHOLDER. IF NO DIRECTION IS SPECIFIED, THIS PROXY WILL BE VOTED "FOR" PROPOSALS 1 AND 2 .

1. The election of Directors: [insert names of nominees]

FOR each nominee listed above☐

(except as marked to the contrary below)

WITHHOLD AUTHORITY to vote
for all nominees listed above☐**INSTRUCTION:**

To withhold authority to vote for any individual nominee, write that nominee's name on the space provided below:

2. Proposal to ratify the appointment of [insert name of accounting firm] as independent accountants for the year ending [insert date]

FOR ☐ **AGAINST** ☐ **ABSTAIN** ☐

3. In their discretion the proxies are authorized to vote upon such other business as may properly come before the Annual Meeting of Shareholders or any adjournments thereof.

The undersigned acknowledges receipt of the Notice of Annual Meeting and Proxy Statement.

Signature:

Signature:

Dated:

Please sign exactly as your name(s) appear(s) hereon. When signing as attorney, executor, administrator, trustee, guardian or for a corporation, please give your full title as such. If shares are owned jointly, both owners should sign.

To help our preparations for the meeting, please check here if you plan to attend: _____. n35

PLEASE MARK, DATE AND SIGN THIS PROXY AND RETURN IT PROMPTLY IN THE ENCLOSED ENVELOPE.

FOOTNOTES:

(n1)Footnote 1. Rule 14a-4(a)(1) under the Securities Exchange Act of 1934 is reprinted in the Primary Law Sourcebook, Volume B, Section F.

(n2)Footnote 2. Rule 14a-10 prohibits solicitation of an undated or post-dated proxy, and forbids proxy cards which are deemed to be dated subsequent to the date of execution by the shareholder. Rule 14a-4(a)(2). Rule 14a-10 does not specifically invalidate an undated proxy card. If the proxy is not returned properly dated, the postal dating on the returned envelope is probably sufficient to validate it.

(n3)Footnote 3. Rule 14a-4(a)(3).

(n4)Footnote 4. Sec. Exch. Act. Rel. No. 34-31326, Fed. Sec. L. Rep. (CCH) P 85,051, 57 FR 48276 (Oct. 22, 1992) .

While this rule is applied in a rigorous fashion by the SEC, the Commission will entertain exceptions where the application of the rule could involve a serious risk of misunderstanding on the part of the voting shareholder.

Prior to adoption of these rules in 1992, a company was expressly permitted to give the shareholder a single vote on a "group of related matters." Where the company expressly conditioned approval of one matter on approval of another related matter, the matters were not required to be separately set forth in the proxy card.

(n5)Footnote 5. *Koppel v. 4987 Corp.*, 167 F.3d 125 (2d Cir. 1999) .

(n6)Footnote 6. Rule 14a-4(a)(3).

(n7)Footnote 7. Rule 14a-4(c)(1); 17 C.F.R. § 240.14a-4(c)(1). The release adopting amendments to Rule 14a-4 in 1998 makes clear that the requirements of an advance notice by-law provision will take precedence over the 45--day period specified in the Rule. Under certain circumstances, the period determined in accordance with an advance notice period may be shorter than the 45--day period. The 45--day period specified in Rule 14a-4(c)(1) is measured from the date of mailing of the prior year's proxy material whereas advance notice bylaw provisions often specify a period based on the date of the prior year's annual meeting. If the company did not hold an annual meeting during the prior year or if the date of the meeting has changed more than 30 days from the prior year, then notice must have been received a reasonable time before the registrant mails its proxy materials for the current year.

(n8)Footnote 8. Rule 14a-4(c)(2); 17 C.F.R. § 240.14a-4(c)(2). Even if the information specified in Rule 14a-4(c)(2) is included in the company's proxy statement, its ability to exercise discretionary authority with respect to the matters identified may be limited. Such limitations are described below.

(n9)Footnote 9. Rule 14a-4(c)(3); 17 C.F.R. § 240.14a-4(c)(3).

(n10)Footnote 10. Rule 14a-4(c)(4); 17 C.F.R. § 240.14a-4(c)(4).

(n11)Footnote 11. Rule 14a-4(c)(5); 17 C.F.R. § 240.14a-4(c)(5).

(n12)Footnote 12. Rule 14a-4(c)(6); 17 C.F.R. § 240.14a-4(c)(6).

Rule 14a-8, 17 C.F.R. § 240.14a-8, and Rule 14a-9, 17 C.F.R. § 240.14a-9 are discussed below.

(n13)Footnote 13. Rule 14a-4(c)(7); 17 C.F.R. § 240.14a-4(c)(7).

(n14)Footnote 14. Such information is the nature of the matter and how the company intends to exercise its discretion to vote on each matter. Rule 14a-4(c)(2); 17 C.F.R. § 240.14a-4(c)(2).

(n15)Footnote 15. Rule 14a-4(c)(2)(i); 17 C.F.R. § 240.14a-4(c)(2)(i).

(n16)Footnote 16. Rule 14a-4(c)(2)(ii); 17 C.F.R. § 240.14a-4(c)(2)(ii).

The requirements for filing proxy materials with the Commission arise under Rule 14a-6 (17 C.F.R. § 240.14a-6) which is described elsewhere herein.

(n17)Footnote 17. Rule 14a-4(c)(2)(iii); 17 C.F.R. § 240.14a-4(c)(2)(iii).

(n18)Footnote 18. Rule 14a-4(b)(1).

(n19)Footnote 19. The provisions of Rule 14a-4(b)(2) are not applicable to a merger, consolidation or other plan if the election of directors is an integral part thereof. Instruction 1 to Rule 14a-4(b)(2).

(n20)Footnote 20. The rule does not require that the proxy card contain a method by which the shareholder may vote against the slate of directors as a group.

(n21)Footnote 21. The proxy card may provide the following means for shareholders to withhold authority to vote for director-nominees:

(i) a box opposite the name of each nominee which may be marked to indicate that authority to vote for such nominee is withheld; or

(ii) an instruction in bold-face type which indicates that the security holder may withhold authority to vote for any nominee by lining through or otherwise striking out the name of any nominee; or

(iii) designated blank spaces in which the security holder may enter the names of nominees with respect to whom the shareholder chooses to withhold authority to vote; or

(iv) any other similar means, provided that clear instructions are furnished indicating how the security holder may withhold authority to vote for any nominee.

Rule 14a-4(b)(2)(i)-(iv).

(n22)Footnote 22. Instruction 2 to Rule 14a-4(b)(2).

(n23)Footnote 23. Rule 14a-4(b)(2).

(n24)Footnote 24. Rule 14a-4(d)(1) and (4).

(n25)Footnote 25. Prior to amendment of the so-called "bona fide nominee rule" in October 1992, a dissident shareholder's proxy card could not grant authority to the proxyholder to vote for any of management's nominees. If a shareholder cast his or her vote using the dissident's proxy card, such shareholder was effectively barred from voting for any of management's nominees. *See* Sec. Exch. Act Rel. No. 34-31,326, Fed. Sec. L. Rep. (CCH) P 85,051, 57 FR 48276 (Oct. 22, 1992) .

(n26)Footnote 26. Procedurally, this could be accomplished by including the following in the dissident's proxy card: (1) the names of the dissident's nominees; (2) the names of the management nominees whom the dissident will not vote for; (3) a statement that the dissident will vote for the management nominees who are not named; and (4) a method for the shareholder to withhold authority to vote for management's nominees, by including a space in which the shareholder may write the name of such nominee or nominees.

(n27)Footnote 27. Rule 14a-4(d).

(n28)Footnote 28. Rule 14a-4(b)(1).

(n29)Footnote 29. Rule 14a-4(d)(2) and (3). Despite the reference in Rule 14a-4(d)(2) to "the next annual meeting," it should apply to special meetings of shareholders as well. *See* Aranow & Einhorn, *Proxy Contests for Corporate Control* 164 (2d ed. 1968).

(n30)Footnote 30. Rule 14a-4(e).

(n31)Footnote 31. For companies filing with the Commission, the "mailed for filing" option is, as a practical matter, not available because the definitive proxy material must be filed electronically.

Rule 14a-4(f).

Subsection (f) of Rule 14a-4, which was added in October 1992, permits a solicitation of proxies to commence upon delivery to the shareholder of a preliminary, as compared to a definitive, proxy statement. However, no proxy card may be given until the definitive proxy statement is delivered. *See* § 7.02 *supra*.

(n32)Footnote 32. "Among the devices which the Commission will regard as contrary to the section are arguments or recommendations as to the merits of proposals, emphasis upon the management's position beyond the mere statement of the fact that the management favors or opposes a proposal, the use of arrows or any other visual device designed to direct the stockholder's attention to the place on the proxy for voting one way and away from the place for voting the contrary and the switching of boxes in order to procure the result desired by the management." Sec. Exch. Act Rel. No. 4185, Fed. Sec. L. Rep. (CCH) P 24,101, 13 FR 6680 (1948) .

(n33)Footnote 33. *See* 9 Cavitch, *Business Organizations* ch. 110 (Matthew Bender & Co., Inc. 2007).

(n34)Footnote 34. If a company has in effect a dividend reinvestment plan, a proxy card may confer authority to vote the shares allocated to the shareholder's account under the plan. The following may be used for this purpose: (including shares, if any, held on behalf of the undersigned, and indicated on the reverse side hereof, by (name), under the Company's dividend reinvestment plan).

(n35)Footnote 35. For planning purposes, some proxy cards request that the shareholder indicate whether or not

the shareholder intends to attend the annual meeting. In some cases, admission tickets are thereafter mailed to the shareholder and are required for entrance to the annual meeting.



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Federal Securities Exchange Act of 1934

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CHAPTER 7 Proxy Regulation

1-7 Federal Securities Exchange Act of 1934 § 7.06

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§ 7.06 Requirements If Proxies Not Solicited--Section 14(c); Regulation 14C

Section 14(c) of the Exchange Act n1 extended the protection of the proxy rules to shareholders in public companies that do not solicit proxies. The general tenor of Section 14(c) was described as follows in the House Committee Report:

[Section 14(c)] would empower the Commission to adopt rules and regulations to require issuers that do not solicit proxies in connection with an annual or other meeting of shareholders to file with the Commission and to transmit to record holders of its registered securities information substantially equivalent to that which would be required to be transmitted if a solicitation were made. The information would be distributed to shareholders prior to the annual or other meeting of shareholders and would pertain to all matters to be voted upon at such meeting as to which disclosure would be required in solicitation materials under the proxy rules. n2

Pursuant to the authority granted to it under Section 14(c), the Commission adopted Regulation 14C, n3 which requires the distribution of an information statement if corporate action by shareholders is proposed to be taken but proxies, consents or authorizations are not to be solicited in accordance with Regulation 14A. n4 The information required to be included in the information statement is substantially the same as the information that would be required in a proxy statement were proxies being solicited. n5 Regulation 14C applies to any company with a class of securities registered under Section 12 of the Exchange Act n6 or that is registered as an investment company under the Investment Company Act of 1940. n7 It is especially important to note that preparation and distribution of an information statement is required whether the action is proposed to be taken (i) at a meeting for which proxies are not solicited or (ii) by written consent or authorization without a meeting.

[1] Contents of the Information Statement--Schedule 14C

Schedule 14C n8 requires disclosure of the four items described below. n9 Rule 14c-4 n10 provides that the information included in an information statement must be clearly presented and divided into appropriate sections with appropriate captions. As in the case of a proxy statement, no statement need be made in response to any item that is inapplicable. n11 Further, any information required to be included in an information statement as to the terms of securities or other subject matter that from a standpoint of practical necessity must be determined in the future may be stated in terms of

present knowledge and intention; subject to this qualification, any information that is not known to the company and that is not reasonably within the power of the company to ascertain or procure may be omitted if a brief statement of the circumstances rendering the information unavailable is made. n12 Technical requirements applicable to information statements are prescribed in Rule 14c-4. n13

[a] Item 1. Information Required by Items of Schedule 14A. In general, Item 1 of Schedule 14C requires a company to furnish as part of the information statement all the information called for by Schedule 14A n14 that would be applicable to any matters to be presented at the meeting if proxies were to be solicited in connection with the meeting. Notwithstanding this general requirement, an information statement need not include the information required by Item 1(c) of Schedule 14A (a statement of the date by which shareholder proposals intended to be presented at the next annual meeting must be received by the company for inclusion in the company's proxy material), Item 2 of Schedule 14A, "Revocability of Proxy," Item 4 of Schedule 14A, "Persons Making the Solicitation," and Item 5 of Schedule 14A, "Interest of Certain Persons in Matters to Be Acted Upon." n15 Notes A, C, D and E to Schedule 14A are also applicable to Schedule 14C. n16

[b] Item 2. Statement That Proxies Are Not Solicited. Item 2 of Schedule 14C requires that the following statement be included on the first page of the information statement in bold-face type: **"We Are Not Asking You for a Proxy and You Are Requested Not To Send Us a Proxy."**

[c] Item 3. Interest of Certain Persons in or Opposition to Matters to Be Acted Upon. Item 3 of Schedule 14C provides for disclosure of any substantial interest, direct or indirect, by security holdings or otherwise, of any person who has been a director or officer n17 of the company at any time since the beginning of the company's last fiscal year, who is a nominee for election as a director or who is an associate n18 of any of them in any matter to be acted upon, other than elections to office. n19 Also, the name of any director of the company who has given written notice to the company that such director intends to oppose any action to be taken by the company at the annual meeting must be disclosed, as well as the action that the director intends to oppose. n20

[d] Item 4. Proposals by Shareholders. Item 4 of Schedule 14C requires that, if any shareholder entitled to vote at the meeting or by written authorization or consent has submitted to the company a reasonable time before the information statement is distributed, n21 a proposal (other than a proposal relating to elections to office) that is accompanied by notice of the shareholder's intention to present the proposal for action at the meeting, the company must include in the information statement a statement to that effect. In addition, the company must identify the proposal and indicate the action proposed to be taken in respect of the proposal by the company at the meeting. n22

[2] Distribution of Information Statement to Shareholders

Unlike Regulation 14A, which does not prescribe any minimum time period prior to a meeting of shareholders when proxy material must be distributed, n23 Regulation 14C contains substantive provisions concerning the timing of distribution. In general, an information statement must be distributed to all shareholders entitled to vote not less than 20 days prior to the date of the meeting; in the case of action proposed to be taken by written authorization or consent, the date of distribution must be at least 20 days prior to the earliest date on which the corporate action may be taken. n24 However, in the case of a "roll-up transaction," n25 the information statement must be distributed no later than the lesser of (i) 60 calendar days prior to the date on which the meeting of shareholders is to be held or action on written consent or authorization is taken and (ii) the maximum number of days permitted for giving notice under applicable state law. n26

Notwithstanding the general rule that an information statement must be delivered to each shareholder entitled to vote, (i) in the case of a class of securities in unregistered or bearer form, the information statement needs to be sent only to those shareholders whose names are known to the company and (ii) no information statement needs to be sent to a shareholder if the company would be excused from delivery of an annual report or a proxy statement under Rule 14a-3(e)(2). n27

[3] Annual Report to Shareholders

If the action to be taken at an annual meeting or by written consent includes the election of directors, the information statement must be preceded or accompanied by an annual report to shareholders. n28 The annual report to shareholders must provide the same information required under Rule 14a-3(b) n29 for annual reports to shareholders delivered at or before the time proxy material is distributed.

Seven copies of the annual report must be mailed to the Commission for its information not later than the date of which the annual report is first sent or given to shareholders or the date on which preliminary copies (or definitive copies, if the filing of preliminary copies is not required) of the information statement are filed with the Commission, whichever date is later. n30

[4] Filing of Information Statement With the Commission

Five preliminary copies of an information statement must be filed with the Commission at least 10 days before definitive copies of the information statement are first sent or given to shareholders. n31 However, a company need not file a preliminary information statement if that statement relates to an annual meeting (or special meeting in lieu of an annual meeting) at which the only matters to be acted upon are:

- the election of directors;
- the election, approval or ratification of accountants;
- a shareholder proposal identified in the company's information statement pursuant to Item 4 of Schedule 14C; n32 and/or
- the approval or ratification of a plan (as defined in Item 402(a)(7)(ii) of Regulation S--K) or an amendment to a plan.

The exclusion from the requirement to file a preliminary information statement does not apply, however, if the company comments upon or refers to a solicitation in opposition to any matter to which the information statement relates. n33

Preliminary information statements are to be marked "Preliminary Copies" and will be immediately available for public inspection unless confidential treatment is obtained. n34 Confidential treatment of preliminary information statements will be accorded if the action to be taken is a matter specified in Item 14 of Schedule 14A n35 (i.e., mergers, consolidations, acquisitions and similar matters) if the material is marked "Confidential, For Use of the Commission Only." n36 However, if the matter to be acted upon is either subject to Rule 13e-3 n37 (a "going-private" transaction) or is a "roll-up" transaction as defined in Item 901(c) of Regulation S-K, n38 confidential treatment will not be given to the preliminary information statement. n39

Eight definitive copies of the information statement must be filed or mailed for filing with the Commission not later than the date it is first given or sent to shareholders and three definitive copies must be filed or mailed for filing with each national securities exchange upon which any security of the company is listed and registered. n40 For companies filing with the Commission, the "mailed for filing" option is, as a practical matter, not available because the definitive information statement must be filed electronically.

If any information statement filed pursuant to the Rule 14c-5 is amended or revised, two of the copies of the amended or revised materials must be marked to indicate clearly and precisely the changes effected therein. n41

At the time either a preliminary information statement or a definitive information statement is filed, the company is

required to indicate, in the case of a preliminary information statement, the date on which the information statement is intended to be released to shareholders or, in the case of a definitive information statement, the date on which the material was released to shareholders or on which it will be released. n42

Whenever an information statement is filed either in preliminary or definitive form, it must be accompanied by a cover sheet containing certain identifying information about the company and the document being filed; this requirement applies both to electronic and paper filers. n43

[5] Obligations of Companies in Facilitating Communications With Shareholders

A company obligated to distribute information statements is also obligated to take steps to provide reasonable assurance that the information statement, and annual report to shareholders, if required, reach the beneficial owners of its shares. These obligations, contained in Rule 14c-7, n44 are virtually the same as a company's obligations under Rule 14a-13, n45 including the obligation to make inquiry of record owners and fiduciaries and providing copies of material to be sent to the beneficial owners.

The only substantive difference between the obligations of a company under Rule 14c-7 and under Rule 14a-13 is that the date by which inquiry must be made by a company planning on distributing an information statement is the earlier of (a) 20 business days prior to the record date for the meeting of shareholders or the record date for written consents in lieu of a meeting or (b) 20 business days prior to the date the information statement is required to be sent or given to shareholders. n46

[6] False or Misleading Statements

Regulation 14C contains a general antifraud provision applicable to information statements. n47 This rule provides that no information statement shall contain any statement that, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact or that omits to state any material fact necessary in order to make the statements therein not false or misleading. n48 As in the case of proxy statements, the fact that an information statement has been filed with or examined by the Commission is not deemed a finding by the Commission that such material is accurate or complete or not false or misleading. The fact of filing or examination is also not deemed to indicate that the Commission has passed upon the merits of or approved any statement therein. n49

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 78n(c).

(n2)Footnote 2. H. R. Rep. No. 1418, 88th Cong., 2d Sess., 19 (1964), *reprinted* in the Primary Law Sourcebook, Volume C, Section I *infra*.

(n3)Footnote 3. Regulation 14C, 17 C.F.R. § 240.14c-1 *et seq.* , consists of Rule 14c-1 through Rule 14c-7 and Schedule 14C, 17 C.F.R. § 240.14c-101.

(n4)Footnote 4. 17 C.F.R. § 240.14a-1 *et seq.*

(n5)Footnote 5. If the company is a "small business issuer" as defined under Rule 12b-2, the disclosure obligations are governed by the items of Regulation S-B, 17 C.F.R. § 228.10 *et seq.* , corresponding to the items of Regulation S-K, 17 C.F.R. § 229.10 *et seq.* If there is no comparable disclosure item in Regulation S-B, the small business issuer need not provide the information requested.

See § 4.03 supra.

(n6)Footnote 6. *See § 4.01 supra.*

(n7)Footnote 7. 15 U.S.C. § 80a-1 *et seq.*

(n8)Footnote 8. 17 C.F.R. § 240.14c-101.

(n9)Footnote 9. The presentation of information in an information statement is governed by Rule 14c-4 under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G, which is similar to Rule 14a-5(a), (b) and (d). *See § 7.04 supra.*

A Note to Schedule 14C provides that any item, other than Item 4, need be answered only with respect to proposals to be made by the issuer, where that item calls for information concerning any matter to be acted upon at the annual meeting.

(n10)Footnote 10. 17 C.F.R. § 240.14c-4.

(n11)Footnote 11. Rule 14c-4(a).

(n12)Footnote 12. Rule 14c-4(b).

(n13)Footnote 13. These requirements relate to the order of information, the use of tables and figures and the minimum type size. Rule 14c-4(d) provides that where the proxy statement is delivered through an electronic medium, legibility requirements applicable to printed documents such as type size and fonts may be satisfied by presenting all information "in a format readily communicated to investors." Similar provisions apply to proxy statements (Rule 14a-5(d)(2)), and annual reports (Rule 14a-3(b)(2)(ii)).

(n14)Footnote 14. 17 C.F.R. § 240.14a-101. *See § 7.04[2] supra* for a discussion of Schedule 14A.

(n15)Footnote 15. In the case where an information statement is being provided in connection with action proposed to be taken upon written consent or authorization, it would be logical to assume that information corresponding to that required by Schedule 14A would be required in the information statement. For example, Item 1 of Schedule 14A requires disclosure in a proxy statement of the date, time and place of the meeting of shareholders. Since there is no meeting of shareholders if action is taken by written consent or authorization, this information could not be included in an information statement. Nevertheless, corresponding information (*i.e.*, the earliest date on which action is proposed to be taken) should be included.

(n16)Footnote 16. For a discussion of Notes A, C, D and E to Regulation 14A, *see § 7.04 supra.*

(n17)Footnote 17. Unlike other items in Schedule 14A or Regulation S-K, Item 3 of Schedule 14C uses the term "officer" rather than "executive officer." In particular, Item 5(a)(1) of Schedule 14A requires corresponding disclosure in a proxy statement for any person who has been an executive officer of the company at any time since the beginning of the last fiscal year.

(n18)Footnote 18. "Associate" is defined in Rule 14c-1(a) as follows:

The term "associate," used to indicate a relationship with any person, means: (1) any corporation or organization (other than the registrant or a majority owned subsidiary of the registrant) of which such person is an officer or partner or is, directly or indirectly, the beneficial owner of 10 percent or more of any class of equity securities; (2) any trust or other estate in which such person has a substantial beneficial interest or as to which such person serves as trustee or in a similar fiduciary capacity; and (3)

any relative or spouse of such person, or any relative of such spouse, who has the same home as such person or who is a director or officer of the registrant or any of its parents or subsidiaries.

(n19)Footnote 19. Item 3(a) of Schedule 14C.

(n20)Footnote 20. Item 3(b) of Schedule 14C.

While Item 3(b) does not specifically require disclosure of any director who intends to oppose any action to be taken by written consent, it would seem that such information would be equally significant to a shareholder.

(n21)Footnote 21. A company need not respond to Item 4 as to any proposal submitted with respect to an annual meeting if the proposal is submitted less than 60 days in advance of a day corresponding to the date of mailing a proxy statement or information statement in connection with the last annual meeting of shareholders. Instruction 1 to Item 4 of Schedule 14C.

(n22)Footnote 22. Item 4 of Schedule 14C.

In addition, if a company intends to rule a proposal submitted by a shareholder out of order, the Commission must be notified 20 days prior to the date that definitive copies of the information statement are filed with the Commission of that intention accompanied by a statement of the reasons why the proposal is not deemed to be a proper subject for action by shareholders. Instruction 2 to Item 4 of Schedule 14C.

(n23)Footnote 23. In general, the state laws under which a company is incorporated will require that notice be distributed between some minimum and maximum number of days prior to the date of the meeting of shareholders.

(n24)Footnote 24. Rule 14c-2(b).

(n25)Footnote 25. A "roll-up transaction" is defined for these purposes in Item 901(c) of Regulation S-K, 17 C.F.R. § 229.901(c). See § 4.03[10] *supra*.

(n26)Footnote 26. Rule 14c-2(c).

(n27)Footnote 27. Rule 14c-2.

(n28)Footnote 28. Rule 14c-3(a).

(n29)Footnote 29. 17 C.F.R. § 240.14a-3(b).

(n30)Footnote 30. Rule 14c-3(b). Compare Rule 14a-3(c) in the case of a proxy solicitation, discussed in § 7.03 *supra*.

As in the case of annual reports to shareholders provided to the Commission pursuant to Rule 14a-3(c), companies are requested to indicate in a letter to the Commission whether the financial statements in the report reflect a change from the preceding year in any accounting principles or practices or in the method of applying any such principles or practices. Note to Rule 14c-3(b).

(n31)Footnote 31. Rule 14c-5(a).

In computing the 10-day period, the filing date of the preliminary copies (*i.e.*, the date such preliminary copies are received by the Commission) is counted as the first day and the eleventh day is the date on which definitive copies of the information statement may be mailed to shareholders. Rule 14c-5(a).

The filing of a revised preliminary information statement will not recommence the 10-day time period unless the revised material contains material revisions or material new proposal(s) that constitute a fundamental change in the information statement previously filed. Note 1 to Rule 14c-5(a).

(n32)Footnote 32. Rule 14c-5(a).

In this regard, Rule 14c-5(a) should be compared with Rule 14a-6(a). Rule 14a-6(a) provides that registered investment companies need not file preliminary proxy materials with respect to meetings at which a proposal to continue without change any advisory or other contract or agreement that previously has been the subject of a proxy solicitation or a proposal to increase the number of shares authorized to be issued is to be considered.

(n33)Footnote 33. Rule 14c-5(a). For purposes of the exclusion from filing a preliminary information statement, a "solicitation in opposition" includes (i) any solicitation opposing a proposal supported by the company and (ii) any solicitation supporting a proposal that the company does not expressly support, other than a shareholder proposal identified in the company's information statement pursuant to Item 4 of Schedule 14C. The identification of a shareholder proposal in the company's information statement does not constitute a "solicitation in opposition" even if the company opposes the proposal and includes a statement in opposition to such proposal. Note 3 to Rule 14c-5(a).

A company which is filing preliminary copies of an information statement solely because it has comments on or has referred to an opposing solicitation should indicate that fact in the transmittal letter to the Commission. Note 4 to Rule 14c-5(a).

(n34)Footnote 34. Rule 14c-5(d)(1).

(n35)Footnote 35. Rule 14a-101.

(n36)Footnote 36. Rule 14c-5(d)(2)(ii).

Even if the preliminary information statement is not publicly available, the Commission may disclose the information to any department or agency of the United States Government and to the Congress.

(n37)Footnote 37. 17 C.F.R. § 240.13e-3. *See* § 7A.04 *infra*.

(n38)Footnote 38. 17 C.F.R. § 229.901(c). *See* § 4.03[10] *supra*.

(n39)Footnote 39. Rule 14c-5(d)(2)(i).

(n40)Footnote 40. Rule 14c-5(b).

A filing fee is payable only in connection with information statements regarding an acquisition, spinoff, consolidation or proposed sale or other disposition of substantially all the assets of the company. Rule 14c-5(g). If a fee is required, it is calculated pursuant to Rule 0-11. 17 C.F.R. § 240.0-11.

(n41)Footnote 41. Rule 14c-5(e).

For filings with the Commission submitted electronically, the changes would be marked as prescribed in the EDGAR Filer Manual.

(n42)Footnote 42. Rule 14c-5(c).

(n43)Footnote 43. Rule 14c-5(h). The form of the cover page is contained in Schedule 14C.

(n44)Footnote 44. 17 C.F.R. § 240.14c-7.

(n45)Footnote 45. 17 C.F.R. § 240.14a-13. *See also* § 7.02[3] *supra*.

(n46)Footnote 46. Rule 14c-7(a)(3).

(n47)Footnote 47. Rule 14c-6.

(n48)Footnote 48. This prohibition is similar to the prohibition contained in Rule 14a-9 applicable to proxy materials. *See* § 7.09 *infra* for a discussion of Rule 14a-9.

(n49)Footnote 49. Rule 14c-7(b).



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Federal Securities Exchange Act of 1934

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CHAPTER 7 Proxy Regulation

1-7 Federal Securities Exchange Act of 1934 § 7.07

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§ 7.07 Shareholder Proposals in Proxy Material--Rule 14a-8

A shareholder who wants to present a proposal for action at an upcoming shareholders' meeting may require the company to include the proposal in its proxy statement, provided the shareholder complies with the requirements of Rule 14a-8 n1 concerning such matters as eligibility of the proponent, proof of beneficial ownership, attendance at the meeting by the proponent or a representative and timeliness. The shareholder-proponent may only submit one proposal and an accompanying supporting statement (limited to an aggregate of 500 words) for inclusion in the proxy materials.

The company, however, may omit certain types of proposals and the related supporting statements. These include the following: (i) proposals that are not proper subjects for shareholder action under the laws of the company's domicile, (ii) proposals that would require the company to violate federal, state or foreign laws, (iii) proposals or supporting statements that are contrary to the Commission's proxy rules and regulations (including Rule 14a-9 n2 regarding false and misleading statements), (iv) proposals that constitute a personal claim or grievance or that are designed to benefit a personal interest not shared with the company's shareholders as a group, (v) proposals that are not significantly related to the company's business, (vi) irrelevant proposals (*i.e.*, beyond the company's power to effectuate), (vii) proposals dealing with ordinary business operations, (viii) proposals relating to an election to office, (ix) counterproposals to proposals made by the company, (x) proposals relating to specific amounts of cash or stock dividends, (xi) moot proposals, (xii) duplicative proposals or (xiii) proposals dealing with substantially the same subject matter as a prior proposal submitted to shareholders. The company must follow a prescribed procedure, including making filings with the Commission and notifying the shareholder-proponent, if it determines to omit a shareholder proposal from the proxy material or to include in the proxy statement a statement in opposition to the shareholder proposal.

After extensive debate and the issuance of two alternative proposals regarding the grant of increased shareholder access to the nomination of directors, the Commission decided (November 28, 2007) to adhere to its existing position that shareholder proposals on the subject of access to the making of board nominations may be excluded under Rule 14a-8 (despite the decision in *AFSCME v. AIG*, *supra*, Section 7.07[9]). *Shareholder Proposals Relating to the Election of Directors*. n3 The alternative proposal would have allowed shareholders owning five percent of the company's outstanding stock for at least one year and eligible to file as a passive investor on Schedule 13G to include in the company's proxy materials a proposal to amend the bylaws mandating procedures to allow shareholders to nominate candidates to the board to the extent permissible under the laws of the state of incorporation as well as the company's

charter and bylaws. n4 The proposal also would have encouraged companies and shareholders to establish or make use of electronic shareholders forums by exempting them from liability for statements or information provided to the forum by any other person. The proposal would also have exempted solicitations (other than solicitation for a proxy, rescission, abstention, consent or authorization) made more than 60 days before the meeting. n5

The Commission early came to the conclusion that any shareholder who wanted to present a matter to fellow shareholders should be able to include the proposal and a supporting statement in the company's proxy material. n6 Rule 14a-8 outlines the requisite steps to be taken if a shareholder wishes to present a proposal for action at an upcoming shareholders' meeting and contains the rules governing when a company may omit the proposal and supporting statement from its proxy material. In 1998, the Commission substantially revised Rule 14a-8 (17 C.F.R. § 240.14a-8) including recasting the entire rule to comply with the Commission's "plain English" initiatives. Rule 14a-8 is now presented in a question and answer format. n7

The success or failure of proposals to be adopted should not necessarily be judged by the actual vote tabulated. Virginia Rosenbaum of the Investor Responsibility Research Center has suggested that shareholder proposals that are withdrawn before ever coming to a vote may be the most highly successful of all, since the withdrawal is often made because the company has agreed to implement the changes sought by the proposal. n8

[1] Definition of "Proposal"--Rule 14a-8(a)

The Commission's response to Question 1 n9 defines what a shareholder proposal is. A shareholder proposal is a recommendation or requirement from a shareholder that the company and/or its board of directors take action, which the shareholder intends to present at a meeting of the company's shareholders. This response states that a shareholder proposal should state as clearly as possible the course of action that the shareholder believes the company should follow. The response informs the shareholder proponent that, if the shareholder's proposal is placed on the company's proxy card, the company must also provide in the form of proxy means for shareholders to specify by boxes a choice between approval or disapproval or abstention. Finally, the response to Question 1 states that "proposal" as used in Rule 14a-8 includes both the proposal and the corresponding statement in support submitted by the proponent.

[2] Eligibility--Rule 14a-8(b)

Question 2 n10 addresses the eligibility requirements for a shareholder to be able to submit a proposal to the company and the way a shareholder demonstrates eligibility to the company.

The response to Question 2 states that, in order to be eligible to submit a proposal, the proponent must have continuously held at least \$2,000 in market value, or 1%, of the company's securities n11 entitled to be voted on the proposal at the meeting for at least one year by the date the shareholder submits the proposal. n12 The response also includes the requirement that the shareholder must continue to hold those securities through the date of the meeting. n13

The response to Question 2 notes that the company can verify a shareholder proponent's eligibility on its own if the proponent owns the requisite number of shares in the proponent's own name. However, if the shares are held in nominee or street name, this response informs the shareholder that there are two ways to establish the shareholder's eligibility to submit a proposal for inclusion in the company's proxy material. The shareholder may:

- submit to the company a written statement from the "record" holder of the shareholder's securities n14 verifying that, at the time the proposal is submitted, the shareholder continuously held the securities for at least one year together with a written statement of the shareholder that the shareholder intends to continue to hold the securities through the date of the meeting of shareholders; n15
- if the shareholder has filed a Schedule 13D, n16 Schedule 13G n17 or a Form 3, n18 Form 4 n19

and/or Form 5 n20 or amendments to those documents or updated forms, reflecting ownership of the shares as of or before the date on which the one-year eligibility period begins, the shareholder can demonstrate eligibility by submitting the following to the company:

- a copy of the schedule and/or form and any subsequent amendments reporting a change in ownership level; n21
- a written statement from the shareholder that the shareholder continuously held the required number of shares for the one-year period as of the date of the shareholder's written statement; n22 and
- a written statement from the shareholder that the shareholder intends to continue ownership of the shares through the date of the company's annual or special meeting. n23

[3] Number of Proposals--Rule 14a-8(c)

The response to Question 3 n24 specifies that a shareholder may submit no more than one proposal to a company for a particular meeting of shareholders. n25

[4] Length of Proposal--Rule 14a-8(d)

The response to Question 4 n26 specifies that the proposal (including both the proposal and any accompanying supporting statement) may not exceed 500 words. n27

[5] Deadline for Submitting Proposal--Rule 14a-8(e)

The response to Question 5 n28 advises a shareholder that there are deadlines which must be met in order for the shareholder's proposal to be included in the company's proxy material. n29

- If the proposal is being submitted for the company's annual meeting, the shareholder can generally find the deadline in the proxy statement for the company's annual meeting held in the prior year. The response also tells a shareholder that, if the company did not hold an annual meeting in the prior year or has changed the date of its meeting for the current year more than 30 days from the prior year's meeting, the shareholder can usually find the deadline in one of the company's quarterly reports on Form 10-Q n30 or 10-QSB n31 or in shareholder reports of an investment company under Rule 30d-1 n32 under the Investment Company Act of 1940. The response further advises shareholders that the shareholder should submit any proposal by means, including electronic means, that permit the shareholder to prove the date of delivery. n33
- If the proposal is submitted for a regularly scheduled annual meeting, the proposal must be received at the company's principal executive offices not less than 120 calendar days before the date of the company's proxy statement released to shareholders in connection with the previous year's annual meeting. The response also notes that, if the company did not hold an annual meeting the previous year, or if the date of the current year's annual meeting has been changed more than 30 days from the date of the previous year's meeting, then the deadline is a reasonable time before the company begins to print and mail its proxy materials. n34
- The response states that a shareholder proposal being submitted for a meeting of shareholders other than a regularly scheduled annual meeting must be submitted a reasonable time before the company begins to print and mail its proxy materials. n35

[6] Failure to Meet Eligibility--Rule 14a-8(f)

The response to Question 6 n36 informs the shareholders of the consequences of failing to meet the eligibility requirements explained in the answers to Questions 1 through 4. These consequences are:

- The Company may exclude the proposal from its proxy material, but only after it has notified the shareholder proponent of the problem and the shareholder proponent has failed adequately to correct it. The response further states that the company must notify the proponent in writing of any procedural or eligibility deficiencies within 14 calendar days of receiving the proposal and of the time-frame for a response from the shareholder. The shareholder response must be postmarked, or transmitted electronically, no later than 14 days from the date the shareholder receives the company's notification. The company need not provide the shareholder notice of a deficiency if the deficiency cannot be remedied. n37
- If the shareholder proponent fails in its promise to hold the required number of securities through the date of the meeting of shareholders, then the company will be permitted to exclude any proposal from that shareholder from its proxy materials for any meeting held in the following two calendar years. n38

[7] Burden of Persuasion--Rule 14a-8(g)

Question 7 n39 asks who has the burden of persuading the Commission or its staff that a shareholder proposal can be excluded. The response is that, except as otherwise noted, the burden is on the company to demonstrate that it is entitled to exclude a proposal.

[8] Presentation of Proposal at Meeting--Rule 14a-8(h)

Question 8 n40 asks whether the shareholder proponent must appear personally at the shareholders' meeting to present the proposal. The Commission's response has three components:

- Either the shareholder proponent, or a representative of the shareholder proponent who is qualified under state law to present the proposal, must attend the meeting to present the proposal. The response also cautions that whether the shareholder proponent attends the meeting or sends a qualified representative, the shareholder proponent or the qualified representative must follow the proper state law procedures for attending the meeting and/or presenting the proposal. n41
- If the company holds its shareholder meeting in whole or in part via electronic media and the company permits the shareholder proponent or the proponent's representative to present the proposal via such media, then the shareholder proponent or qualified representative may appear through electronic media rather than traveling to the meeting to appear in person. n42
- If the shareholder proponent or a qualified representative of the shareholder proponent fails to appear and present the proposal, without good cause, the company will be permitted to exclude all proposals of the shareholder proponent from its proxy materials for any meetings held in the following two calendar years. n43

[9] Bases for Excluding Shareholder Proposals--Rule 14a-8(i)

In response to Question 9 n44 as to the bases on which a company may rely to exclude a shareholder proposal, the Commission identifies 13 bases on which a company can exclude a shareholder proposal. A shareholder proposal can be excluded:

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- If the proposal is not a proper subject for action by shareholders under the laws of the jurisdiction of the company's organization; n45
- If the proposal would, if implemented, cause the company to violate any state, federal or foreign law to which it is subject; n46
- If the proposal or supporting statement is contrary to any of the Commission's proxy rules, including Rule 14a-9 which prohibits materially false or misleading statements in proxy soliciting materials; n47
- If the proposal relates to the redress of a personal claim or grievance against the company or any other person, or if it is designed to result in a benefit to the shareholder proponent, or to further a personal interest which is not shared by the other shareholders at large; n48
- If the proposal relates to operations which account for less than 5 percent of the company's total assets at the end of its most recent fiscal year, and for less than 5 percent of its net earnings and gross sales for its most recent fiscal year, and is not otherwise significantly related to the company's business. n49
- If the company would lack the power or authority to implement the proposal; n50
- If the proposal deals with a matter relating to the company's ordinary business operations; n51
- If the proposal relates to an election for membership on the company's board of directors or analogous governing body: n52
- If the proposal directly conflicts with one of the company's own proposals to be submitted to shareholders at the same meeting; n53
- If the company has already substantially implemented the proposal; n54
- If the proposal substantially duplicates another proposal previously submitted to the company by another proponent that will be included in the company's proxy materials for the same meeting; n55
- If the proposal deals with substantially the same subject matter as another proposal or proposals, that has or have been previously included in the company's proxy materials within the preceding five calendar years, n56 a company may exclude from its proxy materials for any meeting held within three calendar years of the last time it was included if the proposal received:
 - Less than 3% of the vote if proposed once within the preceding five calendar years; n57
 - Less than 6% of the vote on its last submission to shareholders if proposed twice previously within the preceding five calendar years; n58 or
 - Less than 10% of the vote on its last submission to shareholders if proposed three times or more previously within the preceding five calendar years; n59 and
- If the proposal relates to specific amounts of cash or stock dividends. n60

The Staff of the Commission has issued a series of Staff Legal Bulletins regarding the basis on which proposals are excludable.

In Staff Legal Bulletin No. 14B, n61 the Staff announced that companies would no longer be allowed to exclude proposals because of deficiencies in a proposal's supporting statement, on the basis of being materially false or misleading. The Staff will not exclude supporting statement language or a proposal itself where the basis of exclusion is alleged to be unsupported factual assertions, or assertions that may be disputed or countered, or assertions that may be interpreted by shareholders in a manner unfavorable to the Company, its directors or officers, or are matters of opinion but not identified as such. The Staff stated that companies should address those objections in their statements of opposition in the proxy statement. This policy does not apply to statements which impugn character, integrity or personal reputation, statements which the Company demonstrates are materially false or misleading, proposals inherently vague or so indefinite that they are incapable of determination as to what is required, and supporting statements containing substantial portions of irrelevant matter.

The Staff of the Commission subsequently released Staff Legal Bulletin No. 14C n62 on the application of Rule 14A-8 to shareholder proposals about director independence and environmental or public health issues.

The Division will allow omission of a proposal requiring a director to maintain independence at all times, on the ground that the Company would lack the power or authority to implement it. A proposal calling for directors to be independent is only includable "if the proposal does not require a director to maintain independence at all times or contains language permitting the company to cure a director's loss of independence."

Regarding environmental or public health issues, a proposal may not be omitted if it focuses on significant social policy issues that "transcend the day-to-day business matters," *e.g.*, if the focus is on the Company minimizing or eliminating harmful operations, the proposal may not be omitted as relating to ordinary business operations.

Staff Legal Bulletin No. 14D addresses proposals that recommend, request or require a board of directors to unilaterally amend the company's articles or certificate of incorporation, and states that such proposals are includable only if they provide that the board of directors "take the steps necessary" to amend the company's charter (such as submit the proposed amendment to a vote of stockholders).

[10] Procedures the Company Must Follow to Exclude Proposals--Rule 14a-8(j)

In response to Question 10, n63 the Commission outlines the procedures which the company must follow if it intends to exclude a shareholder proposal from its proxy materials. These procedures are:

- If the company intends to exclude a proposal from its proxy materials, it must file its reasons with the Commission no later than 80 calendar days before it files its definitive proxy statement and form of proxy with the Commission. The company must simultaneously provide the shareholder proponent with a copy of its submission. The Commission staff may permit the company to make its submission later than 80 days before the company files its definitive proxy statement and form of proxy if the company demonstrates good cause for missing the deadline. n64
- The company must file six paper copies of the following:
 - The proposal; n65
 - An explanation of why the company believes that it may exclude the proposal which should, if possible, refer to the most recent applicable authority, such as prior letters of the Division of Corporation Finance issued under the proxy rules; n66 and

- A supporting opinion of counsel when such reasons are based on matters of state or foreign law. n67

[11] Whether the Shareholder May Respond to Company Arguments--Rule 14a-8(k)

The Commission's response to Question 11 n68 states that the shareholder proponent may, but is not required to, submit a response to the company's arguments for excluding a proposal. The Commission notes that the shareholder proponent should try to submit any response to it, with a copy to the company, as soon as possible after the company makes its submission so that the Commission staff will have time to consider fully that submission before it issues its response. The shareholder proponent should submit six paper copies of any response.

[12] Information to be Included about Shareholder Proponent--Rule 14a-8(l)

In response to Question 12, n69 the Commission states that, if the company includes a shareholder proposal, the proxy statement must include the name and address of the shareholder proponent, as well as the number of the company's voting securities that the shareholder proponent holds. The Commission notes, however, that instead of providing that information, the company may include a statement that it will provide the information to shareholders promptly upon receiving an oral or written request. n70

In the same response, the Commission states that the company is not responsible for the contents of a shareholder proposal or the supporting statement. n71

[13] Shareholder Disagreement with Company Statements--Rule 14a-8(m)

Question 13 n72 poses the question of what a shareholder proponent can do if the proponent believes that the company is including in its proxy statement reasons why it believes shareholders should not vote in favor of the proposal and the shareholder proponent disagrees with some of the company's statements. The Commission's response has three parts:

- The company may elect to include in its proxy statement reasons why it believes shareholders should vote against the proposal. The company is allowed to make arguments reflecting its own point of view, just as the shareholder proponent may express the proponent's point of view in the proposal's supporting statement. n73
- If the shareholder proponent believes that the company's opposition to the proposal contains materially false or misleading statements that may violate the anti-fraud rule, the proponent should promptly send to the Commission's staff and the company a letter explaining the reason for the proponent's view. To the extent possible, the letter should include specific factual information demonstrating the inaccuracy of the company's claims. n74 The Commission also notes that, time permitting, the shareholder proponent may wish to try to work out differences with the company directly before contacting the Commission staff. n75
- The Commission notes that it requires the company to send the shareholder proponent a copy of its statements opposing a shareholder proposal before it mails its proxy materials, so that the shareholder proponent may bring to the Commission's attention any materially false or misleading statements, under the following timeframes:
 - If the Commission's no-action response requires that the shareholder proponent make revisions to the proposal or supporting statement as a condition to requiring the company to include it in its proxy materials, then the company must provide the shareholder

proponent with a copy of its opposition statements no later than five calendar after the company receives a copy of the shareholder proponent's revised proposal; n76 or

■ In all other cases, the company must provide the shareholder proponent with a copy of its opposition statements no later than 30 calendar days before it files definitive copies of its proxy statement and form of proxy with the Commission. n77

FOOTNOTES:

(n1)Footnote 1. 17 C.F.R. § 240.14a-8.

(n2)Footnote 2. 17 C.F.R. § 240.14a-9.

(n3)Footnote 3. Sec. Exch. Act Rel. No. 34-56914.

(n4)Footnote 4. Shareholder Proposals, Sec. Exch. Act Rel. No. 34-56160.

(n5)Footnote 5. The Commission's proposals regarding Electronic Shareholder Forums were later adopted effective February 25, 2008 in Release 34-57172. See discussion in *Section 7.02[2]*, *supra*.

(n6)Footnote 6. The Division of Corporation Finance, *Staff Report on Corporate Accountability: A Re-examination of Rules Relating to Shareholder Communications, Shareholder Participation in Corporate Electoral Process and Corporate Governance Generally*, 96th Cong. 2d Sess. (Comm. Print) (Comm. on Banking, Housing and Urban Affairs of the U.S. Senate) p. 155 (1980) [hereinafter Staff Report] proposed minor changes to Rule 14a-8 to clarify the procedural requirements applicable to proponents and the company in connection with shareholder proposals.

The Staff Report recommended amendments of:

(1) Rule 14a-8(a)(2) under the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section G, discussed in § 7.07[1] *infra*, to clarify that any person qualified under state law to present a proposal, whether or not the person is also a company shareholder, may represent the proponent at the annual meeting;

(2) Rule 14a-8(b), discussed in § 7.07[2] *infra*, to require disclosure in proxy materials of names, addresses and share holdings of shareholder-proponents; and

(3) Rule 14a-8(a)(4), discussed in § 7.07[1] *infra*, which previously limited the text of a proposal to 300 words and a proponent's supporting statement to 200 words, to permit a proponent to use 500 words, to be divided between the proposal and supporting statements at the proponent's discretion.

Staff Report at 222-23.

In addition, the Staff Report recommended that the shareholder proposal rule be reexamined in light of the Supreme Court's decision in *First National Bank of Boston v. Bellotti*, 435 U.S. 765, 98 S. Ct. 1407, 55 L. Ed. 2d 707 (1978), to clarify the substantive grounds in Rule 14a-8 for excluding proposals under the "not significantly related to the company's business" standard under Rule 14a-8(c)(5) and the "ordinary business" standard under Rule 14a-8(c)(7). In *Bellotti*, the Court held that a Massachusetts statute that prohibited corporate expenditures or contributions intended to influence the vote on any questions submitted to shareholders that have no material connection with the corporate

business was an unconstitutional abridgment of speech protected under the *First Amendment*.

The Staff Report recommended that the Commission issue an interpretative release to clarify and consolidate past positions taken by the Commission on the meaning of the phrase "ordinary business" in Rule 14a-8(c)(7), discussed in § 7.07[3] *infra*. Staff Report at 223.

As to the "not otherwise significantly related to the [issuer's] business" standard under Rule 14a-8(c)(5), discussed in § 7.07[3] *infra*, the Staff Report concluded that, in light of the *Bellotti* decision, the existing proxy rule provisions may not afford an adequate remedy for shareholders seeking to hold their companies accountable for the use of corporate funds for political purposes, such as support of political action committees, contributions to referendum campaigns, and advocacy advertising. *Id.* at 39. Accordingly, the Staff Report recommended that a concept release be issued to consider:

- (1) whether to adopt requirements for disclosure of corporate political activities and expenditures consistent with the procedures of corporate democracy articulated by the Supreme Court in *Bellotti*;
- (2) the role of the shareholder proposal process in meeting the goals and assumptions of corporate democracy as set forth in *Bellotti*;
- (3) the need, if any, for treating shareholder proposals that seek disclosure of corporate political expenditures and activities differently from proposals requesting positive or negative corporate action;
- (4) whether the standards and concepts should be limited to political activities and, if not, what other areas should be included;
- (5) how to define political activities;
- (6) what forms of political contributions and activities should be covered; and
- (7) whether a threshold amount or level of activity would be appropriate and, if so, how to determine that threshold.

Id. at 40, 41.

The Commission, in response to the recommendations of the Staff Report, proposed several technical changes to the shareholder proposal rule in Sec. Exch. Act Rel. No. 34-17517, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,817 (Feb. 5, 1981).

Additionally, as part of the Commission's proxy review program (discussed in § 7.01[5][c] *supra*), the Commission proposed three alternatives for amending Rule 14a-8 involving the following:

- (1) retention of the basic concepts underlying the rule with clarifying revisions to certain of its procedural and other provisions;
- (2) adoption of a supplemental rule that would allow a company, with the approval of shareholders, to adopt its own procedures governing shareholder access to the company's proxy statement; or
- (3) inclusion of any proposal proper under state law and not involving an election of directors, subject to a numerical limit on the number of proposals required to be included in the proxy statement.

Sec. Exch. Act Rel. No. 34-19135, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,262 (Oct. 14, 1982).

In 1983, the Commission adopted the first of the three alternatives of proposed amendments to Rule 14a-8, retaining the framework but revising certain procedural provisions of the Rule. Sec. Exch. Act Rel. No. 20091, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,417 (Aug. 16, 1983).

The Commission has, in response to the *Bellotti* decision and to the Staff Report recommendations for a clarification of the meaning of the phrase "ordinary business" in Rule 14a-8(c)(7), taken the position that proposals requesting companies to prepare reports on specific aspects of their business that involve matters of ordinary business may be excluded under Rule 14a-8(c)(7), discussed in § 7.07[2][e] *infra*, and made related amendments to Rule 14a-8(c)(5), discussed in § 7.07[2][d] *infra*. Sec. Exch. Act Rel. No. 34-20091, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,417 (Aug. 16, 1983).

See also Schwartz & Weiss, *An Assessment of the SEC Shareholder Proposal Rule*, 65 *Geo. L.J.* 635 (1977).

(n7)Footnote 7. In *Roosevelt v. E.I. Du Pont De Nemours & Co.*, 958 *F.2d* 416 (D.C. Cir. 1992), the Court of Appeals for the District of Columbia held that a shareholder has an implied private right of action to sue for inclusion of a shareholder proposal in proxy material. The court found that "[a]ccess to management proxy solicitations to sound out management views and to communicate with other shareholders on matters of major import" is an informational right "appropriately enforced" by a private right of action under Section 14(a) of the Exchange Act, 15 *U.S.C.* § 78n(a). 958 *F.2d* at 421. The court agreed, however, that the shareholder proposal, involving the phasing out of chlorofluorocarbons, involved the ordinary business operations of the company and could be excluded under Rule 14a-8(c)(7). See § 7.09 for a discussion of implied private rights of action under Section 14(a) of the Exchange Act. In Sec. Exch. Act Rel. No. 34-14970, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,645, n.27 (July 18, 1978), the Commission noted that, according to its records, approximately 50 percent of all the shareholder proposals received by companies are included by management in the proxy materials without resort to the Commission's no-action procedures.

(n8)Footnote 8. 18 *BNA Corporate Counsel Weekly*, No. 31, page 248 (August 6, 2003).

(n9)Footnote 9. Rule 14a-8(a); 17 *C.F.R.* § 240.14a-8(a).

(n10)Footnote 10. Rule 14a-8(b); 17 *C.F.R.* § 240.14a-8(b).

(n11)Footnote 11. Security holdings of co-proponents will be aggregated in determining the eligibility for inclusion of a proposal. In determining whether a proponent has held the company's securities having the requisite market value, the value is computed by use of the average of the bid and asked prices of the securities as of a date within 60 days prior to the date the proposal is submitted. Sec. Exch. Act Rel. No. 34-20091, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,417 (Aug. 16, 1983).

(n12)Footnote 12. For example, a proponent who owned a security that could be voted on the election of some of the issuer's directors but on no other matters could not submit a proposal relating to the issuer's business activities, since he would not be able to vote on it personally. Sec. Exch. Act Rel. No. 34-12999, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,812, at 87,124 (Nov. 22, 1976).

See *Ruddick Corp.*, SEC No-Action Letter (Nov. 20, 1989) (the staff determined that shares of the employee-proponent held for his account in an employee stock ownership plan for over one year could be counted when determining the minimum stock ownership requirement under former Rule 14a-8(a)(1) (the predecessor to current Rule 14a-8(b)), even though voting power did not attach to the shares until approximately nine months prior to submission of the proposal).

(n13)Footnote 13. Rule 14a-8(b)(1); 17 C.F.R. § 240.14a-8(b)(1).

(n14)Footnote 14. The response indicates that the "record" holder is usually a broker or bank. Rule 14a-8(b)(2); 17 C.F.R. § 240.14a-8(b)(2).

(n15)Footnote 15. Rule 14a-8(b)(2)(i); 17 C.F.R. § 240.14a-8(b)(2)(i).

(n16)Footnote 16. 17 C.F.R. § 240.13d-101.

(n17)Footnote 17. 17 C.F.R. § 240.13d-102.

(n18)Footnote 18. 17 C.F.R. § 249.103.

(n19)Footnote 19. 17 C.F.R. § 249.104.

(n20)Footnote 20. 17 C.F.R. § 249.105.

(n21)Footnote 21. Rule 14a-8(b)(2)(ii)(A); 17 C.F.R. § 240.14a-8(b)(2)(ii)(A).

(n22)Footnote 22. Rule 14a-8(b)(2)(ii)(B); 17 C.F.R. § 240.14a-8(b)(2)(ii)(B).

(n23)Footnote 23. Rule 14a-8(b)(2)(ii)(C); 17 C.F.R. § 240.14a-8(b)(2)(ii)(C).

(n24)Footnote 24. Rule 14a-8(c); 17 C.F.R. § 240.14a-8(c).

(n25)Footnote 25. See Santa Fe Pacific Corp., SEC No-Action Letter (Feb. 17, 1993) (in respect of a proposal requesting that the positions of chairman and chief executive officer not be permitted to be held by the same person and requesting that the chairman be elected from among the company's outside directors, the staff indicated that "the entire submission relates to a by-law amendment to provide new qualifications" for the board chairman, and is not two distinct proposals involving different considerations, as counsel had argued).

(n26)Footnote 26. Rule 14a-8(d); 17 C.F.R. § 240.14a-8(d).

(n27)Footnote 27. The Commission has stated that it:

is aware of the possibility that some proponents may attempt to evade the new limitations through various maneuvers, such as having other persons whose securities they control submit two proposals each in their own names. The Commission wishes to make it clear that such tactics may result in measures such as the granting of requests by the affected managements for a 'no-action' letter concerning the omission from their proxy materials of the proposals at issue.

Sec. Exch. Act Rel. No. 34-12999, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,812, at 87,127 (Nov. 22, 1976) (footnote omitted).

(n28)Footnote 28. Rule 14a-8(e); 17 C.F.R. § 240.14a-8(e).

(n29)Footnote 29. The Commission has stated that:

As a final note to the discussion of the timeliness requirements, the Commission wishes to reiterate a view that its staff has expressed informally on many occasions in the past. That is, changes to a timely submitted proposal or supporting statement may be made by the proponent after the timeliness deadline has passed, provided the changes are minor in nature and do not alter the substance of the proposal. Examples of such changes would be a change in the form of the proposal to bring it into accord with the

requirements of the applicable state law, or a change in the proposal or supporting statement to revise or delete misleading statements contained therein.

The above position has been taken by the Commission and its staff in recognition of the fact that most proponents are not sophisticated in matters of securities law such as Rule 14a-8. Because of their lack of sophistication, such persons frequently are apt to submit proposals that generally comply with the substantive requirements of Rule 14a-8 but nevertheless contain some relatively minor defects that are easily correctable. In such circumstances, the Commission believes the concept of corporate democracy underlying section 14(a) of the Exchange Act is best served by affording such persons the opportunity to correct the defects that have been pointed out to them. Thus, under this view, a proponent may make non-substantive changes to his original submission after the timeliness deadline has passed without being considered to have submitted an entirely new proposal that would be excludable under the timeliness provisions of subparagraph [Rule 14a-8(e)].

Sec. Exch. Act Rel. No. 34-12999, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,812, at 87,127 (Nov. 22, 1976).

(n30)Footnote 30. 17 C.F.R. § 249.308a.

(n31)Footnote 31. 17 C.F.R. § 249.308b.

(n32)Footnote 32. 17 C.F.R. § 270.30d-1.

(n33)Footnote 33. Rule 14a-8(e)(1); 17 C.F.R. § 240.14a-8(e)(1).

(n34)Footnote 34. Rule 14a-8(e)(2); 17 C.F.R. § 240.14a-8(e)(1).

(n35)Footnote 35. Rule 14a-8(e)(3); 17 C.F.R. § 240.14a-8(e)(3).

(n36)Footnote 36. Rule 14a-8(f); 17 C.F.R. § 240.14a-8(f).

(n37)Footnote 37. Rule 14a-8(f)(1); 17 C.F.R. § 240.14a-8(f)(1).

(n38)Footnote 38. Rule 14a-8(f)(2); 17 C.F.R. § 240.14A-8(f)(2).

(n39)Footnote 39. Rule 14a-8(g); 17 C.F.R. § 240.14a-8(g).

(n40)Footnote 40. Rule 14a-8(h); 17 C.F.R. § 240.14a-8(h).

(n41)Footnote 41. Rule 14a-8(h)(1); 17 C.F.R. § 240.14a-8(h)(1).

(n42)Footnote 42. Rule 14a-8(h)(2); 17 C.F.R. § 240.14a-8(h)(2).

(n43)Footnote 43. Rule 14a-8(h)(3); 17 C.F.R. § 240.14a-8(h)(3).

(n44)Footnote 44. Rule 14a-8(i); 17 C.F.R. § 240.14a-8(i).

(n45)Footnote 45. Rule 14a-8(i)(1); 17 C.F.R. § 240.14a-8(i)(1).

The Staff of the SEC has for the first time certified to the Delaware Supreme Court the question of whether a proposal submitted by AFSCME Employees Pension Plan is valid under Delaware law. The proposal in question would require CA, Inc. to reimburse solicitations by dissidents in an election contest for less than fifty percent of the Board seats if

any of the proposed dissident nominees are elected. While insurgents who win Board control have been able to recover their expenses, the company had opposed the proposal on several grounds, one of which was that the matter was not a proper matter for shareholder action under state law. The Delaware Supreme Court ruled that the proposal was a proper subject for shareholder action under Delaware law but that the proposal if adopted would cause CA to violate Delaware law, in denying to CA's board the ability to perform its fiduciary obligation under Delaware law to determine whether indemnification is proper under Delaware statute. Del. Sup. Ct. No. 329, 2008, decided 7/17/08, modified 8/15/08 on Certification of Questions of Law from the United States Securities and Exchange Commission.

Depending on the subject matter, some proposals are not considered proper under state law if they would be binding on the company if approved by shareholders. The Commission notes, however, that in its experience most proposals that are cast as recommendations or requests that the board of directors take specified action are proper under state law. The Commission will assume that a proposal drafted as a recommendation or suggestion is proper unless the company demonstrates otherwise. Note to Rule 14a-8(i)(1); 17 C.F.R. § 240.14a-8(i)(1).

See Westland Dev. Co., Inc., SEC No-Action Letter (Sept. 10, 1982), in which the staff was unable to conclude that a company could rely upon Rule 14a-8(c)(1) (the predecessor to Rule 14a-8(i)(1)) to omit a proposal requesting a two-thirds vote of the shareholders for the company to alienate certain lands where the proposal involved an important policy matter with which shareholders were properly concerned, was presented in the form of a request, and would not be required to be implemented by the company's board of directors even if the proposal received a majority of the votes cast.

See also Exxon Corp., SEC No-Action Letter (Feb. 28, 1992) (the staff was unable to grant Exxon's no-action request regarding exclusion of a shareholder proposal regarding a bylaw amendment establishing a shareholder advisory committee having the power, among other things, to incur expenses to be paid by the company, based in part on the staff's being "unable to conclude that the applicable state law [New Jersey] prohibits a bylaw for a committee with a charter limited to advising the Company's board").

But see Pennzoil Co., [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,681 (Mar. 22, 1993), in which the staff would not recommend enforcement action if, pursuant to Rule 14a-8(c)(1) (the predecessor to Rule 14a-8(i)(1)), the company omitted from its proxy material a reformatted shareholder proposal (involving the creation of a shareholder committee with the power to review board activities and to advise the board of shareholder views, and whose activities would be funded by the company) even though the proposal was made precatory and was phrased as a bylaw amendment (an action permitted to shareholders under Delaware law) because "there is a substantial question as to whether, under Delaware law, the directors may adopt a by-law provision that specifies that it may be amended only by shareholders."

"Indeed it has been the Commission's view that mandatory proposals are improper even in those areas in which the state law requires a vote of shareholders--such as charter amendments, recapitalizations, mergers, consolidations, sales of substantially all of the corporate assets, and liquidations--if state law also leaves it to the directors to initiate those procedures." L. Loss & J. Seligman, *Securities Regulation* 2050 (3d ed. 1990 & Supp. 1992). Determining whether or not a proposal is proper under state law can be difficult, and the Commission itself has not always been consistent in its position. *Id.* at 2010. See also *Brooks v. Standard Oil Co.*, 308 F. Supp. 810 (S.D.N.Y. 1969).

In general, the Commission considers that the purpose of state laws "is to place in the directors exclusive authority with respect to the profit-making aspects of the business--the running of the business in all its operational phases--and no more." This leaves in the area of stockholder authority the whole field of the qualification, selection and remuneration of the directors and officers and their accountability and reporting to stockholders." L. Loss & J. Seligman, *supra*, at 2047 n.341 (footnote omitted).

As might be expected, where the subject matter is specifically covered by statute, the proposal may be omitted. *Dyer*

v. SEC, 289 F.2d 242 (8th Cir. 1961) . However, it is common for a state statute simply to provide that "the business of the corporation shall be managed by the board of directors." See, e.g., N.Y. Bus. Corp. L. § 701; 8 Del. Code Ann. § 141(a). State court decisions determining what duties are exclusively assigned to directors, and not proper subjects for shareholder action under Rule 14a-8(i)(1), are relatively rare.

See *Brooks v. Standard Oil Co.*, 308 F. Supp. 810, 814 (S.D.N.Y. 1969) :

The relevant statute reads:

"The business and affairs of a corporation shall be managed by its board, except as in this act or its certificate of incorporation otherwise provided. (*New Jersey Stat.: 14A:6-1.*)"

"Standard Oil's by-laws also provide that 'the business and affairs' of the corporation shall be managed by its board of directors."

"Each party here stresses that the other cannot point to any New Jersey judicial decision that squarely holds that plaintiff's proposal is or is not a proper subject for shareholder action."

(n46)Footnote 46. Rule 14a-8(i)(2); 17 C.F.R. § 240.14a-8(i)(2).

The Commission notes that it will not apply this basis for exclusion to permit exclusion of a proposal on grounds that it would violate foreign law if compliance with the foreign law would result in a violation of any state or federal law.

The Commission has approved exclusion of proposals that governing documents be amended to require directors to be elected by majority vote where the proposed action contravenes state law. Goodyear Tire & Rubber Co. when the proposal would violate Ohio law (38 Sec. Reg. Law Rep. 231 (Feb. 6, 2006)); and PG&E, 38 Sec. Reg. Law Rep. 459 (Mar. 13, 2006) (California law). To the same effect, Goodyear Tire & Rubber Co., SEC No-Action Letter, Avail. Jan. 18, 2006 (proposal would cause company to violate Ohio corporate law).

A proposal which would bar indemnification of directors in respect of any Commission proceeding under the Investment Company Act of 1940 could properly be omitted. Farmer Bros. Co., SEC No-Action Letter (Sept. 26, 2006) (proposal would violate Delaware law).

See Litton Indus., SEC No-Action Letter, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,766 (Sept. 9, 1980) (a company could not rely on Rule 14a-8(c)(2) (the predecessor to Rule 14a-8(i)(2)) to omit a shareholder proposal that sought to limit proxy soliciting expenditures and did not affect shares eligible to be voted or the existing manner in which the proxies were counted, absent a more specific indication of how compliance with the proposal would require the company to violate state law).

But see Niagara Mohawk Power Corp., SEC No-Action Letter (Mar. 11, 1993) (there appeared to be some basis for the view that the shareholder proposal recommending that the company's proxy card be changed to replace the "withhold authority" box in respect of the election of nominees for director with a vote "against" box would violate Rule 14a-4(b)(2) under the Exchange Act).

See also Exxon Corp., SEC No-Action Letter (Dec. 31, 1992) (staff would not recommend enforcement action if a shareholder proposal were omitted based on counsel's opinion that its implementation would violate New Jersey law that prohibits companies from issuing stock with differing voting rights within the same class).

See also Apple Computer, Inc., SEC No-Action Letter (Oct. 15, 1992), which involved a shareholder proposal asking the company to seek qualified women to serve as members of the company's board of directors. The staff would not

recommend enforcement action if the proposal were excluded from the company's proxy material because "there appears to be some basis for [counsel's] opinion that the proposal is discriminatory" in violation of federal law.

See also Citicorp, SEC No-Action Letter, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,520 (Feb. 23, 1978) (management could omit, under Rule 14a-8(c)(2) (the predecessor to Rule 14a-8(i)(2)), a shareholder proposal that would require the bank to violate the rights of its customers to have their transactions with the bank remain confidential; however, if the shareholder-proponent were to amend the proposal to eliminate any request for information pertaining to individual borrowers, then management could no longer rely on Rule 14a-8(c)(2) for the omission).

(n47)Footnote 47. Rule 14a-8(i)(3); 17 C.F.R. § 240.14a-8(i)(3).

For a discussion of Rule 14a-9, *see* § 7.04[4] *supra*; and § 7.09 *infra* .

See Amdahl Corp., SEC No-Action Letter (Mar. 2, 1993) (shareholder proposal requesting that the company take steps to cease sales of products to entities involved in the enforcement or maintenance of apartheid is not vague and indefinite within the meaning of Rule 14a-9).

See also Daniel Green Co., SEC No-Action Letter (Feb. 5, 1993) (proposal requesting search be made for a buyer of the company and a monthly progress report made to a committee comprised of the five largest outside shareholders of the company was not false or misleading under Rule 14a-9).

(n48)Footnote 48. Rule 14a-8(i)(4); 17 C.F.R. § 240.14a-8(i)(4).

In Ford Motor Co., SEC No-Action Letter (Mar. 11, 1993), the staff would not recommend enforcement action if a shareholder proposal were excluded on the grounds that, notwithstanding the language of the proposal (which would require the company to implement an affirmative action plan, including specific hiring and promotional goals for minorities, women, the handicapped and homosexuals), there was some basis for the view that the proposal involved a personal grievance by the proponent against the company, based on a purportedly excessive settlement agreement between Ford and a corporation in which the proponent was an executive officer.

See also General Electric Co., SEC No-Action Letter (Jan. 6, 1993) (enforcement action would not be recommended if a shareholder proposal were excluded, the staff noting that the intent of the proponent in submitting the proposal appeared to be "toward redressing a personal grievance against the Board resulting solely from its decisions to exclude some of the numerous proposals previously submitted by the proponent...").

See also Pyramid Technology Corp., SEC No-Action Letter (Dec. 4, 1992), in which enforcement action would not be recommended if the company excluded a shareholder proposal recommending a policy against entering into agreements with executives and directors for compensation upon a change in control without shareholder approval. Counsel for the company indicated that the proponent was a former employee who alleged that the termination was wrongful and that the motive behind the proposal was to embarrass management and force the demanded settlement. The staff stated that "the proposal, while drafted to address other considerations, appears to involve one in a series of steps relating to the longstanding grievance against the Company by the proponent."

If the proposal is clearly motivated by personal pique of the shareholder, the proposal may be omitted. *Jansky v. Miller*, 474 F.2d 365 (9th Cir. 1973) .

(n49)Footnote 49. Rule 14a-8(i)(5); 17 C.F.R. § 240.14a-8(i)(5).

"It was not the intent of Rule 14a-7 [now Rule 14a-8] to permit stockholders to obtain the consensus of other stockholders with respect to matters which are of a general political, social or economic nature. Other forums exist for

the presentation of such views." Sec. Exch. Act Rel. No. 34-3638, 3 Fed. Sec. L. Rep. (CCH) P 24,102 (1945).

In *Lovenheim v. Iroquois Brands, Ltd.*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,995 (D.D.C. 1985), the court enjoined a company from excluding from its proxy statement under Rule 14a-8(c)(5) (the predecessor to Rule 14a-8(i)(5)) a shareholder's proposal for a study of the company's alleged mistreatment of animals involving methods used to force-feed geese for the production of pate de foie gras, since the shareholder showed a likelihood of prevailing on the merits on the issue of whether his proposal was "otherwise significantly related" to the company's business, considering the ethical and social significance of the proposal and its implication on the level of sales. The court noted that although the pate de foie gras accounted for significantly less than five percent of the company's total assets, net earnings and gross sales, the history of Rule 14a-8(c)(5) indicated the Commission's intent to require inclusion of proposals raising policy questions important enough to be considered "significantly related to" a company's business notwithstanding their failure to reach specified economic thresholds.

See also *Bristol-Myers Squibb Co.*, SEC No-Action Letter (Mar. 7, 1991) (the staff did not take a no-action position regarding exclusion of a proposal involving giving money to organizations that "support, counsel or perform abortions," notwithstanding the fact that the rule's economic tests allegedly were not met. "[C]onsidering the social and public policy implications of the subject matter of the proposal (*i.e.*, abortion), the staff is unable to conclude that the proposal is not otherwise significantly related to the registrant's business").

But see *American Tel. & Tel. Co.*, SEC No-Action Letter (Jan. 30, 1992), in which the staff stated that it would not recommend enforcement action be taken if the shareholder proposal were omitted. The proposal involved the phase-out by the company of the sale of its products to Israel because of the way Israel treats Palestinians. The staff noted that "the policy issue raised by the proposal, Israel's treatment of Palestinians, is not significant, and in fact is not related, to the Company's business."

See n. 3 *supra* for a discussion of recommendations by the Staff Report on revisions of the predecessor to Rule 14a-8(i)(5).

(n50)Footnote 50. Rule 14a-8(i)(6); 17 C.F.R. § 240.14a-8(i)(6).

See *New York City Employees' Retirement Sys. v. Brunswick Corp.*, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,932 (S.D.N.Y. 1992) (shareholder proposal regarding a national health insurance plan was beyond the power of the company to effectuate and could be excluded from proxy materials.)

See *Metrocare, Inc.*, SEC No-Action Letter, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,337 (May 31, 1977), in which the staff would not recommend enforcement action if the shareholder proposal, involving the liquidation of the company's assets and the appointment of a shareholders' group to administer the distribution of the proceeds of liquidation, were excluded from the company's proxy material. Since the proposal called for the delegation of certain duties to persons not elected as directors in contravention of state law, it was beyond the company's power to effectuate.

(n51)Footnote 51. Rule 14a-8(i)(7); 17 C.F.R. § 240.14a-8(i)(7).

The Commission has stated that it: "is of the view that the provision adopted today can be effective in the future if it is interpreted somewhat more flexibly than in the past. Specifically, the term 'ordinary business operations' has been deemed on occasion to include certain matters which have significant policy, economic or other implications inherent in them. For instance, a proposal that a utility company not construct a proposed nuclear power plant has in the past been considered excludable under former subparagraph (c)(5) [*see* *Potomac Electric Power Co.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,294 (Mar. 5, 1976)]. In retrospect, however, it seems apparent that the economic and safety considerations attendant to nuclear power plants are of such magnitude that a determination whether to construct

one is not an 'ordinary' business matter. Accordingly, proposals of that nature, as well as others that have major implications, will in the future be considered beyond the realm of an issuer's ordinary business operations, and future interpretative letters of the Commission's staff will reflect that view." Sec. Exch. Act Rel. No. 34-12999, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,812, at 87,131 (Nov. 27, 1976).

See American Home Prods. Corp., SEC No-Action Letter (Feb. 25, 1993), in which a shareholder proposal asking the company to eliminate animal testing was found by the staff to relate to "the substantial policy issue of the humane treatment of animals in product development and testing."

In Union Pacific Corp., SEC No-Action Letter, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,633 (Feb. 5, 1993), the staff did not take a no-action position involving a shareholder proposal recommending that the board implement a program under which shareholders could designate, in proportion to their holdings, the company's charitable contributions. The staff determined that the decision regarding allocation of company funds among charitable donees appears to be "extraordinary in nature and beyond the Company's ordinary business operations." *But see* Pacific Telesis Group, SEC No-Action Letter (Feb. 20, 1992) (shareholder proposal requesting corporate contributions to a particular charity, in this case Planned Parenthood Federation of America, could be excluded on the basis that the proposal involved the ordinary business operations of the company; the staff stated that its position represented "a reconsideration of earlier letters relating to shareholder proposals which requested issuers to commence contributions to a particular charity").

See also Wellman Inc., SEC No-Action Letter (Mar. 6, 1991), in which the staff was unable to give a no-action letter involving a shareholder proposal requiring management to obtain shareholder approval for certain transactions valued over \$100 million because "[a] requirement for shareholder approval of certain extraordinary corporate transactions which are economically significant involves a matter that goes beyond the conduct of the Company's ordinary business operations."

See also Loews Corp., SEC No-Action Letter, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,600 (Feb. 22, 1990). According to the staff, a proposal that called on the board of directors to take action leading to the eventual stoppage of the manufacture of tobacco and tobacco products could not be omitted from a proxy statement. The staff's position was that since the public policy issues relating to the tobacco industry were of growing significance, the proposal went beyond the realm of the company's ordinary business.

See also Aetna Life & Casualty Co., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,705 (Feb. 28, 1991) (insurance company could not exclude a shareholder's proposal requesting that a review committee be established to report on investment policies to reduce the company's investments in cigarette companies; the Division of Corporation Finance stated that the proposal raised issues that involve policy decisions regarding the company's investment policies which are beyond the conduct of its ordinary business operations).

The Division of Corporation Finance has observed in a number of recently issued no-action letters that shareholder proposals relating to compensation of senior executives and directors may no longer be considered matters relating to the conduct of a company's ordinary business operations. See letters reported at Fed. Sec. L. Rep. (CCH) PP 76,101-76,110.

See, e.g., Reebok Int'l Ltd., SEC No-Action Letter, [1991- 1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,131 (Mar. 16, 1992), where the staff determined that shareholder proposals concerning issues of executive compensation could no longer be excluded from proxy materials as matters relating to the ordinary business of the company, due to the wide-spread public debate and the increasing recognition that they raise significant policy issues.

See also Transamerica Corp., SEC No-Action Letter, [1989 - 1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,338 (Jan. 10, 1990) (shareholder proposal recommending adoption of a policy prohibiting company from making

"golden parachute" arrangements could not be omitted, assuming certain revisions were made to the proposal; the staff stated that golden parachute arrangements are increasingly seen as raising significant policy issues and, accordingly, differ from ordinary compensation arrangements that generally can be excluded as being related to the conduct of a firm's ordinary business operations).

See also New York State Elec. & Gas Corp., SEC No-Action Letter (Mar. 11, 1993) (prior notice of pay or pension increases for executives and directors); Occidental Petroleum Corp., SEC No-Action Letter (Dec. 22, 1992) (salary ceiling for employees and consultants); Baker Hughes Inc., SEC No-Action Letter (Nov. 20, 1992) (limiting awards to executives under certain benefit plans). In each case, the staff was unable to give a no-action letter if the compensation-related proposal were excluded from the company's proxy material.

In *Cracker Barrel Old Country Store, Inc.*, SEC No-Action Letter, [1992 - 1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,418 (Oct. 13, 1992), *aff'd* by full Commission, *Cracker Barrel Old Country Store, Inc.*, SEC No-Action Letter (1993), the full Commission confirmed the view of the staff, which had reconsidered its prior no-action positions regarding employment-based proposals. The staff's letter stated that "the fact that a shareholder proposal concerning a company's employment policies and practices for the general workforce is tied to a social issue will no longer be viewed as removing the proposal from the realm of ordinary business operations of the registrant." The proposal at issue requested that the company include in the corporate policy statement a policy of nondiscrimination on the basis of sexual orientation.

The staff's response in *Cracker Barrel* represented a change from its prior no-action position involving Rule 14a-8(c)(7) (the predecessor to Rule 14a-8(i)(7)) and employment-related proposals. In general, employment matters concerning a company's work force were excludable, but exceptions were made in cases where the employment-related proposal also raised social policy concerns. Notwithstanding these prior determinations, the staff reconsidered this treatment of employment-related proposals that are tied to social issues, such as discrimination, and decided that "determinations with respect to any such proposals are properly governed by the employment-based nature of the proposal," thus excludable under the ordinary business operations exception.

In the *Cracker Barrel* letter, although enforcement action would not be recommended if the shareholder proposal at issue were excluded from the company's proxy material, the staff reiterated its determination that, "unlike proposals relating to the rank and file work force, proposals concerning senior executive and director compensation are viewed by the Commission as inherently outside the scope of normal or routine practices in the running of the company's operations."

In 1998, at the time it adopted amendments to the shareholder proposal rule, the Commission also announced that it was again reversing its position in *Cracker Barrel* and that future determinations of whether a shareholder proposal comes within the "ordinary business operations" exclusion would be made on a case by case basis.

The staff of the Commission has ruled that proposals may be omitted:

- Allowing the company to omit the names and telephone numbers of the Company's five largest shareholders from a supporting statement for an unopposed proposal to reclassify the Board of the Company, on the ground that the information excluded would not assist shareholders in deciding how to vote on the proposal. *Bob Evans Farms Inc.*, SEC No-Action Letter, June 26, 2006, 38 Sec. Reg. Law Rep. 1221 (July 10, 2006).
- Requiring the New York Times Company to put to a vote whether the company keeps its dual-class structure, and that the roles of chairman and publisher of the company's flagship newspaper be separated. *The New York Times Co.*, SEC No-Action Letter December 2006. Such shareholder activism may come at a stiff price. The proposal was submitted by Hassan Elmasry, a portfolio manager for Morgan Stanley

Investment Management, which owns more than 7% of the New York Times Company's shares. Mr. Elmasry has been pressing for a change in the New York Times Company dual stock structure since June 2005, saying that the current arrangement limits accountability. The members of the Ochs-Sulzberger family control the company through a special class of stock. The family has announced that it is withdrawing most of its personal assets from management by Morgan Stanley, according to Lazaroff, www.bloomberg.com (Feb. 2, 2007) who speculated that it may have been in retaliation against Mr. Elmasry's activism.

- Requiring the Board of Directors to prepare a report on the costs, benefits and impacts of the Sarbanes-Oxley Act. Morgan Stanley, SEC No-Action Letter, Jan. 8, 2007. The staff noted that it would not recommend enforcement action if the proposal were omitted as relating to ordinary business operations.
- Requesting that the Company provide a report on the implications of rising health care expenses. Kohl's Corp., SEC No-Action Letter, Jan. 8, 2007, on the ground that the proposal related to a matter of ordinary business operations, *i.e.*, employee benefits.
- Requiring the Board to create an ethics oversight committee of independent directors to monitor the Company's compliance with applicable laws and regulations and the ES Code of Business Conduct and Ethics. AES Corp., SEC No-Action Letter, Jan. 9, 2007, as dealing with ordinary business operations, *i.e.*, "general conduct of a legal compliance program."
- Requiring H&R Block to cease issuance of high interest loans. H&R Block, Inc., SEC No-Action Letter, Aug. 1, 2006. Proposal could be omitted as relating to ordinary business operations, *i.e.*, credit policies, loan underwriting and customer relations.
- Requiring establishment of the "Office of the Board of Directors" to enable direct communication between non-management directors and shareholders. Converse Technology, Inc., SEC No-Action Letter (Sept. 8, 2003) (proposal deals with ordinary business operations).
- Requiring adoption of a policy to limit the buyback of shares within specified limits. Pfizer Inc., SEC No-Action Letter (Feb. 7, 2003) (ordinary business operations).
- Requiring all options to management and board of directors to be no less than the "highest stock price" and that the options contain a buyback provision. Pfizer Inc., SEC No-Action Letter (Feb. 8, 2003) (vague and indefinite).
- Requiring redemption of all outstanding shares of 4.5% preferred stock. Cleco Corp., SEC No-Action Letter (Jan. 21, 2003) (ordinary business operations).
- Requiring a cap of \$1,000,000 on "salaries and benefits" for officers and directors. General Electric Co., SEC No-Action Letter (Jan. 23, 2003) (vague and indefinite).
- Requiring that the company refrain from making charitable contributions. Bank of America Corp., SEC No-Action Letter (Jan. 23, 2003) (ordinary business operations).
- Requiring amendment to by-laws to require the company to include the name of any person nominated for election to the board by a stockholder owning 3% or more of the company's stock. Citigroup Inc., SEC No-Action Letter (Jan. 31 2003) (relates to an election for membership on board of directors).

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- Requiring amendment of certificate of incorporation to reinstate the rights of the shareholders to take action by written consent and to call special meetings. Burlington Resources Inc., SEC No-Action Letter (Feb. 7, 2003) (violation of law; absence of power-authority).
- Requiring adoption of a policy changing outside auditors at least every five years, starting with the next auditing cycle. WGL Holdings, Inc., SEC No-Action Letter (Dec. 6, 2002) (management functions, relating to ordinary business matters).
- Requiring that a decision to adjourn the annual meeting be subject to objection by any shareholder present at the meeting. Walt Disney Co., SEC No-Action Letter (Nov. 29, 2002) (management functions, relating to ordinary business).
- Requiring shareholder approval of all equity compensation plans "other than those that would not result in material potential dilution." Adobe Systems Inc., SEC No-Action Letter (Feb. 1, 2002) (ordinary business operations, *i.e.*, general compensation matters).
- Requiring disassociation from any offensive imagery to the American Indian community in product marketing, advertising, endorsements, sponsorships and promotions. Tootsie Roll Industries Inc., SEC No-Action Letter (Jan. 31, 2002) (ordinary business operations, *i.e.*, the manner in which a company advertises its products).
- Requiring amendment of pension plan to increase retirement benefits. Otter Tail Corp., SEC No-Action Letter (Jan. 15, 2002) (ordinary business operations, *i.e.*, employee benefits).

The staff has required inclusion of proposals:

- A proposal that the Board take the necessary steps to amend bylaws and governing documents to give holders of 10 percent of the outstanding common stock (or the lowest percentage allowed by law above 10%) the power to call special meetings of stockholders. *Burlington Northern Santa Fe Corp.*, SEC No-Action Letter issued 1/12/09.
- A proposal that the Board adopt a policy giving shareholders the opportunity at annual meetings to vote on an advisory resolution to ratify the compensation of the executive officers named in the summary compensation table. The company had argued that the proposal was materially misleading because it was non-binding and provided no actual way to ratify or approve compensation, and that it was excludable under Rule 14a-8 because a request for future votes is not a proper form for a proposal. *Allegheny Energy, Inc.*, *Fed. Sec. Law Rep.* § 79, 754.
- That Coca Cola Co. and Intel Corp. place limits on "remuneration to any of the top five persons named in Management." The Staff advised that the proposals could not be excluded as vague or misleading in reliance on Rule 14a-8(i)(3). Coca Cola Corp., SEC No-Action Letter (Jan. 29, 2007); Intel Corp., SEC No-Action Letter (Jan. 30, 2007).
- That General Electric Co.'s Board establish an independent committee to prepare a report on pay differentials between senior executives and the lowest paid 10% of employees. The Staff stated it was unable to concur that the proposal could be excluded as vague, indefinite or false and misleading under Rule 14a-8-i-3. General Electric Co., SEC No-Action Letter (Jan. 18, 2007).

- A proposal that a company participating in the TARP program impose numerous restrictions on executive compensation in addition to those mandated by the ARRA legislation adopted for TARP participants. *Regions Financial Corporation*, SEC No-action Letter issued 2/5/09.
- A proposal requesting the board to take the steps necessary so that voting requirements in the charter and bylaws calling for greater than a simple majority be changed to a majority of the votes cast for and against related proposals cannot be omitted in reliance on Rule 14a-8(i)(6). *NYSE Euronext*, Fed. Sec. Law Rep. No 2364 (2/11/09).
- That Hewlett Packard's board of directors initiate the appropriate process to amend the company's governance documents to provide that director nominees be elected by the affirmative vote of the majority of votes cast. Hewlett Packard had based its argument on the fact that it had adopted a majority voting policy under which a director who receives a greater number of votes "withheld" from his or her election than votes "for" such election is required to tender his or her resignation for consideration by the company's Nominating and Corporate Governance Committee. *BNA Corporate Counsel Weekly* (Jan. 18, 2006).
- To amend governing documents to require that the Chairman of the Board of Directors serve only in that capacity. *General Motors Corp.*, 38 Sec. Reg. Law Rep. 150 (Jan. 23, 2006).
- That Whole Foods Markets, Inc.'s Board of Directors take steps necessary for a simple majority vote to apply on each issue subject to a stockholder vote. 38 Sec. Reg. Law Rep. 40 (Jan. 2, 2006). To the same effect, *IBM*, 38 Sec. Reg. Law Rep. 228 (Feb. 6, 2006).
- That Honeywell's Board of Directors adopt a policy that a shareholder's vote be required on the amendment of any "golden parachute" or "golden hello" issued in any merger, as a ballot item separate from the merger itself. 38 Sec. Reg. Law Rep. 353 (Feb. 27, 2006).
- That Gannett amend its governing documents to require the directors to be elected by majority vote. 38 Sec. Reg. Law Rep. 150 (1/23/06); similarly, *Hewitt-Packard Co.*, Sec. No-Action Letter (Jan. 23, 2006).
- That Occidental Petroleum Corporation's Board publish annually a scientific report on global warming/cooling. 38 Sec. Reg. Law Rep. 309 (Feb. 20, 2006).
- Computer Associates filed objections with the Commission to a proposal by Harvard Law School Professor Lucian Bebchuk which would mandate unanimous Board action to adopt a poison pill and require a one-year expiration date on any rights plan not approved by stockholders. Computer Associates claimed that the proposal violated Delaware law. In a Delaware court action brought by Professor Bebchuk to declare the proposals valid under Delaware law, the Delaware Chancery Court held that the case was premature but observed that the proposals were not obviously contrary to Delaware law. Computer Associates voluntarily agreed to include the proposals in its proxy material. *Bebchuk v. CA, Inc.*, 902 A.2d 737 (June 22, 2006) (Lamb, Vice Chancellor).
- Requiring the independent directors to prepare a report on the implications of a policy for reducing potential harm from chemical releases. *E.I. DuPont de Nemours & Co.*, SEC No-Action Letter (Feb. 24, 2006) (Staff unable to concur that the proposal relates to ordinary business operations).
- Requiring shareholder approval for future severance agreements with senior executives providing benefits exceeding 2.99 times the sum of the executive's base salary plus bonus. *Emerson Electric Co.*,

SEC No-Action Letter (Oct. 24, 2005).

- Requiring that an investment banking firm be engaged to pursue a sale of the company. Gyrodyne Co. of America, Inc., SEC No-Action Letter (Sept. 26, 2005).
- To retain an investment banker to develop a plan for recapitalization to result in one vote per share for all outstanding company stock. 36.82% of the voting power of the company was controlled through ownership of Class B stock by the chairman of the company. The company argued that the implementation of a recapitalization would be beyond the power of the company or its board of directors to implement in view of such control, a position which was rejected by the Staff. Affiliated Computer Services, Inc., SEC No-Action Letter (Aug. 9, 2005).
- To amend by-laws to require that an independent director who has not served as CEO serve as chairman of the board. Clear Channel Communications Inc., SEC No-Action Letter (March 5, 2003). Tyco International Limited, Fed. Sec. L. Rep. (CCH) P 78,421 (2003).
- Requiring shareholder approval of equity compensation plans that may be used to compensate only senior executive officers and directors; however, proposals that would require shareholder approval for equity compensation plans that also cover the general workforce may be excluded under the ordinary business exemption. SEC's Staff Legal Bulletin No. 14A, Fed. Sec. L. Rep. (CCH) P 60,014A (2002).
- Which urges the board of directors to take the necessary steps to declassify the board so that each director would be elected annually instead of every three years. Starbucks Corp., SEC No-Action Letter (Dec. 12, 2001). Honeywell International Inc., Fed. Sec. L. Rep. (CCH) P 78,433 (2003).
- That shareholder approval be required prior to a board of directors adopting any poison pill, and that any pill then in effect be redeemed or terminated unless approved by shareholders at the next shareholder meeting. UAL Corp., SEC No-Action Letter (Feb. 1, 2002) (includable subject to revision).
- That the board of directors incorporates specific measures for use in awarding performance-based executive compensation related to rebuilding core air transport business following September 11, 2001 attack. UAL Corp., SEC No-Action Letter (Jan. 28, 2002).
- Prohibiting the company's outside auditor from performing other non-audit services for the company. Walt Disney Co., Fed. Sec. L. Rep. (CCH) P 78,221. Motorola Inc., SEC No-Action Letter (Jan. 16, 2002).
- Calling for the elimination of super-majority voting requirements. Honeywell International Inc., SEC No-Action Letter (Oct. 16, 2001) (subject to revision).
- That the company institute a policy of paying dividends. Drexler Technology Corp., SEC No-Action Letter (Aug. 23, 2001) (subject to revision). Sonoma West Holdings Inc., SEC No-Action Letter (Aug. 17, 2000).
- That the board of directors adopt a policy of phasing out the manufacture of PVC-containing or phthalate-containing medical supplies by its subsidiary where safe alternatives are available. Tyco International Ltd., SEC No-Action Letter (Dec. 5, 2002).
- That all future stock option grants to senior executives be performance based. Goldman Sachs Group, Inc., Fed. Sec. L. Rep. (CCH) P 78,429 (2003). Maximus, Inc., Fed. Sec. L. Rep. (CCH) P 78,420

(2003).

- Requiring the company to adopt a policy that senior executives retain a significant percentage of shares acquired through equity compensation programs during employment and to report to shareholders before the next annual meeting. Adobe Systems Inc., Fed. Sec. L. Rep. (CCH) P 78,439 (2003).
- Establishing a cap on total compensation to the CEO in a given year equal to 50 times the average compensation paid to non-exempt employees. Verizon Communications Inc., SEC No-Action Letter (Jan. 24, 2003).
- Requiring shareholder approval for future severance agreements with senior executives providing benefits exceeding 2.9 times the sum of the executives basic salary plus bonus. Raytheon Co., SEC No-Action Letter (Jan. 22, 2003).
- Requiring diversification of the board of directors. ExxonMobil Corp., SEC No-Action Letter (Jan. 22, 2001).
- Limiting the number of stock option grants to executive officers to more than 5% of total options granted in a single year, and aggregate grants to the group of executive officers to no more than 10%. Walt Disney Co., Fed. Sec. L. Rep. (CCH) P 78,033 (2000).
- Requesting that the company endorse a list of principles on human rights for workers in China. Microsoft Corp., SEC No-Action Letter (Sept. 14, 2000).
- Requesting that the board of directors arrange for the prompt sale of the company to the highest bidder. NCH Corp., SEC No-Action Letter (Apr. 27, 2000).
- Requesting that the board of directors take the steps necessary to insure that all directors are elected annually with a 70 percent majority being independent directors. Raytheon Co., SEC No-Action Letter (Mar. 9, 1999).
- Requesting that the board review or amend where applicable the company's standards for international operations and report a summary to shareholders including a description of policies designed to protect human rights, efforts to ensure that the company does not employ children under the age of fifteen, policies to ensure no use of forced labor, and consistent standards for workers' health and safety. RR Donnelley & Sons Co., SEC No-Action Letter (Jan. 14, 1999).
- Calling for a bylaw amendment prohibiting the repricing of stock options below the original strike price without prior approval of company stock holders. General DataComm Industries Inc., SEC No-Action Letter (Dec. 9, 1998).

For additional letters in which the staff was unable to take a no-action position if the shareholder proposal were excluded, see Westinghouse Electric Co., SEC No-Action Letter, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,636 (Feb. 3, 1993) (proposal to develop a plan for withdrawal from the nuclear weapons business); Eastman Kodak Co., SEC No-Action Letter (Jan. 30, 1992) (proposal involving eventual cessation from involvement in the production, packaging and marketing of cigarettes); TRW Inc., SEC No-Action Letter (Feb. 12, 1990) (shareholder proposal calling for the establishment of a shareholders' advisory committee to advise the board of directors on shareholders' interests); Eli Lilly & Co., SEC No-Action Letter, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,629 (Feb. 25, 1993) (price restraint proposal relates to a "fundamental business strategy with respect to [the company's] pricing policy for

pharmaceutical products"); and Westinghouse Electric Corp., SEC No-Action Letter (Jan. 4, 1993) (CERES principles proposal involving environmental code for corporations involves matters that have "significant policy, economic [and] other implications and involves decisions that are beyond the conduction of the Corporation's ordinary business operations").

Sec. Exch. Act Rel. No. 34-12999, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,812 (Nov. 22, 1976).

"Current staff interpretations of this exclusion emphasize 'ordinary' and attempt to separate matters with major implications from those involving day to day concerns. Typical subjects which have been held to be ordinary business are: conduct of legal matters; management training methods; limitations on selling and administrative expenses and funded debt, providing discounts for shareholders on company products and accounting practices. Matters which have been held not to constitute ordinary business include establishment of special committees to examine major issues and report to shareholders; environmental questions; construction of nuclear power facilities; liquidation of the company and charitable contributions."

"Nonetheless, efforts to make distinctions which carry out the statutory intent continue to be difficult, and additional guidance may be necessary."

Staff Report, n.3 *supra*, at 204-205 (footnotes omitted).

See Roosevelt v. E.I. Du Pont De Nemours & Co., 958 F.2d 416 (D.C. Cir. 1992) , where the court held that issues concerning both the target date of a company's phase-out of an environmentally hazardous product and management reports detailing efforts to find and market environmentally safe substitutes could be excluded from proxy materials since they related to ordinary business operations.

See also Mosinee Paper Corp., SEC No-Action Letter (Feb. 18, 1993), in which the staff would not recommend enforcement action if a shareholder proposal asking the company to implement a dividend reinvestment plan was omitted because it "deals with the determination of methods of raising capital, a fundamental aspect of Mosinee's ordinary business operations."

See also Kmart Corp., SEC No-Action Letter (Feb. 23, 1993) (shareholder proposal requesting the company to refrain from selling reading materials variously described as "soft core porn," "sexually explicit" and "adult" relates to the ordinary business of "the sale of a particular category of products" and, therefore, could be omitted).

In McDonald's Corp., SEC No-Action Letter (Mar. 16, 1993), a shareholder's proposal requesting that corporate facilities, including facilities of new franchisees, become smoke-free, the staff determined that such proposal, involving the management of the place of business, constituted an ordinary business operation of the company.

See also Capital Cities/ABC, Inc., SEC No-Action Letter, [1990 - 1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,690 (Apr. 4, 1991), in which the Commission stated that a shareholder proposal requesting detailed information regarding the composition of the company's work force, employment policies and selection of its television program content may be omitted from the company's proxy materials pursuant to Rule 14a-8(c)(7) (the predecessor of Rule 14a-8(i)(7)) since it involved matters relating to the conduct of the company's ordinary business operations. The Commission reversed the Division of Corporation Finance's position on the proposal, which had stated that inquiries regarding affirmative action involve policy decisions beyond the scope of ordinary business operations.

See also Grimes v. Ohio Edison Co., [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,840 (S.D.N.Y. 1992), *aff'd*, 992 F.2d 455 (2d Cir. 1993) , *cert. denied*, 62 U.S.L.W. 3348 (Nov. 15, 1993) . (A shareholder proposal requiring prior shareholder approval for capital or construction expenditures unless the yearly amount of such expenditures was less than the cash dividends paid to shareholders in the previous year was found to relate to the ordinary business

operations of the company. As such, the proposal could be omitted from the proxy materials under Section 14a-8(c)(7)).

See also Austin v. Consolidated Edison Co. of New York, 788 F. Supp. 192 (S.D.N.Y. 1992), where the court found that the issue presented by plaintiffs (whether employees could retire after 30 years of service, regardless of age) was excludable from the company's proxy materials because it was in the ordinary course of business. Since there were other forums of debate, such as collective bargaining, where this particular issue could be raised, a shareholder vote was not the only forum, nor the most effective forum, for this discussion. The court further commented that general compensation issues and pension proposals are often excluded from proxy statements. Therefore, the company was not compelled to include plaintiffs' proposal in the proxy statement.

For additional no-action letters in which enforcement action would not be recommended if the shareholder proposal were excluded from the company's proxy material, *see* Unisys Corp., SEC No-Action Letter (Feb. 19, 1993) (equal employment opportunity in Northern Ireland); Roadway Services Inc., SEC No-Action Letter (Mar. 16, 1993) (minimum pensions); General Electric Co., SEC No-Action Letter (Feb. 2, 1993) (television programming); and International Business Machines Corp., SEC No-Action Letter (Jan. 23, 1992) (benefits to "committed domestic partners" of homosexual employees); Capital Trust, Inc., Fed. Sec. Law Rep. No. 2366 (proposal that the board adopt and disclose a detailed CEO succession plan policy).

(n52)Footnote 52. Rule 14a-8(i)(8); 17 C.F.R. § 240.14a-8(i)(8).

The Second Circuit has overruled the Commission's issuance of a No-Action Letter allowing exclusion of a proposal for the adoption of a bylaw amendment allowing insurgents to submit nominees on Company ballots. *AFSCME v. AIG*, 462 F.3d 121 (2d Cir. 2006). The Court held that a proposal to establish a procedure by bylaw amendment whereby shareholders can propose nominees for election "does not relate to an election within the meaning of [Rule 14a-8(i)(8)] and therefore cannot be excluded from corporate proxy materials under that regulation" citing a 1976 SEC interpretation reflecting the view that the permitted exclusion only applies to proposals dealing with election to an identified Board seat, not election procedures generally.

The Commission then issued two alternative proposals dealing with director nominations by shareholders, one (Sec. Exch. Act Rel. 34 56160) proposing a limited right to propose electoral changes through bylaw amendment by 5% shareholders, and one (Sec. Exch. Act Rel. 34 56161) denying shareholders the right to intervene in the elective process absent an election contest. The Commission in Sec. Exch. Act Rel. 34-56914 adopted the latter alternative. *See* discussion at § 7.07, SHAREHOLDER PROPOSALS-INTRODUCTION, *supra*.

In reviewing developments in the 2007 proxy season at a D.C. bar program on the proxy rules and corporate governance, Ted Yu, Special Counsel in the Division of Corporation Finance Office of Chief Counsel, noted receipt of a number of no action requests to exclude proposals seeking advisory votes on executive pay. The Commission has approved exclusion of proposals on the Compensation Committee report but not on the company's Compensation Disclosure and Analysis discussion in the company's proxy statement. The Commission has allowed exclusion of proposals seeking a vote on whether compensation is too high, too low or just right, but not proposals seeking advisory votes on the summary compensation tables. He noted that many companies attempt to preempt shareholders on advisory votes on compensation proposals by adopting bylaw amendments on majority votes. S.R.L.R. No. 2269 (2007).

In response to a request for a No-Action Letter on exclusion of a proposal to amend bylaws to require that the company include the name of any person nominated for election to the Board by a stockholder who has beneficially owned 3% or more of the company's outstanding common stock for at least two years, the Staff declined to concur or dispute the exclusion, noting that the company's submission relied on certain prior staff interpretations as precedent which ran counter to the *AFSCME v. AIG* case referred to above. The Staff declined to concur or disagree with the company's assumption that a different circuit would have jurisdiction for purposes of the request, and expressed no view on excludability. *Hewlett-Packard Co.*, 2261 Fed. Sec. Law Rep. (January 31, 2007).

In *Rauchman v. Mobil Corp.*, 739 F.2d 205 (6th Cir. 1984), the court held that Rule 14a-8(c)(8) (the predecessor of Rule 14a-8(i)(8), 17 C.F.R. § 240.14a-8(i)(8)), permitted the omission from the proxy statement of a shareholder's proposed bylaw amendment that would have prevented a Saudi Arabian citizen, appointed to the company's board of directors, from running for reelection. Although the court assumed that a private right of action exists under Section 14(a) of the Exchange Act, even when premised on a violation of Rule 14a-8 rather than Rule 14a-9, the court stated that the company properly excluded the shareholder's proposal since it related to an election to office.

(n53)Footnote 53. Rule 14a-8(i)(9); 17 C.F.R. § 240.14a-8(i)(9).

The Commission notes that the company's submission to the Commission relying on this basis for exclusion should specify the points of conflict with the company's proposal. Note to Rule 14a-8(i)(9); 17 C.F.R. § 240.14a-8(i)(9).

See *Chrysler Corp.*, SEC No-Action Letter (Feb. 26, 1993), in which the staff took the position that compliance with the executive compensation disclosure rules adopted in 1992 did not render moot a shareholder proposal requesting the board of directors to review the company's executive compensation policies and report on the review to shareholders. The new rules involved "a discussion of the prior year's compensation, not a discussion of recommendations for changes in existing compensation policy."

See also *Rockwell Int'l Corp.*, SEC No-Action Letter (Dec. 16, 1992) (shareholder proposal requesting that the board of directors create a panel to develop criteria for accepting military contracts may not be excluded as moot because the staff did not believe that the company "substantially implemented the proposal concerning the specific social, ethical and other concerns of defense contracting").

(n54)Footnote 54. Rule 14a-8(i)(10); 17 C.F.R. § 240.14a-8(i)(10).

A proposal rendered moot by the company's action or otherwise may be omitted from the company's proxy materials. The reason for the mootness of the proposal is immaterial; it may be omitted if moot for any reason.

See *Chevron Corp.*, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,706 (Feb. 27, 1991), in which the staff stated that it would not recommend enforcement action if a company omitted a shareholder's proposal regarding environmental policies from its proxy materials. The shareholder's proposal and a company-sponsored proposal also involving environmental policies would present alternative and complementary decisions for shareholders; implementing both would provide ambiguous and inconsistent results.

(n55)Footnote 55. Rule 14a-8(i)(11); 17 C.F.R. § 240.14a-8(i)(11).

It would appear that the rule requires a company to include in its proxy material the first proposal which it receives covering a subject matter, notwithstanding the fact that a later proposal covering the identical or similar subject matter may be better written or more easily understandable by shareholders.

(n56)Footnote 56. "[T]his provision will be considered to be available in the future for the omission of a proposal which, although not substantially the same as any one proposal submitted in a prior year, is composed essentially of the elements of two or more proposals that were submitted for a vote in prior years and failed to receive the percentage of the total vote specified in the rule." Sec. Exch. Act Rel. No. 34-12999, [1976 - 1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,812 (Nov 22, 1976).

In *Newmont Mining Corp.*, SEC No-Action Letter, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,555 (Feb. 21, 1978), the staff was of the opinion that management could not rely on Rule 14a-8(c)(12)(ii) (the predecessor of Rule 14a-8(i)) as a basis for omitting a shareholder proposal from its proxy soliciting material for its 1978 annual meeting where the company inadvertently omitted part of the shareholder's supporting statement from the company's 1977 proxy

material. Furthermore, the proposal did receive more than three percent of the votes cast at the 1976 annual meeting (as required under prior Rule 14a-8(c)(12)(i) in effect at that time) and therefore could not be omitted pursuant to Rule 14a-8(c)(12)(i) (now Rule 14a-8(i)(12)(ii)).

See also E.I. Du Pont De Nemours & Co., SEC No-Action Letter, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,510 (Dec. 16, 1977) (management could not exclude proposal pursuant to Rule 14a-8(c)(12)(i) (now Rule 14a-8(i)(12)) because 1978 proposal not substantially the same as 1976 proposal).

(n57)Footnote 57. Rule 14a-8(i)(12)(i); 17 C.F.R. § 240.14a-8(i)(12)(i).

(n58)Footnote 58. Rule 14a-8(i)(12)(ii); 17 C.F.R. § 240.14a-8(i)(12)(ii).

(n59)Footnote 59. Rule 14a-8(i)(12)(iii); 17 C.F.R. § 240.14a-8(i)(12)(iii).

(n60)Footnote 60. Rule 14a-8(i)(13); 17 C.F.R. § 240.14a-8(i)(13).

The purpose of this provision is to prevent shareholders from being burdened with a multitude of conflicting proposals on such matters. The problem arises when several proponents independently submit proposals asking that differing amounts of dividends be paid.

(n61)Footnote 61. Sept. 15, 2004.

(n62)Footnote 62. June 28, 2005.

(n63)Footnote 63. Rule 14a-8(j); 17 C.F.R. § 240.14a-8(j).

(n64)Footnote 64. Rule 14a-8(j)(1); 17 C.F.R. § 240.14a-8(j)(1).

(n65)Footnote 65. Rule 14a-8(j)(3)(i); 17 C.F.R. § 240.14a-8(j)(3)(i).

(n66)Footnote 66. Rule 14a-8(j)(3)(ii); 17 C.F.R. § 240.14a-8(j)(3)(ii).

(n67)Footnote 67. Rule 14a-8(j)(3)(iii); 17 C.F.R. § 240.14a-8(j)(3)(iii).

(n68)Footnote 68. Rule 14a-8(k); 17 C.F.R. § 240.14a-8(k).

(n69)Footnote 69. Rule 14a-8(l); 17 C.F.R. § 240.14a-8(l).

(n70)Footnote 70. Rule 14a-8(l)(1); 17 C.F.R. § 240.14a-8(l)(1).

(n71)Footnote 71. Rule 14a-8(l)(2); 17 C.F.R. § 240.14a-8(l)(2).

(n72)Footnote 72. Rule 14a-8(m); 17 C.F.R. § 240.14a-8(m).

(n73)Footnote 73. Rule 14a-8(m)(1); 17 C.F.R. § 240.14a-8(m)(1).

(n74)Footnote 74. In *United Paperworkers Int'l Union v. International Paper Co.*, 985 F.2d 1190 (2d Cir. 1993), the court of appeals held that International Paper Co. materially misrepresented its environmental record in responding to a shareholder proposal requesting adoption of the Valdez principles on environmental responsibility and affirmed that proxy rule violations had occurred. Suit was brought by a shareholder (not the proponent) alleging that the company's statement in opposition included in the 1992 proxy statement (stating that the company had addressed environmental concerns "in an appropriate and timely manner") was misleading by not disclosing that the company had been accused of numerous environmental offenses, had pled guilty to several felonies involving environmental issues, had paid large

finances and had been the target of numerous administrative complaints involving environmental compliance. Although certain environmental disclosures had been included in the company's annual report to shareholders, the court of appeals stated that the "disclosures contained in the annual report failed to cure the materially misleading representations and omissions in the Proxy Statement. The district court properly ruled that the Company had violated § 14(a) and Rule 14a-9." *Id.*; at 1201. The court also ordered the company to include a description of the judgment against it in its 1993 proxy materials.

(n75)Footnote 75. Rule 14a-8(m)(2); 17 C.F.R. § 240.14a-8(m)(2).

It may not be the best corporate policy to adopt a "higgling approach" under Rule 14a-8 given the remote likelihood of shareholder approval. L. Loss & J. Seligman, § 7.04[4], *supra*, at 2050.

"The very opportunity to submit proposals, even of an advisory nature, affords a safety valve for stockholder expression at a price to the registrant that would seem to be relatively slight." *Id.* at 2051.

(n76)Footnote 76. Rule 14a-8(m)(3)(i); 17 C.F.R. § 240.14a-8(m)(3)(i).

(n77)Footnote 77. Rule 14a-8(m)(3)(ii); 17 C.F.R. § 240.14a-8(m)(3)(ii).



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Federal Securities Exchange Act of 1934

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CHAPTER 7 Proxy Regulation

1-7 Federal Securities Exchange Act of 1934 § 7.08

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§ 7.08 Election Contests

Proxy contests involving the election or removal of directors at any annual or special meeting of shareholders are subject to special requirements involving reporting and disclosure of the identity of any "participant" in the contest and of the interest of each participant in the matters to be acted upon. A dissident shareholder has certain rights to assure dissemination of the shareholder's proxy material to the company's shareholders. Certain activities by dissident shareholders intended to influence the outcome of elections are exempt from the proxy statement requirements.

[1] In General--Rule 14a-12(c)

If a shareholder determines to solicit n1 proxies or consents for the purpose of opposing a solicitation under Regulation 14A n2 with respect to the election or removal of directors, both sides in the resulting proxy contest become subject to the special provisions of Rule 14a-12(c). n3

[a] Solicitations Constituting Election Contests. Before an election contest can commence, there must be a solicitation subject to Regulation 14A (the "Primary Solicitation") with respect to the election or removal of directors. n4 A solicitation (other than an exempt solicitation) made in opposition to that first solicitation (the "Opposing Solicitation") begins the election contest. In most cases the Primary Solicitation is conducted by the board of directors of the company, and an Opposing Solicitation is conducted by dissident shareholders. Once the Opposing Solicitation has begun, Rule 14a-11 would also apply to any further solicitation by the person or group conducting the Primary Solicitation. Rule 14a-11 would not apply to activities that do not constitute "solicitations" for purposes of Rule 14a-1(l)(2) n5 or to activities that are exempt from Regulation 14A (other than Rule 14a-9) n6 pursuant to Rule 14a-2(b). n7 Rule 14a-11 is not applicable to shareholder proposals not related to the election or removal of directors but would be applicable if a proposal involves any election or removal of directors. n8

[b] Definition of "Participant." Since complete disclosure of the identity of any participant in the contest and of any interest in the election contest is required, the definition of "participant" is central to an understanding of Rule 14a-11. "Participant" for purposes of Item 4 ("Persons Making the Solicitation") and Item 5 ("Interest of Certain Persons in Matters to Be Acted Upon") of Schedule 14A n9 is defined in Instruction 3(a) to Item 4 of Schedule 14A to include any of the following:

- the registrant (*i.e.*, the company whose shareholders are being solicited);
- any director of the company or any nominee for whose election as a director proxies are solicited;
- any committee or group that solicits proxies, any member of such a committee or group, or any person whether or not named as a member of such a committee or group, who, acting alone or with one or more other persons, either directly or indirectly takes the initiative, or engages in organizing, directing or arranging for the financing of any such committee or group; n10
- anyone who contributes more than \$500 to the expense of solicitation; contributors of up to \$500 are not considered to be participants merely because of their donations; n11
- any person who lends money or furnishes credit or enters into any other arrangements, pursuant to any contract or understanding with a participant, for the purpose of financing or otherwise inducing the purchase, sale, holding or voting of shares of the company by any participant or other person, in support of or in opposition to a participant; n12 and
- any person who solicits n13 proxies.

The term "participant" does not include:

- any person or organization retained or employed by a participant to solicit shareholders and whose activities are limited to the duties required by such employment;
- any person who merely transmits proxy soliciting material or performs related ministerial or clerical duties;
- any attorney, accountant, or advertising, public relations or financial adviser employed by a participant and whose activities are limited to the duties required by such employment;
- any person regularly employed as an officer or employee of the company or any of its subsidiaries who is not otherwise a participant; or
- any officer or director of, or any person regularly employed by, any other participant, if the officer, director or employee is not otherwise a participant. n14

In *Chris-Craft Indus., Inc. v. Independent Stockholder's Comm.*, n15 a stockbroker who merely called shareholders to verify that they were actually Chris-Craft shareholders and to inform them that a proxy battle was going on was not a participant.

[c] Information to Be Included in Proxy Statement of Participants in Proxy Contests.

Proxy statements issued by participants in an election contest must contain the information specified in Regulation 14A. n16 Item 4(b), "Persons Making the Solicitation," Item 5(b), "Interest of Certain Persons in Matters to Be Acted Upon," and Item 7, "Directors and Executive Officers," of Schedule 14A contain references to the contents of proxy statements used in election contests.

[i] Persons Making the Solicitation. Item 4(b) of Schedule 14A requires that the following information be included in proxy statements relating to solicitations that are subject to Rule 14a-12(c):

- the identity of the person by whom the solicitation is being made and a description of the methods employed and to be employed to solicit shareholders;
- the manner and nature of employment of any regular employees of the participant who have been or are to be employed to solicit shareholders;
- if specially engaged employees, representatives or other persons have been or are to be employed to solicit shareholders, (i) the material features of any contract or arrangement for such solicitation and the identity of the parties, (ii) the cost or anticipated cost thereof, and (iii) the approximate number of such employees or employees of any other person (naming such person) who will solicit shareholders;
- the total amount estimated to be spent and the total expenditures to date in connection with the solicitation of shareholders;
- the person by whom the cost of the solicitation will be borne; n17 and
- the terms of any settlement between the company and any other participant, including the cost or anticipated cost thereof to the company, if the solicitation is terminated pursuant to a settlement.

[ii] Interest of Certain Persons in Matters to Be Acted Upon. Specific information is required in proxy soliciting material relating to an election contest with respect to the interest of certain persons in the election contest. n18 Any such proxy statement must:

- describe briefly any substantial interest, direct or indirect, by security holdings or otherwise of each participant (other than the company) in any matter to be acted upon at the meeting, and include with respect to each participant n19 the following information or a fair and accurate summary thereof:

(i) the name and business address of the participant;

(ii) the participant's present principal occupation or employment and the name, principal business and address of any corporation or other organization in which such employment is carried on;

(iii) a statement as to whether or not, during the past ten years, the participant has been convicted in a criminal proceeding (excluding traffic violations or similar misdemeanors) and, if so, the dates, nature of conviction, name and location of court, and penalty imposed or other disposition of the case; n20

(iv) the amount of each class of securities of the company that the participant owns beneficially, n21 directly or indirectly;

(v) the amount of each class of securities of the company that the participant owns of record but not beneficially;

(vi) the date on which securities of the company were purchased or sold within the past two years and the amount purchased or sold on each date;

(vii) if any part of the purchase price of any of the securities purchased during the past two years is represented by funds borrowed or otherwise obtained for the purpose of acquiring or holding such securities, a statement to that effect and an indication of the

amount of such indebtedness as of the latest practicable date; n22

(viii) a statement as to whether or not the participant is, or was within the past year, a party to any contract, arrangement or understanding with any person with respect to any securities of the company, including joint ventures, loan or option arrangements, puts or calls, guarantees against loss or guarantees of profit, division of losses or profits, or the giving or withholding of proxies and, if so, the names of the parties to such contracts, arrangements or understandings and the details thereof;

(ix) a statement as to the amount of securities of the company owned beneficially, directly or indirectly, by each of the participant's associates n23 and the name and address of each such associate;

(x) a statement as to amount of each class of securities of any parent or subsidiary of the company that the participant owns beneficially, directly or indirectly;

(xi) the information for the participant and any associate of the participant with respect to transactions with the company required by Item 404(a) of Regulation S-K; n24

(xii) a statement as to whether or not the participant or any associate of the participant has any arrangement or understanding with any person (A) with respect to any future employment by the company or any affiliate of the company or (B) with respect to any future transaction to which the company or any of its affiliates will or may be a party and, if so, a description of each arrangement and understanding and a statement of the names of the parties thereto; and

(xiii) describe any substantial interest, direct or indirect, by security holdings or otherwise, that any person (other than a director or executive officer of the company acting solely in that capacity) who is a party to any arrangement or understanding pursuant to which a nominee for election as director is proposed to be elected has in any matter to be acted upon at the meeting and furnish the information described in [xi] or [xii] above.

[iii] Directors and Executive Officers. A proxy statement used in connection with an election contest must contain the information specified in Item 7 of Schedule 14A n25 with respect to directors and executive officers. However, for soliciting material distributed on behalf of persons other than the company, the information required needs to be furnished only as to the nominees of the persons making the solicitation. n26

[iv] Other Information. While Items 4, 5 and 7 of Schedule 14A specify information to be included in proxy statements used in connection with election contests, Schedule 14A as a whole would apply to such proxy statements. It would seem logical, however, to conclude that only those items relevant to the participant's proxy material should need to be included. n27

[v] Additional Soliciting Material. If the person making the initial solicitation distributes additional proxy soliciting material after the election contest begins, such additional soliciting material would be subject to the requirements of Rule 14a-12(c).

[d] Solicitations Before Furnishing Written Proxy Statement--Rule 14a-12(c). In the context of an election contest, solicitations of proxies are now permitted prior to the furnishing of written proxy material to the shareholders solicited subject to compliance with the general requirements applicable to all other types of solicitations, n28 and subject to compliance with the additional conditions regarding the filing of annual reports and of reprints or

reproductions incorporated in or incorporating references to any soliciting material as outlined in Section 7.08(1)(h) *infra*. n29

[e] Filing of Material Used Prior to Furnishing Written Proxy Statement--Rule 14a-12. If, pursuant to Rule 14a-12, any proxy soliciting material is published, sent or given to shareholders prior to the furnishing of a written proxy statement meeting the requirements of Schedule 14A, such material must be filed with the Commission no later than the date such material is published, sent or given to any shareholder and three copies must be filed with, or mailed for filing to, each national securities exchange upon which any class of securities of the company is listed and registered. n30

The requirement for filing multiple copies and the option of mailing for filing would not apply to proxy soliciting material filed with the Commission since Regulation S--T n31 requires that such material be filed electronically. n32 Any soliciting material filed with the Commission pursuant to Rule 14a-12(b) must include a cover page in the form set forth in Schedule 14A.

[f] Application to Annual Reports--Rule 14a-12(c)(1). If any portion of an annual report distributed by the company as required by Rule 14a-3(b) n33 comments upon or refers to any solicitation subject to Rule 14a-12(c) or to any participant in such solicitation other than the company, such portion of the annual report must be filed electronically with the Commission as proxy material. n34

[g] Instructions for Filing--Rule 14a-12. The provisions of Rule 14a-6(b), (c), (d) and (e) n35 apply, to the extent pertinent, to soliciting material required to be filed pursuant to Rule 14a-12. These rules relate to the filing of definitive proxy statements and other soliciting materials and personal soliciting materials, the release date of materials and the public availability of information. No filing fee is required except in connection with preliminary proxy material involving acquisitions, mergers, spinoffs, consolidations or proposed sales or other dispositions of substantially all of the assets of the company. n36 If the proxy material involves one of the enumerated transactions, a nonrefundable fee determined in accordance with Rule 0-11 n37 is payable when preliminary proxy material is filed. n38

[h] Use of Reprints or Reproductions--Rule 14a-12(c)(2). If any solicitation relating to an election contest includes, in whole or in part, any reprint or reproduction of any previously published materials, the soliciting material must:

- state the name of the author and publication, the date of prior publication and the identity of any person who is quoted without being named in the previously published material; n39
- state whether or not the consent of the author and publication has been obtained to the use of the previously published material, except in the case of a public official document or statement; n40 and
- state the circumstances if any participant using the previously published material, or anyone on the participant's behalf, has paid, directly or indirectly, for the preparation or prior publication of the material or has made or proposes to make any payments or given any other consideration in connection with the publication or republication of the material. n41

[i] New York and American Stock Exchange Proxy Contest Rules. Rules 450 through 460 of the New York Stock Exchange n42 govern the granting of proxies by New York Stock Exchange member organizations for securities held by them but beneficially owned by others. In general, a member organization is required to forward proxy soliciting material to each beneficial owner with a request for voting instructions or a signed proxy indicating the number of shares held for such beneficiary. n43 If a broker does not receive voting instructions from the beneficial owner, the broker nevertheless has authority to vote the shares under certain circumstances. n44 One situation where a member organization may not give a proxy without instructions from the beneficial owner is where the matter to be voted upon "is the subject of a counter-solicitation, or is part of a proposal made by a stockholder which is being

opposed by management (*i.e.*, a contest)." n45

If a discretionary proxy has been given in good faith by the broker before an election contest has begun and thereafter a contest develops, each member organization has the authority to determine whether or not to revoke such discretionary proxies. n46 It should be noted that this policy applies to any matter where a contest develops and not solely to election contests. n47 After a contest has developed, the member organization should not give further proxies without direction from the beneficial owner. n48

No member organization or officers or employees of a member organization may participate in a proxy contest with respect to a company if the member organization specializes in the stock of that company. n49

The American Stock Exchange has similar rules relating to the giving of proxies by member organizations and, in particular, similar rules relating to the responsibilities of member organizations in the event of an election contest. n50

[2] The Shareholder List--Rule 14a-7

It would seem obvious that the ability to succeed in an election contest requires that the participant be able to communicate with the persons entitled to vote the shares. For the company, possession of the shareholder list, together with the obligations of brokers and banks to forward proxy soliciting materials to the beneficial owners, n51 assures that the board of directors will be able to communicate with the shareholders entitled to vote. Participants in an election contest do not have possession of the shareholder list and, in the context of the federal securities laws, n52 must rely on Rule 14a-7 n53 to furnish soliciting material to the company's shareholders. n54

Once a company has determined to solicit proxies or consents in connection with shareholder action, the company has an obligation to assist a shareholder who satisfies certain procedural requirements n55 in distributing soliciting material on behalf of such shareholder. After receiving a request complying with Rule 14a-7(c), the company must either:

- send to the shareholders the requesting shareholder's soliciting material, at the requesting shareholder's expense, reasonably promptly after receiving the shareholder's soliciting materials and payment of the company's reasonable expenses; n56 or
- provide shareholder and beneficial ownership information in the form reasonably requested by the shareholder so the shareholder can mail the material directly. n57

Except in the case of a "going private" transaction subject to Rule 13e-3 n58 or a roll-up transaction as defined in Item 901(c) of Regulation S-K, n59 the company has the choice as to whether it will mail the soliciting material on behalf of the shareholder or provide the ownership information to the shareholder. n60 In the case of a "going private" or roll-up transaction (with limited exceptions), the shareholder can require that the company provide the shareholder list and beneficial ownership information. n61

The company will almost invariably opt to mail the soliciting material on behalf of the shareholder, thereby retaining substantial control over the situation and obtaining advance knowledge of the contents of the material and an opportunity to respond promptly. n62

If a company opts to mail the soliciting material for the dissident shareholders, the dissident group may nevertheless be able to compel the company to furnish it with a shareholders list under the applicable state law. n63

FOOTNOTES:

(n1)Footnote 1. For a discussion of the definition of "solicit" and a description of certain activities, including certain communications by shareholders, which do not constitute a solicitation, see § 7.02[1] and [2] *supra*.

(n2)Footnote 2. 17 C.F.R. § 240.14a-1 *et seq.*

(n3)Footnote 3. 17 C.F.R. § 240.14a-12(c).

The conduct of proxy contests is the subject of a treatise by E. Aranow & H. Einhorn, *Proxy Contests for Corporate Control* (2d ed. 1968). See also K. Eppler & T. Gilroy, *Proxy Contests, Institutional Investor Initiatives, Management Responses* (P.L.I. 1990).

Where a contest for control also involves the purchase of equity securities of the issuer, consideration must also be given to the possible application of Sections 13(d) and 14(d) of the Exchange Act, 15 U.S.C. § 78m(d) and § 78n(d) (requiring certain disclosures by anyone acquiring more than five percent of the equity securities of an issuer). See § 7A.02[1] and § 7A.03[2] *infra*, respectively).

Many of the problems involved in proxy contests, *e.g.*, the propriety of reimbursement to management or an insurgent of expenses incurred, are governed by general corporate law and are not treated in this section.

(n4)Footnote 4. A proxy contest is not started merely by an objection of a stockholder to a proposed corporate action. *Dyer v. SEC*, 266 F.2d 33 (8th Cir.), *cert. denied*, 361 U.S. 835 (1959).

(n5)Footnote 5. 17 C.F.R. § 240.14a-1(l)(2). See § 7.02 *supra* for a discussion of this rule.

(n6)Footnote 6. 17 C.F.R. § 240.14a-9 (the general antifraud rule applicable to proxy material). See § 7.04 *supra* for a discussion of this rule.

(n7)Footnote 7. 17 C.F.R. § 240.14a-2(b). See § 7.02[2] *supra* for a discussion of this rule.

(n8)Footnote 8. See § 7.07 *supra* for a discussion of the obligations of a company under Rule 14a-8 to include proposals of shareholders in proxy materials distributed by the company.

(n9)Footnote 9. 17 C.F.R. § 240.14a-101.

(n10)Footnote 10. This definition, it should be noted, includes any committee, whether formed in support of the company or in opposition. See *Chris-Craft Industries, Inc. v. Independent Stockholders Committee*, 354 F. Supp. 895 (D. Del. 1973) (corporate officer was an active participant under Rule 14a-11 and violated that rule by not filing the required materials).

See also *SEC v. York*, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,271 (S.D. Cal. 1981) (the founder and chairman of a shareholders' protective committee who was also a company director and shareholder was a participant since his name was used in the proxy solicitations); *SEC v. May*, 134 F. Supp. 247 (S.D.N.Y. 1955), *aff'd*, 229 F.2d 123 (2d Cir. 1956) (failure to disclose active participant in proxy statement of shareholders' committee in response to Item 3 [now Item 4] of Schedule 14A violated rules); *SEC v. Henwood*, [1961-1964 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,125 (S.D. Cal. 1961), *modified and aff'd*, 298 F.2d 641 (9th Cir.), *cert. denied*, 371 U.S. 814 (1962).

(n11)Footnote 11. See *Chris-Craft Indus.*, *n.10 supra*, 354 F. Supp. at 908, 909-10 (neither a defendant nor a corporation in which another defendant had a controlling interest were found to be participants, but another party together with his employer contributed \$5,000 to the proxy contest and thereby became participants. That a party's money is returned after a proxy fight is over has no bearing on whether the contribution was made initially, *i.e.*, whether the contributor is a participant).

(n12)Footnote 12. The term "participant," however, does not include a bank, broker or dealer which, in the ordinary course of business, lends money or executes orders for the purchase or sale of securities and which is not otherwise a participant. Schedule 14A, Item 4, Instruction 3(a)(v). *See Chris-Craft Indus., n.10 supra*, 354 F. Supp. at 908 (lender motivated by desire to influence proxy contest in favor of the shareholder's committee was a participant).

See also National Home Prods., Inc. v. Gray, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,752 (D. Del. 1976) (client of a participant in an election contest was not a participant herself within the meaning of the proxy rules by transferring stock to a participant in exchange for a promissory note, prior to the struggle for control of the corporation).

(n13)Footnote 13. For a discussion of the definition of "solicit" and "solicitation" under Rule 14a-1(l), *see* § 7.02 *supra*. Under Rule 14a-2, discussed in § 7.02 *supra*, certain activities which constitute solicitations are nevertheless not subject to the provisions of Rule 14a-12(c). Any person who engages in such activities would, in effect, not be a participant in an election contest. It is not entirely clear whether, if a company solicits proxies and a shareholder thereafter engages in a solicitation exempt from Rule 14a-1, pursuant to Rule 14a-2, the exempt activities of the shareholder would constitute the beginning of an election contest. If it does commence an election contest, subsequent proxy soliciting material of the company would be subject to Rule 14a-12(c).

(n14)Footnote 14. Instruction 3(b) to Item 4 of Schedule 14A. It should be noted that a director of a participant other than the company is not, merely because of that fact, a participant. On the other hand, a director of the company is a participant whether or not his or her election is being contested. *Compare* Instruction 3(a)(ii) with Instruction 3(b)(iv) to Item 4 of Schedule 14A.

(n15)Footnote 15. 354 F. Supp. 895, (D. Del. 1973) .

(n16)Footnote 16. For a discussion of the information generally required to be included in a proxy statement under Regulation 14A, *see* § 7.04 *supra*.

Schedule 14B, which specified the information required to be included in proxy statements relating to election contests, was repealed by the Commission in 1992. At that time, modifications were made to the requirements of Schedule 14A.

(n17)Footnote 17. If the cost is to be borne initially by a person other than the company, the proxy statement must also state whether reimbursement will be sought from the company and, if so, whether the question of such reimbursement will be submitted to a vote of shareholders. Item 4(b)(5) of Schedule 14A.

For solicitations subject to Rule 14a-12(c), costs include fees for attorneys, accountants, public relations or financial advisers, solicitors, advertising, printing, transportation, litigation and other costs incidental to the solicitation. Nevertheless, the company may exclude the amount normally expended by it in the solicitation of proxies for an election of directors in the absence of a contest if a statement to that effect is included in the proxy statement. Instruction 1 to Item 4 of Schedule 14A.

(n18)Footnote 18. Item 5(b) of Schedule 14A.

(n19)Footnote 19. While Item 5(b)(1) of Schedule 14A specifies "each participant," it would be logical to interpret this requirement as meaning only each of the participants who are soliciting proxies with the proxy material in which the interest is being described.

(n20)Footnote 20. Although this item indicates that a participant must state whether or not there has been a conviction, the item goes on to state that a negative answer need not be included. Item 5(b)(1)(iii) of Schedule 14A.

(n21)Footnote 21. The instruction to Item 5 of Schedule 14A states that, for purposes of Item 5, "beneficial

ownership" is determined in accordance with Rule 13d-3, 17 C.F.R. § 240.13d-3. *See § 7A.02[2][b][ii] infra.* As defined in Rule 13d-3, "beneficial ownership" means having sole or shared voting power or sole or shared investment power over the shares in question. This definition of "beneficial ownership" is different from the definition used for reporting ownership for purposes of Section 16 of the Exchange Act. Rule 16a-1, 17 C.F.R. § 240.16a-1 defines "beneficial ownership" in terms of having a direct or indirect pecuniary interest.

(n22)Footnote 22. In addition, if such funds were borrowed or obtained otherwise than pursuant to a margin account or bank loan in the regular course of the business of a bank, broker or dealer, the proxy statement must describe briefly the transaction and state the names of the parties. Item 5(b)(1)(vii) of Schedule 14A.

(n23)Footnote 23. "Associate" is defined in Rule 14a-1(a). *See § 7.04 supra.*

(n24)Footnote 24. 17 C.F.R. § 229.404(a). For a discussion of Item 404(a) of Regulation S-K, 17 C.F.R. § 229.404(a), *see § 4.03[5][d] supra.*

(n25)Footnote 25. For a description of the information required by Item 7 of Schedule 14A, *see § 7.04 supra.*

(n26)Footnote 26. Item 7 of Schedule 14A.

(n27)Footnote 27. For example, if a company proposes to elect directors and to consider the adoption of an option plan at a shareholders' meeting and another participant solicits proxies with respect to the election of directors, the proxy statement of the other participant should not need to include information responding to Item 10 of Schedule 14A ("Compensation Plans").

(n28)Footnote 28. *See generally § 7.02[4], supra.*

(n29)Footnote 29. 17 C.F.R. § 240.14a-12(a) and (b). Rule 14a-12(a) and (b) describes circumstances where solicitations are permitted prior to furnishing a written proxy statement whether or not an election contest is involved. For a discussion of Rule 14a-12(a) and (b), *see § 7.02[4], supra.*

(n30)Footnote 30. Rule 14a-12(b).

(n31)Footnote 31. 17 C.F.R. Part 232.

(n32)Footnote 32. Rule 101 of Regulation S--T, 17 C.F.R. § 232.101.

(n33)Footnote 33. 17 C.F.R. § 240.14a-3(b).

(n34)Footnote 34. Rule 14a-12(c)(1).

(n35)Footnote 35. 17 C.F.R. § 240.14a-6(b), (c), (d) and (e).

Rule 14a-6(b) requires that eight definitive copies of the proxy statement, form of proxy and other soliciting material be filed with the Commission not later than the date such material is first sent or given to any shareholder; and that three copies be filed with, or mailed for filing to, each national securities exchange upon which any class of securities of the company is listed and registered.

Rule 14a-6(c) requires the filing of written instructions or other material to be used in connection with solicitations to be made in whole or in part by personal solicitation.

Rule 14a-6(d) requires that filings of preliminary proxy statements and forms of proxy be accompanied by a statement of the date on which definitive copies are intended to be released to shareholders.

Rule 14a-6(e) concerns the public availability of preliminary proxy statements and forms of proxy.

For a discussion of the provisions of Rule 14a-6, *see* § 7.04 *supra*.

(n36)Footnote 36. Rule 14a-6(i).

(n37)Footnote 37. 17 C.F.R. § 240.0-11.

(n38)Footnote 38. Rule 14a-6(b)(1).

(n39)Footnote 39. Rule 14a-12(c)(2)(i).

(n40)Footnote 40. Rule 14a-12(c)(2)(ii).

(n41)Footnote 41. Rule 14a-12(c)(2)(iii).

(n42)Footnote 42. The Rules are available at <http://rules.nyse.com/NYSE/NYSE%5FRules/>.

(n43)Footnote 43. Rule 451, New York Stock Exchange Rules. This rule applies to brokers, whether or not there is an election contest. The New York Stock Exchange rules would also require a broker to forward materials for any participant in an election contest. In connection with forwarding such materials, a broker is entitled to be reimbursed for its reasonable expenses. Brokers have similar obligations under Rules 14b-1, 17 C.F.R. § 240.14b-1, and 14b-2, 17 C.F.R. § 240.14b-2, which are discussed in § 7.02 *supra*.

(n44)Footnote 44. Rule 452, New York Stock Exchange Rules. The New York Stock Exchange has filed with the SEC a proposal to amend Rule 452 to remove from brokers the authority to vote in uncontested elections for director without instructions from the beneficial owner. See discussion at *Section 7.02 [2], supra*.

(n45)Footnote 45. Supplementary Material to Rule 452, New York Stock Exchange Rules.

(n46)Footnote 46. Supplementary Material to Rule 452, New York Stock Exchange Guide (CCH Internet Service). Since brokers typically will not vote pursuant to their discretionary authority until shortly before the date of the meeting, this situation will not arise frequently.

(n47)Footnote 47. Rule 14a-12(c) applies only to election contests. Counter solicitations on matters other than elections to office would be regulated by the balance of Regulation 14A.

(n48)Footnote 48. Supplementary Material to Rule 452, New York Stock Exchange Guide (CCH Internet Service).

(n49)Footnote 49. Rule 460(a), New York Stock Exchange Guide (CCH Internet Service).

(n50)Footnote 50. Sections 701 through 726 of the American Stock Exchange Guide (especially §§ 720-726, American Stock Exchange Guide (CCH Internet Service).

(n51)Footnote 51. Brokers and banks are obligated to forward proxy soliciting materials to the beneficial owners pursuant to Rule 14b-1 and Rule 14b-2.

(n52)Footnote 52. Under applicable state law, a shareholder wishing to communicate with other shareholders may have the right to access to the shareholder list, but such state law considerations are beyond the scope of this material.

(n53)Footnote 53. 17 C.F.R. § 240.14a-7. For a more complete discussion of Rule 14a-7, *see* § 7.02 *supra*.

(n54)Footnote 54. Once proxy material is provided to brokers and banks either by the company on behalf of a participant or by the participant in accordance with Rule 14a-7, the brokers and banks have obligations to forward such

material to the beneficial owners under Rule 14b-1 or Rule 14b-2.

(n55)Footnote 55. These procedural requirements include providing evidence of ownership and an affidavit to the effect that the shareholder will not use any information provided for any purpose other than solicitation. Rule 14a-7(c). The shareholder is required to reimburse the company for the reasonable expenses incurred by the company in mailing materials for the shareholder or providing a copy of the shareholder list and related material. Rule 14a-7(e).

(n56)Footnote 56. Rule 14a-7(a)(2)(i).

A company did not unduly delay the transmission to shareholders of information required by Rule 14a-7(a) where one day was required for the transfer agent to collect the information and two other days fell on a weekend. *Knapp v. Walden*, 367 F. Supp. 385, 387 (S.D.N.Y. 1973) .

(n57)Footnote 57. Rule 14a-7(a)(2)(ii).

(n58)Footnote 58. 17 C.F.R. § 240.13e-3.

(n59)Footnote 59. 17 C.F.R. § 229.901(c).

(n60)Footnote 60. Rule 14a-7(b).

A shareholder has no standing to demand a list of shareholders if the company desires to take the other alternative. See *Gaudiosi v. Franklin*, 166 F. Supp. 353 (E.D. Pa. 1958) , *aff'd on other grounds sub nom. Gaudiosi v. Mellon*, 269 F.2d 873 (3d Cir.) , *cert. denied*, 361 U.S. 902 (1959) .

Where a dissident shareholder has lawfully obtained a copy of the list of shareholders, Rule 14a-7 does not apply to any communications the dissident may wish to send out independently to the shareholders. *First Surety Corp. v. Community Bank*, 337 F. Supp. 667 (D. Cal. 1971) (dissident shareholder may mail proxy material to shareholders without regard to any time restrictions in Rule 14a-7).

See also *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715 (8th Cir. 1974) , *cert. denied*, 419 U.S. 1107 (1975) (management violated Rule 14a-7 by refusing to furnish assignees of voting trust certificates the names of shareholders except by court order).

(n61)Footnote 61. Rule 14a-7(b). Exceptions are partnerships whose investors will receive new securities or securities in another entity that are not reported under a transaction reporting plan declared effective before December 17, 1993 by the Commission under Section 11A of the Exchange Act; or partnerships whose investors' securities are reported under a transaction reporting plan declared effective before December 17, 1993 by the Commission under Section 11A of the Exchange Act.

(n62)Footnote 62. The company may not include in the same envelope material that it wishes to send out to shareholders, unless the shareholders whose material the company is mailing knows and consents to such inclusion. Sec. Exch. Act Rel. No. 7078, 3 Fed. Sec. L. Rep. (CCH) P 24,103 (1963).

(n63)Footnote 63. It is beyond the scope of this Section to discuss the rights of a shareholder in this situation, such proceeding being only ancillary to the election contest itself.

The rights given by Rule 14a-7 are in addition to any rights given to shareholders to inspect the shareholder list by state law; Rule 14a-7 does not preempt the field. *Alabama Gas Corp. v. Morrow*, 265 Ala. 604, 93 So. 2d 515, *Fed. Sec. L. Rep. (CCH) P 90,806* (1957) ; *Application of Joslyn*, 191 Misc. 512, 78 N.Y.S. 2d 183 (N.Y. Sup. Ct. 1948) , *aff'd*, 273 A.D. 945, 78 N.Y.S.2d 923 (N.Y. App. Div. 1948) .

See also *Wood, Walker & Co. v. Evans*, 300 F. Supp. 171 (D. Colo. 1969) , *aff'd*, 461 F.2d 852 (10th Cir. 1972) (no election between state and federal law; shareholder may pursue right under Rule 14a-7 and then seek to invoke right of inspection under state law).

If a dissident shareholder has violated the federal proxy rules in connection with a state court action, a federal court will enjoin the dissident from further pursuing such action. *Studebaker Corp. v. Gittlin*, 360 F.2d 692 (2d Cir. 1966) (injunction granted; obtaining of shareholder authorizations to compel disclosure of a shareholders list under state law was a solicitation subject to the federal proxy rules, which had been violated in obtaining the authorizations); *Greater Iowa Corp. v. McLendon*, 378 F.2d 783 (8th Cir. 1967) (no preliminary injunction granted but solicitation of membership in a voting trust found to be within the federal proxy rules).

In *Stern v. South Chester Tube Co.*, 390 U.S. 606, 88 S. Ct. 1332, 20 L. Ed. 2d 177 (1968) , it was held that a federal district court has the power to issue proper orders to enforce a stockholder's state-granted right to inspect corporate records. See *Wood, Walker & Co. v. Evans*, *supra*.



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Federal Securities Exchange Act of 1934

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CHAPTER 7 Proxy Regulation

1-7 Federal Securities Exchange Act of 1934 § 7.09

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§ 7.09 Enforcement of the Proxy Rules

[1] Introduction

The principal means for attacking violations of the Exchange Act proxy solicitation and related requirements are the means generally available for enforcement of the federal securities laws:

- the Commission's statutory right to seek relief by injunction in a federal district court;
- its statutory right to refer willful violations to the Department of Justice for criminal prosecution; and
- the judicially recognized right of affected shareholders or the issuer (either through its management against insurgents or derivatively by insurgents) to bring a private action.

The private right of action may result in a large award of damages to security holders or, at least in theory, the setting aside of consummated transactions.

The federal securities laws provide for administrative proceedings against certain parties subject to specific Commission regulation, such as broker-dealers, investment advisers and investment companies. n1 The Commission has administrative power to protect the integrity of the securities markets and may suspend trading in any security (other than an "exempted security"). n2 Although suspension of trading would clearly be available to the Commission when defective proxy materials improperly affected the market value of the security, suspension must be invoked with caution because of its detrimental effects on innocent security holders.

In the usual solicitation of proxies, in addition to administrative proceedings, the Commission may pursue a judicial proceeding. Thus, if a recalcitrant party rejects the advice of the Commission or its staff and proposes to distribute defective materials, the Commission may enforce compliance with the proxy rules through an action in the United States district court for an injunction, which has the potential for preventing or correcting much of the injury threatened or inflicted by a proxy violation. The court may, for example, set aside or enjoin the use of improperly obtained proxies, require adjournment of the meeting in question, and require resolicitation of proxies with a corrected proxy statement.

Of course, a court is more willing to grant such pre-meeting or pre-consummation relief than it is to set aside past actions, a task that becomes progressively more problematic as the rights of third parties become more involved. In the case of a merger of two publicly held companies, for example, a court may consider the task of setting aside the transaction as impracticableⁿ³ from both the business aspect (reestablishing the former entities, with their separate management, properties, employees, etc.) and the securities holders' aspect (tracing the changes in ownership since the effective date of the merger, for example). Unlike an antitrust court, which considers *future market effects* of a merger, the judge in a securities case is quite likely to consider an award of damages to be all that is necessary or practicable to correct a past violation.

[2] Administrative Practices and Procedures

Common sense, civility and regard for effective use of judicial and agency resources dictate that, where feasible, a deficiency in proposed proxy materials be dealt with at the administrative level by the staff of the Commission prior to a party's use of the materials, rather than in a district court. The same considerations would appear to be applicable to the resolution of interpretative questions. In addition, the views of the Commission and its staff must be weighed carefully even by parties who consider a given agency interpretation of law to be incorrect; the agency's views will undoubtedly be given weight by the court in any subsequent legal action. The risks of delay and the uncertainty of victory attendant upon litigating the question with the Commission, or with a private party urging a position espoused by the Commission, may dictate accommodation, compromise or withdrawal of the proposed action.

The administrative procedures employed in the context of the proxy rules are generally as follows:

- The "no action" letter procedure permits private parties to determine in advance whether a *proposed* transaction is sufficiently within the limits of the statute and rules to allow the staff to assure the parties involved that it would not recommend that the Commission take enforcement action against the transaction. The staff's position is based solely upon the facts stated in the request; however, a change in the transaction may alter the staff's position. ⁿ⁴

The "no action" procedure is frequently used for determinations under Rule 14a-8: whether a shareholder's proposal may be omitted from management's proxy materials. If the question is resolved against the management's position, it must either include the proposal or face the risk of an injunction action. ⁿ⁵

- Other informal interpretative advice and pre-filing assistance are provided by the staff by telephone and through conferences. ⁿ⁶
- Informal statements of the views of the Commission itself may be available concerning a particular problem, particularly on "matters of substantial importance and when the issues are novel or highly complex." The decision to make such a statement is, however, entirely within the discretion of the Commission. ⁿ⁷
- Proxy statements and information statements and related materials are selectively reviewed by the Division of Corporation Finance. ⁿ⁸ Upon discovery of deficiencies in such materials, the staff will contact the filing party and request that corrections be made. If the filing party refuses to make the indicated corrections, the staff may refer the matter to the Division of Enforcement. ⁿ⁹ Unlike the Securities Act, however, the Exchange Act provides no "stop order" or similar procedure for administrative delay of the use of proxy materials. ⁿ¹⁰ If the Commission determines to stop the solicitation and the issuer refuses to acquiesce in the changes wanted by the staff, the Commission must in most cases bring an action in a United States district court for an injunction.

- The Commission may, pursuant to Exchange Act Section 21(a), make an investigation "to determine whether any person has violated, is violating, or is about to violate" the Act, the Commission's rules or the rules of a self-regulatory agency. The same provision authorizes the agency to publish "information concerning any such violations." n11

- The Commission may summarily suspend trading in the issuer's securities for a period of no more than 10 days pursuant to Exchange Act Section 12(k). n12 The Commission is also authorized to suspend or revoke the *registration* of a security pursuant to Section 12(j) n13 by order, if it finds on the record after notice and opportunity for hearing that the issuer has failed to comply with the Exchange Act or the Commission's rules thereunder. Under either subsection (k) or (j), the Commission's action would prohibit trading in the security by *any* broker, dealer or exchange member in *any* market. As stated, a summary suspension may not exceed 10 days; n14 the more exacting procedure under subsection 12(j) may result in a suspension of registration for not more than 12 months or "revocation." n15 A revocation of registration, or indeed a lengthy suspension, under circumstances that prohibit public trading would have such devastating effects on public security holders that its use may be inappropriate except in the most extreme cases.

- Rule 2(e) administrative proceedings n16 may be directed against accountants, attorneys and other professionals to deny such persons the right to appear or practice before the Commission temporarily or permanently. n17

[3] Judicial Review of Administrative Action

Section 25(a) of the Exchange Act provides for review in a federal Court of Appeals of "a final order of the Commission" upon the written petition of a "person aggrieved." n18 The Securities Act Amendments of 1975 eliminated the former requirement that the person requesting review be a "party" to the proceeding in which the Commission issued the order. That change would appear to permit a security holder, although not a party to the Commission proceedings, to challenge an order of the Commission that involves his or her company, if the security holder meets other standing requirements.

The Commission does not issue an "order" under the proxy or information statement rules in the usual case, thus foreclosing review under Section 25(a). The Court of Appeals for the District of Columbia had held in *Medical Committees for Human Rights v. SEC* n19 that Commission affirmance of a staff "no action" letter under Rule 14a-8 possessed sufficient formality and finality to be considered a final order. That holding is now considered to be questionable, although subsequent decisions of that court have merely distinguished it. n20 In any event, it seems clear that a staff determination is not subject to judicial review if the Commission refuses to review the staff's action; n21 nor is the Commission's refusal to review the staff's action ordinarily subject to attack under Section 25(a). n22

The Exchange Act is clear that the decision not to make an investigation n23 or to bring an action in the district court n24 is within the discretion of the Commission and not subject to judicial review. n25

In sum, there appears to be no basis for judicial review of Commission procedures in a matter under the proxy rules unless there is a formal administrative proceeding held against a broker-dealer or similar registered party, an order suspending trading or affecting the registration of the security, Commission review of a staff position, or a Rule 2(e) proceeding.

[4] The Legality of Corporate Actions Accomplished Through Proxy Violations

As will be made clear in subsequent discussion, n26 violations of the rules concerning solicitation of proxies and

distribution of proxy and information statements are corrected by a variety of remedies available to the Commission, complaining shareholders, and the issuer acting through its management or through a shareholder derivative action.

[a] Is the Action "Void" or "Voidable"? As a preliminary and separate matter, however, it is appropriate to consider the effects of Exchange Act Section 29(b), which on its face *voids* contracts made in violation of the Act or any rule or regulation thereunder as regards the rights of the violator or the rights of a successor in interest of a violator. n27

A literal reading of that provision might appear to require a court to set aside a transaction accomplished through the use of proxies obtained in violation of the proxy rules. n28 Perhaps the most dramatic example is the case of a consummated merger that has been accomplished by voting proxies obtained through the use of a materially false or misleading proxy statement. Does proof of such a violation in a subsequent attack by shareholders require that the merger be set aside? That would appear to be a Draconian result in view of the immense difficulties to all concerned, the judicial burdens involved, the confusion and concern of third parties who have dealings with the surviving corporation, and the real prospect of injury to the corporation's shareholders through the effects on the securities markets.

In reality, however, the judicial approach has been one of reluctance to set aside a consummated merger. The federal courts, by evaluating the totality of the circumstances before deciding to set aside a consummated transaction, have thus adopted the more cautious, and certainly less disruptive, approach that they would evidently take in the absence of Section 29(b) or in the absence of the Commission's power to seek equitable relief. At a very early date, in a Securities Act case, the Supreme Court affirmed the power of a district court to provide various forms of equitable relief to defrauded purchasers even though the Securities Act on its face merely provided for an action for money damages under Section 12(2). n29

The Supreme Court held in *Mills v. Electric Auto-Lite* n30 that the effect of Section 29(b) is to make an agreement *voidable* at the request of "the innocent party." In the case of a merger, there is some difficulty in identifying the innocent party. A complaining minority shareholder who voted against the merger was evidently not deceived by the defective proxy statement. A shareholder who voted for the merger, according to the Court, could only rescind his or her proxy, which would be a futile gesture unless the number of shares held was sufficient to defeat adoption of the agreement of merger by the shareholders. But what if the action is brought in a derivative capacity, in the right of the corporation? The answer there is the same as in the preceding two cases. The question whether to set aside the merger is committed to the discretion of the court, which must determine whether such drastic relief would be "in the best interests of the shareholders as a whole." n31 Section 29(b), then, does not make the contract "void," but merely "voidable," and then only at the urging of the innocent "party." That interpretation is "eminently sensible." n32

[b] Remedy in a Merger Case. Once it is concluded that the choice of a remedy is in the hands of a district court judge, the question becomes far more complicated than a pure question of legality. Much as their counterparts in traditional equity courts have done even when confronted with arguably void transactions, n33 federal judges must weigh all the "equities" in arriving at a decree reasonably adapted to all the circumstances, including the rights of persons other than parties to the litigation. Although the Supreme Court has said that a merger might be set aside in an appropriate case, n34 no decree under the federal securities laws has gone to that extreme.

A court considering a completed corporate combination under the federal securities laws upon the complaint of deceived shareholders views its task as providing relief to the *shareholders whose proxies were solicited*, not subsequent or future shareholders. n35 The determination of that relief will almost always turn on the court's determination of what the plaintiffs and other security holders in a merged corporation, for example, *should* have received for parting with their securities. n36 In all but the most extraordinary case, it appears to be in the best interest of all concerned to reduce *retrospective* relief in a merger-related violation to a question of money, rather than to engage in the monumental task of setting aside a merger. n37

The foregoing considerations emphatically do not mean that the courts will *never* grant retrospective relief other than damages, or that they will not take effective action to *prevent* a merger or other transaction where the effort to accomplish the transaction involves a material violation of the proxy rules. They do mean, however, that the relief will be fashioned by a court to suit the situation. On occasion, the undoing of previously authorized actions may be required; n38 in other instances, postponement of the shareholders' meeting to permit distribution of corrected proxy materials and resolicitation on the basis of the new materials may be all that is warranted. n39

[5] Actions for Injunctive Relief

[a] Who May Bring an Action?

The Commission and private parties have the right to bring actions for injunctive relief of a prospective or retrospective nature for violations of the proxy provisions. n40

[i] The Commission's Right of Action. The Commission's right of action is set forth in Exchange Act Section 21(d):

Wherever it shall appear to the Commission that any person is engaged or is about to engage in any acts or practices constituting a violation ... it may in its discretion bring an action in the proper district court of the United States ... to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond n41

In addition, Section 21(e) grants jurisdiction to the federal district courts "to issue writs of mandamus, injunctions, and orders" commanding compliance with the Exchange Act, the rules, regulations and orders thereunder, and with rules of designated self-regulatory organizations, upon application of the Commission. n42

[ii] The Private Right of Action. The private right of action, which extends to both equitable relief and money damages, was confirmed by the Supreme Court in *J.I. Case v. Borak*, n43 which stated that "federal courts have the power to grant all necessary remedial relief." n44 The real significance of *Borak* lay in its endorsement of retrospective relief, such as an award of damages. Prospective relief had been much more readily approved by the district and appeals courts. n45 The Court's admonition in *Borak* that the federal courts should "be alert to provide such remedies as are necessary to make effective the congressional purpose" was given emphasis in *Mills v. Electric Auto-Lite Co.*, n46 which stated that one possible form of retrospective relief in that case would "include setting aside the merger or granting other equitable relief." n47 Although a court acting under the securities laws is very reluctant to "undo" a consummated merger, n48 the Court's indicated willingness to consider that radical form of relief has been viewed as an *a fortiori* argument to the effect that all lesser forms of relief are authorized where appropriate. n49

The opinion in *Borak* stated that the shareholder's private right of action under Section 14(a) extended to both direct and derivative actions. That statement prompted the lower courts to disavow some previous restrictions. For example, the Second Circuit acknowledged in *Studebaker v. Gittlin* n50 that *Borak* had "clearly overruled" a decision that had refused to recognize an action by an issuer, as represented by its management, where it was alleged that the insurer's stockholders had been solicited by insurgents through a violation of the Commission's rules. n51

[iii] Private Parties' Standing. Although the Supreme Court has not attempted to formulate rules for determining the particular plaintiffs who have standing to prosecute a private action, it is evident that Section 14(a) was designed to protect those who own n52 and hold voting securities. n53 The plaintiff may be a joint owner of the shares, n54 or an equitable owner. n55

A proxy contestant does not have standing to sue under Section 14(a) for false and misleading statements in management's proxy statement where such suit was brought as a disappointed proxy contestant, not as a shareholder. n56 Similarly, in *AMR Corp. v. UAL Corp.*, n57 the U.S. District Court for the Southern District of New York ruled

that American Airlines lacked standing to bring Section 14(a) claims challenging the joint proxy statement issued by Air Wis Services Inc. and VAL Corp. in connection with the proposed merger of the two firms. American alleged that the proxy statement was false and misleading. The court found that American was not attempting to advance the general interests of Air Wis shareholders or to promote its own interests as an Air Wis shareholder, but was simply trying to "bust up" the merger of Air Wis and VAL in order to acquire Air Wis' jet slots. Further, the court said that the denial of standing was appropriate as a "matter of policy" to discourage parties such as American "from simply purchasing a lawsuit, which is exactly what American hoped to do when it bought 100 shares of Air Wis stock."

In *Salomon Brothers Mun. Ptnrs Fund v. Thornton*, n58 the defendant solicited hostile proxies opposing plaintiff's proposed management agreement. When defendant discovered that a quorum for the meeting would be defeated if he failed to appear and vote, he abstained from attending the meeting and so advised the shareholders he represented, all of whom had granted proxies opposing the agreement. Despite SEC rule 14a-4(e) which requires a proxy statement to state that solicited proxies will be voted, the Court refused to grant a mandatory injunction requiring defendant to vote the opposing proxies, declaring that, assuming *arguendo* the refusal to vote violated the statutes, only the shareholders had standing to enforce the rule, not the plaintiff issuer.

By contrast, in *In re AOL Time Warner Sec. & "ERISA" Litig.*, n59 where the parties to a merger issued a joint proxy statement, the officers and directors of one party to the merger may be deemed to have solicited the proxies of the other party to the merger, and an allegation of misstatements by such persons supports the complaint of a 14(a) violation against a motion to dismiss.

Since the harm to the shareholders as a group may be achieved even if *some* shareholders, including the plaintiff, are not deceived or misled by the violation, the better rule would seem to be that the plaintiff's individual response to the violation should not be determinative of his or her right to bring the action. n60 However, there are decisions, particularly in the Ninth Circuit, to the effect that a shareholder plaintiff, even if seeking only remedial relief, is restricted to a derivative action if the plaintiff did not give a proxy. n61 It may be, however, that even if such a rule were to gain acceptance in other circuits, it should be confined to plaintiffs who seek retroactive, as opposed to prospective, relief. n62

[b] Equitable Requirements for Injunctive Relief

[i] Commission Actions. The Commission is not required to demonstrate threatened irreparable harm or the inadequacy of other remedies in order to obtain injunctive relief. n63 In the case of *provisional* relief, the requirement of Section 21(d) of a "proper showing" is met by the establishment of a *prima facie* case. n64

[ii] Private Actions. The private right of action, however, is encumbered with the traditional equity requirements. Thus, a corporate or shareholder plaintiff must demonstrate the existence of threatened irreparable harm "and other usual prerequisites for injunctive relief." n65 In the case of a preliminary injunction, the plaintiff must demonstrate both threatened irreparable injury and probable success on the merits. n66 The court must also determine the balance of hardships. The threatened injury, such as a proposed merger, n67 must be weighed against the hardships to the other side if relief is granted. The latter hardships may be the expense and delay occasioned by a postponement of the meeting, n68 the confusion and uncertainty that may be produced, n69 and the possibility that the shareholders may regard the preliminary decree as an adjudication of wrongdoing. n70

Relief may also be denied because of the plaintiff's laches n71 or unclean hands, n72 or if the matter is moot. n73

[c] Who May Be Liable? Section 14(a) makes it unlawful for "any person ... to solicit or to permit the use of his name to solicit any proxy" in violation of the Commission's rules. The definition of "participant" in a solicitation is discussed elsewhere in this chapter as it bears on the requirements of proxy contests. n74 Apart from the question of who is a "participant," however, there is the problem of the meaning of the statute's terms insofar as it purports to cover a person who "permit[s] the use of his name" in a solicitation. It is too much to say that any mention of one's name in a

proxy statement suffices to justify responsibility for the statement's contents. The Ninth Circuit, in *Yamamoto v. Omiya*, said there must be a "substantial connection between the use of the person's name and the solicitation effort." n75 It found that such a connection did not exist where the defendant appeared in the proxy statement only as the prospective purchaser of the corporation's chief asset, a parcel of land. The court found it very unlikely that the shareholders were influenced by his identity. n76

Persons who are more directly involved with the preparation of the proxy materials or the conduct of the solicitation, such as nominees for positions on an issuer's board, may be held liable, n77 as may directors, including outside directors. n78

In addition, a party to a transaction involving control of the issuer through the issuance of a block of preferred stock has also been held liable under Section 14(a); the court concluded that the defendant's connection with the transaction was "more than substantial." n79

The liability of attorneys as aiders and abettors for the violation of the securities laws by another person was for many years the most prevalent form of claim, until the U.S. Supreme Court held in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* n80 ("*Central Bank*") that a private cause of action does not exist for aiding and abetting under § 10(b) of the Securities Exchange Act of 1934. n81 Similarly, a majority of courts have concluded that a claim for aiding and abetting liability does not exist under § 11 n82 or § 12 n83 of the Securities Act of 1933. Cases involving claims of liability for aiding and abetting are rare under § 14(a) of the 1934 Act. *Gould v. American Hawaiian Steamship Co.* n84 in dicta stated that "§ 14(a) imposes liability on individuals soliciting proxies, and not on the attorneys or accountants preparing them." However, a later case found liability for materially misleading proxy solicitation materials where the attorney acted "recklessly." n85

Accountants are rarely charged as primary violators of § 14(a) and under the *Central Bank* case appear to share the same immunity as attorneys from aiding and abetting liability in private damage actions. n86

The *Central Bank* case left unanswered the question of whether the SEC has the right to pursue aiding and abetting enforcement actions under § 14(a). Its right to pursue such actions under § 10(b) was confirmed by Congress through the passage of § 104 of the Private Securities Litigation Reform Act of 1995; the wording of that statute appears broad enough to encompass violations of § 14(a). n87

While insulated by *Central Bank* from aider and abettor liability to a private party, attorneys and accountants may still be held primarily liable where their responsibility for the securities law violation is sufficiently significant. n88 Similarly, attorneys have been held primarily liable as controlling persons under § 20 of the 1934 Act as well as under § 15 of the 1933 Act. n89

In *Brown v. Enstar Group Inc.*, n90 the Eleventh Circuit adopted a new three-prong test for "controlling person" liability under Section 20A of the Securities Exchange Act. Kinder-Care Inc. founder and Board Chairman, Perry Mendel, adopted a restructuring plan involving establishment of Kinder-Care Learning Centers Inc. as a wholly-owned subsidiary. Mendel resigned his positions with the parent and became chairman of the subsidiary's board. The parent board, at a meeting not attended by Mendel, approved a rights offering whereby the stock of the subsidiary would be sold to the parent company shareholders. The parent and its successor CEO soon thereafter declared bankruptcy, and Mendel was personally sued by the parent company's shareholders for the parent company's failure to disclose material facts in the prospectus offering the shares. In affirming dismissal of the charges against Mendel, the court stated that a controlling person is liable under Section 20A if: (1) he or she had the power to control the general affairs of the entity at the time of the alleged securities law violation; (2) he or she had the power to control the specific corporate policy that resulted in the primary liability; (3) the controlled person committed a securities law violation. The court found that Mendel did not have the requisite control over the parent company at the time the securities law violations were committed. n91

There is no private liability for failure to make a public disclosure required by the SEC's new fair disclosure rules, Regulation FD, nor would it be a common occurrence for the SEC Division of Enforcement to charge an analyst with aiding and abetting, or causing, an unlawful disclosure by a company, in the absence of some arrangement between a company and an analyst that the analyst will be favored with nonpublic material information. n92

[d] Jurisdiction and Venue.

The Exchange Act grants the federal courts "exclusive jurisdiction of violations" of its provisions and the rules and regulations thereunder and "of all suits in equity and actions at law brought to enforce any liability or duty created by [the Act] or the rules and regulations thereunder." n93 Section 21(d) and (e), which deal with the Commission's right of action, are expressly limited to the federal district courts. Once the action is commenced in a federal district court, the defendant may be served "wherever [he or she] may be found," n94 which permits service outside the United States. n95 The venue provision for civil actions is also "user friendly" from the plaintiff's viewpoint: venue is proper in any district in which an act or transaction constituting a violation occurred, or where the defendant is found, or is an inhabitant, or transacts business. n96

[i] Pendent Jurisdiction. In addition to the federal claims presented by an action under the Exchange Act, the federal courts may, in their discretion, exercise pendent jurisdiction of state law claims, if the federal claim is substantial enough to confer subject matter jurisdiction. n97 The substantiality of the federal claim is usually judged by its ability to withstand a motion to dismiss for failure to state a claim or a motion for summary judgment. n98 The court may lack pendent jurisdiction of state claims against *parties* not subject to the jurisdiction of the court under the federal claim. n99

[ii] Intrastate Communications. It should also be borne in mind that the jurisdictional language in Section 14(a) of the Exchange Act ("use of the mails ... means or instrumentality of interstate commerce or of any facility of a national securities exchange ...") is greater than it seems. The Securities Acts Amendments of 1975 amended the definition of "interstate commerce" in Section 3(a)(17) of the Exchange Act to include *intrastate* use of a telephone or other interstate means of communication, or any interstate instrumentality, or a facility of a securities exchange.

[e] Transnational Solicitations. The solicitation of proxies from outside the United States through the mails, telephone or other means of communication is subject to Section 14, provided the security is registered under Section 12(b) or (g). n100 In the case of an unregistered security, such a transaction may be subject to the general anti-fraud provisions, such as *Rule 10b-5*. n101

The reverse situation, in which only foreign shareholders are injured by a defective solicitation from the United States, is also clearly within the federal jurisdiction, n102 even if the defendants are also foreign citizens. n103

[f] The Requisite Violation--"Materiality"

[i] Violations Not Shown to Be "Material." The statutory authorization for the Commission's action for injunctive relief expressly contemplates actions against a person who "is engaged or is about to engage in acts or practices constituting a violation" of the Act, the Commission's rules, or the rules of self-regulatory organizations, including registered exchanges and the NASD. Thus, the Commission is authorized to proceed against an ongoing or incipient "violation" of the Act or its rules, without an express requirement that the violation be of a substantial character, *i.e.*, that it be "material." The point is relevant because of the controversy concerning the Commission's views on the "qualitative" versus "quantitative" materiality of information n104 about the integrity of an issuer's management. n105 It seems clear that, regardless of a court's views on that controversy, a solicitor of proxies or distributor of an information statement is obligated to abide by the Commission's rules as to information that must be contained in the proxy or information statement, including specific information on such matters as conflicts of interest and criminal convictions. n106 However, as will be seen in subsequent discussion, that is not the end of the matter: an agency request

for an injunction "is an appeal to the sound discretion which guides the determinations of courts of equity." n107 While the continued refusal of a proxy solicitor to comply with an SEC rule is certainly sufficient to justify judicial intervention, n108 the mere existence of a past violation is not, although it is usually possible to glean evidence of the likelihood of future misconduct from the facts of the past violation, i.e. the seriousness of the violation and indications whether the violation was deliberate. n109

Thus, any violation may be sufficient for an enforcement action in particular circumstances. However, the most significant aspect of a violation is the degree to which it threatens the function of Section 14(a) and (c), which is to require that holders of securities be supplied with accurate and complete information. n110 The latter point is important in persuading a court to grant mandatory relief, *e.g.*, a resolicitation of corrected proxy materials.

[ii] "Material" Violations.

The primary function of the proxy provisions is to provide security holders with information. Since the Commission's specific disclosure rules cannot deal with every possible fact that may be of relevance in a given election or transaction, most controversies concerned with the existence of a "violation" arise under the general antifraud provision of the Commission's rules, Rule 14a-9, which speaks in terms of "material" facts. n111

[A] The Judicial Definition of "Materiality." It was not until 1976 that the Supreme Court attempted a definitive statement of the concept of materiality, following what has been referred to as the "Great 'Would-Might' Debate." n112 Originally, the Court, in *Mills v. Electric Auto-Lite Co.*, n113 in the context of a determination of causation, spoke of a "defect ... of such character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote." n114 Such a defect was one that had "a significant *propensity* to affect the voting process" n115 Judge Friendly of the Second Circuit soon expressed discomfort with the "might have been" standard, believing that it suggested "somewhat too low a threshold" for the imposition of liability under Rule 14a-9. n116 He thought that particularly so in view of his concurrent ruling that the standard of culpability should be negligence, not scienter, and that very heavy damages may be imposed in a private action. n117 He, therefore, substituted "would" for "might have been," stating that a "standard tending toward probability rather than toward mere possibility is more appropriate" n118

Three years later, Justice Marshall, writing for the Court in *TSC Industries Inc. v. Northway*, agreed that the "might" standard was too low. n119 Justice Marshall wrote:

The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with *Mills'* general description of materiality as a requirement that "the defect have a significant *propensity* to affect the voting process." It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. n120

There has been no subsequent judicial definition of "substantial likelihood" or "significantly altered," as used in Justice Marshall's opinion; it seems clear that any attempt to define with certainty these terms, and by extension "materiality," would be futile. n121 The Court in *TSC Industries* enunciated a standard of materiality in "objective" terms addressed solely to the anticipated or surmised effects of a given "fact" on the deliberations of a hypothetical reasonable shareholder. n122 There are indications, however, that other considerations enter the judicial "total mix." Cases involving corporate mismanagement or directorial misconduct that falls short of illegality have tended to be given short

shrift by the courts in Section 14(a) cases. n123

In *Minzer v. Keegan*, n124 the Second Circuit held that a materially misleading omission in a merger-proxy statement will not invalidate a merger if the court concludes as a matter of law that the omitted information "would not have made a reasonable shareholder any less likely to favor the objected-to transaction, and such an omission, *material or not*, could not have caused the injury for which damages are sought" (emphasis supplied). In *Minzer*, Chief Judge Winter, a highly experienced corporate jurist, speaking for a three-judge panel, affirmed dismissal by the district court n125 of an amended complaint which alleged that a proxy statement issued jointly by two parties to a proposed merger was materially misleading in failing to disclose (a) details of a rival offer and management's thwarting of such offer, and (b) that the acquired company's board and management were unduly influenced by offers of future employment and compensation. The complaint further attacked the opinion of Sandler O'Neill, the acquired company's investment bankers, that the merger was "fair from a financial point of view" in the face of a higher rival offer. The court concluded that as a matter of law a reasonable shareholder would not, upon learning of such information, have been induced to vote against the merger; that such a shareholder would have concluded that defeat of the merger would have left the company's shareholders with no deal at all because the shareholder would not have believed that there was a substantial likelihood of a near-term and more favorable merger with the rival bidder after rejection of the acquirer's offer. The court further stated that had the plaintiffs alleged that the premium paid for the acquired bank's shares was substantially below that of comparable transactions, or that the price paid did not adequately reflect the present value of expected future free-cash flows to the stockholders, the plaintiffs' attack on the Sandler O'Neill opinion might have survived the motion to dismiss.

Rosenberg v. Nabors Industries, Inc. n126 quotes with approval the statement in *Minzer* that the definition of materiality in the proxy context "assumes that the omitted information would have influenced a reasonable shareholder against the proposed transaction for which the proxies were sought," n127 a somewhat confusing citation since *Minzer* clearly states that an omission can be material but still may not have caused the injury. The question appears to be more one of causation than of materiality.

In re Fleet/Norstar Securities Litigation n128 involved an attack upon proxy materials for failure to disclose corporate mismanagement in following conservative lending policies and establishing adequate loan loss reserves. The complaint asserted that the proxy materials failed to disclose defendant-directors' failure "to fulfill even their basic functions as corporate fiduciaries and to safeguard Fleet assets." The court held that the complaint at best made out a claim of mismanagement, and followed *Kas v. Financial General Bankshares* n129 in holding that failure to disclose mismanagement is not materially misleading and thus not actionable under Section 14(a).

In *Gaines v. Haughton*, n130 the Ninth Circuit stated that director misconduct that did not inure to the "direct, personal benefit of the directors" n131 or involve certain kinds of illegal conduct, especially conduct involving criminal convictions, need not be disclosed in proxy solicitations. Thus, in the Ninth Circuit's view, director misconduct that does not involve self-dealing or serious illegality is not a material fact within the meaning of the federal securities laws. The court of appeals was concerned with shareholder-plaintiff attempts to gain a federal forum for claims of "corporate mismanagement" that it believed should be addressed to the state courts. The opinion cites *Santa Fe Industries v. Green*, n132 a *Rule 10b-5* damage action, and similar cases n133 for the proposition that the federal securities laws were not intended to promote the "federalization of corporate law." n134 The *Gaines* opinion concedes that "[m]any corporate actions taken by directors in the interest of the corporation might offend and engender controversy among some stockholders." n135 However, it believed that such stockholders should either bring a state action against the "responsible directors" or "if all else fails ... sell or trade their stock." n136

The last quoted remark appears to indicate that the court of appeals is not talking about "materiality" in the same sense as that used by the Supreme Court in *TSC Industries*. n137 If a fact is so significant to a reasonable shareholder that he will sell his shares, the fact is "material" under any standard based upon the perceived effects of the information on the shareholders. The Supreme Court grounded its definition on that basis. *Gaines* is more concerned with barring certain

kinds of allegations from trial in federal court on the grounds of comity and the perceived functions of the federal securities laws than it is with the importance of certain information to shareholders. n138

To force corporate officials to describe otherwise undisclosed misconduct in their proxy material is an instance of compelling people to "undress in public." There may be substantial reasons for the Commission and the courts to "make haste slowly" in imposing such a requirement. n139 Thus the *Gaines* approach may be viewed as an example of judicial restraint in resistance to over-expansion of the disclosure requirements of the securities laws. However, even the court of appeals in *Gaines* takes pains to note that "[t]here are clearly instances of illegal conduct by director-nominees, unrelated to self-dealing, ... which would have to be disclosed, especially if they involved criminal convictions." n140

For example, in *Citron v. Daniell*, n141 a derivative action against officers and directors of United Technologies Corporation, the U.S. District Court for Connecticut concluded that disclosures that United Technologies Inc. was being investigated in connection with its government contracting activities gave adequate notice "that the company might be involved in dealings" that could affect its stock price. The court thus dismissed the plaintiffs' Section 14 allegations. In ruling that claims that the defendants violated Section 14(a) by issuing materially misleading proxy statements must be dismissed, the court pointed out that the government's investigation of the company was revealed in each of United Technologies' annual reports that were referenced in the proxy statements that were alleged to be false and misleading. Rejecting as "absurd" the plaintiff's argument that the defendants should have stated in their annual reports and, in turn, their proxy statements, that they, the board of directors, were taking bribes and engaged in conspiracies, the court said that it "would be unreasonable to require board members to tell the world they are thieves, unless, of course, they have been charged and/or convicted." Here, however, the factual disclosures were "sufficient to put the investing public on notice that the company might be involved in dealings which could, quite possibly, affect the price of the company's stock." n142

A claim against directors and officers for fraudulent misrepresentation in proxy materials survived a motion to dismiss in *In re Meridian Securities Litigation*, n143 despite defendants' plea that the complaint merely alleged mismanagement.

Misstating a company's environmental record in opposing a stockholder proposal for adoption of the "Valdez" principles is actionable under Section 14(a), even though the company could have lawfully remained silent regarding its record. n144

[B] Is "Materiality" Only Quantitative? In Staff Accounting Bulletin No. 99 (issued August 12, 1999, entitled "Materiality"), the SEC addresses the propriety of using quantitative thresholds as "rules of thumb" to assist in the preparation of financial statements, such as a rule suggesting that the misstatement or omission of an item that falls under a 5% threshold is not material in the absence of particularly egregious circumstances, such as self-dealing or misappropriation by senior management. While not objecting to the use of such "rule of thumb" as an initial step in assessing materiality, the staff makes it clear that it provides only a starting point for the analysis. The staff quotes with approval from the FASB's Statement of Financial Accounting Concepts No. 2 as follows:

The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

The staff regards this test as substantially identical to the test adopted by the Supreme Court in *TSC Industries v. Northwestern, Inc.*, n145 that a fact is material if there is "a substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." It points out that misstatements of relatively small amounts could have a material effect on financial statements, depending on a number of variables, including:

- whether the misstatement arises from an item capable of precise measurement or whether it arises from an estimate and, if so, the degree of imprecision inherent in the estimate;
- whether the misstatement masks a change in earnings or other trends;
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise;
- whether the misstatement changes a loss into income or vice versa;
- whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability;
- whether the misstatement affects the registrant's compliance with regulatory requirements;
- whether the misstatement affect the registrant's compliance with loan covenants or other contractual requirements;
- whether the misstatement has the effect of increasing management's compensation--for example, by satisfying requirements for the award of bonuses or other forms or incentive compensation; and
- whether the misstatement involves concealment of an unlawful transaction.

The staff adopts the view that while intent of management does not per se render a misstatement material, "it may provide significant evidence of materiality," and that this evidence may be particularly "compelling" where management deliberately misstates items in order to "manage" reported earnings. It goes on to state:

the materiality of a misstatement may turn on where it appears in the financial statements, for example, a misstatement may involve a segment of the registrants' operations. In that instance, in assessing materiality of a misstatement to the financial statements taken as a whole, registrants and their auditors should consider not only the size of the misstatements but also the significance of the segment information to the financial statements taken as a whole. "A misstatement of the revenue and operating profit of a relatively small segment that is represented by management to be important to the future profitability of the entity" is more likely to be material to investors than a misstatement in a segment that management has not identified as especially important. n146

The importance of this issue is highlighted by the significance given by the investing community to analysts' forecasts of company quarterly earnings. A failure to meet the analysts' forecasts, even by a penny, can often have a dramatic impact on a company's stock price (thereby meeting the test of materiality discussed below). One may assume that public companies generally will apply the greatest possible effort and ingenuity to meeting analysts' expectations after watching the carnage wreaked upon their less fortunate brethren, and it would appear to be naive to suppose that some sort of "management" of earnings is not at work in overcoming a shortfall of one or two cents per share. The bottom line would appear to be that, while certain types of "management" of earnings may be tolerated, such as judgmental use of reserves within reasonable parameters, such discretionary management practices must meet the test of reasonableness, and companies may not intentionally falsify their financial statements to overcome even that small gap of one or two cents a share.

Recent cases have indicated that the inquiry is highly fact-sensitive. For example, a district court erred in holding that a misstatement of 1.7% in pre-tax revenues was immaterial as a matter of law, the appeals court rejecting a bright-line "formulaic" approach at the pleading stage, saying materiality is a mixed question of law and fact. n147

A 2% overstatement of assets was held not to be material because of the company's history of very rapid growth, and the court's conclusion that an overstatement would not impact the entire range of information available to the public. n148

On the other hand, a change in a company's debt to equity ratio from the 60% range to the 80% range was material information and the company should have stopped disseminating information regarding its total debt. n149

As early as 1968, Judge McLean was grappling with the concepts of materiality in his landmark opinion in *Escott v. BarChris Construction Corp.*, n150 where he held that a 7% error in reported sales and a 14% error in reported net operating income were not material, stating:

Since no one knows what moves or does not move the mythical "average prudent investor," it comes down to a question of judgment, to be exercised by the trier of fact as best he can in the light of all the circumstances. It is my best judgment that the average prudent investor would not have cared about these errors in the 1960 sales and earnings figures, regrettable though they may be. I therefore find that they were not material within the meaning of Section 11.

Similarly, *Bond Opportunities Fund v. Unilab Corporation*, n151 involved a claim against former directors, an investment banker and others that proxy materials containing false and misleading statements were used in furtherance of a scheme to induce former shareholders to sell their shares at an unfairly low price pursuant to a buyout arising from a merger. The district court held that the plaintiffs failed to meet the pleading standards for fraud under the Private Securities Litigation Reform Act, stating that while the disclosure may not have been perfect, the "total mix" of information provided was sufficiently complete and accurate to allow a shareholder to make an informed decision and the misstatements or omissions alleged could not pass the materiality test. The court further held that the allegations were insufficient to support a claim that the directors were negligent in their failure to disclose material information in the proxy statement.

In *California Public Employees' Retirement System, et al. v. The Chubb Corporation, et al.*, n152 the Third Circuit affirmed the dismissal of an action based in part upon a claim that a proxy statement issued in connection with a proposed merger between Chubb and Executive Risk contained false and misleading statements regarding the financial condition and future performance of Chubb's standard commercial insurance business. The court held that the complaint failed to satisfy the heightened pleading requirements imposed by the Private Securities Litigation Reform Act (PSLRA) n153 by failing to plead with particularity the true facts and "purporting to show how or why the alleged statements were false". The court noted that an action under Section 14(a) does not require any allegation of scienter. Circuit Judge Sloviter, dissenting in part, noted that the proxy statement failed to disclose a material decline in operating results for Chubb's second quarter, which were published subsequent to the issuance of the proxy materials but were known prior to the shareholder vote. The dissent would require a trial of the issue of whether the failure to disclose the disappointing second quarter results was material, relying on *Gould v. American-Hawaiian S.S. Co.*, n154 holding that "the basic test of materiality in a Section 14(a) setting is whether it is probable that a reasonable shareholder would attach importance to the fact falsified, misstated or omitted in determining how to cast his vote on the question involved."

However, in *Shaev v. Saper*, n155 shareholders were asked to vote on a proposed amended executive bonus plan. Reversing a dismissal by the district court, the appeals court found the proxy material misleading in two respects: the proxy statement had erroneously described the Executive Bonus Plan as complying with treasury regulations which make executive compensation in excess of \$1,000,000 deductible only if based on objective performance goals established not later than 90 days after the start of the relevant period of service; and the proxy statement failed to adequately disclose the terms of an earlier bonus plan of which the plan under consideration was an amended version, or even to mention a still earlier plan from which the subsequent plans were derived. The court stated, "to determine the

overall incentive effects, stockholders would have had to read the three documents together, and they did not have them." While the court conceded that a proxy statement need not disclose "the specific business criteria" upon which bonuses are contingent, n156 that regulation did not insulate the board from a claim under Rule 14a-9 for failure to disclose the bonus plan's material terms and general performance goals.

Similarly, where a company solicited proxies for adoption of certain anti-takeover measures without disclosing that the measures were being proposed in order to fight off a takeover threat from an existing shareholder, the court in *ODS Technologies L.P. v. Marshall*, n157 enjoined the shareholder vote until corrective disclosures could be made, the court holding that the failure to disclose the true reason for the proposal was materially misleading, and that a reasonable shareholder would be led to believe that the proposals were "merely routine measures adopted on a clear day and designed to insure continuity and stability." The court granted a preliminary injunction, holding that the plaintiff has firmly established a reasonable likelihood of success on the merits of its claim for a breach of the fiduciary duty of disclosure.

In some cases, courts have found a lack of materiality in a lack of causation. In *Akerman v. Oryx Communications, Inc.*, n158 the court found that a "theoretically material" misstatement was not "materiality in fact" when the company's stock price "actually rose somewhat after public disclosure of the error." n159

Failure to disclose development of a high nicotine tobacco seed was immaterial as a matter of law, as well as failure to disclose a criminal investigation to which the company submitted a guilty plea several months later where there was no evidence the company was aware of the investigation at the time the proxy statement was mailed. n160

Claims that a company's proxy statement falsely held out a director as being a member of the board of a second company were not material. n161 Further, the company had no duty to disclose the potential value of a lost contract where such value would be speculative.

The case of *Seinfeld v. Bartz* n162 presented a claim by a stockholder that a proxy statement soliciting proxies for the approval of stock options granted to outside directors was materially misleading for failing to include the value of option grants to the directors based on the Black-Scholes option pricing model. On appeal from the district court's dismissal of the case for failure to state a claim, the Ninth Circuit confirmed, holding that there is nothing in the proxy rules which requires any specific valuation methodology, of which the Black-Scholes model is just one, and that in any event, neither Item 402(g) of Regulation S-K nor any other provision of Item 402 "expressly requires disclosure of the grant-date value of stock options proposed to be provided to the directors." n163

An allegedly undisclosed (or misdisclosed) fact is to be judged solely by its presently evident *economic* potential or consequences, rather than its significance as an indicator of management's "integrity." If, for example, the greatest part of a company's business is dependent upon contracts obtained through bribery or similar violations of law that would be vigorously prosecuted if detected, that fact would seem to be material to shareholders who were indifferent to the social and moral implications of the conduct, since it would pose a significant risk to their investment in the company's future income. n164 But a hypothetical, prudent, amoral investor may not be at all concerned with bribery or similar conduct that relates only to an insignificant part of the business. n165 The Commission's view has traditionally been that:

[Q]uestionable or illegal payments that are significant in amount or that, although not significant in amount, relate to a significant amount of business, are material and required to be disclosed. n166

The Commission added that repeated questionable or illegal payments not authorized by the board and made "without proper accounting" could be material regardless of other factors if they reflected upon the "quality of management" or raised "questions regarding improper exercise of corporate authority." n167 Furthermore, the Commission believes that authorized payments may be material if they subject the enterprise to quantitatively material risks. n168

The Commission's views concerning materiality in the improper payment context thus have met with a mixed reaction in the courts, the Ninth Circuit having decided that "director misconduct" absent self-dealing or serious illegality is immaterial *as a matter of law*, n169 while the Second Circuit has indicated agreement with the Commission's views. n170 The Commission's views would seem to be soundly grounded to the extent they are based upon readily demonstrable "quantitative materiality," *e.g.*, bribes that (i) are significant in amount, (ii) relate to a significant amount of business, or create significant quantitative risks.

In addition to those instances, the materiality of management self-dealing is beyond dispute. n171 However, disclosure that is *only* concerned with "policy" or the "integrity" or "quality" of corporate leaders, apart from "quantitative materiality," is a much more difficult matter. Although such material may well be of great interest to shareholders, n172 judges feel uneasy passing upon the propriety of corporate policies apart from readily perceived economic risks or insider's self-dealing under the vague terms of an antifraud provision, absent a specific disclosure requirement in the Commission's rules. On the other hand, shareholders, like the owners of any business, are entitled to information concerning "mismanagement" of their business, even if the sole legal means of correcting the underlying problem is an action under state law, and the only efficacious means of providing them with such information in today's corporate world is through federal disclosure requirements. The states have in general confined themselves to authorizing voting by proxy, without requiring that the shareholders be provided with detailed information concerning the directors or transactions for which their proxies are sought. n173 In view of the states' default and the fact that the informational role of federal law is the sole legal requirement that all shareholders be supplied with significant categories of information, it is essential that the federal rules embrace *all* the information needed by shareholders in reaching their decision. The function of federal proxy law is to facilitate the "actual and informed vote of the stockholders." n174

[C] Completeness, Relevance and Prominence of Disclosure. If a Commission rule, *e.g.*, a "line item" of a form, requires a given fact to be disclosed, it must be disclosed in a fashion that is not misleading. For example, if an issuer, in response to a specific requirement, states that its labor relations are "satisfactory," it must add such *other* information as is necessary to prevent that information from being misleading, *e.g.*, that its labor relations are dependent upon bribes to union leaders. n175 The soliciting materials must be complete in their own right; the Supreme Court's resort to the "total mix" description in *TSC Industries v. Northway* n176 presumably does not mean that a proxy solicitor may rely upon information in an opponent's material to fill gaps in his or her own. n177

It is also evident that materiality is not to be judged in a vacuum; a fact is only material if it is of importance to the shareholders' deliberations on the matter to be voted upon. n178

Equally important is the manner and prominence of presentation, *i.e.*, is the information presented in a manner that obscures its significance? For example, if shareholders are advised on pages 2 and 3 of a proxy statement that the board of directors has recommended adoption of an agreement of merger, it is not sufficient to point out on pages 21 and 23 facts that would reveal to a diligent reader that the directors are nominees of the other party to the transaction. n179

[D] Disclosure to Whom? A related consideration is the level of sophistication of the disclosure. In *Gerstle v. Gamble-Skogmo*, n180 Judge Friendly found the "fateful paragraph" there at issue insufficient:

While "corporations are not required to address their stockholders as if they were children in kindergarten," ... it is not sufficient that overtones might have been picked up by the sensitive antennae of investment analysts. n181

The issue has remained unsolved throughout the history of federal securities legislation. The Wheat Report concluded that disclosure must "to the extent possible, [meet] the needs of all who have a stake in the securities markets." n182 That view was adopted in *Feit v. Leasco Data Processing Corp.*, n183 a Securities Act case involving an exchange offer for the securities of an insurance company. The district court in *Feit* held that disclosure must serve the purposes of the average shareholder and the securities professional and the sophisticated investor.

[E] What Is a "Fact"? The identification of a "fact" can be difficult in many situations, particularly where a "mere possibility," which need not be disclosed, n184 must be distinguished from reasonably anticipated future prospects and developments. However, there are limitations to a future-oriented perspective for issuers and professionals who must prepare documents for scrutiny under the securities laws. They must anticipate that the most thorough examination of their efforts will be conducted by a fact-finder in litigation assisted by hindsight. If they paint too optimistic a picture, the legal results may be disastrous. The most famous statement concerning the delicate act of disclosing the likelihood of future developments is contained in *SEC v. Texas Gulf Sulphur*, n185 a *Rule 10b-5* case involving a mineral discovery in Timmins, Ontario, which had not been thoroughly evaluated, but which was undoubtedly significant:

[m]aterial facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities.

In each case, then, whether facts are material within *Rule 10b-5* when the facts relate to a particular event and are undisclosed by those persons who are knowledgeable thereof will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity. n186

A frequent problem is that of distinguishing between a corporation's "plans," which may be material to shareholders and prospective investors, and "just talk," *i.e.*, possibilities for corporate action in such an early, formative stage that no one should attach much significance to them. n187 Where the plans represent the present intention of management, they must be disclosed if relevant to the shareholder's decision, and the shareholder must be given the information needed to make an informed decision whether to engage in the transaction. An illustration is provided by *Gerstle v. Gamble-Skogmo*, n188 in which the Court of Appeals for the Second Circuit found that there was inadequate disclosure of an acquiring company's intent to sell off the assets of the company being acquired. That deficiency was accompanied by the failure to disclose the resale value of the assets, typically not revealed in corporate balance sheets. To that extent, *Gerstle* fits well with prior decisions involving nondisclosure of indications of value in excess of the market price of the stock or the corporation's financial statements. n189 In that connection, Judge Friendly drew a sharp distinction between appraisals of the market value of assets, on the one hand, and "firm offers" from third parties, on the other. He noted the Commission's long-standing opposition to the disclosure of asset appraisals, and refused to find liability on that basis. He thought that a different conclusion might be warranted by the failure to disclose "firm offers," however, stating that such offers, "emanating from outside sources, do not have the potential of overstatement of prospects at the instance of management that has so alarmed the SEC about appraisals." n190

Gerstle, like *Mills* n191 and other cases, involved a transaction in which the acquiring party was on both sides of the transaction through representation in management. In that type of situation, a judicial fact-finder is aware that insiders are often more sensitive to indications of future profits or losses at an earlier date than outsiders. n192

Disagreements among the directors of a merging corporation as to the wisdom of the proposed merger may also be material. In *Gilmartin v. Adobe Resources Corp.*, n193 the chief executive officer and the chief operating officer, both directors, argued against approval of the merger of an oil and gas company with another corporation on the ground that the depressed state of the gas market made it a bad time to sell the company. The court, while noting that two investment banking firms had recommended the merger, and that the two officer-directors had ultimately voted in favor of the transaction, held on a motion for injunctive relief that the omission of the negative views of the two individuals was material to the preferred shareholders (who had a class vote) and that the plaintiff preferred shareholders would probably prevail in their claim that such omission violated the directors' duty of candor to all of the stockholders.

[g] The Relevance of Motivation and Belief. Management's underlying motivation for embarking on a proposed course of action can be as relevant to a shareholder's vote as the course of action itself. In *Mendell v. Greenberg*, n194

the controlling shareholders failed to disclose the need for cash to pay estate taxes that led them to negotiate a merger of Loehmann's, Inc. with a subsidiary of AEA Investors, Inc. in exchange for cash.

In *Virginia Bankshares, Inc. v. Sandberg*, n195 Justice Souter attempted to put to rest uncertainty as to whether a misstatement as to belief could give rise to Section 14(a) liability. The plaintiffs, who were minority stockholders whose vote was not needed under the Virginia statute to validate the merger (but whose vote was nevertheless solicited for reasons of public or shareholder relations), claimed that the statement in the proxy materials that "[t]he Directors voted to accept the proposal because they believe it offers a high value" was false in that the directors did not hold such a belief and therefore could not have voted for the proposal for such a reason. While Justice Souter states clearly that misrepresentations as to motivation or belief may be actionable, he also makes it crystal clear that a statement of motivation or belief without more, *i.e.*, without some misrepresentation as to the subject matter of the belief (in his case, the "fair value" of the shares being "high") is not actionable. Justice Souter stated: "We think that proof of mere disbelief or belief undisclosed should not suffice for liability, under § 14(a), and if nothing more had been required or proven in this case we would reverse for that reason." n196

Justice Scalia in his concurring opinion reinforces this conclusion, stating: "I recognize that the Court's disallowance ... of an action for misrepresentation of belief is entirely contrary to the modern law of torts I have no problem with departing from modern tort law in this regard, because I think the federal cause of action at issue here was never enacted by Congress ... and hence the more narrow we make it (within the bounds of rationality) the more faithful we are to our task." n197 Justice Souter found that underlying misrepresentations as to the subject matter of the misstated beliefs may well have existed, *i.e.*, that the value offered to minority shareholders was not "high," although it did represent a 30 percent premium over market price--in a thin market, as the Court pointed out, and may not have represented a premium over book value. The Court viewed with approval plaintiff's argument that book value should have taken account of unrealized appreciation in the market value of the bank's real estate, a somewhat startling departure from generally accepted accounting principals.

Notwithstanding the Court's finding of a material misrepresentation of a material fact, plaintiff's case failed (by a 5-4 vote) for lack of causation, on the ground that, even if plaintiff (and all other minority shareholders) had voted against the merger, they did not have sufficient votes to prevent the majority shareholder from forcing it through. n198

Expressions of opinion may give rise to claims under 14(a) but the threshold of pleading and proof is high. In *Knollenberg v. Harmonic, Inc.*, n199 plaintiffs failed to adequately plead violation of § 14(a) because statements that the merger was in the best interests of the shareholders were expressions of opinion not shown to be false on the face of the pleadings. PSLRA pleading requirements apply, but lack of reference in 14(a) to "a manipulative device or contrivance" indicates there's no scienter requirement. Negligence is sufficient for both forward and non-forward-looking statements. Statements that the merger was "in the best interests of the shareholders" were expressions of opinion that are only actionable if shown to be false objectively or subjectively. In *In re Textainer Partnership Securities Litigation*, n200 plaintiffs claimed that proxy statements were materially false in soliciting proxies for approval of an asset sale of shipping containers, in failing to disclose that the containers were being sold below market due to a management contract requirement. Dismissing (for the fourth time) for failure to plead with particularity and thereby to meet the heightened pleading requirements of the Private Securities Litigation Reform Act, the court stated that a defendant may only be liable for statements of opinion (in this case, that the price was fair to and in the best interests of the limited partners) only if (1) the speaker did not actually hold the opinion, and (2) the opinion was objectively false or misleading.

The Delaware District Court has declined to rule on the issue of what "state of mind" of the defendant must be pleaded and proved by the plaintiff in a suit attacking the correctness of statements in a proxy statement regarding the deductibility of executive incentive bonuses. n201 Plaintiff contended that a mental state is not required because he sought only an injunction, or alternatively, that only negligence is required to prove a violation of § 14(a). Defendants contended that actual knowledge is required under a safe harbor provision for forward-looking statements. The issue

remains unresolved.

Similarly, a claim of fraudulent misrepresentations in a merger proxy statement could not support a 10b-5 damage action by minority shareholders where the holders of at least 66% of the shares could compel the merger without the minority, causation being lacking to support the action. n202

[h] Causation. The elements of an injunction suit discussed thus far have been concerned with establishing a violation of the federal rules under Section 14(a) or (c) upon the complaint of the Commission or a private party. The need to establish the additional elements of causation and culpability turns on the particular relief sought. n203

The element of causation is not essential in an action that seeks prospective relief. In the context of an active unfinished proxy solicitation, where the purpose of the proceeding is to *prevent* threatened injury through timely prophylaxis, there is no need for the SEC or a private moving party to establish causation, which is concerned with an accomplished injury. n204 In such a case, a finding of a *material* omission or a *material* misstatement is itself a finding that shareholders may be misled and thus presumes a causal connection. n205 Similarly, a failure to include a shareholder's proposal (if the proposal is proper and timely submitted) is itself sufficient to require a resolicitation. n206 *De minimis* violations are a different matter and will not justify the extraordinary relief of an injunction on the motion of a private party, n207 although in an injunction action the Commission is more equal than a private party since it represents the public interest in having the proxy rules obeyed. n208

With respect to accomplished transactions, however, equitable relief under the proxy rules can be granted only if the transaction was "caused" by the asserted violation. In *Weisberg v. Coastal States Gas Corp.*, n209 the district court had dismissed plaintiff's complaint for "lack of transaction causation" where she alleged that there had been a failure to disclose improper payments in connection with the election of directors. The Second Circuit reversed, distinguishing cases in which damages were sought from those in which the plaintiff is attacking the election itself. In the latter case, the proxy solicitation was "an essential link in the accomplishment" of the transaction, *i.e.*, the election. n210 The case was remanded to permit "discovery or other opportunity" to establish the materiality of the alleged omissions. Materiality was the sole question bearing on causation because, under *Mills v. Electric Auto-Lite, Co.*, n211 a showing of materiality is sufficient to establish causation where the proxy solicitation is an "essential link in the accomplishment" of the disputed transaction.

The proof of causation in the context of the adverse effect of misrepresentation on the price of stock has taken a more specific tack. The Supreme Court in a unanimous decision ruled in *Dura Pharmaceuticals, Inc. v. Broudo*, n212 that allegations that defendants' misrepresentations or omissions caused the price of a security to be artificially inflated, standing alone, do not suffice to plead loss causation. The court noted that if the purchaser sells later after the truth makes its way into the marketplace, an initially inflated purchase might mean a later loss, but that is not inevitably so. The plaintiff must tie the disclosure of the new information, or the materialization of the concealed risk, to the subsequent movement of the stock price. This was followed by *In Re Acterna Corp. Securities Litigation*, n213 where the court dismissed a complaint because of a failure to allege a significant stock price decline immediately following the announcement that revealed the fraud to the public. Subsequent cases make clear that the disclosure need not be made by the company but may come from other sources. In *Teamsters Local 445 Freight Division Pension Fund v. Bombardier*, n214 the corrective disclosure may be revealed by some other source, or may simply be a concealed risk that "materializes". Particularly difficult would be the case where the disclosure is accompanied by the announcement of other bad news which is timely made, placing on the plaintiff the heavy burden of isolating the price impact of the omitted or misstated information from the new unfavorable information. n215

The Tenth Circuit in a recent opinion in *In re Williams Securities Litigation* n216 has analyzed in detail the burden imposed on the plaintiff to clearly allocate causation to the corrective disclosures when there are other factors at work unrelated to the fraud or the corrective disclosures which may be deemed to have had an adverse effect on the market price of the security.

The Court stated that "Because loss causation demands that plaintiffs show that their losses were caused by a revelation of the fraud and not some non-compensable cause", the District Court was justified in refusing to allow the issue to be submitted to the jury (even assuming the truth and materiality of the alleged fraudulent statements) and the Court affirmed the granting of summary judgment for the defendants by the District Court.

[i] Culpability-Negligence Versus Scienter. Like causation, the element of culpability (*i.e.*, negligence, recklessness or worse) must be proven separately only with regard to accomplished actions. While lower courts have generally held that mere negligence will support a damage claim under § 14(a), in contrast to actions under § 10(b), the Supreme Court in *Virginia Bankshares, Inc. v. Sandberg*, n217 in noting that the Court in *TSC Industries v. Northway, Inc.* had reserved the question whether scienter was necessary for liability generally under § 14(a), commented: "We reserve it still." n218

Although the Supreme Court treats the issue as still open, a powerful opinion by Judge Richard Posner of the 7th Circuit may have virtually sealed its fate. n219 In Judge Posner's view, a statement in a proxy statement is either misleading or not. Intent has nothing to do with the matter. He states "a proxy solicitation that contains a misleading misrepresentation or omission violates [Section 14 (a)] even if the issuer believed in perfect good faith that there was nothing misleading in the proxy materials," quoting Prosser and Keeton on the Law of Torts: "negligence is conduct, and not a state of mind." n220 In other words, it is totally objective, not subjective. Judge Posner distinguishes the requirement in the Private Securities Litigation Reform Act n221 for pleading a state of mind, stating that it arises only in a securities case in which "the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind." He states "Section 14 (a) requires proof only that the proxy solicitation was misleading, implying at worst negligence by the issuer," observes that negligence is a failure to come up to the specified standard of care, "whether conscious or even unavoidable (by the particular defendant, who may be below average in his ability to exercise due care)."

The Ninth Circuit has held that negligence is sufficient to support a claim for a violation of § 14(a) for both forward-looking and non-forward-looking statements. Where the misstatement relates to an opinion, a plaintiff must allege particularized facts showing that the opinion was both subjectively and objectively false. n222

In re Real Estate Associates Ltd. Partnership Litigation, n223 involved a complaint by limited partners against the officers and directors of their managing general partner alleging, *inter alia*, that defendants' statements of opinion in a proxy statement were subjectively and objectively false (thereby implicating the speaker's "state of mind"). On a motion to dismiss for failure to state a claim, involving the falsity of a statement of opinion, the Court held that the plaintiff is required to plead the evidentiary facts showing the speaker knew the opinion to be false. "In general, scienter is not required to prove a violation of the rule prohibiting material misstatements and omissions in connection with a proxy solicitation; a showing of negligent conduct will suffice." In any event, allegations that defendants made false and misleading statements in group-published documents were sufficiently particular to plead corporate securities fraud. Similarly, see *State of New Jersey v. Sprint*, 531 F. Supp. 2d 1273 (D. Kan. 2008) .

However, the Second Circuit has imposed a scienter requirement. In *Kalnit v. Eichler*, n224 MediaOne entered into an agreement to be acquired by Comcast for approximately 48 billion dollars and agreed that it would not directly or indirectly solicit any superior offer (although it could accept one within 45 days). Shortly thereafter Hostetter, MediaOne's largest shareholder, expressed his dissatisfaction with the terms of the Comcast agreement and requested that MediaOne release him from an earlier standstill restriction to allow him to develop a superior proposal. MediaOne agreed that Hostetter could speak with third parties about a superior proposal, subject to his agreement not to make a public announcement of his efforts without the written consent of MediaOne's board. Shortly thereafter MediaOne sent its shareholders a proxy statement informing them that a special meeting regarding the proposed merger with Comcast would likely occur, but failing to disclose any of the communications between Hostetter and MediaOne's board of directors. Immediately thereafter Plaintiff sold 1,820 shares at \$65.44 per share. Six days later, AT&T proposed a

merger with MediaOne for 58 billion dollars and Hostetter filed a Schedule 13D with the SEC disclosing that the proposal resulted from his discussions with AT&T. Plaintiff filed a class action complaint on behalf of all shareholders who sold MediaOne securities in ignorance of the AT&T proposal. The trial court dismissed the action because the complaint failed to adequately allege scienter, *i.e.* intent by the defendants to deceive, manipulate or defraud MediaOne shareholders. In confirming dismissal of the complaint, the appeals court distinguished the case from *Buxbaum* n225 and *MCI* n226 on the ground that both of those cases involved affirmative misstatements rather than merely a "failure to disclose [MediaOne's] waiver of a then three year old standstill provision. The recklessness of this behavior is not apparent from the facts alleged by plaintiff." The court stated that "because this case does not present facts indicating a clear duty to disclose, plaintiff's scienter allegations do not provide *strong* circumstantial evidence of conscious misbehavior or recklessness."

In *Tellabs, Inc. v. Makor Issues & Rights, Ltd.* n227 the Supreme Court for the first time addressed the heightened requirements for pleading scienter under the Private Securities Litigation Reform Act of 1995, under which a plaintiff in a case claiming damages for violating *Rule 10b-5* must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind." 15 U.S.C. Section 78 u-4 (b) (2). In *Tellabs*, by a vote of eight to one, the Supreme Court rejected the Seventh Circuit's definition of "strong inference" as a "reasonable inference," stating, in an opinion by Justice Ginsburg, that the factual allegations in a securities fraud complaint must create an inference of scienter that "must be more than really plausible or reasonable--it must be cogent and at least as compelling as any opposing inference of non-fraudulent intent." The Supreme Court further held that courts must consider plausible, non-culpable explanations for the defendant's conduct as well as inferences favoring the plaintiff. Upon remand to the Seventh Circuit, the Appellate Court again found in favor of the plaintiff, the court in an opinion by Judge Posner stating that the inferences of non-culpable conduct were "highly implausible" and "very unlikely." n228 In the first case applying the pleading standards subsequent to the *Tellabs* case, the Kansas District Court in granting a preliminary injunction held that a claim brought under Section 14 (a) for misrepresentation under the proxy rules, which in the District Court's view are to be pleaded in negligence and not fraud, was nevertheless subject to the same "strong inference" pleading standard as applied in *Tellabs* to allegations of scienter. *State of New Jersey v. Sprint Corp.*, 531 F. Supp. 2d 1273 (D. Kan. 2008) . On the issue of whether allegations of negligence suffice under Section 14(a) for liability, see the discussion in *Sec. 7.09[5][h]*, *supra*.

When the Commission or a private party seeks to prevent a threatened violation of the proxy rules, the judicial focus concerns whether the threatened conduct would constitute a violation. Once it is established to the court's satisfaction that the conduct would be illegal, it is inconceivable that the court would permit the defendant to accomplish the violation simply because the defendant demonstrated that he or she had acted in good faith.

The question of the defendant's culpability is much less involved in an injunction action than in a private action for damages, except when the court is asked to grant a decree prohibiting similar conduct in the future. In that instance, the defendant's inclination to violate the law may be significant in assessing the need to compel the defendant to avoid other violations in the future. n229

[j] Preliminary Relief. As previously discussed, n230 the Commission has substantial advantages over a private plaintiff in seeking preliminary or permanent injunctive relief, since it need not meet such usual requirements for equitable relief as demonstrating threatened irreparable harm or an unfavorable balance of hardships.

While the Commission appears before the court as a public representative, a private plaintiff usually has a self-interest in the matter under consideration, *e.g.*, as a combatant in a struggle for corporate control. In a private action, a court must be mindful that the grant of a preliminary injunction will be viewed by at least some stockholders as an indication of wrong-doing by the defendants, prior to a trial of the facts. n231 "Courts are understandably reluctant to interfere with an on-going proxy solicitation absent the clearest showing of irreparable harm." n232 To a large extent, the intrusion of a court into the situation tends to defeat the function of preliminary relief, *i.e.*, to preserve the *status quo ante* pending trial on the merits n233 since the action itself will alter the situation. Such considerations become even

more prominent when the application has been made immediately prior to the scheduled shareholders meeting, at the "eleventh hour." n234 Indeed the erroneous intervention of a district court by an "election-eve decision" may subsequently prompt a court of appeals to order a new election to preclude a result attributable to the ill effects of the trial court's decision. n235 A court must also take into consideration such omissions as the plaintiff's failure to adjourn, or to request a stay of, the meeting even though he requests that the defendant's solicitation be stopped. n236

All in all, the federal courts are often very skeptical of charges hurled in a proxy contest, n237 particularly if they believe a disputed matter will be thoroughly "aired" during the solicitation. n238

The presence or absence of action by the Commission can make a great difference. In purely private cases, the court is aware that the proxy statements in a proxy war have, in the usual case, been cleared by the Commission. n239 That the particular controversy has in fact been brought to the Commission's attention prior to clearance is of greater significance, n240 although the Commission's position is not always upheld. n241

In a clear case of material omission or misstatement, however, "the application for a preliminary injunction is the time when relief can best be given." n242 One reason for that view is that the material can often be corrected prior to the shareholders' vote, thereby permitting the shareholders, rather than the courts, to make the decision concerning the transaction in question. n243

[k] Forms of Relief. The specific type of relief that will be granted by a court under the proxy rules is dependent upon the facts of the particular situation and upon the point at which relief is sought. While the Commission may have an easier time than a private party in establishing its case because of its expertise and lack of personal interest, the *form* of the relief, apart from damages, is not dependent on the moving party. It is the defect in the solicitation and its consequences that are the concern of the court. As will be seen, the court is not limited to the most obvious remedy: enjoining the illegal solicitation or use of the proxies illegally solicited. n244

[i] Relief Before the Meeting. Pre-meeting injunctive relief can take the form of an order requiring one or more of the following:

- inclusion of a shareholder's proposal in management's proxy statement; n245
- filing of materials with the Commission; n246
- mailing of a shareholder's proxy material by management; n247
- compelling disclosures in proxy material, or requiring amendments to, and resolicitation of the proxy material; n248 and
- holding of a new meeting after the court sets aside the results of or postpones a prior scheduled meeting. n249

The plaintiff may also seek a prohibitory injunction against the use of proxy materials containing insufficient or misleading disclosure n250 or against the further solicitation of proxies. n251 Since such relief may disfranchise shareholders who have already given proxies, courts should couple such relief with a postponement of the scheduled meeting to permit resolicitation. n252

[ii] Relief After the Meeting.

The question whether relief could be granted to a shareholder after the holding of the meeting for which proxies were solicited was the subject of much uncertainty n253 until the *J.I. Case Co.* decision n254 in 1964. This decision affirmed

the powers of the federal courts to grant whatever remedial relief is required to enforce the proxy rules, including relief based on the laws of the state of incorporation. Such power is not confined to prospective or declaratory relief. n255 In addition to the traditional remedy of an injunction or damages, the Commission or a shareholder plaintiff may seek such ancillary relief as the appointment of nonmanagement directors. Post-meeting relief obtained *before* the consummation of the transaction authorized by the shareholders' vote is at least theoretically more desirable than postconsummation relief. At least in a private action, however, the plaintiff's counsel may not wish to post a required bond or may believe that there is a chance for a larger recovery, and attendant increase in fee, if the transaction is completed. Postconsummation relief presents the court with the alternatives of undoing the transaction, impracticable in many cases, or awarding damages. n256

[A] Preconsummation Relief. If the meeting has been held and the shareholders have approved a proposed transaction n257 or elected directors to the board, n258 the results of the meeting may be set aside and a new meeting ordered upon application to the court with proof of material violation of the proxy rules. n259 Such relief may be denied if the private litigant has failed to promptly seek pre-meeting relief n260 or a substantial period has expired between the date of the shareholder meeting and the date of institution of the suit. n261

The possibility that the court could always set aside the results of a shareholder vote should not be used as a pretense for denying preliminary relief before a meeting. n262 In addition to the unnecessary expense and delay n263 caused by the rescheduling of another shareholder's meeting, the degree of difficulty in obtaining the necessary relief after a post-meeting review increases. n264

It is clear that a court has the power to set aside the results of a shareholder vote and order a new or special election: but under what circumstances will the court exercise this power? In *Ohio Drill and Tool Co. v. Johnson*, n265 the court noted that it could not set aside the election of directors since the corporation, being previously merged into another corporation, no longer existed. Instead, the court awarded damages to shareholders based on their out-of-pocket losses. n266

The case of *Ainslie v. Sandquist* n267 is illustrative of other factors a court may consider before setting aside the results of a shareholder vote. Although the court in *Ainslie* found various violations of the proxy rules, it refused to set aside the results of the shareholders meeting and order a new meeting. The court reasoned that rescheduling a new meeting would be fruitless since defendants possessed sufficient votes to preclude any different result and that the expenses of rescheduling a new meeting when measured against the triviality of the issue to be voted upon would place an unwarranted burden on the corporation.

[B] Postconsummation Relief. As has been discussed, Section 29(b) of the Exchange Act has been interpreted to avoid the conclusion that a merger or other transaction must be set aside merely because the transaction was accomplished through a violation of the Act. n268 Rescission is in fact remote in the case of a merger and difficult in the case of other transactions. n269 Only where rescission of the corporate transaction would be in the best interests of the shareholders will a court exercise its discretion to set aside the transaction and order restitution to return the parties to the *status quo ante*. n270 The difficulty of such a restoration may prove to be the major stumbling block in granting recessionary relief. Although the plaintiff must establish "irreparable harm" and the absence of any "adequate remedy at law" n271 and that the action has been pursued with reasonable dispatch after discovery of the grounds for rescission, n272 final relief may be denied on the grounds that the assets of the surviving and merged corporation are totally commingled, n273 the former corporation n274 or its securities no longer exist, n275 or the task of tracing the shares of the former and merged corporation is impossible. n276

If rescission is impractical, a shareholder may pursue an action for damages if the shareholder has suffered as a result of the consummated transaction. n277

[iii] Ancillary Relief. The courts have fashioned a broad range of remedies for the violations of the securities laws,

including disgorgement of profits, appointment of a receiver or special agent to preserve the assets of a corporation and to ensure compliance with the securities laws, and the imposition of corporate procedures to prevent recurrences of violations. n278

Often, violations of Section 14(a) are caused by management misconduct. In such a case, an independent outside director or directors may be appointed to supervise management compliance with the securities laws, n279 a special counsel representing shareholder interests may be appointed to "investigate and initiate possible removal proceedings against wrongdoers and to conduct a special election of new directors" n280 or the corporation may be required to adopt special corporation policies or procedures. n281 In *Springer v. Jones*, a private enforcement action involving violations of the proxy rules, the following relief was agreed upon as part of a court-approved settlement of the litigation: the appointment of independent outside directors and the utilization of the proxy machinery to ensure their reelection; amendment of the articles of incorporation to require that the board be composed of at least 60 percent independent outside directors; and placement of the appointed directors in voting control of the board's executive committee, as well as the board itself. n282

Attorneys' fees, as a form of relief, may be awarded to a successful litigant but only under limited circumstances. n283 The Supreme Court in *Mills v. Electric Auto-Lite, Co.* n284 approved in principle the right of a litigant to be awarded attorneys' fees upon the establishment of a violation of the securities laws by the corporation or its officials. The subsequent decision by the Court in *Alyeska Pipeline Service v. Wilderness Society* appears to have limited *Mills* to cases in which award of attorneys' fees in a derivative or class action is to be paid by the parties who have benefited from the suit, the corporation or its security holders. n285

In *Boeing Co. v. Van Gemert*, n286 the Supreme Court affirmed the traditional doctrine that a litigant or lawyer who recovers a common fund for the benefit of persons other than himself or his client is entitled to a reasonable attorney's fee from the fund as a whole. In that case, the attorney's fees were assessed against the unclaimed portion of the fund, as well as against the moneys that had been obtained by security holders through proof of their individual claims. In *Smillie v. Park Chemical Co.*, n287 the Sixth Circuit affirmed the award of attorneys' fees absent an award of money damages to the shareholders, since the action was viewed as having conferred a "substantial benefit" on the corporation and its shareholders. Although the case would have justified a fee of \$24,000, the amount was reduced to the value of the benefit, \$10,000.

[iv] Injunctions Against Future Violations. Actions for injunctions under the proxy rules are often brought:

- during the course of the disputed activity (e.g., during a proxy fight), or
- to prevent implementation of, or rescind, corporate action authorized through a defective solicitation.

But often, particularly in Commission actions, it is found that the defendant has been guilty of an accomplished violation. The question then is whether the court will enjoin the defendant from future violations, *i.e.*, violations that may not even be a gleam in the defendant's eye at the moment, but that he or she may subsequently commit. The crucial question for determination by a court with respect to the grant of an injunction against future violations of the proxy provisions is the same as that applied in other areas of the federal securities laws, *i.e.*, whether there is a reasonable likelihood of future violations if the defendant is not enjoined. n288 The Commission or other moving party must establish the likelihood of future violations; n289 proof of past violations is insufficient by itself. n290 Thus, Chief Judge Kaufman of the Second Circuit stated in *SEC v. Management Dynamics*:

Whether the inference that defendant is likely to repeat the wrong is properly drawn, however, depends on the totality of circumstances, and the factors suggesting that the infraction might not have been an isolated occurrence are always relevant. n291

If the moving party meets its burden, the defendant must rebut with a showing that no reasonable likelihood of future violation exists. n292 Mere cessation of past proscribed conduct whether before or after commencement of suit will be insufficient of itself, n293 and, as stated in *SEC v. Management Dynamics*, will be but one factor that the court must evaluate. n294

[v] Collateral Estoppel Effect of Decree. The Supreme Court has held that a decree previously obtained by the Commission could be used offensively by a private party to foreclose the defendant from relitigating the issues decided in the prior injunction action. n295 As noted by the Court, the private party plaintiff could not have had his or her action consolidated with the Commission action over the Commission's objection. n296

[6] Damage Actions

As previously discussed, the Supreme Court's decision in *J.I. Case v. Borak* n297 confirmed the shareholder's private right of action, in both direct and derivative capacities, for violations of Section 14(a), including the right to such retrospective relief as damages. n298 However, an action for damages does not lie when the plaintiff sues as a disappointed proxy contestant rather than as an aggrieved shareholder. n299

The action for damages presents more issues, at least conceptually, than an action for an injunction. That the target of a hostile tender offer may have standing to sue for injunctive relief n300 does not necessarily mean that it has standing to sue for damages n301 under Section 14(a). The plaintiff must establish not only the existence of the violation, n302 but must also address the issues of causation, culpability and valuation. Similarly, in *Koppel v. 4987 Corp.*, n303 it was noted that courts have a strong preference for injunctive relief over damages under § 14(a) lest plaintiffs be encouraged to sit on their claims until after a shareholders' vote hoping to collect damages and attorneys' fees; but *Koppel* goes on to point out that the circumstances may make it impossible (a) to enjoin the prohibited actions, or (b) for a shareholder to recognize the import of a misrepresentation before the vote, thus making damages the only feasible remedy.

[a] Causation. A private party's right of action would be heavily burdened if the plaintiff were required to prove that a given corporate transaction would not have been authorized by the shareholders if a particular proxy violation had not been committed by the defendant. However, the Supreme Court in *Mills v. Electric Auto-Lite* n304 eliminated the need to prove a causal nexus between the material defect and its effect on the actual voting. Finding that such a requirement was inherently impractical, n305 the Court adopted the following test for causation:

Where there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction. n306

The Ninth Circuit has stated that *Mills* should be limited to its facts: transactions that require shareholder approval such as mergers and other fundamental corporate changes. n307 The District Court of Delaware ruled in *Ash v. Brunswick Corporation* that a plaintiff is required to show causation to obtain relief for a violation of Rule 14a-3 (i.e., a violation of a "line item" requirement, that does not of necessity require materiality), although not for a violation of Rule 14a-9. n308

The *Mills* decision specifically left open the question of whether there exists any causal relationship when management controls sufficient votes to ensure approval of the transaction without soliciting proxies from the minority shareholders. That question was resolved by *Virginia Bankshares, Inc. v. Sandberg*, n309 in which the Supreme Court, in a decision written by Justice Souter, ruled that minority shareholders whose votes were not needed to authorize a merger failed to show that an allegedly false proxy statement caused them damages compensable under Section 14(a) of the Securities Exchange Act of 1934. Mr. Justice Souter also held separately that knowingly false statements purporting to explain directors' reasons for recommending certain corporate actions may be actionable under Section 14(a), even though the statements are conclusory in form.

The litigation arose out of a May 1987 merger involving First American Bank of Virginia and Virginia Bankshares. Subsequent to the merger, Sandberg brought a suit in the U.S. District Court for Eastern Virginia alleging, among other things, that the two banks and the individual directors violated Section 14(a) by issuing a misleading proxy statement. Sandberg succeeded on her claims at the district court and Fourth Circuit levels. The Supreme Court reversed, concluding that the minority shareholders failed to show causation of damages compensable under Section 14(a) because their votes were not required by state law or by corporate by-law to authorize the merger. Virginia Bankshares owned 85 percent of First American's stock prior to the merger and approximately 2,000 minority shareholders owned the remaining 15 percent.

Justices Kennedy, Marshall, Blackmun and Stevens dissented from the causation portion of Souter's opinion. Stevens and Marshall argued that shareholders should be able to sue under Section 14 whenever materially false and misleading statements are made in proxy statements. The fact that the solicitation of proxies is not required by state law or by the corporation's by-laws does not authorize corporate officers to avoid Section 14's provisions. According to Justice Kennedy, causation is established where the solicitation of proxies is an essential link in completing the transaction, even if the minority lacks sufficient votes to defeat a proposal of management. He noted with approval Sandberg's argument that, had all the material facts been disclosed, the merger proposal would likely have been withdrawn or revised. The stated objective of the controlling shareholder was to have a "friendly" transaction, with a price believed to be "so high, that any reasonable shareholder will accept it." Under the ruling by the majority, however, all such considerations are now irrelevant to a § 14(a) cause of action.

Subsequently, the Northern District of New York in *Wilson v. Great American Industries* n310 held that minority shareholders in a similar situation may have been deprived of their appraisal rights. The court found that *Virginia Bankshares* "expressly left open the question whether shareholders who may have forfeited state law rights in approving a corporate transaction might still have a cause of action under Section 14(a)." Consequently, the court determined that the Supreme Court's decision did not clearly dictate that the plaintiffs in the instant case had no cause of action and therefore did not warrant overturning the lower court's previous decisions.

Following the *Virginia Bankshares* decision, the plaintiffs in *Booth v. Connelly Containers* n311 withdrew their Section 14(a) claim on similar facts and attempted to rely on Section 10(b), claiming defendants deliberately understated CCI's earnings and stock value. The court granted summary judgment to defendants, holding in reliance on *Virginia Bankshares* that plaintiffs failed to show causation since their votes were not needed for the merger.

Similarly, *In re Digital Island Securities Litigation* n312 involved a claim that defendants defrauded the shareholders of Digital Island, the target company, into approving the sale of the company to Cable & Wireless for less than fair value. Cable and Wireless had made a tender offer for Digital Island's shares. After acquiring 80% of the outstanding shares, Cable and Wireless solicited proxies for the approval of a merger with Digital Island in order to cash out the remaining 20%. The plaintiffs alleged that the proxy statement was materially misleading in failing to reference two important contracts that had been entered into by Digital Island prior to the tender offer, and had failed to adequately disclose the terms of employment offers made by Cable & Wireless to Digital Island executives. The plaintiffs claimed that the misleading statements deprived them of the opportunity to seek state appraisal remedies. The court granted a motion to dismiss for failure to state a claim, stating that "to prevail on a claim under Section 14(a), the plaintiffs must demonstrate, among other things, 'that the proxy solicitation itself ... was an essential link in the accomplishment of the transaction.'" n313 In fact the court went on to state "clearly, the proxy statement was not an 'essential link' in effecting the merger, and the plaintiff's Section 14(a) [claim] must fail as a matter of law."

In *Fink v. Weill*, n314 the complaint alleged that the failure of the proxy statement to include a discussion of a series of risky and fraudulent transactions which the company had engaged in with companies that subsequently experienced severe financial difficulties made the proxy statement false and misleading in connection with the election of directors because the directors had caused injury to the bank by allowing it to engage in such transactions. The District Court

dismissed the proxy violation claims, stating that the wrongs complained of were from "improper governance and injury resulting from undisclosed transactions rather than from any particular action taken by shareholders on the basis of the proxy statements." n315

In *In re J.P. Morgan Chase & Co. Shareholder Litigation*, n316 plaintiffs commenced a class action alleging disclosure violations in a merger proxy statement. In the proposed 2004 merger of Bank One with and into J.P. Morgan Chase & Co., shortly before the closing, the New York Times reported that James Dimon, Bank One's CEO, had proposed to do the deal for no premium if he could become the Chief Executive immediately. The merger agreement as ultimately signed provided that Morgan's CEO was to continue as the CEO of the combined enterprise for two years, after which Dimon would become the CEO. The gist of the complaint was that the proxy statement never revealed Dimon's proposal. The stockholder vote was therefore uninformed, and Morgan overpaid for Bank One, causing damages of \$7,000,000,000 to Morgan shareholders. The Delaware Supreme Court, en banc, affirmed the lower court's dismissal of the complaint, holding that the proper remedy was a derivative action for waste, and that a stockholder class cannot rely on a disclosure claim to obtain what essentially are derivative damages. The Court denied plaintiff's request for nominal damages on the basis that there was no cognizant injury to "economic" or "voting" interests. The Court noted that the plaintiffs failed to seek an injunction prior to the closing of the merger which might have led to an order requiring Morgan to amend the proxy statement and re-solicit the stockholders' votes.

[b] Culpability. Before liability attaches, a plaintiff must prove the defendant's culpability for his or her acts. Under the proxy rules, it appears to be firmly established that:

[A]n individual who participates in a solicitation which utilizes materially false or misleading statements is liable if he knew or should have known that the statements were false or misleading. n317

The first case to extensively discuss culpability in a proxy situation was *Gould v. American-Hawaiian Steamship Co.* n318 At issue in that case was whether nonmanagement outside directors n319 should be held liable for material misstatements in proxy statements. The court rejected strict liability as imposing too harsh a standard. n320 The court also refused to draw an analogy to Sections 10(b) and 18 of the Exchange Act, believing scienter would impair a plaintiff's ability to enforce the statutory purposes of Section 14(a) to foster full fair disclosure. n321 The *Gould* court reasoned that since a director as a fiduciary must exercise responsibility n322 to examine proxy statements with reasonable care or due diligence and correct facts that may be misleading or erroneous, negligence would be the more appropriate standard. n323

However, the Court in *Virginia Bankshares, Inc. v. Sandberg* specifically reserved the question whether scienter was necessary for liability generally under Section 14(a). n324

[c] Types and Measures of Damages. The monetary recovery for injury suffered by a shareholder as a result of violations of the proxy rules is limited by Section 28(a) of the Exchange Act as follows:

[N]o person permitted to maintain a suit for damages under the provisions of this title [the Exchange Act] shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his *actual damages* on account of the act complained of. [Emphasis added.]

Section 28(a) precludes an award of punitive or exemplary damages. n325 In trying to refine the meaning of the term "actual damages," the Supreme Court in *Mills* delineated certain guidelines for granting postconsummation monetary relief:

Monetary relief will, of course, also be a possibility. Where the defect in the proxy solicitation relates to the specific terms of the merger, the district court might appropriately order an accounting to ensure that the shareholders receive the value that was represented as coming to them. On the other hand, where, as here, the misleading aspect of the solicitation did not relate to terms of the merger, monetary

relief might be afforded to the shareholders only if the merger resulted in a reduction of the earnings or earnings potential of their holdings. *In short, damages should be recoverable only to the extent that they can be shown.* If commingling of the assets and operations of the merged companies makes it impossible to establish direct injury from the merger, relief might be predicated on a determination of the fairness of the terms of the merger at the time it was approved. These questions, of course, are for decision in the first instance by the District Court on remand, and our singling out of some of the possibilities is not intended to exclude others. n326

However, the lower courts have not followed these standards with any precision. n327

We read all this as commanding the lower courts to do their best to achieve fair compensation for injured plaintiffs without being too draconian on defendants, at least in a situation where the inadequacy of a proxy statement may lie more in a failure of articulation than in an outright desire to deceive. n328

Since Section 28(a) speaks in terms of "actual damages," the dilemma of the court is not determining whether the defects are "related" or "unrelated" n329 to the transaction in question, but awarding an amount not in excess of the actual loss suffered by the party. n330 In the usual case, courts award as damages amounts representing a diminution in the investment occurring as a result of the defect ("out-of-pocket loss") n331 or they may award a "restitutional measure of damages." n332 In addition to the "out-of-pocket loss," a plaintiff may also recover an amount equal to the loss of a potential profit or other benefit, n333 unless this loss is wholly speculative. n334 Although some courts disagree, the limit is reached when the damages awarded transcend those that can be actually shown, or what the transaction caused the plaintiffs to actually lose. n335

In *Gould v. American-Hawaiian Steamship Co.*, n336 although the defect in the proxy material would not have affected the terms of the merger, plaintiff was held to be entitled to recover damages based on the premium he would have received in the exchange of shares had full disclosure been made. Similarly, in *Gerstle v. Gamble-Skogmo, Inc.*, n337 plaintiff received damages to the extent of the difference in value of the assets of the merged corporation and the value of the preferred stock that the shareholders of the merged company received in the merger. The value of the assets was calculated on the basis of their market value, rather than their balance sheet value, which was severely understated.

[7] Proxy Solicitations and Rule 10b-5

An action cannot be maintained under Section 14(a) if the security in respect of which a proxy is solicited is not registered under Section 12, since the former Section explicitly applies only to such registered securities. A Commission action under Exchange Act Section 21(d), however, is not foreclosed in the case of a merger or like transaction, since the consequent exchange of securities (at least for the shareholders of the "disappearing" corporation) involves the purchase or sale of a security within the meaning of *Rule 10b-5*. n338 This reasoning would also seem to dictate the same result in a private action: the consummation of a merger, consolidation or sale of assets involves the surrender of the disappearing or selling corporation's shares for either a different security or for cash. n339

To proceed under *Rule 10b-5*, the plaintiff must be prepared to plead and prove intentional "manipulation" or "deception," n340 in addition to meeting the "standing" requirement. n341

The Supreme Court has reserved for future decision the question of whether scienter is required in order to sustain a private action under Section 14(a). n342 The cause of action must not rest on asserted mere "mismanagement" or similar grounds traditionally within the province of state law, but must involve failure to disclose a material fact, or false or misleading statements of material facts. n343 *Rule 10b-5* has in fact provided an alternative basis in several cases, n344 and has been the sole grounds in others. n345

The Ninth Circuit in *Knollenberg v. Harmonic, Inc.*, n346 has taken the position that scienter is not required in an action

based on a violation of Securities Exchange Act § 14(a), on the ground that § 14(a) does not contain the reference to "a manipulative device or contrivance" which appears in § 10(b) of that Act.

FOOTNOTES:

(n1)Footnote 1. *See, e.g.*, Section 15(b)(4) of the Exchange Act of 1934, reprinted in the Primary Law sourcebook, Volume B, Section F. 15 U.S.C. § 78o(b)(4); Sections 11(g), 12(g) of the Public Utility Holding Company Act, 15 U.S.C. §§ 79k(g), 79 l(e); Section 20(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-20(a); Section 203(e)(4), (5) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-3(e)(4)(5).

Administrative proceedings against brokers, dealers and associated persons are discussed in § 3.03[7] *supra*.

Under the Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984), the Commission was given authority under Section 15(c)(4) of the Exchange Act to bring administrative proceedings against persons who violate Section 14 of the Exchange Act.

(n2)Footnote 2. Suspension of trading is discussed in § 4.01[7] *supra*.

(n3)Footnote 3. *See, e.g.*, *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973) , *aff'g and modifying* 348 F. Supp. 979 (E.D.N.Y. 1973) . Prior district court opinions are reported in 332 F. Supp. 644 (E.D.N.Y. 1971) ; 298 F. Supp. 66 (E.D.N.Y. 1969) . Both the court of appeals and the district court characterized setting the consummated merger aside as "impossible." 478 F.2d at 1289 (per Friendly, J.); 298 F. Supp. at 100 (per Bartels, J.).

(n4)Footnote 4. "No action" letters are expressions of opinions by the Commission's staff with request to proposed--not consummated--transactions, in response to private requests. Their name derives from the usual form of the letter, *i.e.*, that, based on the facts submitted, the staff will not recommend to the Commission that enforcement action be taken.

"No action" letters are not binding on the Commission but do represent the views of those who work continuously with the federal securities laws.

The positions expressed in response to requests for "no action" letters are not binding on the requesting parties. If a "no action" request has elicited staff opposition to the proposed transaction, the requesting party may proceed in the face of the risk that the staff will recommend that the Commission authorize enforcement proceedings, *e.g.*, a Commission action for an injunction under Section 21(d) of the Exchange Act, 15 U.S.C. § 78u(d).

There are certain questions on which the staff will not respond to "no action" letter requests, including such matters as whether a particular person is an "affiliate" of another person.

(n5)Footnote 5. *See, e.g.*, *SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947) , *cert. denied*, 332 U.S. 847 (1948) .

The procedures for "no action" requests in the context of shareholder proposals are discussed in § 7.07 *supra*.

(n6)Footnote 6. *17 C.F.R. § 202.2. See also 17 C.F.R. § 202.1(d):*

While opinions expressed by members of the staff do not constitute an official expression of the Commission's views, they represent the views of persons who are continuously working with the provisions of the statute involved. And any statement by the director, associate director, assistant director, chief accountant, chief counsel, or chief financial analyst of a division can be relied upon as representing the views of that division... [t]he staff may present such a question to the Commission 'upon request or on its own motion.'

(n7)Footnote 7. *17 C.F.R. § 202.1(d)*. The staff may present such a question to the Commission "upon request or on its own motion." *Id.*

(n8)Footnote 8. *See discussion in § 7.04[3] supra, with respect to the filing and comment procedures.*

(n9)Footnote 9. *17 C.F.R. § 202.3(a):*

[T]he usual practice is to bring the deficiency to the attention of the person who filed the document by letter from the Assistant Director assigned supervision over the particular filing, and to afford a reasonable opportunity to discuss the matter and make the necessary corrections. This informal procedure is not generally employed when the deficiencies appear to stem from careless disregard of the statutes and rules or a deliberate attempt to conceal or mislead or where the Commission deems formal proceedings necessary in the public interest.

(n10)Footnote 10. Section 8(d) of the Securities Act of 1933 ("Securities Act"), *15 U.S.C. § 77h(d)* authorizes the Commission to issue a "stop order suspending the effectiveness of the registration statement" after notice and opportunity for hearing if the registration statement appears to contain any misleading or untrue statement of a material fact or omits a material fact. The "stop order" is lifted when the registration statement has been amended in accordance with the stop order.

As stated in the text, the Securities Act stop order proceeding is not applicable to materials filed under Section 14(a) or 14(c) of the Exchange Act, *15 U.S.C. § 78n(a), (c)*. In the case of a submission of a proposed merger to a vote of shareholders, however, it may be necessary to register the securities being offered under the Securities Act pursuant to Rule 145 under that Act, *17 C.F.R. § 230.145*. The applicable Securities Act registration form may require the incorporation of information required by the Regulation 14A or Regulation 14C proxy and information statement requirements, in which case such material will be subject to the Securities Act. *See Securities Act Form S-4 and Rule 14a-6(k), 17 C.F.R. § 240.14a-6(k)*.

(n11)Footnote 11. *15 U.S.C. § 78u(a)*. *See, e.g., Kukatush Mining Corp. v. SEC, 198 F. Supp. 508 (D.D.C. 1961), aff'd, 309 F.2d 647 (D.C. Cir. 1962) .*

SEC informal and formal investigations are discussed in § 9.02 *infra*. *See generally 17 C.F.R. § 202.5.*

(n12)Footnote 12. *15 U.S.C. § 78 l(k)*. *See, e.g., VTR, Inc., Sec. Exch. Act Rel. Nos. 34-7392 (1965), 34-7894 (1966)*. Section 12(k) is also discussed in § 4.01[6] *supra*.

(n13)Footnote 13. *15 U.S.C. § 78 l(j)*.

(n14)Footnote 14. The Commission may not "roll over" trading suspension orders for the same single set of circumstances. The previous Commission practice of entering consecutive 10-day suspensions based upon the same allegedly improper activity was struck down in *SEC v. Sloan, 436 U.S. 103, 98 S. Ct. 1702, 56 L. Ed. 2d 148 (1978) .*

See § 4.01[6] *supra*.

(n15)Footnote 15. The Commission's powers of suspension and revocation with respect to listed securities are discussed in § 4.01[7] *supra*.

(n16)Footnote 16. 17 C.F.R. § 201.102(e).

(n17)Footnote 17. Rule 2(e) proceedings are discussed in § 9.02[2][a][iii] *infra*.

(n18)Footnote 18. 15 U.S.C. § 78y(a).

(n19)Footnote 19. 432 F.2d 659 (D.C. Cir. 1970) , *vacated*, 404 U.S. 403 (1972) .

(n20)Footnote 20. See *Kixmiller v. SEC*, 492 F.2d 641 (D.C. Cir. 1974) ; *Natural Resources Defense Council, Inc. v. SEC*, 606 F.2d 1031, 1047 n.19 (D.C. Cir. 1979) (McGowan, J.).

(n21)Footnote 21. *Kixmiller v. SEC*, 492 F.2d 641 (D.C. Cir. 1974) .

(n22)Footnote 22. *Id.* at 645 .

(n23)Footnote 23. Section 21(a) of the Exchange Act, 15 U.S.C. § 78u(a).

(n24)Footnote 24. Section 21(e) of the Exchange Act, 15 U.S.C. § 78u(e).

(n25)Footnote 25. *Leighton v. SEC*, 221 F.2d 91 (D.C. Cir. 1955) (per curiam), *cert. denied*, 350 U.S. 825 (1955) (Commission refusal to investigate under Securities Act not reviewable); *Crooker v. SEC*, 161 F.2d 944 (1st Cir. 1947) . *Crooker* held that the court had no power to direct the Commission to institute a "stop order" proceeding under Securities Act Section 8(d).

The Administrative Procedure Act also excepts from judicial review "agency action... committed to agency discretion by law." 5 U.S.C. § 701(a)(2).

See also *SEC v. Howatt*, 525 F.2d 226 (1st Cir. 1975) ; *SEC v. Brigadoon Scotch Distrib. Co.*, 480 F.2d 1047 (2d Cir. 1973) , *cert. denied*, 415 U.S. 915 (1974) ; *Leighton v. SEC*, 221 F.2d 91 (D.C. Cir. 1955) ; *General Motors v. Federal Energy Regulatory Comm'n*, 613 F.2d 939, 944 (D.C. Cir. 1979) ("If an agency considers all the relevant factors so that a court can satisfy itself that the agency has actually exercised its discretion, an agency's decision to refrain from investigation is unreviewable. 'If an agency simply ignores issues whose relevance to the public interest is obvious, the agency's decision may be reversed.' " (citations omitted)).

(n26)Footnote 26. The forms of relief are discussed in § 7.09[5][i] *infra*.

(n27)Footnote 27. 15 U.S.C. § 78cc(b).

(n28)Footnote 28. See, e.g., *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967) , *cert. denied*, 390 U.S. 951 (1968) . The question concerned the ability of a jury to award rescission and rescissional damages in a case in which the plaintiffs were defrauded *sellers* in a *Rule 10b-5* case. They sought damages reflecting the increase in value after the sales of their shares to the defendants. The court stated: "Here, neither the jury nor the court was required to rescind the agreement, Section 29(b) of the statute itself declares the sale void, once there is found a violation of *Rule 10b-5*." *Id.* at 742 . Since such a contract is void as a matter of law, the court said, the plaintiff is entitled to restitution of what he sold, or, the defendants having disposed of the stock in question, to an equivalent money judgment, which made the action one at law for money damages.

The context in which the court was deciding the question must, of course, be kept in mind. Neither the reasoning nor

the result in *Myzel* is altered by the rule that Section 29(b) merely gives the injured party the *option* to rescind. It seems clear that profits subsequently made by a purchaser who obtains securities by fraud may be awarded to the plaintiff as damages. See *Janigan v. Taylor*, 344 F.2d 781 (1st Cir. 1965) .

In any event, those questions appear to have been resolved by *Mills v. Electric Auto-Lite*, 396 U.S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970) (discussed in text accompanying ns. 29-31 *infra*).

(n29)Footnote 29. *Deckert v. Independence Shares Corp.*, 311 U.S. 282, 61 S. Ct. 229, 85 L. Ed. 189 (1940) . Allegedly defrauded purchasers sought various forms of equitable relief, including an injunction against a third party and appointment of a receiver for the vendor. The trial court initially granted an injunction that prohibited the third party from transferring certain assets of the vendor which it held pending resolution of the litigation, and reserved decision on the appointment of a receiver. The respondents' motions sought to dismiss the bill because it failed to state any cause of action and because the district court lacked jurisdiction. The Court held that these motions were correctly denied: "We think the Securities Act does not restrict purchasers seeking relief under its provisions to a money judgment. On the contrary, the Act as a whole indicates an intention to establish a statutory right which the litigant may enforce in designated courts by such legal and equitable actions or procedures as would normally be available to him."

The landmark decision under the proxy provisions is *J.I. Case v. Borak*, 377 U.S. 426, 84 S. Ct. 1555, 12 L. Ed. 2d 423 (1964) , which determined that both derivative and direct shareholder rights of action exist under the provisions of Section 14(a) notwithstanding Congressional silence on the question. The Court found that "federal courts have the power to grant all necessary remedial relief... ." 377 U.S. at 435, 84 S. Ct. at 1561, 12 L. Ed. 2d at 429 .

(n30)Footnote 30. 396 U.S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970) (expanding upon the nature of the remedial relief).

(n31)Footnote 31. 396 U.S. at 388, 90 S. Ct. at 623, 24 L. Ed. 2d at 604 .

(n32)Footnote 32. *Id.*

See *Yamamoto v. Omiya*, 564 F.2d 1319 (9th Cir. 1977) . The Ninth Circuit (Hufstедler, J., dissenting) affirmed the action of the trial court, before trial, in striking plaintiff's prayer for rescission of a sale by the issuer of certain real property allegedly accomplished through defective proxy materials. The majority framed the inquiry on the propriety of the trial court's action as follows: "May a shareholder, either individually or as a representative of the class, obtain a rescission of proxies and avoidance of the sales contract as a matter of right, merely by showing that the proxy materials are materially misleading? To put the question another way, is the sales contract voidable at the instance of a shareholder?" *Id.* at 1323 .

It is suggested, however, that the issue is broader, since the opinion is clear that the plaintiff was also proceeding in a *derivative* capacity, *i.e.*, in the right of the corporation itself. If the issue is whether the corporation may rescind the transaction under Section 29(b)--*i.e.*, as the "innocent party" at whose option the contract is "voidable"--the courts' problems become much more perplexing. And *Mills* is fairly clear on the "right to rescind" by an "innocent party." 396 U.S. at 387-88, 90 S. Ct. at 623, 24 L. Ed. 2d at 603-04 . To cast the issue solely in terms of the right of "a shareholder," as done in *Yamamoto*, is evasive.

In addition, it seems overdone to compare a merger, on the one hand, with the sale of a "parcel of land," on the other. *Yamamoto*, 564 F.2d at 1324 . For example, in the case of a merger, at least one of the corporate entities no longer exists, the shareholders of the merged company no longer hold its shares, the properties, personnel and business relations of the constituent corporations have been "scrambled," and the securities issued in the merger have been traded in the public markets.

Cf. *Lewis v. Byrnes*, 538 F. Supp. 1221, 1226 (S.D.N.Y. 1982) , distinguishing *Yamamoto*: "[Defendant] Korman may

be correct that it is simply too late in the day to declare the Hotel/Casino Acquisitions null and void. It is undoubtedly correct, however, that it is simply too early in the day to make this determination."

(n33)Footnote 33. *See, e.g., Beling v. American Tobacco Co.*, 72 N.J. Eq. 32, 65 A. 725 (1907) . The complainant attacked the legality of a transaction whereby three New Jersey corporations were "merged" into a new company (*i.e.*, the process now known as a "consolidation"). Vice Chancellor Pitney brushed the legalities aside forcefully in view of the immensity of the task that the bill's prayer asked him to assume, *i.e.* unraveling a combination of three companies years after the closing of the transaction. Characterizing the task as "now well-nigh impossible," he refused the relief on that ground, and on the ground of laches.

(n34)Footnote 34. *Mills*, 396 U.S. at 388, 90 S. Ct. at 623, 24 L. Ed. 2d at 604 .

There are precedents under the antitrust laws for divestiture, but very different considerations guide an antitrust court, which must eliminate the *continuing effects* of the violation on the *relevant* market. *See* 1 von Kalinowski, *Antitrust Laws and Trade Regulation*, Desk Edition § 2.04[4][d].

(n35)Footnote 35. *See, e.g., Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973) , *aff'd and modifying* 348 F. Supp. 979 (E.D.N.Y. 1973) . Prior district court opinions are reported in 332 F. Supp. 644 (E.D.N.Y. 1971) ; 298 F. Supp. 66 (E.D.N.Y. 1969) .

(n36)Footnote 36. In *Gerstle*, the district court determined in light of events transpiring after a merger that the proxy statement was materially defective in not disclosing the presolicitation intent of the management to sell many of the merged company's assets after the merger became effective. The shareholders were denied the opportunity to realize substantial profits by retaining their company as a separate entity and causing it to sell the assets. The acquiring company controlled the seller prior to the solicitation. The district court found that the terms of the merger agreement, which were based upon market values of the shares, were unfair. Since the liquidation value of the seller exceeded the value reflected in the market value of its shares, the merger ratio should have been based upon the liquidation values.

The defects alleged and proven are familiar. *See Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951) . (*Rule 10b-5* case based upon failure of insider purchaser to disclose its intent to "capture" undisclosed increase in value of tobacco inventory.) The court of appeals in *Gerstle* did not rule on the fairness of the merger ratio. The latter opinion was concerned with the failure of the proxy material to disclose the intent to sell assets and awarded damages calculated on the basis of the difference in value between: (1) the preferred stock of the acquiring company distributed to the acquired company's shareholders, and (2) the market value of the assets of the acquired company.

Both the district court, 478 F.2d at 1289 , and the court of appeals, 298 F. Supp. at 100 , in *Gerstle* said that it was "impossible" to set the merger aside.

See § 7.09[5][j][ii][B] *infra*.

(n37)Footnote 37. *See, e.g., Basch v. Talley Industries, Inc.*, 53 F.R.D. 9, 12 (S.D.N.Y. 1971) .

(n38)Footnote 38. *See, e.g., Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715 (8th Cir. 1974) , *cert. denied*, 419 U.S. 1107, 95 S. Ct. 778 (1975) .

(n39)Footnote 39. *See, e.g., SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir. 1947) , *cert. denied*, 332 U.S. 847 (1948) .

(n40)Footnote 40. Matthews, *S.E.C. Civil Injunctive Actions*, 5 Rev. of Sec. Reg. 949, 969 (1972); Pitt & Markham, *S.E.C. Civil Injunction Actions*, 6 Rev. of Sec. Reg. 955 (1975); Program of the Committee on Federal Regulation of Securities, *S.E.C. Civil Injunction Actions*, 30 Bus. Law. 1303 (1974); Comment, *Injunctive Relief in*

S.E.C. Civil Injunctive Actions: The Scope of Judicial Discretion, 10 *Colum. J.L. & Soc. Probs.* 328 (1975); Comment, *Equitable Remedies in SEC Enforcement Actions*, 123 *U. Pa. L. Rev.* 1188 (1975).

(n41)Footnote 41. Prior to the Securities Acts Amendments of 1975, the current Section 21(d) and (e) appeared as Section 21(e) and (f). In the course of those amendments, Section 21(d) (formerly 21(e)) was redrafted slightly from its previous wording: "Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation"

Section 21(d) provides that the decision of the Commission to proceed by an injunction action is not an alternative to criminal proceedings.

(n42)Footnote 42. The Section also authorizes such relief, upon the Commission's application, to implement the Commission's oversight functions with respect to securities exchanges, the NASD and registered clearing agencies, *see* § 2.03 *supra*.

(n43)Footnote 43. 377 U.S. 426, 84 S. Ct. 1555, 12 L. Ed. 2d 423 (1964) .

(n44)Footnote 44. 377 U.S. at 435, 84 S. Ct. at 1561, 12 L. Ed. 2d at 429 .

(n45)Footnote 45. *See Dann v. Studebaker-Packard Corp.*, 288 F.2d 201 (6th Cir. 1961) .

(n46)Footnote 46. 396 U.S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970) . *See* § 7.09[4][a] for a discussion of *Mills*.

(n47)Footnote 47. 396 U.S. at 386, 90 S. Ct. at 622, 24 L. Ed. 2d at 603 .

(n48)Footnote 48. *See* § 7.09[4][a] *supra*.

(n49)Footnote 49. Loss, *Fundamentals of Securities Regulation* 493 (Little, Brown 2d ed. 1988).

(n50)Footnote 50. 360 F.2d 692 (2d Cir. 1966) . This case permitted the issuer's management to challenge insurgents at an early stage in their solicitation, at the time that the insurgents sought access to the shareholders list.

More recent cases have also recognized that preliminary actions may constitute "solicitations" if they are steps in a process that will result in the actual solicitations of proxies. Communication through the media and the financial community of a proposal to "disaggregate" the business of the issuer may be a "solicitation." *Trans World Corp. v. Odyssey Partners*, 561 F. Supp. 1315 (S.D.N.Y. 1983) . *But see Radol v. Thomas*, 534 F. Supp. 1302 (S.D. Ohio 1982) (materials disseminated in "two-tier" tender offer and merger arrangement, at the time of tender offer, were not proxy solicitation material.) *But see Citizens First Bancorp, Inc. v. Harreld*, 559 F. Supp. 867 (W.D. Ky. 1982) .

A Rule 14e-2 statement may also be subject to the proxy rules in a situation in which the management will solicit proxies in respect of a competitive proposal. *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1 (2d Cir. 1983) , *rev'g*, 568 F. Supp. 1538 (S.D.N.Y. 1983) , *cert. denied*, 465 U.S. 1052 (1984) .

Solicitation of proxies is discussed in § 7.02 *supra*.

(n51)Footnote 51. *Howard v. Furst*, 238 F.2d 790 (2d Cir. 1956) , *cert. denied*, 353 U.S. 937 (1957) .

(n52)Footnote 52. *Cf. Drachman v. Harvey*, 453 F.2d 722 (2d Cir. 1971) . Plaintiffs, whose shares were held in "street name," had standing to sue derivatively under *Rule 10b-5*.

(n53)Footnote 53. A warrant or option holder does not have standing under Section 14(a), *Werfel v. Kramarsky*,

61 F.R.D. 674 (S.D.N.Y. 1974) ; *Wulc v. Gulf & Western Indus., Inc.*, 400 F. Supp. 99 (E.D. Pa. 1975) .

The plaintiff must have owned his shares at the time of the solicitation, *Smillie v. Park Chemical Co.*, 466 F. Supp. 572 (E.D. Mich. 1979) , *aff'd*, 710 F.2d 271 (6th Cir. 1983) . *See also* *Mutual Shares Corp. v. Genesco*, 384 F.2d 540 (2d Cir. 1967) . *But see* *Zell v. Intercapital Income Sec. Inc.*, 459 F. Supp. 819 (N.D. Cal. 1978) , *rev'd*, 675 F.2d 1041 (9th Cir. 1982) (class representative had standing as a shareholder although he held his shares only during the second of two allegedly fraudulent solicitations, where the fraud was allegedly present in both solicitations and the facts he would develop would apply to losses suffered by all investors).

(n54)Footnote 54. *Union P. R. Co. v. Chicago & N.W. Ry. Co.*, 226 F. Supp. 400 (N.D. Ill. 1964) .

(n55)Footnote 55. *Rosenfeld v. Schwitzer Corp.*, 251 F. Supp. 758 (S.D.N.Y. 1966) , *appeal dismissed*, 268 F.2d 192 (2d Cir. 1959) ; *see* *Phillips v. Tobin*, 403 F. Supp. 89 (S.D.N.Y. 1975) .

Since under Rule 14a-7(c) an issuer need not furnish a shareholder's list to a shareholder solicitor, the shareholder has no standing to sue under the proxy rules to gain access to the list. *See* *Gaudiosi v. Franklin*, 166 F. Supp. 353 (E.D. Pa. 1958) , *aff'd on other grounds sub nom. Gaudiosi v. Mellon*, 269 F.2d 873 (3d Cir.) , *cert. denied*, 361 U.S. 902 (1959) ; *see also* § 7.08[2] *supra*. Hence, the shareholder must proceed under state law. *See*, *Week, Walder & Co. v. Evans*, 300 F. Supp. 171 (D. Colo. 1969) . *See also* *Studebaker Corp. v. Gittlin*, 360 F.2d 692 (2d Cir. 1966) (although shareholders had succeeded in obtaining list through state court action, the action was enjoined, as the first step in a solicitation, due to the shareholder's failure to comply with the proxy rules).

In *Duplan Corp. v. Iroquois Indus., Inc.*, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,318 (W.D.N.Y. Oct. 4, 1968), a disgruntled merger candidate who owned no stock was not permitted to maintain an action for violation of the proxy rules.

In *Union P. R. Co. v. Chicago & N.W. Ry. Co.*, 226 F. Supp. 400 (N.D. Ill. 1964) , the court recognized (as an alternative to its standing as a shareholder) plaintiff's standing as a party to a provisional contract of merger which was to be approved or disapproved at a shareholder's meeting.

In *Reserve Management v. Anchor Daily Income Fund, Inc.*, 459 F. Supp. 597 (S.D.N.Y. 1978) , an investment advisor firm had no standing to bring suit against directors of a mutual fund for nondisclosure in proxy solicitation of the advisor's proposal for assuming management of the fund since the advisor was not a shareholder. In addition, the advisor could not claim standing as an "offeror" under Section 14(e) since its proposals to the directors were not tender offers within the purview of the securities law.

(n56)Footnote 56. *See* *Royal Business Group Inc. v. Realist Inc.*, 933 F.2d 1056 (1st Cir. 1991) , discussed in n.242 *infra*.

(n57)Footnote 57. 781 F. Supp. 292 (S.D.N.Y. 1992) .

(n58)Footnote 58. 410 F. Supp. 2d 330 (S.D.N.Y. 2006) .

(n59)Footnote 59. 381 F. Supp. 2d 192 (S.D.N.Y. 2004) .

(n60)Footnote 60. *Dann v. Studebaker-Packard Corp.*, 288 F.2d 201, 209 (6th Cir. 1961) ; *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66, 96 (S.D.N.Y. 1972) , *modified on other grounds*, 478 F.2d 1281 (2d Cir. 1973) ; *see also* *Greater Iowa Corp. v. McLendon*, 378 F.2d 783, 794 (8th Cir. 1967) ; *Electronic Specialty Co. v. International Controls Corp.*, 295 F. Supp. 1063, 1071 (S.D.N.Y. 1966) , *modified on other grounds*, 409 F.2d 937 (2d Cir. 1969) .

See *Hershfang v. Knotter*, 562 F. Supp. 393 (E.D. Va. 1983), *aff'd*, 725 F.2d 675 (1984) (plaintiff who did not rely on proxy statement had standing under Section 14(a) since the alleged omissions may have caused him damage by misleading other shareholders.) See also *Fradkin v. Ernst*, 98 F.R.D. 478 (N.D. Ohio 1983) (plaintiff had standing as class action representative even though he had not read the proxy statement and had failed to vote against the proposal).

(n61)Footnote 61. *Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982); *Klaus v. Hi-Shear Corp.*, 528 F.2d 225 (9th Cir. 1975). *Gaines* cited in decisions such as *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 97 S. Ct. 926, 51 L. Ed. 2d 124 (1977) (defeated tender offeror has no standing under Section 14(e) in an action for damages), and *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S. Ct. 1917, 44 L. Ed. 2d 539 (1975) (only actual purchaser or seller has standing for damages under *Rule 10b-5*). The *Piper* opinion in particular is most emphatic on the point that it was concerned only with the question whether a defeated tender offeror had standing to sue for damages. On the other hand, applications for *equitable* relief involve other considerations; as the Supreme Court noted in *Piper*:

[I]n corporate control contests the stage of preliminary injunctive relief, rather than post-contest lawsuits, "is the time when relief can best be given." Furthermore, awarding damages to parties other than the protected class of shareholders has only a remote, if any, bearing upon implementing the congressional policy of protecting shareholders who must decide whether to tender or retain their stock.

430 U.S. at 42, 97 S. Ct. at 949, 51 L. Ed. 2d at 153 .

The Court specifically noted that it was *not* deciding the question whether "shareholder-offerees, the class protected by § 14(e), have an implied cause of action under § 14(e)" 430 U.S. at n.28. Similarly, *Blue Chip Stamps* held that persons who were not purchasers or sellers had no standing to recover damages under *Rule 10b-5*. The Supreme Court in *Blue Chip Stamps* acknowledged that the decision in *SEC v. National Sec., Inc.*, 393 U.S. 453, 89 S. Ct. 564, 21 L. Ed. 2d 668 (1969) "established that the purchaser-seller rule imposes no limitation on the standing of the S.E.C. to bring actions for injunctive relief under § 10(b) and *Rule 10b-5*." 421 U.S. at 751 n.14, 95 S. Ct. at 1933 n.14, 44 L. Ed. 2d at 558.

Thus it seems that *Piper* and *Blue Chip Stamps* are not persuasive authority in the context of a suit for injunctive relief, as opposed to an action for damages. See *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981); *Kahan v. Rosenstiel*, 424 F.2d 161 (3d Cir.) , *cert. denied*, 398 U.S. 950 (1970) (private party who is neither a purchaser nor seller but who seeks only injunctive relief, as opposed to money damages for an alleged 10b-5 violation, has standing to sue if he can establish a causal connection between the alleged violations and his injury).

Secondly, those cases are beside the point to the extent that they were concerned with the standing of parties not "of the class for whose *especial* benefit the statute was enacted" *Piper*, 430 U.S. at 37, 97 S. Ct. at 947, 51 L. Ed. 2d at 151 (quoting *Cort v. Ash*, 422 U.S. 66, 95 S. Ct. 2080, 45 L. Ed. 2d 26 (1975)). It is clear that the proxy and information provisions of the Exchange Act were enacted for the benefit of the shareholders of securities registered under Section 12 in the exercise of their corporate voting rights. If the plaintiff alleges that he or she was injured as a shareholder by fraudulent, deceptive or misleading proxy information statement materials in violation of Section 14(a) or (c), he or she would appear to have standing. Unlike the plaintiffs in *Piper* and *Blue Chip Stamps*, the shareholder plaintiff is clearly of the "class intended to be benefitted by Congress." And it seems obvious that *all* shareholders may be damaged by majority action accomplished on the basis of false or misleading information since the vote of the majority will bind all holders of the relevant class.

Moreover, it seems strange that the rule barring undeceived shareholders would prevent action by the most diligent and alert shareholders, leaving the initiative to be taken only by those who are in the worst position to do so, *i.e.*, the "deceived."

Jacobs v. Airlift Int'l, Inc., 440 F. Supp. 540 (S.D. Fla. 1977) followed the rule stated in *Klaus v. Hi-Shear Corp.*, 528 F.2d 225 (9th Cir. 1975) .

See *Leff v. CIP Corp.*, 540 F. Supp. 857 (S.D. Ohio 1982) (both tendering and non-tendering shareholders had standing to sue for violations of Section 14(a).

See *Shapiro v. Midwest Rubber Reclaiming Co.*, 626 F.2d 63 (8th Cir. 1980) , cert. denied, 449 U.S. 1079 (1981) (plaintiffs who had not exchanged their stock in response to allegedly unlawful exchange offer not eligible to represent persons who had tendered).

(n62)Footnote 62. *Tully v. Mott Supermarkets, Inc.*, 540 F.2d 187 (3d Cir. 1976) . In a Rule 10b-5 action, the court held that the *Kahan* exception to the "purchaser-seller" rule, 424 F.2d at 173 , was intended to provide only prophylactic relief, to enjoin deceptive practices that, if continued, would lead to purchases or sales resulting in Rule 10b-5 violations. The court found the exception to be inapplicable to the case before the court "involving a consummated illegal stock transaction." 540 F.2d at 195 .

(n63)Footnote 63. See *SEC v. Management Dynamics, Inc.*, 515 F.2d 801 (2d Cir. 1975) .

(n64)Footnote 64. *SEC v. General Refractories*, 400 F. Supp. 1248, 1254-55 (D.D.C. 1975) .

See also *SEC v. Harwyn Ind.*, 326 F. Supp. 943 (S.D.N.Y. 1971) ; *Securities & Exchange Com. v. Bennett & Co.*, 207 F. Supp. 919 (D.N.J. 1962) (a sufficient prima facie case.)

Requiring a "strong" prima facie case: *SEC v. Boren*, 283 F.2d 312 (2d Cir. 1960) ; *SEC v. Capital Growth*, 391 F. Supp. 593 (S.D.N.Y. 1974) ; *SEC v. Keller Indus. Inc.*, 342 F. Supp. 654 (S.D.N.Y. 1972) ; *SEC v. Globus Int'l Ltd.*, 320 F. Supp. 158 (S.D.N.Y. 1970) .

Some courts have required the same standards of the Commission for provisional relief as in a private action: *SEC v. Century Inv. Transfer Corp.*, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,232 (S.D.N.Y. Oct. 5, 1971); *SEC v. Arco Indus.*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,921 (S.D.N.Y. Jan. 18, 1971), [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,973 (S.D.N.Y. Mar. 9, 1971); *SEC v. Conglomerates Inc.*, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,293 (S.D.N.Y. Oct. 23, 1968). Cf. *SEC v. Frank*, 388 F.2d 486 (2d Cir. 1968) .

See 4 L. Loss & J. Seligman, *Securities Regulation* 2111-19 (Little, Brown 3d ed. 1990). Commission injunction actions under Section 21 of the Act are discussed in § 9.02[3] *infra*.

The kinds of proof that the Commission must present varies with the case, *i.e.*, whether there is a serious dispute concerning the facts requiring an evidentiary hearing rather than proceeding on the basis of affidavits and oral argument. See *SEC v. Frank*, 388 F.2d 486, 490-91 (2d Cir. 1968) ; *SEC v. Great American*, 407 F.2d 453 (2d Cir. 1968) , cert. denied, 395 U.S. 920 (1969) ; *SEC v. General Refractories*, 400 F. Supp. 1248 (D.D.C. 1975) .

See generally *Program of the Committee on Federal Regulation of Securities; S.E.C. Civil Injunction Actions*, 30 Bus. Law. 1301 (1975).

(n65)Footnote 65. *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 95 S. Ct. 2069, 45 L. Ed. 2d 12 (1975) . In an action under Section 13(d) of the Exchange Act, the Court read *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970) , which was concerned with an action under the proxy provisions, as supporting its conclusion that a court's determination concerning the relief to be granted should be made on the basis of "traditional principles." 422 U.S. at 64, 95 S. Ct. at 2079, 45 L. Ed. 2d at 24 .

In *Pantry Pride, Inc. v. Rooney*, 598 F. Supp. 891 (S.D.N.Y. 1984), the court denied the application of plaintiff-directors for injunction against certification of a possible victory by dissidents in a forthcoming proxy fight since the incumbents had not established irreparable harm. The court observed that should the dissidents prevail in the proxy contest under circumstances that violate the securities laws, the court would have the power to set aside the election. Further, if the dissidents won the proxy contest, and then attempted, on behalf of the corporation, to dismiss the action challenging their conduct of the proxy fight, the court could appoint a trustee to continue the action.

The SEC successfully argued in an *amicus* brief filed in *Roosevelt v. E.I. DuPont de Nemours & Co.*, 958 F.2d 416 (D.C. Cir. 1992), that a private right of action exists to enforce a minority shareholder's right to have a proposal included in management's proxy statement under Rule 14a-8, despite the issuance by the SEC's staff of a no-action letter upholding the defendant's right to exclude the shareholder proposal in question as involving a matter relating to the conduct of the defendant's ordinary business operations, *i.e.*, DuPont's timing of its planned phase-out of chlorofluorocarbons as damaging to the ozone layer. However, the court held on the merits that the proposal was properly excluded for the reasons stated.

(n66)Footnote 66. "[A] preliminary injunction should issue only upon a clear showing of either: (1) probable success on the merits and *possible* irreparable injury, or (2) sufficiently serious questions going to the merits to make them a fair ground for litigation *and* a balance of hardships tipping decidedly toward the party requesting the preliminary relief." *Sonesta Int'l Hotels Corp. v. Wellington Assoc.*, 483 F.2d 247, 250 (2d Cir. 1973).

See *Denison Mines Ltd., v. Fibreboard Corp.*, 388 F. Supp. 812 (D. Del. 1974); *Twentieth Century Fox Film Corp. v. Lewis*, 334 F. Supp. 1398 (S.D.N.Y. 1971); *Elgin Nat'l Indus., Inc. v. Chemetron Corp.*, 299 F. Supp. 367 (D. Del. 1969); *Sherman v. Posner*, 266 F. Supp. 871 (S.D.N.Y. 1966); *Kauder v. United Board & Carton Corp.*, 199 F. Supp. 420 (S.D.N.Y. 1961); *Mack v. Mishkin*, 172 F. Supp. 885 (S.D.N.Y. 1959).

See *Reserve Management v. Anchor Daily Income Fund*, 459 F. Supp. 597 (S.D.N.Y. 1978) (preliminary injunction denied); *Kass v. Arden-Mayfair, Inc.*, 431 F. Supp. 1037 (C.D. Cal. 1977) (preliminary injunction denied).

See also *FMC Corp. v. R.P. Scherer Corp.*, 545 F. Supp. 318 (D. Del. 1982), in which a preliminary injunction enjoining a shareholder meeting at which anti-takeover amendments to a target company's certificate of incorporation were to be voted on was denied since irreparable harm would not otherwise ensue, *i.e.*, if the proxy materials soliciting the vote were later found misleading,

(1) the tender-offeror could seek to have the vote voided and the amendments resubmitted for a second vote, and

(2) the target company's shareholders could seek damages if the tender-offeror withdrew its offer and the shareholders were thereby deprived of the opportunity to tender their shares at a premium.

(n67)Footnote 67. See, *e.g.*, *Denison Mines Ltd. v. Fibreboard Corp.*, 388 F. Supp. 812 (D. Del. 1974); *Studebaker Corp. v. Allied Prod. Corp.*, 256 F. Supp. 173 (W.D. Mich. 1966); *Union P. R. Co. v. Chicago & N.W. Ry. Co.*, 226 F. Supp. 400 (N.D. Ill. 1964); *Shvets v. Industrial Rayon Corp.*, 212 F. Supp. 308 (S.D.N.Y. 1960).

In *Denison Mines*, the court, after finding that the plaintiff had established the existence of a violation of Rule 14a-9, granted a preliminary injunction postponing the meeting and ordering a resolicitation. The court found that: "[w]here the transaction is a merger which contemplates integration of the two enterprises, as here, divestiture may well turn out to be an unfeasible remedy; it would at the least be a painful one." 388 F. Supp. at 828. See, *e.g.*, *Allis-Chalmers Mfg. Co. v. White Consol., Inc.*, 414 F.2d 506 (3d Cir. 1969). *Electronic Specialty Co. v. International Controls*, 409 F.2d 937 (2d Cir. 1969).

Accord *Union Pacific R.R. Co. v. Chicago & N.W. Ry. Co.*, 226 F. Supp. at 413 ; see *Mills v. Electric Auto-Lite*, 396 U.S. at 386, 90 S. Ct. at 622, 24 L. Ed. 2d at 603 .

In *Lessler v. Dominion Textile Ltd.*, 411 F. Supp. 40 (S.D.N.Y. 1975) , plaintiff sought a preliminary injunction to postpone the holding of a shareholder's meeting to approve a proposed merger. The court denied the injunction, finding no risk of irreparable injury. The adequacy and ease of the availability of the statutory appraisal rights, coupled with the fact that money damages would adequately compensate the plaintiff, convinced the court that no injunction should be issued.

(n68)Footnote 68. *Denison Mines*, 388 F. Supp. at 828 ; *Twentieth Century Fox Film Corp. v. Lewis*, 334 F. Supp. 1398 (S.D.N.Y. 1971) (preliminary injunction denied); *Elgin National Indus.*, 299 F. Supp. at 374 (preliminary injunction denied); *Studebaker Corp. v. Allied Prod. Corp.*, 256 F. Supp. 173, 189 (W.D. Mich. 1966) (preliminary injunction technically denied but, because proxy materials were misleading, court ordered production of stockholder list, set new record date and new annual meeting date and supervised content of proxy materials); *Union Pacific*, 226 F. Supp. at 413 (preliminary injunction granted); *Dunn v. Decca Records*, 120 F. Supp. 1, 3 (S.D.N.Y. 1954) (preliminary injunction denied).

(n69)Footnote 69. *Dunn*, 120 F. Supp. at 3 .

In *McConnell v. Lucht*, 320 F. Supp. 1162 (S.D.N.Y. 1970) , the court cited the following reasons for denying injunctive relief:

Company-employee relationships have been strained and recruitment of new key personnel has been interfered with due to adverse publicity centering about the proxy fight, and the company's credit rating, it is alleged, is being adversely affected. All these effects would be exacerbated to the point of irreparable injury, if the injunction were granted.

Id. at 1166-67 (footnote omitted).

(n70)Footnote 70. *Jewelcor, Inc. v. Pearlman*, 397 F. Supp. 221 (S.D.N.Y. 1975) . Although plaintiff was likely to prevail on the merits, a preliminary injunction was denied because the shareholders might view a preliminary injunction as a final determination of wrongdoing on the part of the proxy solicitor "and thus thwart any future legitimate efforts by [the proxy solicitor] to form a business combination with [the plaintiff corporation]." *Id.* at 242 .

See also *Wolpert v. First Nat'l Bank of East Islip*, 381 F. Supp. 625 (E.D.N.Y. 1974) (preliminary injunction denied); *Twentieth Century Fox*, 334 F. Supp. at 1402 (preliminary injunction denied); *General Time Corp. v. Talley Indus., Inc.*, 283 F. Supp. 832, 837 (S.D.N.Y.) , *aff'd*, 403 F.2d 159 (2d Cir. 1968) , *cert. denied*, 393 U.S. 1026 (1969) (preliminary injunction denied); *Kauder v. United Board & Carton Corp.*, 199 F. Supp. 420, 424 (S.D.N.Y. 1961) (preliminary injunction denied); *Mack v. Mishkin*, 172 F. Supp. 885, 889 (S.D.N.Y. 1959) (preliminary injunction denied).

(n71)Footnote 71. *Wolpert v. First Nat'l Bank*, 381 F. Supp. 625 (E.D.N.Y. 1974) (preliminary relief denied); *McConnell v. Lucht*, 320 F. Supp. 1162 (S.D.N.Y. 1970) ; *Raffa v. The Mechanics Building Material Co.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,535 (E.D.N.Y. Apr. 28, 1976); see generally *Lincoln Mercury Corp. v. Victory Life Ins. Co.*, 375 F. Supp. 112, 115 (D. Kan. 1974) ; *Walpert v. Bart*, 280 F. Supp. 1006, 1016 (D. Md. 1967) , *aff'd*, 390 F.2d 877 (4th Cir. 1968) .

(n72)Footnote 72. *Chris-Craft Indus., Inc. v. Independent Stockholders Comm.*, 354 F. Supp. 895, 921-22 (D. Del. 1973) . The paradox of the doctrine of unclean hands in the proxy environment has not gone unnoticed. *Union Pacific*,

226 F. Supp. at 410 (application of the doctrine would leave "the shareholders unprotected when they have been doubly misled, stultifying the underlying purpose of the national securities laws").

(n73)Footnote 73. See *Dillon v. Berg*, 326 F. Supp. 1214 (D. Del.), *aff'd*, 453 F.2d 876 (3d Cir. 1971). See also *SEC v. Medical Comm. for Human Rights*, 404 U.S. 403, 92 S. Ct. 577, 30 L. Ed. 2d 560 (1972) (less than three percent of voting shareholders supported contested proposals; issue rendered moot); *Isaacs Bros. Co. v. Hibernia Bank*, 481 F.2d 1168 (9th Cir. 1973) (meeting held and proposal included in following year's proxy statement, therefore making injunctive relief or rescheduling meeting unlikely); *Klastorin v. Roth*, 353 F.2d 182 (2d Cir. 1965) (meeting held pending appeal); *Doyle v. Milton*, 73 F. Supp. 281 (S.D.N.Y. 1947) (suit for injunction against solicitation of proxies was held to be moot since by time motion to dismiss was decided transaction approved at shareholder's meeting had progressed to completion).

(n74)Footnote 74. See § 7.08[1][b] *supra*.

See *Chris-Craft Indus., Inc. v. Independent Stockholders Comm.*, 354 F. Supp. 895 (D. Del. 1973).

(n75)Footnote 75. 564 F.2d 1319, 1323 (9th Cir. 1977).

See *Caspary v. Louisiana Land & Exploration Co.*, 579 F. Supp. 1105 (S.D.N.Y. 1983) (director not responsible for advertisement written and paid for by his father).

(n76)Footnote 76. Of course, it would be easy to posit facts in which the identity of the purchaser would be material, *e.g.*, where the prospective purchaser's obligation or stock would be the consideration for the transfer, or the prospective purchaser was a director's son or daughter or business partner.

(n77)Footnote 77. *Chris-Craft*, 354 F. Supp. at 915 :

These nominees held out their names and reputations to shareholders as evidence that the group backing them was the proper choice to run the corporation. Having put their reputations in issue, the nominees cannot divorce themselves from improper actions taken in the proxy battle by the participants acting under the banner of their names. Moreover, since the major object of the proxy contest was to install the nominees into positions where they would ostensibly control the corporation, all participants working for their election are in a sense agents of the nominees, and thus the nominees must be expected to assume some responsibility for the actions of their agents.

(n78)Footnote 78. *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761 (3d Cir. 1976).

See also *Lewis v. Dansker*, 68 F.R.D. 184, 195 (S.D.N.Y. 1975) :

(1) Norman Dansker, having signed the proxy statement in question, is individually and directly liable for the R. 14a-3 violation.

(2) Jerome and Raphael Dansker, having been aware of the proxy statement, having had an opportunity to read it as members of the Board of Directors, having been instrumental in its approval by the Board and having been the chief beneficiaries of the resolutions contained therein, are also individually and directly liable for the R. 14a-3 violation, despite the fact that their names do not appear thereon.

But see *Mader v. Armel*, 461 F.2d 1123 (6th Cir. 1972), *cert. denied*, 409 U.S. 1023, *aff'g*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,027 (S.D. Jan. 25, Ohio 1971). Cf. *Lanza v. Drexel*, 479 F.2d 1277, 1322 (2d

Cir. 1973) (en banc) (footnote omitted; *Rule 10b-5* action):

We recognize that *participation* by a director in the dissemination of false information reasonably calculated to influence the investing public may subject such a director to liability under the Rule. But it is quite a different matter to hold a director liable in damages for failing to insure that all material, adverse information is conveyed to prospective purchasers of the company's stock absent substantial participation in the concealment or knowledge of it.

(n79)Footnote 79. *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 69 (D.C. Cir. 1980) , *cert. denied sub nom. Kalmanovitz v. SEC*, 449 U.S. 1012 (1980) .

See also Lewis v. Byrnes, 538 F. Supp. 1221 (S.D.N.Y. 1982) :

This transaction was more than a cash sale where the purchaser and seller meet, exchange cash for kind, and go their separate ways. The terms of the transaction necessarily entailed a continuing relationship between H&H and Korman. Korman was to become a director, an employee and a debtor of H&H. In these circumstances, it is true for Korman as it was for Kalmanowitz in the *Falstaff* case that "information about him and his plans certainly was material to the shareholder deciding whether to give his proxy to persons supporting the transaction." *S.E.C. v. Falstaff*, *supra*, 629 F.2d at 69 n.8 . Unlike the situation in the *Yamamoto* case, Korman's identity clearly could have been an inducing factor in a shareholder's grant of his proxy. Thus, Korman permitted the use of his name in a manner substantially connected to the proxy solicitation such that, as a matter of law, he may be held liable under § 14(a) for any misstatements contained in the proxy materials.

Id. at 1224-25 (citing *Falstaff*, 629 F.2d at 69 n.8) (footnote omitted).

See also Norte & Co. v. Huffines, 304 F. Supp. 1096 (S.D.N.Y. 1968) , *aff'd*, 416 F.2d 1189 (2d Cir. 1969) , *cert. denied*, 397 U.S. 989 (1970) .

(n80)Footnote 80. 511 U.S. 164 (1994) .

(n81)Footnote 81. *See* discussion at § 5B.02[1][b].

(n82)Footnote 82. *See* § 5B.04[2] *supra*.

(n83)Footnote 83. *See* § 5B.05[3] *supra*.

(n84)Footnote 84. 351 F. Supp. 853 (D. Del. 1972) ; *see* discussion at § 5B.05[3] *supra*.

(n85)Footnote 85. *National Home Products, Inc. v Gray*, 416 F. Supp. 1293 (D. Del. 1976) .

(n86)Footnote 86. *See* discussion at § 5A.05 *supra*.

(n87)Footnote 87. *See* 15 U.S.C. § 78t, 109 Stat. 737 (1995); 15 U.S.C. § 78u(d), 109 Stat. 756 (1995).

(n88)Footnote 88. *See* discussion at § 5B.02[2][c]; § 5A.02 *et seq. supra*.

(n89)Footnote 89. *See* discussion at § 5B.06 *supra*.

(n90)Footnote 90. 84 F.3d 393 (11th Cir. 1996) .

(n91)Footnote 91. *See also Lasker v. New York State Electric & Gas Corp.*, 85 F.3d 55 (2d Cir. 1996) .

(n92)Footnote 92. See remarks of SEC Enforcement Division Director, Richard H. Walker, to the Securities Industry Association reported in Federal Securities Law Reports No. 1949 (CCH) (November 15, 2000).

(n93)Footnote 93. Section 27 of the Exchange Act of 1934, 15 U.S.C. § 78aa.

(n94)Footnote 94. Section 27 of the Exchange Act, 15 U.S.C. § 78aa.

(n95)Footnote 95. *Leasco Data Processing Equip. Corp. v. Maxwell*, 468 F.2d 1326, 1340 (2d Cir. 1972) ; *see also Kauthar SDN BHD v. Sternberg*, 149 F.3d 659, Fed. Sec. L. Rep. (CCH) P 90,240 (7th Cir. 1998) .

(n96)Footnote 96. Section 27 of the Exchange Act, 15 U.S.C. § 78aa.

(n97)Footnote 97. 28 U.S.C. § 1367(a); *United Mine Workers v. Gibbs*, 383 U.S. 715, 86 S. Ct. 1130, 16 L. Ed. 2d 218 (1966) . As noted in *Dominick v. Marcove*, 809 F. Supp. 805 (D. Colo. 1992) , the court may decline to exercise supplemental jurisdiction over state law claims if the federal claim has been dismissed. 28 U.S.C. § 1367(c)(3).

(n98)Footnote 98. *Tully v. Mott Supermarkets, Inc.*, 540 F.2d 187 (3d Cir. 1976) .

In *Kavit v. A.L. Stamm & Co.*, 491 F.2d 1176, 1180 (2d Cir. 1974) , Judge Friendly wrote: "If it appears that the federal claims are subject to dismissal under *F.R. Civ. P. 12(b)(6)* or could be disposed of on a motion for summary judgment under *F.R. Civ. P. 56*, the court should refrain from exercising pendent jurisdiction absent exceptional circumstances."

In the appended note, Judge Friendly stated:

Such circumstances might be found when the defendant fails to call the court's attention to the weakness of the federal claim before the court has invested a substantial amount of time in the case, *see, e.g., A.H. Emery Co. v. Marcan Prods. Corp.*, 389 F.2d 11, 19-21 (2d Cir.) , *cert. denied*, 393 U.S. 835, 89 S. Ct. 109, 21 L. Ed. 2d 106 (1968) ; when the pendent claim significantly invokes questions of federal policy, as in *Gibbs* itself, *see also Almenares v. Wyman*, 453 F.2d 1075, 1085 ; or when dismissal of the pendent claims would otherwise sharply clash with the directive in *Gibbs* that pendent jurisdiction serve the ends of "judicial economy, convenience and fairness to litigants." 383 U.S. at 726, 86 S. Ct. at 1139 .

(n99)Footnote 99. *See Aldinger v. Howard*, 427 U.S. 1, 96 S. Ct. 2413, 49 L. Ed. 2d 276 (1976) .

(n100)Footnote 100. *Madonick v. Denison Mines, Ltd.*, 63 F.R.D. 657 (S.D.N.Y. 1974) . *Cf. SEC v. OSEC Petroleum, S.A.* [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,915 (D.D.C. Dec. 18, 1974) (under Section 13(d)).

(n101)Footnote 101. *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255 (3d Cir.) , *cert. denied*, 409 U.S. 874 (1972) .

(n102)Footnote 102. *SEC v. Kasser*, 548 F.2d 109 (3d Cir.) , *cert. denied*, 431 U.S. 938 (1977) .

(n103)Footnote 103. *Grunenthal GmbH v. Hotz*, 712 F.2d 421 (9th Cir. 1983) .

(n104)Footnote 104. See discussion at § 7.09 (5)(f)(B) *infra*.

(n105)Footnote 105. See Longstreth, *S.E.C. Disclosure Policy Regarding Management Integrity*, 38 Bus. Law.

1414 (1983); Fedders, *Law Enforcement Against Those Who Fail to Disclose Illegal Behavior*, 14 *Sec. Reg. & L. Rep. (BNA)* 2057 (Nov. 26, 1982) ; Branch & Rubright, *Integrity of Management Disclosures Under the Federal Securities Laws*, 37 *Bus. Law.* 1447 (1982); Ferrara, Starr & Steinberg, *Disclosure of Information Bearing on Management Integrity and Competency*, 76 *Nw. U. L. Rev.* 555 (1981).

(n106)Footnote 106. See *United States v. Fields*, 592 F.2d 638 (2d Cir. 1978) , cert. denied, 442 U.S. 917 (1979) (violation of Item 7(f) of Schedule 14A is a violation of Section 14(a)); *Lewis v. Dansker*, [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,141 (S.D.N.Y. Aug. 23, 1973): "In effect, the Danskers' position is that a showing of materiality is prerequisite to a violation of any of the proxy rules or regulations. We find nothing in the language of Section 14(a), Rule 14a-3, or Item 11 of Schedule 14A, the legislative history of those Sections, or the cases decided under those Sections, which requires such a showing."

See also *SEC v. Kalvex Inc.*, 425 F. Supp. 310 (S.D.N.Y. 1975) .

But see *Ash v. GAF Corp.*, 546 F. Supp. 89, 94 (E.D. Pa. 1982) . The court granted defendant's motion for summary judgment in a private action alleging a violation under Rule 14a-3(b) (defendant mailed annual report by third-class mail, proxy material by first-class mail four to five days later). "Assuming arguendo there was a wrong, it was one so trivial that a court cannot redress it. At worst in this situation, it remains a wrong without a private remedy." The Third Circuit affirmed, 723 F.2d 1090 (3d Cir. 1983) . The plaintiff was found to have established a violation; but he had failed to demonstrate injury or an adverse effect on the integrity of the election.

See also *In re Sears, Roebuck & Co. Sec. Litig.*, 792 F. Supp. 977 (E.D. Pa. 1992) , where the court held that the company's failure to disclose in proxy statements that it had been sued under state law for mismanagement and breach of fiduciary duty is not a material omission actionable under Section 14(a) of the Exchange Act. After a restructuring, numerous shareholders sued Sears and its directors, alleging, among other things, a violation of Section 14(a) because of the alleged omission. The case was settled. Sears did not disclose the suit in proxy statements for the next three years. The court found Sears' omission nonmaterial because no fraud, deception or manipulation was alleged in the suits. As such, under *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977) , there was no material omission under Section 14(a). Also, because such information was nonmaterial, it need not have been disclosed under Regulation S-K, Item 103. Moreover, the directors in the earlier suits were not adverse to the company and need not have been included under Item 103.

The question of the relief to be granted in a private suit for a violation of Rule 14a-3(a) after the meeting in question turns upon the plaintiff's ability to show causation. See *Dillon v. Berg*, 326 F. Supp. 1214, 1234-35 n.31 (citing cases), aff'd, 453 F.2d 876 (3d Cir. 1971) . See also *Ash v. Brunswick Corp.*, 405 F. Supp. 234, 247 (D. Del. 1975) ("Notwithstanding this violation of the proxy rules, plaintiff is entitled to no relief without proof of causation--that is that the violation reasonably could be thought to have affected the outcome of the vote.") In a case under Rule 14a-9, the defect must be material by the terms of the Rule and its materiality is sufficient to establish causation under *Mills v. Electric Auto-Lite*, 396 U.S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970) . See § 7.09[5][f][ii] and § 7.09[6][a] infra .

(n107)Footnote 107. *Meredith v. City of Winter Haven*, 320 U.S. 228, 235, 64 S. Ct. 7, 11, 88 L. Ed. 9, 13 (1943) , quoted in *Hecht Co. v. Bowles*, 321 U.S. 321, 64 S. Ct. 587, 88 L. Ed. 754 (1944) . (Emergency Price Control Act of 1942).

See discussion in § 7.09[5][h] and § 7.09[5][i] infra .

(n108)Footnote 108. See, e.g., *SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir.) , cert. denied, 332 U.S. 847 (1947) , aff'g and modifying, 67 F. Supp. 326 (D. Del. 1946) .

An express refusal of a defendant to comply with an SEC rule would place him or her squarely in the category of those against whom injunctions are granted, i.e., defendants who present the danger of future violations. Cf. *Securities*

& *Exchange Com. v. Mono-Kearsarge Consol. Mining Co.*, 167 F. Supp. 248 (D. Utah 1958) (defendant continued disputed activities after action commenced); *SEC v. Manor Nursing Centers, Inc.*, 340 F. Supp. 913 (S.D.N.Y. 1971), *aff'd*, 458 F.2d 1082 (2d Cir. 1972) (retention of proceeds of fraudulent scheme).

See also *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 95 S. Ct. 2069, 45 L. Ed. 2d 12 (1975) (private action under Williams Act amendments to Exchange Act; an action for an injunction is "designed to deter." Injunction denied where defendant acted in ignorance of the law, complied as soon as he was aware of the requirement, and insufficient harm was shown to justify injunctive relief).

(n109)Footnote 109. See *SEC v. Koracorp Indus., Inc.*, 575 F.2d 692 (9th Cir.), *cert denied sub nom. Helfat v. SEC*, 439 U.S. 953 (1978). The court described the decision whether to issue an injunction as turning on two factors: (1) the character of past conduct, and (2) "the bonafides of the expressed intent to comply." *Id.* at 699 (quoting *United States v. W.T. Grant Co.*, 345 U.S. 629, 633, 73 S. Ct. 894, 898, 97 L. Ed. 1303 (1953)).

(n110)Footnote 110. *J.I. Case v. Borak*, 377 U.S. 426, 431, 84 S. Ct. 1555, 1559, 12 L. Ed. 2d 423, 427 (1964):

The purpose of § 14(a) is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate disclosure in proxy solicitation. The Section stemmed from the congressional belief that "[f]air corporate suffrage is an important right that should attach to every equity security bought on a public exchange." H.R. Rep. No. 1383, 73d Cong. 2d Sess., 13, reprinted in the Primary Law Sourcebook, Volume C, Section I of the 1934 Act. It was intended to "control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which... [had] frustrated the free exercise of the voting rights of stockholders." *Id.* at 14. Too often proxies are solicited without explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought.

Section 14(c), which requires the distribution of information statements by management when proxies are not solicited for any "annual or other" meeting, was added to the statute as part of its Securities Acts Amendments of 1964. Pub. L. No. 88-467, 78 Stat. 565.

(n111)Footnote 111. The Note to Rule 14a-9 states:

NOTE: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this Section.

- (a) Predictions as to specific future market values.
- (b) Material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation.
- (c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.
- (d) Claims made prior to a meeting regarding the results of a solicitation.

The comparable provision for information statements under Section 14(c) is Rule 14c-6.

Rule 14a-9 is discussed in § 7.04[2] *supra*.

(n112)Footnote 112. Jennings & Marsh, *Securities Regulation: Cases and Materials* 1052 (6th ed. 1987).

(n113)Footnote 113. 396 U.S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970) .

(n114)Footnote 114. Mills, 396 U.S. at 384, 90 S. Ct. at 621, 24 L. Ed. 2d at 602 .

(n115)Footnote 115. Mills, 396 U.S. at 384 .

(n116)Footnote 116. *Gerstle v. Gamble Skogmo, Inc.*, 478 F.2d 1281, 1302 (2d Cir. 1973) .

(n117)Footnote 117. *Gerstle*, 478 F.2d at 1302 . See discussion of negligence versus scienter in § 7.09[5][i] and [6][b], *infra*.

(n118)Footnote 118. *Gerstle*, 478 F.2d at 1302 .

(n119)Footnote 119. 426 U.S. 438, 449, 96 S. Ct. 2126, 2132, 48 L. Ed. 2d 757, 766 (1976) , *mot. denied*, 429 U.S. 810, 97 S. Ct. 48 (1976) .

(n120)Footnote 120. *TSC Indus. Inc.*, 426 U.S. at 449 .

(n121)Footnote 121. See Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, 95th Cong. 1st Sess. 327 (Nov. 3, 1977):

Although the Committee believes that ideally it would be desirable to have absolute certainty in the application of the materiality concept, it is its view that such a goal is illusory and unrealistic. The materiality concept is judgmental in nature and it is not possible to translate this into a numerical formula. The Committee's advice to the Commission is to avoid this quest for certainty and to continue consideration of materiality on a case-by-case basis as disclosure problems are identified.

The TSC definition of materiality now "appears to be accepted as an all-purpose definition of materiality under the Federal Securities Laws." *SEC v. Steadman*, 967 F.2d 636, 643 (D.C. Cir. 1992) .

(n122)Footnote 122. *TSC Indus. Inc.*, 426 U.S. at 445, 96 S. Ct. at 2130, 48 L. Ed. 2d at 763 : "The question of materiality, it is universally agreed, is an objective one, involving the significance of an omitted or misrepresented fact to a reasonable investor."

See also *Wilson v. Great Am. Indus., Inc.*, 855 F.2d 987 (2d Cir. 1988) (failure of merger proxy statement to disclose unfavorable district court decision awarding substantial damages against merging company and one of its subsidiaries for stripping of assets of another subsidiary to avoid paying its union obligations, and characterizing merging company's management's conduct as highly fraudulent, were material nondisclosures.) Similarly, *In re Sears, Roebuck and Co. Sec. Litig.*, 792 F. Supp. 977 (E.D. Pa. 1992) , found the omission of facts regarding a suit for breach of fiduciary duty and mismanagement to be nonmaterial.

See also *Yabsley v. Conover*, 644 F. Supp. 689 (N.D. Ill. 1986) , in which the court dismissed a claim under Section 14(a) and Rule 14a-9 alleging that misleading proxy material fraudulently induced the plaintiffs to vote against a corporate reorganization, since the reorganization was adopted despite the plaintiffs' negative votes, and as a result they suffered no injury.

See also *Keyser v. Commonwealth Nat'l Fin. Corp.*, 644 F. Supp. 1130 (M.D. Pa. 1986) in which the court held:

(1) that the failure to disclose in a proxy statement seeking shareholder approval of a proposed merger that the issuer had received a merger offer from another party was not material where that offer had been withdrawn; and

(2) that a promise by the offeror that following the merger the issuer's board would remain in place with responsibilities unchanged did not represent a conflict of interest serious enough to require disclosure in the proxy statement, since no wrongful motive was alleged, and only two of the issuer's 15 directors held senior management positions.

See also *Woodward & Lothrop, Inc. v. Schnabel*, 593 F. Supp. 1385 (D.D.C. 1984), in which the alleged misstatements contained in proxy materials were held to reflect only differing opinions and expert calculations concerning a proposed merger, but not gaps in the total mix of information available in violation of Section 14(a).

In *GAF Corp. v. Heyman*, 724 F.2d 727 (2d Cir. 1983), the court held that the failure of an insurgent whose slate decisively won a fiercely contested proxy contest, to disclose in the proxy materials sent to shareholders unadjudicated allegations against him pending family lawsuit in a state court was not a material omission. The Second Circuit did not believe that fuller disclosure of the state action would have had a significant effect on the voting process.

(n123)Footnote 123. See *Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981), cert. denied, 454 U.S. 1145 (1982), discussed *infra*.

(n124)Footnote 124. 218 F.3d 144 (2d Cir. 2000), cert. denied, 531 U.S. 1192 (2001).

(n125)Footnote 125. *Minzer v. Keegan*, No. 97-CV-4077, 1997 U.S. Dist. LEXIS 16445 (E.D.N.Y. 1997).

(n126)Footnote 126. Civ. No. H-02-1942 (S.D. Tex 2002).

(n127)Footnote 127. *Minzer*, 218 F.3d 144 at 149.

(n128)Footnote 128. 1991 U.S. Dist. LEXIS 7874, C.A. No. 90-0173B (D.C.R.I. 1991).

(n129)Footnote 129. 796 F.2d 508 (D.C. Cir. 1986). But see *In re Lear Corporation Shareholder Litigation*, 926 A.2d 94 (Del. Ch. 2007) where, in a going private transaction negotiated by the CEO of Lear Corporation with Carl Icahn, the CEO asked the Lear board to change his employment arrangements to allow him to cash in his retirement benefits immediately while negotiating with Icahn to continue to run the company. In a suit by stockholders to enjoin the shareholders' vote on the merger, the Delaware Chancery Court held the proxy materials were deficient in failing to disclose the CEO's request to the board, and it granted a preliminary injunction preventing a vote on the merger until full disclosure was made to the shareholders.

(n130)Footnote 130. 645 F.2d 761 (9th Cir. 1981), cert. denied, 454 U.S. 1145 (1982).

(n131)Footnote 131. *Gaines*, 645 F.2d at 779.

The following cases ruled that failures to disclose breaches of fiduciary duties did not give rise to rights of action under the federal securities laws: *Selk v. St. Paul Ammonia Prods. Inc.*, 597 F.2d 635 (8th Cir. 1979) (failure to characterize transactions as improvident); *Amalgamated Clothing v. J.P. Stevens & Co.*, 475 F. Supp. 328 (S.D.N.Y. 1979) (failure to disclose corporation's alleged policy of thwarting labor laws; matter relates to a questioning of management's business judgment not actionable under Section 14(a)).

See also *Seibert v. Sperry Rand Corp.*, 586 F.2d 949 (2d Cir. 1978) (management not required to disclose that one of

its directors was also director of five separate corporations, one of which allegedly violated labor laws); *Umbriac v. Kaiser*, 467 F. Supp. 548 (D. Nev. 1979) ; *Nemo v. Allen*, 466 F. Supp. 192 (S.D.N.Y. 1979) (no requirement to characterize facts as criminal in nature where shareholders can draw their own conclusions); *Rodman v. Grant Found.*, 460 F. Supp. 1028 (S.D.N.Y. 1978) , *aff'd*, 608 F.2d 64 (2d Cir. 1979) (direct benefit to directors/officers adequately disclosed); *Gans v. Filmways, Inc.*, 453 F. Supp. 1116 (E.D. Pa. 1978) , *aff'd*, 595 F.2d 1212 (3d Cir. 1979) ; *Freedman v. Barrow*, 427 F. Supp. 1129 (S.D.N.Y. 1976) ; *Polin v. Conductron Corp.*, 552 F.2d 797 (8th Cir. 1977) , *cert. denied*, 434 U.S. 857 (1977) ; *Cole v. Schenley Indus., Inc.*, 563 F.2d 35 (2d Cir. 1977) ; *Golub v. PPD Corp.*, 576 F.2d 759 (8th Cir. 1978) (failure to disclose true motivation of management in sale of assets and to properly characterize management bonuses). *Kass v. Arden-Mayfair, Inc.*, 431 F. Supp. 1037 (C.D. Cal. 1977) , held that it was not material to fail to inform shareholders that one of the management's candidates for the board of directors was disciplined by the Commission for alleged violations of the federal securities laws. *See also Goldberger v. Baker*, 442 F. Supp. 659 (S.D.N.Y. 1977) (the proxy rules are not violated because management has allegedly mismanaged the company and the proxy statement does not say so).

(n132)Footnote 132. 430 U.S. 462, 477-80, 97 S. Ct. 1292, 1302-05, 51 L. Ed. 2d 480, 494-96 (1977) .

(n133)Footnote 133. *See Gaines*, 645 F.2d at 779 n.33 .

(n134)Footnote 134. 645 F.2d at 779 . Such judicial rulings have not deterred the SEC's staff from imposing its own requirements on the conduct of shareholder meetings, e.g., requiring the registrant to state in its proxy material that it will not vote proxies in favor of adjournment of a meeting, if the proxies have been voted against the primary proposal.

See also the additional cases cited in n.114 *supra*, which refused to find violations of federal law in the failures of the defendants to disclose breaches of state law fiduciary obligations.

(n135)Footnote 135. 645 F.2d at 778 .

(n136)Footnote 136. 645 F.2d at 779 .

(n137)Footnote 137. *TSC Indus. Inc.*, 426 U.S. at 445 , *supra*.

The *TSC Industries* formulation of "materiality" under the proxy rules has gained acceptance as a standard under the provisions dealing with purchases and sales of securities. *See, e.g., SEC v. MacDonald*, 699 F.2d 47 (1st Cir. 1982) (Rule 10b-5 case); *Healy v. Catalyst Recovery of Pa., Inc.*, 616 F.2d 641 (3d Cir. 1980) (Rule 10b-5 case); *Alton Box Board Co. v. Goldman Sachs & Co.*, 560 F.2d 916 (8th Cir. 1977) .

(n138)Footnote 138. *Compare Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981) , *cert. denied*, 454 U.S. 1145 (1982) with *Canfield v. Rapp & Sons, Inc.*, 654 F.2d 459 (7th Cir. 1981) . *Canfield* held that the purchase of all the common stock of an issuer does not involve a "security" within the federal securities laws, because the transaction is merely the purchase of the business. To reach that conclusion, the Seventh Circuit had to reject a literal reading of the federal securities laws, which purport to extend the definition of a "security" to include "any... stock." *Contra Golden v. Garafalo*, 678 F.2d 1139 (2d Cir. 1982) .

The Ninth Circuit's ruling in *Gaines* that director misconduct is never material under the federal securities laws unless it involves self-dealing is a similar judicial inference drawn from the court's perception of the purposes of the federal securities laws. In each case, however, there is an absence of statutory language on which the judge-made limitation may be based. *Canfield* disregarded not only the definition of a "security" in the Securities Act, but also the express applicability of Sections 17 and 12(2) to private, local and small transactions. Similarly, the limitation on the duty to disclose imposed by the *Gaines* court finds no support in the sweeping terms of Section 14(a) and (c) of the Exchange Act. *Canfield* and *Gaines* thus impose limitations on the scope of the federal securities laws through an interpretative

method that is different from that used by the Supreme Court in such decisions as *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976) (language of Section 10(b), limited to manipulative or deceptive device or contrivance, requires scienter); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S. Ct. 1917, 44 L. Ed. 2d 539 (1975) (none of the express remedies contained in the Securities and Exchange Acts apply by their terms to non-purchasers or non-sellers). Cf. *Aaron v. SEC*, 446 U.S. 680, 100 S. Ct. 1945, 64 L. Ed. 2d 611 (1980) (Section 17(a)(1) of Securities Act requires scienter because language of subsection evinces Congressional intent to proscribe only knowing or intentional misconduct; subsections (2) and (3) of same Section do not require scienter in absence of terms requiring it).

The Supreme Court's reliance on the terms of the statutes in its restrictive interpretations of the securities laws and its willingness to reach the curious bifurcated result in *Aaron* with respect to Section 17(a) suggest that the limitations on the scope of the securities laws imposed by *Gaines* and *Canfield* may eventually be reversed.

(n139)Footnote 139. See Longstreth, *S.E.C. Disclosure Policy Regarding Management Integrity*, 38 *Bus. Law* 1413, 1424 (1983):

[T]he Commission found itself asking directors and officers to disclose illegal and unethical behavior and even intentions. There is no problem with compelling disclosure of such matters where they have economically material consequences. To ask management to recount all illegal actions taken over the past year or illegal intentions for the next will obviously not promote disclosure. As District Judge Pierre Leval said in *Amalgamated Clothing and Textile Workers Union v. J.P. Stevens & Co., Inc.*, [475 F. Supp. 328, 332 (S.D.N.Y. 1979) , vacated, 638 F.2d 7 (2d Cir. 1980)] "it is simply contrary to human nature' to expect management to make such disclosures."

See also *id.* at 1426 (footnotes omitted):

Looking to the future, I do not believe the Commission should require line item disclosure of something that common sense tells us will seldom, if ever, be disclosed. For example, it would be ineffective to require disclosure of all illegal acts committed by management over the past year. Investors would not be informed.

Nor do I believe the Commission should require line item disclosure of the ethical behavior of management. I have tried to write such a rule to elicit management's approach to compliance with laws--a matter on which important differences no doubt exist among companies. How close to the wind do you sail? What role does counsel play in determining whether a particular corporate initiative is legal? These questions and others might be useful to investors. However, what one quickly realizes is that a boilerplate response would immediately result from such a demand, conveying little or nothing of importance to investors.

On the other hand, disclosure of illegal acts may be required in order to answer correctly line items eliciting other corporate information. Returning to the examples mentioned at the outset, a company that describes its labor relations as satisfactory but fails to disclose that the peace it enjoys is built upon bribes paid to labor union officials has omitted a material fact necessary to make the statements not misleading.

As to ethics, it does not seem useful to demand of a director standing for election that he describe how honest he has been or what code of ethics he will bring to his job. No meaningful disclosure is likely to result. However, if, as in one of the examples, an investment company touts the responsible management and financial strength of its investment adviser in proxy materials soliciting shareholder approval of the advisory contract, it becomes necessary, to avoid misleading statements, to disclose that the adviser's parent has some twenty-two major lawsuits against it, alleging breaches of fiduciary duty

and seeking damages equal to twenty-five percent of its consolidated assets.

Similarly, in the example of a management decision to ignore a pollution statute on the basis of a cost-benefit analysis, disclosure of the likelihood and magnitude of the fines, penalties, and other effects of this policy may be necessary, although not economically material in and of themselves, to prevent other required disclosures covering the corporation's business, financial statements, capital expenditures for environmental compliance, or legal proceedings from being misleading. This was the Commission's position in the 1979 administrative proceedings against United States Steel Corporation.

(n140)Footnote 140. *Gaines, n.113 supra*, 645 F.2d at 777 n.24 .

(n141)Footnote 141. 796 F. Supp. 649 (D. Conn. 1992) .

(n142)Footnote 142. *Id.* at 654 .

(n143)Footnote 143. 772 F. Supp. 223 (E.D. Pa. 1991) . In this securities fraud class action, the plaintiffs alleged that the defendants misrepresented and concealed from the investing public the financial condition of Meridian Bancorp, Inc. On motion to dismiss, the court ruled, among other things, that the plaintiffs' complaints under Rule 14a-9 of the Exchange Act are legally sufficient. The court stated that its finding that the allegations were legally sufficient under *Rule 10b-5* establishes their sufficiency under Section 14 because there is no different standard for proxy claims under Rule 14a-9 as opposed to 10b-5. The court further ruled that the defendants' argument that there is no duty to confess mismanagement in proxy materials must fail after the *Virginia Bankshares* decision (discussed in § 7.09[5][g] *infra*). Here the plaintiffs asserted that the proxy materials failed to disclose "the utter failure of the individual defendants and the co-directors to cause Meridian to disseminate reports to the investing public and to file with the SEC documents in full compliance with the federal securities laws, and to continue [sic] to cause the Company to overstate its earnings, assets and net worth by under-reserving for loan losses." The court stated that the plaintiffs alleged that the proxy statement failed to disclose facts that a reasonable shareholder would consider important in deciding how to vote. The court also found that there was sufficient "transaction causation" as there was proof that the proxy solicitation itself, rather than the defect in the solicitation materials, served as an essential link in the accomplishment of the transaction: "where, as here, the harm alleged is the election of corporate directors on the basis of false and misleading proxy statements, the plaintiffs need not prove that the omissions or misstatements decisively affected voting." *Id.* at 229 .

(n144)Footnote 144. *United Paperworkers Int'l Union v. International Paper Co.*, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,342 (2d Cir. Feb. 12, 1993). The U.S. District Court for the Southern District of New York determined that the response by International Paper Company's board of directors to a shareholder proposal recommending the adoption of the Valdez Principles materially misrepresented the Company's environmental record, thus violating Rule 14a-9. As such, the shareholder's vote rejecting the proposal must be voided and the company's board of directors must resubmit the proposal to a vote at the next annual meeting. The board's response failed to disclose numerous recent or pending actions against it by state and federal environmental authorities, giving the total impression that the Company is a model of environmental rectitude. The board's written response to the shareholder proposal advised that the Company's "environmental conduct code in fact is both more stringent and more industry specific than the Valdez Principles." The district court found this statement misleading in violation of Rule 14a-9 and voided the vote on the proposal. The board was under no duty to discuss its environmental record in responding to the shareholder proposal and could have simply stated that it opposed the proposal. But once the board chose to offer specific representations about the Company's environmental record and policies, it was obligated to portray that record fairly. The court found the requisite transaction causation, stating that the union need only show that the board "knowingly made misleading misstatements or omissions, and that such misstatements or omissions had a *significant propensity* to affect the voting process." The court ordered that the proposal be resubmitted to a vote of shareholders. On appeal, the second circuit affirmed but modified the district court order to the effect that the sponsor of the proposal be permitted to describe the judgment in the proxy statement and to quote from the court's opinion.

See also *In re Sears Roebuck & Co. Sec. Litig.*, 792 F. Supp. 977 (E.D. Pa. 1992) , where the omission from proxy materials of information regarding settlement of an earlier suit for mismanagement was held nonmaterial (discussed in n.93 *supra*).

(n145)Footnote 145. 426 U.S. 438 (1976) , discussed at § 7.09[5], *supra*.

(n146)Footnote 146. SAB 99, quoting with approval from American Institute of Certified Public Accountants, Codification of Statements on Auditing Statements (AU) § 326.33.

(n147)Footnote 147. *Ganino v. Citizens Utilities Co.*, 228 F.3d 154 (2d Cir. 2000) .

(n148)Footnote 148. *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539 (8th Cir. 1997) .

(n149)Footnote 149. *Weiner v. The Quaker Oats Co.*, 129 F.3d 310 (3rd Cir. 1997) .

(n150)Footnote 150. 283 F. Supp. 643, 683 (S.D.N.Y. 1968) .

(n151)Footnote 151. Fed. Sec. L. Rep. (CCH) P 92,418 (S.D.N.Y. 2003), *aff'd* Fed. Sec. L. Rep. (CCH) P 92,683 (2d Cir. 2004).

(n152)Footnote 152. 394 F.3d 126 (3rd Cir. 2004) .

(n153)Footnote 153. The PSLRA sets forth a heightened pleading standard for claims based on misleading statements and omissions; the complaint must "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." See 15 U.S.C. § 78u-4(b)(1).

(n154)Footnote 154. 535 F.2d 761, 771 (3rd Cir. 1976) .

(n155)Footnote 155. 320 F.3d 373, 2003 U.S. App. LEXIS 3272 (3rd Cir. 2003) .

(n156)Footnote 156. citing 26 C.F.R. Section 1.162-27(e)(4)(iii)(A).

(n157)Footnote 157. Del. Ch., No. Civ. A. 20527 (10/2/03).

(n158)Footnote 158. 810 F.2d 336 (2d Cir. 1987) .

(n159)Footnote 159. See also the discussion in Davis, *Materiality and SEC Disclosure Filings*, 24 Sec. Reg. L.J. 180 (Summer 1996), where Mr. Davis examines the materiality standard applied by the SEC in cases involving inaccuracies in disclosure filings and finds it to be inconsistent with the meaning of materiality as applied to Section 10(b) liability cases such as *Basic, Inc. v. Levinson*, 485 U.S. 224 (1987) .

Mr. Davis concludes that "[t]he reasonable investor cares about facts that are likely to affect the value of a security, and it is these facts alone that are material. There is no other standard of materiality. A misstatement or omission in a company's disclosure filing with the SEC is material only if it affects (or could reasonably be expected to affect) the market price of the company's securities. The size of the accounting discrepancy is irrelevant if the market has not been deceived... . Only by ascertaining how the market reacted or estimating how it would react can we properly determine if a matter is material." 24 Sec. Reg. L.J. at 198.

(n160)Footnote 160. *In re DNAP Securities Litigation*, Fed. Sec. L. Rep. (CCH) P 91,212, 2000 U.S. Dist. LEXIS 13482 (N.D. Cal. 2000) .

(n161)Footnote 161. *Desaigoudar v. Meyercord*, 223 F.3d 1020 (9th Cir. 2000) .

(n162)Footnote 162. Fed. Sec. L. Rep. (CCH) P 92,294 (9th Cir. 3/7/03).

(n163)Footnote 163. Fed. Sec. L. Rep. (CCH) P 92,294 (9th Cir. 3/7/03) (citing *Resnik v. Swartz*, 303 F.3d 147 (2d Cir. 2002)) .

(n164)Footnote 164. See *United States v. Stirling*, 571 F.2d 708 (2d Cir.) , cert. denied, 439 U.S. 824 (1978) . In *Stirling*, a prospectus and annual report described labor relations as "satisfactory" and reported that issuer was "the first modular housing manufacturer to sign a national labor contract ... for both in plant production and on-site installation." It failed, however, to mention the issuer's bribery of union officials through stock transactions. The court of appeals said:

The true nature of Homex's labor relations was important to a potential investor. Once Homex decided to make representations concerning its labor relations, it should have described them accurately. Corporate funds were being used improperly to aid in the maintenance of peaceful labor relations, a fact that investors did not know. Knowledge of the true machinations would have given a prudent investor considerable pause--labor relations would not have looked as normal as they were made to appear nor would the corporate financial practices have appeared so sound.

Id. at 729 .

(n165)Footnote 165. See Longstreth, *S.E.C. Disclosure Policy Regarding Management Integrity*, 38 *Bus. Law* at 1418 *supra*:

The *Gaines* case purports to establish a per se rule of immateriality for director misconduct without the element of self-dealing--at least for proxy statements. The opinion seems to rest on the rather cynical assumption that shareholders, in exercising their rights of corporate suffrage, care plenty about a management that is stealing *from* the company, but are concerned not a whit about a management that is stealing *for* the company.

See Branch & Rubright, *Integrity of Management Disclosures Under the Federal Securities Laws*, 37 *Bus. Law*. 1447, 1479-81 (1982) (footnotes omitted):

Meaningful standards for integrity disclosures should ideally be grounded upon "objective, quantitative and uniform" criteria susceptible of meaningful application in different contexts, as one commissioner has correctly observed. Uncertain standards or standards involving ethical or moral judgments regarding illegal or unethical conduct not previously disclosed lack a clear nexus with the financial origins and purposes of the federal securities laws, are inconsistent with a self-policing mechanism of voluntary disclosure, and provide inadequate guidance to counsel on matters of critical importance. Similarly, any *per se* rule, whether it requires disclosure or permits nondisclosure of illegal conduct, is equally inconsistent with the concept of materiality irrevocably embodied in the federal securities laws. Any objective and uniform standard should be grounded upon considerations of financial materiality since the federal securities laws remain primarily concerned with matters of economic consequence to shareholders and investors. In the opinion of the authors, the materiality of senior management misconduct not involving self-dealing or prior criminal convictions should be analyzed within the same framework of financial materiality as any other conduct or circumstances relevant to making or continuing an investment in an enterprise.

In the case of conduct that does not involve self-dealing and which has not been revealed outside of

the corporation, the materiality of such conduct should be determined on the basis of two concurrent factors, both of which are ultimately grounded upon financial materiality. First, is the conduct or are the implications of the conduct directly material from a financial point of view? Second, does the conduct materially impeach the integrity of management in a manner likely to have financially material consequences relevant to the shareholder interests protected by the federal securities laws? The application of each of these factors is discussed separately below.

With regard to direct financial materiality, objective criteria for evaluating the materiality of the conduct should be derived by analogy to the standards of financial materiality applicable to conduct not involving senior management integrity. To the extent that the commission's analysis of the materiality of management misconduct relates such conduct to foreseeable, financially material consequences, the commission's analysis in its *Report on Questionable Payments* is unobjectionable. For example, if the conduct actually subjects material portions of the corporation's business to greater than ordinary risks, the conduct may be material. Similarly, if the conduct has already been revealed and thereby subjects the corporation to significant risks of damaging penalties or prohibitions, the directly foreseeable consequences of the conduct may be material.

In the case of conduct not previously disclosed, there must also be an analysis of the likelihood that the consequences will be realized, which in turn focuses upon an analytical framework analogous to the standards for financial statement disclosure of contingent liabilities. *Financial Accounting Standards Bulletin No. 5* (FASB No. 5), which addresses the scope of disclosures to be made in financial statements regarding contingent liabilities, provides that "[d]isclosure is not required of a loss contingency involving an unasserted claim or assessment when there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless it is considered probable that a claim will be asserted and there is a reasonable possibility that the outcome will be unfavorable."

(n166)Footnote 166. SEC Report On Questionable and Illegal Corporate Payments and Practices 14-15 (May 1976).

Accord Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 118 (2d Cir. 1982) (grant of Rule 10b-5 motion to dismiss reversed). *See also SEC v. Jos. Schlitz Brewing Co.*, 452 F. Supp. 824 (E.D. Wis. 1978) (on motion to dismiss Rule 10b-5 and Section 17(a) claims).

(n167)Footnote 167. SEC Report On Questionable and Illegal Corporate Payments and Practices 14-15 (May 1976), *supra*.

(n168)Footnote 168. SEC Report On Questionable and Illegal Corporate Payments and Practices 14-15 (May 1976), *supra*.

For example, public knowledge that a company is making such illegal payments, even of a minor nature, in one foreign country could cause not only expropriation of assets in that country but also a similar reaction or discontinuation of material amounts of business in other countries as well.

The Commission noted that this had in fact occurred in the case of a major oil company.

(n169)Footnote 169. *Compare Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982), with *Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111 (2d Cir. 1982). As previously noted, the court in *Gaines* stated that there were clearly instances of illegal conduct by director-nominees unrelated to self-dealing that would have to be disclosed especially if they involved criminal convictions.

(n170)Footnote 170. See *Decker*, 681 F.2d at 118-19 . But cf. *Maldonado v. Flynn*, 597 F.2d 789 (2d Cir. 1979) .

(n171)Footnote 171. *Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981) , cert. denied, 454 U.S. 1145 (1982) ; *Maldonado v. Flynn*, 597 F.2d 789 (2d Cir. 1979) ; *Bertoglio v. Texas International Co.*, 488 F. Supp. 630 (D. Del. 1980) . In *Maldonado*, the Second Circuit, per Mansfield, J., addressed plaintiff's claim that the directors violated Section 14(a) by failing to disclose in the proxy materials that they had modified a stock option plan for their own benefit:

Since self-dealing presents opportunities for abuse of a corporate position of trust, the circumstances surrounding corporate transactions in which directors have a personal interest are directly relevant to a determination of whether they are qualified to exercise stewardship of the company. *Goldsholl v. Shapiro*, 417 F. Supp. 1291, 1298-99 (S.D.N.Y. 1976) . For this reason Rule 14a-9 specifically sets out minimum standards for disclosure and, going beyond the Rule, it has been recognized that shareholders are entitled to truthful presentation of factual information 'impugning the honesty, loyalty or competency of directors' in their dealings with the corporation to which they owe a fiduciary duty.

See also *Texas Partners v. Conrock, Inc.*, 685 F.2d 1116 (9th Cir. 1982) , cert. denied, 460 U.S. 1029 (1983) , in which the court held that omissions in a proxy statement proposing antitakeover amendments to an issuer's charter may have been materially misleading.

See also *SEC v. Parklane Hosiery, Inc.*, 558 F.2d 1083 (2d Cir. 1977) , held that the failure of the proxy materials to disclose that the reason that the company was engaging in a "going private" merger was to pay off the personal debts of its principal shareholder was a material nondisclosure.

But see *GAF Corp. v. Heyman*, 724 F.2d 727 (2d Cir. 1983) (failure of dissident shareholder seeking seat on issuer's board to disclose unadjudicated charges of breach of fiduciary duty by family member in unrelated state litigation held not to be material omission).

But see *Berg v. First American Bankshares, Inc.*, 796 F.2d 489 (D.C. Cir. 1986) (failure to report in a proxy statement that a principal shareholder who endorsed a proposed merger intended to use the proceeds from the sale of his shares to provide liquidity needed to settle his estate was not a material omission, since there was no indication that this factor influenced the shareholder's opinion as to the fairness of the price).

Accord *Kas v. Financial Gen. Bankshares*, 796 F.2d 508 (D.C. Cir. 1986) .

(n172)Footnote 172. See Longstreth, 38 Bus. Law at 1423 *supra* (footnotes omitted):

For one given to speculate about the future, it is interesting to ponder where investor notions of materiality may lead the Commission in the years ahead. Over the past two decades, noninsured pension funds, both private and public, have been distinctly the fastest growing group of equity owners in the United States, increasing their share of the aggregate market value for all stocks listed on the New York Stock Exchange from less than five percent in 1960 to 17.7% in 1980. While Peter Drucker appears to have grossly exaggerated the numbers, he is no doubt correct in predicting an acceleration of this trend toward employee ownership of, as he put it, "the means of production." This new group of investors might insist on disclosure different from what we now offer. For example, they might instruct their trustees to insist on satisfactory disclosure as to labor practices, retirement plans, corporate governance, political activities, plant closing and relocation policies or other aspects of the business not considered, today, as sufficiently material to investors to warrant compulsory disclosure.

(n173)Footnote 173. State law on proxy solicitation is barely rudimentary in some respects. Beyond authorization of voting by proxy, which was not permitted under common law absent a bylaw or charter provision, the statutes are silent. They generally do not purport to regulate proxy solicitation and are generally silent on the points of mechanics and information requirements. Eisenberg, *Access to the Corporate Proxy Machinery*, 83 Harv. L. Rev. 1489, 1491-92 (1970). See generally Cavitch, Business Organizations, ch.110 (Matthew Bender).

In the case of the corporations subject to the Exchange Act proxy requirements, that is a particularly troublesome aspect of state law because the proxy solicitation is in fact the functional equivalent of the shareholders meeting in a smaller company. In the large corporation context, the proxy solicitation supplants the shareholders meeting. *Id.* at 1494. In the usual situation, the proxy solicitation has determined the results of the meeting in advance and the effect of the meeting itself is merely to confirm the results of the solicitation.

(n174)Footnote 174. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 381, 90 S. Ct. 616, 620, 24 L. Ed. 2d 593 (1970):

The decision below, by permitting all liability to be foreclosed on the basis of a finding that the merger was fair, would allow the stockholders to be bypassed, at least where the only legal challenge to the merger is a suit for retrospective relief after the merger has been held. A judicial appraisal of the merger's merits could be substituted for the actual and informed vote of the stockholders.

(n175)Footnote 175. *United States v. Stirling*, 571 F.2d 708 (2d Cir.), cert. denied, 439 U.S. 824, 99 S. Ct. 93, 58 L. Ed. 2d 116 (1978).

See *Zell v. Intercapital Income Sec., Inc.*, 675 F.2d 1041 (9th Cir. 1982), in which the court reversed the grant of the defendant's motion for summary judgment because the failure of the proxy statements, which solicited approval by an investment fund's shareholders of investment advisory agreements with an investment manager, to disclose a score of lawsuits charging violations of state and federal laws pending against the parent of the investment manager and the parent's brokerage subsidiary may have been a material omission since there was a substantial likelihood that a reasonable stockholder of the fund would consider the financial condition and quality of the management of the parent and its subsidiary to have actual significance in deciding whether to approve the agreements.

See *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149 (D.C. Cir. 1978); *Trans World Airlines v. Catalano*, [1979-1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) § 97,159 (S.D.N.Y. Oct. 31, 1979).

In *Berg v. First American Bankshares, Inc.*, 796 F.2d 489 (D.C. Cir. 1986), the court observed that where a proxy statement sets forth the factors considered by one of the issuer's principal shareholders in endorsing a proposed merger, there is an obligation to portray them accurately and completely. The court held, however, that there was no material misrepresentation or omission in describing the factors considered by the shareholder.

(n176)Footnote 176. 426 U.S. 438, 96 S. Ct. 2126, 48 L. Ed. 2d 757 (1976), mot. denied, 429 U.S. 810 (1976). See *Spielman v. General Host Corp.*, 538 F.2d 39 (2d Cir. 1976) ("total mix" of communications rendered potentially misleading omission harmless). In *Mills v. Esmark, Inc.*, 544 F. Supp. 1275 (N.D. Ill. 1982), the court held that the description in a proxy statement of a company's employee incentive plan that used net earnings per common share as the measure of awards under the plan was materially misleading because the total mix of information available to shareholders suggested that the plan was intended to compensate the employees for their contribution to long-term corporate growth rather than their contribution to capital gains, even if in isolation the phrase "net earnings per common share," when used to describe long-term growth of the plan, would be deemed by a reasonable investor to include capital gains.

But see *Freedman v. Value Health, Inc.*, Fed. Sec. L. Rep. (CCH) P 91,791 (2d Cir. 2003), which held that the

District Court of Connecticut had properly dismissed a fraud claim on materiality grounds in finding that a prospectus describing a proposed merger had adequately disclosed all material facts; the company was not required to disclose all internal profit projections if the disclosures as a whole were not materially misleading. Claims that the merger partner falsely stated that he had a "thriving" business were "mere puffery" and were likewise not material.

(n177)Footnote 177. *Gladwin v. Medfield Corp.*, 540 F.2d 1266, 1270 (5th Cir. 1976) ; *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 265 (3d Cir.) , cert. denied, 409 U.S. 874 (1972) .

But see Kennecott Copper Corp. v. Curtiss-Wright Corp., 584 F.2d 1195 (2d Cir. 1978) (court noted that Kennecott in its own proxy materials, repeating language from Curtiss-Wright material, found no need to clarify certain terms). *See also General Time Corp. v. Talley Indus., Inc.*, 403 F.2d 159, 162 (2d Cir. 1968) , cert. denied, 393 U.S. 1026 (1969) ; *McConnell v. Lucht*, 320 F. Supp. 1162, 1164 (S.D.N.Y. 1970) .

(n178)Footnote 178. *See In re BEA Systems, Inc. Shareholder Litigation*, Del. Ch. No. 3298 (March 26, 2008) where the Delaware Chancery Court refused to enjoin Oracle's cash acquisition of BEA, stating that the omission from BEA's proxy material of elements of BEA's financial advisor's presentation to the BEA board did not make disclosure of such elements mandatory where no showing was made that the board relied on such information or found it reliable.

Similarly, the failure of Morgan Stanley to include in its annual meeting proxy material the fact that the company had received a Wells notice from the SEC was not per se a material omission. *In re Morgan Stanley Derivative Litigation*, No. 05 Civ. 6515 (SDNY March 27, 2008).

In *Markewich v. Adikes*, 422 F. Supp. 1144 (E.D.N.Y. 1976) , the failure of the proxy material to reveal alleged inaccuracies in the company's annual reports and financial statements was held not to be a violation of the proxy rules because the alleged inaccuracies did not relate to the purpose of the proxy solicitation. The court also held that the mere mention of these annual reports and financial statements in the proxy material did not incorporate them by reference into the proxy material.

Cf. Maldonado v. Flynn, 597 F.2d 789 (2d Cir. 1979) : "The prevailing definition of a 'material fact' under Rule 14a-9 presupposes that the rule applies only when shareholders are asked to vote... ." *Cf. Bertoglio v. Texas International Co.*, 488 F. Supp. 630, 650 (D. Del. 1980) .

See also Pavlidis v. New England Patriots Football Club, Inc., 737 F.2d 1227 (1st Cir. 1984) (although a corporate officer's self-dealing would be material in a proxy soliciting votes for the reelection of that officer, it was not material to the question of whether to accept the amount offered for the defendant's stock).

In *Kas v. Financial Gen. Bankshares, Inc.*, 796 F.2d 508 (D.C. Cir. 1986) , the court held that in a proxy statement soliciting shareholder approval of a proposed merger, the dual role of two attorneys who were counsel to the acquiring company and directors of the target company was properly disclosed, despite the failure of the statement to expressly characterize the dual role as a "potential conflict of interest."

(n179)Footnote 179. *Mills v. Electric Autolite Co.*, 403 F.2d 429 (7th Cir. 1968) , vacated on other grounds, 396 U.S. 375 (1970) ; *Gould v. American Hawaiian Steamship Co.*, 331 F. Supp. 981 (D. Del. 1971) , aff'd, 535 F.2d 761 (3d Cir. 1976) ; *Kohn v. American Metal Climax, Inc.*, 322 F. Supp. 1331 (E.D. Pa. 1971) , aff'd, 458 F.2d 255 (3d Cir. 1972) .

But see Smallwood v. Pearl Brewing Co., 489 F.2d 579, 602 (5th Cir.) , cert. denied, 419 U.S. 873 (1974) (footnote omitted):

We have already stated that the information required in a proxy statement is extensive. Difficult decisions must be made as to what information to place toward the beginning and what to place further

toward the end of proxy statements, what to emphasize and what to state more blandly. It is, of course, impossible to emphasize everything, and every fact cannot be contained in the beginning. *DiJulio v. Digicon, Inc.*, 339 F. Supp. 1284, 1290 (D. Md. 1972) . We require those who draw up proxy statements to be fair and sensitive to the needs of shareholders in exercising their rights of corporate suffrage. But we do not require that the writers of proxy statements be clairvoyant. A fact essential for a shareholder decision today may become irrelevant tomorrow, and vice versa. It is enough that proxy statements be complete and not misleading in light of the circumstances existent and reasonably anticipated at the time distributed.

(n180)Footnote 180. 478 F.2d 1281, 1297 (2d Cir. 1973) (quoting *Richland v. Crandall*, 262 F. Supp. 538, 554 (S.D.N.Y. 1967)) .

(n181)Footnote 181. 478 F.2d at 1297 .

(n182)Footnote 182. Disclosure to Investors--A Reappraisal of Administrative Policies Under the '33 and '34 Act (1969).

(n183)Footnote 183. 332 F. Supp. 544 (E.D.N.Y. 1971) .

(n184)Footnote 184. See *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 96 S. Ct. 2126, 48 L. Ed. 2d 757 (1976) .

(n185)Footnote 185. 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied sub nom. *Coates v. SEC*, 394 U.S. 976 (1969) .

But see *Sunray DX Oil Co. v. Helmerich & Payne, Inc.* 398 F.2d 447 (10th Cir. 1968) ; *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90 (10th Cir. 1971) , cert. denied, 404 U.S. 1004 (1971) .

(n186)Footnote 186. 401 F.2d at 849 .

(n187)Footnote 187. *Harkavy v. Apparel Industries, Inc.*, 571 F.2d 737 (2d Cir. 1978) .

See also *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971) , discussed in n.147 *supra* (Securities Act case; investigations concerning various proposals for planned reorganization need not be disclosed in takeover offer).

(n188)Footnote 188. 478 F.2d 1281 (2d Cir. 1973) .

See also *James v. Gerber Prods.*, 587 F.2d 324, 327 (6th Cir. 1978) ; *Radol v. Thomas*, 534 F. Supp. 1302 (S.D. Ohio 1982) ; *Efros v. Nationwide Corp.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,077 (S.D. Ohio Jan. 17, 1983) (the failure to provide preliminary budget projections from subsidiaries was not a material omission; preliminary figures are purely speculative); *Caspary v. Louisiana Land & Exploration Co.*, 579 F. Supp 1105 (S.D.N.Y. 1983) (failure to disclose predictions of future recovery rates and exploration costs of oil company not material omission).

See also *Pavlidis v. New England Patriots Football Club, Inc.*, 737 F.2d 1227 (1st Cir. 1984) . See also *Basic Inc. v. Levinson*, 485 U.S. 224, 108 S. Ct. 978, 99 L. Ed. 2d 194 (1988) , declaring that the materiality of a contingent event, such as a prospective merger, depends upon a balancing of the indicated probability that the event will occur and the anticipated magnitude of the event.

(n189)Footnote 189. See *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1955) , *aff'd*, 235 F.2d 369 (3d Cir. 1956) (*Rule 10b-5*; failure by purchaser to reveal appreciated value of tobacco inventory).

See also *United States Smelting, Refining & Mining Co. v. Clevite Corp.*, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,691 (N.D. Ohio June 17, 1968) (failure to disclose higher offer for merger.)

(n190)Footnote 190. *478 F.2d at 1294-95*. It was not necessary to determine the materiality of the firm offers, however, because of the failure of the acquiror's management to describe its intent "to pursue aggressively the policy of selling" the acquired company's assets. Judge Friendly thus split the question to arrive at the more traditional ground of liability for failure to disclose the defendant's intention to sell the assets upon completion of the merger while knowing of the undisclosed appreciation in value.

(n191)Footnote 191. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970), discussed in § 7.09[4][a] and § 7.09[5][f][ii] *supra*.

(n192)Footnote 192. See *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (*Rule 10b-5*, purchase by undisclosed insiders); *Janigan v. Taylor*, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965). A *Rule 10b-5* case, *Janigan* involved purchases by a general manager who stated that business was "about the same": "One month after the stockholders meeting the defendant made an offer himself and the representation in question. Essentially the representation was false because there had been a firming of prices and an increasing backlog of orders such that the first quarter of 1956 could be expected by defendant, due to his detailed knowledge, to show a profit." *344 F.2d at 785*. Furthermore, the court found various changes in practice with respect to pricing of inventory, and actual alterations to conceal an improvement in profits.

Viewed against a background of past fluctuations, we might not find the misrepresentation to be of the importance intimated by the court's opinion. Certainly it could not be claimed that the change presaged the dramatic improvement that occurred subsequently in the company's affairs, or that the defendant could have any thought that it did. On the other hand, even as a new upswing not uncharacteristic of the business, plus some promising overtones, we could not find that as a matter of law the true situation was fairly disclosed, within the heavy requirements of the Act, by the single statement that things were "about the same."

344 F.2d at 785.

(n193)Footnote 193. 1992 Del. Ch. LEXIS 80.

(n194)Footnote 194. [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,819 (2d Cir. Mar. 7, 1991). The court held that "the motivation of a controlling shareholder for favoring a course proposed in a proxy statement must be disclosed when there is a substantial likelihood that its disclosure will have a significant bearing on a reasonable shareholder's assessment of the recommended course of action." Applying this test, the Second Circuit found that the lower court improperly dismissed a Loehmann's shareholder's claim under Section 14(a) of the Securities and Exchange Act that the merger proxy misleadingly failed to disclose that the Loehmann family needed cash to pay estate taxes.

See *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 111 S. Ct. 2749, 115 L. Ed. 2d 929 (1991), holding that knowingly false statements purporting to explain directors' reasons for recommending certain corporate actions may be actionable under Section 14(a), even though the statements are conclusory in form.

But see *Freer v. Mayer*, 796 F. Supp. 89 (S.D.N.Y. 1992), holding that failure to disclose the business purpose for a company's entering into a retirement agreement with its former chief executive officer was not a material omission when all the relevant details of the agreement were disclosed. The court reasoned that, if a shareholder believed the execution of the retirement agreement "was a business decision that reflected poorly on a particular director, he or she could vote against that director's election." However, the court emphasized "the directors were under no duty to disclose

their motives, either pure or unclean, so long as all of the information concerning the deal was revealed in the supplemental proxy... . There is no duty to disclose mere mismanagement."

See also *meVC Draper Fisher Jurvetson Fund I, Inc. v. Millennium Partners, L.P.*, 260 F. Supp. 2d 616 (S.D.N.Y. 2003) where the court held that participants in a proxy fight are not required to reveal in their proxy materials what their strategy will be in the event that they prevail in the proxy fight. Similarly, in *Tracinda Corp. v. DaimlerChrysler AG*, 502 F. 3d 212 (3d Cir. 2007), the Third Circuit affirmed dismissal of proxy fraud claims that the merger of Daimler-Benz AG and Chrysler Corp. was misrepresented as a "merger of equals." The court affirmed the district court's factual finding that the proxy and associated documents contained no material misrepresentations despite the fact that, subsequent to the merger, resignations and changes in the board of directors of the resulting company resulted in control of the company shifting to the prior management of Daimler-Benz. Plaintiffs had alleged that had they known the merger was a takeover rather than a merger of equals, they would have demanded a change in control premium upon consummation of the merger, and that the conclusion of the district court that the corporate governance provisions in the merger agreement applied only until the moment in time when DaimlerChrysler was created rendered the entire proxy solicitation process meaningless. The court observed that a management board perpetually divided between five Daimler-Benz designees and five Chrysler designees is "potentially unworkable and legally flawed. Upon closing, Daimler-Benz and Chrysler merged into one new company, at which point there were no longer two independent companies to make future board membership designations."

(n195)Footnote 195. 501 U.S. 1083, 111 S. Ct. 2749, 115 L. Ed. 2d 929 (1991) .

(n196)Footnote 196. 111 S. Ct. at 2760, *supra*.

A merger proxy statement was held not to be materially misleading in failing to disclose defendant CEO's alleged state of mind that he did not intend to comply with a "no-shop" provision in a merger agreement where it was clear on the face of the provision that the company could be acquired by a third party on payment of a large breakup fee. In re U.S. West, Inc., Securities Litigation, Fed. Sec. L. Rep. (CCH) P 92,429 (3rd Cir. 2003).

(n197)Footnote 197. *Id.* at 2767 (citations omitted).

(n198)Footnote 198. See § 7.09[5][h] *infra*.

The Court specifically refrained from deciding whether an action would have been sustainable had the plaintiff lost a remedy under state law, such as an appraisal right by being induced by a misleading statement to vote in favor of the merger, or a loss of an opportunity to enjoin the transaction under state law, 111 S. Ct. at 2765-66 (citing *Swanson v. American Consumers Indus., Inc.*, 475 F.2d 516 (7th Cir. 1973); *Healey v. Catalyst Recovery of Pennsylvania, Inc.*, 616 F.2d 641, 647-48 (3d Cir. 1980)). Justice Souter pointed out that no appraisal right existed in Virginia for bank mergers in the first place, and that there was no evidence that any state remedy by way of injunctive relief had been lost (dismissing a suggestion by Justice Kennedy that such a state remedy might be lost if Virginia's standard of materiality were different from the federal standard, as having no evidence in the record to support it).

Subsequently, *Howing Co. v. Nationwide Corp.*, 972 F.2d 700 (6th Cir. 1992), held that a Section 13(e) damage action should be sustained based on loss of the state remedy of appraisal, despite a strong dissent claiming that the appraisal remedy had been deliberately abandoned in favor of pursuing the Section 13(e) claim (the court finding that Sections 13(e) and 14(a) are governed by similar rules.) The Sixth Circuit concluded that minority shareholders who lost certain state appraisal rights when they were frozen out in a 1982 "going private" transaction still have valid proxy claims under Section 13(e) of the Exchange Act, even though the majority shareholders did not need any minority votes to meet shareholder approval requirements for the transaction. The court found that the minority shareholders' loss of their state law appraisal remedy in connection with the freeze-out merger satisfied Section 13(e)'s causation requirement.

The dispute started when Nationwide Corp. ("Nationwide") merged in 1982 with one of its parent companies, Nationwide Mutual Ins. Co. ("Nationwide Mutual"). Nationwide Mutual and another company, Nationwide Mutual Fire Ins. Co. ("Nationwide Fire"), together owned 85 percent of Nationwide immediately before the merger. In November 1982, Nationwide's directors approved the freeze-out, which called for Nationwide Mutual and Nationwide Fire to acquire the approximately 15 percent of Nationwide shares still publicly held. Shareholder approval of the transaction required a favorable vote from a simple majority of the shares; hence, with the combined 85 percent ownership of Nationwide's two parents, the outcome of the shareholder vote was a foregone conclusion. After approval of the merger, two Nationwide shareholders brought a class action alleging that Nationwide and Nationwide Mutual violated Section 13(e) and breached their fiduciary duty under state law.

The district court granted summary judgment in favor of the defendants, ruling that the premerger proxy solicitation's compliance with Rule 13e-3 was adequate, and that any omissions were not material. After also ruling that statutory appraisal under Ohio law was the plaintiff's only state law remedy--a remedy they failed to assert--the district court dismissed the complaint. The Sixth Circuit decided that the reasoning and result in *Virginia Bankshares* did not preclude the Nationwide minority shareholders from bringing their Section 13(e) claims. The Nationwide plaintiffs argued that causation should be recognized when a misleading proxy statement induces minority shareholders to forfeit a state law remedy such as appraisal. Agreeing with the plaintiffs, the Sixth Circuit concluded that the Supreme Court in *Virginia Bankshares* did not intend to close the door on the minority shareholders who lacked the power to block a transaction. Thus, loss of a state law remedy can support a Section 13(e) action.

In *Benton Inv. Co. v. Interstate-Johnson Lane Inc.*, 24 *Sec. Reg. & L. Rep. (BNA)* 1552 (M.D. N.C. 1992), the court found that the plaintiff had shown a likelihood of success on its claims that the proxy solicitation was defective because one of two general partners allegedly failed to disclose that removing the other general partner (the plaintiff) from the limited partnership would trigger default provisions in a partnership loan agreement. In a related claim about a second limited partnership, the plaintiff failed to show a likelihood of success where it alleged that the proxies failed to disclose the defendant's financial interest in plaintiff's removal as general partner, misstated the administrative savings that the limited partnership would have as a result of plaintiff's removal, falsely stated that the defendant had certain management experience that it lacked, and falsely stated that the defendant had negotiated first mortgage financing for a shopping mall.

(n199)Footnote 199. 152 *Fed.Appx.* 674 (9th Cir. 2005) .

(n200)Footnote 200. 2007 U.S. Dist. LEXIS 5283 (N.D. Cal. 2007) .

(n201)Footnote 201. *Seinfeld v. Barrett, et al.*, 2006 U.S. Dist. LEXIS 14827 (March 31, 2006) .

(n202)Footnote 202. *Grace v. Rosenstock*, 228 *F.3d* 40, *Fed. Sec. L. Rep. (CCH)* P 91,058 (2d Cir. 2000) .

(n203)Footnote 203. For further discussion of causation and culpability, see § 7.09[6] *infra*.

(n204)Footnote 204. Section 21(d) of the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section F, 15 *U.S.C. § 78u(d)*, authorizes a Commission action for an injunction whenever any person "is engaged or is about to engage" in a violation of the Act or the rules and regulations under the Act. See the discussion in § 7.09[5][f][i] *supra*. As previously discussed in § 7.09[5][b][i] *supra*, the Commission is not required to show that irreparable injury is threatened, thus dispensing with even a prospective showing of causation. Although a private party must demonstrate threatened irreparable harm, see § 7.09[5][b][ii] *supra*, to obtain injunctive relief, that is a less burdensome requirement than proving after the fact that a violation caused specific injury. See *Ash v. GAF Corp.*, 723 *F.2d* 1090 (3d Cir. 1983) . There is, moreover, an inclination on the part of the courts to take preventive action in the early stages of a proxy violation, before the court's alternatives are reduced by corporate action. See *Electronic Specialty Co. v. International Controls*, 409 *F.2d* 937 (2d Cir. 1969) (Friendly, J.); *Denison Mines Ltd. v. Fibreboard Corp.*, 388 *F. Supp.* 812 (D. Del. 1974) .

(n205)Footnote 205. See § 7.09[5][f][ii][A] *supra*. As explained in that discussion, the focus of the concept of "materiality" is on the anticipated effects of the fact in question on the deliberations of shareholders.

(n206)Footnote 206. *SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir.) , *cert. denied*, 332 U.S. 847 (1947) .

(n207)Footnote 207. See *Ash v. GAF Corp.*, 546 F. Supp. 89, 94 (E.D. Pa. 1982) , *aff'd*, 723 F.2d 1090 (3d Cir. 1983) . GAF had mailed its annual report by third-class mail and its proxy statement five days later by first class mail. Plaintiff Ash complained when the annual report arrived long after the proxy statement, and claimed that GAF failed to comply with the rule requiring that the annual report "precede the proxy solicitation," a complaint that the court rejected as not significant in the absence of evidence that the violation reasonably could be thought to have affected the election. The opinion goes on to state that "courts in this circuit, as well as in other circuits, have rejected the principle that a violation of the rules is sufficient in itself. Something more must be shown: that the integrity of the election was impaired." 546 F. Supp. at 92 .

See § 7.09[5][b][i] *supra*, concerning the Commission's relatively light burden for obtaining relief.

(n208)Footnote 208. Cf. *Hecht Co. v. Bowles*, 321 U.S. 321, 64 S. Ct. 587, 88 L. Ed. 754 (1944) (standards of the public interest, not the requirements of private litigation, determine whether injunction will issue).

(n209)Footnote 209. 609 F.2d 650 (2d Cir. 1979) , *cert. denied*, 445 U.S. 951 (1980) .

(n210)Footnote 210. 609 F.2d at 654 (quoting *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970)) .

Accord *Gaines v. Haughton*, 645 F.2d 761, 775-76 (9th Cir. 1981) , *cert. denied*, 454 U.S. 1145 (1982) .

In *Sisters of the Precious Blood, Inc. v. Bristol-Myers Co.*, 431 F. Supp. 385 (S.D.N.Y. 1977) , the court held that an issuer's alleged misrepresentations in a proxy statement in connection with its opposition to a shareholder's defeated proposal did not entitle the shareholder to an injunction requiring the issuer to resubmit the proposal to stockholders, since the proposal was precatory and not mandatory. Therefore, even if the proposal, which *requested* the issuer to report to shareholders certain information concerning the sales of one of its product lines, had carried, it would not have bound the corporation to provide the requested report. As a result, plaintiff could not show transaction causation, *i.e.*, that the proxy solicitation and vote resulted in some action by the issuer.

But see Trans World Corp. v. Odyssey Partners, 561 F. Supp. 1315 (S.D.N.Y. 1983) , in which the court, distinguishing *Sisters of the Precious Blood*, declined to dismiss Section 14(a) claims based on the defendants' solicitation of the issuer's shareholders to support a nonbinding resolution requesting the issuer's board of directors to develop a program for splitting the issuer into two separate, independent entities. The court observed that unlike *Sisters of the Precious Blood*, which involved a resolution merely requesting an information report, the present case involved a proposal concerning a change in the management or structure of the corporation, and that substantial shareholder support for the action would exert a substantial influence on management policies.

(n211)Footnote 211. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970) , discussed in § 7.09[4][a] and § 7.09[5][f][ii] *supra* .

(n212)Footnote 212. 544 U.S. 336, 125 S.Ct. 1627, 161 L. Ed. 2d 577 (2005) .

(n213)Footnote 213. 378 F.Supp.2d 561 (C.D. Md. 2005) .

(n214)Footnote 214. 2005 U.S. Dist. LEXIS 19506 (Sept. 6, 2005) .

(n215)Footnote 215. See "Proving Loss Causation After 'Dura': What's Happening in the Lower Federal Courts?"

by Richard A. Rosen, *BNA Corporate Counsel Weekly*, Jan. 4, 2006.

(n216)Footnote 216. 2009 U.S.App. LEXIS 3032 , No. 07-5119 (10th Cir. February 18, 2009).

(n217)Footnote 217. 501 U.S. 1083, 111 S. Ct. 2749, 115 L. Ed. 2d 929 . See further discussion of culpability in § 7.09[6][b], *infra* .

(n218)Footnote 218. 501 U.S. 1301, 112 S. Ct. 1, 115 L. Ed. 2d 1087, 1090, note 5 .

(n219)Footnote 219. *Beck v. Dobrowski, et al.*, 2009 U.S.App. LEXIS 5807 (7th Cir. March 20, 2009) .

(n220)Footnote 220. § 31, p. 169 (5th ed. 1984).

(n221)Footnote 221. 15 U.S.C. § 78 u-4 (b)(2).

(n222)Footnote 222. *Knollenberg v. Harmonic, Inc.*, 152 Fed. Appx. 674, 2005 U.S. App. LEXIS 24274 (9th Cir. 2005) .

(n223)Footnote 223. 223 F. Supp. 2d 1142 (D. Pa. 2002) .

(n224)Footnote 224. 264 F. 3d 131 (2d Cir. 2001) .

(n225)Footnote 225. *Buxbaum v. Deutsche Bank, A.G.*, 2000 U.S. Dist. LEXIS 5838 (S.D.N.Y. 2000) .

(n226)Footnote 226. *In re MCI WorldCom, Inc. Securities Litigation*, 93 F. Supp. 2d 276 (E.D.N.Y. 2000) .

(n227)Footnote 227. 551 U.S. 308, 127 S. Ct. 2499 (June 21, 2007) .

(n228)Footnote 228. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 513 F.3d 702 (7th Cir. 2008) .

(n229)Footnote 229. See § 7.09[5][j][iv] *infra*.

(n230)Footnote 230. See § 7.09[5][b][i] *supra*.

(n231)Footnote 231. See, e.g., *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, 584 F.2d 1195, 1200-01 (2d Cir. 1978) ; *Twentieth Century Fox Film Corp. v. Lewis*, 334 F. Supp. 1398, 1402-03 (S.D.N.Y. 1971) ; *Kass v. Arden-Mayfair, Inc.*, 431 F. Supp. 1037, 1041-42 (C.D. Cal. 1977) ; *Kauder v. United Board & Carton Corp.*, 199 F. Supp. 420, 423 (S.D.N.Y. 1961) .

(n232)Footnote 232. *United Canso Oil & Gas, Ltd. v. Clark*, 497 F. Supp. 111 (S.D.N.Y. 1980) .

(n233)Footnote 233. See *Kass*, 431 F. Supp. at 1041 .

(n234)Footnote 234. *United Canso Oil & Gas*, 497 F. Supp. at 115 ; *McConnell v. Lucht*, 320 F. Supp. 1162, 1166 (S.D.N.Y. 1970) (at the "zero hour").

(n235)Footnote 235. *Kennecott Copper*, 584 F.2d at 1200-01 . The court of appeals had previously stayed the trial court's decree, *id.* at 1200 , but the district court *opinion* was viewed as prejudicial to the defendant because of certain critical remarks.

(n236)Footnote 236. *Twentieth Century Fox Film Corp. v. Lewis*, 334 F. Supp. 1398, 1402 (S.D.N.Y. 1971) .

(n237)Footnote 237. See *Kennecott Copper*, 584 F.2d at 1200 .

(n238)Footnote 238. *McConnell*, 320 F. Supp. at 1165 , quoted with approval in *Kennecott Copper*, 584 F.2d at 1200 .

(n239)Footnote 239. See *McConnell*, 320 F. Supp. at 1166 .

But see Rule 14a-9(b) (Commission review or examination not a finding that the material is accurate or complete).

See also the following cases which rejected the notion that any inference should be drawn from the Commission's inaction respecting alleged violation of its rules: *Klastorin v. Roth*, 353 F.2d 182 (2d Cir. 1965) ; *Miller v. Steinbach*, 268 F. Supp. 255 (S.D.N.Y. 1967) ; *Millimet v. George Fuller Co.*, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,570 (S.D.N.Y. Aug. 19, 1965).

In *J.I. Case v. Borak*, 377 U.S. 426, 84 S. Ct. 1555, 12 L. Ed. 2d 423 (1964) , the Supreme Court noted:

The Commission advises that it examines 2,000 proxy statements annually and each of them must necessarily be expedited. Time does not permit an independent examination of the facts set out in the proxy material and this results in the Commission's acceptance of the representation contained therein at their face value, unless contrary to other material on file with it.

377 U.S. at 432, 84 S. Ct. at 1560, 12 L. Ed. 2d at 428 .

The transaction at issue in *Borak* occurred prior to 1964, the year in which issuers of over-the-counter securities became subject to the proxy, reporting and short swing insider trading provisions of the Exchange Act, thereby increasing the Commission's burden in reviewing submitted materials. The Commission's Annual Report for the year 1982 states that it handled a record 65,000 full disclosure filings during fiscal year 1982, a 5% increase over the 62,000 handled in fiscal 1981. The most complex filings, including merger proxy statements, were also at record levels.

(n240)Footnote 240. *General Time Corp. v. Talley Indus., Inc.*, 403 F.2d 159, 163 (2d Cir. 1968) , cert. denied, 393 U.S. 1026 (1969) (per Judge Friendly); *Twentieth Century Fox Film*, 334 F. Supp. at 1401-02 ("In this connection, the Court thinks it is significant that the Securities and Exchange Commission, which has these statements before it and is apprised of plaintiff's contentions... has taken no action... ."); *Brooks v. Standard Oil Co.*, 308 F. Supp. 810 (S.D.N.Y. 1969) ; *Walpert v. Bart*, 280 F. Supp. 1006 (D. Md. 1967) ; *Union P. R. Co. v. Chicago & N.W. Ry. Co.*, 226 F. Supp. 400 (N.D. Ill. 1964) ; *Dunn v. Decca Records*, 120 F. Supp. 1 (S.D.N.Y. 1954) ; see also *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973) (reliance by proxy solicitor on long-standing commission policy against disclosure of asset appraisals). Cf. *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970) , vacated, 404 U.S. 403 (1972) .

(n241)Footnote 241. See *Gaines v. Haughton*, 645 F.2d 761 (9th Cir. 1981) , cert. denied, 454 U.S. 1145 (1982) ; see also *Gerstle v. Gamble-Skogmo*, 478 F.2d 1281 (2d Cir. 1973) , discussed in § 7.09[5][f][ii][E] *supra*.

(n242)Footnote 242. *Electronic Specialty Co. v. International Controls*, 409 F.2d 937, 947 (2d Cir. 1969) .

The considerations on a motion for preliminary relief under the proxy rules differ from those on a motion for preliminary relief against a tender offer based on antitrust grounds, which requires that the losing party contemplate prolonged trial of complex facts under the antitrust laws. The attendant delay following the grant of a preliminary injunction on antitrust grounds "spells the almost certain doom of a tender offer." *Missouri Portland Cement Co. v. Cargill, Inc.*, 498 F.2d 851, 870 (2d Cir.) , cert. denied, 419 U.S. 883, 95 S. Ct. 150, 42 L. Ed. 2d 123 (1974) .

See also *FMC Corp. v. R.P. Scherer Corp.*, 545 F. Supp. 318 (D. Del. 1982) , in which a preliminary injunction enjoining a shareholder meeting at which antitakeover amendments to a target company's certificate of incorporation

were to be voted on was denied since irreparable harm would not otherwise ensue, *i.e.*, if the proxy materials soliciting the vote were later found misleading:

(1) the tender-offeror could seek to have the vote voided and the amendments resubmitted for a second vote, and

(2) the target company's shareholders could seek damages if the tender offeror withdrew its offer and the shareholders were thereby deprived of the opportunity to tender their shares at a premium.

See *Steadman Sec. Corp. v. Diebold Venture Capital Corp.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,815 (S.D.N.Y. Oct. 20, 1976) (preliminary injunction denied), relying on *Sonesta v. Wellington*, 483 F.2d 247 (2d Cir. 1973), for its two-pronged test.

(n243)Footnote 243. See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 at 380-81, 90 S. Ct. 616, 620, 24 L. Ed. 2d 593 (1970).

(n244)Footnote 244. See *Henwood v. SEC*, 298 F.2d 641 (9th Cir.), *cert. denied*, 371 U.S. 814 (1962); *SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir.), *cert. denied*, 332 U.S. 847 (1947); *Central Foundry v. Gondelman*, 166 F. Supp. 429, *modified*, 167 F. Supp. 821 (S.D.N.Y. 1958); *SEC v. May*, 134 F. Supp. 247 (S.D.N.Y. 1955), *aff'd*, 229 F.2d 123 (2d Cir. 1956); *SEC v. Okin*, 58 F. Supp. 20 (S.D.N.Y. 1944); *SEC v. O'Hara Re-Election (or Proxy) Committee*, 28 F. Supp. 523 (D. Mass. 1939).

See Aranow & Einhorn, *Proxy Contests for Corporate Control* 458 (2d ed. 1968).

(n245)Footnote 245. See, *e.g.*, *Jansky v. Miller*, 474 F.2d 365 (9th Cir. 1973); *SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir.), *cert. denied*, 332 U.S. 847 (1947); *Brooks v. Standard Oil Co.*, 308 F. Supp. 810 (S.D.N.Y. 1969); *Curtin v. American Tel. & Tel.*, 124 F. Supp. 197 (S.D.N.Y. 1954); *Peck v. Greyhound Corp.*, 97 F. Supp. 679 (S.D.N.Y. 1951) (but relief denied for failure to exhaust administrative remedies); *cf. Medical Comm. for Human Rights v. SEC*, 432 F.2d 659 (D.C. Cir. 1970), *vacated*, 404 U.S. 403 (1972).

(n246)Footnote 246. See, *e.g.*, *Chris-Craft Indus., Inc. v. Independent Stockholders Comm.*, 354 F. Supp. 895 (D. Del. 1973); *Ainslie v. Sandquist*, 270 F. Supp. 382 (D. Mass. 1967); *Union P. R. Co. v. Chicago & N.W. Ry. Co.*, 226 F. Supp. 400 (N.D. Ill. 1964).

(n247)Footnote 247. See, *e.g.*, *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715 (8th Cir. 1974), *cert. denied*, 419 U.S. 1107 (1975); *Rosenblatt v. Northwest Airlines*, 435 F.2d 1121 (2d Cir. 1970); *Knapp v. Walden*, 367 F. Supp. 385 (S.D.N.Y. 1973); *Rosen v. Alleghany Corp.*, 133 F. Supp. 858 (S.D.N.Y. 1955).

(n248)Footnote 248. *Studebaker Corp. v. Allied Products Corp.*, 256 F. Supp. 173 (W.D. Mich. 1966) (court ordered production of shareholder list, set a new record date, set a new date for the annual meeting, and supervised the content of the proxy materials); see *Clairdale Enters., Inc. v. C.I. Realty Investors*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,277 (S.D.N.Y. Sept. 3, 1975); *Pabst Brewing Co. v. Jacobs*, 549 F. Supp. 1068 (D. Del. 1982), *aff'd*, 707 F.2d 1392 (3d Cir. 1982) (requiring corrective disclosure and 30-day waiting period from date of mailing of corrective disclosure before action could be taken).

(n249)Footnote 249. See, *e.g.*, *Studebaker Corp. v. Allied Prods. Corp.*, 256 F. Supp. 173 (W.D. Mich. 1966); see also *SEC v. Transamerica Corp.*, 163 F.2d 511 (3d Cir.), *cert. denied*, 332 U.S. 847 (1947); *SEC v. O'Hara Re-Election (or Proxy) Committee*, 28 F. Supp. 523 (D. Mass. 1939).

See also *Camelot Indus. Corp. v. Vista Resources, Inc.*, 535 F. Supp. 1174 (S.D.N.Y. 1982) (where target company

violated Section 14(a) and Rule 14a-9 by falsely stating in proxy statement issued in connection with special shareholders' meeting called to vote on proposed anti-takeover amendments to issuers charter, that it had no knowledge of any planned or threatened takeover, and tender offeror, a controlling shareholder, made false and misleading statements in proxy material opposing the proposed amendments, proper remedy was postponement of the meeting and resubmission by both parties of corrected proxy material).

See also Dynamics Corp. of America v. CTS Corp., 794 F.2d 250 (7th Cir. 1986) , in which the court held that a letter to shareholders and a press release by incumbent directors during a proxy contest, which included an artificially inflated estimate of the value per share of the issuer's stock in the event of a sale of the issuer, were materially misleading. The court enjoined the issuer from voting any proxies it received after publication of the press release, ordered to issuer to send corrective material to shareholders, and enjoined the issuer from any contact with shareholders until the corrective material was received.

See also GAF Corp. v. Heyman, 724 F.2d 727 (S.D.N.Y. 1983) , in which the court reversed the decision of the district court which had voided the proxies of a dissident director elected by the issuer's shareholders, holding that it was immaterial that the dissident had failed to disclose in his proxy statement that he was the defendant in an action alleging his breach of a fiduciary duty in administering a family trust.

Where the defects in the proxy material have been remedied in the material covering a superseding meeting, the court will not interfere. *Schy v. Susquehanna Corp.*, 419 F.2d 1112 (7th Cir. 1970) , *cert. denied*, 400 U.S. 826 (1970) .

(n250)Footnote 250. *See, e.g., Union P. R. Co. v. Chicago & N.W. Ry. Co.*, 226 F. Supp. 400 (N.D. Ill. 1964) ; *Textron, Inc. v. American Woolen Co.*, 122 F. Supp. 305 (D. Mass. 1954) (partial invalidity of proxies).

(n251)Footnote 251. *See, e.g., Studebaker Corp. v. Gittlin*, 360 F.2d 692 (2d Cir. 1966) ; *Coalition to Advocate Pub. Util. Responsibility, Inc. v. Engels*, 364 F. Supp. 1202 (D. Minn. 1973) . *SEC v. O'Hara Re-Election (or Proxy) Committee*, 28 F. Supp. 523 (D. Mass. 1939) .

(n252)Footnote 252. *See, e.g., Newgard v. Electro-Nucleonics*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,805 (S.D.N.Y. Dec. 7, 1976); *Studebaker Corp. v. Allied Prods. Corp.*, 256 F. Supp. 173 (W.D. Mich. 1966) ; *Union P. R. Co. v. Chicago & N.W. Ry. Co.*, 226 F. Supp. 400 (N.D. Ill. 1964) ; *Central Foundry Co. v. Gondelman*, 166 F. Supp. 429 (S.D.N.Y. 1958) , *modified sub nom. Securities & Exchange Com. v. Central Foundry Co.*, 167 F. Supp. 821 (1958) . *See also General Time Corp. v. Talley Indus., Inc.*, 403 F.2d 159 (2d Cir. 1968) , *cert. denied*, 393 U.S. 1026 (1969) (postponement denied).

In *Mack v. Mishkin*, 172 F. Supp. 885 (S.D.N.Y. 1959) , a preliminary injunction against the use of false and misleading proxies was denied on the grounds that plaintiff had failed to establish a fair probability of success on the merits. An additional reason given for denial of the injunction was the fact that the election results could always be set aside later, a resolicitation ordered and a new election scheduled. *See McConnell v. Lucht*, 320 F. Supp. 1162, 1166 (S.D.N.Y. 1970) ; *Kauder v. United Board & Carton Corp.*, 199 F. Supp. 420, 424 (S.D.N.Y. 1961) ; *see also Steadman Sec. Corp. v. Diebold Venture Capital Corp.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,815 (S.D.N.Y. Oct. 20, 1976); *but see Union P. R. Co. v. Chicago & N.W. Ry. Co.*, 226 F. Supp. 400 (N.D. Ill. 1964) (rejected this course of action as causing undue expense to the corporation).

(n253)Footnote 253. *See* 9 L. Loss & J. Seligman, *Securities Regulation* 4322 (3d ed. 1992); *see also Dann v. Studebaker-Packard Corp.*, 288 F.2d 201 (6th Cir. 1961) ; *Howard v. Furst*, 238 F.2d 790 (2d Cir. 1956) , *cert. denied*, 353 U.S. 937 (1956) .

Professor Loss has postulated that if courts can grant premeeting and postmeeting relief, they can grant necessary relief, in appropriate cases, *during* the meeting, *i.e.*, to enjoin the inspectors of elections from counting proxies that were unlawfully solicited. 9 L. Loss & J. Seligman, *supra*, at 4322 .

(n254)Footnote 254. 377 U.S. 426, 84 S. Ct. 195, 11 L. Ed. 2d 143 (1964) .

(n255)Footnote 255. In devising retrospective relief, the Supreme Court in *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 386, 90 S. Ct. 616, 24 L. Ed. 2d 593, 603 (1970) , noted:

the federal courts should consider the same factors that would govern the relief granted for any similar illegality or fraud. One important factor may be the fairness of the terms of the merger. Possible forms of relief will include setting aside the merger or granting other equitable relief, but, as the Court of Appeals below noted, nothing in the statutory policy requires the court to unscramble a corporate transaction merely because a violation occurred. 403 F.2d 429, 436 . In selecting a remedy, the lower courts should exercise 'the sound discretion which guides the determination of courts of equity' keeping in mind the role of equity as 'the nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims.' *Hecht Co. v. Bowles*, 321 U.S. 321, 329-330 ; 64 S. Ct. 587, 88 L. Ed. 754, 760 (1944) quoting from *Meredith v. Winter Haven*, 320 U.S. 228, 235, 64 S. Ct. 7, 88 L. Ed. 9 (1945) .

396 U.S. at 386, 90 S. Ct. at 622, 24 L. Ed. 2d 603 .

In *Dann v. Studebaker Packard Corp.*, 288 F.2d 201 (6th Cir. 1961) , the court recognized the right of a federal court to enter judgment declaring the validity or invalidity of illegal proxies. *But cf. Browning Debenture v. DASA Corp.*, 524 F.2d 811 (2d Cir. 1975) , where a postmeeting request to declare that a shareholder's meeting was conducted illegally was denied on the ground that declaratory relief, in such an instance, would serve no enforcement purpose. *See Edelman v. Salomon*, 559 F. Supp. 1178 (D. Del. 1983) (charter amendment obtained through violation of the proxy rules decreed void).

See also Pantry Pride Inc. v. Rooney, 598 F. Supp. 891 (S.D.N.Y. 1984) .

(n256)Footnote 256. *Mills v. Electric Autolite Co.*, 396 U.S. at 388, 90 S. Ct. at 623, 24 L. Ed. 2d at 604 : "a determination of what relief should be granted... must hinge on whether setting aside the merger would be in the best interest of the shareholders as a whole. ... [T]he merger should be set aside only if a court of equity concludes from all the circumstances, that it would be equitable to do so."

On remand from the Supreme Court, the Seventh Circuit in *Mills v. Electric Auto-Lite Co.*, 552 F.2d 1239 (7th Cir. 1977) , overturned the district court's award of damages. It supported the lower court's finding that the commingling of assets made it impossible to establish any direct injury resulting from the merger but disagreed with the lower court's determination that the merger terms were unfair at the time the merger took place. The court applied a formula suggested by Professors Brudney and Chirelstein in *Fair Shares in Corporate Mergers and Takeovers*, 88 Harv. L. Rev. 297, 308-09 (1974), and computed that the market value of the stock received by an Auto-Lite shareholder in the merger was higher than both the value of his original holdings, and the market value of the stock received by a Mergenthaler Linotype Co. (the other party to the merger) shareholder whose premerger stock equaled the value of the Auto-Lite shareholder's premerger stock.

Yamamoto v. Omiya, 564 F.2d 1319 (9th Cir. 1977) , upheld a lower court decision, made before trial, that rescission of a contract for the sale of a building was an inappropriate remedy for use of an allegedly misleading proxy statement in soliciting shareholder approval for that sale.

Justice Hufstедler dissented from this part of the opinion on the grounds that there was no authority, either in the case law or the Federal Rules of Civil Procedure, that would allow a court to deny equitable relief before a trial on the merits is held. She cited the following excerpt from *J.I. Case Co. v. Borak*, in her opinion:

Our finding that federal courts have the power to grant all necessary remedial relief [in a securities fraud case] is not to be construed as any indication of what we believe to be the necessary and appropriate relief in this case. We are concerned here only with a determination that federal jurisdiction for the purpose does exist. *Whatever remedy is necessary must await the trial on the merits.*

Id. at 1327 (quoting *J.I. Case Co. v. Borak*, 377 U.S. at 435, 84 S. Ct. at 1561, 12 L. Ed. 2d at 429 (emphasis added)).

See also *In re National Student Mktg. Litig.*, 445 F. Supp. 157 (D.D.C. 1978), later decision, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 97,9267 (D.D.C. Mar. 26, 1981).

See also *Cohen v. Bloch*, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 98,385 (S.D.N.Y. Apr. 14, 1981) (court refused to set aside a plan of recapitalization since the effect of this relief would be to harm the common shareholders by increasing the exchange ratio for Class A shareholders).

(n257)Footnote 257. *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715 (8th Cir. 1974), cert. denied, 419 U.S. 1107 (1975) (approval of extension of voting trust agreement); *Ainslie v. Sandquist*, 270 F. Supp. 382 (D. Mass. 1967) (change of corporate name); *Sherman v. Posner*, 266 F. Supp. 871 (S.D.N.Y. 1966) (injunction against consummation of exchange offer denied).

(n258)Footnote 258. *Ohio Drill & Tool Co. v. Johnson*, 498 F.2d 186 (6th Cir. 1974); *Gladwin v. Medfield Corp.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,013 (M.D. Fla. Jan. 30, 1975), modified and aff'd, 540 F.2d 1266 (5th Cir. 1976); *Dillon v. Berg*, 326 F. Supp. 1214 (D. Del.), aff'd, 453 F.2d 876 (3d Cir. 1971); see also *Dillon v. Scotten, Dillon Co.*, 335 F. Supp. 566 (D. Del. 1971).

(n259)Footnote 259. See *Mills v. Electric Auto-Lite*, 396 U.S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970); *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715 (8th Cir. 1974), cert. denied, 419 U.S. 1107 (1975); *Ohio Drill & Tool Co. v. Johnson*, 498 F.2d 186 (6th Cir. 1973); *Gladwin v. Medfield Corp.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,013 (M.D. Fla. Jan. 30, 1975), modified and aff'd, 540 F.2d 1266 (5th Cir. 1976).

In addition to setting aside the results of a meeting and ordering a new vote, the court may also supervise the contents of any new proxy materials which are solicited. *Gladwin v. Medfield*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,013 (M.D. Fla. Jan. 30, 1975), modified and aff'd, 540 F.2d 1266 (5th Cir. 1976); *Dillon v. Berg*, 326 F. Supp. 1214 (D. Del.), aff'd, 453 F.2d 876 (3d Cir. 1971).

(n260)Footnote 260. See *Howard v. Furst*, 140 F. Supp. 507, 513 (S.D.N.Y. 1956), aff'd, 238 F.2d 790 (2d Cir. 1956), cert. denied, 353 U.S. 937 (1957); cf. *Walpert v. Bart*, 280 F. Supp. 1006 (D. Md. 1967), aff'd, 390 F.2d 877 (4th Cir. 1968).

(n261)Footnote 261. See 9 L. Loss & J. Seligman, *Securities Regulation* 4320 (3d ed. 1992).

(n262)Footnote 262. *Newgard v. Electro-Nucleonics*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,805 at 90,920 (S.D.N.Y. Dec. 7, 1976); *Union P. R. Co. v. Chicago & N.W. Ry. Co.*, 226 F. Supp. 400 (N.D. Ill. 1964); but see *McConnell v. Lucht*, 320 F. Supp. 1162 (S.D.N.Y. 1970); *Kauder v. United Board & Carton Corp.*, 199 F. Supp. 420 (S.D.N.Y. 1961); *Mack v. Mishkin*, 172 F. Supp. 885 (S.D.N.Y. 1959).

See *Steadman Sec. Corp. v. Diebold Venture Capital Corp.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,815 (S.D.N.Y. Oct. 20, 1976), where in the course of denying plaintiff's application for a preliminary injunction for failing to make a clear showing for relief, the court noted that, even if plaintiff should later succeed on the merits, relief

could be therein granted after the meeting has been held. The contemplated reorganization of the defendant did not involve the intermingling of the defendant's assets or shareholders with those of any other entity.

(n263)Footnote 263. *Union Pacific*, 226 F. Supp. at 413 .

(n264)Footnote 264. 9 L. Loss & J. Seligman, Securities Regulation 4322 (3d ed. 1992).

(n265)Footnote 265. 498 F.2d 186 (6th Cir. 1974) .

(n266)Footnote 266. 498 F.2d 186 at 193 , *supra*.

See Cohen v. Ayers, 449 F. Supp. 298 (N.D. Ill. 1978) , *aff'd*, 596 F.2d 733 (1979) .

See also In re Tenneco Sec., 449 F. Supp. 528 (S.D. Tex. 1978) (refusing to set aside election held pursuant to allegedly misleading proxy solicitation where the same directors were subsequently reelected pursuant to proxy solicitations that were not misleading).

The traditional means for questioning the incumbency of directors is the extraordinary writ of quo warranto (supplanted by specific statutory provisions in some states). But the federal courts have long asserted that they have the powers, sitting as chancellors, to rule upon the validity of such matters if they have subject matter jurisdiction. *See Andrews v. Drake*, 83 F.2d 767, 773 (6th Cir. 1936) , *cert. denied*, 299 U.S. 572 (1936) .

(n267)Footnote 267. 270 F. Supp. 382 (D. Mass. 1967) (the plaintiff only sought equitable relief and waived all rights to damages).

(n268)Footnote 268. *See* § 7.09[4] *supra*.

(n269)Footnote 269. *Del Noce v. Delyar Corp.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,670 (S.D.N.Y. July 30, 1976) (inequitable to unscramble merger seven years after consummation); *Basch v. Talley Indus., Inc.*, 53 F.R.D. 9, 12 (S.D.N.Y. 1971) ; *see also* *Steadman Sec. Corp. v. Diebold Venture Capital Corp.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,815 (S.D.N.Y. Oct. 20, 1976); *cf. Kohn v. American Metal Climax*, 458 F.2d 255 (3d Cir. 1972) , *cert. denied*, 409 U.S. 874 (1973) (court ordered an exchange offer instead of rescinding the merger).

On the *sua sponte* offer to rescind a completed transaction, *see* Bromberg, *Curing Securities Violations: Rescission Offers and Other Techniques*, 1 J. of Corp. Law 1 (1975).

(n270)Footnote 270. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970) ; *see also* *Galfand v. Chestnutt Corp.*, 545 F.2d 807 (2d Cir. 1976) ; *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715 (8th Cir. 1974) , *cert. denied*, 419 U.S. 1107 (1975) ; *Chris-Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.) , *cert. denied*, 414 U.S. 910 (1973) ; *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967) , *cert. denied*, 390 U.S. 951 (1968) ; *McIntyre v. KDI Corp.*, 406 F. Supp. 592 (D. Ohio 1975) ; *Heit v. Davis*, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,698 (S.D.N.Y. May 31, 1966).

In ordering restitution of "any benefit conferred" as a result of the transaction, the court should include in its award an accounting of profits. *See* Restatement 2d of Restitution § 151; *see also Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971) , *cert. denied sub nom. Lazard Freres v. Rosenfeld*, 409 U.S. 802 (1972) .

For additional cases on restitution, *see* *Baumel v. Rosen*, 412 F.2d 571 (4th Cir. 1969) , *cert. denied*, 396 U.S. 1037, 90 S. Ct. 681, 24 L. Ed. 2d 681 (1970) ; *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967) , *cert. denied*, 390 U.S. 951 (1968) ; *Fox v. Kane-Miller Corp.*, 398 F. Supp. 609 (D. Md. 1975) , *aff'd*, 542 F.2d 915 (4th Cir. 1976) .

See Comment, *Causation and Liability in Private Actions for Proxy Violations*, 80 Yale L.J. 107, 128 n.86 (1970).

(n271)Footnote 271. *Deckert v. Independence Shares Corp.*, 311 U.S. 282, 61 S. Ct. 229, 85 L. Ed. 189 (1940) ; *McIntyre v. KDI Corp.*, 406 F. Supp. 592 (S.D. Ohio 1975) ; *Goodman v. Poland*, 395 F. Supp. 660 (D. Md. 1975) ; *Mills v. Electric Auto-Lite Co.*, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,354 (N.D. Ill. 1972) (on remand.)

(n272)Footnote 272. *Johns Hopkins Univ. v. Hutton*, 488 F.2d 912 (4th Cir. 1973) , cert. denied, 416 U.S. 916 (1974) ; *Baumel v. Rosen*, 412 F.2d 571 (4th Cir. 1969) , cert. denied, 396 U.S. 1037, 90 S. Ct. 681, 24 L. Ed. 2d 681 (1970) ; *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967) , cert. denied, 390 U.S. 951 (1968) ; *Estate Counseling Serv., Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 303 F.2d 527 (10th Cir. 1962) ; *Goodman v. Poland*, 395 F. Supp. 660 (D. Md. 1975) .

(n273)Footnote 273. See *Steadman Sec. Corp. v. Diebold Venture Capital Corp.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,815 (S.D.N.Y. Oct. 20, 1976) (dicta); see also *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715 (8th Cir. 1974) , cert. denied, 419 U.S. 1107 (1975) .

(n274)Footnote 274. *McIntyre v. KDI Corp.*, 406 F. Supp. 592 (S.D. Ohio 1975) .

(n275)Footnote 275. *Fox v. Kane-Miller Corp.*, 398 F. Supp. 609 (D. Md. 1975) , aff'd, 542 F.2d 915 (4th Cir. 1976) .

(n276)Footnote 276. *Basch v. Talley Indus., Inc.*, 53 F.R.D. 9 (S.D.N.Y. 1971) ; *Bowers v. Columbia General Corp.*, 336 F. Supp. 609 (D. Del. 1971) ; see also *Fox v. Kane-Miller Corp.*, 398 F. Supp. 609 (D. Md. 1975) , aff'd, 542 F.2d 915 (4th Cir. 1976) .

See discussion on restitution and rescission in Note, *Private Remedies Available Under Section 14(a) of the Securities Exchange Act of 1934*, 55 Iowa L. Rev. 657, 667-69 (1970).

(n277)Footnote 277. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 389, 90 S. Ct. 616, 624, 24 L. Ed. 2d 593, 604 (1970) ; *Browning Debenture Holders' Committee v. DASA Corp.*, 524 F.2d 811 (2d Cir. 1975) ; *Simon v. New Haven Board & Carton Co.*, 516 F.2d 303 (2d Cir. 1975) ; *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974) , cert. denied, 421 U.S. 976 (1975) , appeal dismissed, 551 F.2d 531 (2d Cir. 1977) ; *Lewis v. Dansker*, 68 F.R.D. 184 (S.D.N.Y. 1974) (damages minimal).

(n278)Footnote 278. See § 9.02 *infra*.

(n279)Footnote 279. *Springer v. Jones*, Civ. No. 74-1455 (C.D. Cal. 1974) as reported at Comment, *Court-Appointed Directors: Ancillary Relief in Federal Securities Law Enforcement Actions*, 64 Geo. L. J. 737, 738 (1976); see *SEC v. Mattel, Inc.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,754 (D.D.C. Aug. 8, 1974), later proceeding [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,807 (D.D.C. 1974).

(n280)Footnote 280. See *SEC v. Lockheed Aircraft Corp.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,509 (D.D.C. Apr. 13, 1976) (special committee of nonmanagement directors and/or unaffiliated persons ordered to be appointed to investigate allegations of illegal foreign payments, false accounting entries and false and misleading proxy statements, and to file a report with the court and the SEC); cf. *SEC v. Parklane Hosiery Co.*, 422 F. Supp. 477 (S.D.N.Y. 1976) (special counsel denied), aff'd, 558 F.2d 1083 (2d Cir. 1977) .

(n281)Footnote 281. See *SEC v. General Tire & Rubber Co.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,542 (D.D.C. May 10, 1976); *SEC v. Lockheed Aircraft Corp.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,509 (D.D.C. Apr. 13, 1976); *SEC v. Lum's Inc.*, [1973-1974 Transfer Binder] Fed. Sec. L. Rep.

(CCH) P 94,504 (S.D.N.Y. Apr. 11, 1974).

(n282)Footnote 282. As reported in Comment, *Court-Appointed Directors: Ancillary Relief in Federal Securities Law Enforcement Actions*, 64 *Geo. L. J.* 737, 738, 763 (1976).

(n283)Footnote 283. The rule regarding the award of attorneys' fees is that a litigant is not entitled to collect a reasonable attorneys' fee from the loser. There are five exceptions to this rule:

- (1) the award of attorneys' fees is specifically authorized by statute;
- (2) the trustee of a fund or property may recover attorneys' fees from the fund or property itself;
- (3) a party preserving or recovering a fund for the benefit of others, in addition to himself, may recover attorneys' fees from the fund or property itself or directly from the other parties enjoying the benefit;
- (4) attorneys' fees may be awarded for the "willful disobedience of a court order as part of the fine to be levied on the defendant"; or
- (5) attorneys' fees may be awarded when the losing party has "acted in bad faith, vexatiously, wantonly, or for oppressive reasons."

Alyeska Pipeline Serv. v. Wilderness Society, 421 U.S. 240, 257-59, 95 S. Ct. 1612, 1621-22, 44 L. Ed. 2d 141, 153-54 (1975) .

See also *Straub v. Vaisman & Co.*, 540 F.2d 591 (3d Cir. 1976) ; *Bailey v. Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976) ; *Voegel v. North American Rockwell Corp.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,609 (S.D.N.Y. May 20, 1976). See *Derfner & Wolf*, *Court-Awarded Attorney's Fees*, § 1.02[2] (Matthew Bender).

(n284)Footnote 284. 396 U.S. 375, 389-90, 90 S. Ct. 616, 624-25, 24 L. Ed. 2d 593, 604-05 (1970) ; see also *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1309 (2d Cir. 1973) .

(n285)Footnote 285. 421 U.S. 240, 263-64, 95 S. Ct. 1612, 1624-25, 44 L. Ed. 2d 141, 156-57 (1975) .

The Court has the discretion to award attorneys' fees in a civil action pursuant to Section 18(a).

(n286)Footnote 286. 444 U.S. 472, 100 S. Ct. 745, 62 L. Ed. 2d 676 (1980) .

(n287)Footnote 287. 710 F.2d 271 (6th Cir. 1983) . *Smillie* involved alleged proxy violations relating to a stock option plan, which the court refused to rescind, notwithstanding the finding of some violations.

See also *Barton v. Drummond Co.*, 636 F.2d 978 (5th Cir. 1981) . *Barton* held that the abandonment of a "freeze out" merger could be a sufficient benefit to justify an award of attorneys' fees under state law, which it found to be the same as the *Mills* rule.

(n288)Footnote 288. See § 9.02[3] *infra*.

(n289)Footnote 289. *United States v. W. T. Grant Co.*, 345 U.S. 629, 633, 345 U.S. 629, 633, 73 S. Ct. 894, 97 L. Ed. 1303, 1953 *Trade Cas.* (CCH) P67493 (1953) : "[T]he moving party must satisfy the court that relief is needed. The necessary determination is that there exists some cognizable danger of recurrent violation, something more than the mere possibility which serves to keep the case alive."

In *SEC v. Parklane Hosiery*, 422 F. Supp. 477 (S.D.N.Y. 1976), *aff'd*, 558 F.2d 1083 (2d Cir. 1977), the court found material misstatements in proxy statements solicited for the purpose of seeking approval of a merger converting the company to privately owned status. The court denied injunctive relief and the appointment of a special counsel to determine the fair value of defendant's shares, notwithstanding the finding that a violation had occurred. The court found that: (1) no urgency for the relief requested was shown, (2) there were then pending three private actions and a separate appraisal proceeding, (3) the controlling shareholder was merely an investor and his violation was an isolated occurrence, and (4) that no other improprieties were shown.

See also *SEC v. Comstock Tunnel & Drainage*, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,712 (D.D.C. Jan. 9, 1973), where the court found material misstatements in the proxy materials but denied injunctive relief since defendant was willing to resolicit the proxies and not carry out the action approved as the result of the first solicitation. Cf. also *SEC v. Koracorp Ind.*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,532 (N.D. Cal. Mar. 26, 1976), *rev'd*, 575 F.2d 692 (9th Cir. 1978), *cert. denied sub nom. Helfat v. SEC*, 439 U.S. 953 (1978) (injunction denied; no showing of violations in 18 months preceding action); *SEC v. Keller Indus. Inc.*, 342 F. Supp. 654 (S.D.N.Y. 1972) (injunction denied; harm to corporation outweighed harm to public and SEC had delayed six months before pursuing action); *SEC v. Commonwealth Sec. Investors*, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,859 (E.D. Ky. Oct. 21, 1970) (injunction denied as against certain defendants whose violations of Investment Company Act lacked "sufficient 'flagrancy'").

(n290)Footnote 290. See, e.g., *W.T. Grant*, 345 U.S. at 633, 73 S. Ct. at 898, 97 L. Ed. at 1309; *SEC v. Culpepper*, 270 F.2d 241 (2d Cir. 1959); *SEC v. Torr*, 87 F.2d 446 (2d Cir. 1937); *SEC v. Comstock Tunnel & Drainage*, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,712 (D.D.C. Jan. 9, 1973); *SEC v. Bangor Punta Corp.*, 331 F. Supp. 1154, 1162 (S.D.N.Y. 1974), *aff'd in part sub nom. Chris-Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), *cert. denied sub nom. SEC v. Bangor Punta*, 414 U.S. 924 (1973); *SEC v. Broadwall Sec.*, 240 F. Supp. 962 (S.D.N.Y. 1965) (cessation of unlawful sale of securities does not preclude issuance of an injunction).

(n291)Footnote 291. 515 F.2d 801, 807 (2d Cir. 1975); see also *SEC v. Harwyn Ind.*, 326 F. Supp. 943, 957-8 (S.D.N.Y. 1971).

(n292)Footnote 292. *W.T. Grant*, 345 U.S. at 633, 73 S. Ct. at 898, 97 L. Ed. at 1309.

(n293)Footnote 293. *Id.*; *Hecht v. Bowles*; 321 U.S. 321, 327, 64 S. Ct. 587, 591, 88 L. Ed. 754, 759 (1944); *SEC v. Management Dynamics*, 515 F.2d 801 (2d Cir. 1975); *SEC v. Manor Nursing Centers*, 340 F. Supp. 913 (S.D.N.Y. 1971), *aff'd*, 458 F.2d 1082 (2d Cir. 1972); *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied sub nom. Coates v. SEC*, 394 U.S. 976 (1969); *SEC v. Boren*, 283 F.2d 312, 314 (2d Cir. 1960); *Culpepper*, 270 F.2d at 243.

(n294)Footnote 294. 515 F.2d at 807. Other factors the court may consider are:

(1) The intent or bad faith of the violator, *Securities & Exchange Com. v. Mono-Kearsarge Consol. Mining Co.*, 167 F. Supp. 248 (D. Utah 1958) (defendant continued unlawful activities even after suit instituted); see also *SEC v. Manor Nursing Centers*, 340 F. Supp. 913 (S.D.N.Y. 1971), *aff'd*, 458 F.2d 1082 (2d Cir. 1972);

(2) the demeanor and cooperation of the violator, *SEC v. Comstock Tunnel & Drainage*, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,712 (D.D.C. Jan. 9, 1973) (defendant willingly corrected proxies and resolicited them);

(3) failure to disclose potential personal gain to violator, *SEC v. Koenig*, 469 F.2d 198 (2d Cir. 1972); see also *SEC v. Manor Nursing Centers*, *supra*; *SEC v. General Refractories*, 400 F. Supp. 1248 (D.D.C. 1975);

(4) previous injunctions or violations, *see, e.g., SEC v. Bangor Punta Corp.*, 331 F. Supp. 1154, 1162 (S.D.N.Y. 1971), *aff'd in part and rev'd in part sub nom. Chris-Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir. 1973), *cert. denied sub nom. SEC v. Bangor Punta Corp.*, 414 U.S. 924 (1973);

(5) defendant is not in a position to violate the law in the future, *SEC v. Parklane Hosiery*, 422 F. Supp. 477 (S.D.N.Y. 1976), *aff'd*, 558 F.2d 1083 (2d Cir. 1977) (defendant merely an investor after transaction in question); or

(6) that the private detriment outweighs any potential benefit to the public, *SEC v. Keller Indus. Inc.*, 342 F. Supp. 654 (S.D.N.Y. 1972).

In *SEC v. American Beef Packers, Inc.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,079 (D. Neb. May 4, 1977), the court enjoined the former president of a corporation from ever again becoming an officer of that corporation because of his past participation in the distribution of misleading proxy materials unless upon a showing to the court he demonstrates that procedures have been instituted to prevent a recurrence of the violations. An injunction was not entered against the corporation because its new management had not participated in any violations. In *SEC v. Falstaff Brewing Corp.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,117 (D.D.C. Aug. 1, 1977), *aff'd*, 629 F.2d 62 (D.C. Cir. 1980), *cert. denied sub nom. Kalmanovitz v. SEC*, 449 U.S. 1012 (1980), the court issued a preliminary injunction that prohibited:

(1) the defendant from further use of a proxy statement to solicit proxies; and

(2) the voting of any shares already solicited.

The court found numerous proxy violations and noted that the new management was not sufficiently free from any relation to these violations to justify denying injunctive relief.

(n295)Footnote 295. *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 99 S. Ct. 645, 58 L. Ed. 2d 552 (1979).

(n296)Footnote 296. Section 21(g) of the Securities Exchange Act of 1934, reprinted in the Primary Law Sourcebook, Volume B, Section F, 15 U.S.C. § 78u(g).

(n297)Footnote 297. 377 U.S. 426, 84 S. Ct. 195, 12 L. Ed. 2d 423 (1964).

(n298)Footnote 298. *See* § 7.09[5][a][ii] *supra*.

(n299)Footnote 299. *Royal Business Group Inc. v. Realist Inc.*, 933 F.2d 1056 (1st Cir. 1991), where Judge Selya stated:

To imply a private right of action in favor of a disappointed proxy contestant seeking to recover damages for an election contest that, in retrospect, it would have preferred not to wage would stretch section 14(a) beyond any reasonable limit. Because the plaintiffs brought suit in their capacity as proxy contestants, and did not initiate suit in their capacity as shareholders, the plaintiffs did not come within the class for whose particular benefit section 14(a) was enacted. Thus, although there is a private right of action under section 14(a) for shareholders, one will not be implied for "regretful proxy contestants."

Here the plaintiff's specific claim arose from its role as a proxy contestant, not from its role as a shareholder. Thus, the relief sought would not serve the statutory purpose of safeguarding the corporate voting process. The court also found

that the plaintiffs failed to establish a causal nexus between their alleged injury and some corporate transaction authorized or defeated as a result of the allegedly false and misleading proxy statements.

See the discussion regarding *Paskowitz v. Wohls*, Md. Spec. App., No. 841, 5/5/03, BNA Corp. Counsel Weekly 5/21/03 p. 161, at § 7.09[5] *supra* .

(n300)Footnote 300. *General Time Corp. v. Talley Indus., Inc.*, 403 F.2d 159, 161 (2d Cir. 1968) , cert. denied, 393 U.S. 1026 (1969) ; *Ameribanc Investors Group v. Zwart*, 706 F. Supp. 1248 (E.D. Va. 1989) .

(n301)Footnote 301. In *Diceon Electronics, Inc. v. Calvary Partners, L.P.*, 772 F. Supp. 859 (D. Del. 1991) , defendants followed up an unsuccessful proxy contest with a tender offer. Plaintiff sought damages and injunctive relief for allegedly false statements made both in proxy materials and in tender offer materials filed by defendants with the SEC. The court dismissed the Section 14(a) claim for damages as being beyond the scope of the implied right of action approved by the Supreme Court in *Borak*, 377 U.S. 426 (1969) (citing *Virginia Bankshares v. Sandberg*, 501 U.S. 1083, 111 S. Ct. 2749, 2761, 115 L. Ed. 2d 929 (1991)) . The contrary decision in *CNW Corp. v. Japonica Partners, L.P.*, 874 F.2d 193 (D. Del. 1990) , was disapproved as contrary to the reasoning in the subsequently decided *Virginia Bankshares* case.

(n302)Footnote 302. See § 7.09[5][a][ii] *supra*.

(n303)Footnote 303. 167 F.3d 125 (2d Cir. 1999) , where the court found both transaction causation and loss causation to support a damage claim. See also *Zemel Family Trust v. Philips Int'l Realty Corp.*, 2000 U.S. Dist. LEXIS 17320 (S.D.N.Y. 2000) , an action for injunctive relief where the court, citing *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1298-1301 (2d Cir. 1973) , stated: "[i]n the Second Circuit, a plaintiff may satisfy the *scienter* requirement of 14(a) by showing negligence." Query whether the terms "*scienter*" and "negligence" are not mutually exclusive. Thus, Judge Bartel stated, that "the basis for incorporating *scienter* into a *Rule 10b-5* action does not exist in a *Rule 14a-9* suit" and that "[n]egligence alone either in making a misrepresentation or in failing to disclose a material fact in connection with proxy solicitation is sufficient to warrant recovery." *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66, 97 (E.D.N.Y. 1969) (quoted with approval on appeal).

(n304)Footnote 304. 396 U.S. 375, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970) .

(n305)Footnote 305. 396 U.S. at 384-85, 90 S. Ct. at 621-22, 24 L. Ed. 2d at 602 (footnotes omitted):

There is no need to supplement... this requirement, with a requirement of proof of whether the defect actually had a decisive effect on the voting. ... This objective test will avoid the impracticalities of determining how many votes were affected, and, by resolving doubts in favor of those the statute is designed to protect, will effectuate the congressional policy of ensuring that the shareholders are able to make an informed choice when they are consulted on corporate transactions. Cf. *Union Pac. R. Co. v. Chicago & N.W.R. Co.*, 226 F. Supp. 400, 411 (D.C. N.D. Ill. 1964) ; 2 Loss, Securities Regulation 962, n.411 (2d ed. 1961); 5 *id.* at 2929-2930 (Supp. 1969).

(n306)Footnote 306. 396 U.S. at 385, 90 S. Ct. at 622, 24 L. Ed. 2d at 602 .

Two cases have held that the *Mills* causation rule applies only to *Rule 14a-9* cases. See *Ash v. Brunswick*, 405 F. Supp. 234, 247 (D. Del. 1975) ; *Dillon v. Berg*, 326 F. Supp. 1214, 1234-35 n.31 (D. Del. 1971) , *aff'd*, 453 F.2d 876 (3d Cir. 1971) (dicta).

(n307)Footnote 307. *Gaines v. Haughton*, 645 F.2d 761 (9th Cir.) , cert. denied, 454 U.S. 1145, 102 S. Ct. 1006, 71 L. Ed. 2d 297 (1981) .

(n308)Footnote 308. 405 F. Supp 234 (D. Del. 1975) .

(n309)Footnote 309. 501 U.S. 1083, 111 S. Ct. 2749, 115 L. Ed. 2d 929 (1991) .

See also *Grace v. Rosenstock*, 228 F. 3d 40 (2d Cir. 2000) , cert. denied sub nom. *Grace v. Genser*, 532 U.S. 923 (2001) , where the court held that plaintiffs, minority shareholders in a freeze out merger, failed to show that alleged fraudulent misrepresentations in a merger proxy statement caused them damage.

(n310)Footnote 310. 770 F. Supp. 85 (N.D.N.Y. 1991) .

(n311)Footnote 311. [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 46,213 (E.D. Pa. Aug. 30, 1991). To the same effect, see *Grace v Rosenstock*, 228 F.3d 40, Fed. Sec. L. Rep. (CCH) P 91,058 (2d Cir. 2000) .

(n312)Footnote 312. Fed. Sec. L. Rep. (CCH) P 92,210 (D. Del. 9/9/02).

(n313)Footnote 313. citing *General Electric Co. by Levit v. Cathcart*, 980 F.2d 927, 932 (3d Cir. 1992) , where the court stated that "the standard of materiality in a Section 14(a) case is identical to that in a Section 10(b) case," citing *Basic v. Levinson*, 485 U.S. 224,231-32 (1988) .

(n314)Footnote 314. 2005 U.S. Dist. LEXIS 20659 (Sept. 15, 2005) .

(n315)Footnote 315. 2005 U.S. Dist. LEXIS 20659, at *18 .

(n316)Footnote 316. C.A. No. 218, 906 A.2d 766, 2006 Del. LEXIS 124 (Del. Mar. 8, 2006) .

(n317)Footnote 317. *Gould v. American Hawaiian S.S. Co.*, 351 F. Supp. 853, 860 (D. Del. 1972) , aff'd, 535 F.2d 761 (3d Cir. 1976) .

Negligence, as the criterion for determining culpability under Section 14(a), appears to be the accepted standard. See *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973) ; *Del Noce v. Delyar Corp.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,670 (S.D.N.Y. 1976); *Berman v. Thomson*, 403 F. Supp. 695 (N.D. Ill. 1975) ; *Chris-Craft Indus., Inc. v. Independent Stockholders Comm.*, 354 F. Supp. 895 (D. Del. 1973) ; *Norte & Co. v. R.L. Huffines*, 304 F. Supp. 1096 (S.D.N.Y. 1968) , aff'd in part and remanded in part, 416 F.2d 1189 (2d Cir. 1969) , cert. denied, 397 U.S. 989 (1970) (dicta); see also *Gruss v. Curtis Publishing Co.*, 534 F.2d 1396 (2d Cir. 1976) , cert. denied, 429 U.S. 887 (1976) .

Adams v. Standard Knitting Mills, 623 F.2d 422 (6th Cir. 1980) , cert. denied, 449 U.S. 1067, 101 S. Ct. 795, 66 L. Ed. 2d 611 (1980) , which held that scienter is required for liability of accountants and other "outsiders." But see *Fradkin v. Ernst*, 571 F. Supp. 829 (N.D. Ohio 1983) (negligence is a sufficient basis when the corporate issuer is the defendant, distinguishing *Adams*).

See also *Herskowitz v. Nutri/System*, 857 F.2d 179 (3d Cir. 1988) , cert. denied, 489 U.S. 1054 (1989) (scienter not required for liability of a bank that gave a fairness opinion in a leveraged buyout).

(n318)Footnote 318. 351 F. Supp. 853 (D. Del. 1972) , aff'd, 535 F.2d 761 (3d Cir. 1976) .

(n319)Footnote 319. *Gould* also recognized that it will not always be a director who is sued. "It should be noted that the liability of any individual defendant is dependent upon his due diligence or exercise of reasonable care, and therefore, the negligence standard embodies a criterion which would permit consideration of the individual's particular position with the corporation and his relationship to the pertinent information held to be erroneously or incompletely stated in the proxy materials." 351 F. Supp. at 865 .

See, e.g. *Chris-Craft Indus. v. Independent Stockholders Comm.*, 354 F. Supp. 895 (D. Del. 1973) (director nominees, although not liable for every incorrect statement in proxy, had duty to verify charges of misstatements made by other participants).

(n320)Footnote 320. *Gould*, 351 F. Supp. at 859 ; see also *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d at 1281 , 1300 (2d Cir. 1973).

See also *Shidler v. All American Life & Fin. Corp.*, 775 F.2d 917 (8th Cir. 1985) , *aff'd in part, rev'd in part and remanded sub nom. Nelson v. All American Life & Financial Corp.*, 889 F.2d 141 (8th Cir. 1989) (strict liability not the appropriate standard of liability under Section 14(a) and Rule 14(a-q)).

(n321)Footnote 321. *Gould*, 351 F. Supp. at 861-62 . Cf. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976) .

"Section 10(b) makes unlawful the use or employment of 'any manipulative or deceptive device or contrivance' in contravention of Commission rules. The words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct." *Ernst & Ernst*, 425 U.S. at 197, 96 S. Ct. at 1383, 47 L. Ed. 2d at 679 .

The *Gould* court also rejected any analogy to Section 18 of the Exchange Act.

[I]n spite of portions of overlap, §§ 18 and 14(a) involve the regulation of two fundamentally different types of securities activities. Section 18 provides broad coverage for any document filed pursuant to the 1934 Act and subjects an individual to liability to anyone buying or selling a security in reliance on a misleading statement in such a document. Section 14(a) is considerably more limited as it encompasses solely the solicitation of proxies and proxy materials. In light of the Supreme Court's admonitions concerning the paramount necessity to insure the sanctity of the mechanisms of corporate suffrage and for the dissemination of information to shareholders, see *J.L. Case Co. v. Borak*, *supra* , the conclusion that a more demanding standard of conduct might be imposed under § 14(a) than under § 18 is readily acceptable.

351 F. Supp. at 864 .

See also *Gerstle*, 478 F.2d at 1299-1300 .

(n322)Footnote 322. The *Gould* court also noted that Section 14(a) placed primary responsibility for the accuracy of proxy statements on the individuals soliciting the proxies and not on attorneys or accountants who prepared them. 351 F. Supp. at 865, 867 .

In *Adams v. Standard Knitting Mills*, 623 F.2d 422 (6th Cir. 1980) , *cert. denied*, 449 U.S. 1067, 101 S. Ct. 795, 66 L. Ed. 2d 611 (1980) , the Sixth Circuit held that scienter is an element of liability in private actions under Section 14(a) and Rule 14a-9 against accountants and other outsiders. The court of appeals read the Senate Report to the Exchange Act (the "Fletcher Report") as indicating that: "its authors contemplated that 14(a) would be applied only against the knowing or reckless wrongdoing of outsiders." *Id.* at 430 . "The common denominator of all these depictions of the problem is wrongdoing with some degree of knowledge, i.e., scienter; and nowhere, not in the committee reports nor in the House or Senate debates, does it appear that Congress desired to protect the investor against negligence of accountants as well." *Id.*

It is suggested that the *Adams* opinion is guilty of a non sequitur in this instance. As amply illustrated by the legislative history of the Securities Act of 1933, it does *not* follow: (a) from the fact that Congress was exercised about

blatantly misleading and false practices, that (b) it was *only* concerned with intentional or reckless wrongdoing. See Section 11 of the Securities Act, 15 U.S.C. § 77k.

Cf. SEC v. Frank, 388 F.2d 486 (2d Cir. 1968) , where a Commission enforcement action was brought against an attorney for preparing an allegedly misleading offering circular. In its opinion the court stated: "[a] lawyer, no more than others, can escape liability for fraud by closing his eyes to what he saw and could readily understand." *Id.* at 489 .

See also *SEC v. Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973) ; *Wechsler v. Steinberg*, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,449 (E.D.N.Y. Feb. 13, 1976); *SEC v. National Student Mktg. Corp.*, 402 F. Supp. 641 (D.D.C. 1975) , *aff'd*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,612 (D.C. Cir. 1976); *SEC v. Century Inv. Transfer Corp.*, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,232 (S.D.N.Y. Oct. 5, 1971) (preparation of opinion letters crucial to distribution of unregistered securities is sufficient to find attorney an aider and abettor where statements "go enough beyond being mere mistakes in legal judgment to constitute probable violations of the anti-fraud provisions of the securities laws").

In *H.L. Federman & Co. v. Greenberg*, 405 F. Supp. 1332 (S.D.N.Y. 1975) , allegations that a third-party corporate lender who played an integral part in a transaction for which shareholder approval was obtained was guilty of aiding and abetting in the solicitation of a false and misleading proxy statement in violation of *Rule 10b-5* stated a claim upon which relief could be granted; the complaint alleged that the corporate lender with knowledge that such statements were false and misleading had failed to disclose that fact to shareholders. *But see Beatty v. Bright*, 345 F. Supp. 1188 (S.D. Iowa 1972) (acquiring company not liable under Section 14(a) or 10(b) since facts failed to show that they exercised control over the wording of the merger partner's proxy statement).

(n323)Footnote 323. *Gould*, 351 F. Supp. at 865 . See also *Gerstle*, 478 F.2d at 1300 .

(n324)Footnote 324. 501 U.S. 1083, 1090 (1991) . See, discussion of negligence versus scienter in § 7.09[5][h], *supra* .

(n325)Footnote 325. *Gould v. American-Hawaiian Steamship Co.*, 535 F.2d 761 (3d Cir. 1976) ; *Simon v. New Haven Board & Carton Co.*, 516 F.2d 303 (2d Cir. 1975) ; *Richardson v. MacArthur*, 451 F.2d 35 (10th Cir. 1971) ; *de Haas v. Empire Petroleum Co.*, 435 F.2d 1223 (10th Cir. 1970) ; *Globus v. Law Research Serv.*, 418 F.2d 1276 (2d Cir. 1969) , *cert. denied*, 397 U.S. 913 (1970) ; *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968) , *cert. denied sub nom. Troster, Singer & Co. v. Green*, 395 U.S. 977 (1969) .

Punitive damages may be permitted where there is a pendent state claim. *Young v. Taylor*, 466 F.2d 1329 (10th Cir. 1972) .

See also *Gridley v. Sayre & Fisher Co.*, 409 F. Supp. 1266 (D.S.D. 1976) , *aff'd sub nom. Gridley v. Cunningham*, 550 F.2d 551 (1977) (upon showing of malice or bad faith); *Nagel v. Prescott & Co.*, 36 F.R.D. 445 (N.D. Ohio 1964) (malice).

No damages for pain and suffering or wrongful death resulting from violations of the Exchange Act can be awarded. *Weiss v. Hayden Stone Inc.*, 340 F. Supp. 1074 (E.D.N.Y. 1972) .

(n326)Footnote 326. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 387, 90 S. Ct. 616, 24 L. Ed. 2d 593 (1970) (emphasis added).

(n327)Footnote 327. See, e.g. *Gould v. American-Hawaiian Steamship Co.*, 535 F.2d 761 (3d Cir. 1976) ; *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973) ; *Del Noce v. Delyar Corp.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,670 (S.D.N.Y. 1976); *Pierre J. LeLandaïs & Co. v. MDS-ATRON, Inc.*, 387 F. Supp. 1310 (S.D.N.Y. 1974) , *cert. denied*, 429 U.S. 1062 (1977) .

(n328)Footnote 328. *Gerstle*, 478 F.2d at 1304 .

(n329)Footnote 329. See *Gould v. American-Hawaiian Steamship Co.*, 535 F.2d 761 (3d Cir. 1976) ; *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973) .

(N330)Footnote 330. *Gould*, 535 F.2d at 781 ; *Myzel v. Fields*, 386 F.2d 718, 749 (8th Cir. 1967) , cert. denied, 390 U.S. 951 (1968) .

The plaintiff may have a duty to mitigate damages. *Pierre J. LeLandaïs & Co. v. MDS-ATRON, Inc.*, 387 F. Supp. 1310 (S.D.N.Y. 1974) , cert. denied, 429 U.S. 1062 (1977) .

(n331)Footnote 331. *Gould*, 535 F.2d at 781 ; *Gerstle*, 478 F.2d at 1303 ; *Del Noce v. Delyar Corporation*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,670 (S.D.N.Y. 1976); *Gruss v. Curtis Publishing Co.*, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,036 (S.D.N.Y. Mar. 21, 1975), rev'd on other grounds, 534 F.2d 1396 (2d Cir. 1976) , cert. denied, 429 U.S. 887 (1976) ; *Pierre J. LeLandaïs & Co., Inc. v. MDS-ATRON, Inc.*, 387 F. Supp. 1310 (S.D.N.Y. 1974) , cert. denied, 429 U.S. 1062 (1977) ; *Norte & Co. v. R.L. Huffines*, 304 F. Supp. 1096 (S.D.N.Y. 1968) , aff'd in part and remanded in part, 416 F.2d 1189 (2d Cir. 1969) , cert. denied, 397 U.S. 989 (1970) . See *Affiliated Ute Citizens v. U.S.*, 406 U.S. 128, 155, 92 S. Ct. 1456, 1473, 31 L. Ed. 2d 741, 762 (1972) .

(n332)Footnote 332. *Myzel*, 386 F.2d at 743-49 ; *Gottlieb v. Sandia American Corp.*, 304 F. Supp. 980 (E.D. Pa. 1969) , cert. denied, 404 U.S. 938 (1971) , modified, 452 F.2d 510 (1971) .

Restitutional measure of damages was defined in *Myzel v. Fields* as: "Rescission calls for cancellation of the bargain, and the return of the parties to the *status quo ante*; where this is impossible because of the disposal or retirement of the stock, then equivalent value of the stock at the time of the resale... or at the time of judgment ... should be the proper measure of damages." 386 F.2d. at 742 (footnotes and citations omitted).

(n333)Footnote 333. *Gould v. American-Hawaiian Steamship Co.*, 535 F.2d 761 (3d Cir. 1976) ; *Ohio Drill & Tool Co. v. Johnson*, 498 F.2d 186, 190 (6th Cir. 1974) ; *Gerstle*, 478 F.2d 1305-06 (profits from assets awarded); see also *Affiliated Ute Citizens v. U.S.*, 406 U.S. 128, 155, 92 S. Ct. 1456, 1473, 31 L. Ed. 2d 741, 762 (1972) ; *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 516 F.2d 172 (2d Cir. 1975) , rev'd on other grounds, 430 U.S. 1, 97 S. Ct. 926 (1977) ; *Zeller v. Bogue Electric Mfg. Corp.*, 476 F.2d 795, 801 (2d Cir. 1973) , cert. denied, 414 U.S. 908 (1973) ; *Levine v. Seilon*, 439 F.2d 328, 334 (2d Cir. 1971) ; *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967) , cert. denied, 390 U.S. 951 (1968) ; *Janigan v. Taylor*, 344 F.2d 781, 786-787 (1st Cir.) , cert. denied, 382 U.S. 879 (1965) ; cf. *Marcus v. Otis*, 169 F.2d 148 (2d Cir. 1948) , judgment entered on remand, 83 F. Supp. 893 (S.D.N.Y. 1949) (restitution; recovery of property enhanced in value).

(n334)Footnote 334. See *Bailey v. Meister Brau, Inc.*, 535 F.2d 982, 991 (7th Cir. 1976) ; *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 891, 895 (3d Cir. 1975) , cert. denied, 425 U.S. 993 (1976) ; *Wolf v. Frank*, 477 F.2d 467, 478 (5th Cir.) , cert. denied, 414 U.S. 975 (1973) ; *Abrahamson v. Fleschner*, 392 F. Supp. 740, 746 (S.D.N.Y. 1975) , decision reserved, 537 F.2d 27 (2d Cir. 1975) , aff'd in part, rev'd and remanded in part, 568 F.2d 862 (1977) , cert. denied, 436 U.S. 913 (1978) ; *Schaefer v. First Nat'l Bank of Lincolnwood*, 326 F. Supp. 1186, 1193 (N.D. Ill. 1970) , appeal dismissed, 465 F.2d 234 (7th Cir. 1972) .

(n335)Footnote 335. *Gould v. American-Hawaiian Steamship Co.*, 535 F.2d 761 (3d Cir. 1976) ; *Simon v. New Haven Board & Carton Co.*, 516 F.2d 303 (2d Cir. 1975) ; *Richardson v. MacArthur*, 451 F.2d 35 (10th Cir. 1970) ; de *Haas v. Empire Petroleum Co.*, 435 F.2d 1223 (10th Cir. 1970) ; *Globus v. Law Research Serv.*, 418 F.2d 1276 (2d Cir. 1969) , cert. denied, 397 U.S. 913 (1970) ; *Green v. Wolf Corp.*, 406 F.2d 291 (2d Cir. 1968) , cert. denied sub nom. *Troster, Singer & Co. v. Green*, 395 U.S. 977 (1969) .

(n336)Footnote 336. 535 F.2d 761 (3d Cir. 1976) . See also *Osofsky v. Zipf*, 645 F.2d 107 (2d Cir. 1981) ,

appealed after remand sub nom. Osofsky v. J. Ray McDermott & Co., 725 F.2d 1057 (2d Cir. 1984) , in which the court applied a "benefit-of-the-bargain" measure of damages when a misrepresentation was made in the tender offer and proxy solicitation materials as to the consideration to be forthcoming upon an intended merger since the amount of damages--the difference between what was represented as coming to the security holders and what they actually received--could be determined with certainty.

(n337)Footnote 337. *478 F.2d 1281 (2d Cir. 1973)* .

(n338)Footnote 338. *SEC v. National Sec. Indus.*, 393 U.S. 453, 89 S. Ct. 564, 21 L. Ed. 2d 668 (1969) . For a discussion of civil liability under *Rule 10b-5*, see ch. 5 *supra*.

(n339)Footnote 339. Moreover, Section 3(a)(14) of the Exchange Act defines "sale" and "sell" to "include any contract to sell or otherwise dispose of." Clearly, by adopting a merger or like agreement, the shareholders of the corporation to be merged or consolidated adopt an agreement that results in the disposition of their securities. The same result should obtain in a sale of assets in which the vendor is required by the terms of the agreement with the vendee to liquidate and distribute the consideration received for its assets to its shareholders. Again, the shareholders of the vendor, by approving the agreement, obligate themselves to the disposition of their securities. That analysis should prevail of whether the particular plaintiff voted for or against the transaction, since the action of the required majority is in fact binding on all the shareholders under modern corporation law. The reality is that the modern shareholder obligates himself to be bound by the act of a sufficient majority of his fellow shareholders when he becomes a shareholder.

To make distinctions based on minute or fragments analysis of any part of such fundamental changes in the shareholders' situation when the economic reality is that the former shareholders have in fact bound themselves to the disposition of their securities would seem contrary to the Supreme Court's recent admonition to let the economic realities of a transaction, rather than terminology, guide the interpretative process. *United Housing Found., Inc. v. Forman*, 421 U.S. 837, 95 S. Ct. 2051, 44 L. Ed. 2d 621 (1975) .

The situation of the shareholders in the surviving or vendee corporation is different from those of the selling or disappearing company, at least where the quantity or denomination of their share holdings is not affected by the transaction. But even in such cases, the economic realities of the situation may suggest a closer analysis, *e.g.*, where the corporation is formally the "acquiring" company is in fact being acquired through a shift in control or by being a smaller part of the resulting entity. See, *e.g.* *Farris v. Glen Alden Corp.*, 393 Pa. 427, 143 A.2d 25 (1958) .

(n340)Footnote 340. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976) .

(n341)Footnote 341. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S. Ct. 1917, 44 L. Ed. 2d 539, 1975-1 Trade Cas. (CCH) P60351 (1975) .

(n342)Footnote 342. *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991) (where the Court stated in Note 5 at page 1090: "In *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 444, n. 7, 96 S. Ct. 2126, 48 L. Ed. 2d 757 (1976) , we reserved the question whether *scienter* was necessary for liability generally under § 14(a). We reserve it still."

(n343)Footnote 343. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 97 S. Ct. 1292, 51 L. Ed. 2d 480 (1977) .

(n344)Footnote 344. See, *e.g.* *In re Fleet/Norstar Sec. Litig.*, 1991 U.S. Dist. LEXIS 7874 , C.A. No. 90-0173B (D.C. R.I. 1991); *Kas v. Financial Gen'l Bankshares, Inc.*, 796 F.2d 508 (D.C. Cir. 1986) ; *SEC v. National Sec. Indus.*, 393 U.S. 453, 89 S. Ct. 564, 21 L. Ed. 2d 668 (1969) ; *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283 (2d Cir.) , *rev'd on other grounds*, 430 U.S. 462, 97 S. Ct. 1292, 51 L. Ed. 2d 480 (U.S. March 23, 1977) ; *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255 (3d Cir. 1972) , *cert. denied*, 409 U.S. 874 (1973) .

(n345)Footnote 345. *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974) , *cert. denied*, 421 U.S. 976 (1975) , *appeal dismissed*, 551 F.2d 531 (2d Cir. 1977) ; *Del Noce v. Delyar Corp.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,670 (S.D.N.Y. 1976); *Laurenzano v. Einbender*, 264 F. Supp. 356 (S.D.N.Y. 1966) , *aff'd*, 448 F.2d 1 (2d Cir. 1971) ; *Norte & Co. v. Huffines*, 304 F. Supp. 1096 (S.D.N.Y. 1968) , *modified*, 416 F.2d 1189 (2d Cir. 1969) , *cert. denied*, 397 U.S. 989 (1971) ; *but see Richland v. Crandall*, 262 F. Supp. 538 (S.D.N.Y. 1967) .

(n346)Footnote 346. 152 Fed. Appx. 674 (9th Cir. 2005).



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Federal Securities Exchange Act of 1934

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CHAPTER 7A The Williams Act Amendments-- Controlling Shareholders and Tender Offers

2-7A Federal Securities Exchange Act of 1934 7A.syn

AUTHOR: Chang-Do Gong This chapter was prepared by Morton A. Pierce and Chang-Do Gong with the assistance of Daniel Hackney. Messrs. Pierce and Gong are partners of Dewey & LeBoeuf LLP. and Mr Hackney is an associate of Dewey & LeBoeuf LLP.

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Chang-Do Gong n1

FOOTNOTES:

(n1)Footnote 1.

This chapter was prepared by Morton A. Pierce and Chang-Do Gong with the assistance of Daniel Hackney. Messrs. Pierce and Gong are partners of Dewey & LeBoeuf LLP. and Mr Hackney is an associate of Dewey & LeBoeuf LLP.



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Federal Securities Exchange Act of 1934

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Summary of This Chapter

Prior to the adoption of the Williams Act in 1968, any person or group of persons could gain control of a company in a cash takeover bid without disclosing information about themselves or their plans for the target company. In reaction to this lack of disclosure, Congress enacted the Williams Act, which amended the Securities Exchange Act of 1934, as amended (the "Exchange Act"), by adding Sections 13(d), 13(e), 14(d), 14(e), and 14(f), which compel offerors or bidders to publicly file significant disclosures with Securities and Exchange Commission (the "Commission"). Under the Williams Act, an intricate framework of rules and regulations prevent an offeror from engaging in fraudulent activity in connection with his or her offer. Concurrently, the Williams Act helps to ensure that an offeror discloses adequate and meaningful information about his or her offer to security holders in order to facilitate an informed decision-making process. Moreover, the Williams Act provides for public disclosure of significant accumulations of issuer securities generally. *See infra* § 7A.01.

Depending on the facts and circumstances surrounding the ownership interest, a person or group of persons acquiring "beneficial ownership" of more than five percent of any class of equity security of an issuer must file certain disclosures with the Commission on either a Schedule 13D or the abbreviated Schedule 13G, pursuant to Sections 13(d) or (g) of the Exchange Act. In a filing on Schedule 13D, the acquiring person or group of persons must disclose, among other things, his or her identity, purpose in acquiring the securities, source of funds, and the amount of securities of the issuer held by such person or group of persons as of the date of the filing. Nonetheless, the rules contain exemptions from the filing requirements for any acquisition by means of a registration statement, any acquisition of an equity security by the issuer of such security, and any acquisition that, together with all other acquisitions of that class of security by the same person during the preceding twelve months, does not exceed two percent of that class of security. *See infra* § 7A.02.

If a controlling shareholder fails to make the required disclosures, the Commission may order compliance, and may obtain injunctive relief in federal court if the Commission shows a "reasonable likelihood" that the defendant will commit future violations of the rules. Additionally, violators of these rules may also be subject to private actions for

damages and/or injunctive relief. See *infra* § 7A.02.

According to the Commission, a tender offer is a broad solicitation by a bidder for the purchase of a substantial percentage of equity securities of a subject company which remains open for a limited period of time. While the term "tender offer" has never been defined in statutory provisions or Commission rules, courts generally apply the eight-factor test established in *Wellman v. Dickinson* to determine whether an acquisition program constitutes a tender offer. These factors include whether the transaction: (1) involves an active and widespread solicitation of public shareholders; (2) involves a solicitation made for a substantial percentage of the target company's stock; (3) offers a premium to the prevailing market price; (4) has fixed rather than negotiable terms; (5) is an offer contingent on the tender of a fixed minimum number of shares to be purchased; (6) is only open for a limited period of time; (7) pressures offerees to sell their stock; and (8) is accompanied by public announcement of a purchase program for the target company's securities which precedes or accompanies a rapid accumulation of large amounts of the target company's securities. No single factor is dispositive and courts do not need to conclude that all eight factors are present in order to determine that an acquisition program is a tender offer. See *infra* § 7A.03[1].

During a tender offer, a bidder solicits the subject company's shareholders to tender their shares at a fixed price, which is usually at a premium over the pre-offer market price of the underlying securities. Generally, the offer to purchase is contingent upon the shareholders tendering a particular number of shares in the transaction. The type of consideration received in the transaction determines whether or not the tender offer is a "cash offer" or an "exchange offer." In a "cash offer," the bidder seeks to acquire the target company's stock for cash, whereas in an "exchange offer," the bidder offers to exchange his or her own stock for stock in the target company. See *infra* § 7A.03.

Prior to launching a tender offer, a bidder, who would own more than five percent of a class of equity securities of the target company following successful completion of the tender offer, must file a Schedule TO with the Commission. Then the bidder must deliver a copy of the Schedule TO to the target company, its shareholders and any other bidders that filed a Schedule TO with the Commission relating to a tender offer that has not terminated for the same class of securities of the target company. The Schedule TO must disclose, among other things, the bidder's identity, the amount of the target company's securities sought and the consideration offered, the bidder's source of funds, the purpose(s) of the tender offer, and whether the bidder plans to acquire the target company's shares in order to change the target company's board of directors, divest material assets of the target company, merge with the target company or any of its subsidiaries, or change the target company's capital structure. See *infra* § 7A.03[2][a].

Further, the target company's shareholders must be provided with certain information by the bidder including, among other things, the offering price, the duration of the offer, how securities must be tendered, and the terms under which tendered securities may be withdrawn. The target's shareholders must also be informed of the identity of the bidder and of any person or group of persons soliciting shareholders on the bidder's behalf. Similar information must be furnished to the target company's shareholders by the target company if the target company intends to solicit shareholders in opposition to the tender offer. See *infra* § 7A.03.

In order to reduce the risk of market manipulation and insider trading, a bidder is prohibited from acquiring shares of the target company outside of the offer during the offering period, subject to certain exceptions. See *infra* § 7A.03.

Under Section 14(e), material misstatements or omissions and fraudulent, deceptive or manipulative practices in connection with tender offers are prohibited. A misstatement or omission is "material" if a reasonable shareholder would consider it important in deciding whether or not to tender its shares. A private right of action for violations of Section 14(e) applies not only against the bidder but also against the target company. See *infra* § 7A.03.

In regard to tender offers wherein the issuer seeks to acquire its own shares, either in a "going private" transaction or through an "issuer tender offer," the issuer must provide its shareholders with substantially the same information as would be required from an third party bidder. See *infra* § 7A.04[1].



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CHAPTER 7A The Williams Act Amendments-- Controlling Shareholders and Tender Offers

2-7A Federal Securities Exchange Act of 1934 § 7A.01

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§ 7A.01 Introduction to the Williams Act

On July 29, 1968, Congress enacted legislation known as the "Williams Act," named after its sponsor, Senator Harrison Williams. The Williams Act amended the Exchange Act by adding Sections 13(d), 13(e), 14(d), 14(e), and 14(f), n1 which require offerors or bidders in a tender offer to file significant disclosures with the Commission and provide these disclosures to the target company's shareholders and ultimately the public at large.

Congress enacted the Williams Act in reaction to a growing concern that tender offers and other large stock accumulations were not being adequately regulated under the securities laws. In fact, prior to the adoption of the Williams Act, any person or group of persons could gain control of a company in a cash takeover bid without disclosing pertinent information about themselves, their source of funds, their financial ability to complete the offer, or their future plans for the target company. n2 Even though the securities laws regulated "exchange offers" through the registration of newly issued securities with the Commission under the Securities Act of 1933, as amended (the "Securities Act"), and regulated "proxy contests" challenging an incumbent board of directors under Section 14 of the Exchange Act, n3 cash tender offers were left largely unregulated. n4 This lack of information often led to improper activity by offerors and/or coerced ill-informed decision-making on the part of tendering security holders. Accordingly, the Williams Act was designed to prevent fraudulent activity and enhance disclosure by requiring offerors to provide adequate and meaningful information about their offers to security holders in order to facilitate an informed decision-making process.

One of the most important provisions in the Williams Act is embodied in Section 13(d), which requires, among other things, a person or group of persons acquiring more than five percent ownership of a public issuer to file with the Commission and then send to the issuer a statement containing information about such person or group of persons and the reasons for making the purchase. n5

The Williams Act's other provisions provide for additional regulation and disclosure. For instance, Section 13(e) regulates self-tender offers and the purchases by an issuer of its own securities. n6 Section 14(d) imposes disclosure requirements and substantive restrictions on certain types of tender offers. n7 Section 14(e) is an antifraud provision that applies to statements or conduct in connection with any type of tender offer. n8

Additionally, the Williams Act amendments provide the Commission with rulemaking authority. Through such authority, the Commission promulgated a number of rules immediately following Congress's enactment of the Williams Act. n9 Over the years, the Commission added new rules and made various amendments to the requirements set forth in older rules. n10 In addition, Congress has made various statutory adjustments throughout the years.

A House Report on the Securities Exchange Act Amendments of 1968 (i.e., the "Williams Act") makes it clear that the Williams Act's purpose was neither to encourage nor discourage tender offers, but rather to ensure that stockholders have sufficient information in order to allow them to intelligently decide whether or not to tender their securities. n11

The House Report recognized that while the Williams Act's disclosure requirements may discourage some tender offers, ultimately "this is a small price to pay for investor protection." n12 In fact, except for a brief decline in tender offers directly following the passage of the Williams Act, n13 the disclosure requirements do not appear to have significantly impeded the number of tender offers. n14 However, in conjunction with the state takeover statutes, the Williams Act amendments thoroughly changed the manner and process by which tender offers are launched and executed. n15

FOOTNOTES:

(n1)Footnote 1. Williams Act of July 29, 1968, Pub. L. No. 90-439, §§ 2, 3, 82 Stat. 454, 455 (1968) (amending 15 U.S.C. §§ 78m, 78n).

(n2)Footnote 2. See Hugh L. Sowards and James S. Mofsky, *Corporation Take-Over Bids: Gap in Federal Securities Regulation*, 41 ST. JOHN'S L. REV. 499 (1967).

(n3)Footnote 3. See *supra* Ch. 7 for a discussion of proxy regulation.

(n4)Footnote 4. However, it is noteworthy that *Rule 10b-5* prohibits fraud in the purchase or sale of any security. This applies to all types of purchases, including those made pursuant to a tender offer for the purpose of acquiring corporate control. See *supra*. Ch. 5.

(n5)Footnote 5. See *infra* § 7A.02

(n6)Footnote 6. See *infra* § 7A.04[1].

(n7)Footnote 7. See *infra* § 7A.03.

(n8)Footnote 8. See *infra* § 7A.03.

(n9)Footnote 9. See Adoption of Temporary Rules and Regulations under Sections 13(d) and (e) and Sections 14(d) and (f), Exchange Act Release No. 8370, [1967-1968 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 977,581 (July 30, 1968). Such rules include Regulation 13D, Regulation 14D, Rule 13e-1, and Rule 14f-1.

(n10)Footnote 10. See, e.g., Amendments to Beneficial Reporting Requirements, Exchange Act Release No. 34-39538 [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 86,002 (Jan. 12, 1998) (amending Regulation 13D-G).

(n11)Footnote 11. A house committee report described the state of affairs prior to the adoption of the Williams Act thus:

The cash tender offer has advantages over the proxy contest as a means of obtaining control of a

corporation. One such advantage is that by using a cash tender offer the person seeking control can operate in almost complete secrecy. At present, the law does not even require that he disclose his identity, the source of his funds, who his associates are, or what he intends to do if he gains control of the corporation. As a practical matter, unless incumbent management explains its position publicly, the investor is severely limited in obtaining all of the facts on which to base a decision whether to accept or reject the tender offer.

The public shareholder must, therefore, with severely limited information, decide what course of action he should take. He has many alternatives. He can tender all of his shares immediately and hope they are all purchased. However, if the offer is for less than all the outstanding shares, perhaps only a part of them will be taken. In these instances, he will remain a shareholder in the company, under a new management which he has helped to install without knowing whether it will be good or bad for the company.

The shareholder, as another alternative, may wait to see if a better offer develops, but if he tenders late, he runs the risk that none of his shares will be taken. He may also sell his shares in the market or hold them and hope for the best. Without knowledge of who the bidder is and what he plans to do, the shareholder cannot reach an informed decision. He is forced to take a chance. For no matter what he does, he does it without adequate information to enable him to decide rationally what is the best possible course of action. This is precisely the kind of dilemma which our Federal securities laws are designed to prevent.

It was urged during the hearings that takeover bids should not be discouraged because they serve a useful purpose in providing a check on entrenched but inefficient management. It was also recognized that these bids are made for many other reasons, and do not always reflect a desire to improve the management of the company. The bill avoids tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid. It is designed to require full and fair disclosure for the benefit of investors while at the same time providing the offeror and management equal opportunity to fairly present their case. H.R. REP. NO. 90-1711 (1968), *reprinted in* FEDERAL SECURITIES EXCHANGE ACT OF 1934 (A.A. Sommer, Jr., ed., Matthew Bender 1971) 5-806 *et seq.*

(n12)Footnote 12. "While the bill may discourage tender offers or other attempts to acquire control by some who are unwilling to expose themselves to the light of disclosure, the committee believes this is a small price to pay for adequate investor protection. In fact, experience under the Securities Act of 1933 and the Securities Exchange Act of 1934 has amply demonstrated that the disclosure requirements of the Federal securities acts are an aid to legitimate business transactions, not a hindrance." *Id.*

One commentator stated: "The bill will probably have some net deterrent effect on tender offers for a variety of reasons, including: (1) the additional cost of complying with the regulatory process; (2) the extra cost of extending any price increase to earlier tenders; (3) the higher probability of lawsuits over the disclosure of matters--like plans for the target company--which are inherently contingent and subject to change; and (4) the possibility that forced disclosure, *e.g.*, of plans, will raise the price the offeror has to pay to attract shares." Alan R. Bromberg, *The Securities Law of Tender Offers*, 15 N.Y.L. SCH. L. REV. 462, 468 (1969). (footnotes omitted).

(n13)Footnote 13. Robert W. Hamilton, *Some Reflections on Cash Tender Offer Legislation*, 15 N.Y.L. SCH. L. REV. 269, 276 (1969).

(n14)Footnote 14. For instance, according to the Thomson ONE financial news and data network, the number of

significant tender offers in the United States has increased measurably since era of the Williams Act's passage.

(n15)Footnote 15. See Dan H. Reuben & Gary M. Elden, *How to be a Target Company*, 23 N.Y.L. SCH. L. REV. 423 (1978).



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CHAPTER 7A The Williams Act Amendments-- Controlling Shareholders and Tender Offers

2-7A Federal Securities Exchange Act of 1934 § 7A.02

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§ 7A.02 Filings by Five Percent Shareholders

When a person or group of persons, known as a "five percent shareholder," acquires beneficial ownership of more than five percent of any class of equity security of an issuer, it must file a report of beneficial ownership on either Schedule 13D or 13G pursuant to Sections 13(d) or (g) of the Exchange Act with the Commission and provide the issuer with the information required by the report, including the identity of the five percent shareholder, its purpose in acquiring the shares, its source of funds, and the amount of the issuer's shares held by the five percent shareholder as of the date of the report. The rules also contain exemptions from the filing requirements for any acquisition by means of a registration statement, any acquisition of an equity security by the issuer of the security, and any acquisition that, together with all other acquisitions of that class of security by the same person during the preceding twelve months, does not exceed two percent of that class or is otherwise material under the circumstances.

If a five percent shareholder fails to make the disclosures required, the Commission may order compliance, and may obtain injunctive relief in the federal district courts if the Commission shows a "reasonable likelihood" that the defendant will commit future violations.

Additionally, violators of these rules may also be subject to private actions for damages and/or injunctive relief.

[1] The Obligation to File.

[a] Who Must File.

[i] Section 13(d) and Section 13(g). Section 13(d) of the Exchange Act requires any person who, after acquiring directly or indirectly the beneficial ownership of any equity security of a class registered under Section 12 of the Exchange Act (or any equity security of an insurance company that would be required to register under Section 12, except for the exemption in Section 12(g)(2)(G) or any equity security issued by a closed-end investment company registered under the Investment Company Act of 1940), is the beneficial owner of more than five percent of such class to file a statement containing the information specified in Section 13(d) (1)(A)-(E) of the Exchange Act and "such additional information, as the Commission may by rules and regulations prescribe as necessary or appropriate in the

public interest or for the protection of investors." n1

Section 13(d)(6) provides certain exemptions from the requirements of Section 13(d), including exemptions for (1) any acquisition by means of a registration statement, n2 *i.e.* stock for stock exchanges registered under the Securities Act, n3 (2) any acquisition, which together with all other acquisitions of that class of security by the same person during the preceding twelve months, does not exceed two percent of that class, and (3) any acquisition of an equity security by the issuer of that security. n4 Section 13(d)(6)(D) allows the Commission to exempt from the filing requirements any acquisition that is not made for the purpose of influencing or controlling the issuer or that is not otherwise within the purposes of Section 13(d). The Commission, under Section 13(d)(5), also has the authority to allow such persons to file a simplified statement.

The Domestic and Foreign Investment Improved Disclosure Act of 1977 n5 added, among other things, Section 13(g) to the Exchange Act. Section 13(g) was designed to ensure that any person or group of persons, who directly or indirectly beneficially owns more than five percent of a class of equity securities specified in Section 13(d)(1) of the Exchange Act would be required to file a beneficial ownership statement with the Commission containing the information required in Section 13(g)(1)(A) and (B) of the Exchange Act.

Section 13(g) is designed to "close the gaps" found in Section 13(d) such that all five percent shareholders will be required to file beneficial ownership reports under Section 13. n6 Unlike Section 13(d), Section 13(g) has no specific statutory exemptions and does not require a recent acquisition of stock to trigger its application. Section 13(g)(5) directs the Commission to take such steps as it deems necessary (1) to achieve centralized reporting of information regarding ownership and (2) to avoid unnecessarily duplicative and burdensome reporting. n7 In order to carry out this mandate, the Commission has integrated all its rules under Section 13(d) and 13(g) into Regulation 13D-G. n8 The Commission has also created Schedule 13G, which provides an abbreviated and less burdensome form of ownership reporting that certain passive and institutional investors may use as an alternative to Schedule 13D. A Schedule 13G may also be filed by persons who made their acquisitions while the issuer was privately held, so long as such filing person does not acquire more than two percent of the issuer's securities in any subsequent 12-month period.

It is noteworthy that every person, who owns more than ten percent of a company registered under Section 12, is required to file reports under Section 16(a) n9 as well as under Section 13. However, these reporting requirements each serve a different function--Section 16(a) is designed to prevent "insiders" from making short-swing or windfall profits, while Sections 13(d) and 13(g) are concerned with the issue of corporate control. n10

Further, Sections 13(d) and 13(g) are both applicable to any partnership, syndicate or other group formed for the purposes of acquiring, holding or disposing of securities of a particular issuer. n11 Thus, if such a group owns more than five percent of the equity securities of an issuer, it may be subject to the reporting requirements of Section 13. Similar to Section 13(d), Section 13(g) allows the Commission to make exemptions from its provisions. n12

[iii] Rule 13d-1. Rule 13d-1 sets forth the specifics of filing Schedules 13D and 13G. Paragraph (a) of Rule 13d-1 directs that a Schedule 13D be filed under the circumstances mandated by Section 13(d)(1), *i.e.*, by any person who through an acquisition of stock becomes the beneficial owner of more than five percent of any class of equity securities registered pursuant to Section 12. However, this does not apply to persons who are exempt from filing under the provisions of Section 13(d)(6). Pursuant to its authority under this subsection, the Commission adopted Rule 13d-6, which exempts persons who own more than five percent of a class of any equity security from reporting an additional acquisition of such security if the additional acquisition is made solely through the exercise of preemptive subscription rights as part of a *pro rata* offering by the issuer to all securityholders of that class. n13

Paragraph (d) of Rule 13d-1 directs that a shorter Schedule 13G be filed for certain exempt investors as well as "Qualified Institutional Investors" and "Passive Investors," as described below.

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Paragraph (b)(1) of Rule 13d-1 uses the authority given to the Commission by Section 13(d)(5) n14--it provides that persons ("Qualified Institutional Investors") who would otherwise be obligated to file a Schedule 13D under Rule 13d-1(a), may in lieu thereof file the shorter Schedule 13G, provided that:

"(i) Such person has acquired such securities in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect, including any transaction subject to Rule 13d-3(b); and

(ii) Such person is:

(A) A broker or dealer registered under Section 15 of the Exchange Act;

(B) A bank as defined in Section 3(a)(6) of the Exchange Act;

(C) An insurance company as defined in Section 3(a)(19) of the Exchange Act;

(D) An investment company registered under Section 8 of the Investment Company Act of 1940;

(E) Any person registered as an investment adviser under Section 203 of the Investment Advisers Act or under the laws of any state;

(F) An employee benefit plan as defined in Section 3(3) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), that is subject to the provisions of ERISA, or any such plan that is not subject to ERISA that is maintained primarily for the benefit of the employees of a state or local government or instrumentality, or an endowment fund;

(G) A parent holding company or control person, provided the aggregate amount held directly by the parent or control person, and directly and indirectly by their subsidiaries or affiliates that are not persons specified in Rule 13d-1(b)(1)(ii)(A) through (J), does not exceed one percent of the securities of the subject class;

(H) A savings association as defined in Section 3(b) of the Federal Deposit Insurance Act;

(I) A church plan that is excluded from the definition of an investment company under Section 3(c)(14) of the Investment Company Act;

(J) A non-U.S. institution that is the functional equivalent of any of the institutions listed in paragraphs (b)(1)(ii)(A) through (I) of this section, so long as the non-U.S. institution is subject to a regulatory scheme that is substantially comparable to the regulatory scheme applicable to the equivalent U.S. institution; and

(K) A group, provided that all the members are persons specified in Rule 13d-1(b)(1)(ii)(A) through (J); and

(iii) Such person has promptly notified any other person (or group within the meaning of Section 13(d)(3) of the [Exchange] Act) on whose behalf it holds, on a discretionary basis, securities exceeding five percent of the class, of any acquisition or transaction on behalf of such other person which might be reportable by that person under Section 13(d) of the [Exchange] Act. This paragraph only requires notice to the account owner of information which the filing person reasonably should be expected to know and which would advise the account owner of an obligation he may have to file a statement pursuant to Section 13(d) of the [Exchange] Act or an amendment thereto." n15

Furthermore, paragraph (b)(2) of Rule 13d-1 exempts the persons previously mentioned in paragraph (b)(1) from filing a Schedule 13G, if at the end of the calendar year, such persons own less than five percent of the security in question. Since the Schedule 13G filings made pursuant to Rule 13d-1(b)(1) do not have to be filed until after the end of the year in which the acquisition is made, n16 these persons can own more than five percent of an equity security for a limited time without incurring any obligation to report their holdings. However, a Schedule 13G must be filed within ten days after the end of the first month in which such person's beneficial ownership exceeds ten percent of a class of equity securities, n17 and thereafter, an amendment to Schedule 13G must be filed within ten days after the end of any month in which such person's beneficial ownership increases or decreases by more than five percent of that class. n18 If an amendment has been filed reflecting beneficial ownership of five percent or less of that class, then no additional monthly filings of Schedule 13G are required unless the person becomes the owner again of more than five percent of that class of securities and is required to file pursuant to Rule 13d-1. n19

In 1998, the Commission modified Regulation 13D-G to expand the use of Schedule 13G to cover certain passive investors (a "Passive Investor" or collectively, "Passive Investors"). n20 Rule 13d-1(c) provides that a person, who would otherwise be obligated to file a Schedule 13D under Rule 13d-1(a), may file a Schedule 13G instead if they comply with the following requirements set forth in the rule:

"(c) A person who would otherwise be obligated under paragraph (a) of this Rule 13d-1 to file a statement on Schedule 13D may, in lieu thereof, file with the Commission, within 10 days after an acquisition described in paragraph (a) of this Rule 13d-1, a short-form statement on Schedule 13G, provided, that the person:

- (1) Has not acquired the securities with any purpose, or with the effect of, changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having that purpose or effect, including any transaction subject to Rule 13d-3(b);
- (2) Is not a person reporting pursuant to paragraph (b)(1) of this Section 13d-1; and
- (3) is not directly or indirectly the beneficial owner of 20 percent or more of the class."

Essentially, these amendments provide Passive Investors with the ability to file a report disclosing their beneficial ownership on the abbreviated Schedule 13G instead of filing a longer and more complex report on Schedule 13D. According to the rules, a Passive Investor must file a Schedule 13G within ten days after the acquisition of five percent or more of an equity security. n21 In addition, an amendment must also be promptly filed when a Passive Investor's beneficial ownership exceeds ten percent of the class of security and thereafter must be promptly filed upon the Passive Investor's beneficial ownership increasing or decreasing by more than five percent. n22

A person relying on Rule 13d-1(b) or (c) in order to file a Schedule 13G in lieu of a Schedule 13D must continue to meet the applicable requirements of such rules. If such person still owns more than five percent of a class of equity securities, but now has the purpose or effect of influencing or controlling the issuer, n23 or, in the case of a Qualified Institutional Investor, ceases to be one of the persons listed in subparagraph (b)(1)(ii) n24 (reprinted *supra*), or, in the case of a Passive Investor, acquires more than twenty percent of the class of equity securities, then that person becomes subject to Rule 13d-1(a) and must, within ten days, file a Schedule 13D. A person filing a Schedule 13D because the purpose or effect of its securities ownership has changed or, in the case of a Passive Investor, because such investor has acquired more than twenty percent of the class of equity security, cannot, for ten days thereafter, vote these securities or acquire additional securities of the same type. n25 A person filing on Schedule 13G because its shares were acquired prior to the issuer's initial public offering need only convert to Schedule 13D if the filing person acquires more than two percent of the issuer's shares in any 12-month period following issuer's initial public offering.

Whenever two or more persons are required to file with respect to the same securities, n26 they may report jointly on the same schedule if they are all eligible to use that schedule. n27 In conjunction with filing the joint schedule, each

person must provide a written agreement that the joint schedule is filed on behalf of each of them. Anyone who is allowed to file a Schedule 13G may make a joint filing on a Schedule 13D since the latter contains all the information required by the former. However, a person who must use Schedule 13D may not participate in a joint filing on Schedule 13G since such a filing would be incomplete with respect to that person. n28 Accordingly, each person is responsible for the completeness and accuracy of the information concerning himself or herself contained in the joint statement. However, each person is not responsible for the information concerning another person making the joint filing unless that person knows or has reason to believe that such information is inaccurate.

[b] Information Required.

[i] Schedule 13D. n29 Section 13(d)(1) specifies the information that must be contained in a statement filed pursuant to Section 13(d). n30 It also gives the Commission the authority to request additional information that is "in the public interest or for the protection of investors." All of this required information is listed in Schedule 13D of the accompanying regulations.

Schedule 13D's cover page(s) includes, among other things, the name of issuer, the title of class of securities, the CUSIP number, n31 and the name, address and telephone number of the filer or a person authorized to receive notice and communications. As well, a Schedule 13D includes information about the filer of the report and the number of issuer securities held by such filer. It should be noted that if there is more than one filer, each filer is required to list the number of shares held on separate pages. Stylistically, the tabular format of Schedule 13D's cover page helps the Commission, and other readers who may use the report, by providing a summary of the pertinent disclosures contained in the item section of the report. Accordingly, to avoid unnecessary duplication, items on the Schedule 13D may be answered by an appropriate cross-reference to items on the cover page, provided that all of the information required by the item is disclosed.

Schedule 13D requires the following information:

Item 1, "Security and Issuer," calls for the title of the class of securities and the address of the principal executive offices of the issuer.

Item 2, "Identity and Background," requires a corporation, limited or general partnership, syndicate or other group of persons to state its name, the state or other place of its organization, its principal business, the address of its principal office, whether or not it has been convicted in a criminal proceeding (excluding traffic violations or similar misdemeanors) in the past five years, and, if so, the date and nature of the conviction, the name and location of the court, and the disposition of the case, and whether or not it was in the past five years subject to a civil decree, final order, or judgment of a court or administrative body that enjoined future violations of federal or state securities laws or found any violation with respect to such laws and if so, a description of these proceedings and a summary of the terms of the judgment.

A person must state his name, home or business address, occupation, the name, principal business and address of the employer, citizenship, and whether or not he has been subject to any criminal or civil proceedings as described above. n32

Item 3, "Source and Amount of Funds or Other Consideration," calls for the disclosure of the source and amount of funds or other consideration used in making the purchase, including a description of any transaction in which funds were borrowed for this purpose. n33 Where material, such information should also be provided with respect to prior acquisitions not previously reported under Regulation 13D-G. If the securities were not purchased, the method of their acquisition must be described.

Item 4, "Purpose of Transaction," n34 requires a statement of the purpose(s) of acquiring the securities n35 and a

description of any plans that relate to or would result in (1) the acquisition or disposition of additional securities of the issuer; (2) any change in the present board of directors or management of the issuer, including any plans or proposals to change the number or term of directors or to fill any existing vacancies on the board; (3) any merger, reorganization, liquidation or major sale or transfer of assets of the issuer or any of its subsidiaries; (4) changes in the issuer's business or corporate structure, and changes in its capitalization or dividend policy; (5) amending the issuer's charter or bylaws to make takeover of the issuer more difficult; (6) causing a class of the issuer's securities to be delisted from a national securities exchange, or no longer quoted in a system under a registered national securities association; or (7) making a class of the issuer's securities eligible for deregistration by reducing the number of shareholders to less than three hundred. n36 Any action similar to one of those listed above should also be reported.

Item 5, "Interest in Securities of the Issuer," requires that the number and percentage of the class of securities identified in Item 1 beneficially owned by each person named in Item 2 and by each person who is in a "group" with a person named in Item 2, be stated. n37 Those shares that there is a right to acquire must be identified. All transactions in this security effected by the above persons during the past sixty days or the most recent filing on Schedule 13D, whichever is less must be reported. n38 The nature of the securities ownership of the above people, *i.e.*, whether or not the power to vote the stock or direct the vote, dispose of it or direct the disposition, or receive or direct the receipt of dividends is shared with any other person must be explained. The information in Item 2 about such person must be given if he shares in the voting and disposition rights of a class of securities, and his name must be stated if he has the right to receive or direct the receipt of dividends from more than five percent of that class of securities. If applicable, the date on which the reporting person ceased to be a five percent beneficial owner must be stated.

Item 6, "Contracts, Arrangements, Understandings or Relationships With Respect to Securities of the Issuer," requires a description of any contracts, arrangements, understandings or relationships (legal or otherwise) among the persons named in Item 2 and between such persons and any person with respect to any securities of the issuer, including but not limited to transfer or voting of any of the securities, finder's fees, joint ventures, loan or option arrangements, puts or calls, guarantees of profits, division of profits or loss, or the giving or withholding of proxies. The person with whom such contracts, arrangements, understandings or relationships have been entered into must be named. Such information must also be included for any of the securities that are pledged or otherwise subject to a contingency the occurrence of which would give another person voting power or investment power over such securities except that disclosure of standard default and similar provisions contained in loan agreements need not be included. n39

Item 7, "Material to be Filed as Exhibits," requires that the following shall be filed as exhibits: copies of each written agreement relating to the filing of joint acquisition statements as required by Rule 13d-1(k), and copies of all written agreements, contracts, arrangements, understanding, plans or proposals relating to (1) the borrowing of funds to finance the acquisition as disclosed in Item 3; (2) any changes in the issuer as disclosed in Item 4; and (3) any contracts or arrangements with respect to the securities as disclosed in Item 6.

[ii] Schedule 13G. Schedule 13G's cover page also requires the abstraction of pertinent information contained in the items in Schedule 13G into tabular format. This layout allows the Commission to disseminate the information contained in the report to the public with greater ease. The following is a summary of the items contained in Schedule 13G:

Item 1, requires the name of the issuer and the address of its principal executive offices.

Item 2, requires the name, address (the principal business office, or if none, residence) and citizenship of the filing person. It also calls for the title of the class of securities and their CUSIP number.

Item 3, requires a person filing pursuant to Rules 13d-1(b) or 13d-2(b) or (c) to state his classification under those rules.

Item 4, "Ownership" requires that the amount of shares beneficially owned, the percent of the class, and the number of

shares for which there is (1) sole power to vote or to direct the vote, (2) shared power to vote or to direct the vote, (3) sole power to dispose or to direct the disposition of, and (4) shared power to dispose or to direct the disposition of must be stated.

Item 5, "Ownership of Five Percent or Less of Class," should be checked if the person is reporting that he has ceased to be the beneficial owner of more than five percent of a class of equity securities.

Item 6, "Ownership of More Than Five Percent on Behalf of Another Person," states that if any other person has the right to receive or direct the receipt of dividends from, or the proceeds from the sale of, the securities, this fact should be noted. If such person has this power with respect to more than five percent of the class, this person should be identified.

n40

Item 7, "Identification and Classification of the Subsidiary Which Acquired the Security Being Reported on by the Parent Holding Company or Control Person" requires a parent holding company or control person filing this schedule pursuant to Rule 13d-1(c), Rule 13d-1(d) or Rule 13d-1(b)(ii)(G) to attach an exhibit stating the identification of the relevant subsidiary. If the holding company is filing pursuant to Rule 13d-1(b)(ii)(G), this exhibit must also state the Item 3 classification of this subsidiary. n41

Item 8, "Identification and Classification of Members of the Group," states that if a group has filed this schedule pursuant to Rule 13d-1(c), Rule 13d-1(d) or Rule 13d-1(b)(1)(ii)(J), an exhibit must be attached that identifies each member of the group. If the group is filing pursuant to Rule 13d-1(b)(1)(ii)(J), the Item 3 classification of each group member must also be included in this exhibit.

Item 9, "Notice of Dissolution of Group," states that notice of dissolution of a group may be furnished as an exhibit stating the date of dissolution and that all further transactions in the security reported on will be filed, if required, by members of the group, in their individual capacity.

Item 10, "Certifications," requires the signature of the person filing the form after certifying that all the information set forth is true, complete, and correct, to the best of that person's knowledge and belief. An additional certification stating that the securities were acquired not for the purpose of, and not with the effect of, changing or influencing the control of the issuer of the securities must also appear under this item, if the schedule is being filed pursuant to Rule 13d-1(b) or Rule 13d-1(c). Furthermore, any person filing a Schedule 13G pursuant to Rule 13d-1(b) must also certify that the securities were acquired in the ordinary course of business. n42

[c] When and Where to File.

Any person acquiring sufficient stock to trigger the reporting requirements of Section 13(d) must file, within ten days following such acquisition, a Schedule 13D with the Commission (including all related exhibits), n43 and then send a copy of such filing to the issuer at its principal executive office by registered or certified mail and also send a copy of such filing to each national securities exchange where the security is traded. n44

A person filing a Schedule 13G in lieu of Schedule 13D (pursuant to Rule 13d-1(b)(1)) must file, within 45 days following the end of the calendar year in which such person's accumulation of beneficial ownership exceeds five percent but does not exceed ten percent of an issuer's securities, a Schedule 13G n45 (including all related exhibits) with the Commission and send a copy of the filing to the issuer. n46 Amendments to the Schedule 13G (reflecting, among other things, changes in the filing person's levels of beneficial ownership) also need not be filed until forty-five days following the end of the year in which the changes occur. n47 However, should a person's beneficial ownership exceed 10 percent, he or she must file a Schedule 13G within 10 days following the end of the first month in which the person's beneficial ownership exceeds 10 percent of the class and must amend the filing within ten days after the end of any month in which the person's beneficial ownership interest increases or decreases by more than five percent

thereafter. n48 Persons required to file a Schedule 13G pursuant to Rule 13d-1(c) must follow this procedure within ten days following their initial acquisition of over five percent of the issuer's securities but may amend their filing pursuant to the same timing schedule as 13G filers under who have filed under Rule 13d-1(b). n49 When a person becomes ineligible to use Schedule 13G in lieu of Schedule 13D, including due to a change in investment purpose, a Schedule 13D must be filed in the manner previously described within ten days after such change. n50

[d] Filing of Amendments.

Section 13(d)(2) of the Exchange Act states that whenever there is any material change in the facts contained in a statement filed under Section 13(d)(1) "an amendment shall be transmitted to the issuer and the exchange and shall be filed with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Similarly, Section 13(g)(2) contains identical language with respect to statements filed under Section 13(g). Accordingly, the Commission implemented both of these sections in Rule 13d-2.

Rule 13d-2(a) requires that, after a material change, an amendment to Schedule 13D must be "promptly" n51 filed with the Commission and sent to the issuer at its principal executive office, by registered or certified mail, and to each exchange on which the security is traded. The rule provides no guidance as to what constitutes a "material change," except to state that it includes material increases or decreases in the amount of stock owned, and that an acquisition or disposition of securities of one percent or more of the class is automatically material under the rule. Further, an acquisition or disposition of less than one percent may also be material, depending upon the facts and circumstances of the individual case.

It is noteworthy that the Commission has taken a "no-action" position with respect to whether or not a company that filed a Schedule 13D must amend it to reflect changes amongst its own executive officers that have no effect its ownership of the stock. n52 However, one case held that when a controlling shareholder of an issuer, who was a Schedule 13D filer, made proposals for a merger between the issuer and an affiliate company of the controlling shareholder, this course of action and change of purpose clearly constituted the type of "material change" that must be promptly reported. n53 Additionally, the standard announced by the Supreme Court in *TSC Industries, Inc. v. Northway, Inc.* n54 would likely be applied in any determination of materiality. The Court there stated:

"An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." n55

In addition the SEC has taken the position that a filing person's "generic disclosure" under Item 4 reserving its right to engage in any of the kinds of actions enumerated in Item 4 must be amended when the security holder has formulated a specific intention with respect to a disclosable matter. n56

Rule 13d-2(b) requires that any person who has filed a Schedule 13G, and is still obligated to do so, must amend the schedule within forty-five days after the end of the calendar year to reflect any changes, as of the end of the calendar year, in the information reported in the previously filed statement. However, no amendment need be filed with respect to a change in the percent of class of securities outstanding previously reported if the change results solely from a change in the aggregate number of securities outstanding. n57

The SEC has taken the position that a shareholder reporting beneficial ownership on Schedule 13D must file an amendment to disclose that its beneficial ownership has fallen below the 5 percent threshold. n58

Finally, if an amendment has been filed reflecting five percent ownership or less, no further amendments are required unless the person thereafter becomes the beneficial owner of more than five percent of the class and therefore must re-file under Rule 13d-1. The SEC has provided guidance regarding the actions and steps which should be taken by

shareholders who have failed to file required amendments to a Schedule 13D in a timely manner. n59

[2] Determining Five Percent Beneficial Ownership of an Equity Security.

In order to determine whether a person must report his or her securities holdings under Section 13(d) or Section 13(g), the following questions must be answered: (1) Is the type of security owned by that person an equity security? (2) If so, how many shares of that class does he or she beneficially own? (3) Did he or she make an acquisition of any of these shares? and (4) What is the total number of outstanding shares of this class to be used for computing his or her percentage ownership? Careful consideration should be given to the answers to these questions, especially when a situation arises where a person will be deemed to beneficially own shares even though he or she is not the record owner of such shares.

[a] What is an "Equity Security"? Section 13(d) of the Exchange Act applies to "any equity security of a class which is registered pursuant to Section 12 of this title, n60 or any equity security of an insurance company which would have been required to be so registered except for the exemption contained in Section 12(g)(2)(G) of this title, or any equity security issued by a closed end investment company registered under the Investment Company Act of 1940...." n61 Additionally, Section 13(g) is applicable to the same types of securities and incorporates by reference the language in Section 13(d). n62 Rule 13d-1(i) defines an "equity security" as any of the above-mentioned types of securities, except that non-voting securities are not equity securities under Rule 13d-1(i)'s definition. However, if a person owns non-voting securities that can be converted into equity securities within sixty days, he will be deemed to own the equity securities. n63

[b] Determination of Beneficial Ownership.

A person does not have to be the record owner of a security in order to be considered its beneficial owner under Section 13(d) or Section 13(g). However, the concept of beneficial ownership under these sections, and Rule 13d-3 promulgated thereunder, differs from the concept of beneficial ownership used under the rules regulating insider trading as well as other aspects of the securities laws, such as Section 16 of the Exchange Act. n64

[i] Groups. One type of indirect ownership arising under Section 13(d) or Section 13(g) is based on Sections 13(d)(3) and 13(g)(3), both of which state the following:

"When two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for the purposes of this subsection."

Thus, each member of a group formed for the purpose of acquiring, holding, or disposing of securities will be deemed to own the aggregate of all such securities beneficially owned by the members of the group. n65

There is only one basic element needed to establish the existence of such a group, which is evidenced in an agreement to act together for one of the above stated purposes. n66 Importantly, a written agreement is not required because such a requirement would defeat the purpose of the statute. n67 However, as the court stated in *Texasgulf, Inc. v. Canada Development Corp* :

"[A] relationship among persons or entities, whether family, personal, or business is insufficient to create a group which is deemed to be a statutory person. There must be agreement to act in concert." n68

In *Texasgulf*, the court strongly rejected the plaintiff's attempt to link the stock purchase of the defendant with those of another company solely because a vice chairman and director of the defendant was president of a company that owned a controlling interest in the other company. n69 Likewise, in *Corenco Corp. v. Schiavone & Sons, Inc.* n70 a defendant-stockbroker would have been paid a finder's fee if the plaintiff acquired the defendant. Even though the

broker and the defendant each owned just under five percent of the plaintiff's stock and allegedly had several meetings during the period when the defendant was acquiring the plaintiff's stock, the Court of Appeals for the Second Circuit held that no group existed. According to the court:

"It is true that Michael Schiavone controlled 4.8 percent of Corenco's outstanding shares. Rubin, [the defendant-stockholder], assuming for present purposes that he exercised sufficient dominion over the three accounts for which he had purchased shares, would have controlled another 4.996 percent. These percentages indicate an acute awareness on the part of both parties of the 5% figure fixed by Section 13(d). However, absent an agreement between them a 'group' would not exist. While it is charged that Rubin met several times with Joel Schiavone during the period of Michael Schiavone's purchases, Judge Ward noted that Rubin's fee depended on Corenco acquiring Schiavone rather than vice versa and that some Corenco stock was actually sold out of the accounts allegedly controlled by Rubin during the period of the supposed conspiracy. Upon this record we cannot conclude that Judge Ward's finding of no agreement or conspiracy was 'clearly erroneous.'" n71

Courts are currently addressing the controversial issue of whether or not ownership of total return equity swaps ("TRSs") n72 (typically arranged between a party and a bank counterparty) triggers beneficial ownership of the underlying security under Section 13(d) of the Exchange Act. Such cases frequently address circumstances in which, absent a Schedule 13D filing, TRSs have been used to acquire a total economic stake in a subject company's voting securities significantly exceeding a five percent level of ownership. It is commonly alleged that some form of collusive relationship existing between the parties to the TRS arrangement may effectively deliver voting power or control over the underlying voting securities to the holder of the derivative security. n73 Such arrangements or understandings, should they exist, would require that the parties to the TRS arrangement be treated as a group under Section 13(d) and, as such, that their beneficial ownership of the issuer's voting securities must be combined for purposes of Section 13(d)'s reporting requirements.

For instance, in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*, n74 the district court ruled that The Children's Investment Fund ("TCI") and 3G Capital Partners ("3G"), two activist hedge funds engaged in a proxy contest with CSX, violated Section 13(d) of the Exchange Act by using TRSs to secretly acquire beneficial ownership of more than five percent of CSX's common shares without properly disclosing such ownership on Schedule 13D. The court held that, pursuant to Rule 13d-3(b) under the Exchange Act, where a party has entered into a TRS arrangement as part of a plan or scheme to evade the reporting requirements of Section 13(d), it is deemed to be the beneficial owner of the shares held by the counterparty to the swap arrangement for the purpose of hedging such company's exposure under the TRS arrangement. As the court's finding was based solely upon the anti-evasion provisions of Rule 13d-3(b), the court's decision did not affirmatively rule that Section 13(d) applies to shares held pursuant to otherwise passive or benign swap or derivative arrangements. Instead, the court specifically applied Section 13(d)'s reporting requirements to instances in which parties have entered into swap or derivative arrangements with the intent of creating a false appearance that there is not a large accumulation of issuer shares which might have a control shifting effect. The court also found that TCI and 3G violated Section 13(d) by acting for months in close coordination with each other but failing to timely disclose their formation of a group on Schedule 13D. The finding that a group had been formed significantly prior to its disclosure by TCI and 3G was based upon a pattern of circumstantial evidence, including a close prior relationship between TCI and 3G, multiple communications discussing CSX and a rough synchronization of the parties' trading in CSX's shares.

However, when it is obvious that several people are acting together, the courts will not hesitate to find the existence of a group. n75 For instance, in *Financial General Bankshares v. Lance*, n76 the defendants contended "that the facts reflect nothing more than independent purchases of F.G. (Financial General) stock by the four Middle Eastern defendants." The court (for the purpose of deciding a motion for a preliminary injunction) did not agree and noted that (1) two of the American defendants were dissatisfied with Financial General's management; (2) they recommended Financial General's stock as an attractive investment to a manager of a foreign bank for that bank's clients, and there were several

meetings amongst the defendants that included discussions about the foreign bank manager's decision to purchase the plaintiff's stock on behalf of his clients, which was followed by his recommendation of the stock to his clients; (3) the defendants conducted an intense program of open and private market purchases, acquiring nearly twenty percent of the plaintiff's stock within six weeks; and (4) defendant made statements indicating that he represented a group of foreign investors. n77

Over the years, several questions arose as to what constitutes a group under Section 13(d)(3). For instance, when several banks make a joint loan, or refinance an old loan, to a company, the banks will sometimes receive warrants to purchase that company's stock. Once these warrants become exercisable, then the banks will be deemed to own the underlying stock pursuant to Rule 13d-3. n78 Accordingly, an issue arises as to whether these banks will be considered a group under Section 13(d)(3). Initially, the Commission took the view that they were a group, and refused, in two separate instances, to exempt groups of such banks from filing a Schedule 13D where their aggregate beneficial ownership exceeded the five percent threshold, even though in both cases there were no agreements or arrangements between the banks concerning the warrants. n79 However, in 1977, the Commission exempted a group of banks from filing a Schedule 13D provided that the banks had no agreement or arrangement to act in concert with respect to the warrants. n80]

In *Roth v. Jennings*, n81 the Court of Appeals for the Second Circuit set forth to further define what constitutes a group for purposes of determining beneficial ownership of securities under Section 13(d) of the Exchange Act. In *Roth*, the plaintiff, suing derivatively on behalf of Metal Management, Inc. ("MMI"), sought disgorgement of defendant shareholder's "short-swing" (opposite way transactions made within a period of 6 months) profits under Section 16 of the Exchange Act on the grounds that, if its shares were properly aggregated with those of another larger shareholder, the selling shareholder would be categorized as a principal shareholder (a holder of 10 percent or more of an issuer's shares) and be subject to Section 16 of the Exchange Act. Section 16 requires the short-swing profits of directors, officers and 10 percent shareholders to be disgorged to the company. n82 In addition, the rules under Section 16 provides that, solely for the purposes of determining whether a person is a principal shareholder beneficially owning 10 percent or more of an issuer's shares, the term "beneficial owner" means a person who is a beneficial owner pursuant to Section 13(d) of the Exchange Act. n83 The defendant, Jennings, purchased 8.3 percent of MMI's shares through funds supplied by a loan agreement with an existing 14.8 percent shareholder ("EMR"). The plaintiff alleged that Jennings and EMR constituted a group under Section 13(d) because EMR's loan was made for the specific purpose of purchasing MMI shares and because the parties otherwise had an agreement regarding the acquiring, holding or disposing of MMI's shares. Both Jennings and EMR reported their beneficial ownership in Schedule 13D filings which disclosed their respective ownership levels and contained the terms of the loan agreement. n84 In addition, both the Schedule 13D filings and the loan agreement itself specifically disclaimed the existence of any arrangement regarding MMI's shares and disclaimed that Jennings and EMR constituted a group. The court ruled that such formal disclaimers of group status will not serve to preclude a finding that parties had a triggering arrangement regarding an issuer's securities and constitute a group under Section 13(d). The court noted that parties' self serving disclaimers of group status will not, in itself, prove the truth of such an assertion. Under Section 13(d), parties which act with the purpose of acquiring an issuer's shares will have formed a group regardless of their attempts to disclaim such joint action. n85

Another problem to consider is whether or not a group already in control of a corporation falls within the purview of Section 13(d)(3). One early opinion from the Court of Appeals for the Seventh Circuit stated, in dicta, that:

"Our review of the legislative history convinces us that the overriding purpose of Congress in enacting this legislation was *to protect the individual investor* when substantial shareholders or management undertake to acquire shares in a corporation for the purpose of solidifying their own position in a contest over how or by whom the corporation should be managed." n86

However, the Court of Appeals for the Second Circuit noted, in dicta, that:

"Management groups *per se* are not customarily formed for the purpose of 'acquiring, holding, or disposing of securities of [the] issuer' and would not be required to file unless the members conspired to pool their securities interests for one of the stated purposes." n87 (footnote omitted).

The Court of Appeals for the Second Circuit further discussed this issue in its decision in *Corenco Corp. v. Schiavone & Sons, Inc.*, n88 where the defendants claimed that Corenco's management and their affiliates were a group because they pooled their shares for the purpose of defeating the tender offer made by the defendants. The court held that because Section 14(d)(4) of the Exchange Act requires that management make certain disclosures when it advises its shareholders to reject a tender offer, n89 "it would be pointless to superimpose requirements found in another section, which does not deal specifically with management disclosures." n90 Further, the court in *Scott v. Multi-Amp Corp.*, n91 adopted a similar position, holding that a control group that decided to sell all the assets of a corporation and then liquidate it, need not file under Section 13(d), since it had to file proxy materials under Section 14(a) in order to carry out their plan.

Later opinions held that management is subject to Section 13(d) when, in the absence of a tender offer, it forms a group for the purpose of defending its corporate control from an outside group. n92 The Commission has ruled that whenever a Schedule 13D filing management group owning more than five percent of a company's stock acquires additional shares, it must file an amended Schedule 13D, even where each member of the group reported his or her individual acquisition on a Form 4. n93

[ii] Rule 13d-3. Rule 13d-3 sets forth the circumstances under which a person will be considered the beneficial owner of stock for the purposes of Section 13(d) and 13(g). Originally, the rule only applied to persons who could acquire equity securities through the exercise of warrants or options or the conversion of convertible securities. n94 However, the judiciary quickly extended the concept of beneficial ownership to anyone who had voting control of stock, regardless of whether or not that person owned the stock. n95 In accordance, the current Rule 13d-3 adopted this concept and expanded upon it, stating that:

"(a) For the purposes of Sections 13(d) and 13(g) of the [Exchange] Act a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares:

- (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or
- (2) Investment power which includes the power to dispose, or to direct the disposition of, such security." n96

The right to acquire voting rights or investment power over a security is sufficient for beneficial ownership. Rule 13d-3(d)(1)(i) also provides that a person shall be deemed to be the beneficial owner of a security, subject to the provisions of paragraph (b) of this rule, if that person has the right to acquire beneficial ownership of such security, as defined in Rule 13d-3(a) within 60 days, including but not limited to any right to acquire: (A) through the exercise of any option, warrant or right; (B) through the conversion of a security; (C) pursuant to the power to revoke a trust, discretionary account, or similar arrangement; or (D) pursuant to the automatic termination of a trust, discretionary account or similar arrangement; *provided, however*, any person who acquires a security or power specified in paragraph (A), (B) or (C) above, with the purpose or effect of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having such purpose or effect, immediately upon such acquisition shall be deemed to be the beneficial owner of the securities which may be acquired through the exercise or conversion of such security or power. Any securities not outstanding which are subject to such options, warrants, rights or conversion privileges shall be deemed to be outstanding for the purpose of computing the percentage of outstanding securities of the class owned by such person but shall not be deemed to be outstanding for the purpose of computing the percentage of the class by any other person.

Rule 13d-3 also contains several exceptions to its provisions. For instance, a member of a national securities exchange can hold securities on behalf of another person without being deemed the beneficial owner of such securities, provided that the member cannot vote the securities, without instruction, on any contested matter that may substantially affect the rights or privileges of the real owner of the securities. n97 Also, an underwriter who acquires securities by participating in a "firm commitment underwriting" n98 registered under the Securities Act is not the beneficial owner of such securities until forty days after the acquisition. n99 Additionally, a person who becomes a pledgee of securities in the ordinary course of business under a written pledge agreement is not deemed to be the beneficial owner of such pledged securities until the pledgee has taken all the formal steps required to declare a default and determines that the power to vote or dispose of the securities will be exercised. This exception is subject to the following provisos: (1) the pledge agreement must be bona fide and not made for the purpose of changing or influencing the control of the issuer; (2) the pledgee is a person eligible to use Schedule 13G as specified in Rule 13d-1(b)(1)(ii), n100 and (3) the pledge agreement, prior to default, does not give the pledgee the power to vote or dispose of the securities, other than the grant of such powers to a registered broker or dealer extending credit subject to "Regulation T" (a regulation promulgated by the Federal Reserve Board regarding the extension of credit extended for the purchase of securities). n101

Importantly, under Rule 13d-3, if any person attempts to evade the reporting requirements of Section 13(d) or 13(g) by divesting himself or herself of beneficial ownership of a security through the use of a trust, power of attorney, proxy, pooling arrangement, or any other contract, arrangement, or device, he or she will be deemed to beneficially own that security under Rule 13d-3(b).

Finally, Rule 13d-4 allows any person to expressly declare, in any filed statement that covers the subject securities, that the filing of such statement is not an admission that the person is the beneficial owner of such securities for the purposes of Section 13(d) or 13(g).

[c] Acquisitions. Section 13(d) is not applicable without an acquisition of stock, n102 whereas Section 13(g) applies to anyone who merely holds five percent or more of an equity security class. n103 The term "acquisition" does not necessarily require the "purchase" of securities. According to Rule 13d-5(a), a person who obtains beneficial ownership of a security is deemed to have acquired the security, whether or not the acquisition was through a purchase. Thus, receiving securities as a gift or inheritance qualifies as an acquisition. Similarly, when an executor or administrator of a decedent's estate obtains beneficial ownership n104 of securities in the subject estate, the executor or administrator will be deemed to have acquired the securities when he or she qualifies under local law to perform his or her duties.

In regard to acquisitions by groups, Rule 13d-5(b)(1) provides that a Section 13(d)(3) group shall be deemed to have acquired beneficial ownership of all equity securities beneficially owned by any of the group members as of the date that the group is formed. This proposition means that a group formed for the purpose of acquiring or holding the securities of an issuer, which owns more than five percent of those securities, will, in the absence of an exemption, be required to file a Schedule 13D regardless of whether or not the group later acquires any additional securities of the issuer. n105

It should be noted that early in the history of the Williams Act, and prior to the adoption of Rule 13d-5 in 1977, this point was the subject of judicial controversy. For instance, in *Bath Industries, Inc. v. Blot*, n106 the Court of Appeals for the Seventh Circuit held that a group was not subject to Section 13(d)(1) unless, after its formation, its members agreed to acquire additional securities. The court adopted this interpretation because it was not the purpose of the Williams Act to protect current management by proscribing "legitimate cooperation among existing shareholders to assert their determination to take over control of management, *absent* an intention to acquire additional shares for the furtherance of such purpose." (emphasis in opinion.) n107

However, in *GAF Corp. v. Milstein*, n108 the Court of Appeals for the Second Circuit disagreed with the conclusion stated in *Bath*. In *Milstein*, Judge Kaufman stated that "the purpose of Section 13(d) is to alert the marketplace to every

large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control...." This situation would happen whenever a group holding a sufficiently large block of shares is formed, even if they do not acquire any additional shares. Thus, disclosure of a group's shareholdings should not be dependent upon the group's acquisition of stock after formation.

Milstein focuses on the primary purpose of the Williams Act--the disclosure of stock ownership by a person or group of persons possessing the potential to control or influence a company. *Bath*, on the other hand, places a secondary purpose of the Williams Act in that it should not protect the current management of a company ahead of the primary purpose. Following these two cases, the majority of the subsequent decisions agreed with the holding in *Milstein*, n109 and ultimately, the Commission adopted this holding in Rule 13d-5.

Importantly, paragraph (b)(2) of Rule 13d-5 provides an exception from the group acquisition rule for private placements of stock going directly from the issuer to certain institutions. n110 The rule states that a group shall be deemed not to have acquired any equity securities beneficially owned by its members solely because they acted together to purchase the equity securities directly from an issuer in a transaction not involving a public offering provided that: (1) all the group members are persons specified in Rule 13d-1(b)(1)(ii); n111 (2) each member is making the purchase in the ordinary course of its business, and not for the purpose of influencing or controlling the issuer or avoiding the reporting requirements; and (3) the group acts together only to facilitate the specific purchase involved, and, after the closing date of the private offering, only to conclude ministerial matters directly related to the completion of the offer or sale of the securities.

In *Litzler v. CC Investments, L.D.C.*, n112 the federal court found that three hedge funds simultaneously investing in Data Race, Inc. ("Data Race") had not acted in concert so as to have formed a group. n113 Plaintiff argued that the three funds had formed a group in their acquisitions of Data Race shares because they acted through common counsel in the negotiation and drafting of the acquisition documents. The court found plaintiff's argument to be unconvincing and found that a group had not been formed. The court noted the Commission's position that business considerations, such as cost savings, "that generally lead to cooperative activity characteristic of an institutional placement" are not sufficient to demonstrate that "investors were motivated by a desire to affect control or by some other indicia of concerted activity." n114 In addition, the court noted that the investing parties had separately conducted their own due diligence review of Data Race, had been separately advised by counsel in making their decision to pursue an investment in Data Race and had not maintained a pre-existing prior relationship.

[d] Computing the Percentage of Beneficial Ownership. In order to determine the number of securities beneficially owned by a filer, Section 13(d)(4) instructs that, for any computation under Section 13(d), a class of securities consists of the amount of outstanding securities in that class, exclusive of any securities in that class held by or for the account of the issuer or a subsidiary of the issuer. Section 13(g)(4) is identical to Section 13(d)(4), except that it applies to computations under Section 13(g). To help provide further guidance in this area, the Commission adopted Rule 13d-1(j), which allows for the amount of outstanding equity securities in a class to be obtained from the issuer's most recent quarterly or annual report, or any current report subsequent thereto, filed with the Commission. Nonetheless, a person may not use this number if he or she knows or has reason to believe that it is inaccurate.

Under the rules, if a person is deemed to own securities that are not outstanding, *i.e.*, securities held by or for the issuer, because of his or her right to acquire such securities (by the exercise of any option, warrant, right, or conversion privilege), n115 these securities will be deemed to be outstanding for the purpose of computing that person's percentage of beneficial ownership. However, such securities would not be considered to be outstanding with respect to any other person. n116

Events that occur after an acquisition of five percent of a subject company's equity are irrelevant. In *American Pepsi Cola Bottlers, Inc.* ("APC") n117, for instance, Industrial Capital Corporation ("Industrial") acquired 6.2 percent of APC's stock. Within the ten day filing period after Industrial's acquisition, APC made a public offering of its securities

thereby reducing Industrial's ownership in APC stock to 3.7 percent. The Commission was of the opinion that Industrial was not relieved of its obligations to file a Schedule 13D despite APC's subsequent public offering, pointing out that Industrial had obtained over five percent ownership on the date that it made the acquisition.

According to the beneficial ownership rules (discussed in *supra* Section 7A.02[2][b]), a person determines how many securities he or she owns. Nonetheless, all securities of the same class beneficially owned by a person must be aggregated regardless of the different forms of ownership in which these securities may be held. n118 This broad concept applies to securities deemed to be owned through a convertible security, option, or warrant, even if the warrant is also an equity security and may therefore give rise to a separate obligation to file. n119

[3] Relief for Violation of Section 13(d) and Section 13(g). n120

[a] Actions by the Commission. Under Section 15(c)(4) of the Exchange Act, Congress empowers the Commission to take action against violators of Sections 13 or 14. Accordingly, if the Commission finds, after notice and opportunity for a hearing, any material violation of Sections 13(d) or 13(g), or the rules promulgated thereunder, the Commission may order compliance with such provisions upon such terms and conditions as it specifies. n121 Additionally, such an order may result from a court action brought by the Commission. n122 The Commission may also bring a suit in district court to enjoin future violations of Section 13(d). n123 In order for the court to issue an injunction, the Commission must show a "reasonable likelihood" that the defendant will commit future violations. n124 Even though the Commission does not need to prove that the defendant acted with scienter, n125 proof of previous willful violations of Section 13(d) is usually instrumental in obtaining an injunction. n126 Finally, an unrepentant attitude on the part of the defendant will also influence the court into granting injunctive relief. n127

Some courts even go as far as stating that an issuer, rather the Commission, is in the best position to enforce Section 13(d). According to a decision from the Court of Appeals for Second Circuit, an issuer is in the best position to enforce Section 13(d) because the Commission, in addition to being short on manpower, "does not have the issuer's day to day familiarity with the facts which would enable it to appraise accurately the statements in the Schedule (13D)." n128 This observation comes from the fact that there are a small number of reported cases where the Commission sought to enjoin violations of Section 13(d). Even in these cases, most of them involved purported violations of other reporting requirements, n129 or of the proxy rules. n130

[b] Private Suits

[i] Standing. The issue of whether or not an individual had standing to sue for a violation of Section 13(d) was considered in *Grow Chemical Corp. v. Uran*. n131 In *Grow Chemical* the plaintiff alleged that he purchased stock at a price in excess of what he would have paid had his search through the public filings of the Commission and the American Stock Exchange revealed that the defendant owned more than ten percent of the same class of stock. In rejecting the defendant's motion to dismiss, the court stated that:

"Defendant contends that neither § 13(d) nor § 16(a) is designed for the protection of this plaintiff. It appears to [the court] that if a plaintiff claims that as a purchaser of securities he has been injured as a result of the violation by a defendant of the securities laws, then the plaintiff has stated a claim upon which relief may be granted. Plaintiff is not asserting a general injury to the public. It is asserting an injury involving its stock interest in Guardsman flowing from the defendant's failure to disclose his interest in that very stock in contravention of law." n132

Additionally, the issue of whether or not an issuer had the right to sue for a violation of Section 13(d) has been interpreted by the courts. For instance, in *Bath Industries, Inc. v. Blot*, n133 the Court of Appeals for the Seventh Circuit simply assumed that the right of the issuer to sue for Section 13(d) violations existed without even discussing the point. Following the decision in *Bath*, the Court of Appeals for the Second Circuit specifically established the right of the issuer to sue for Section 13(d) violations in *GAF Corp. v. Milstein*, n134 holding that suits by the issuer were necessary

to effectuate the legislative purpose of the statute. In *Milstein*, the court noted that:

"GAF, as the issuer, unquestionably is in the best position to enforce section 13(d). The statute requires a copy of the statement to be sent by registered mail to the issuer (this provision alone might support the issuer's standing), and the issuer, in the course of constantly monitoring transactions in its stock, better than anyone else will know when there has been a failure to file. *Cf. Comment*, 81 *Harv.L.Rev.* 501, 502 (1967). Moreover, the issuer has not only the resources, but the self-interest so vital to maintaining an injunctive action. See *Electronic Specialty, supra*, at 946. To play upon management's self-interest, of course, raises some threat to Congress's express desire not to tip the scales in favor of incumbent management as against the takeover group. But, this danger can be adequately counteracted, if the district court carefully scrutinizes self-serving management claims allegedly made in the interest of investor protection.

Even if the Commission had the requisite manpower to delve into the details of each Schedule 13D filing, it does not have the issuer's day-to-day familiarity with the facts which would enable it to appraise accurately the statements in the Schedule. An already overburdened Commission staff, taxed with reviewing increased filings under the securities acts, should welcome 'a necessary supplement' to its action.

Nor is it realistic to expect shareholders to deter persons from filing inaccurate statements by resort to the antifraud provisions. Stockholders are generally unaware of the necessary background information to judge the truth or falsity of the statements. Additionally, since the [Exchange] Act does not require the statements to be disseminated to shareholders, they do not have the immediate access of the issuer to the filings."

The court also held that although Section 13(d) did not specifically prohibit a false filing, such a filing could still be challenged under that section. n135 The court reasoned "that the obligation to file *truthful* statements is implicit in the obligation to file with the issuer" n136 because a false filing would subvert the purpose of the statute by misleading investors. It should be noted that the holding in *Milstein* concerning the issue of standing has been subsequently examined by other courts. n137 Furthermore, a district court has held that an individual shareholder has a private right of action for injunctive relief for Section 13(d) violations. In *Bender v. Jordan*, n138 the district court, noting that the Courts of Appeals are in widespread agreement that Section 13(d) creates an implied private right of action for injunctive relief brought by an issuer of securities, held that issuers derive this right of action from their role as representative of the shareholders. The court held that "[b]ecause the foundation for the issuer's standing is its action on behalf of shareholders, a shareholder *a fortiori* has standing to seek injunctive relief." n139

[ii] Injunctive Actions. Traditionally, before a federal court will issue an injunction, the court requires proof that a party will suffer an irreparable harm in the absence of an injunction. n140 The Supreme Court held, in *Rondeau v. Mosinee Paper Corp.*, n141 that this irreparable harm standard, together with the other usual prerequisites for equitable relief, applies to injunctions sought under the Williams Act. In *Rondeau*, a businessman, ("Rondeau"), acquired over five percent of the common stock of Mosinee Paper Corp. ("Mosinee Corp.") through open market purchases. Rondeau was unaware of his obligation to file under Section 13(d) until Mosinee Corp.'s chairman of the board informed him that his purchases had caused problems under the securities law. After consulting with his attorney, Rondeau filed a Schedule 13D with the Commission about three months after it was originally due. The schedule stated that Rondeau intended to obtain control of Mosinee Corp. by making additional acquisitions of its stock, and that, if successful, he would make changes to Mosinee Corp.'s management.

Shortly thereafter, Mosinee Corp. brought a suit against Rondeau, claiming that because Rondeau had violated the beneficial ownership disclosure requirements: (1) shareholders sold stock to him lacking material information; and (2) Mosinee Corp. was not able to properly defend its interests. Mosinee Corp. requested an injunction from the court that

would prohibit Rondeau from acquiring additional shares; from voting or pledging his stock; and order the divestiture of his stock. The district court granted Rondeau's motion for summary judgment since Rondeau's violation was unintentional and Mosinee Corp. could not demonstrate any irreparable harm that resulted from the violation. n142 The Court of Appeals for the Seventh Circuit reversed the district court, holding that Mosinee Corp. was harmed because of the delay it suffered in responding to Rondeau's efforts to take control of the company, and that, in any event, it need not prove irreparable harm as a prerequisite to obtaining injunctive relief since "as issuer of the securities it is in the best position to assure that the filing requirements are being timely and fully complied with and to obtain speedy and forceful remedial relief when necessary." n143 Accordingly, the Court of Appeals for the Seventh Circuit ordered the district court to enjoin Rondeau from further violations of the Williams Act, and from voting the shares purchased between the due date of the Schedule 13D and the date of its filing for a period of five years.

On appeal, the Supreme Court concluded that this injunction served little purpose since Mosinee Corp. had not been harmed by the late filing because Rondeau had not attempted to obtain control over the company. Since Rondeau's Schedule 13D was now on file with the Commission, and there was no evidence to suggest that he would not amend it, Mosinee Corp. and its shareholders would be likely to have the proper information before them regarding any future takeover attempt by Rondeau. Thus, none of the usual reasons for injunctive relief were present since Mosinee Corp. was not facing any irreparable harm and Rondeau was not currently violating Section 13(d), nor was it likely that he would do so in the future. Additionally, shareholders who sold stock to Rondeau between the due date and filing date of the Schedule 13D have an adequate damage remedy at law if they can prove that Rondeau's nondisclosures depressed the price of their stock. n144

The Court also rejected the Court of Appeals' holding that irreparable harm was not a prerequisite to injunctive relief under the Williams Act, noting that:

"Respondent urges, however, that the 'public interest' must be taken into account in considering its claim for relief and relies upon the Court of Appeals' conclusion that it is entitled to an injunction because it 'is in the best position' to insure that the Williams Act is complied with by purchasers of its stock. This argument misconceives, we think, the nature of the litigation. Although neither the availability of a private suit under the Williams Act nor respondent's standing to bring it has been questioned here, this cause of action is not expressly authorized by the statute or its legislative history. Rather, respondent is asserting a so-called implied private right of action established by cases such as *J. I. Case Co. v. Borak*, 377 US 426, 84 S Ct 1555, 12 L. Ed 2d 423 (1964). Of course, we have not hesitated to recognize the power of federal courts to fashion private remedies for securities laws violations when to do so is consistent with the legislative scheme and necessary for the protection of investors as a supplement to enforcement by the [Commission]." (Citations omitted.)

"However, it by no means follows that the plaintiff in such an action is relieved of the burden of establishing the traditional prerequisites of relief. Indeed, our cases hold that quite the contrary is true." n145

The Supreme Court's decision in *Rondeau* halted a trend by the lower courts toward looser standards for granting injunctions under the Williams Act. n146 One of the first cases to grant injunction relief under Section 13(d) was *Bath Industries, Inc. v. Blot*, n147 where the court enjoined the defendants from carrying out a planned takeover because no Schedule 13D had been filed, and the corporation stood to lose a very large contract if the battle for its control was allowed to continue. In *Bath*, the court reasoned that the corporation might well have suffered less of an adverse impact in its efforts to win the contract if the rift in management had been disclosed earlier through the filing of a Schedule 13D. n148

However, several subsequent cases enjoined takeover attempts, where, unlike *Bath*, there was no specific harm alleged to the corporation and its investors, other than the supposed injury they suffered from not possessing the information

contained in Schedule 13D. n149 Since the Supreme Court's decision in *Rondeau*, lower courts no longer presume that a violation of Section 13(d) will cause irreparable harm, and will not prevent a defendant from voting his shares or soliciting proxies unless there is a clear need to do so. In *Gearhart Indus, Inc. v. Smith Int'l, Inc.*, the Court of Appeals for the Fifth Circuit denied a target company's request for preliminary injunctive relief under Section 13(d) since neither a breach of a standstill agreement nor purchases made under cover of misleading filings by the bidder warranted enjoining the tender offer. The court noted that the breach had no misleading effect on investors and the Williams Act's purpose is to benefit investors, not corporate management. Similarly, the misleading purchases harmed only the target company's attempt to resist the takeover rather than harming investors. Moreover, any Section 13(d) violations were ultimately cured in an amended Schedule 13D in which the bidder disclosed its intent to acquire control. Thus, the court held that there was no irreparable harm to justify the issuance of a preliminary injunction. Furthermore, any stockholder who might have sold target company stock on the basis of misleading Section 13(d) filings could be awarded damages and, therefore, enjoining the tender offer on that basis would be an "inappropriate and over-drastic" act. The court also refused to sterilize the bidder's voting rights in shares purchased following the filing of the bidder's misleading Section 13(d) statement and reiterated the Supreme Court's dicta in *Rondeau* that the Williams Act's purpose is to protect shareholders, not to provide a weapon for incumbent management in corporate control struggles. n150

In *Rondeau*, the Court stated that it was not deciding under what circumstances a shareholder currently in violation of Section 13(d) could be enjoined from acquiring more stock, exercising voting rights or launching a takeover bid. n151 Accordingly, courts will generally issue such injunctions in cases in which the requisite irreparable harm has been found through sufficiently pleaded allegations of *continuing* material nondisclosures or inaccurate, incomplete, or misleading statement. n152 Since the purpose of Section 13(d) is to give investors an opportunity to "assess the potential for changes in corporate control and adequately evaluate the company's worth....," n153 depriving them of the information necessary to do this constitutes irreparable harm. A court may grant injunctive relief and require the filing of an amended Schedule 13D where there is a reasonable basis for concluding that the Schedule 13D is "inaccurate, incomplete or misleading in its statement of any of the matters expressly demanded by section 13(d)". n154

Additionally, a current violation is likely to become consequential if it is followed by actions that are designed to influence or control the issuer. Thus, an injunction against such activities does not unduly penalize the offending party if it is to be removed upon the filing of a proper Schedule 13D. n155

Several cases have indicated that an injunction against future violations of Section 13(d) is appropriate in a private action if it can be proved that the defendant is likely to commit such violations. n156 Of course, where a party can prove that he has no further interest in acquiring the issuer's securities, or meddling in its affairs, an injunction is not appropriate, even though the defendant may have committed past violations with respect to that issuer. n157

Subsequent case law has followed the Supreme Court's suggestion in *Rondeau* that the appropriate remedy for shareholders buying or selling stock at a price affected by violations of Section 13(d) is an action for damages, not an injunction. n158

However, in *Bath Industries, Inc. v. Blot*, n159 the Court of Appeals for the Seventh Circuit held that past reliance by investors made it inappropriate to lift an injunction against a takeover attempt until there was a trial on the merits, even if an accurate Schedule 13D was filed before the trial. The court stated:

"If defendant-appellants were in fact required to file statements pursuant to the Williams Act sometime near midsummer of 1969, the filing of 13D Schedules in October, 1969 may well be insufficient to cure the failure to file earlier. The purpose of the filing and notification provisions is to give investors and stockholders the opportunity to assess the insurgents' plans *before* selling or buying stock in the corporation. It additionally gives them the opportunity to hear from incumbent management on the merit or lack of merit of the insurgents' proposals. If the defendant-appellant's late filing is sufficient, then no insurgent group will ever file until news of their existence and plan leaks out and

prompts a law suit. By that time it will be too late to avoid the evils which the Williams Act is designed to eliminate." n160

Allowing the injunction to be lifted upon the filing of a Schedule 13D and an offer of rescission to persons who sold their stock to the defendants without the benefit of proper disclosure could protect the latter class without unnecessarily restricting the defendants and would appear to be preferable to the remedy granted in *Bath*. n161

[iii] Damages. There is no implied private right of action for damages under any of the reporting provisions in Section 13. n162 Any such action must be brought under Section 18 of the Exchange Act, n163 which provides that any person who, in reliance upon a false or misleading statement in a report filed under the Exchange Act, purchases or sells a security at a price affected by that statement may collect damages from the person filing the report, unless the latter had no knowledge that the statement was false or misleading. n164 Further, courts have held that the "forced sale" doctrine developed under *Rule 10b-5* also applies to Section 18. n165 In *Weisman v. Darneille*, a plaintiff-shareholder alleged that the defendants bought six percent of the issuer's stock on the open market because the defendants knew its real value was substantially higher. Then the defendants brought about a liquidation of the issuer by a sale of all its assets followed by redemption of all its stock. As a result, the defendants made a substantial profit from this transaction, and apparently did not divulge their motive for buying this stock in their Schedule 13D. The court refused to dismiss the case for lack of standing and ruled that if the plaintiff was forced to sell his stock as part of a liquidation that was aided by the filing of a fraudulent Schedule 13D, the plaintiff had standing as a "seller" to sue under Section 18. n166

However, other courts have held that a plaintiff who can not prove how his purchase or sale of stock was affected by an alleged violation does not have a valid cause of action. n167 Similarly, in *Dewitt v. American Stock Transfer Co.*, n168 the court ruled that the plaintiff's late filing of a Schedule 13D did not justify the defendant's refusal to transfer his stock because the defendant could not demonstrate how it was injured by the delay in filing.

FOOTNOTES:

(n1)Footnote 1. Section 13(d)(1) of the Securities Exchange Act of 1934, *reprinted in* The Securities Primary Law Sourcebook, Vol. B, § G.

(n2)Footnote 2. Section 13(d)(6)(A).

(n3)Footnote 3. *See* Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 15348, 16 SEC Docket 228 (Nov. 22, 1978).

(n4)Footnote 4. Section 13(d)(6)(C). The Commission has taken a no-action position with respect to a subsidiary of an issuer that purchased a large block of its parent's stock without filing under Section 13(d). The Commission stated that although such a transaction is not literally within the Section 13(d)(6)(C) exemption, in the absence of unusual circumstances it will not recommend any enforcement action in this situation. *Coronet Investment Co./Transport Life Insurance Co.*, SEC No-Action Letter, 1978 SEC No-Act LEXIS 9171 at *1 (Mar. 27, 1978).

An issuer purchasing its own securities may be subject to Rule 13e-1, *See infra* § 7A.04[1].

See also Old Republic Int'l Corp., SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2577, at *1 (June 30 1982), wherein the Division of Corporation Finance stated that it would not pursue an enforcement action if a subsidiary acquires 10.4 percent of its parents company's stock and then transfers that stock to its wholly-owned subsidiary but does not file a Schedule 13D, when the shares acquired could not be voted and would be treated as held in treasury rather than as outstanding. The Division of Corporation Finance, however, did not necessarily agree that the Section 13(d)(6)(C) exemption is applicable to the acquisition of an issuer's stock by a subsidiary of that issuer. *Id.* at 78,024.

(n5)Footnote 5. Domestic and Foreign Investment Improved Disclosure Act of 1977 of the Foreign Corrupt Practices Act of 1977, Pub. L. No 95-213, 91 Stat. 1498 (1977).

The Domestic and Foreign Investment Improved Disclosure Act of 1977 also added a new Section 13(h) to the Exchange Act directing the Commission to report to Congress within thirty months of the date enactment of Section 13(h) on the effectiveness of the reporting requirements contained in Title II of the Act and on the possibility of changing the five percent threshold used in Section 13(d)(1) and 13(g)(1) of the Exchange Act.

Pursuant to this mandate, the Commission concluded in its report to Congress that the ownership reporting requirements are generally effective, although legislation may still be necessary in certain areas (*e.g.*, in acquisitions during filing periods and in private rights of action). In addition, the report revealed that rule making may be appropriate to help close disclosure gaps in order to make disclosure more meaningful and to lessen the costs and burdens of compliance. The Commission also found that it was not presently feasible or desirable to reduce or modify the five percent reporting threshold in Section 13(d)(1) and (g)(1). Report of the Securities and Exchange Commission on Beneficial Ownership Reporting Requirements Pursuant to Section 13(h) of the Securities Exchange Act of 1934, C.C.H. Fed. Sec. L. Rep. P 82,616 (1980).

(n6)Footnote 6. S. Rep. No. 95-114 at 13 (1977), *reprinted in* The Securities Primary Law Sourcebook, Vol. C § I of the 1934 Act. Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 15348, 16 SEC Docket 228 (Nov. 22, 1978) states:

"Moreover, the legislative history is clear that Section 13(g) was intended to 'supplement the current statutory scheme by providing legislative authority for certain additional disclosure requirements that in some cases could not be imposed administratively.' The principal effect of Section 13(g) is to provide the authority necessary to 'close the gaps' previously described in the disclosure requirements under Section 13(d)." (footnotes omitted).

(n7)Footnote 7. Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 15348, 16 SEC Docket 228 (Nov. 22, 1978) provides:

"Section 13(g)(1) of the Securities Exchange Act of 1934, reprinted in the [Securities Primary Law Sourcebook, Volume B, Section F] taken literally would require disclosure of the prescribed information, as well as that which may be required pursuant to the Commission's general rulemaking authority thereunder, regardless of whether the persons subject thereto are also required to report similar ownership information under other sections of the Exchange Act. Section 13(g)(5), however, directs the Commission to take such steps as are necessary and appropriate in the public interest and for the protection of investors to achieve centralized reporting of the information, to avoid unnecessary duplicative reporting, and to minimize the compliance burden on persons required to report."

(n8)Footnote 8. *See* Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 15348, 16 SEC Docket 228 (Nov. 22, 1978).

(n9)Footnote 9. *See infra* Ch. 8 for a discussion of Section 16(a).

(n10)Footnote 10. Section 16 is a prophylactic provision designed to prevent the use of inside information by certain "insiders" to derive short-swing profits on purchases and sales of the issuer's securities within a six month period. The overriding concern under Section 16 is in regard to the economic incidents of ownership. Section 13(d), in contrast, focuses on the obtainment of voting power and the ability to appoint directors rather than the accumulation of a pecuniary interest in the securities. *See* Filing and Disclosure Requirements Relating to Beneficial Ownership,

Exchange Act Release No. 15348, 16 SEC Docket 228 (Nov. 22, 1978).

(n11)Footnote 11. See Section 13(d)(3); see also Section 13(g)(3).

A person in charge of a takeover group would be subject to liability for the failure of the group to comply with the reporting requirements of Section 13. See, e.g., *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, C.C.H. Fed. Sec. L. Rep. P 98,295 (D.C. Cir. 1981).

However, in *Pantry Pride, Inc. v. Rooney*, 598 F. Supp. 891, C.C.H. Fed. Sec. L. Rep. P 91,866 (S.D.N.Y. 1984), the court held that an alleged "group" of investors engaged in a proxy contest did not violate Section 13(d) filing requirements although the group held, in the aggregate, more than five percent of an issuer's stock, where the group merely discussed the possibility of a future agreement to vote their shares against the issuer's management in the proxy contest. The group did not control five percent of the stock until an agreement was actually executed.

(n12)Footnote 12. "The Commission may, by rule or order, exempt, in whole or in part, any person or class of persons from any or all of the reporting requirements of this subsection as it deems necessary or appropriate in the public interest or for the protection of investors." Section 13(g)(6).

(n13)Footnote 13. This exemption is also conditioned on compliance with the reporting requirements of Section 16(a), if applicable. Rule 13d-6(c).

(n14)Footnote 14.

"The Commission, by rule or regulation or by order, may permit any person to file in lieu of the statement required by paragraph (1) of this subsection or the rules and regulations thereunder, a notice stating the name of such person, the number of shares of any equity securities subject to paragraph (1) which are owned by him, the date of their acquisition and such other information as the Commission may specify, if it appears to the Commission that such securities were acquired by such person in the ordinary course of his business and were not acquired for the purpose of and do not have the effect of changing or influencing the control of the issuer nor in connection with or as a participant in any transaction having such purpose or effect." Section 13(d)(5).

(n15)Footnote 15. Rule 13d-1(b)(1).

The intent of subparagraph (b)(1)(ii) is to allow parent holding companies to use short form reporting when the stock holdings of their subsidiaries that are otherwise qualified to use Schedule 13G makes the parent a beneficial owner of more than five percent of a class of equity securities. (See *infra* § 7A.02[2] for a discussion of "beneficial ownership"). A requirement that the parent's direct ownership, together with its non-qualified subsidiaries direct or indirect ownership of a class of securities, not exceed one percent of that class, prevents a parent from setting up a holding company solely for the purpose of avoiding the "long form" report on Schedule 13D, without forcing the parent to use the "long form" report merely because it or one of its non-qualified subsidiaries owns a single share of that class. See Exchange Act Release No. 14910 (1978).

(n16)Footnote 16. See *infra* § 7A.02[1][c].

(n17)Footnote 17. Rule 13d-1(b)(2). The ownership percentages are to be computed on the last day of the month.

(n18)Footnote 18. Rule 13d-2(b).

(n19)Footnote 19. Rule 13d-2(b).

2-7A Federal Securities Exchange Act of 1934 § 7A.02

(n20)Footnote 20. See Amendments to Beneficial Reporting Requirements, Exchange Act Release No. 34-39538 [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 86,002 (Jan. 12, 1998).

(n21)Footnote 21. Rule 13d-1(c).

(n22)Footnote 22. Rule 13d-2(d).

(n23)Footnote 23. Rule 13d-1(b)(1)(i).

(n24)Footnote 24. Rule 13d-1(e)(1),(f)(1).

(n25)Footnote 25. Rule 13d-1(e)(2),(f)(2).

(n26)Footnote 26. This can occur if they are beneficial co-owners or members of a group formed for the purpose of holding that security. See *infra* § 7A.02[2][b].

(n27)Footnote 27. Rule 13d-1(k)(1).

(n28)Footnote 28. Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 14692, 16 SEC Docket 228 (Nov. 22, 1978).

(n29)Footnote 29. Previously, Schedule 13D was also the schedule to be filed by tender offerors under Rule 14d-1, until a separate Schedule 14D-1 was adopted in Sec. Exch. Act Rel. No. 34-13787 (1977). See *infra* § 7A.03[2][a].

(n30)Footnote 30. This information is as follows:

"(A) The background, and identity residence, and citizenship of, and the nature of such beneficial ownership by, such person and all other persons by whom or on whose behalf the purchases have been or are to be effected;

(B) The source and amount of the funds or other consideration used or to be used in making the purchases, and if any part of the purchase price or proposed purchase price is represented or is to be represented by funds or other consideration borrowed or otherwise obtained for the purpose of acquiring, holding, or trading such security, a description of the transaction and the names of the parties thereto, except that where a source of funds is a loan made in the ordinary course of business by a bank, as defined in section 3(a)(6) of this title, if the person filing such statement so requests, the name of the bank shall be made available to the public;

(C) If the purpose of the purchases or prospective purchases is to acquire control of the business of the issuer of the securities, any plans or proposals which such persons may have to liquidate such issuer, to sell its assets to or merge it with any other persons, or to make any other major change in its business or corporate structure;

(D) The number of shares of such security which are beneficially owned, and the number of shares concerning which there is a right to acquire, directly or indirectly, by (i) such person, and (ii) by each associate of such person, giving the background, identity, residence and citizenship of each such associate, and;

(E) Information as to any contracts, arrangements, or understandings with any person with respect to any securities of the issuer, including but not limited to transfer of any of the securities, joint ventures, loan or option arrangements, puts or calls, guaranties of loans, guaranties against loss or guaranties of profits, division of losses or profits, or the giving or withholding of proxies, naming the persons with whom such contracts, arrangements, or understandings have been entered into, and giving the details

thereof."

Section 13(d)(1).

(n31)Footnote 31. CUSIP stands for the "Committee on Uniform Securities Identification Procedures." The disclosure of the CUSIP number assists the Commission in identifying security holders, thereby expediting the processing of their beneficial ownership statements. See Schedule 13D.

(n32)Footnote 32. In *SEC v. Zimmerman*, 407 F. Supp. 623 (D.D.C. 1976) , *aff'd sub nom SEC v. Savoy Indus., Inc.*, 587 F.2d 1149 , C.C.H. Fed. Sec. L. Rep P 96,497 (D.C. Cir. 1978), the court enjoined the defendant, who failed to disclose his membership in a group filing a Schedule 13D, thereby also avoiding disclosure of his previous securities laws violations, from voting any of the shares acquired in the transaction covered by the Schedule 13D.

(n33)Footnote 33. The name of a bank that provided all or any part of these funds in the ordinary course of business shall not be made public if a written request to this effect is sent to the Secretary of the Commission at the time of filing. Section 13(d)(1)(B); Schedule 13D, Item 3.

(n34)Footnote 34. See *Warner Commc'n, Inc. v. Murdoch*, 581 F. Supp. 1482 , C.C.H. Fed. Sec. L. Rep. P 91,435 (D. Del. 1984), where the court held that the existence of a control group formed for the purpose of holding and acquiring corporate stock must be disclosed on Schedule 13D. The court stated that an amendment to the Schedule 13D that discloses allegations of the group's existence is insufficient disclosure. See also *Sea Containers Ltd. v. Stena AB*, 890 F.2d 1205, 1209 (D.C. Cir. 1989) (denying hostile acquirer's motion for a preliminary injunction against target company to amend its 13D disclosure). Furthermore, if the purposes of the group's formation was to deter a hostile takeover this purpose must be disclosed.

(n35)Footnote 35. See *Saunders Leasing Sys., Inc. v. Societe Holding Gray D'Albion*, 507 F. Supp. 627 , C.C.H. Fed. Sec. L. Rep. P 97,881 (N.D. Ala. 1981), where a defendant with an intention of acquiring twenty-five percent of the issuer's stock had to disclose a control purpose on Schedule 13D, although this intention had not taken shape as a fixed plan. See also *Gearhart Indus. v. Smith Int'l., Inc.*, 741 F.2d 707, 726 (5th Cir. 1984) (agreeing with *Saunders*, but denying injunctive relief after acquirer re-filed Schedule 13D to disclose its control interest).

See also *Fin. Fed'n, Inc. v. Ashkenazy*, C.C.H. Fed. Sec. L. Rep. P 91,489 (C.D. Cal. 1983) (total mix of information available was sufficient); *Marshall Field & Co. v. Icahn*, C.C.H. Fed. Sec. L. Rep. P 98,481 (S.D.N.Y. 1982) (temporary restraining order imposed on further acquisition of shares by defendants under a Schedule 13D that not only failed to disclose, but in fact disclaimed, tentative plans by the defendants that would include extraordinary corporate transactions, material sales of assets, and material changes in the target company's business); *Chock Full O'Nuts Corp. v. Finkelstein*, 548 F. Supp. 212, C.C.H. Fed. Sec. L. Rep. P 99,015 (S.D.N.Y. 1982) (the failure of a group of insurgent stockholders to disclose in a Schedule 13D that they acquired their shares with an intent to pressure management to buy them back at a price far in excess of their market value, but who disclosed their intent to wage a proxy contest with management, was not a material omission since any reasonable investor would realize that if offered a sufficient price by management, any stockholder would sell).

If a group owns a potentially controlling share of stock, and collaborates to oust directors, "such situation requires 13D filings...[and] any effort to change or affect control...may be enjoined pending the completion of the required 13D filings, when, however, a corrective filing is made and an adequate opportunity is provided for the information to be digested by shareholders, the corrective injunction should be terminated." *ICN Pharm. v. Khan*, 2 F.3d 484, 489 (2d Cir. 1993) .

A subsequent 13D filing as to the purpose of a transaction admitting a false disclosure or omission in the 13D can cure the filing and render the alleged Section 13D violations moot. But filing an amendment merely disclosing allegations of

falsities and omissions, without actually admitting the charges will not necessarily result in dismissal of the action. *Horsehead Res. Dev. Co. v. B.U.S. Envtl. Serv., Inc.* 916 F. Supp. 305, 309 (S.D.N.Y. 1996) .

(n36)Footnote 36. See Section 12(g)(4), discussed in *supra* § 4.01.

(n37)Footnote 37. *Jewelcor, Inc. v. Pearlman*, 397 F. Supp. 221, 235 (S.D.N.Y. 1975) (holding that it need not be revealed that the securities are being held in a nominee's name under a custody bank account). See also *Hubco Inc. v. Rappaport*, 628 F. Supp. 345, 359 (D.N.J. 1985) ("Section 13(d) does not require disclosure of the fact that stock was held in a nominee's name.").

(n38)Footnote 38. *Instruction*. The description of a transaction required by Item 5(c) shall include, but not necessarily be limited to: (1) the identity of the persons covered by Item 5(c) who effected the transaction; (2) the date of the transaction; (3) the amount of securities involved; (4) the price per share of unit; and (5) where and how the transaction was effected. *Instruction*, Item 5(c), Schedule 13D.

(n39)Footnote 39. *Jewelcor, Inc. v. Pearlman*, 397 F. Supp. 221 (S.D.N.Y. 1975) (holding that a purchaser of securities need not disclose that it has obtained a confidential report about the issuer that is based solely on public information).

(n40)Footnote 40. A listing of the shareholders of a registered investment company or the beneficiaries of an employee benefit plan, pension fund or endowment fund is not required.

(n41)Footnote 41. See Rule 13d-1(b)(1).

(n42)Footnote 42. A Person filing on Schedule 13G because its shares were acquired prior to the issuer's initial public offering need not provide Item 10 certifications.

(n43)Footnote 43. Schedules filed with the Commission pursuant to Section 13 of the Exchange Act must be submitted in electronic format prepared in accordance with the EDGAR Filer Manual. See Rule 101(a)(1)(iii) of Regulation S-T. If such schedule is filed in paper format due to a hardship exemption or continuing hardship exemption pursuant to Rules 201 and 202 of Regulation S-T, the schedule must be filed under cover of Form TH or Form SE, respectively. See Rules 201 and 202 of Regulation S-T. In addition, a Schedule 13D or 13G filed in paper format must include a signed original and five copies of the schedule, including all exhibits. See Rules 13d-101 and 13d-102.

(n44)Footnote 44. Section 13(d)(1); Rule 13d-1(a); Rule 13d-7. See *Nicholson File Co. v. H.K. Porter Co.*, 341 F. Supp 508 (D.R.I. 1972) , where the court held that although a group may have been formed for the purpose of acquiring control of the defendant on or before January 1, 1972, the ten day period first started running on February 25, 1972. Only upon the latter date did the group's plan to acquire the plaintiff's stock become definite enough to disclose. Prior to that time, potential antitrust problems made their plans uncertain, and disclosure would have been premature and potentially misleading.

(n45)Footnote 45. Rule 13d-1(b)(2).

(n46)Footnote 46. Pursuant to § 204.00(B) of the New York Stock Exchange Listed Company Manual as well as § 5005(a)(15) of the Nasdaq Marketplace Rules, the filing of such materials with the Commission on the EDGAR system satisfies the Commission's rules requiring that copies of Section 13 filings be sent to each national securities exchange on which the security is traded.

(n47)Footnote 47. No filing is required at all if the person's beneficial ownership is five percent or less on the last day of the year in which the acquisition is made. See *supra* § 7A.02[1][a][ii].

(n48)Footnote 48. Rule 13d-1(b)(2).

(n49)Footnote 49. Rule 13d-1(c).

(n50)Footnote 50. Rule 13d-1(g).

(n51)Footnote 51. See *Feldman v. Simkins Indus., Inc.*, 679 F.2d 1299, C.C.H. Fed. Sec. L. Rep. P 98,745 (9th Cir. 1982), where the court held that filing a Section 13(d)(2) amendment the first day after sales (which constituted a "material change") were completed and the fourth trading day after the sales had begun, was "prompt" as a matter of law. However, as a matter of good practice, "prompt" is generally considered to be less than four business days.

(n52)Footnote 52. Plantronics, Inc., C.C.H. Fed. Sec. L. Rep. P 80,774 (Div. Corp. Fin. 1976).

(n53)Footnote 53. See, e.g., *Nachman Corp. v. Halfred, Inc.*, C.C.H. Fed. Sec. L. Rep. P 94,455 (N.D. Ill. 1973).

(n54)Footnote 54. 426 U.S. 438, 96 S. Ct. 2126, 48 L. Ed.2d 757 (1976) .

(n55)Footnote 55. 426 U.S. at 449 . *Northway* was a case under the proxy rules, but its materiality standard has been applied in other federal securities law cases. See *Harkavy v. Apparel Indus., Inc.*, 571 F.2d 737 (2d Cir. 1978) . (*Northway* standard used under Rule 10b-5); *Flynn v. Bass Bros. Enter., Inc.*, C.C.H. Fed. Sec. L. Rep. P 96,611 (E.D. Pa. 1978) (*Northway* standard applied under Section 14(e)).

(n56)Footnote 56. Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting, Compliance and Disclosure Interpretations, Division of Corporation Finance, Securities and Exchange Commission, September 14, 2009 (hereinafter "Section 13(d) Compliance and Disclosure Interpretations").

(n57)Footnote 57. The Commission amended Rule 13d-2(b) to delete the requirement that any person who has filed a Schedule 13G must file an annual amendment to the statement when no changes have occurred in the information contained in the previously filed Schedule 13G. Beneficial Ownership Disclosure Requirements, Exchange Act Release No. 19188, 26 SEC Docket 681 (Oct. 28, 1982).

(n58)Footnote 58. Section 13(d) Compliance and Disclosure Interpretations.

(n59)Footnote 59. The SEC has provided in its Section 13(d) Compliance and Disclosure Interpretations as follows: "Rule 13d-2(a) requires that a security holder amend its Schedule 13D promptly when 'any material changes occur in the facts set forth in the Schedule 13D. If a security holder has failed to timely file any required Schedule 13D amendments, the security holder should immediately amend its Schedule 13D to disclose the required information. If the security holder failed to file multiple amendments to the Schedule 13D when required, it may disclose that information by filing multiple amendments or filing one combined amendment. Regardless of the approach taken, the security holder must ensure that the filings contain the information that it should have disclosed in each required amendment, including the dates and details of each event that necessitated a required amendment. Any of these steps taken by the security holder in these situations will not necessarily affect the determination of liability under the federal securities laws for the failure to promptly file a required amendment to a Schedule 13D."

(n60)Footnote 60. This means securities that are traded on a national securities exchange or that are issued by a company that has over \$1,000,000 in assets and a class of equity securities held by five hundred or more people. See *supra* § 4.01.

(n61)Footnote 61. Section 13(d)(1).

(n62)Footnote 62. Section 13(g)(1).

(n63)Footnote 63. Rule 13d-3(d)(1)(i). ("A person shall be deemed to be the beneficial owner of a security, subject to the provisions of paragraph (b) of this rule, if that person has the right to acquire beneficial ownership of such security, as defined in Rule 13d-3(a) within sixty days, including but not limited to any right to acquire: (A) through the

exercise of any option, warrant or right; (B) through the conversion of a security; (C) pursuant to the power to revoke a trust, discretionary account, or similar arrangement; or (D) pursuant to the automatic termination of a trust, discretionary account or similar arrangement; *provided, however*, any person who acquires a security or power specified in paragraphs (A), (B) or (C) above, with the purpose or effect of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having such purpose or effect, immediately upon such acquisition shall be deemed to be the beneficial owner of the securities which may be acquired through the exercise or conversion of such security or power. Any securities not outstanding which are subject to such options, warrants, rights or conversion privileges shall be deemed to be outstanding for the purpose of computing the percentage of outstanding securities of the class owned by such person but shall not be deemed to be outstanding for the purpose of computing the percentage of the class by any other person.")

(n64)Footnote 64. *See* Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 15348, 16 SEC Docket 228 (Nov. 22, 1978).

(n65)Footnote 65. A group may meet its filing obligation either jointly or in individual filings by each member of the group. *See supra* § 7A.02[1][a][ii].

(n66)Footnote 66. In *Lane Bryant, Inc. v. Hatleigh Corp.*, C.C.H. Fed. Sec. L. Rep. P 97,529, 97,766 (S.D.N.Y. 1980), the court stated:

"In general, Section 13(d) seems carefully drawn to permit parties seeking to acquire large amounts of shares in a public company to obtain information with relative freedom, to discuss preliminarily the possibility of entering into agreements and to operate with relative freedom until they get to the point where they do in fact decide to make arrangements....By requiring the existence of a 'group,' the law is designed to avoid discouraging and making risky that kind of preliminary activity."

See also *Fin. Fed., Inc. v. Ashkenazy*, C.C.H. Fed. Sec. L. Rep. P 91,489 (C.D. Cal. 1983) (no actual agreement of any kind, either express or implied, to act with any person for the purpose of acquiring, holding, voting or disposing of corporation's stock as a group was found); *Advanced Computer Techniques Corp. v. Lecht*, C.C.H. Fed. Sec. L. Rep. P 98,795 (S.D.N.Y. 1982) (the formation of a group holding more than five percent of an issuer's stock would not trigger an obligation to file Schedule 13D if the group merely offers a slate of candidates for board of directors positions absent a showing that any member of the group had purchased, sold, or intended to trade in the issuer's stock since the decision to offer the slate).

See also *Corenco Corp. v. Schiavone & Sons, Inc.*, 488 F.2d 207, 217-18 (2d Cir. 1973) ; *Texasgulf, Inc. v. Can. Dev. Corp.*, 366 F. Supp. 374, 403 (S.D. Tex. 1973) ; *Twin Fair, Inc. v. Reger*, 394 F. Supp. 156, 160 (W.D.N.Y. 1975) .

(n67)Footnote 67. *Twin Fair, Inc. v. Reger*, 394 F. Supp. 156 (W.D.N.Y. 1975) ; *Water & Wall Ass., Inc. v. Am. Consumer Indus.*, C.C.H. Fed. Sec. L. Rep. P 93,943 (D.N.J. 1973).

(n68)Footnote 68. 366 F. Supp. at 403. (D. Tex 1973); *see also* *Management Assistance, Inc. v. Edelman* 584 F. Supp. 1016, 1019 (S.D.N.Y. 1984) (where the court relied upon the definition of a group set forth in *Texasgulf*); *SEC v. Savoy Indus.*, 587 F.2d 1149, 1162-63 (D.C. Cir. 1978); *Scott v. Multi-Amp Corp.*, 386 F. Supp. 44, 67-68 (D.N.J. 1974) .

(n69)Footnote 69. The court also found that several other defendants were not part of any conspiracy to seize control of the plaintiff. *Id.* at 398-404 .

For an interesting case deciding when a relationship between two parties ripened into a Section 13(d)(3) group, *see* *Universal Container Corp. v. Horwitz*, C.C.H. Fed. Sec. L. Rep. P 96,161 (S.D.N.Y. 1977).

(n70)Footnote 70. *488 F.2d 207* .

(n71)Footnote 71. *Id. at 217-18* .

(n72)Footnote 72. Total return equity swaps are a type of derivative that gives its holder substantially all of the indications of share ownership other than formal voting rights and investment power in the underlying security.

(n73)Footnote 73. Bank counterparties to such swap or derivative arrangements frequently purchase a corresponding interest in the underlying security for the purpose of hedging their exposure.

(n74)Footnote 74. *See CSX Corporation v. The Children's Investment Fund Management (UK) LLP*, 562 F.Supp.2d 511 (S.D.N.Y. 2008) .

(n75)Footnote 75. *See, e.g., General Aircraft v. Lampert*, 556 F.2d 90, 95 (1st Cir. 1977) , where the court stated:

"The evidence upon which the District Court predicated its finding included: the 150,485 shares of GAC common stock were acquired simultaneously in identical transactions (except for amount) by all three appellants; Scuderi's shares were held in Lampert's name from the time of purchase; a single Schedule 13D was filed on behalf of all three appellants and signed by all three; copies of correspondence with GAC from any one appellant were sent to the others. On this record, the District Court could not have concluded other than that the three appellants constituted a 'group' and thus, as a 'person,' were subject to the provisions of Section 13(d)." (footnote omitted).

See also Wellman v. Dickinson, 682 F.2d 355 , C.C.H. Fed. Sec. L. Rep. P 98,731 (2d Cir.1982) (representations made to prospective purchasers and a common desire to profit from a change in corporate control indicated that the defendants were all part of a group that reached an understanding to act in concert to dispose of their securities and thereby aid a third party acquisition of a controlling interest in the corporation).

See also Ozark Air Lines, Inc. v. Cox, 326 F. Supp. 1113 (E.D. Miss. 1971) where there was an agreement, set forth in an exchange of letters, to acquire additional shares of Ozark's stock for the purpose of electing a majority of the Ozark board of directors.

However, *see Transcon Lines v. A.G. Becker, Inc.*, C.C.H. Fed. Sec. L. Rep. P 96,806 (S.D.N.Y. 1979), holding that an individual was not a member of a Section 13(d)(3) group even though he lent assistance to its activities, because he was not a beneficial owner of any of the stock in question and the purpose of Section 13(d)(3) is to prevent a pooling of stock.

(n76)Footnote 76. *Fin. Gen. Bankshares v. Lance*, C.C.H. Fed. Sec. L. Rep. P 96,403 (D.D.C. 1978).

(n77)Footnote 77. *Id. at P 93,425*.

(n78)Footnote 78. *See infra* § 7A.02[2][b][ii].

(n79)Footnote 79. *The Budd Co.*, SEC No-Action Letter, 1971 SEC No-Act LEXIS 3454, at *1 (Oct. 22, 1971). *Great Sw. Corp.*, C.C.H. Fed. Sec. L. Rep. P 78,714 (Div. Corp. Fin. 1972). In the latter instance, the Commission justified its position upon the assertion that "the recipients of the warrants are acting in concert for the purpose of refinancing the transaction." This assertion is obviously true, but it has little relevance to either the literal meaning or purpose of Section 13(d)(3).

(n80)Footnote 80. *Telco Mktg. Serv., Inc.*, SEC No-Action Letter, 1977 SEC No-Act LEXIS 227, at *1 (Feb. 4, 1977).

(n81)Footnote 81. 489 F.3d 499 (2d Cir. 2007) .

(n82)Footnote 82. Section 16(b).

(n83)Footnote 83. Rule 16a-1(a).

(n84)Footnote 84. It was uncontroverted that both Jennings and EMR had Schedule 13D filing requirements due to the beneficial ownership by each of over 5 percent of MMI's shares.

(n85)Footnote 85. *Id.*, at 511 .

(n86)Footnote 86. *Bath Industries, Inc. v. Blot*, 427 F.2d 97, 109 (7th Cir. 1970) .

(n87)Footnote 87. *GAF Corp. v. Milstein*, 453 F.2d 709, 719 (2d Cir. 1971) , *cert. denied* 406 U.S. 910 (1972) .

(n88)Footnote 88. *Corenco Corp. v. Schiavone & Sons, Inc.*, 488 F.2d 207, 218 (2d Cir. 1973) .

(n89)Footnote 89. *See infra* § 7A.02.

(n90)Footnote 90. 488 F.2d at 218 .

(n91)Footnote 91. 386 F. Supp. 44 (D.N.J. 1974) .

(n92)Footnote 92. *Jewelcor Inc. v. Pearlman*, 397 F. Supp. 221, 243-44 (S.D.N.Y. 1975) (stating that the fact that a non-management member was part of the group provided additional support for their conclusion, but that their position would be the same if the group was comprised solely of management members); *Podesta v. Calumet Indus., Inc.*, C.C.H. Fed. Sec. L. Rep. P 96,433 (N.D. Ill. 1978).

See also Warner Commc'n, Inc. v. Murdoch, 581 F. Supp. 1482 , C.C.H. Fed. Sec. L. Rep. P 91,435 (D.Del. 1984), wherein the court stated that Section 13(d)'s disclosure obligations should not apply to management groups *per se*. According to the court, officers and directors are required to disclose beneficial ownership of corporate stock to the Commission. Furthermore, it is common knowledge that management wants to maintain its position and this fact should serve as notice to investors that such a management group exists. The court concluded that Section 13(d) should not be used as a vehicle to circumvent the principle that management is not obligated to disclose an entrenchment plan. However, the court noted that a voting or pooling arrangement between management and third parties constitutes a Section 13(d)(3) group, and must be disclosed in a Schedule 13D statement, since such an arrangement might alter and enlarge the control structure of the corporation beyond what investors would ordinarily presume.

(n93)Footnote 93. *Tony Lama Co.*, SEC No-Action Letter, 1974 SEC No-Act LEXIS 2643. Section 13(d)(6) is discussed in *supra* § 7A.02[1][a][i]. For an additional case discussing group formation, *see also Schaffer v. CC Invs., LDC*, Fed. Sec. L. Rep. (CC) P 92,248 (S.D.N.Y. 2002) (holding that there was sufficient evidence to support a finding of group formation where three shareholders entered into an agreement together with the issuer to purchase preferred stock and warrants to purchase additional common stock, sold certain patent rights together under an executed patent security agreement, and allowed the issuer to repurchase the preferred shares at any time, all over the span of 18 months).

(n94)Footnote 94. Exchange Act Release No. 8392 (Aug. 30, 1968).

See Transcon Lines v. A.G. Becker, Inc., C.C.H. Fed. Sec. L. Rep. P 96,806 (S.D.N.Y. 1979), where the court held that a person's expectation that someone else would in the future would sell him stock upon his request did not constitute a "right to acquire" stock within Rule 13d-3.

(n95)Footnote 95. *Bath Indus., Inc. v. Blot*, 427 F.2d 97, 112 (7th Cir. 1970) .

(n96)Footnote 96. Rule 13d-3(a). *See also Wellman v. Dickinson*, 682 F.2d 355, C.C.H. Fed. Sec. L. Rep. P 98,731 (2d Cir. 1982) , in which the events in question occurred prior to the effectiveness of Rule 13d-3, where the court held that beneficial ownership is evidenced by the power to dispose of securities, since that power represents a means for effecting changes in corporate control in addition to the possession of voting control.

(n97)Footnote 97. Rule 13d-3(d)(2).

(n98)Footnote 98. In a "firm commitment underwriting," the underwriter agrees to take up any securities that he or she cannot sell.

(n99)Footnote 99. Rule 13d-3(d)(4).

(n100)Footnote 100. Rule 13d-1(b)(1)(ii) includes the following persons:

- "(A) A broker or dealer registered under Section 15 of the Exchange Act;
- (B) A bank as defined in Section 3(a)(6) of the Exchange Act;
- (C) An insurance company as defined in Section 3(a)(19) of the Exchange Act;
- (D) An investment company registered under Section 8 of the Investment Company Act;
- (E) Any person registered as an investment adviser under Section 203 of the Investment Advisers Act of 1940 or under the laws of any state;
- (F) An employee benefit plan as defined in Section 3(3) of the Employee Retirement Income Security Act of 1974, as amended, ("ERISA") that is subject to the provisions of ERISA, or any such plan that is not subject to ERISA that is maintained primarily for the benefit of the employees of a state or local government or instrumentality, or an endowment fund;
- (G) A parent holding company, provided the aggregate amount held directly by the parent, and directly and indirectly by their subsidiaries or affiliates that are not persons specified in Rule 13d-1(b)(ii)(A) through (J), does not exceed one percent of the securities of the subject class;
- (H) A savings association as defined in Section 3(b) of the Federal Deposit Insurance Act;
- (I) A church plan that is excluded from the definition of an investment company under Section 3(c)(14) of the Investment Company Act;
- (J) A non-U.S. institution that is the functional equivalent of any of the institutions listed in paragraphs (b)(1)(ii)(A) through (I) of this section, so long as the non-U.S. institution is subject to a regulatory scheme that is substantially comparable to the regulatory scheme applicable to the equivalent U.S. institution; and
- (K) A group, provided that all the members are persons specified in Rule 13d-1(b)(1)(ii)(A) through (I)...."

(n101)Footnote 101. Rule 13d-3(d)(3).

(n102)Footnote 102. Section 13(d)(1) applies to "any person who, after *acquiring* directly or indirectly the beneficial ownership of any equity security..." (emphasis added). Furthermore, such acquisition, combined with all other acquisitions in the preceding twelve months, must exceed one percent of that class of securities or otherwise be

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"material" under the circumstances, or the acquisition is exempt under Section 13(d)(6)(B) or Rule 13d-2(a).

(n103)Footnote 103. Section 13(g)(1) applies to "any person who *is* directly or indirectly the beneficial owner of more than five percentum of a security...." (emphasis added).

(n104)Footnote 104. See Rule 13d-3, discussed in § 7A.02[2][b].

(n105)Footnote 105. See *supra* § 7A.02[2][b].

(n106)Footnote 106. *Bath Indus. v. Blot*, 427 F.2d 97 (7th Cir. 1970) .

(n107)Footnote 107. *Id. at 109-10* . The court also stated:

"Having all of these aspects of the legislative intent in mind, it is our conclusion that the Act should be interpreted to require compliance with its disclosure provisions when, but only when, any group of stockholders owning more than 10% now 5% of the outstanding shares of the corporation agree to act in concert *to acquire additional shares*.

This construction focuses on the decision on the part of a group owning more than 10% now 5% of a corporation to acquire more shares. Thus it honors the repeated expressions of legislative intent to draft a statute to protect investors rather than to protect current management. It does not proscribe informal discussion among existing shareholders concerning the performance of current management. Nor does it proscribe legitimate cooperation among existing shareholders to assert their determination to take over control of management, *absent* an intention to acquire additional shares for the furtherance of such purpose." *Id.* (emphasis in original).

This opinion was strongly criticized in Comment, *Section 13(d) and Disclosure of Corporation Equity Ownership*, 119 U. Pa. L. Rev. 853 (1971).

(n108)Footnote 108. *GAF Corp.v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971) , *cert. denied* 406 U.S. 910 (1972) .

(n109)Footnote 109. Cases supporting *Milstein* are: *Texasgulf, Inc. v. Can. Dev. Corp.*, 366 F. Supp. 374 (S.D. Tex. 1973) ; *Twin Fair, Inc. v. Reger*, 394 F. Supp. 156 (W.D.N.Y. 1975) ; *Fin. Gen. Bankshares, Inc. v. Lance*, C.C.H. Fed. Sec. L. Rep. P 96,403 (D.C. Cir. 1978); *Graphic Sci. Inc. v. Int'l Mogul Mines, Ltd.*, 397 F. Supp. 112, 124, n. 35 (D.D.C. 1974) .

Ozark Air Lines v. Cox, 326 F. Supp. 1113 (E.D. Mo. 1971) , expressed a view similar to the one in *Bath* by holding that after a group is formed, it must make an actual acquisition to come within Section 13(d).

(n110)Footnote 110.

"New Rule 13d-5(b)(2) reflects a suggestion by commentators that an exemption from the predecessor of the Rule 13d-5(b) be provided for institutional private placements directly from the issuer. The Commission agrees with the commentators that such transactions are not within the primary scope of Section 13(d)(3). The legislative history of that Section indicates that it was intended primarily to prevent a group of persons seeking to change or influence issuer control from evading the provisions of Section 13(d) because no one individual owned more than five percent of a class of securities. The cooperative activity characteristic of an institutional private placement directly from the issuer generally results from sound business considerations such as cost savings resulting from the use of common counsel and forms, rather than from a desire to affect control of the issuer. Moreover, since the cooperative activity generally ends when the transaction is completed, the information obtained in such a

group filing is of little interest to investors and is available to the issuer." (footnote omitted). Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 14692, 14 SEC Docket 862 (April 21, 1978).

(n111)Footnote 111. See Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 14692, 14 SEC Docket 862 (April 21, 1978).

(n112)Footnote 112. *411 F.Supp.2d 411 (S.D.N.Y. 2006)* .

(n113)Footnote 113. Had the investors been found to be a group, they would have held over 10 percent of Data Race's shares and, as a consequence of their subsequent sales, would have been liable for short-swing profit recovery under Section 16.

(n114)Footnote 114. *Id at 415* .

(n115)Footnote 115. See Rule 13d-3 discussed at *supra* § 7A.02[2][b].

(n116)Footnote 116. Rule 13d-3(d)(1)(i).

(n117)Footnote 117. American Pepsi Cola Bottlers, Inc., SEC No-Action Letter, 1972 SEC No-Act. LEXIS 1655, at *1 (April 24, 1972).

(n118)Footnote 118. Rule 13d-3(c).

(n119)Footnote 119. Rule 13d-3(d)(1)(ii).

(n120)Footnote 120. Since the provisions of Section 13(g) closely parallel those of Section 13(d), the remedies available for a violation of Section 13(g) are similar to those available for a violation of Section 13(d).

(n121)Footnote 121. Section 15(c)(4).

(n122)Footnote 122. See *SEC v. Falstaff Brewing Corp.*, C.C.H. Fed. Sec. L. Rep. P 96,583 (D.D.C. 1978); *SEC v. Zimmerman*, 407 F. Supp. 623 (D.D.C. 1976) , *aff'd sub nom SEC v. Savoy Indus., Inc.*, 587 F.2d 1149 (D.C. Cir. 1978) .

(n123)Footnote 123. Section 21(d).

(n124)Footnote 124. *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149 .

(n125)Footnote 125. *Id. at 1167* .

(n126)Footnote 126. "Having established a violation, we must determine whether the district court erred in entering an injunction against Zimmerman for his violation of Section 13(d)(1) and 13(d)(3). We conclude that there is no error. Where, as here, the [Commission] is not attempting to halt an ongoing violation, 'the ultimate test is whether the defendant's past conduct indicates...that there is a *reasonable likelihood* of further violations in the future.'" (citations omitted).

"Zimmerman's past conduct is highly suggestive of his propensity to commit securities law violations and the likelihood that he will commit such violations in the future. *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1100 (2d Cir. 1972) . His violation was not an isolated incident; he has not demonstrated that he understands his conduct to have been wrongful; and he does not give sufficient assurances against future violations. Furthermore, the nature of the appellant's business activities may

present him with further temptations to violate the law. *SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044, 1048; *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 807 (2d Cir. 1975) . Under these circumstances, we believe that there is a sufficient probability of a future violation to uphold the district court on this issue. The absence of an express finding on the probability of future violations by the district court does not impair our ability to sustain the district court's injunction where the necessary factors are so obviously present. *Id.* at 807-08 ; *SEC v. Culpepper*, 270 F.2d 241, 250 (2d Cir. 1959) . *Id.* at 1168 ." (footnote omitted).

SEC v. Savoy Indus. Inc., 587 F.2d. 1149, 1168 .

See also *SEC v. Falstaff Brewing Corp.*, C.C.H. Fed. Sec. L. Rep. P 96,583 (D.D.C. 1978); *SEC v. IMC Int'l, Inc.* 384 F. Supp 889 (N.D. Tex. 1974) , *aff'd without opinion* 505 F.2d 733 (5th Cir. 1974) .

(n127)Footnote 127. "Not only may the threat of future violations of the securities laws be properly inferred from past violations, but such an inference is significantly strengthened, where, as here, no attempt is made by the defendants to cease their violations even after the institution of an injunctive action. (cites omitted)." *SEC v. IMC International, Inc.*, 384 F. Supp. 889, 894 (N.D. Tex. 1974) .

(n128)Footnote 128. *GAF Corp. v. Milstein*, 453 F.2d 709, 721 (2d Cir. 1971) , *cert. denied* 406 U.S. 910 (1972) .

(n129)Footnote 129. *SEC v. Savoy Indus., Inc.*, 587 F.2d. 1149 (D.C. Cir. 1978) ; *SEC v. Falstaff Brewing Corp.*, C.C.H. Fed. Sec. L. Rep. P 96,583 (D.D.C. 1978); *SEC v. IMC Int'l, Inc.*, 384 F. Supp. 889 (N.D. Tex. 1974) ; *SEC v. Gen. Refractories Co.*, C.C.H. Fed. Sec. L. Rep. P 95,291 (D.D.C. 1975).

(n130)Footnote 130. *SEC v. Falstaff Brewing Corp.*, C.C.H. Fed. Sec. L. Rep. P 96,583 (D.D.C. 1978); *SEC v. Gen. Refractories Co.*, C.C.H. Fed. Sec. L. Rep. P 95,291 (D.D.C. 1975); the proxy rules are discussed in Ch. 7 *supra*.

(n131)Footnote 131. *Grow Chem. Corp. v. Uran*, 316 F. Supp. 891 (S.D.N.Y. 1970) .

(n132)Footnote 132. *Id.* at 892.

(n133)Footnote 133. *Bath Indus., Inc. v. Blot*, 427 F.2d 97 (7th Cir. 1970) .

(n134)Footnote 134. *GAF Corp. v. Milstein*, 453 F.2d 709 (2d Cir. 1971) . The court considered this issue *sua sponte*, as the defendant did not challenge the standing of the issuer.

But see *Woodward & Lothrop, Inc. v. Baron*, C.C.H. Fed. Sec. L. Rep. P 91,534 (D.D.C. 1984), where the court held that an issuer was not the most appropriate party to assert its shareholders' rights under Section 10(b) since individual shareholders were present as plaintiffs in the action. The court stated that no departure from the general rule that purchasers and sellers, but not issuers, are the proper parties to raise Section 10(b) claims were warranted. Any injury that occurred from defendant's manipulation of the market for issuer's stock as a result of withholding material information was indirect at best.

See also *Saunders Leasing Sys., Inc. v. Societe Holding Gray D'Albion*, 507 F. Supp. 627 , C.C.H. Fed. Sec. L. Rep. P 97,881 (N.D. Ala. 1981).

But see *Hanna Mining Co. v. Norcen Energy Resources Ltd.*, C.C.H. Fed. Sec. L. Rep. P 98,878 (N.D. Ohio 1982), where the court, relying upon a narrow exception created by the Court of Appeals for the Second Circuit in *Milstein*, held that a target company has standing to maintain a private right of action for injunctive relief under Section 10(b) and *Rule 10b-5* although the target is not a "purchaser or seller" of securities.

(n135)Footnote 135. 453 F.2d 709, 719-21 (2d Cir. 1971) , cert. denied, 406 U.S. 910 (1972) .

See also *Dan River, Inc. v. Unitex Ltd.*, 624 F.2d 1216, C.C.H. Fed. Sec. L. Rep. P 97,515 (4th Cir. 1980) , holding that it was not sufficient that the defendants had "facially" met the requirements of Section 13(d), since an obligation exists to file a complete and accurate Schedule 13D.

See also *SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1165 (D.C. Cir. 1978) .

(n136)Footnote 136. *GAF v. Milstein*, 453 F.2d 709 (2d Cir. 1971) (emphasis in original).

(n137)Footnote 137. *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975) ; see also *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, C.C.H. Fed. Sec. L. Rep. P 91,667 (5th Cir. 1984) (a private right of action for injunctive relief is available under Section 13(d)).

See also *Kirsch Company v. Bliss & Laughlin Indus., Inc.*, 495 F. Supp. 488 , C.C.H. Fed. Sec. L. Rep. P 97,580 (W.D. Mich. 1980) (private right of action for injunctive relief available to target company under Section 13(d) to require a purchaser to correct all misrepresentations and omissions in its Schedule 13D).

But see *Gateway Indus., Inc. v. Agency Rent A Car, Inc.*, 495 F. Supp. 92 , C.C.H. Fed. Sec. L. Rep. P 97,540 (N.D. Ill. 1980), where the court held that no implied right of action for injunctive relief exists under Section 13(d) for a target company suing on its own behalf or for the benefit of its shareholders. See also *Leff v. CIP Corp.*, 540 F. Supp. 857 , C.C.H. Fed. Sec. L. Rep. P 98,662 (S.D. Ohio 1982), where the court held that no private right of action for injunctive relief could be implied under Section 13(d) since:

- (1) the terms of Section 13(d) do not create any rights but only constitute a reporting requirement;
- (2) the legislative history of Section 13(d) is silent on the question of any private right of action; and
- (3) the enforcement scheme of the Exchange Act indicates that Congress expressly provides remedies elsewhere in the Exchange Act for the violations alleged i.e., Sections 18 and 21.

See also *Liberty Nat'l Ins. Holding Co. v. Charter Co.*, 734 F.2d 545 , C.C.H. Fed. Sec. L. Rep. P 91,539 (11th Cir. 1984), where the Court of Appeals for the Eleventh Circuit held that an issuer alleging that a shareholder violated Section 13(d) by filing a false Schedule 13D did not have an implied right of action under Section 13(d) to seek an injunction requiring the purchaser to divest itself of the issuer's stock. The court stated that investors, not corporations, are the intended beneficiaries of Section 13(d). Furthermore, reviewing the legislative and judicial history of Section 13(d), the court determined that Congress did not intend to provide such a remedy since the primary effect would be detrimental to shareholders. Finally, the court concluded that implying the private remedy sought by the issuer would be inconsistent with the Exchange Act's purpose since it would tip the balance of regulation in favor of management. When it comes to private rights of action seeking damages for violations of Section 13(d), no court has been sympathetic to Liberty National's position. See, e.g., *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.*, 286 F.3d 613 (2d Cir. 2002) .

(n138)Footnote 138. 439 F. Supp.2d 139 (D.D.C. 2006) .

(n139)Footnote 139. *Id.* at 160 .

(n140)Footnote 140. See e.g., *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, C.C.H. Fed. Sec. L. Rep. P 91,667 (5th Cir. 1984), where the court held that since a NYSE delisting may cause irreparable injury to corporate shareholders, injunctive relief may be available depending on the facts. Accordingly, the issue was remanded to the district court to

make a factual determination.

See also *Beacon Theatres, Inc. v. Westover*, 359 U.S. 500, 506-07, 79 S. Ct. 948, 3 L. Ed.2d 988 (1959) . When a preliminary injunction is requested, a likelihood of success on the merits of the case must also be proved. *Sonesta Int'l. Hotels Corp. v. Wellington Associates*, 483 F.2d 247, 250 (2d Cir. 1973) .

(n141)Footnote 141. *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 95 S. Ct. 2069, 45 L. Ed.2d 12 (1975) .

(n142)Footnote 142. *Mosinee Paper Corp. v. Rondeau*, 354 F. Supp. 686 (W.D. Wis. 1973) .

(n143)Footnote 143. *Mosinee Paper Corp. v. Rondeau*, 500 F.2d 1011, 1016-17 (7th Cir. 1974) .

(n144)Footnote 144. *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 58-60, 95 S. Ct. at 2075-77, 45 L. Ed.2d 20-22 . See *infra* § 7A.02[3][b][iii] for a discussion of damage remedies under Section 13(d).

See also *Standard Metals Corp. v. Tomlin*, C.C.H. Fed. Sec. L. Rep. P 97,894 (S.D.N.Y. 1981) (an injunction may be issued in connection with a claim under Section 13(d) only to the extent of insuring that information currently provided is accurate; inaccuracies or material omissions in previously filed Schedules 13D may be the basis for an action for damages, but cannot form the basis for injunctive relief).

(n145)Footnote 145. *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 62-63, 95 S. Ct. at 2078, 45 L. Ed.2d at 23 .

(n146)Footnote 146. See Richard H. Porter & Kathleen Hyland, *Rondeau v. Mosinee Paper Company and the Williams Act Injunction*, 59 Marq. L. Rev. 743, 758 (1976).

(n147)Footnote 147. *Bath Indus. v. Blot*, 427 F.2d 97 (7th Cir. 1970) .

(n148)Footnote 148. See also *Committee for New Management of Butler Aviation v. Widmark*, 335 F. Supp. 146, 155 (E.D.N.Y. 1971) , where the court said:

"Here we are only concerned with admitted statutory violation by a large stockholder, once part of the management of a corporation, who determined on his own to launch a campaign to regain control. In doing so he has clearly plunged the corporation into a costly proxy contest it can ill afford--one which might have been avoided had early disclosure of his plans been made.

If Section 13(d) means anything, plaintiff Dopp should not be permitted to gain advantage from a course of action pursued in clear violation of law. At the very least, consideration of equity demand that Dopp be disenfranchised from voting at the December 14th meeting those shares he acquired after January 4, 1971, in excess of the 2% exemption provided by the Williams Act."

(n149)Footnote 149. *Twin Fair, Inc. v. Reger*, 394 F. Supp. 156, 161 (W.D.N.Y. 1975) ; *Graphic Sci., Inc. v. Int'l. Mogul M. Ltd.*, 397 F. Supp. 112 (D.D.C. 1974) .

(n150)Footnote 150. Noting injunctive overkill, the Fifth Circuit in *Gearhart Industries, Inc. v. Smith International, Inc.* C.C.H. Fed. Sec. L. Rep. P 91,667 (5th Cir. 1984), See also *Edelson v. Ch'ien*, 405 F.3d 620 (7th Cir. 2005) (denying a former outside director shareholder injunctive relief as a remedy for a 13(d) violation).

See also *Energy Ventures, Inc. v. Appalachian Co.*, 587 F. Supp. 734, C.C.H. Fed. Sec. L. Rep. P 91,556 (D. Del. 1984) , the court denied interim injunctive relief under Section 13(d) since, even if an acquiring company's initial Schedule 13D filing failed to disclose an alleged decision to acquire a majority of a target company's common stock to gain control of the target's management and board of directors, a subsequent filing cured any prior nondisclosure.

See also *Lane Bryant, Inc. v. Hatleigh Corp.*, C.C.H. Fed. Sec. L. Rep. P 97,529 (S.D.N.Y. 1980), a target company's request for an injunction preventing the defendant purchasers from voting their stock was denied on the ground that any harm the target's shareholders could sustain was outweighed by the harm the defendants would suffer if deprived of their right to participate in the annual meeting and thereby protect their investment.

See also *University Bank and Trust Co. v. Gladstone*, 574 F. Supp. 1006, C.C.H. Fed. L. Rep. P 99,594 (D. Mass. 1983), the court denied granting an injunction to prevent a purchaser, who allegedly violated Section 13(d) by filing false and misleading statements from voting, selling or otherwise disposing of shares since:

- (1) subsequent amendments stating his intention to take over plaintiff-bank cured any disclosure deficiencies and enabled shareholders to freely vote, sell or retain their shares with full information about the purchaser's intentions; and
- (2) regarding shareholders who had already sold their shares when the alleged deficient filings were in effect, the proper remedy would be an action for damages rather than an injunction.

See also *Condec Corp. v. Farley*, 573 F. Supp. 1382, C.C.H. Fed. Sec. L. Rep. P 99,535 (S.D.N.Y. 1983) (no showing of irreparable harm to warrant preliminary injunctive relief under Section 13(d) since Schedule 13D filings made subsequent to this court action adequately disclosed all relevant facts and information about the defendants' improper use of company pension funds to purchase target company stock); *Treadway Co., Inc. v. Care Corp.*, C.C.H. Fed. Sec. L. Rep. P 97,603 (2d Cir. 1980) (no risk of irreparable injury when the target shareholders had four months to "digest" the corrected deficiencies in the acquiring company's Schedule 13D); *Financial General Bankshares, Inc. v. Lance*, C.C.H. Fed. Sec. L. Rep. P 97,611 (D.D.C. 1980) (no injunctive relief granted for violation of Section 13(d) because the defendant was no longer in a position to cause irreparable harm); *Standard Metals Corp. v. Tomlin*, 503 F. Supp. 586, C.C.H. Fed. Sec. L. Rep. P 97,606 (S.D.N.Y. 1980) (no showing of sufficient possible irreparable harm to warrant preliminary injunction against the defendants); *Ludlow Corp. v. Tyco Labs., Inc.*, C.C.H. Fed. Sec. L. Rep. P 98,383 (D. Mass. 1981) (injunctive relief denied when ambiguity that may have been created by Schedules 13D was dispelled by subsequent unequivocal filings).

But see *Camelot Industries Corp. v. Vista Res., Inc.*, 535 F. Supp. 1174, C.C.H. Fed. Sec. L. Rep. P 98,611 (S.D.N.Y. 1982), the court held that a tender offeror violated Section 13(d) by failing to disclose in its Schedule 13D filing a voting agreement, it had entered into with the target's largest shareholder. Thus, the court enjoined the tender offer with permission to reoffer after compliance with the proxy and disclosure rules.

But see *General Aircraft v. Lampert*, 556 F.2d 90, 97 (1st Cir. 1977), where the court refused to enjoin the defendants from voting their stock because an injunction against soliciting proxies was sufficient relief for their violation absent an imminent contest for control. In its ruling, the court stated that "[i]nvestors are entitled to the legitimate fruits of their investment."

See also *Universal Container Corp. v. Horwitz*, C.C.H. Fed. Sec. L. Rep. P 96,161 (S.D.N.Y. 1977), the court refused to sterilize the defendants' shares for minor violations of Section 13(d), where the parties had a private agreement to neutralize any votes to alter the management of the corporation until the dispute was settled in court.

See also *Financial General Bankshares, Inc. v. Lance*, C.C.H. Fed. Sec. L. Rep. P 96,403 (D.D.C. 1978), where the court refused to order divestiture of stock acquired by the defendants while violating Section 13(d); and a pre-*Rondeau* case, *Scott v. Multi--Amp Corp.*, 386 F. Supp. 44 (D.N.J. 1974), a pre-*Rondeau* case, where no injunction was granted since the violation was committed four years prior, and everyone knew of the defendant's stock acquisitions since they resulted in the defendants taking control of the issuer.

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(n151)Footnote 151. *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49, 59 n. 9, 95 S. Ct. at 2076, n.9, 45 L. Ed.2d at 21, n.9.

(n152)Footnote 152. See *Marshall Field & Co. v. Icahn*, C.C.H. Fed. Sec. L. Rep. P 98,481 (S.D.N.Y. 1982), discussed in *supra* § 7A.02; *Saunders Leasing Sys., Inc. v. Societe Holding Gray D'Albion*, 507 F. Supp. 627, C.C.H. Fed. Sec. L. Rep. P 97,881 (N.D. Ala. 1981), discussed in *supra* § 7A.02 *Kaufman & Broad, Inc. v. Belzberg*, 522 F. Supp. 35 (S.D.N.Y. 1981) .

See also *Gen. Aircraft Corp. v. Lampert*, 556 F.2d 90, 96-7 (1st Cir. 1977) ; ; *Jewelcor, Inc. v. Pearlman*, 397 F. Supp. 221, 253 (S.D.N.Y. 1975) ; *Bath Indus., Inc. v. Blot*, 427 F.2d 97, 113 (7th Cir. 1970) .

(n153)Footnote 153. *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971) (footnote citation omitted).

(n154)Footnote 154. *Dan River, Inc. v. Unitex LTD*, 624 F.2d 1216, 1224 (4th Cir. 1980) .

(n155)Footnote 155. The injunctions granted in *General Aircraft v. Lampert*, 556 F.2d 90 (1st Cir. 1977) and *Jewelcor, Inc. v. Pearlman*, 397 F.Supp. 221 (S.D.N.Y. 1975) provided for their dissolution upon a proper filing.

A motion for the renewal of a temporary restraining order that had been granted in *Marshall Field & Co. v. Icahn*, C.C.H. Fed. Sec. L. Rep. P 98,481 (S.D.N.Y. 1982), discussed in § 7A.02 n.39 *supra*, was denied since the filing of a modified Schedule 13D provided adequate disclosure and the plaintiff's shareholders would not be irreparably harmed by further acquisitions of shares by the defendant. *Marshall Field & Co. v. Icahn*, C.C.H. Fed. Sec. L. Rep. P 98,484 (S.D.N.Y. 1982).

(n156)Footnote 156. See *Rondeau v. Mosinee Paper Co.*, 422 U.S. 49, 59 , where the court stated: "Thus, the usual basis for injunctive relief 'that there exists some cognizable danger of recurrent violation,' is not present here. (cite omitted)."

See *Lane Bryant, Inc. v. Hatleigh Corp.*, C.C.H. Fed. Sec. L. Rep. P 97,529 (S.D.N.Y. 1980), where the defendant was enjoined from making additional purchases of the target stock until potential sellers were aware of the plaintiff's allegations that the purchasers had violated reporting and antifraud provisions of the federal securities laws; disclosure of the allegations was considered sufficient to avoid irreparable harm.

See *Fin. Gen. Bankshares, Inc. v. Lance*, C.C.H. Fed. Sec. L. Rep. P 96,511 (D.D.C. 1978) (denied an injunction where there was no evidence to suggest future violations).

(n157)Footnote 157. *Fin. Gen. Bankshares, Inc. v. Lance*, C.C.H. Fed. Sec. L. Rep. P 96,511 (D.D.C. 1978); *Nachman Corp. v. Halfred, Inc.*, C.C.H. Fed. Sec. L. Rep. P 94,799 (D.D.C. 1974).

(n158)Footnote 158. *General Aircraft v. Lampert*, 556 F.2d 90, 97 (1st Cir. 1977) ; *Universal Container Corp. v. Horwitz*, C.C.H. Fed. Sec. L. Rep. P 96,161 (S.D.N.Y. 1977).

See also *University Bank and Trust C. v. Gladstone*, 574 F. Supp. 1006 (D. Mass, 1988) (holding that the proper remedy was damages not injunctive relief); *Lane Bryant, Inc. v. Hatleigh Corp.*, C.C.H. Fed. Sec. L. Rep. P 97,529 (S.D.N.Y. 1980); *Ludlow Corp. v. Tyco Labs., Inc.*, C.C.H. Fed. Sec. L. Rep. P 98,382 (D. Mass. 1981).

See also *Gearhart Indus., Inc. v. Smith Int'l., Inc.*, C.C.H. Fed. Sec. L. Rep. P 91,667 (5th Cir. 1984).

(n159)Footnote 159. *Bath Indus., Inc. v. Blot*, 427 F.2d 97 (7th Cir. 1970) .

(n160)Footnote 160. *Id.* at 113 . Since the defendants were effectively disenfranchised by this injunction, to preserve the status quo, the court ordered the postponement of the annual shareholders' meeting.

(n161)Footnote 161. *See also* *Marshall Field & Co. v. Icahn*, C.C.H. Fed. Sec. L. Rep. P 98,484 (S.D.N.Y. 1982), where the court stated that the renewal of a temporary restraining order might harm plaintiff shareholders by:

- (1) barring the principal existing bidder from purchasing shares, and
- (2) deterring plaintiff's management from seeking competitive bidders.

The court, however, suggested that the defendant may be subject to:

- (1) an injunction barring the voting of shares acquired, or
- (2) actions for damages or rescission brought by uninformed or misled sellers, resulting from the defendant's acquisition of shares under the original, allegedly fraudulent, Schedule 13D.

(n162)Footnote 162. *Myers v. Am. Leisure Time*, 402 F. Supp. 213 (S.D.N.Y. 1975) .

(n163)Footnote 163. *Id.*

See also *Kalmanovitz v. G. Heileman Brewing Co., Inc.*, 595 F. Supp. 1385, C.C.H. Fed. Sec. L. Rep. P 91,851 (D. Del. 1984) .

(n164)Footnote 164. Section 18(c) provides, for all suits brought under Section 18, a one year limitation after discovery of the facts constituting the cause of action and a three year limitation after the cause of action accrued.

Additionally, injunctive actions do not have to be brought under Section 18(a), and consequently are not subject to the "purchase or sale" rule contained therein. *W.A. Krueger Co. v. Kirkpatrick*, 494 Sec. Reg. & L. Rep. A-10 (BNA D. Neb. 1979).

(n165)Footnote 165. *Weisman v. Darneille*, C.C.H. Fed. Sec. L. Rep. P 96,278 (S.D.N.Y. 1978).

(n166)Footnote 166. *See also* *Madison Fund, Inc. v. Denison Mines Ltd.*, 90 F.R.D. 89, C.C.H. Fed. Sec. L. Rep. P 98,268 (S.D.N.Y. 1981) , where the court permitted an amendment to a complaint to include the addition of a claim under Section 13(d) that the failure of a defendant to disclose in the Schedule 13D the formation of a "group," within the meaning of Section 13(d)(3), for the purpose of acquiring, holding, or disposing of a company's stock, was materially misleading in connection with the plaintiff's sale of the company's stock to the defendants although:

- (1) two presidents of the plaintiff may have known that one defendant was selling the company's stock to another defendant; and
- (2) the Schedule 13D filed by a defendant disclosed that the defendant reserved the right to purchase additional stock, since this knowledge and disclosure did not necessarily mean that the plaintiff knew or should have known of the existence of a "group" that was purchasing stock for resale to the company at a premium.

(n167)Footnote 167. *See* *Wellman v. Dickinson*, 682 F.2d 355, C.C.H. Fed. Sec. L. Rep. P 98,731 (2d Cir. 1982) , where the court denied damages because plaintiffs did not demonstrate that the failure of the defendant-director to file a Schedule 13D denied the plaintiffs the opportunity to share in a premium offered by a corporation attempting to acquire control of the issuer or caused the acquiring corporation to purchase the director's shares. The acquiring corporation was

interested in purchasing the director's shares because the transaction would enable it to acquire a large block of stock expeditiously by dealing with a limited number of individuals).

See also Stirling v. Chem. Bank, 382 F. Supp. 1146 , C.C.H. Fed. Sec. L. Rep. P 94,810 (S.D.N.Y. 1974); *Washburn v. Madison Square Garden Corp.*, 340 F. Supp. 504, C.C.H. Fed. Sec. L. Rep. P 93,346 (S.D.N.Y. 1972) .

(n168)Footnote 168. *Dewitt v. Am. Stock Transfer Co.*, 433 F. Supp. 994, C.C.H. Fed. Sec. L. Rep. P 96,089 (S.D.N.Y. 1977) .



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CHAPTER 7A The Williams Act Amendments-- Controlling Shareholders and Tender Offers

2-7A Federal Securities Exchange Act of 1934 § 7A.03

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§ 7A.03 Regulation of Tender Offers

There are two types of tender offers, including a cash tender offer and an exchange offer. In a cash tender offer, the bidder seeks to acquire the target company's stock for cash, while in an exchange offer, the bidder offers to exchange its stock for stock in the target company.

Prior to launching a tender offer, a bidder must file a Schedule TO with the Commission and provide a copy of the filing with the target company that discloses, among other things, the bidder's identity, the amount of the target company's securities sought, the consideration offered, the bidder's source of funds, the purpose(s) of the tender offer, and whether the bidder intends on acquiring the target company's shares to change the target company's board of directors, divest the target company of material assets, merge the target company or any of its subsidiaries, or change the target company's capital structure.

Additionally, the target company's shareholders must be provided with information by the bidder that includes the offering price, the duration of the offer, how securities must be tendered, and the terms under which tendered securities may be withdrawn. The target company's shareholders must also be informed of the identity of the bidder and of any persons who may be soliciting shareholders on the bidder's behalf. It should be noted that similar information must be furnished to the target company's shareholders by the target company if the target company intends to solicit shareholders in opposition to the tender offer.

In order to reduce the risk of market manipulation and insider trading, a bidder is prohibited from acquiring shares of the target company during the period of the offer except pursuant to the offer. Accordingly, any person who acquires material nonpublic information concerning a tender offer from the bidder or the target company is prohibited from trading in the target company's stock unless the information is first made public.

Rule 14e-5 prohibits a "covered person" from "directly or indirectly purchas[ing] or arrang[ing] to purchase any subject securities or any related securities except as part of the tender offer" starting from the time of "public announcement" of the offer and lasting until the offer expires. n1 Rule 14e-5 was promulgated by the Commission in order to prevent a

bidder engaged in a tender offer from purchasing securities outside of the tender offer on terms preferable to those offered to security holders tendering their securities through the offer or from securing ownership and control of blocks of the issuer's shares outside of the tender offer process. Rule 14e-5 was further "designed to prevent fraudulent, deceptive or manipulative acts or practices in connection with a tender offer for equity securities." n2

It should be noted, however, that under certain circumstances the Commission will grant "no-action" relief to a "covered person" who makes purchases outside of the tender offer. n3 In fact, Rule 14e-5(d) expressly permits the Commission to grant an exemption, either unconditionally or under specified terms, from Rule 14e-5 "to any transaction or class of transactions or any security or class of securities, or any person or class of persons" upon written application or upon the Commission's own motion. n4

Under Section 14(e) of the Exchange Act, material misstatements or omissions as well as fraudulent, deceptive or manipulative practices in connection with a tender offer are prohibited. A misstatement or omission is "material" if a reasonable shareholder would consider it important in deciding whether or not to tender his or her shares in the offer. There is a private right of action for violations of Section 14(e) not only against the bidder but also against the target company as well, although the statute does not expressly so provide. However, private rights of action for damages are unavailable to a defeated tender offeror.

Tender offers are regulated by the Williams Act amendments to the Exchange Act. The consideration paid by an offeror in a tender offer may be for cash or an exchange of securities in the subject company. Additionally, tender offers may be "hostile," *i.e.*, not recommended by the subject company's board of directors, or "friendly," *i.e.*, recommended by the subject company's board of directors. In a cash tender offer, the offeror will offer to purchase the outstanding shares of the company that it is seeking to acquire (the "target company") in exchange for cash. However, in an exchange offer, the offeror will offer to exchange its own securities for securities in the target company. n5 A "friendly" tender offer is one that is welcomed and perhaps has even been negotiated by the management of the target company and approved by its board of directors, whereas a "hostile" offer is one that is not welcomed by the target company and is often launched by the offeror as a surprise. If an offeror seeks to acquire all of the shares of a target company in a tender offer, but is only partially successful, the offeror will often seek to effectuate a merger at some time after the completion of the tender offer in order to achieve complete ownership of the target company. These transactions are generally known as "two-step" or, in some cases, "multi-step" acquisitions.

Tender offers involve a number of participants. The offeror will usually retain the assistance of expert outside legal counsel, who is well versed and experienced in mergers and acquisitions, to provide advice regarding the many complex federal and state securities, corporate, tax, and antitrust law implications of the transaction. In addition to retaining expert outside legal counsel, an offeror in a tender offer will often require the assistance of many other financial services and banking professionals to help manage and conduct the offer, including, among others: (1) a financial printer, who is relied upon to meet deadlines and keep information found in the offering documents confidential; n6 (2) a proxy solicitation firm, who communicates with shareholders; (3) a depository bank, who receives and provides payment for tendered shares; and (4) an investment bank, who acts as dealer-manager in the transaction. n7 Both the dealer-manager and the offeror's counsel take leading roles in structuring the tender offer by advising the offeror on strategy, tactics, pricing and other matters that often arise during the course of the tender offer. n8

Upon receiving notice of the tender offer, the target company will often need to retain outside expert legal counsel and an investment banker in order to evaluate the adequacy of the offer. Sometimes the target company's investment banker will search for a competing offeror (a so called "White Knight") and will be involved in conducting negotiations with the White Knight. The target company's investment banker and legal counsel are crucial participants in planning the target company's strategic response to the offer regardless of whether or not it is "friendly" or "hostile." n9

[1] What is a "Tender Offer"?

The Williams Act and the various amendments to it do not provide a definition of the term "tender offer." The Commission has avoided formulating a definition "since the dynamic nature of tender offers requires administrative and judicial flexibility in determining what types of transactions should be subject to the [a]ct and [the] [r]egulations." n10 While the term "tender offer" has never been defined in statutory provisions or rules, courts generally apply the eight-factor test established in *Wellman v. Dickinson* n11 to determine whether an acquisition program constitutes a tender offer. These factors include whether the transaction: (1) involves an active and widespread solicitation of public shareholders; (2) involves a solicitation made for a substantial percentage of the target's stock; (3) offers a premium to the prevailing market price; (4) has fixed rather than negotiable terms; (5) is an offer contingent on the tender of a fixed minimum number of shares to be purchased; (6) is only open for a limited period of time; (7) pressures offerees to sell their stock; and (8) is accompanied by public announcement of a purchase program for the target's securities which precedes or accompanies a rapid accumulation of large amounts of the target's securities. No single factor is dispositive and courts do not need to conclude that all eight factors are present in order to determine that an acquisition program is a tender offer. n12

Sections 14(d) and 14(e) were designed to protect the recipients of a conventional tender offer by insuring that they are treated fairly and equally and are not stampeded into accepting the offer. To that end, the Williams Act provides that various disclosures must be made including information about the purpose of the offer, the plans that the bidder has for the target company and other detailed information about the bidder and about the offer. n13 If such disclosure is incomplete, false or misleading, the bidder may be subject to civil liability or injunction or to an enforcement action by the Commission. n14 Further, if a bidder makes a tender offer for less than all of the outstanding equity securities of a class, but a greater number of securities are tendered, then the bidder must pay for the tendered securities *pro rata*, disregarding fractions, according to the number of securities tendered by each security holder during the period in which the offer remains open. n15 If the offering price is raised after the offer has commenced, then the increased price must be paid to all whose tendered shares are purchased. n16 Finally, securities tendered may be withdrawn at any point during which the offer remains open. n17

Additionally, courts hold that the Williams Act applies to methods of acquiring stock other than by a formally announced tender offer. n18 Pre-purchase publicity can make a stock acquisition program equivalent to a tender offer. n19 However, open market purchases made without advance publicity of the buyer's intent are generally not tender offers. n20 Likewise, privately negotiated purchases usually have not been treated as tender offers. n21 One reason is that privately negotiated purchases are frequently made from knowledgeable investors who are unlikely to be pressed into making hasty, uninformed decisions to sell their shares. n22 Open market purchases made immediately before a formal tender offer are not integrated with the subsequent tender if they are within the 5 percent limit which Section 14(d) specifies. n23 But certain actions taken in connection with a tender offer, even if taken prior to commencement of the offer, may be regulated under Sections 14(d) and (e). n24

[2] The Regulatory Scheme.

Section 14(d) of the Exchange Act contains several important requirements and procedures, including:

- (1) It requires a bidder to file certain information with the Securities and Exchange Commission before commencing a tender offer;
- (2) It regulates how solicitation for or against the offer may be conducted; and
- (3) It contains provisions that govern certain terms of the offer itself.

[a] Filing with the Commission. Section 14(d)(1) states that it is unlawful for any person, directly or indirectly,

by use of (i) the mails or other means of interstate commerce or (ii) any facility of a national securities exchange, to make a tender offer for any class of equity security registered under the Exchange Act, n25 if, after completion of the offer, such person would, directly or indirectly, be the beneficial owner of more than 5 percent of such class, unless at the time copies of the tender offer are first published or sent or given to security holders, such person has filed with the Commission a statement containing the information specified in Section 13(d) of the Exchange Act along with such additional information as the Commission may prescribe by rule or regulation. Significantly, Section 14(d) and Regulation 14D, as opposed to Section 14(e) and Regulation 14E, applies to securities registered under the Exchange Act. A copy of the statement must also be sent to the target company.

For the purpose of computing a person's percentage of beneficial ownership of a class of securities, only the outstanding securities of the issuer are counted to determine the total number of shares in that class; securities held by or for the account of the issuer or a subsidiary of the issuer are not included. n26 Rule 14d-1(g)(1) states that the definition of beneficial owner set forth in Rule 13d-3 also applies to Section 14(d). n27 Generally, that definition provides that anyone who has, or shares, the power to vote a security or the power to direct its investment is a beneficial owner of that security. n28 Furthermore, anyone, who through an option, warrant, the power to revoke a trust, or other means, has the right to acquire such beneficial ownership within sixty days, is also deemed to be a beneficial owner of that security. n29 In connection with any inquiry into the question of percentage of beneficial ownership sought by an offeror, the identity of such offeror can also be an issue as Section 14(d), and regulations promulgated thereunder, will require significant disclosure regarding the person or persons on whose behalf an offer is made. n30

Section 14(d)(2)'s standard of group status is identical to Section 13(d)(3); n31 it states that a group acting together for the purpose of acquiring, holding or disposing of securities is to be treated as a single "person" for the purposes of Section 14(d). n32

Section 14(d)(8) provides two exemptions from the provisions of Section 14(d). One is for tender offers, which taken together with all other acquisitions of the same security within the past twelve months, would not result in the acquisition of more than two percent of an issuer's outstanding securities. It is questionable if there are any tender offers small enough to make use of this exemption. The second exemption is for any issuer making a tender offer for its own securities.

Section 14(d)(8) also grants the Commission the authority to exempt, by rule or order, a tender offer from the provisions of Section 14(d), provided that the offer does not have the purpose or effect of changing or influencing the control of the issuer.

The date of commencement of a tender offer is determined by Rule 14d-2. Rule 14d-2(a) provides that a tender offer commences, and thus, the tender offer rules apply, "at 12:01 a.m. on the date when the bidder has first published, sent or given the means to tender to security holders." For purposes of Rule 14d-2, the means to tender includes the transmittal form or a statement regarding how the transmittal form may be obtained.

Further, all written communications that relate to a tender offer beginning with and including the first public announcement of the transaction must be filed on a Schedule TO-C with the Commission on the date the communication is first made. In addition, written communications must contain a legend advising security holders to read the full tender or recommendation statement when it becomes available. n33

The Schedule TO must be filed at the commencement of the tender offer. Rule 14d-3(a) requires that the Schedule TO, including all exhibits, must be filed with the Commission, and that one copy, including all exhibits, must be hand delivered to the target company and to any competing tender offeror that has filed a Schedule TO. A copy of the Schedule TO, including all exhibits, must be mailed first class to each national securities exchange that lists the securities that are the subject of the offer. n34 Additionally, telephone notification of the offer must be given to such exchanges, and the Financial Industry Regulatory Authority ("FINRA"), where applicable. n35 The above steps must be

taken "as soon as practicable on the date of the commencement of the tender offer." n36

Rule 14d-6 establishes specific disclosure requirements for tender offers. A tender offer disseminated by long-form publication must contain the information required by Rule 14d-6(d)(1). n37 A tender offer disseminated by summary publication must contain the information required by Rule 14d-6(a)(2) and the materials to be furnished upon the request of a security holder must comply with Rule 14d-6(d)(1). n38 If a tender offer is made by use of a stockholder's list, the summary advertisement must contain the information required by Rule 14d-6(d) and, the materials published or sent or given to shareholders must comply with Rule 14d-6(d)(1). n39 A tender offer disseminated by any means other than those enumerated must comply with Rule 14d-6(d). n40

Rule 14d-6(d)(1) requires the following information:

- (1) the summary term sheet required by Item 1 of Schedule TO and
- (2) the disclosure required by the remaining Items of Schedule TO for third-party tender offers, except Item 12 of Schedule TO, or a fair and adequate summary thereof.

Rule 14d-6(d)(2) requires the following information:

- (1) the identity of the bidder n41 and the subject company;
- (2) information required by Item 1004(a)(1) of Reg. M-A;
- (3) if the tender offer is for less than an entire class of securities, a statement as to whether the purpose of the offer is to acquire influence or control of the target company;
- (4) a statement that information required by Rule 14d-6(d)(1) is incorporated by reference into the summary advertisement;
- (5) instructions on how to promptly obtain the bidder's tender offer materials, and
- (6) if the offer is made through the use of stockholder lists, a statement that such lists are being requested and that tender offer materials will be mailed to record holders and will be furnished to brokers, banks, and other persons holding securities on behalf of beneficial owners.

In responding to a Schedule TO, the bidder must keep in mind, in addition to the literal requirements of the schedule, that Section 14(e) prohibits the omission of material facts in connection with a tender offer if such omission makes other statements made materially misleading. The Schedule TO calls for the following information n42:

Item 1, "Summary Term Sheet," requires a brief description, in bullet point format, of the essential features of the proposed transaction.

Item 2, "Subject Company Information," requires the name of the target company, the address of its principal executive offices and the title and number of shares outstanding of the class of equity securities being sought. n43 The principal market in which such securities are traded and their high and low sales price on that market for each quarterly period during the past two years must also be stated.

Item 3, "Identity and Background of Filing Person," requires a corporation partnership, limited partnership syndicate or other group to state its name, the state or other place of its organization, its principal business, the address of its principal office, and whether, during the last five years, it has either (i) been convicted in a criminal proceeding, or (ii) was a

party to a civil proceeding of a judicial or administrative body that found a violation of state or federal securities laws, or enjoined it from future violation of such laws. The particulars concerning any such criminal or civil proceeding must be supplied.

A natural person must state his name, citizenship, residence or business address, principal occupation, the address of his employer, employment history for the past five years, and the information described in the preceding paragraph concerning criminal and civil proceedings.

Item 4, "Terms of the Transaction," requires, among other things, a description of the total number and class of securities sought in the offer, the type and amount of consideration offered, the scheduled expiration date, whether a subsequent offering period will be available, whether and how the offer will be extended, the dates before and after which security holders may withdraw tendered securities, the procedures for tendering and withdrawing securities and a brief description of the accounting treatment and financial income tax consequences of the transaction, if material.

Item 5, "Past Contract, Transactions, or Negotiations and Agreements," requires a description of any contacts, negotiations or transactions between the bidder or its subsidiaries and the target company or its affiliates concerning: a merger, consolidation or acquisition, n44 a tender offer or other acquisition of securities, an election of directors, or a sale or other transfer of a material amount of assets. n45

Other contracts, negotiations, and transactions between these parties must be disclosed if they involve an amount equal to one percent or more of the target company's consolidated revenues for the fiscal year in which the transaction occurs. Transactions between the bidder and the executive officers and directors of the target company must be disclosed if the amount involved in the transaction exceeds \$60,000.

Item 6, "Purpose of the Transaction and Plans or Proposals," mandates disclosure of critical information for making a rational investment decision. The bidder must state the purpose(s) of the tender offer and describe any plans that relate to or would result in:

- (1) A merger, reorganization, or liquidation of the target company or any of its subsidiaries;
- (2) A sale of a material part of the assets of the target or any of its subsidiaries;
- (3) Any material change in the capitalization, indebtedness, dividend policy, corporate structure or business of the target company;
- (4) Any change in the present board of directors or management;
- (5) Any other material change in the target company's corporate structure or business;
- (6) Causing a class of the target company's securities to be delisted from a national securities exchange or to lose its trading authorization on an inter-dealer quotation system;
- (7) A class of equity securities of the target company becoming eligible for deregistration under Section 12(g)(4) of the Exchange Act because the number of its holders has been reduced to less than three hundred;

There are only two basic purposes for making a tender offer, including investment and/or control. In a number of cases, the adequacy of the bidder's disclosure concerning his or her intent to take over the target company has been challenged. Generally, if the bidder discloses some intent to exercise control, this will be considered sufficient. n46 Where no intent of taking control is stated, a court may infer this intent from other facts even though successful completion of the tender

offer would not give the bidder a majority of the target company's stock. For example, in *Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Co.*,ⁿ⁴⁷ the Court of Appeals for the Second Circuit held that a tender offer for fifteen percent of A&P's stock (Gulf & Western already held four percent) was made for control purposes, despite Gulf & Western's claim that it was an investment. The court stated that "G&W has a well-established practice of eventually acquiring firms in which it initially purchases only a small percentage of the outstanding shares."ⁿ⁴⁸ The court also noted that the tender offer was the largest commitment in Gulf & Western's history and that Gulf & Western believed that A&P was in need of new management. In *Anaconda Co. v. Crane Co.*,ⁿ⁴⁹ the district court held that the target company had not proven that a tender offer for 22.6 percent of its shares was an attempt to gain control, where the bidder had promised not to acquire more shares, nor to seek representation on the board of directors, for so long as it owned any of the target company's stock acquired in its tender offer.

Over the years, courts dealt with the question of how definite a plan or proposal, or the details of one, must be for its disclosure to be required under Item 6. In the leading case, *Electronic Specialty Co. v. International Controls Corp.*,ⁿ⁵⁰ the bidder stated that it might consider a merger with the target company based on "the relative market prices of their common stock." Judge Friendly ruled that this disclosure was adequate, since the bidder had not shown a firm intention to merge with the target company if it successfully completed its tender offer. He stated:

"It would be as serious an infringement of these regulations to overstate the definiteness of the plans as to understate them."ⁿ⁵¹

Another case held that revealing an intent to merge, without more, was sufficient, despite the existence of potential terms for a merger.ⁿ⁵² The court found that these were hypothetical terms that were submitted to the bidder's bank for illustrative purposes only, stating that:

"In every tender offer looking forward to a combination of the offeror and the target, the offeror conducts analyses to determine the feasibility of the tender plan. While every case must be judged on its own facts, when no specific terms for the combination have been decided upon, reference to *possible* terms, even if so labeled, will not ordinarily provide a basis for informed stockholder judgment and will hold some potential for miscommunication."ⁿ⁵³

Another court considered the absence of any specific plans or proposals to merge to be crucial, and held that disclosing that there was a possibility of a merger was adequate even though the record of the bidding company indicated that it was almost a certainty.ⁿ⁵⁴

Item 7, "Source and Amount of Funds or Other Consideration," requires the bidder to state the source of its funds and the total amount it would need to purchase the maximum number of shares for which the offer is being made.ⁿ⁵⁵ If all, or any part of such funds are, or are expected to be, borrowed, a summary of the loan agreement must be provided. This summary must contain all material terms, including the identity of the parties, the term of the loan, the collateral, and the stated and effective interest rates.

Item 8, "Interest in the Securities of the Subject Company," requires each person named in Item 3 (and each associate and majority owned subsidiary of such person) to state his beneficial ownership, in both numbers and percentage, of any class of securities issued by the target company. Any transaction in such securities by the same people during the past sixty days must also be described.ⁿ⁵⁶ If this information is not available at the time the Schedule TO is initially filed, it may be filed up to three business days after the initial filing.

Item 9, "Persons/Assets, Retained, Employed, Compensated or Used," requires the identification of all persons and classes of persons employed by the bidder, or by any person on the bidder's behalf, to make solicitations in connection with the tender offer. A brief description of the terms of such employment must also be included.

Item 10, "Financial Statements," requires a bidding company (this item does not apply to natural persons) n57 to supply financial information concerning itself, if its financial condition is material to the tender offer.

The bidder is required to provide audited financial statements required to be filed with its annual report under Sections 13 and 15(d) of the Exchange Act, unaudited financial statements required to be included in its most recent quarterly report under the Exchange Act, its ratio of earnings to fixed charges and its book value per share as of the date of the most recent balance sheet presented. In addition, if material, its pro forma information is required disclosing the effects of the transaction.

In the release adopting *Item 10*, the Commission stated that whether financial information concerning the bidder was material depends on the facts and circumstances of the tender offer, including the following: n58

- (1) the terms of the tender offer, particularly those with respect to the amount of securities being sought;
- (2) whether the purpose of the tender offer is to take control of the target company;
- (3) the plans or proposals of the bidder as described in *Item 5* of the Schedule; and
- (4) the ability of the bidder to pay for the securities sought in the tender offer, and to repay any loans made in connection with it, or otherwise.

The release noted that these factors are not exclusive, nor must all be present to make a financial statement material.

However, *Item 10* includes an Instruction, which states that a bidder's financial information is not material when:

- (1) only cash consideration is offered;
- (2) the offer is not subject to any financing condition; and either:
- (3) the bidder is a public reporting company that files reports electronically with the Commission; or
- (4) the offer is for all outstanding securities of the target.

Item 11, "Additional Information," requires disclosure of the following information, if material to a decision by a holder of the securities being sought:

- (1) any present or proposed material contracts, arrangements, understandings or relationships between the bidder of any of its executive officers, directors, controlling persons, or subsidiaries, and the target company or any of its officers, directors, controlling persons or subsidiaries that were not required to be disclosed pursuant to Items 1000 through 1016 of Regulation M-A; n59
- (2) regulatory requirements that must be complied with, or approvals that must be obtained in connection with the tender offer, to the extent known to the bidder after reasonable investigation; n60
- (3) the applicability of the anti-trust laws; n61
- (4) the applicability of the margin requirements of Section 7 of the [Exchange] Act and the rules thereunder; n62
- (5) a brief description of any pending legal proceeding relating to the tender offer, and a copy of any

pleadings, orders, injunctions, or opinions; and

(6) any other information necessary to make the required statements not materially misleading.

Item 12, "Exhibits," requires the bidder to furnish a copy of: (i) all material sent to the security holders in connection with the tender offer; (ii) any loan agreement for financing the offer; (iii) any document containing the terms of any understandings or contracts referred to in Item 1005(e) or Item 1011(1)(i) of Regulation M-A; (iv) any written opinion regarding the tax consequences of the tender offer prepared for the bidder by legal counsel; (v) the prospectus required by Rule 434(b) in an exchange offer where securities of the bidder have been or are to be registered under the [Securities] Act; and (vi) any written instruction or other materials furnished to persons making oral solicitations of security holders on behalf of the bidder.

If any material change occurs in the facts set forth in the Schedule TO, an amended Schedule TO must be promptly filed with the Commission and, one copy must be delivered to the target company and to any exchange and/or FINRA upon which the securities of the target company are approved for listing or approved for quotation. n63

[b] Communications with Shareholders. Section 14(d)(1) gives the Commission the authority to regulate the information contained in any advertisement making a tender offer or request for the tender of a security. n64 Copies of all such materials must be filed with the Commission and sent to the target company no later than the date it is first published or sent or given to any security holder. n65

The initial offer must contain the information specified in Rule 14d-6. n66

Rule 14d-4 sets forth certain standards for the dissemination of tender offers. It should be noted that these standards are not mandatory since tender offers may be disseminated by other means. For tender offers in which the consideration consists solely of cash or securities exempt from registration under Section 3 of the Securities Act, Rule 14d-4(a) states that a tender offer shall be deemed "published or sent or given to security holders" within the meaning of Section 14(d)(1) if the bidder:

- (1) makes adequate newspaper publication of a long-form publication of the tender offer;
- (2) makes adequate newspaper publication of a summary advertisement of the tender offer and mails first class, or otherwise furnishes with reasonable promptness, its tender offer materials to any security holder who requests them; or
- (3) uses stockholder lists and security position listings under Rule 14d-5. n67

A bidder using stockholder lists must also make either long-form or summary publication of the offer, as described above. n68 Depending upon the facts and circumstances, "adequate publication" of a tender offer may require publication in a newspaper of national circulation, or it may only require publication in a metropolitan or regional newspaper. n69 If a tender offer has been disseminated by one of the means specified in Rule 14d-4(a), any material changes in the information contained therein must be disseminated in a manner reasonably designed to inform security holders of such change. n70

Section 14(d)(4) authorizes the Commission to regulate any solicitation or recommendation to security holders regarding the acceptance or rejection of a tender offer. Rule 14d-9 applies to solicitations or recommendations by:

- (1) the target company, or any of its directors, officers, employees, affiliates, or subsidiaries;
- (2) owners of any security issued by the target company, the bidder, or any of their affiliates; or

2-7A Federal Securities Exchange Act of 1934 § 7A.03

(3) any person acting on behalf of the foregoing parties, or on behalf of the bidder by means of a solicitation not filed with the Commission. n71

Rule 14d-9 does not apply to a bidder who has filed a Schedule TO or to advice about a tender offer provided by an attorney, bank, broker, fiduciary, or investment adviser, whose participation in the offer is solely ministerial, if such advice is given to a client who:

- (1) made an unsolicited request for such advice, or
- (2) has a general contract to receive such advice. n72

All parties subject to Rule 14d-9 must file eight copies, including all exhibits, of a Schedule 14D-9 Information Statement with the Commission. The target company or one of its affiliates must also hand deliver a copy of the Schedule 14D-9 to the bidder. Other parties subject to Rule 14d-9 must mail a copy of the schedule to the bidder and to the target company. n73

If a material change occurs in the facts set forth in a Schedule 14D-9, copies of an amended Schedule 14D-9 must be filed in the same manner, and such change must be promptly disclosed and disseminated to security holders. n74

Any solicitation or recommendation about a tender offer must include the name of the person making it and the information required by Items 1 through 8 of Schedule 14D-9 or a fair and adequate summary thereof. n75 However, information provided in a previous solicitation by the same person may be omitted.

Rule 14d-9 does not apply to "stop-look-and-listen" communications from the target company to its security holders that only state that management is considering the tender offer and that, on or before a specified date, within ten business days from the commencement of the tender offer, management will express an opinion on the offer. Until then, security holders should defer deciding whether to accept or reject the offer. n76

Schedule 14D-9 requires the following information:

- (1) the identity of the target company and the class of securities being sought;
- (2) the name and business address of the person filing the statement (the filer) and the identity of the tender offer to which the Schedule 14D-9 relates and the bidder;
- (3) any material agreements, arrangements, or conflict of interest between the filer or its affiliates and the bidder or the target company, or any of their executive officers, directors, or affiliates;
- (4) the nature of the solicitation or if a recommendation, the position of the filer on the tender offer and the reasons therefor and "to the extent known by the filing person after making a reasonable inquiry, whether the filing person or any executive officer, director, affiliate or subsidiary of the filing person currently intends to tender, sell or hold the subject securities that are held of record or beneficially owned by that person"; n77
- (5) the identity of any persons employed or retained by the filer to solicit security holders, and a brief description of the terms of employment or retainer;
- (6) a description of any transaction in the past sixty days by the filer or any of its executive officers, directors, affiliates, or subsidiaries in the securities sought, and, if known, whether any of these persons

intend to tender or retain the securities sought;

(7) if the target company is filing the statement, state whether there are negotiations underway for its merger, reorganization, or recapitalization, the sale of its assets, the acquisition of its securities, acquisitions of securities by it; n78

(8) any additional information necessary to make the required statements not materially misleading; and

(9) a copy of

(a) any written solicitation published or sent to security holders concerning the solicitation or recommendation referred to in (4) above,

(b) any written instruction or other material given to persons making oral solicitations, and

(c) any contract or arrangement referred to in (3) above.

In *Anaconda Co. v. Crane Co.*, n79 Crane proposed a tender offer based on the exchange of securities. Anaconda, without filing a Schedule 14D, issued a press release, stating in part that:

"When Crane does file a registration statement and preliminary prospectus with the S.E.C., Anaconda will be in a position to consider an evaluation of the situation. Until that time it should not be assumed that the Anaconda management is sympathetic to the proposed offer." n80

The court rejected Crane's argument that this was a solicitation against the tender offer and held that it was within the "wait for our advice" exception provided for statements by the issuer. n81

Nonetheless, the antifraud provision of Section 14(e) applies to all communications with shareholders, and a violation of this section can lead to an injunction against the offending party. n82

Under Rule 14d-5, a bidder may request the use of the target company's shareholder list to disseminate its tender offer material. The target company may elect either to turn over its list or to distribute the bidder's tender offer materials to its security holders. n83 Oral notification of the target company's choice must be given within two business days after it receives the request. n84 If the target company conducts the distribution, it must follow the detailed requirements of Rule 14d-5(b). Also, the target company is entitled to a monetary advance from the bidder to cover its mailing costs, and to prompt reimbursement from the bidder for its direct costs that are incidental to compliance with Rule 14d-5(b). n85 These costs are determined under Rule 14d-5(g)(2). If the target company decides to turn over its shareholder list to the bidder, the bidder must use this list solely for the dissemination of its tender offer materials, keep the list confidential, and return the list after the completion of the tender offer without retaining any copy thereof. n86

[c] Controls Over the Terms of the Offer. Rule 14e-1 requires tender offerors to hold tender offers open for not less than twenty business days from the date that the offer is first published, sent or given to security holders, n87 and if the consideration offered or the dealer's soliciting fee to be given in a tender offer is increased, the offer must remain open for at least ten business days from the date the increase is first published, sent or given to security holders. n88

If the offeror extends the tender offer, n89 Rule 14e-1(d) requires the offeror to issue notice of the extension by press release, or other public announcement, and to disclose in the notice the approximate number of securities deposited as of the date of the notice.

Rule 14d-2, in conjunction with Rule 14d-4 and Rule 14d-6 establishes a detailed method for calculating the starting point of a tender offer. Rule 14d-2 establishes the commencement date of a tender offer as the date when the holder "has first published, sent or given the means to tender to security holders." Pre-commencement communications are permitted, however, all written communications related to the tender offer must be filed with the Schedule TO no later than the date of the communication. In addition, the bidder must deliver the first communication that is filed to the target company and any other bidder for the same class of securities. To minimize the potential for dissemination of false offers into the marketplace, Rule 14e-8 prohibits bidders from announcing an offer (1) without an intent to commence the offer within a reasonable time and complete the offer, (2) with the intent to manipulate the price of the bidder or the target company's securities or (3) without a reasonable belief that the bidder will have the means to purchase the securities sought.

Section 14(d)(5) provides that securities deposited pursuant to a tender offer may be withdrawn at any time until seven days after the offer is first published or sent or given to security holders. Unless they have already been accepted, n90 shares may be withdrawn once sixty days has passed from the date of the original offer. Section 14(d)(5) empowers the Commission to alter these provisions by rules or order, either for the public interest or for the protection of investors. Pursuant to this authority, the Commission adopted Rule 14d-7, which entitles a security holder to withdraw tendered securities during the entire period that the tender offer remains open. n91 Further, Rule 14d-7 provides that written notice of the withdrawal specifying the name of the shareholder and the amount of shares being withdrawn must be given to the bidder. A bidder may impose other reasonable conditions, including a signed request for withdrawal accompanied by a signature guarantee, on the release of the securities. n92

After the expiration of the initial tender offer period, and if disclosed sufficiently in advance of the expiration of the initial offer, an offeror may provide for a "subsequent offering period" of between three and twenty business days during which no withdrawal rights are available. A subsequent offering period is only available if the initial offer is for all outstanding securities, all conditions to the initial offer are satisfied or waived, the offeror accepts and promptly pays for all securities tendered during the initial offer, the offeror announces the results of the initial offer by 9:00 a.m. on the next business day following the close of the initial offer period, and the offeror immediately accepts and promptly pays for all securities as they are tendered in the subsequent offering period.

When more shares have been tendered than were requested in the offer, Section 14(d)(6) requires the bidder to accept pro rata shares tendered within ten days after the offer was first published or sent or given to security holders. (Of course, the bidder may elect to, or may have committed itself to, purchase all shares tendered in excess of the amount requested in the offer.) Shares tendered within ten days after notice of an increase in the price of the offer is first published or sent or given to security holders must also be accepted pro rata.

The Commission, by rule, has extended the period during which tender offerors must accept shares pro rata. Rule 14d-8 requires a bidder in an over subscribed partial tender offer to accept securities on a pro rata basis according to the number of securities deposited by each stockholder during the entire period of the tender offer. n93 Since Rule 14e-1 requires that a tender offer remain open for at least twenty business days, the adoption of Rule 14d-8 more than doubles the minimum proration period from the ten calendar days required by Section 14(d)(6). n94

Rule 14e-4 (formerly Rule 10b-4) supplements the pro rata provisions of Sections 14(d)(6). Rule 14e-4 prohibits a person from tendering any security unless he owns or has a right to acquire it at the time of the tender offer. Additionally, a person may not tender securities on behalf of another person unless he or she has possession of the securities or has reason to believe that the other person either owns the securities and will promptly tender them, or has the right to acquire the securities and will do so to the extent necessary to deliver the tendered securities. The purpose of Rule 14e-4 is to prevent the manipulation of the pro rata requirements of a tender offer. n95 In *Bache & Co. v. International Control Corp.*, n96 the court held that a broker who accidentally tendered on behalf of its customers 148 shares more than it was supposed to tender did not violate Rule 10b-4 (now Rule 14e-4), according to the court:

"Rule 10b-4 does not properly apply to such a situation where the error is of such minor proportions and where there is no specific intent to defraud."

Basic contract law applies to tender offers. Thus, a bidder need not accept any shares that are not tendered in accordance with the terms of the offer, as long as those terms comply with Section 14 of the Exchange Act. n97 For instance, in *Indiana National Bank v. Mobil Oil Corp.*, n98 the defendant allowed certain institutions to accept its tender offer by sending a transmittal letter without having to deposit their shares until eight business days after a public announcement by Mobil of the number of shares it would purchase. This announcement was made in the form of a press release. The plaintiff sent the transmittal letter, but failed to deposit the shares in time. The court held that the shares were improperly tendered, and that Mobil did not violate Section 14(d)(6) by refusing to take them up pro rata. The court also held that Mobil's press release was a sufficient public announcement and that Mobil had no obligation to give the plaintiffs individual notice of its release. n99

Section 14(d)(7) requires a bidder which has increased the price of its tender offer to pay that increased price for all shares tendered under the offer, including those shares tendered before the announcement of the price increase. The Commission has adopted Rule 14d-10 (applying to third-party tender offers) and its corollary, Rule 13e-4(f)(8) (applying to issuer self-tenders), commonly referred to as the "Best Price Rule," requiring that:

1. tender offers be open to all holders of the class of securities sought by the offer; n100 and
2. the consideration paid to any security holder for securities tendered in the tender offer be the highest consideration paid to any other security holder for securities tendered in the tender offer. n101

The Best Price Rule has the effect of requiring that the highest price paid to any security holder must also be paid to all other security holders of the same class.

Prior to the amendments to the Best Price Rule released by the Commission in 2006, n102 the Best Price Rule was the subject of much uncertainty, particularly in the context of merger and acquisition transactions. There was a split among federal courts as to whether the Best Price Rule applied to arrangements, usually compensatory in nature, entered into by an offeror in a tender offer and the employees or directors of the subject company in contemplation of an acquisition. n103 Corporate officers and directors of a subject entity are frequently also shareholders who are themselves provided with an opportunity to tender shares in the offer. Their dual status raises the specter that inducements and offers relating to future service by the offeror might be construed as having also been made as an inducement or as consideration for their tendering of shares and support of the offer. Should such payments or compensation paid to directors or employees be deemed to have been made pursuant to the tender offer (or as an inducement to their decision to tender), the resulting obligation to provide equivalent consideration to all tendering shareholders could result in tremendous damages. n104

The amendments promulgated by the Commission in 2006 have clarified that the Best Price Rule applies only with respect to consideration paid for securities tendered in a tender offer. n105 Also, the rule has been amended to add an exemption for amounts paid pursuant to the negotiation, execution or amendment of an employment compensation, severance or other employee benefit arrangement, so long as the amount payable under the arrangement "is being paid or granted as compensation for past services performed, future services to be performed, or future services to be refrained from performing, by the security holder (and matters incidental thereto)" and "is not calculated based on the number of securities tendered or to be tendered in the tender offer by the security holder." n106 This exemption applies to arrangements entered into between any security holder and the bidder or subject company, in the case of a third party tender offer, or the issuer or any affiliate, in the case of an issuer self-tender. n107 In addition, the Commission established a non-exclusive "safe harbor" provision that would allow the compensation committee (or other committee comprised of independent directors) of the bidder's or offeror's board of directors to approve an employment compensation, severance or other employee benefit arrangement and thereby have it deemed to be such an arrangement within the meaning of the exemption described above. n108

Under Rule 14d-10, a tender offeror may offer more than one type of consideration, but security holders must be afforded an equal right to elect among alternative considerations, and the highest consideration of each type paid to any security holder must be paid to any other security holder.

Further, Rule 14d-10 does not prohibit an offeror from excluding security holders from a tender offer in a state where the offeror, after making a good faith effort to comply with state law, is prohibited from making the offer. n109 If the form of consideration offered is prohibited by state law, the offeror may offer an alternative form of consideration in that state without making the alternative consideration available to security holders in other states. n110

The rule provides as well that the Commission may waive its provisions where compliance is not necessary or appropriate in the public interest or for the protection of investors. n111

[d] Conflict Between Federal and State Regulation. When the Williams Act was passed in 1968, only one state, Virginia, had a law regulating tender offers for corporations doing business in the state. n112 Since that time, most other states passed or attempted to pass takeover statutes. n113 Many of the state statutes provided protection for the incumbent management, a feature that is not afforded by the Williams Act. Usually, the state statutes required the bidder to file disclosure documents with the state and send them to the target company before the tender offer. In some cases, the states patterned their disclosure requirements after the Williams Act, while in other cases, the states called for much more detailed information. Often, states are empowered to hold a hearing on the takeover bid before allowing a takeover to proceed. As a result, these hearings can significantly delay the start of the offer. However, a number of states exempt a tender offer from the hearing if the tender offer's acceptance is recommended by the target company's management. n114

The question of whether or not these state statutes are preempted by the Williams Act first arose in *Great Western United Corp. v. Kidwell*. n115 In *Kidwell*, Great Western United launched a tender offer for two million shares of Sunshine Mining and Metal Co.'s common stock. Sunshine's principal executive office and over half its assets were located in Idaho, which meant that Great Western had to comply with the Idaho takeover statute. n116 The court, in summarizing Idaho's takeover statute, stated that:

"Idaho's takeover law required Great Western, among other things, (1) to submit to the Director of the Idaho Department of Finance a pre-effective filing disclosing Great Western's intention to make a tender offer and the terms of the offer; (2) to transmit, at the same time, a copy of that filing to Sunshine; (3) to publish an advertisement describing the intention to make an offer and the proposed material terms; (4) to pay the Idaho registration fee; (5) to participate in a hearing, which would be mandatory if Sunshine requested one; and (6) to delay its tender offer until the final determination of any administrative or injunctive proceeding brought by the Director of Finance for violation of the Idaho takeover law. No time limitation is placed on whether, or when, the director must rule on the effectiveness of a registration statement. The director may summarily delay the effectiveness of an offer if he determines that the registration statement is insufficient. Great Western's offer would not have been subject to these requirements if the terms of the tender offer had been accepted by Sunshine's board of directors." n117

In accordance with Idaho law, Great Western made the pre-tender offer filings, but when the Director of Idaho Department of Finance objected to the adequacy of these filings, Great Western sued to enjoin the application of the Idaho statute. The district court granted relief for Great Western on two separate grounds: (1) the Idaho statute conflicted with the Williams Act and thus, was preempted by it; and (2) the Idaho statute placed an unconstitutional burden on interstate commerce. n118

In upholding the district court's decision on both grounds, the Court of Appeals for the Fifth Circuit noted that the

Williams Act was designed to "avoid tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid." n119 The Idaho statute upset this balance because it automatically delayed any tender offer that was not approved by the target company. A delay is perhaps the most important weapon in fighting a tender offer since it gives the target company time to prepare a lawsuit or find a competing bidder or white knight. Furthermore, under the state statute, the target company can insist on a hearing regarding an unfriendly tender offer, thus allowing further delays. The court also noted that the statute's "regulation of defensive efforts by a target company is significantly weaker than...[its]...regulation of an offeror's activities." n120

In defending the state statute, Idaho argued that these provisions were designed not to prevent tender offers, but rather to give the management of a target company the opportunity to fulfill their fiduciary duties to shareholders by allowing management to study the offer and then take appropriate action. n121 The court responded that even if this was the purpose of the Idaho statute, it still conflicted with the Williams Act. The court stated that:

"Idaho's statute is preempted, because the market approach to investor protection adopted by Congress and the fiduciary approach adopted by Idaho are incompatible ... Congress intended for the investor to evaluate a tender offer; Idaho asks the target company management to make that decision on behalf of the shareholders. (Cite omitted).

When Idaho enacted those ... provisions it hampered an offeror's ability to express and explain its position directly to investors. In doing so, Idaho disrupted the neutrality indispensable for the proper operation of the federal market approach to tender offers regulation. The Idaho takeover statute 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives' of the Williams Act." n122

The court also held that the disclosure required by the Idaho statute was excessive, and could obscure relevant disclosures by placing them in the midst of a mass of irrelevant ones. The court was also concerned that a target company might be able to halt a tender offer because the bidder did not make proper disclosure of some immaterial information.

Therefore, the Court of Appeals for the Fifth Circuit found that the statute burdened interstate commerce by disrupting securities markets through its advance notification provision, discouraging tender offers, and regulating disclosure to shareholders, even if none of them lived in the state. Accordingly, it discounted the value of the statute in protecting local investors. Another state interest advanced by Idaho was the effect corporate management can have on how harmoniously the corporation interacts with the community through such means as charitable contributions, pollution control, and job safety. The court observed that Idaho could enact legislation for this purpose that would have a much smaller impact on interstate commerce.

On appeal, the Supreme Court reversed *Kidwell* on the grounds that venue was improper in Texas district court where the suit was originally brought. n123 However, the issue of federal preemption of state takeover laws was not discussed by the Court.

Nonetheless, in *Edgar v. MITE Corp.*, n124 the Supreme Court held the notice and hearing provisions of the Illinois Business Take-Over Act n125 unconstitutional under the *Commerce Clause of the United States Constitution*. The Court held that the Illinois Act imposed a substantial burden on interstate commerce that outweighed its putative benefits, *i.e.*, the protection of resident shareholders and the regulation of companies incorporated under Illinois law. n126 Unlike other state blue sky laws, the Illinois Act directly regulated transactions that took place not only across state lines, but also wholly outside the state of Illinois. In fact, the Illinois Act did not require that a single shareholder of the target company reside in Illinois for it to apply. The Illinois Act, however, applied to every tender offer for a corporation that met two of the following conditions:

- (1) principal executive office in Illinois;
- (2) organization under Illinois law; or
- (3) at least ten percent of stated capital and paid-in surplus represented in Illinois. n127

The Court concluded that the Illinois Act was invalid under the *Commerce Clause* because it:

- (1) purported to regulate directly and to prohibit interstate commerce, including commerce wholly outside Illinois, and
- (2) burdens interstate commerce excessively in relation to the local interests served by the [Illinois] Act, in particular by allowing the Illinois Secretary of State to block any nationwide tender offer. n128

However, in *CTS Corporation v. Dynamics Corporation of America*, n129 the Supreme Court upheld Indiana's takeover statute. n130

The Court held, by a 6 to 3 vote, that the Indiana statute, which provides that an acquirer of more than 20 percent of shares of an issuer organized in Indiana cannot vote those shares unless he obtains the approval of a majority of all disinterested shareholders, did not conflict with the Williams Act or unduly interfere with the *Commerce Clause*. According to the Court, the Indiana statute was found to be a legitimate attempt to set conditions for acquisitions of control of publicly traded companies incorporated in the state and to protect the interests of shareholders in those companies.

Unlike the statutes considered in *Kidwell* and *MITE*, Indiana's regulatory scheme did not require filing with or approval by the state. Instead, Indiana's statute relies on the processes of corporate democracy. The Indiana statute provides that:

- (1) the acquirer of "control shares" in an Indiana corporation covered by the statute, n131 is not entitled to vote those shares unless the exercise of its voting privileges is approved by a majority of the issuers' shareholders; n132
- (2) the shareholders' determination is made at the next regularly scheduled shareholders' meeting, or at a special meeting. The acquirer can require the issuer's management to convene such a special meeting within 50 days by filing an acquiring persons statement with the issuer and agreeing to pay the expenses of the meeting; n133
- (3) if the shareholders do not vote to restore voting rights, the issuer may, but is not required to redeem the control shares from the acquirer at fair market value; n134 and
- (4) if the acquirer fails to file the acquiring persons statement with the issuer, the issuer may, if its by-laws or articles of incorporation provide, redeem the shares at any time after 60 days after the acquirer's last acquisition. n135

The action in *CTS Corporation* arose when Dynamics Corporation, the owner of 9.6 percent of the stock of an Indiana registered company, CTS Corporation, made a tender offer for another million shares of CTS Corporation, which would have brought Dynamics Corporation's interest to 27.5 percent; and CTS Corporation's board of directors elected to be governed by the new "Control Share Acquisitions Chapter" of the Indiana Business Corporation Law (*Section 23-1-17-3(a) of the Indiana Code* (Supp. 1986)).

In the Court's view, the Indiana law was neither preempted by the Williams Act nor in violation of the *Commerce*

Clause. In disposing of the preemption issue, the Court reviewed the concerns of the *MITE* plurality in regards to the belief that the notice and hearing provisions of the Illinois statute favored management against offerors. Writing for the plurality in *MITE*, Justice White feared that the inevitable delay involved in that procedure could be used by management to communicate its position on the offer to shareholders during a period when access to shareholders was denied to the offeror, and to muster other weapons in an effort to defeat the tender offer. However, in the Court's view, the Indiana statute eliminated those concerns. The Indiana statute, by allowing shareholders to vote as a group, operated on the assumption, implicit in the Williams Act, that independent shareholders faced with tender offers are at a disadvantage. In voting as a group, shareholders would be free to reject a tender offer that they considered contrary to the best interests of the issuer even though individual shareholders might be inclined to accept the offer. The voting procedure, moreover, is structured so that neither management nor the offeror would have an advantage in communicating their position to shareholders.

The Court of Appeals for the Seventh Circuit, in overturning the Indiana statute, expressed concern that the law's effect was to impose a 50-day delay in completing a tender offer that was inconsistent with the 20 business day period provided by the Commission's Rule 14e-1. n136

Nevertheless, the Supreme Court did not share the Court of Appeals' concern. The Court emphasized that the statute merely withheld voting rights, but did not prevent the offer from being completed immediately upon expiration of the 20 business day period. In order to assure that it obtained voting rights on the shares acquired, an offeror could condition its offer upon acquiring those rights. The Court observed that this would be no different, from the common practice of making tender offers contingent on obtaining regulatory approval. Further, even if the Indiana statute imposed some delay beyond the period prescribed by the Commission's Rule 14e-1, only an unreasonable delay would result in preemption. Since the 50-day period selected by Indiana is within the 60-day maximum period established by Congress in the Williams Act, the Court was unwilling to characterize it as unreasonable.

In discussing the argument that the Indiana statute was unconstitutional under the *Commerce Clause of the United States Constitution*, the Court noted that:

"Every State in this country has enacted laws regulating corporate governance. By prohibiting certain transactions, and regulating others, such laws necessarily affect certain aspects of interstate commerce. This necessarily is true with respect to corporations with shareholders in States other than the State of incorporation. Large corporations that are listed on national exchanges, or even regional exchanges, will have shareholders in many states and shares that are traded frequently. The markets that facilitate this national and international participation in ownership of corporations are essential for providing capital not only for new enterprises but also for established companies that need to expand their businesses. This beneficial free market system depends at its core upon the fact that a corporation--except in the rarest situations--is organized under, and governed by, the law of a single jurisdiction, traditionally the corporate law of the State of its incorporation." n137

The fact that the burden of a state regulation falls on some interstate companies does not by itself establish a claim that it discriminates against or unacceptably interferes with interstate commerce. In the Court's view, any impact of the Indiana statute on interstate commerce is consistent with Indiana's legitimate interests in regulating its domestic corporations. Additionally, the Court considered the statute to be non-discriminatory as it had the same effects on tender offers whether or not the offeror is a domiciliary or resident of Indiana. Further, the Court noted, the statute pursued the legitimate objective of protecting the shareholders of Indiana corporations by affording them an opportunity when a takeover offer is made, to decide collectively whether that change would be desirable--a power that may be especially beneficial where a hostile tender offer may coerce shareholders into tendering their shares. Finally, unlike the Illinois statute considered in *MITE*, the Indiana statute applied only to corporations that have a substantial number of shareholders in Indiana. As a result, every application of the statute would affect a substantial number of Indiana residents and Indiana had a legitimate interest in protecting those residents.

In 1988, Delaware enacted Section 203 of the Delaware General Corporation Law, entitled "Business Combinations with Interested Stockholders." n138 This statute provides that a corporation may not engage in any business combination n139 with an "interested stockholder," defined as a party owning 15 percent or more of the outstanding voting stock of the corporation, for a period of three years following the time that such stockholder became an interested stockholder, unless:

- (1) Prior to such time the board of directors approved either the business combination or the transaction which resulted in the stockholder becoming an interested stockholder;
- (2) Upon consummation of the transaction which resulted in the stockholder becoming an interested stockholder, the interested stockholder owned at least 85% of the voting stock of the corporation outstanding at the time the transaction commenced, excluding for purposes of determining the voting stock outstanding those shares owned by directors who are also officers and certain employee stock plans; or
- (3) At or subsequent to such time the business combination is approved by the board of directors and authorized at an annual or special meeting of stockholders by the affirmative vote of at least 66 2/3% of the outstanding voting stock which is not owned by the interested stockholder. n140

The Delaware Business Combination Statute contains an "opt out" feature whereby the statute's restrictions will not apply to any corporation (i) that has expressly elected not to be governed by the statute in its original certificate of incorporation, (ii) that amended its bylaws to opt out of the statute within 90 days of the effective date of the statute, or (iii) the stockholders of which have adopted an amendment opting out of the statute to the certificate of incorporation or bylaws through the affirmative vote of least a majority of shares entitled to vote. n141 The Delaware Business Combination Statute also does not apply in cases in which the corporation has no voting stock listed on a national securities exchange and in a variety of other situations. n142 According to one source, only 8.17% of the publicly traded Delaware corporations it tracked had opted out of the statute as of 2003. n143

Like the Indiana statute at issue in *CTS Corporation*, the Delaware Business Combination Statute has been challenged on the ground that it is preempted by the Williams Act and unconstitutional under the *Commerce Clause of the United States Constitution*. The court in *BNS, Inc. v. Koppers Co.* n144 found that the Delaware statute was not preempted by the Williams Act because it would not have the effect of substantially blocking or impeding hostile acquirers or third party tender offers. n145

The *BNS* court, applying the three-part test outlined in *CTS Corporation*, also found that the Delaware statute was constitutional under the *Commerce Clause* because (1) Section 203 does not discriminate between offerors which are Delaware entities and offerors which are not incorporated in Delaware; (2) the legislation would not have the effect of excessively burdening out-of-state persons and entities; and (3) the Delaware statute both promotes stable corporate relationships and protects shareholders, and in so doing, the statute reflects valid state concerns. n146

The district court in *City Capital Associates v. Interco, Inc.* also held that the statute did not constitute an improper delegation of government authority in violation of the *Due Process Clause of the Fourteenth Amendment* because the ability to opt out of Section 203 merely permitted corporate boards to decide corporate matters over which they already have control under Delaware's General Corporation Law. n147

Contrary to the Supreme Court's decision in *CTS Corporation*, a panel for Court of Appeals for the First Circuit upheld a preliminary injunction against the enforcement of Section 3 of the Massachusetts Take-Over Bid Regulation Act in *Hyde Park Partners, L.P. v. Connolly*, n148 ruling that the Massachusetts takeover statute is likely to be held unenforceable under the *Commerce and Supremacy Clauses of the United States Constitution*. n149 The panel found

that the penalty provision, which imposes a one-year moratorium on making a takeover bid after failure to disclose an intent to control prior to reaching the 5% ownership threshold, is likely to violate the *Commerce Clause*. The panel also concluded that the provision requiring disclosure of intent to gain control before acquisition of 5% of the target company's stock probably violates the *Supremacy Clause*. By depriving a purchaser, intent on acquiring control, of the right to increase his or her stake beyond 5% before disclosing the existence of such toehold by the end of ten days, and by assisting incumbent management by giving more time to prepare defensive maneuvers, the provision, according to the panel, intrudes upon the careful balance struck by Congress between providing disclosure to investors and enabling tender offers. By virtue of excluding "friendly offers" from the definition of takeover bids, the state statute also allows management to opt in or out of coverage, thus providing a powerful weapon in defending against a hostile bid.

Additionally, in *Campeau Corp. v. Federated Department Stores*, the district court held that the Ohio Business Acquisitions Act, which requires foreign businesses to file an "application for approval of an acquisition," but does not impose the same requirement on either similarly situated offerors incorporated in the United States or foreign offerors already having substantial interest in Ohio, is a *per se* violation of the *Commerce Clause*. n150

Further, a Nevada district court enjoined the enforcement of a provision of the Nevada takeover act, concluding that the state law's limitation on the duration of a tender offer is unconstitutional. n151

It should be noted that in a situation where there is a failure to show "irreparable harm," the New York federal courts have refused to grant a preliminary injunction against the operation of the New York "anti-takeover" law. n152 Moreover, federal courts in Delaware hold that the Delaware Business Combination Statute n153 is constitutional. n154

On the contrary, a panel for the Court of Appeals for the Sixth Circuit held Tennessee's takeover laws to be violative of the *Commerce Clause of the United States Constitution* because they significantly deter nationwide tender offers for non-Tennessee companies, which impedes the nationwide market for control of corporations. n155

Finally, a panel of for the Court of Appeals for the Seventh Circuit found the Wisconsin takeover statute to be constitutional under both the Supremacy and the *Commerce Clauses of the United States Constitution*. n156 In its decision, that panel noted that the Wisconsin statute provides that, unless the target company's board of directors agrees to the transaction in advance, the bidder must wait three years after buying the shares to merge with the target company or to acquire more than 5% of the target company's assets. The panel reasoned that the Wisconsin law neither alters any of the procedures associated with the tender offers, which are the subject of federal regulation, nor does it in any way interfere with interstate commerce since, as between intrastate and interstate commerce, it is neutral. Accordingly, the panel noted that although the law "may be folly," it is not unconstitutional.

[3] Remedies for Violation of the Tender Offer Rules

[a] Section 14(e). Section 14(e) of the Exchange Act prohibits any person from making any false statement of material fact, or omitting to state any material fact necessary to make other statements made not misleading, or engaging in any fraudulent, deceptive or manipulative acts or practices, in connection with any tender offer or any solicitation urging acceptance or rejection of a tender offer. Section 14(e) authorizes the Commission to make rules pursuant its provisions. n157

Section 14(e), the anti-fraud provision of the Williams Act amendments, has been the basis of a significant amount of litigation involving tender offers. The language of Section 14(e) is very similar to that of *Rule 10b-5* under Section 10(b) of the Exchange Act. n158 Three important features of Section 14(e) should be noted: (1) its prohibitions apply to *all* tender offers, n159 not merely those subject to the disclosure provisions of the Exchange Act; (2) as discussed *infra*, it is less difficult for a plaintiff to obtain standing to sue under Section 14(e) than under *Rule 10b-5* because the plaintiff need not be a purchaser or seller of securities; n160 and (3) unlike other provisions of the Williams Act, the terms of Section 14(e) are not expressly limited to equity securities. Section 14(e) applies to statements about a tender offer, even

if they are made before its commencement. n161

Electronic Specialty Co. v. International Controls Corp. n162 established that a private cause of action exists under Section 14(e), even though it is not explicitly authorized. In reaching the conclusion that a target company and a non-tendering company had standing, under Sections 14(d) and 14(e) of the Exchange Act, to challenge a tender offer, Judge Friendly, writing for the Court of Appeals for the Second Circuit, stated: n163

"While a non-tenderer suffers no immediate injury from inadequacy of price in the sense that he retains his stock, such inadequacy is likely to have a depressing effect on the market for some time and thus may hurt him if, for one reason or another, he should later find it necessary or desirable to sell. Such depression may also harm the target corporation if it should wish to engage in financing or acquisitions, and a still different potential for harm to the corporation will exist where it is claimed that the offeror has evil designs on its treasury or business plans. The rights of the non-tendering stockholder and the corporation thus seem sufficiently independent to give standing to both under all the provisions added to § 14. (Citations omitted). The hidden question is one of policy with respect to suit by the corporation: Should management be allowed to spread the stockholders' money in resisting a tender offer that may well be advantageous and acceptable to a large majority when a stockholder is free to act in his own behalf and the managers will almost inevitably hold stock in their own account? Militating in favor of an affirmative answer is the very fact of the superior resources of the corporation, which can be vital in this context where remedial action must be speedy and forceful. With the considerations thus in balance we would be reluctant to deny standing when Congress, had it recognized the problems, would very likely have thought the rule already recognized under § 14(a) would apply. Moreover, in cases where management causes the corporation to bring a suit motivated by its own interests and contrary to the best interests of the true owners, shareholders have their usual remedies for waste." n164

It should be noted that a non-tendering shareholder can also be harmed by any plans to loot the target company or to squeeze out the remaining shareholders at an unfair price.

Although there can be little doubt that *Electronic Specialty* would have granted a tendering shareholder the right to sue the bidder for making a misleading statement or omission, the *Electronic Specialty* court did not consider this issue, and it remained unsettled until the companion cases of *Dyer v. Eastern Trust and Banking Co.* n165 and *Emmi v. First Manufacturers National Bank* n166 established this right. Moreover, Section 14(e) can also be used against a target company, if, for example, it fraudulently induces one of its stockholders not to tender his shares. n167

However, there is one participant in a tender offer whose right to relief under Section 14(e) is greatly limited. The Supreme Court, in *Piper v. Chris-Craft Industries, Inc.* n168 held that a defeated tender offeror does not have standing to sue for damages under Section 14(e). In that case, Chris-Craft alleged that it had lost an opportunity to gain control over Piper Aircraft Corp. because a competing tender offeror, Bangor Punta Corp., had committed several violations of Section 14(e). After examining the legislative history of the Williams Act, the Court concluded that its sole purpose was to protect the investors in the target corporation. n169 The Court also concluded that Chris-Craft's status as a major shareholder in Piper was not relevant to the case because the damage it suffered, *i.e.*, the lost opportunity to gain control over Piper, related to its status as a defeated tender offeror rather than to its status as a shareholder. n170 As a tender offeror, Chris-Craft was not an intended beneficiary of the Williams Act n171 and thus, allowing it to recover would be inconsistent with the purposes of the Williams Act, as the Court stated:

"As a disclosure mechanism aimed especially at protecting shareholders of target corporations, the Williams Act cannot consistently be interpreted as conferring a monetary remedy upon regulated parties, particularly where the award would not redound to the direct benefit of the protected class. Although it is correct to say that the \$36 million damages award indirectly benefits those Piper shareholders who became Chris-Craft shareholders when they accepted Chris-Craft's exchange offer, it is equally true that

the damages award injures those Piper shareholders who exchanged their shares for Bangor Punta's stock and who, as Bangor Punta shareholders, would necessarily bear a large part of the burden of any judgment against Bangor Punta." n172

The Court also rejected the idea that allowing a defeated tender offer to recover would significantly deter violations of the Williams Act, noting:

"Nor can we agree that an ever-present threat of damages against a successful contestant in a battle for control will provide significant additional protection for shareholders in general. The deterrent value, if any, of such awards can never be ascertained with precision. More likely, however, is the prospect that shareholders may be prejudiced because some tender offers may never be made if there is a possibility of massive damages claims for what courts subsequently hold to be an actionable violation of § 14(e). Even a contestant who 'wins the battle' for control may well wind up exposed to a costly 'war' in a later and successful defense of its victory. Or at worst--on Chris-Craft's damage theory--the victorious tender offeror or the target corporation might be subject to a large substantive judgment, plus high costs of litigation." (footnote omitted). n173

However, *Piper v. Chris-Craft* does not bar a tender offeror from suing for injunctive relief to halt ongoing violations and to prevent future violations of the Williams Act. Such suits can serve the interests of the shareholders of the target corporation by encouraging a more accurate and complete flow of information to these shareholders. n174

It is noteworthy that the significance of the private right of action under Section 14(e) is underscored by the fact that the Commission very rarely takes action with respect to possible violations of the section. n175

[b] Material Misstatements and Omissions. Finding a material misstatement or omission in connection with a tender offer is perhaps the single most important element in proving a violation of Section 14(e). n176 Thus, materiality is a key concept under Section 14(e), just as it is under *Rule 10b-5*. n177

The Supreme Court, in *TSC Industries, Inc. v. Northway, Inc.* n178 adopted the following standard of materiality in a proxy solicitation case under Section 14(a):

"The general standard of materiality that we think best comports with the policies of Rule 14a-9 is as follows: an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with the [*Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970)] general description of materiality as a requirement that 'the defect have a significant *propensity* to effect the voting process.' It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." (footnote omitted). n179

This standard has been applied by the lower federal courts to all types of securities law cases and was held specifically applicable to Section 14(e) in *Flynn v. Bass Brothers Enterprises, Inc.* n180

However, this general standard of materiality is not necessarily applied to tender offers in the same manner as it is to *Rule 10b-5* cases, because in tender offers, both sides frequently have access to the relevant information. In fact, Judge Friendly stated in *Electronic Specialty* that: n181

"Probably there will no more be a perfect tender offer than a perfect trial. Congress intended to

assure basic honesty and fair dealing, not to impose an unrealistic requirement of laboratory conditions that might make the new statute a potent tool for incumbent management to protect its own interests against the desires and welfare of the stockholders. These considerations bear on the kind of judgment to be applied in testing conduct--of both sides--and also on the issue of materiality."

Judge Friendly also held that a company has no duty to correct a misstatement in the press that is not attributable to it.

Nonetheless, where one party's access to the facts is restricted, a tighter standard of materiality may be imposed on the other side. For instance, in *Blanchette v. Providence & Worcester Co.*,ⁿ¹⁸² the court stated that:

"Where one group has complete access to all the relevant facts, where acceptance of the offer will be very much in its interest, and where, as a result, disclosure will be one-sided, management has a heavy burden to insure that disclosure is complete and non-misleading, especially with respect to shareholders whose interests may differ from their own."

This issue can arise where a target company's management cooperates with the bidder to the alleged detriment of the target company's shareholders, as it occurred in *Blanchette*, or where a company makes a tender offer for its own stock.ⁿ¹⁸³

The public or private nature of information can be a crucial factor in deciding whether it must be disclosed. Further, in *Valente v. Pepsico, Inc.*,ⁿ¹⁸⁴ the court held that Pepsico, which was making a tender offer for all outstanding shares of a company in which it held the majority interest, had no duty to reveal the annual earnings per share of that company, since these figures were highlighted in the latter's quarterly and annual reports, and occasionally appeared in the financial pages of major newspapers. Moreover, in *Flynn v. Bass Brothers Enterprises, Inc.*,ⁿ¹⁸⁵ a tender offeror contended that it need not disclose the information in a confidential report about the target company, because it was not an insider. However, the court refused to dismiss the claim, stating that it was "not persuaded at this point that the obligation of disclosure under Section 14(e) is rigidly confined to 'inside' information acquired by reason of the offeror's 'insider' status."ⁿ¹⁸⁶

Additionally, one case indicates that shareholders may also be responsible for certain general knowledge. In *Emhart Corp. v. USM Corp.*, the court held that the target company did not mislead its shareholders by implying that the tender offer was inadequate because it offered a price lower than the book value of the corporation.ⁿ¹⁸⁷ The court stated that "it is well recognized that book value and market value are not identical ... and the recipient of the communication must be held to the knowledge that this is merely an argumentative consideration with respect to value, and by no means necessarily a determinative one."ⁿ¹⁸⁸ However, another court held that (1) a target company misled its shareholders by stating that its stock was equal in value to the sum of all its assets, without explaining that the asset value of the shares only becomes relevant in a liquidation proceeding;ⁿ¹⁸⁹ and (2) the bidder violated Section 14(e) by stating that in the event of a merger after the completion of its offer, dissenting shareholders could receive the fair value of their shares in an appraisal proceeding, but not stating the factors that had to be used under state law in appraising the value of the stock.

Questions may arise as to whether or not a bidder could avoid this problem by not mentioning the appraisal rights. The court in *Valente v. Pepsico, Inc.*ⁿ¹⁹⁰ held that where a bidder stated its intention to merge by buying out the remaining shares at the tender offer price, it must disclose the existence of an appraisal remedy so that shareholders would know that there was an alternative to accepting the tender offer price.

As evidenced by the aforementioned cases, the value of the target company's stock is likely to become a point of contention in an unfriendly tender offer. Information concerning this value is likely to be material. For example, one case stated that a target company may call an offer "inadequate" without even explaining why it is inadequate.ⁿ¹⁹¹ However, the court added that the reasons for the "inadequacy" of the offer were set forth by the management in a

subsequent letter. Additionally, *Emhart Corp. v. USM Corp.* n192 makes it clear that if management questions the adequacy of the offer, it must reveal any inside information it has that tends to contradict this claim.

It should be noted that minority shareholders may remain in the target company even after the conclusion of a successful tender offer. Thus, the plans the bidder has for the future of the target company are material information. n193 In fact, Judge Friendly cautioned that overstating the definiteness of plans is as serious as understating them. n194 Where plans are not definite, it is adequate if the bidder states that it is considering taking certain steps. n195 However, plans for a change in management or a merger are amongst the things that should be disclosed. n196 While a bidder may specifically deny that it plans to merge with the target company, n197 this denial may be considered misleading if the bidder has developed a detailed blueprint for doing so, even if the plan has not received final approval. n198 Since the integrity of the bidder's management can affect the future of the target company, information on this topic may also be material. n199

An issue that has frequently arisen in litigation is whether a possible antitrust violation created by the tender offer has been adequately disclosed. It should be noted that failure to reveal a reasonable possibility of an antitrust violation violates the disclosure and antifraud provision of Section 14 since the existence of such a possibility is likely to lead to an injunction against the tender offer. n200 However, in *Missouri Portland Cement Co. v. Cargill* n201 the court held that where the possibility of an antitrust violation was not clearly apparent at the time of the offer, the bidder did not violate Section 14(e) by failing to disclose this possibility, even though the court found sufficient grounds under the antitrust laws to enjoin the offer. Nonetheless, the court's finding with respect to the existence of an antitrust violation was reversed on appeal. n202

[c] Manipulative or Deceptive Practices. Under Section 14(e) of the Exchange Act, a violation may arise from "fraudulent, deceptive, or manipulative acts or practices," as well as by material misrepresentations and omissions. However, similar provisions of Section 10(b) and *Rule 10b-5* thereunder n203 were restrictively interpreted by the Supreme Court in *Santa Fe Industries, Inc. v. Green*. n204 The Court held that "manipulative or deceptive" conduct under Section 10(b) did not include squeezing minority shareholders out of a corporation at an allegedly unfair price because full disclosure of the information material to the transaction was made, and such a transaction was not by itself "manipulative or deceptive." n205 Shortly after the *Santa Fe* decision, the court in *Altman v. Knight* n206 held that the acquisition of another corporation by the target corporation (even if there was no valid business purpose) was not by itself a manipulative or deceptive act under Section 14(e). In the instant case, the plaintiffs alleged that the sole purpose of the acquisition was to defeat the tender offer so that the incumbent management of the target company could retain power. n207 Similarly, in *Berman v. Gerber Products Co.*, n208 the court held that *Santa Fe* would not permit a shareholder of the target company to sue management under Section 14(e) for opposing a tender offer without a business purpose.

In order to bolster Section 14(e)'s prohibition against manipulative and fraudulent practices, the Commission adopted Rules 14e-1 and 14e-2. Rule 14e-1 defines such practices to include making any tender offer that does not remain open for at least twenty business days; n209 increasing the price of a tender offer without keeping it open for ten business days after the notice of the increase; failing to pay the offered consideration for the tendered shares as soon as reasonably possible after the end of the offer; n210 and extending the length of the offer without giving public notice at least one day after the offer was initially going to expire. n211 Additionally, Rule 14e-2 requires a target company to, no later than ten business days after the commencement of a tender offer, publish, send, or give to its security holders a statement that the target company either recommends acceptance or rejection of the offer, remains neutral to the offer, or is unable to take a position on the offer. n212

Further, Rule 14e-3 is an antifraud rule establishing a "disclose or abstain from trading rule" under the Williams Act. n213 The rule pertains to any person who directly or indirectly acquires material information concerning a tender offer from the person making the tender offer or from the issuer of the securities subject to the tender offer, and the person acquiring the information knows or has reason to know that it is nonpublic. n214 Rule 14e-3 also establishes an

"anti-tipping" rule concerning material, nonpublic information relating to a tender offer, designed to prevent a fraudulent, deceptive, or manipulative act. n215

In addition, Rule 14e-3(a) imposes a duty of disclosure under Section 14(e) upon any person who trades in securities that will be sought or are being sought in a tender offer that another person has taken a substantial step or steps to commence or has commenced. n216 The duty arises if the person who is trading is in possession of material information that he knows or has reason to know is nonpublic and that he acquired directly or indirectly from: n217

- (1) the offering person;
- (2) the issuer of the securities sought or to be sought in the tender offer; or
- (3) any officer, director, partner, employee, or any other person acting on behalf of the offering person or issuer.

Any person subject to Rule 14e-3(a) is prohibited from purchasing or selling, or causing the purchase or sale of, the securities to be sought or being sought in the tender offer, or any other security convertible into or exchangeable for such security, or any option or right to obtain or to dispose of such securities. n218 Liability, however, will not be imposed if within a reasonable time prior to any purchase or sale, the material information and its source are publicly disclosed by a press release or otherwise. n219 The public information may be disclosed by the person who has acquired information subject to the prohibition under the rule, or by another person. n220 If one person makes full and complete disclosure, there is no requirement for duplicative disclosure from a person who would otherwise be required to disclose or abstain from trading. n221

Rule 14e-3(b) contains an exception from the restriction on trading for any person, not a natural person, if the individual making a decision on behalf of that person did not know and did not have access to the material nonpublic information. n222 In addition, for the exception to apply, the institution must show that it had implemented one or more reasonable policies and procedures to ensure that the individuals making the decision would not violate Rule 14e-3(a). These policies and procedures may include but are not limited to:

- (1) those that restrict any purchase, sale, or causing any purchase and sale of any security, and
- (2) those that prevent the individual decision makers from knowing the nonpublic information. n223

The person who is not the natural person, *i.e.*, the multi-service financial institution, carries the burden of proof for both elements of the exception. n224

Rule 14e-3(c) provides two additional exceptions to the restrictions of Rule 14e-3(a):

- (1) for purchases of a security sought in a tender offer by a broker or by another agent on behalf of an offering person; and
- (2) for sales by any person of any security to the offering person.

Rule 14e-3(d) is designed to prevent fraudulent, deceptive, or manipulative acts or practices under Section 14(e). The rule prohibits certain persons from communicating material, nonpublic information relating to a tender offer under circumstances in which it is reasonably foreseeable n225 that the communications likely to result in a violation of Rule 14e-3(a) or Rule 14e-3(d), unless the communication was made to certain other persons.

Persons subject to the anti-tipping rule, *i.e.*, those prohibited from making the communication, include:

(1) the officers, directors, partners, employees, or advisors of the offering person or issuer, or anyone acting on their behalf; or

(2) a tippee of any person mentioned in (1). n226

Rule 14e-3(d) does not apply, however, to communications made in good faith to:

(1) the officers, directors, partners or employees of the offering person or issuer, to its advisors, or to other persons involved in the planning, financing, preparation or execution of the tender offer; or

(2) any person pursuant to a requirement of any statute or rule or regulation promulgated thereunder.

Finally, the person claiming the availability of the exception bears the burden of proof in establishing his or her good faith. n227

[d] Criteria for Injunctive Relief. Many target companies seek preliminary injunctive relief against the bidder under Section 14(e). Such suits have one purpose--to defeat the offer by delaying the offer. Additionally, it is not uncommon for a bidder to seek a preliminary injunction. n228 In *Electronic Specialty Corp. v. International Controls Corp.*, n229 Judge Friendly offered the following statement on the proper use of preliminary injunctive relief in a tender offer dispute:

"We agree with plaintiffs to the extent of believing that the application for a preliminary injunction is the time when relief can best be given. Despite the makeweight argument in the final paragraph of *Symington Wayne, supra*, 383 F.2d 840, 843, on which Judge McLean naturally relied, we think that in administering § 14(d) and (e), district judges would do well to ponder whether, if a violation has been sufficiently proved on an application for a temporary injunction, the opportunity for doing equity is not considerably better then than it will be later on. The court will have a variety of tools usable at that stage. If the filings are defective or the tender offer misleading, the court can require correction, along, of course, with an opportunity to withdraw and an injunction against further solicitation until the period for withdrawal has expired. Since the amount of stock tendered is likely to be smaller at that time, the difficulties with respect to withdrawal described by plaintiffs will at least be less acute than after the offer has been concluded. If the court believes the offeror has improperly depressed the price of the stock before making the offer, it can require rescission and enjoin further solicitation for a period, or allow the offeror the alternative of raising the price for both past and future deposits. We cite these merely as examples; other techniques will doubtless suggest themselves to resourceful judges. On the other hand, we do not mean at all that interlocutory relief should be given lightly. To the contrary, district judges must be vigilant against resort to the courts on trumped-up or trivial grounds as a means for delaying and thereby defeating legitimate tender offers."

In order to obtain preliminary injunctive relief a party must show two things: (1) that there is a substantial probability that a tender offer violation exists; n230 and (2) irreparable harm will occur to that party if the injunction is not issued. n231 In *Rondeau v. Mosinee Paper Co.*, n232 the Supreme Court held that with respect to issuing an injunction under the Williams Act, the "irreparable harm" standard may not be replaced with a weaker one. This applies to both preliminary and permanent injunctions.

Material disclosure violations cause irreparable harm by forcing shareholders to decide whether to accept the tender offer on the basis of faulty information. n233 However, issuing an unconditional preliminary injunction against a tender offer may irreparably harm the bidder, as it might permanently lose its opportunity to acquire the target company. More significantly, an unconditional preliminary injunction may irreparably harm the target company's shareholders by

depriving them of an opportunity to elect to tender their shares into the offer to sell their stock at a profit. Thus, most courts have heeded Judge Friendly's warning in *Electronics Specialty*, and have permitted the tender offer to resume once the bidder has made proper disclosure of the material facts. n234 Further, shareholders who have already tendered their shares will be allowed to withdraw the tendered shares. n235 Nonetheless, preliminary injunctions unconditionally postponing tender offers have been granted in a number of cases where disclosure violations under the securities laws are combined with antitrust violations or violations of other federal statutes. n236 Enjoining a tender offer is inappropriate if the target company has made misleading statements to protect the shareholders. Under those circumstances, the target company should be ordered to make adequate disclosure, as quickly as possible if the offer has already commenced. n237

Target companies have sometimes alleged that they will suffer irreparable harm, if the tender offer is not enjoined, through the loss of business and employee morale. In *Boyetown Burial Casket Co. v. Amedco, Inc.*, n238 the court enjoined a tender offer on this basis. However, the Court of Appeals for the Second Circuit suggested that such claims should be scrutinized carefully. n239

Injunctions can result from harm caused by a violation of Section 14(d). In *Davis v. Emerson Insurance Agency*, n240 the district court enjoined a tender offer that violated the disclosure and the withdrawal rights provisions of Section 14(d) because the offer was likely to reduce the number of shareholders to the point where the stock would be deregistered with the Commission and, as a result, the plaintiff shareholders would suffer irreparable harm.

Whether scienter is a prerequisite to injunctive relief under Section 14(e) was addressed in *SEC v. Wills*. n241 In that case, the district court for the District of Columbia held that the Commission need only prove negligence in an action under Section 14(e). The court reasoned that Section 14(e) is more akin to Section 17(a) of the Securities Act, under which decisions have not required scienter in Commission actions, n242 than it is to Section 10(b) of the Exchange Act. n243 It should be noted that Section 10(b) has a scienter requirement for private damage actions, n244 and for Commission actions. n245 The Supreme Court in *Ernst & Ernst v. Hochfelder* expressly left open the possibility that recklessness satisfied the scienter requirement. Since *Hochfelder*, the circuits have endorsed the notion that recklessness satisfies the scienter requirement. n246

In *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, n247 the court held that some form of culpability must be shown in order to establish a violation of Section 14(e) because it was so similar to *Rule 10b-5*. A subsequent case, which held that scienter must be proved in a private injunctive action, summarized *Chris-Craft's* holdings as follows: n248

"With respect to the concept of culpability, intent to defraud is not an essential element of a § 14(e) violation, just as it is not essential in a private action under *Rule 10b-5*. Knowledge of the falsity of the statement or reckless disregard of the truth may be sufficient. Mere negligent conduct is not sufficient."

[e] Private Damage Actions.

[i] Under Section 14(e). To maintain a cause of action under Section 14(e), a private litigant must allege that he or she has been injured as a result of the defendant's violation of that section. He or she must also have standing to sue. n249 As noted earlier, the Supreme Court ruled in *Piper v. Chris-Craft* n250 that a tender offeror does not have standing to sue for damages for a violation of Section 14(e).

Additionally, plaintiffs who cannot prove damages have no cause of action. In *Emmi v. First Manufacturers National Bank*, n251 the court dismissed a claim that, in an exchange offer, the defendant-offeror *overvalued* the assets of the company in which the plaintiff was a shareholder. An issue that often poses harder problems than proof of damages is whether the plaintiff's alleged injury was caused by the defendant's misconduct. n252 To a certain extent, this issue was simplified by the Supreme Court's decision in *Affiliated Ute Citizens v. United States*, n253 where the Court held that reliance is not a necessary element of proof in non-disclosure cases because it is very difficult for the plaintiff to prove

that had he known all the facts, he would have acted differently. Although, *Affiliated Ute* was a *Rule 10b-5* case, its rule has been held applicable to cases under Section 14(e). n254 Further, cases under *Rule 10b-5* have treated the *Affiliated Ute* rule as a presumption that may be rebutted by specific proof that the plaintiff would not have relied upon the undisclosed information had he known it. n255 Accordingly, there is no reason why this presumption would not be rebuttable under Section 14(e) as well. n256

Many questions concerning causation arise from whether the plaintiff lost an opportunity to sell his stock. The court in *Lowenschuss v. Kane* n257 sustained the sufficiency of a complaint alleging that the plaintiffs were injured by being misled by the bidder into tendering their shares, even though these shares were returned to them when the offer was enjoined because by that time the declining market price made it impossible to sell the shares. The court stated that the plaintiffs could recover if they could prove "that they would have sold their shares at a particular price or time if the shares had not been frozen." n258 Further, *Berman v. Gerber Products, Company*. n259 held that a target company that had valid reason to oppose a tender offer, could not be considered responsible for their shareholders' lost opportunity to tender their shares when the bidder withdrew its offer because of the target company's opposition. n260 The court also stated that:

"If defendants misrepresented or omitted material facts in connection with their opposition to the Anderson, Clayton proposal so that plaintiffs were induced to retain their shares in reliance upon the integrity and good judgment of the board of directors, but had they known the truth they would have sold their stock in the rising market, a direct causative link exists between defendants' acts and plaintiffs' investment decision. In short, defendants' efforts with respect to the causation issue have focused exclusively on the shareholders' decision to tender their shares, and are, therefore, unsuccessful in rebutting the presumption of reliance as it relates to the shareholders' decision to sell on the open market." n261

Moreover, in *Petersen v. Federated Development Co.* n262 the court held that the plaintiff's claim that the defendants sent misleading communications to the shareholders that disparaged the value of the tender offer was rejected because the plaintiff never received these communications since he was out of the country during the entire period of the offer and could not have tendered his shares in any event. Additionally, another case held that a plaintiff, who claimed that an exchange offeror broke its agreement to give him the value of his stock option in the shares of the offering company, could not sue under Section 14(e), because the offer was not addressed to him since he had no voting rights. n263

Importantly, several cases have held that the defendant must exhibit some type of culpable behavior in order to hold him or her liable in a private action under Section 14(e). n264 In fact, no cases involving private actions have held that such behavior is not needed. n265 However, intent to defraud is not required under this standard, rather knowledge of the falsity of the statement or reckless disregard of the truth is likely to be sufficient. n266 Perhaps this accounts for the relative infrequency of cases concerning scienter under Section 14(e), since both the bidder and the target company will usually be aware of, or have easy access to, the facts underlying their statements.

[ii] Under Other Provisions of the Exchange Act. A number of plaintiffs have sought relief under *Rule 10b-5* in cases concerning tender offers. n267 The use of *Rule 10b-5* in private actions is discussed elsewhere in this book. n268 However, it should be noted that the "purchase or sale" requirement of *Rule 10b-5* n269 would bar causes of action permissible under Section 14(e). For example, except in unusual circumstances, target companies and their non-tendering shareholders are not considered sellers of stock. Thus, they would not have standing to bring a damage action under *Rule 10b-5*.

In *Piper v. Chris-Craft*, the Supreme Court held that a defeated tender offeror did not have a valid cause of action under *Rule 10b-6*, which is designed to prevent manipulation of securities prices, where the price it paid for the target company's stock was not affected by the competing tender offeror's violation of that Rule. The Court stated:

"At no time has Chris-Craft complained of or even suggested that the price which it paid for Piper shares was influenced by Bangor's 10b-6 violations. Indeed, Chris-Craft does not assert standing as a *Piper shareholder*; on the contrary, it claims damages because, in its view of the case, it lost the opportunity to gain control of Piper by virtue of Bangor's 10b-6 violations. Assuming the correctness of this theory, the fact remains that Rule 10b-6 is not directed at or concerned with contests for corporate control. This technical rule is focused narrowly upon a precise goal--maintaining an orderly market for the distribution of securities free from artificial or manipulative influences. Thus, as the issues have been framed, Chris-Craft did not come to the courts in the posture of hoodwinked investor victimized by market manipulation; its complaint, as we noted, is that it lost a chance to gain control of a corporation, a claim beyond the bounds of the specific concern of Rule 10b-6." (emphasis in opinion). n270

The rationale of this decision soon resulted in a further constriction of a tender offeror's rights. For instance, in *Crane Co. v. American Standard, Inc.*, n271 a defeated tender offeror alleged that the defendant discouraged shareholders from accepting its offer by purchasing the target company's stock, thereby causing the open market price of the stock to rise above the price offered by the plaintiff. A prior proceeding held that the practice violated Section 9(a)(2) of the Exchange Act because Standard had engaged in the transactions raising the price of Westinghouse Air Brake Co. (WABCO) shares "for the purpose of inducing the...sale" of such shares by Crane. Once American Standard and WABCO merged, Crane was forced to sell its shares because of antitrust considerations. n272 However, the court held that Crane could not recover for this violation, because the Supreme Court found in *Piper* that Section 9 was closely linked with Rule 10b-6, the purpose of both being to prevent market manipulation, and that Crane, like Chris-Craft, was not suing as a hoodwinked-investor. Additionally, the court held that Crane could not recover under *Rule 10b-5*.

[A] The Commission's Guidance on Mini-Tender Offers and Limited Partnership Tender Offers

Mini-tender offers are tender offers that will result in an offeror owning less than five percent of a company's stock. Generally, offers are structured in this manner to avoid the extensive filing, disclosure and procedural requirements of Section 14(d) of the Exchange Act and Regulation 14D. n273 Additionally, mini-tenders have become commonplace in the limited partnership context and are becoming increasingly common for corporate securities and shares of closed-end funds. n274

[B] Mini-Tender Offers

While Congress has limited the application of Section 14(d) of the Exchange Act to tender offers that would result in ownership of more than five percent of a class of securities, Section 14(e) of the Exchange Act and Regulation 14E have no such limitation. Accordingly, holders of securities which are subject to mini-tender offers are protected by Section 14(e) and Regulation 14E, which apply to all tender offers including both mini-tender offers and tender offers under Regulation 14D and Rule 13e-4 for any type of security (including debt securities). n275 Section 14(e) is the antifraud provision that prohibits fraudulent, deceptive, and manipulative acts in connection with a tender offer. Regulation 14E provides for the basic procedural protections for all tender offers. n276

Offering documents distributed to security holders in mini-tender offers are usually brief and do not contain a great deal of information. Additionally, the Commission found that mini-tenders are often made at a price below market value and the offering documents that are provided may not disclose this fact to the security holder. n277 Since tender offers from third parties are conventionally launched at a premium to market prices, a lack of disclosure may cause the security holders to be misled. n278 Moreover, the Commission found that some bidders did not adequately disseminate the materials. The Commission further found that offerors often deliver the offering documents to the Depositary Trust Company ("DTC") and will rely on DTC to forward the notice electronically to broker-dealers and banks. As a result, the information sent by broker-dealer or bank participants is often limited and the offering documents may, in some cases, not be sent to a security holder unless he or she requests the documents. n279 Due to these concerns, the

Commission has made several prophylactic recommendations that offerors should employ when drafting disclosure contained within the offering documents, and has made several recommendations regarding dissemination and payment. n280

To avoid "fraudulent, deceptive or manipulative practices" within the meaning of Section 14(e), the Commission has recommended certain disclosures in mini-tender offering documents, including the following: (1) offer price, including whether or not the price is below the market price; (2) potential changes or reductions of the offer price; (3) information regarding reductions caused by any distributions or fees; (4) withdrawal rights and procedures; (5) acceptance of tendered shares on a *pro rata* basis; (6) information regarding any target company recommendation; (7) identity of offeror and its affiliates; (8) plans or proposals regarding future tender offers of the securities of the same target company; (9) ability of the offeror to finance the offer and its source of funds; (10) conditions to the offer; and (11) extensions of the offer. n281

Offerors must use "reasonable efforts" to distribute the information to offerees. The Commission has approved the three methods stated under Rule 14d-4, which include: (1) publishing the offering documents in a newspaper; (2) publishing a summary in a newspaper and then mailing of offering documents to those who request them; or (3) mailing everyone on a shareholder's list. n282 Accordingly, reliance on DTC's distribution network or posting the information on a website is not considered adequate. n283 As for timing of payment, Rule 14e-1(c) states that a bidder in a mini-tender offer must pay for or return shares within three business days following the close of the offer. n284

[C] Tender Offers For Limited Partnership Units

Limited partnership units constitute equity securities under the Exchange Act and accordingly are subject to Regulation 14D and/or Regulation 14E, as applicable. Tender offers for limited partnership units raise significant concerns regarding disclosure. The Commission has observed that limited partnership units are relatively illiquid and as a result unit holders may face difficulties in disposing of their holdings. The Commission observed that the offer price in a tender offer for limited partnership units is often significantly lower than the original purchase price or the fair market value of the units. Additionally, the above-stated concerns are compounded by the fact that, in the eyes of the Commission, many investors in limited partnerships are unsophisticated retail investors. n285

To avoid misleading investors and violating the antifraud provision, n286 the Commission has recommended that offerors make a number of disclosures in connection with tender offers for limited partnership units. The Commission recommended that disclosures include: (1) risk factors (including any valuations of the subject security exceeding the offering price); (2) an offeror's affiliation with the target company; (3) any conflicts of interest; (4) recent market price and trading values; (5) methods used in determining the offer price; (6) third party reports; (7) valuations by the general partner; (8) purpose of the offer and plans for the issuer; (9) partnership property and business information; (10) financial information; (11) tax consequences; (12) transfer or processing fees; and (13) if applicable, that the price may be reduced by any distributions. n287

According to Rule 14e-2, a general partner has an obligation to respond to an offer within ten days following commencement of the offer for limited partnership units. To protect unit holders, the Commission recommended that target partnerships consider making various disclosures in the tender offer documents that are provided to unit holders, including conflicts of interest, valuations by the general partner and third party reports materially related to the transaction. n288

FOOTNOTES:

(n1)Footnote 1. *See* Rule 14e-5(a).

(n2)Footnote 2. *Id.*

(n3)Footnote 3. *See* Loews Corporation, SEC No-Action Letter, 2008 SEC No-Act. LEXIS 412 (Mar. 27 2008); *See also* Sharegift USA, SEC No-Action Letter, 2008 SEC No-Act. LEXIS 707 (Dec. 3, 2008).

(n4)Footnote 4. *See* Rule 14e-5(d).

(n5)Footnote 5. An exchange offer does pose additional complexities because it must be registered under the Securities Act of 1933. *See* Federal Securities Exchange Act of 1933 (A.A. Sommer, Jr., General Editor) §2.02 (Matthew Bender).

(n6)Footnote 6. *See U. S. v. Chiarella*, 588 F.2d 1358 , C.C.H. Fed. Sec. L. Rep. P 96,608 (2d Cir. 1978) (holding a printer's employee *criminally* liable for willful violation of *Rule 10b-5* because on several occasions he used inside information that he had obtained on his job to purchase the target company's stock before the public announcement of the tender offer).

Chiarella was reversed *sub nom.* *Chiarella v. U.S.*, 445 U.S. 222, 100 S. Ct. 1108, 63 L. Ed.2d 348 , C.C.H. Fed. Sec. L. Rep. P 97,309 (1980).

(n7)Footnote 7. For a more complete list of the persons necessary to make a tender offer, *see* Martin Lipton & Erica H. Steinberger, *Takeovers & Freezeouts*, § 2.4 (N.Y. L. Pub. Co. 1978) (1978).

(n8)Footnote 8. The dealer-manager has other functions as well. For an in depth discussion of the dealer-manager's role in tender offers *see id.* at § 8.1.

(n9)Footnote 9. *See id.* (citing Austin, "Study Reveals Trends in Tactics, Premiums, Success Rates in Offers," N.Y.L.J. June 12, 1978, at 25, col. 3).

(n10)Footnote 10. Tender Offers, Proposed Rules and Schedule, Exchange Act Release No. 15548, 16 SEC Docket 973 (Feb. 5, 1979).

(n11)Footnote 11. 475 F. Supp. 783 (S.D.N.Y. 1979) .

(n12)Footnote 12. *SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945 (9th Cir. 1985) ; *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979) .

(n13)Footnote 13. Sections 14(d)(1) and 14(d)(4). *See infra* § 7A.03[2].

(n14)Footnote 14. Section 14(e). *See infra* § 7A.03[3].

(n15)Footnote 15. Rule 14d-8. *See infra* § 7A.03[2][c].

(n16)Footnote 16. Section 14(d)(7). *See infra* § 7A.03[2][c].

(n17)Footnote 17. Rule 14d-7. *See infra* § 7A.03[2][c].

(n18)Footnote 18. *See, e.g., Cattlemen's Inv. Co. v. Fears*, 343 F. Supp. 1248 (W.D. Okla. 1972) , where the court concluded that defendant, who owned 4.86 percent of the outstanding shares of the plaintiff, and purchased an additional 7.2 percent of those shares during a six week period, by "an active and widespread solicitation of public shareholders in person, over the telephone and through the mails ...," had made a "tender offer" within the meaning of

the Williams Act.

See also S-G Securities Co. v. Fuqua Investment Co., C.C.H. Fed. Sec. L. Rep. P 96,750 (D. Mass. 1978), where the court held that defendants' issuance of several press releases outlining their intent to conduct a public buying program for the purposes of gaining control of the issuer generated publicity that "created a risk of the pressure on sellers that the disclosure and remedial tender offer provisions of the Williams Act were designed to prevent."

But see Hanson Trust PLC v. SCM Corp., C.C.H. Fed. Sec. L. Rep. P 92,305 (2d Cir. 1985), where the court held that the purchase by an unsuccessful tender offeror of 25% of the target's stock in one open market purchase and five privately negotiated transactions after it had terminated its tender offer, did not constitute a de facto tender offer. The court observed that application of the tender offer rules must turn on whether the class of persons affected by a given transaction are among those requiring the protection of the Williams Act.

(n19)Footnote 19. *Nachman Corp. v. Halfred*, C.C.H. Fed. Sec. L. Rep. P 94,455 at 95,592 (N.D. Ill. 1973); *Applied Digital Data Systems, Inc. v. Milgo Elec. Corp.*, 425 F. Supp. 1145, 1155 (S.D.N.Y. 1977) .

(n20)Footnote 20. *Nachman Corp. v. Halfred*, C.C.H. Fed. Sec. L. Rep. P 94,455 (N.D. ILL. 1973); *Financial General Bankshares, Inc. v. Lance*, C.C.H. Fed. Sec. L. Rep. P 96,403 (D.D.C. 1978).

(n21)Footnote 21. *See Astronics Corp. v. Protective Closures Co.*, 561 F. Supp. 329 , C.C.H. Fed. Sec. L. Rep. P 99,176 (W.D.N.Y. 1983) (privately negotiated sale of privately held target company with strong family ties among its shareholders and directors and officers did not involve a tender offer); *Mount Vernon Savings & Loan Association v. Reilly Mortgage Group, Inc.*, 14 B.N.A. Sec. Reg. & L. Rep. 384 (D.D.C. 1982) (purchases of stock by a shareholder following the announcement of a tender offer by a rival shareholder does not constitute a tender offer).

See also Kennecott Copper Corp. v. Curtiss-Wright Corp., 584 F.2d 1195, 1208 (2d Cir. 1978) ; *Financial General Bankshares, Inc. v. Lance*, C.C.H. Fed. Sec. L. Rep. P 96,403, 93,429 (D.D.C. 1978); *D-Z Investment Corp. v. Holloway*, C.C.H. Fed. Sec. L. Rep. P 94,771 (S.D. N.Y. 1974); *Nachman Corp. v. Halfred, Inc.*, C.C.H. Fed. Sec. L. Rep. P 94,455 (N.D. Ill. 1973).

(n22)Footnote 22. *See Kennecott Copper Corp. v. Curtiss Wright Corp.*, 584 F.2d 1195 (2d Cir. 1978) .

(n23)Footnote 23. *See Polinsky v. MCA, Inc.*, 680 F.2d 1286 , C.C.H. Fed. Sec. L. Rep. P 98,761 (9th Cir. 1982), where the court held that purchases made prior to the announcement of a tender offer were not related to the later tender offer because the purchases had none of the indicia associated with tender offers (e.g., there was no pressure exerted on the plaintiffs to sell their stock to the defendant--the plaintiffs voluntarily offered to sell their stock through their broker).

See also Gulf & W. Indus., Inc. v. Great Atlantic & Pacific Tea Company, 356 F. Supp. 1066, 1074 (S.D.N.Y.) , *aff'd* 476 F.2d 687 (2d Cir. 1973) , where the court stated:

This argument is strained at best. It would require the integration of prior market purchases with the amount to be obtained through the tender offer. I find that this not the law. It appears to this Court that the 5 per cent limit included in Section 14(d) permits that amount to be purchased in the open market without regard to any subsequent tender offer. (Footnote omitted.)

See also Copperweld Corp. v. Imetal, 403 F. Supp. 579, 598 (W.D. Pa. 1975) ; *Sunshine Mining Co. v. Great W. United Co.*, C.C.H. Fed. Sec. L. Rep. P 96,049 (D. Idaho 1977).

(n24)Footnote 24. *Epstein v. MCA, Inc.*, 50 F.3d 644 (9th Cir. 1995) ; *Applied Digital Data Systems v. Milgo*

Elec. Corp., 425 F. Supp. 1145 (S.D.N.Y. 1977) ; *Anaconda Co. v. Crane Co.*, 411 F. Supp. 1210 (S.D.N.Y. 1975) .

(n25)Footnote 25. Section 14(d)(1) also applies to tender offers for equity securities that do not have to be registered solely because of the exemption contained for certain insurance companies in Section 12(g)(2)(G) of the Exchange Act, and to tender offers for equity securities issued by a closed-end investment company that is registered under the Investment Company Act of 1940.

However, since sinking fund bonds are long-term debt rather than equity securities, the disclosure requirements of Section 14(d) do not apply to a bondholders trustee's letter soliciting the bondholders' approval of a sale of assets that served as part of the collateral for the bonds. *E.H.I. of Florida, Inc. v. Ins. Co. of N. Am.*, C.C.H. Fed. Sec. L. Rep. P 98,019 (3d Cir. 1981).

(n26)Footnote 26. Section 14(d)(3).

(n27)Footnote 27. For an in-depth discussion of this rule *see supra* § 7A.02[2][b].

(n28)Footnote 28. Rule 13d-3(a).

(n29)Footnote 29. Rule 13d-3(d).

(n30)Footnote 30. *See also* *Koppers Co., Inc. v. Am. Express Co.*, C.C.H. Fed. Sec. L. Rep. P 95,012 (W.D. Pa. 1988). A target company showed a reasonable likelihood that it could show the parent of a tender offeror to be a "person" on whose behalf a tender offer was being made. As such, the parent company was subject to the Williams Act's disclosure requirements. The court noted that the parent played a central role in the offer as adviser, financier, underwriter and equity partner to the offeror.

(n31)Footnote 31. *See supra* § 7A.02[2][b].

(n32)Footnote 32. *See Texasgulf, Inc. v. Can. Dev. Corp.*, 366 F. Supp. 374 (S.D. Tex. 1973) , where the court found that the defendant did not act in concert with others in making its tender offer.

(n33)Footnote 33. *See* Rule 14d-2(b).

(n34)Footnote 34. Rule 14d-3(a)(3).

(n35)Footnote 35. The telephone notice must include the information required by Rule 14d-6(d)(2)(i) and (d)(2)(ii).

(n36)Footnote 36. Rule 14d-3(a).

(n37)Footnote 37. *See* Rule 14d-6(a)(1).

(n38)Footnote 38. *See* Rule 14d-6(a)(2).

(n39)Footnote 39. *See* Rule 14d-6(a)(3).

(n40)Footnote 40. *See* Rule 14d-6(a)(4).

(n41)Footnote 41. A "bidder" is defined by Rule 14d-1(g)(2) as "any person who makes a tender offer or on whose behalf a tender offer is made." In *MAI Basic Four, Inc. v. Prime Computer, Inc.*, C.C.H. Fed. Sec. L. Rep. P 94,357 (1st Cir. 1969), the court incorporated into the "on whose behalf" language the "group" concept of sections 13(d)(3) and 14(d)(2) of the Exchange Act and held that it could not be said, as a matter of law, that an "active adviser-broker-financier-participant" for the offerors was not a "bidder," though the advisor would own less than a

majority interest in the surviving entity. The advisor had a history of close association and equity sharing with the offeror group, "early and pervasive" participation in the formulation and execution of the tender offer and active involvement throughout it, erstwhile representation on the board of the corporation controlling the sole equity participant in the offeror group, and the advisor created the expectation that it would provide further financing if it could not place \$875 million in junk bonds, the bulk of financing. The court affirmed an injunction against consummation of the offer pending curative disclosure of the advisor's financial condition, identification of all affiliated officers and directors of the advisor and description of its recent share trading.

(n42)Footnote 42. Disclosure required within Schedule TO is now broadly contained within Regulation M-A.

(n43)Footnote 43. This information may be based upon the subject company's most recent filing with the Commission, unless the bidder has reason to believe that such information is not current.

(n44)Footnote 44. The Commission has stated that disclosing plans for a merger subsequent to the completion of the tender offer, using unregistered securities of the acquiring company, does not "jump the gun" in violation of the Securities Act.

Interpretations Concerning the Application of Registration Requirements to Certain Tender Offers and the Application of Tender Offer Provisions to certain Cash Option Mergers, Exchange Act Release No. 14699, 14 SEC Docket 894 (April 24, 1978) states:

"The issue here is whether the acquiring company's disclosure in its tender offer materials of the negotiations with the acquired company and/or the merger agreement, including the material terms of the statutory merger contemplated subsequent to the tender offer, constitutes an 'offer to sell' the securities of the acquiring company to be received by the acquired company's shareholders pursuant to the merger within the meaning of Section 2(3) of the [Securities] Act and Rule 145(a) promulgated thereunder. A finding that such disclosure constitutes an 'offer to sell' leads to the conclusion that the bidder's tender offer violates Section 5(c) of the [Securities] Act if at the time of the tender offer a registration statement for the acquiring company's securities to be exchanged in the merger has not been filed with the Commission.

* * * * *

The disclosure philosophy of the Williams Act is juxtaposed with the 'gun jumping' doctrine under the [Securities] Act. That doctrine was designed to prevent an issuer from conditioning the market by arousing investor interest before a registration statement covering the securities proposed to be offered has been filed. In the Division's [Division of Corporation Finance] view, such a doctrine is inappropriate to apply to a cash tender offer subject to Section 14(d) in which the bidder is seeking to buy the securities of the subject company's security holders. The bidder's concern is purchasing the subject company's securities for cash, not priming the market for a subsequent registered offering of securities. Regardless of the bidder's intent, Schedule TO for compelling policy reasons reflected by the Williams Act requires such information in order to provide full disclosure to investors confronted with an investment decision in the context of a tender offer. In the Division's opinion, to apply the 'gun jumping' doctrine, would not further the policies underlying the [Securities] Act and would be inconsistent with the intention of Schedule TO to require disclosure of information available to the bidder regarding its previous contacts, arrangements or agreement and future plans and proposals with respect to the subject company." (footnotes omitted).

(n45)Footnote 45. See *Emhart Corp. v. U.S.M. Corp.*, 403 F. Supp. 660 (D. Mass. 1975) , where the target company was found to have violated Section 14(d) and 14(e) for stating that the tender offer was inadequate without mentioning past negotiations for its stock by the bidder that tended to show that the bidder's current offer was adequate.

(n46)Footnote 46. See *Mo.Portland Cement v. H.K. Porter Co.*, 535 F.2d 388 (8th Cir. 1976) ; *Alaska Interstate Co. v. McMillian*, 402 F. Supp. 532, 541 (D. Del. 1975) .

(n47)Footnote 47. 476 F.2d 687 (2d Cir. 1973) .

(n48)Footnote 48. *Gulf & W. Indus., Inc. v. Great Atl. & Pac. Tea Co.*, 476 F.2d 687 (2d Cir. 1973) .

(n49)Footnote 49. 411 F. Supp. 1210 (S.D.N.Y. 1975) .

(n50)Footnote 50. 409 F.2d 937, 943 (2d Cir. 1969) .

(n51)Footnote 51. 409 F.2d at 948 . See also *Susquehanna Corp. v. Pan American Sulphur Co.*, 423 F.2d 1075, 1084-86 (5th Cir. 1970) , where the court stated that "Though the offeror has an obligation fairly to disclose its plans in the event of a takeover, it is not required to make predictions of future behavior, however tentatively phrased, which may cause the offeree or the public investor to rely on them unjustifiably."

See also *Missouri Portland Cement Co. v. H.K. Porter Co.*, 535 F.2d 388 (8th Cir. 1976) ; *Sunshine Mining Corp. v. Great W. United Corp.*, C.C.H. Fed. Sec. L. Rep. P 96,049 (D. Idaho 1977).

(n52)Footnote 52. *Alaska Interstate Co. v. McMillian*, 402 F. Supp. 532 (D. Del. 1975) .

(n53)Footnote 53. *Id.* at 543 (emphasis in original).

(n54)Footnote 54. See *Sea World Inc. v. MCA, Inc.*, C.C.H., Fed. Sec. L. Rep. P 95,803 (S.D. Cal. 1976) (MCA wholly owned 37 out of its 38 subsidiaries).

(n55)Footnote 55. See *Ronson Corp. v. Liquifin Aktiengesellschaft*, 483 F.2d 846 (3rd Cir. 1973) , where the court upheld a preliminary injunction against a tender offer partly because the very complicated transactions behind the funding of the offer were not revealed. Subsequent disclosures by Liquifin led to the removal of the injunction. *Ronson Corp. v. Liquifin Aktiengesellschaft*, 370 F. Supp. 597 (D. N.J.) , *aff'd*, 497 F.2d 394 (3d Cir.) , *cert. denied* 419 U.S. 870 (1974) .

See also *IU Int'l. Corp. v. NX Acquisition Corp.*, C.C.H. Fed. Sec. L. Rep P 93,633 (4th Cir. 1988), where a divided panel held that a bidder is not required to know and disclose expected sources and expected terms of financing prior to actual financing of the tender offer. The court stated that the Williams Act does not impose a threshold requirement on what condition financing must be in prior to the commencement of a tender offer; the Williams Act only requires disclosure of the financing arrangements already in place. While the existence of a financing contingency is a material term of an offer and the fact of contingency must be stated, the court said, how the financing will ultimately occur is not essential to an offer. The court noted that the Williams Act is designed to maintain neutrality between the bidder and the target company and concluded that requiring knowledge by the bidder of expected sources and hoped for terms of financing and disclosure of such information would favor target companies and upset this neutrality.

See also Letter from General Counsel Daniel L. Goelzer to the Honorable Leonard B. Sand, United States District Court for the Southern District of New York (March 28, 1988) re: CRTF Corp. v. Federated Department Stores, Inc. and R.H. Macy & Co. v. Campeau Corp., C.C.H. Fed. Sec. L. Rep P 84,224 (stating that where a tender offeror has obtained financing commitments for all or substantially all of the remaining financing that it requires for its offer, that is, in the Commission's view, a material change in the offer and investors must be provided with a minimum of five business days). See Rule 14d-4(c) to consider that change.

(n56)Footnote 56. But see *Broder v. Dane*, 384 F. Supp 1312 (S.D.N.Y. 1974) , where the court held that the failure to report an inter-family purchase of stock occurring twenty months before the purchasers caused the issuer to make a "going private" tender offer, was a material omission of fact in violation of Section 14(e), where the price paid

for the stock in the inter-family purchase was substantially higher than the tender offer price.

(n57)Footnote 57. *See* *Arkansas Best Corp. v. Pearlman*, C.C.H. Fed. Sec. L. Rep. P 93,917 (D. Del. 1988) (ruling that the personal finances of individuals who were the dominant and motivating principals behind a tender offer did not have to be disclosed).

(n58)Footnote 58. Regulation of Takeovers and Security Holder Communications, Securities Act Release No. 7760, 70 SEC Docket 2229 (Oct. 22, 1999).

(n59)Footnote 59. An example of an understanding that should be disclosed under this item is one where the bidder makes arrangements for the benefit of the target company's management, presumably in an effort to gain their support. *See Chemetron Corp. v. Crane Co.*, C.C.H. Trade Cas. Rep. P 61,717 (N.D. Ill. 1977).

(n60)Footnote 60. *See Ronson Corp. v. Liquifin Aktiengesellschaft*, 483 F.2d 846, 851 (3d Cir. 1973) , where 'the court held "that clearances from several administrative agencies involved need not be secured prior to a final tender offer," provided that the effects such approvals might have on the tender offeror's business are disclosed. In a subsequent decision concerning this tender offer, the court ruled that adequate disclosure of a foreign regulatory problem had been made. The court noted that such problems are of particular interest to United States investors since they are not familiar with the regulations involved. *See Ronson Corp. v. Liquifin Aktiengesellschaft*, 370 F. Supp. 597 (D.N.J. 1974) , *aff'd*, 497 F. 2d 395 (3d Cir. 1974) , *cert. denied*, 419 U.S. 870 (1974) .

(n61)Footnote 61. This issue had been considered by a number of cases prior to the adoption of Schedule TO. *See Missouri Portland Cement Co. v. Cargill*, 498 F.2d 851 (2d Cir. 1974) ; *Gulf & W. v. Great Atl. & Pac. Tea Co.*, 356 F. Supp. 1066 (S.D.N.Y.) ; *Boyertown Burial Casket Co. v. Amedco, Inc.*, 407 F. Supp. 811 (E.D. Pa. 1976) ; *Elco Corp. v. Microdot, Inc.*, 360 F. Supp. 741 (D. Del, 1973) .

(n62)Footnote 62. These rules are applicable to any tender offer dependent upon borrowed funds; presumably disclosure is only required if a potential violation is present. *See Alaska Interstate Co. v. McMillian*, 402 F. Supp. 532, 553-65 (D. Del. 1975) .

Margin Requirements under the Exchange Act are discussed *supra* § 3.07.

(n63)Footnote 63. *See* Rule 14d-3(b).

(n64)Footnote 64. As noted above, Rule 14d-2(b) requires written communications prior to the making of a tender offer to be filed with the Commission.

(n65)Footnote 65. *See* Section 14(d)(1). This material is to be filed as exhibits pursuant to Item 12 of the Schedule TO.

(n66)Footnote 66. For the information required by Rule 14d-6, *see* § 7A.03[2][a].

(n67)Footnote 67. With respect to summary publication or the use of stockholder lists under Rule 14d-5, the means of dissemination described in Rule 14d-4(a) are exclusive.

(n68)Footnote 68. *See* Rule 14d-4(a)(3).

(n69)Footnote 69. Rule 14d-4(c). Publication in all editions of a daily newspaper with a national circulation is deemed to be adequate publication. *Id.* The Commission's Division of Corporation Finance has stated that adequate dissemination to security holders of the information required by Rule 14d-6 is required regardless of the means used to make the offer. Interpretive Release Relating to Tender Offer Rules, Exchange Act Release No. 16623, 19 SEC Docket 807 (March 5, 1980).

(n70)Footnote 70. *See* Rule 14d-4(d)(1).

(n71)Footnote 71. *See* Rule 14d-9(e)(1).

(n72)Footnote 72. Rule 14d-9(e)(2).

(n73)Footnote 73. Rule 14d-9(b).

(n74)Footnote 74. Rule 14d-9(c).

(n75)Footnote 75. Rule 14d-9(d).

See Steinberg v. Pargas, Inc., C.C.H. Fed. Sec. L. Rep. P 91,979 (S.D.N.Y. 1985), where the court held that a target company's failure to report on Schedule 14D-9 the identity of one of several bidders whose proposals were rejected by the target company's board of directors was not a material misstatement or omission of fact, where the identities of other unsuccessful bidders were not disclosed, and the Schedule 14D-9 contained an accurate description of the terms of the successful bid, of each unsuccessful bid, and of the board of director's reasons for recommending the successful bid and rejecting the others. The court based its finding of lack of materiality on plaintiff's failure to show a substantial likelihood that knowledge of the bidder's identity would have been important to a reasonable shareholder in making his decision on how to vote. As well, the court found that the act was designed to insure disclosure; that the target company had met its obligations in that regard; and that the target company's stockholders had the opportunity to reject the Board's recommendation.

(n76)Footnote 76. Rule 14d-9(f).

(n77)Footnote 77. "Conclusory statements such as 'The tender offer is in the best interests of the shareholders' are not considered sufficient disclosure." Item 1012(b) of Regulation M-A.

(n78)Footnote 78. *See* Radol v. Thomas, C.C.H. Fed. Sec. L. Rep. P 92,289 (6th Cir. 1985), where the court held that where a two-tier tender offer was contemplated in which the bidder, if successful, planned to merge the target company into the bidder, the tender offer materials did not constitute solicitations of shareholder consent to the proposed merger and thus were not required to contain all the information required to be included in a proxy statement soliciting shareholder approval of the merger since a tender offer and a subsequent merger are distinct acts to be considered separately.

(n79)Footnote 79. *Anaconda Co. v. Crane Co.*, 411 F. Supp. 1210 (S.D.N.Y. 1975) .

(n80)Footnote 80. *Id.* at 1215 .

(n81)Footnote 81. *Id.* at 1213 .

"This rule was intended to permit the management of a target company to respond immediately to an attempted corporate takeover. The statement issued by Anaconda is bland enough to fit within the meaning of this provision. Crane argues, however, that Anaconda's press release was really an attempt by Anaconda management to communicate the message that Anaconda would oppose the proposed offer and, as such, was a violation of Section 14(d) of the Act in that it constituted a 'solicitation' or 'recommendation.' The only thing that Crane could otherwise request was that Anaconda's management should have included a statement that it was not necessarily opposed to the proposed offer. This type of requirement of the niceties of language is certainly not required in the real world and I find no violation in the August 8 release."

(n82)Footnote 82. *See infra* § 7A.03[3].

(n83)Footnote 83. Rule 14d-5(a)(3).

(n84)Footnote 84. Rule 14d-5(a)(4).

(n85)Footnote 85. Rule 14d-5(f)(3)(iii) and (iv).

(n86)Footnote 86. Rule 14d-5(f)(4).

(n87)Footnote 87. Rule 14e-1(a). If the tender offer involves a roll-up as defined in item 901(c) of Reg. S-K and the securities being offered are registered (or authorized to be registered) on Form S-4 or Form F-4, the offer may not be open for less than 60 calendar days from the date the tender offer is first published or sent to security holders.

(n88)Footnote 88. Rule 14e-1(b).

*See Kidder, Peabody & Co., Inc., SEC No-Action Letter, 1986 SEC No-Act. LEXIS 2293, at *1 (May 5, 1986), where the staff took the position that it would not recommend an enforcement action against an issuer under Rules 14e-1(a) or (b) if the issuer does not keep a tender offer for its non-convertible debt securities open for the periods of time required under Rule 14e-1(a) or (b), provided that all securities of that class are included in the offer; the offer is disseminated to all security holders in a manner that gives them a reasonable opportunity to participate in the offer; and the offer is not made in response to any other offer for the issuer's securities.*

*See also Salomon Brothers, Inc., SEC No-Action Letter, 1986 SEC No-Act. LEXIS 2033, at *1 (April 17, 1986), the staff took the position that it would not recommend an enforcement action under Rule 14e-1(a) if an issuer made a tender offer for its non-convertible debt securities without registration, provided the issuer offers to purchase all of the class of debt covered by the tender offer; the offer is made to all holders of that class of debt; the debt-holders are given a reasonable opportunity to participate in the offering, including dissemination of tender offer materials on an expedited basis where the offer is to remain open for less than 10 days; and the tender offer is not made in response to other tender offers for the issuer's securities.*

(n89)Footnote 89. *See Murray v. Hospital Corp. of America, C.C.H. Fed. Sec. L. Rep. P 93,926 (M.D. Tenn. 1988) (extension of an oversubscribed tender offer according to its terms did not violate the Williams Act or rules thereunder).*

(n90)Footnote 90. Section 14(d)(5) does not explicitly state that accepted shares are excluded from the sixty day withdrawal provision, but H.R. Rep. NO. 90-1711 (1968) states that:

"This subsection would give shareholders who tender their shares immediately after the offer is made a short period within which to reconsider. At the other end of the spectrum, it would prevent tendered securities from being tied up indefinitely awaiting a decision by the person making the offer as to whether or not he will purchase them."

(n91)Footnote 91. Rule 14d-7(a).

(n92)Footnote 92. Rule 14d-7(b).

(n93)Footnote 93. Pro Rata Rule, Exchange Act Release No. 19336, 26 SEC Docket 1445 (Dec. 15, 1982).

(n94)Footnote 94. *See Pryor v. U. S. Steel Corp., C.C.H. Fed. Sec. L. Rep. P 92,804 (2d Cir. 1986), where the court held that a shareholder's allegation that a tender offeror had violated Section 14(d)(6) by accepting shares for proration after the proration deadline stated a cause of action. The court observed that in adopting Section 14(d)(6)*

Congress intended to spread any premium for control among all shareholders tendering within the proration period, and that the Congressional purpose would be defeated by permitting particular holders from purchasing a greater than pro rata share.

(n95)Footnote 95. The practice of "hedged tendering," where a person tenders securities and immediately sells some of the securities tendered, however, provides the opportunity to manipulate the pro rata requirements of a tender offer without violating the "short tendering" provisions of Rule 14e-4. For example, X and Y each own 1000 shares of stock, which is the subject of a tender offer. X expects acceptance of tendered shares on a 50 percent pro rata basis. Accordingly, X immediately sells 500 shares after tendering 1000 shares. If X's expectation of 50 percent acceptance is correct, his remaining 500 shares, or 100 percent of the shares he now owns, will be accepted by the tender offeror at the conclusion of the acceptance period. Y will have 500 of his shares accepted and 500 shares returned by the tender offeror. X has hedged the possibility of pro rata acceptance of his shares. Short Tendering of Securities Exchange Act Release No. 18050, 23 SEC Docket 632 (Aug. 21, 1981).

Rule 14e-4 addresses the problem of "hedged tendering" by requiring a person who tenders securities to have a net long position equal to or greater than the amount tendered in the securities or equivalent securities at the time of tender and at the end of the pro rata acceptance period. See Rule 14e-4(b)(1). An equivalent security is defined by the Rule 14e-4(a)(2) as being:

(1) any security (including any option, warrant, or other right to purchase the security), issued by the person whose securities are the subject of the offer, that is immediately convertible into, or exchangeable or exercisable for, a subject security, or

(2) any other right or option (other than a standardized call option) that entitles the holder thereof to acquire a subject security, but only if the holder thereof reasonably believes that the maker or writer of the right or option has title to and possession of the subject security, and upon exercise will promptly deliver the subject security. In the preceding example, Rule 14e-4 will require that X repurchase 500 shares before the pro rata acceptance period expires. In addition, paragraph (c) of Rule 14e-4 provides the Commission with the authority to exempt transactions from the Rule's provisions.

(n96)Footnote 96. *324 F. Supp. 998 at 1004 (S.D.N.Y. 1971)* , *aff'd*, *469 F.2d 696 (2d Cir. 1972)* .

(n97)Footnote 97. *Kroeze v. Chloride Group, Ltd.*, *572 F.2d 1099 (5th Cir. 1978)* .

See also *Brill v. Burlington Northern, Inc.*, C.C.H. Fed. Sec. L. Rep. P 91,625 (D.Del. 1984), where tender offers made in December and January were held not to constitute one tender offer with one proration pool since the second offer, made pursuant to an agreement with the target company, was not a continuation of the initial offer but was a separate offer with its own proration pool. The court stated that tender offerors may impose as many conditions or terms as they choose, including conditions concerning time, place and method of acceptance. Therefore as masters of the tender offer, the defendants had the right to terminate the December offer after some of the conditions occurred and to commence a separate and distinct tender offer in January. Furthermore, each tender offer complied with the full range of Williams Act protections, including additional time and proration pools. The court stated that Section 14(d)(6) did not apply to the plaintiff's other two claims involving a contractual severance agreement ("golden parachute") and a stock purchase agreement since the agreements were collateral to the tender offer.

(n98)Footnote 98. *578 F.2d 180 (7th Cir. 1978)* .

(n99)Footnote 99. Compare *Bache & Co. v. Int'l. Controls Corp.*, *324 F. Supp. 998 (S.D.N.Y. 1971)* , where the bidder agreed to give the plaintiff notice of the start of a five day period within which delivery of the shares must be made, and failed to do so. The court held Bache's tender of shares was still timely since the five day period never started

running.

(n100)Footnote 100. Rule 14d-10(a)(1); Rule 13e-4(f)(8)(i).

(n101)Footnote 101. Rule 14d-10(a)(2); Rule 13e-4(f)(8)(ii).

(n102)Footnote 102. Amendments to the Tender Offer Best-Price Rules, Exchange Act Release No. 34-54684 (Nov. 1, 2006).

(n103)Footnote 103. *See, e.g., In re Digital Island Securities Litigation*, 357 F.3d 322 (3d Cir. 2004) (applying a "bright-line" test); *Gerber v. Computer Associates International, Inc.*, 303 F.3d 126 (2d Cir. 2002) (applying an "integral part" test); *Lerro v. Quaker Oats Co.*, 84 F.3d 239 (7th Cir. 1996) (applying a "bright-line" test); *Epstein v. MCA, Inc.*, 50 F.3d 644 (9th Cir. 1995) (applying an "integral part" test), *rev'd on other grounds sub nom.*

(n104)Footnote 104. *See infra* § 7A.03[3][e][i].

(n105)Footnote 105. Amendments to the Tender Offer Best-Price Rules, Exchange Act Release No. 34-54684 (Nov. 1, 2006).

(n106)Footnote 106. Rule 14d-10(d); Rule 13e-4(f)(12)(i).

(n107)Footnote 107. *Id.*

(n108)Footnote 108. Rule 14d-10(d)(2); Rule 13e-4(12)(ii).

(n109)Footnote 109. Rule 14d-10(b).

(n110)Footnote 110. Rule 14d-10(d).

(n111)Footnote 111. Rule 14d-10(e); Rule 14d-10(c). In connection with price, it should also be noted that a joint bid by former rival bidders that reduces the per share price of an offer is permissible. *See Finnegan v. Campeau Corp.*, C.C.H. Fed. Sec. L. Rep. P 95,513 (2d Cir. 1990). The target company shareholder bringing the action alleged that an agreement between bidders who had been in competition with each other constituted a conspiracy in violation of Section 1 of the Sherman Act. The Court of Appeals for the Second Circuit disagreed, explaining that neither the Williams Act nor applicable Commission regulations make any distinction between joint bids made by parties before a battle for control of a target and joint bids made by parties who had been rivals at the outset. Furthermore, it would be difficult to conclude that Congress could have authorized joint bids under the Williams Act and then eliminated that right by authorizing suit against such bidders under the antitrust laws. The court also pointed out that if the antitrust laws were used to invalidate agreements between rival bidders the result would be advantageous to incumbent managements, thus undermining the policy of neutrality which the Williams Act was intended to promote.

(n112)Footnote 112. Va. Code Ann. §§ 3.1-528-13.1-541.

See also Note, Can State Tender-Offer Regulation Be Made Constitutional? Edgar v. MITE Corporation 20 Hous. L. Rev. 1475 (1983).

(n113)Footnote 113. Exchange Act Release No. 34-15548 (1979).

(n114)Footnote 114. *See Diane S. Wilner & Craig A. Landy, The Tender Trap; State Takeover Statutes and their Constitutionality*, 45 Fordham L. Rev. 1, 5-9 (1976).

(n115)Footnote 115. *Great W. United Corp. v. Kidwell*, 577 F.2d 1256 (5th Cir. 1978), *rev'd*, 443 U.S. 173, 99 S. Ct. 2710, 61 L. Ed.2d 464 (1979).

See also Note, *Securities Law and the Constitution: State Tender Offer Statutes Reconsidered*, 88 Yale L.J. 510 (1979).

(n116)Footnote 116. The Idaho statute applied to any company that had substantial assets, or its principal executive offices, or was incorporated in Idaho. Idaho Code § 30-1501(6).

(n117)Footnote 117. *Great W. United Corp. v. Kidwell*, 577 F.2d 1256, 1263 (5th Cir. 1978) . (footnotes omitted). See Idaho Code § 30-1501 *et seq.*

(n118)Footnote 118. *Great W. United Corp. v. Kidwell*, 439 F. Supp. 420 (N.D. Tex. 1977) .

(n119)Footnote 119. *Great W. United Corp. v. Kidwell*, 577 F.2d 1256, 1277 (quoting from S. REP. NO. 90-550 (1967), *reprinted in* Federal Securities Exchange Act of 1934 (A.A. Sommer, Jr., General Editor) 5-756 *et seq.* (Matthew Bender)).

(n120)Footnote 120. *Id. at* 1278 .

(n121)Footnote 121. *Id. at* 1279 .

(n122)Footnote 122. *Id. at* 1279-80 . (citations omitted).

(n123)Footnote 123. *Leroy v. Great W. United Corp.*, 443 U.S. 173, 99 S. Ct. 2710, 61 L. Ed.2d 464, C.C.H. Fed. Sec. L. Rep. P 96,900 (1979) .

(n124)Footnote 124. *Edgar v. MITE Corp.*, 102 S. Ct. 2629, 73 L. Ed.2d 269 , C.C.H. Fed. Sec. L. Rep. P 98,728 (1982).

(n125)Footnote 125. Ill. Rev. Stat., Ch. 1211/2, § 137.51 *et seq.* (Supp. 1980).

(n126)Footnote 126. *Hyde Park Partners, L.P. v. Connolly*, C.C.H. Fed. Sec. L. Rep. at P 93,661 (1982).

(n127)Footnote 127. Ill. Rev. Stat, Ch. 1211/2, § 137.52-10.(2) (Supp. 1980).

(n128)Footnote 128. C.C.H. Fed. Sec. L. Rep. at pp. 93,660-61.

(n129)Footnote 129. *CTS Corp. v. Dynamics Corp. of America*, 481 481 U.S. 69, 107 S. Ct. 1637, 95 L. Ed.2d 67 (1987) .

(n130)Footnote 130. Ind. Code § 23-1-42-1 *et seq.* (2006).

(n131)Footnote 131. Control shares are defined as shares acquired that but for the application of the statute would bring the acquirers voting power in the corporation to or above any of the following three thresholds: 20%; 33 1/3% or 50%. Ind. Code § 23-1-42-1.

The statute applies to any corporation that has 100 or more shareholders, has its principal office or substantial assets within Indiana, and has either:

- (1) more than 10 percent of its shareholders resident in Indiana;
- (2) more than 10 percent of its shares owned by Indiana residents; or
- (3) ten thousand shareholders resident in Indiana. *Id.* § 23-1-42-4(a).

(n132)Footnote 132. *Id.* at § 23-1-42-9.

(n133)Footnote 133. *Id.* at § 23-1-42-7.

(n134)Footnote 134. *Id.* at § 23-1-42-10(b).

(n135)Footnote 135. *Id.* at § 23-1-42-10(a).

(n136)Footnote 136. *Dynamics Corp. of Am. v CTS Corp.*, 794 F.2d 250 , C.C.H. Fed. Sec. L. Rep. P 92,768 (7th Cir. 1986).

(n137)Footnote 137. *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 107 S. Ct. 1637, 95 L. Ed.2d 67 (1987) .

(n138)Footnote 138. *Del. Code Ann. tit. 8, § 203* (2008).

(n139)Footnote 139. *Del. Code Ann. tit. 8, § 203(c)(3)*. "[B]usiness combination," when used in reference to any corporation and any interested stockholder of such corporation, means: (i) any merger or consolidation of the corporation or any direct or indirect majority-owned subsidiary of the corporation with (A) the interested stockholder, or (B) with any other corporation, partnership, unincorporated association or other entity if the merger or consolidation is caused by the interested stockholder and as a result of such merger or consolidation subsection (a) of this section is not applicable to the surviving entity; (ii) any sale, lease, exchange, mortgage, pledge, transfer or other disposition (in one transaction or a series of transactions), except proportionately as a stockholder of such corporation, to or with the interested stockholder, whether as part of a dissolution or otherwise, of assets of the corporation or of any direct or indirect majority-owned subsidiary of the corporation which assets have an aggregate market value equal to 10% or more of either the aggregate market value of all the assets of the corporation determined on a consolidated basis or the aggregate market value of all the outstanding stock of the corporation; (iii) any transaction which results in the issuance or transfer by the corporation or by any direct or indirect majority-owned subsidiary of the corporation of any stock of the corporation or of such subsidiary to the interested stockholder, except (A) pursuant to the exercise, exchange or conversion of securities exercisable for, exchangeable for or convertible into stock of such corporation or any such subsidiary which securities were outstanding prior to the time that the interested stockholder became such, (B) pursuant to a merger under Section 251(g) of this title; (C) pursuant to a dividend or distribution paid or made, or the exercise, exchange or conversion of securities exercisable for, exchangeable for or convertible into stock of such corporation or any such subsidiary which security is distributed, pro rata to all holders of a class or series of stock of such corporation subsequent to the time the interested stockholder became such, (D) pursuant to an exchange offer by the corporation to purchase stock made on the same terms to all holders of said stock, or (E) any issuance or transfer of stock by the corporation, provided however, that in no case under (C)-(E) above shall there be an increase in the interested stockholder's proportionate share of the stock of any class or series of the corporation or of the voting stock of the corporation; (iv) any transaction involving the corporation or any direct or indirect majority-owned subsidiary of the corporation which has the effect, directly or indirectly, of increasing the proportionate share of the stock of any class or series, or securities convertible into the stock of any class or series, of the corporation or of any such subsidiary which is owned by the interested stockholder, except as a result of immaterial changes due to fractional share adjustments or as a result of any purchase or redemption of any shares of stock not caused, directly or indirectly, by the interested stockholder; or (v) any receipt by the interested stockholder of the benefit, directly or indirectly (except proportionately as a stockholder of such corporation) of any loans, advances, guarantees, pledges, or other financial benefits (other than those expressly permitted in subparagraphs (i)-(iv) above) provided by or through the corporation or any direct or indirect majority owned subsidiary.

(n140)Footnote 140. *Del. Code Ann. tit. 8, § 203(a)*.

(n141)Footnote 141. *Del. Code Ann. tit. 8, § 203(b)(1)-(3)*.

(n142)Footnote 142. *Del. Code Ann. tit. 8, § 203(b)(4)-(6)*.

(n143)Footnote 143. *Research Spotlight: Strong Takeover Defenses Encourage Oracle to Increase Bid for PeopleSoft*, SharkRepellent.net, June 23, 2003, https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20030623.html&rnd=158131.

(n144)Footnote 144. 683 F. Supp. 458 (D. Del. 1988) .

(n145)Footnote 145. *Id.* 467-72 .

(n146)Footnote 146. *Id.* at 472-73 . See also, *City Capital Assocs. v. Interco, Inc.*, 696 F. Supp. 1551 (D. Del. 1988) , *aff'd*, 860 F.2d 60 (3d Cir. 1988) .

(n147)Footnote 147. *City Capital Assocs. v. Interco, Inc.*, 696 F. Supp. 1551 at 1556 .

(n148)Footnote 148. *Hyde Park Partners, L.P. v. Connolly*, C.C.H. Fed. Sec. L. Rep., P 93,619 (1st Cir. 1988); *but see Nomad Acquisition Corp. v. Damon Corp.*, C.C.H. Fed. Sec. L. Rep. P 94,098 (D. Mass. 1988) (tender offeror failed to show irreparable harm from application by a target company of the powers granted under the Massachusetts statute regulating control share acquisitions of foreign corporations).

(n149)Footnote 149. C.C.H. Blue Sky Law Rep. P 31,203.

(n150)Footnote 150. *Campeau Corp. v. Federated Dep't. Stores*, C.C.H. Fed. Sec. L. Rep. P 93,650 (S.D. Ohio 1988).

(n151)Footnote 151. *See Batus, Inc. v. McKay*, C.C.H. Fed. Sec. L. Rep. P 93,811 (D. Nev. 1988).

(n152)Footnote 152. *See Salant Acquisition Corp. v. Manhattan Indus., Inc.*, C.C.H. Fed. Sec. L. Rep. P 93,673 (S.D.N.Y. 1988); *accord Delaware Business Combination Statute (Del. Code tit. 8 § 203 et seq . (2006))*; *Black & Decker Corp. v. Am. Standard Inc.*, C.C.H. Fed. Sec. L. Rep. P 93,685 (D. Del. 1988).

(n153)Footnote 153. *Del. Code tit. 8 § 203 (2006)*.

(n154)Footnote 154. *See, e.g., BNS, Inc. v. Koppers Co., Inc.*, C.C.H. Fed. Sec. L. Rep. P 93,730 (D. Del. 1988); *RP Acquisitions Corp. v. Staley Continental, Inc.*, C.C.H. Fed. Sec. L. Rep. P 93,763 (D. Del. 1988), *accord City Capital Associates Limited Partnership v. Interco, Inc.*, C.C.H. Fed. Sec. L. Rep. P 94,079 (D. Del. 1988).

(n155)Footnote 155. *Tyson Foods, Inc. v. McReynolds*, C.C.H. Fed. Sec. L. Rep. P 94,143 (6th Cir. 1989).

(n156)Footnote 156. *Amanda Acquisition Corp. v. UniversalFoods Corp.*, C.C.H. Fed. Sec. L. Rep. P 94,436 (7th Cir. 1989), *cert. denied*, Dkt. 89-372 (U.S. Nov. 6, 1989).

(n157)Footnote 157. Regulation 14 E, Unlawful Tender Offer Practices now contains Rules 14e-1 through 14e-8.

The Commission amended the short tendering rule, Rule 10b-4, and re-designated it as Rule 14e-4. The prohibition against multiple tendering to competing partial offers has been deleted. Otherwise no substantive change in the rule's operation is intended by the redesignation. Both short tendering and hedged tendering will continue to be prohibited by Rule 14e-4. *See Prohibited Transactions in Connection with Partial Tender Offers*, Exchange Act Release No. 34-28660, 47 SEC Docket 1054 (Nov. 30 1990).

(n158)Footnote 158. Section 14(e) states:

"It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or

practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."

Rule 10b-5 states:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange:

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Rule 10b-5 is discussed in *supra* § 5.04.

(n159)Footnote 159. *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 596 (5th Cir.) , cert. denied 419 U.S. 873 (1974) .

(n160)Footnote 160. See, e.g., *Pryor v. U. S. Steel Corp.*, C.C.H. Fed. Sec. L. Rep. P 91,568 (S.D.N.Y. 1984), where the court held that plaintiff target company shareholder had standing to sue for damages under Section 14(e) where a press release issued by the tender offeror allegedly contained material misrepresentations concerning the number of shares perfected that were relied on by the plaintiff in connection with his hedging activities. The court pointed out that, unlike *Rule 10b-5*, Section 14(e) has no purchaser/seller requirement and therefore tendering and non-tendering shareholders have standing to sue under Section 14(e).

(n161)Footnote 161. *Applied Digital Data Sys. v. Milgo Elec. Corp.*, 425 F. Supp. 1145 (S.D.N.Y. 1977) ; *ICM Realty v. Cabot, Cabot & Forbes Land Trust*, 378 F. Supp. 918 (S.D.N.Y. 1974) .

(n162)Footnote 162. *Elec. Specialty Co. v. Int'l Controls Corp.*, 409 F.2d 937 (2d Cir. 1969) .

(n163)Footnote 163. *Id.* at 946 .

(n164)Footnote 164. The rule already recognized under Section 14(a) alluded to by Judge Friendly is the holding in *Studebaker Corp. v. Gittlin*, 360 F.2d 692 (2d Cir. 1966) that an issuer has standing under Section 14(a) to seek an injunction against a violation by a group attempting to gain control of it.

(n165)Footnote 165. *Dyer v. E. Trust and Banking Co.*, 336 F. Supp. 890 (D. Me. 1971) .

(n166)Footnote 166. *Emmi v. First Mfr. Nat'l Bank*, 336 F. Supp. 629 (D. Me. 1971) . Both cases involved the same facts, and were decided on the same day by the same judge. It is hard to say which one established a cause of action for tendering shareholders under Section 14(e). In *Dyer*, Judge Gignoux stated that it was unnecessary to consider whether there was an implied right of action under Section 14(e), since the transaction involved was a reorganization rather than a tender offer. In *Emmi*, he stated: "In its consideration of the Section 14(e) claims in *Dyer*, the Court has

held that Section 14(e) does give rise to an implied private damage remedy."

(n167)Footnote 167. See *Petersen v. Federated Dev. Co.*, 387 F. Supp. 355 (S.D.N.Y. 1974) ; *Berman v. Gerber Prod. Co.*, 454 F. Supp. 1310 (W.D. Mich. 1978) .

(n168)Footnote 168. *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 97 S. Ct. 926, 51 L. Ed.2d 124 (1977) .

(n169)Footnote 169. *Id.* at 26-29, 51 L. Ed.2d 124, 97 S. Ct. 926 . It is arguable that the Williams Act was intended to benefit all parties to a tender offer since it was designed to insure that tender offers are conducted fairly and honestly.

(n170)Footnote 170. *Id.* at, 35-37, 51 L. Ed.2d 124, 97 S. Ct. 926 .

(n171)Footnote 171. *Id.* at 37, 97 S. Ct. 926, 51 L. Ed.2d 124 .

(n172)Footnote 172. *Id.* at 39, 97 S. Ct. 926, 51 L. Ed.2d 124 .

(n173)Footnote 173. *Id.* at 39-40, 51 L. Ed. 2d 124, 97 S. Ct. 926 .

(n174)Footnote 174. *Mobile Corp. v. Marathon Oil Co.*, C.C.H. Fed. Sec. L. Rep. P 98,399 (6th Cir. 1981); *Humana, Inc. v. Am. Medicorp, Inc.*, C.C.H. Fed. Sec. L. Rep. P 96,298 (S.D.N.Y. 1978); *Weeks Dredging & Contracting, Inc. v. Am. Dredging Co.*, 451 F. Supp. 468, 1978-1 Trade Cas. (CCH) P 62,010 (E.D. Pa. 1978).

See also *Klaus v. Hi-Shear Corp.*, 528 F.2d 225, 232 (9th Cir. 1975) , where the court stated:

"Although, as the district court found, Klaus was misled to his detriment by Hi-Shear's misrepresentations, and so made a cash tender offer for fewer shares than he in fact needed for majority control, the Court decided in *Rondeau* that the Williams Act was designed to protect cash tender offerees, not offerors. The district court issued its ESOT injunction entirely on the basis of harm to Klaus. We see no possibility that Hi-Shear's misrepresentation resulted in any harm to the cash tender offerees, certainly none that could not be compensated by money damages." See *Rondeau*, 422 U.S. at 59-60, 95 S. Ct. at 2076-77. See also *CRTF Corp. v. Federated Dep't Stores, Inc.* 683 F. Supp. 422 (S.D.N.Y. 1988) and *R.H. Macy & Co., Inc. v. Campeau Corp.*, C.C.H. Fed. Sec. L. Rep. P 93,711 (S.D.N.Y. 1988).

(n175)Footnote 175. See *OKC Corp. v. Williams*, 461 F. Supp. 540 (N.D. Tex. 1978) , where the plaintiff sued the Commission and some of its employees under Section 14(e) for allegedly advising a third party not to make a tender offer for the plaintiffs' stock. According to Section (3)(c):

"No provision of this title shall apply to, or be deemed to include, any executive department or independent establishment of the United States or any lending agency which is wholly owned, directly or indirectly, by the United States, or any officer, agent, or employee of any such department, establishment, or agency, acting in the course of his official duty as such, unless such provision makes specific reference to such department, establishment, or agency."

The court stated:

"All of the individual defendants are officers and employees of the Commission who are being sued for actions taken in the course of their official duties. The mere fact that OKC alleges that these defendants violated the law does not remove them from the protection of Section 3(c). OKC's claim

under Section 14(e) of the Securities Exchange Act is therefore dismissed for failure to state a claim."
OKC Corp. v. Williams, 461 F. Supp. 540, 549 .

(n176)Footnote 176. Instead of proving a material misstatement or omission, a plaintiff may allege the existence of a manipulative, deceptive, or fraudulent act or practice. However, the grounds for such a complaint are very limited.

Although a tender offeror that controlled the target company may have had a duty to disclose a favorable fourth quarter report of the target company, the tender offeror, although an insider, had no duty to wait for the market's reaction to the report before making its tender offer. *Billard v. Rockwell Int'l Corp.*, 526 F. Supp. 218 , C.C.H. Fed. Sec. L. Rep. P 98,358 (S.D.N.Y. 1981).

See also *Fin. Fed'n, Inc. v. Ashkenazy*, 1983 U.S. Dist. LEXIS 17044 (C.D. Cal. 1983) .

(n177)Footnote 177. See *supra* § 5.05.

(n178)Footnote 178. *TSC Indus., Inc. v. Northway Inc.*, 426 U.S. 438, 96 S. Ct. 2126, 48 L. Ed.2d 757 (1976) .

(n179)Footnote 179. *Id.* at 449, 96 S. Ct. at 2132, 48 L. Ed.2d at 766 .

See *supra* § 7.09[5][f][i] for discussion of *TSC Industries, Inc.* in the context of proxy regulation.

(n180)Footnote 180. *Flynn v. Bass Bros. Enter., Inc.*, C.C.H. Fed. Sec. L. Rep. P 96,611 (E.D. Pa. 1978).

Prior to changes made by the Commission in 1976, although there was a duty to disclose any material fact in connection with a tender offer, as a matter of public policy the inclusion of appraised asset valuations, projections and other "soft information" was not generally required. It was felt that these appraisals lacked a sufficient degree of reliability to merit disclosure. Since 1976 however, the Commission has begun to change its attitude with respect to "forward looking" statements. To give full effect to the changing disclosure laws, the Court of Appeals for the Third Circuit held in *Flynn v. Bass Brothers Enterprises, Inc.*, C.C.H. Fed. Sec. L. Rep. P 91,674 (3d.Cir. 1984), that from now on soft information such as asset appraisals must be disclosed with the tender offer in appropriate cases. In ascertaining the duty to disclose, the court must balance the potential aid the information will give shareholders against the potential harm due to unwarranted reliance. Factors that must be considered in making such a determination include:

- (1) the facts on which the information was based;
- (2) the qualification of the experts who prepared the information;
- (3) the purpose for which the information was originally intended;
- (4) the relevance of the information to the stockholders' impending decision;
- (5) the degree of subjectivity or bias reflected in the information's preparation;
- (6) the degree of uniqueness; and
- (7) the availability to the investor of other more reliable sources of information.

In this case, the court discussed the significant developments in disclosure laws since 1976 and decided not to apply

the announced standards retroactively. Evaluating the defendant's conduct by the standards prevailing in 1976, the court determined that the plaintiff failed to demonstrate that the asset evaluations and other reports about the target company were sufficiently material to require their disclosure. Projections were officially linked with *Flynn's* category of "soft information" in *Hoffman Elec., Inc. v. Emerson Elec. Co.*, 754 F. Supp. 1070 (W.D. Pa. 1991) .

While other jurisdictions have followed the Court of Appeals for the Third Circuit's lead in holding that non-disclosure of projections and appraisals can lead to liability, they have differed in their respective approaches to determine whether projections and appraisals are sufficiently material and reliable to be included in the duty to disclose. Note that it has been held in this context that "unreliable information may be held to be immaterial as a matter of law." See *Garcia v. Cordova*, 930 F.2d 826 (10th Cir. 1991) . The Court of Appeals for the Sixth Circuit, for instance, has held in *Radol v. Thomas*, C.C.H. Fed. Sec. L. Rep. P 92,289 (6th Cir. 1985), in which the court held that the test for materiality of an asset appraisal is not merely whether it is *conceivable* that a reasonable shareholder would have deemed it significant but whether there is a substantial *likelihood* that under all the circumstances the appraisal would have assumed actual significance in the deliberations of a reasonable shareholder.

See also a companion case, *Starkman v. Marathon Oil Co.*, C.C.H. Fed. Sec. L. Rep. P 92,290 (6th Cir. 1985) (a tender offer target must disclose projections and asset appraisals based upon predictions regarding future economic and corporate events only if the predictions underlying the appraisal or projection are substantially certain to hold).

See also *Biechele v. Cedar Point, Inc.*, C.C.H. Fed. Sec. L. Rep. P 91,829 (6th Cir. 1984), where the Court of Appeals for the Sixth Circuit held that the target of a tender offer was not required to disclose a financial analyst's report on the target prepared fifteen months prior to the tender offer that was used as a "selling document" to induce other bidders to make offers for the target's stock, since the report's financial projections and speculative assumptions were mere predictions of future business success. The Court of Appeals for the Fourth Circuit has held, by contrast, that projections, both in the context of omissions as well as misrepresentations, are not considered material absent an association with a specific "guarantee," or unless they legally constitute fraud. See *Hillson v. Adage, Inc.*, 42 F.3d 204 (4th Cir. 1994) (financial forecast not actionable, as it was neither a guarantee nor "fraud on the market"); *Kas v. First Uniform Corp.*, 857 F. Supp. 481 (E.D. Va. 1994) (projections, unless expressed as guarantees, are "generally not actionable"). The Second Circuit appears as though it may agree. See *e.g.*, *Heil v. Lebow* [1994-1995] Fed. Sec. L. Rep. (CCH) P 98,465 (S.D.N.Y. 1994), *aff'd* 1995 U.S. App. LEXIS 39921 (2d Cir. 1995) ("Statements of opinion that express no guarantee do not support a cause of action under federal securities laws.").

For a more context specific holding, see *SEC v. Tex. Int'l Co.*, 498 F. Supp. 1231 , C.C.H. Fed. Sec. L. Rep. P 97,883 (N.D. Ill. 1980), where the court held that a tender offeror bidding for the stock of a company undergoing bankruptcy reorganization need not disclose the:

- (1) sellers' "ask" prices for the target company's stock, in addition to buyers' "bid" prices, since a shareholder need only be told the price he probably would receive in the current market for his stock and "bid" prices are a more accurate reflection of the current market for the stock;
- (2) Commission valuations of the target company as a going concern, since the valuation set by the reorganization court had been disclosed and the Commission valuation had been rejected or discredited by the reorganization court; and
- (3) speculations on the potential effects of outcomes of pending legal proceedings on the tender offer plan, since the defendants could not have perceived a "reasonable likelihood" that the proceedings would be decided one way or another and the speculations could have confused or misled the shareholders.

The court, however, also held that all aspects of any disparity in treatment between two classes of shareholders

included in a tender offer should be disclosed since the disparity is generally of great importance to the disfavored shareholders. See *SEC v. Tex. Int'l Co.*, 498 F. Supp. at 1250-51, C.C.H. Fed. Sec. L. Rep. at pp. 90,471-72.

For a detailed discussion of the law of disclosure in the realm of forward looking information, projections, appraisals and the like, see generally James Robert Brown, *The Regulation of Corporate Disclosure*, § 6 (Aspen Publishers, third ed. 1998) (Supplemented 2002).

(n181)Footnote 181. *Elec. Specialty Co. v. Int'l Controls Corp.*, 409 F.2d 937, 948 (2d Cir. 1969) . See also *Mo. Portland Cement, Inc., v. Cargill, Inc.*, 498 F.2d 851, 872-73 (2d Cir.) , cert. denied, 419 U.S. 883 (1974) , where Judge Friendly stated that:

"Cargill complained also that MP was guilty of misrepresentation when it cautioned shareholders that if they sold their shares or tendered them to Cargill during the term of the offer, they would lose the 25% stock distributions to shareholders of record on February 7, 1974. It argues that the value of the distribution lay in the declaration of the usual 40cent(s) dividend on the increased number of shares which, as a practical matter, was no different than a 25% increase in the dividend, and that the effect of this action would be reflected in appreciation of the market price, which indeed occurred after the announcement. However, MP's statement was literally true and here again we are not disposed to require parties to a tender fight to conform to standards of sterilization that might be appropriate in other contexts." See *Elec. Specialty Co. v. Int'l Controls Corp.*, 409 F.2d 937, 948 (2d Cir. 1969) .

(n182)Footnote 182. *Blanchette v. Providence & Worcester Co.*, 428 F. Supp. 347, 354 (D. Del. 1977) .

(n183)Footnote 183. See *Broder v. Dane*, 384 F. Supp. 1312, 1318 (S.D.N.Y. 1974) , where the court placed "a heavier burden of disclosure and fair dealing upon a corporation and its insiders" who were making a tender offer for their own stock.

(n184)Footnote 184. *Valente v. Pepsico, Inc.*, 454 F. Supp. 1228, 1243 (D. Del. 1978) . The court quoted the following statement from *Arber v. Essex Wire Corp.*, 490 F.2d 414, 420 (6th Cir.) , cert. denied, 419 U.S. 830, 95 S. Ct. 53, 42 L. Ed.2d 56 (1974) , a Rule 10b-5 case:

"We hold that an insider has no affirmative duty to direct a seller's attention to all routine data commonly found in the statements and books of the corporation, at least where the information is readily available; the outsider has knowledge that it is available and made no inquiry; and the information thus available is not of an unusual or extraordinary nature."

However, Item 9 of Schedule 14D-1 requires the bidder to reveal material financial data about itself. It is not likely that the materiality standard under Item 9 is dependent upon whether the financial data is on the public record.

But see *Fisher v. Plessey Co., Ltd.* 559 F. Supp. 442 ; C.C.H. Fed. Sec. L. Rep. P 99,129 (S.D.N.Y. 1983) (a foreign issuer making a tender offer for the convertible debentures of its wholly-owned United States subsidiary was not relieved of its disclosure duty to American debenture holders simply because its corporate earnings and activities were widely reported in the foreign press; in the absence of any substantial press coverage of the tender offeror's activities in the United States, it could not be presumed that the debenture holders reasonably should have known the information from sources other than the tender offer materials).

(n185)Footnote 185. *Flynn v. Bass Bros. Enter., Inc* C.C.H. Fed.Sec. L. Rep. P 96,611 (E.D. Pa. 1978).

(n186)Footnote 186. *Id.* at P 94,631.

(n187)Footnote 187. *Emhart Corp. v. USM Corp.*, 403 F. Supp. 660 (D. Mass.), later proceeding 1975-2 Trade Cas. (CCH) 60598, 527 F.2d 177 (1st Cir. 1977)..

(n188)Footnote 188. *Id.* at 663

(n189)Footnote 189. *Weeks Dredging & Contracting, Inc. v. Am. Dredging Co.*, 451 F. Supp. 468, 1978-1 Trade Cas. (CCH) P62010 (E.D. Pa. 1978) . In part, the court used the large difference between the stock's asset value of (\$150) and its previous market value (\$19-28) to justify its result.

(n190)Footnote 190. *Valente v. Pepsico, Inc.*, 454 F. Supp. 1228, 1240 (D. Del. 1978) .

"Furthermore, the wording of the tender materials is actually misleading to a reasonable shareholder. Taken alone, the statement that PepsiCo intended to merge Wilson into itself, at which time the remaining holders of common shares would receive \$17.50 per share, would lead a reasonable shareholder to infer wrongly that the only two alternatives open to him were to tender his shares for \$17.50 per share, or to receive the same amount at the time of the merger. In other words, the shareholder appeared to be faced with the choice of '\$17.50 now or \$17.50 later.' It was necessary to disclose the existence of a third alternative, the possibility of appraisal, in order to make the statements made in the tender materials not misleading.

The omitted alternative, an appraisal proceeding, is one which would be of importance to most reasonable shareholders. It is the only alternative which gave shareholders any chance to receive a price greater than the \$17.50 which PepsiCo offered. This alternative would be of considerable importance in the decision of any shareholder who believed, rightly or wrongly, that his shares were worth more than \$17.50. The Court finds that reasonable minds could not differ on the conclusion that, under the circumstances of this case, a reasonable shareholder would consider the appraisal alternative important in deciding whether or not to tender his shares." (footnotes omitted).

See also *Boyertown Burial v. Amedco, Inc.*, 407 F. Supp. 811 (E.D. Pa. 1976) which held that the bidder made insufficient reference to the appraisal rights of the target's shareholders.

(n191)Footnote 191. *Gulf & W. Indus, Inc. v. Great Atl. & Pac. Tea Co.*, 356 F. Supp. 1066, 1071 (S.D.N.Y.) , *aff'd* 476 F.2d 687 (2d Cir. 1973) , where the court noted that:

"It is true that the press release does not set forth the basis on which the management of A & P found that the tender offer price was "inadequate". Contrary to the G & W claim, however, I do not find that this constitutes a false and misleading statement or an omission to state a material fact so as to make the statement false and misleading within the meaning of the Securities Exchange Act of 1934. The term inadequate when used in connection with the price of a stock is a highly subjective one. The price of a stock in the general market is controlled not only by the price-earnings ratios and other such mathematical formulae, but by the intuition or hunch of the buyers and sellers of the stock. Once this element of pricing is exposed it follows necessarily that the adequacy or inadequacy of price is subjective.

In any event, the basis for the opinion of the claimed inadequacy of the tender offer price was spelled out by the management of A & P in its letter to shareholders of February 3, 1973, and released to the press on that day. Accordingly, I find no equity to support G & W's assertion that it is entitled to equitable relief on the basis of the A & P press release of February 2, 1973."

But see *Royal Indus., Inc. v. Monogram Indus., Inc.*, C.C.H. Fed. Sec. L. Rep. P 95,863 (C.D. Cal. 1976), holding

that management has a fiduciary duty to treat its shareholders fairly, and thus, violates Section 14(e) by calling an offer "inadequate" without a reasonable basis. In light of the Supreme Court's rejection of reading corporate law standards into securities law antifraud cases in *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) and its belief in not giving an advantage to either the management or the tender offeror, see *Piper v. Chris-Craft*, 430 U.S. 1, 29, 97 S. Ct. 926, 51 L. Ed.2d 124 (1977), it is not likely that a "fiduciary duty" standard of disclosure for the target company's management would now be accepted by the federal courts.

(n192)Footnote 192. *Emhart Corp. v. USM Corp.*, 403 F. Supp. 660. (Management stated that the offer of \$23 per share was "quite inadequate" and an attempt to gain control over USM at "bargain-basement prices." The court held that these statements were made materially misleading by USM's failure to state that several months before the offer they authorized their representatives to negotiate a friendly sale of USM stock at \$25 per share).

Berman v. Gerber Prod., Co., 454 F. Supp. 1310 (W.D. Mich. 1978) (holding that where the management attacked the offer on grounds other than the adequacy of its price, it had no obligation to disclose information that tended to confirm the adequacy of the offering price).

(n193)Footnote 193. For further information on this topic, see the discussion of Schedule 14D-1 in § 7A.03[2][a].

(n194)Footnote 194. *Elec. Specialty Co. v. Int'l Controls Corp.*, 409 F.2d 937, 948 (2d Cir. 1969).

(n195)Footnote 195. *Id.*; *Sunshine Mining Corp. v. Great W. United Corp.*, C.C.H. Fed. Sec. L. Rep. P 96,049 (D. Idaho 1977).

(n196)Footnote 196. These are the two items that come up most frequently in litigation and generally are of the greatest concern to the shareholder. Of course, other plans may be material under Section 14(e) and Schedule 14D-1 requires the disclosure of just about all types of plans.

See *Greenfield v. Heublein, Inc.*, C.C.H. Fed. Sec. L. Rep. P 91,642 (3d Cir. 1984), where the Court of Appeals for the Third Circuit held that there was no duty to disclose a preliminary merger agreement since price and structure had not been established and there was no evidence of a mature understanding between negotiating corporations.

See also *Starkman v. Marathon Oil Co.*, C.C.H. Fed. Sec. L. Rep. P 92,290 (6th Cir. 1985) (preliminary merger discussions need not be disclosed; the duty to disclose arises only after an agreement in principle regarding fundamental terms like price and structure has been reached).

(n197)Footnote 197. See *Susquehanna Corp. v. Pan Am. Sulphur Co.*, 423 F.2d 1075, (5th Cir. 1970) (holding that Susquehanna did not violate Section 14(e) by denying the existence of any merger plans or proposals).

(n198)Footnote 198. See *Otis Elevator Co. v. United Tech. Corp.*, 405 F. Supp. 960 (S.D.N.Y. 1975).

(n199)Footnote 199. See *Berman v. Gerber Co., Inc.*, 454 F. Supp. 1310, 1323 (W.D. Mich. 1978), where the court held that:

"The absence of full disclosure pertaining to Anderson, Clayton's management practices would have made it difficult, if not impossible, for Gerber shareholders to reach an informed decision on the proposed tender offer. In its filings and proposed offer, Anderson, Clayton avoided setting forth the facts of the operation in a simple, straight-forward manner. Rather, it sought to camouflage the specific transactions by the continued use of euphemisms, generalizations, and vague, self-serving language that did not enlighten the shareholder about the true nature, scope, and effect of the transactions and of management's involvement therein. Indeed, even the use of the term 'sensitive payment' was deceptive. It was of utmost importance for the Gerber stockholders to be cognizant of the identities of the Anderson, Clayton officials who took part in the foreign payments scheme so that a complete understanding of the

management's integrity could be possible."

(n200)Footnote 200. See *Gulf & W. Indus., Inc. v. Great Atl. & Pac. Tea Co.*, 356 F. Supp. 1066 (S.D.N.Y.) , *aff'd* 476 F. 2d 687 (2d Cir. 1973) ; *Elco Corp. v. Microdot, Inc.*, 360 F. Supp. 741 (D. Del. 1973) . But see *Copperweld Corp. v. Imetal*, 403 F. Supp. 579 (W.D. Pa. 1975) , where the court did not enjoin the offer despite the possibility of an antitrust violation.

(n201)Footnote 201. *Mo. Portland Cement Co. v. Cargill*, 375 F. Supp. 249, 268 (S.D.N.Y. 1973) , where the court stated that:

"Cargill's failure to disclose the possibility of antitrust violations is claimed by Missouri Portland to be a material omission in its Offer to Purchase. The fact that this Court has issued a preliminary injunction against Cargill on the basis of the antitrust issues presented does not mean that we must automatically conclude that Cargill omitted a material fact because it did not state that there was a likelihood of antitrust violations. To hold such would be to impose a hindsight standard that whenever a court concludes that an acquisition violates the antitrust laws, the acquiring company should have included a statement as to the likelihood of antitrust violations in its tender offer statement.

* * * * *

Here, however, it would not have been unreasonable for Cargill's management to have concluded after appropriate inquiry that no substantial antitrust obstacles stood in the way of its acquisition. Therefore, under the circumstances before us, the possibility that the acquisition would result in antitrust violations, a possibility that exists with every merger, need not have been disclosed to Missouri Portland's shareholders."

(n202)Footnote 202. *Missouri Portland Cement Co. v. Cargill, Inc.*, 498 F.2d 851 (2d Cir. 1973) .

(n203)Footnote 203. Section 10(b) provides in relevant part that it is unlawful for any person to use "any manipulative or deceptive device or contrivance" in contravention of Commission rules in connection with the purchase or sale of any security.

(n204)Footnote 204. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 97 S. Ct. 1292, 51 L. Ed.2d 480 (1977) . See *supra* § 5.04 for a further discussion of this case.

(n205)Footnote 205. The Court reached this conclusion by restricting the meaning of the word "manipulative," as follows:

"Manipulation is 'virtually a term of art when used in connection with securities markets.' *Ernst & Ernst*, 425 U.S. at 199, 96 S. Ct., at 1384 . The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity... No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices. But we do not think it would have chosen this term of art if it had meant to bring within the scope of Section 10(b) instances of corporate mismanagement such as this, in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary."

Id. at 476-77, 97 S. Ct. at 1302, 51 L. Ed.2d at 493-94.

See also *Feldbaum v. Avon Prod., Inc.*, C.C.H. Fed. Sec. L. Rep. P 91,637 (8th Cir. 1984), where the court held that since there were no allegations of deception in the granting of a lockout option or in the disclosure of the option to shareholders, there was no manipulative device in violation of Section 14(e).

See also *Schreiber v. Burlington N., Inc.*, C.C.H. Fed. Sec. L. Rep. P 91,407 (3d Cir. 1984), where the Court of Appeals for the Third Circuit held that since the Williams Act prohibition against manipulative acts requires some form of deception, such as the omission or misstatement of material facts, the alleged harm suffered as a result of the withdrawal of a tender offer did not violate Section 14(e) since the bidder fully disclosed to the shareholders and general public the acts that allegedly constituted a breach of contract. The failure of a tender offeror that controlled the target company to await the market's reaction to a favorable fourth quarter report of the target company before announcing the tender offer was not a manipulative or deceptive device in violation of Section 14(e). *Billard v. Rockwell Int'l Corp.*, 526 F. Supp. 218, C.C.H. Fed. Sec. L. Rep. P 98,733 (2d Cir. 1982). But see *Atchley v. Qonaar Corp.*, 704 F.2d 355, C.C.H. Fed. Sec. L. Rep. P 99,155 (7th Cir. 1983) (allegation that tender offeror's failure to disclose a scheme to depress the target company's earnings and thereby acquire the target's stock at a reduced price stated a claim under Section 14(e) since the omissions were material to a reasonable person's decision to tender his stock pursuant to the offer (the plaintiffs' complaint was not based solely on a breach of fiduciary duties or corporate mismanagement)).

See *Mobil Corp. v. Marathon Oil Co.*, C.C.H. Fed. Sec. L. Rep. P 98,399 (6th Cir. 1981), where the court defined "manipulation" to mean "an affecting of the market for, or price of, securities by *artificial* means, *i.e.*, means unrelated to the natural forces of supply or demand." *Id.* at p. 92,400. The court held that a "lock-up" option in which a target company granted a white knight an option to purchase a unique and significant asset *i.e.*, an interest in an oil and mineral field referred to by the target as its "crown jewel", which could be exercised only if the white knight did not succeed and a third party gained control of the target company, was a violation of Section 14(e) since the stock option was large enough to serve as an artificial and significant deterrent to competitive bidding for the target company and the bid by the white knight therefore amounted to an artificial ceiling on the value the target company's shareholders could receive for their shares. *Id.* at 92,402-05.

But see *Biechele v. Cedar Point, Inc.*, C.C.H. Fed. Sec. L. Rep. P 91,829 (6th Cir. 1984), where the Court of Appeals for the Sixth Circuit distinguished its holding in *Mobil* and held that an "add-on" agreement between a tender offeror and a third party that required the tender offeror to make certain payments to the third party if its offering price exceeded a given figure was not a "manipulative device," since:

- (1) there was no "auction for control" of the target as there was in *Mobil*;
- (2) there was only one bidder, and so the agreement did not have the effect of discouraging any other prospective bidder from entering the market;
- (3) the bidder was not seeking control of the target, its offer being for only 15% of the target's shares; and
- (4) the agreement did not affect the price a third person might be willing to offer for the remaining target stock.

The court also declined to find a "standstill agreement" between the tender offeror and the target to be a manipulative device since:

- (1) the agreement provided no fixed price for future purchases of target stock by the offeror;
- (2) the agreement granted no options to the offeror to purchase target assets or stock;

(3) there were no competing bidders; and

(4) the terms of the agreement would not discourage third party competitive bidders.

See also Radol v. Thomas, C.C.H. Fed. Sec. L. Rep. P 92,289 (6th Cir. 1985), where the court declined to find that a two-tier price structure of a tender offer that was to be followed by a proposed merger, with a disparity in consideration offered to encourage shareholders to tender their shares at the first stage of the transaction, was a manipulative device in connection with the tender offer in the absence of any allegation by the plaintiff of misrepresentation or nondisclosure.

See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, C.C.H. Fed. Sec. L. Rep. P 92,077 (Del. Sup. Ct. 1985) , where in an action brought under Delaware law, the Delaware Supreme Court held that a target company's selective counter offer to purchase its own shares, made for the purpose of defeating a hostile tender offer, which excluded shares held by the hostile tender offeror, was a valid exercise of sound business judgment by the target's board of directors, since the counter offer was made in good faith and after reasonable investigation, which led the directors to conclude that the tender offer was both inadequate and coercive.

See also Data Probe Acquisition Corp. v. Datatab, Inc., 721 F.2d 1 , C.C.H. Fed. Sec. L. Rep. P 99,569 (2d Cir. 1983), where the court held that a "lock-out" option granted by a target company to a bidder while a rival bidder was still active was not a manipulative device in violation of Section 14(e). Absent misrepresentation, an alleged breach of management's fiduciary duty by depriving shareholders of a favorable financial opportunity during a tender offer is not a manipulative act in violation of Section 14(e).

See also Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623, C.C.H. Fed. Sec. L. Rep. P 99,191 (D. Md. 1982) , where the court held that a target company's "scorched earth" and "pac-man" counter tender offer designed to inhibit the original tender offeror was not manipulative in violation of Section 14(e) absent misrepresentations or nondisclosures made in connection with the counter offer although the counter offer divested the original tender offeror of any financial benefits from its offer and aborted its attempt to translate a completed tender offer into a successful takeover; the court emphasized that Section 14(e) is solely concerned with disclosure.

See also Whittaker Corp. v. Edgar, 1982-1 Trade Cas. (CCH) 64608, 535 F. Supp. 933 , C.C.H. Fed. Sec. L. Rep. P 98,483 (N.D. Ill.), *aff'd*, 14 B.N.A. Sec. Reg. & L. Rep. 794 (7th Cir. 1982) (target company's sale of a substantial asset, i.e., a subsidiary that accounted for one-third of the target's after-tax earnings, which would cause a hostile tender offeror to withdraw its tender offer, was not a manipulative act in violation of Section 14(e) since the sale did not create an artificial price ceiling the tender offer market for the target's shares).

(n206)Footnote 206. *Altman v. Knight*, 431 F. Supp. 309 (S.D.N.Y. 1977) . *Cf. Vernon J. Rockler & Co. v. Minneapolis Shareholders Co.*, 425 F. Supp. 145 (D. Minn. 1977) .

(n207)Footnote 207. *Cf. Nw. Indus., Inc. v. B.F. Goodrich Co.*, 301 F. Supp. 706 (N.D. Ill. 1969) (holding that a target corporation issuing a substantial block of stock for a proper corporate purpose does not violate Section 14(e) even if the effect is to thwart the tender offer.

See Royal Indus., Inc. v. Monogram Industries, Inc., C.C.H. Fed. Sec. L. Rep. P 95,863 (C.D. Cal. 1976), where the court, prior to the ruling in *Santa Fe*, held that a target company violates Section 14(e) by making an acquisition for the primary purpose of defeating a tender offer. *See also Applied Digital Data Systems, Inc. v. Milgo Elec. Corp.*, 425 F. Supp. 1145 (S.D.N.Y. 1977) .

(n208)Footnote 208. *Berman v. Gerber Prod. Co.*, 454 F. Supp. 1310, 1318 (W.D. Mich. 1978) . *See also A & K R.R. Materials, Inc. v. Green Bay & W.R. Co.* 437 F. Supp. 636 (E.D. Wis. 1977) (holding that it is not manipulative or

deceptive for the target company to refuse to allow the bidder to inspect its shareholder list).

(n209)Footnote 209. The rule provides for 60 days for tender offers involving a roll-up as defined in Item 901(c) of Regulation S-K and if the offered securities are registered on Form S-4 or Form F-4.

(n210)Footnote 210. A bidder electing to offer a subsequent offering period under Rule 14d-11 may, however, pay for securities during the subsequent offering period in accordance with that Rule.

(n211)Footnote 211. See *Raybestos-Manhattan, Inc. v. Hi-Shear Indus., Inc.*, 503 F. Supp. 1122, C.C.H. Fed. Sec. L. Rep. P 97,806 (E.D.N.Y. 1980), where the defendant was held not to have violated Rule 14e-1 when the offer had been open for less than twenty business days due to injunctive orders requested by the plaintiff rather than because of conditions placed on the offer by the defendant.

(n212)Footnote 212. See *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F. 2d 1, C.C.H. Fed. Sec. L. Rep. P 99,569 (2d Cir. 1983), where the court held that disclosure of objective, non-misleading factual material in a letter sent by target company management to shareholders regarding rejection of a tender offer fulfilled Rule 14e-2 requirements. Failure to state that management favored an alternative offer on the basis of employment guarantees were not misleading since the employment guarantees had been disclosed through reference to the merger agreement.

Rule 14d-9 governs the sending of this recommendation. See *supra* § 7A.03[2][b].

See also *Newell Co. v. Vt. Am. Corp.*, C.C.H. Fed. Sec. L. Rep. P 94,870 (N.D. Ill. 1989), where the federal district court had pendent jurisdiction of certain state law claims alleging breach of fiduciary duty by a board of directors that had taken several steps to defend against an anticipated tender offer. Various Williams Act claims were also made in the case including a claim of an alleged violation of Rule 14e-2. The court found that the board of directors, with reasonable grounds to anticipate a takeover of the target, had justifiably undertaken various defensive tactics including (1) a stock repurchase program, (2) the structuring of a "friendly" merger, and (3) the amendment of the target's shareholder rights plan.

See also *Endervelt v. Nostalgia Network, Inc.*, C.C.H. Fed. Sec. L. Rep. P 96,249 (Del. Chan. Ct. 1991) (acceptance by board chairman and another director of an offer to buy their stock addressed exclusively to executive officers and directors did not breach their fiduciary duty to shareholders, nor did the offer raise a *Revlon* auction duty).

See *Wheelabrator Tech. Inc. Shareholder Litig.*, C.C.H. Fed. Sec. L. Rep. P 95,489 (Del. Chan. Ct. 1990). (nothing that shareholder ratification of a merger would be a complete defense to a charge that the directors who approved the merger failed to discharge their *Revlon* duty to obtain the best possible transaction).

(n213)Footnote 213. Exchange Act Release No. 17120, C.C.H. Fed. Sec. L. Rep. P 82,646 (1980).

Rule 14e-3 is prospective only and should not be given retroactive effect. See *Moss v. Morgan Stanley, Inc.*, 553 F. Supp. 1347, C.C.H. Fed. Sec. L. Rep. P 99,045 (S.D.N.Y. 1983).

See *Litton Indus., Inc. v. Lehman Bros. Kuhn Loeb Inc.*, C.C.H. Fed. Sec. L. Rep. P 94,345 (S.D.N.Y. 1989) (tender offeror lacks a right of action under Rule 14e-3).

A Study of the Office of the Chief Economist on Pre-bid Activity, 19 B.N.A. Sec. Reg. & L. Rep. 371 (1987), after analyzing a study of 172 successful tender offers between 1981 and 1985, concluded that pre-bid activity is not necessarily an accurate indicator of insider trading. The study points to three factors--media speculation, a bidder's foothold in the target company, and whether the bid is friendly or hostile--as influencing pre-bid activity. However, the study does concede the need for further research on the sources of information about prospective takeovers to determine the ultimate source of pre-takeover bid trading in target stocks. It is important to note that the study reflects only the

views of the Office of the Chief Economist. The Commission has expressed no opinion about the study.

(n214)Footnote 214. Rule 14e-3, applies only in the context of tender offers, but the Commission suggest that persons subject to the provisions of Rule 14e-3, particularly broker-dealers, in following "good business judgment and industry standards," should perform acts and implement procedures beyond the minimum standards required by the Rule. *id.*

See also *U. S. v. Chestman*, 903 F.2d 75 , C.C.H. Fed. Sec. L. Rep. No. 95,214 (2.d Cir. 1990), where the Court of Appeals for the Second Circuit casted doubt on the validity of Rule 14e-3 to the extent that the rule effected an implied repeal of the fiduciary duty requirement in the area of tender offer fraud. In *Chestman* the Court of Appeals for the Second Circuit said that a plain reading of Rule 14e-3 could lead to the conclusion that a defendant in violation of Rule 14e-3 could be guilty of a crime even if fraud, deception or manipulation could not be separately proven. Further, the court said that such an interpretation of the rule would render the rule invalid as an improper exercise of the authority granted to the Commission by Congress. Various Supreme Court precedents, e.g. the *Dirks*, *Ernst & Ernst* and *Chiarella*, according to the court, establish that fraud, as a general matter, requires proof of scienter.

In a subsequent rehearing *en banc*, the Court of Appeals for the Second Circuit upheld Rule 14e-3(a), affirming the conviction of a person who traded the target company's securities in a pending tender offer on the basis of material inside information. The court reasoned that even though the rule does not require breach of a fiduciary duty, it does not affect its validity in view of the broad congressional grant of authority to the Commission to regulate behavior in connection with tender offers. However, *Rule 10b-5* convictions were reversed for lack of breach of a fiduciary duty or its functional equivalent. *United States v. Chestman*, C.C.H. Fed. Sec. L. Rep. P 96,259 (2d Cir. 1991).

(n215)Footnote 215. *U. S. v. Chestman*, C.C.H. Fed. Sec. L. Rep. P 96,259 (2d Cir. 1991).

The Commission adopted Rule 14e-3, in part, because the Supreme Court, in *Chiarella v. U.S.*, 445 U.S. 222, 100 S. Ct. 1108, 63 L. Ed.2d 348 , C.C.H. Fed. Sec. L. Rep. P 97,309 (1980), discussed in § 5.04 *supra*, did not decide whether trading while in possession of material nonpublic information that had been misappropriated or obtained or used by unlawful means is violative of Section 10(b) and *Rule 10b-5*. While the Commission believes that this trading may violate *Rule 10b-5*, no inference should be drawn from the adoption of Rule 14e-3 as to the applicability of Section 10(b) and *Rule 10b-5* to this type of trading. Tender Offers Exchange Act Release No. 17120, 20 SEC Docket 1241 (Sept. 4, 1980).

(n216)Footnote 216. The Commission believes that a substantial step or steps to commence a tender offer occurs upon:

- (1) the voting on a resolution by the offering person's board of directors concerning the tender offer;
- (2) the formulation by the offering person, or the person or persons acting on behalf of the offering person, of a plan or proposal to make a tender offer; or
- (3) the occurrence of those activities that substantially facilitate the tender offer, *e.g.*, arranging financing, preparing or directing tender offer materials, or authorizing negotiations, negotiating or entering into agreements with any person to act as a dealer manager, soliciting dealer, forwarding agent or depository in connection with the tender offer. Release No. 34-17120, 20 SEC Docket 1241 (Sept. 4, 1980).

See *SEC v. Gaspar*, C.C.H. Fed. Sec. L. Rep. P 92,004 (S.D.N.Y. 1985), where the court held that Section 14(e) was applicable to disclosures of non-public information concerning negotiations to take over an oil company even though the negotiations did not proceed to an actual tender offer, if any person has taken a "substantial step" toward making a

tender offer. The court observed that the negotiation stage of a tender offer, prior to the time that a public announcement is made, "is precisely the period of time when insider trading problems arise in the tender offer context...."

See also SEC v. Musella, C.C.H. Fed. Sec. L. Rep. P 99,637 (S.D.N.Y. 1984) (the Commission established a prima facie case under Section 14(e) and Rule 14e-3 where there was trading on the basis of material, nonpublic, misappropriated information by tippees who knew or should have known that the information was improperly obtained and substantial steps had been taken towards commencing tender offers).

See Etshokin v. Texasgulf, Inc., 612 F. Supp. 1220, C.C.H. Fed. Sec. L. Rep. P 92,474 (N.D. Ill. 1985) , where the court held that a party to tender offer negotiations was not obliged under Rule 14e-3 to disclose insider information it possessed with respect to the value of certain assets of the target if the information was not material and would not affect the price of the target's stock.

(n217)Footnote 217. The term "acquired" includes information received as well as information obtained by conversion, misappropriation, and other means.

Rule 14e-3(a) applies prior to the commencement of a tender offer as well as after an offer has commenced. Tender Offers, Exchange Act Release No. 17120, 20 SEC Docket 1241 (Sept. 4, 1980).

(n218)Footnote 218. Under the rule, trading is proscribed only in those securities whose market value has a relationship to the security sought or to be sought in the tender offer. *Id.* note 39.

(n219)Footnote 219. This "disclose or abstain" rule is similar to the approach taken in *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976, 89 S. Ct. 1454, 22 L. Ed. 2d 756 (1969), and in the Commission's administrative decision in *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961) , and was cited with approval by the Supreme Court in *Chiarella*, 445 U.S. at 226-30, C.C.H. Fed. Sec. L. Rep. at P 97,099-100. Exchange Act Release No. 17120, C.C.H. Fed. Sec. L. Rep. P 82,646 (1980).

(n220)Footnote 220. Tender Offers, Exchange Act Release No. 17120, 20 SEC Docket 1241 (Sept. 4, 1980).

The Commission does not believe that disclosure prior to trading would justify a breach of a contractual or fiduciary relationship with the offering person or issuer. If either type of relationship exists there may be no other alternative other than abstention from trading that will be both lawful and not in breach of the relationships. Tender Offers, Exchange Act Release No. 17120, 20 SEC Docket 1241 (Sept. 4, 1980).

Disclosure must be made in manner that will fully disseminate the information, including disclosure to a national securities exchange on which the class of securities sought in the tender offer is listed; to the NASD, if the security is authorized for trading in the NASDAQ interdealer quotation system; and to a daily newspaper with a national circulation or a national news service. *Id.*

(n221)Footnote 221. *Id.*

(n222)Footnote 222. This situation may arise, for example, where one department of a multi-service financial institution received material nonpublic information relating to a tender offer while an independent department of the same financial institution made the decision to purchase or sell without knowledge of that information. *Id.*

(n223)Footnote 223. The policies and procedures that are implemented must be reasonable under the facts and circumstances of the institution and that institution's type of business. Tender Offers, Exchange Act Release No. 17120, 20 SEC Docket 1241 (Sept. 4, 1980).

(n224)Footnote 224. *Id.*

After the financial institution had met the initial burden, a person attempting to establish the nonavailability of the exception may attempt to show circumstances under which it would not be reasonable to assume that the individual decisionmaker did not know the information. *Gulf & W. Indus., Inc. v. Great Atl. & Pac. Tea Co.*, 476 F.2d 687 (2d Cir. 1973) .

(n225)Footnote 225. Whether a violation of Rule 14e-3 was "reasonably foreseeable" depends upon such factors as the identity, position, reputation or prior actions of the participants; however, the Rule is not intended to affect casual and innocently motivated social discourse. *Id.*

(n226)Footnote 226. The rule reaches "intermediate tippees" regardless of whether they trade on the information. *Id.*

(n227)Footnote 227. *Id.*

(n228)Footnote 228. See, e.g., *Whittaker Corp. v. Edgar*, 535 F. Supp. 933, C.C.H. Fed. Sec. L. Rep. P 98,483 (N.D. Ill.), *aff'd*, 14 B.N.A. Sec. Reg. & L. Rep. 794 (7th Cir. 1982) (tender offeror has a private cause of action for injunctive relief under Section 14(e) regarding the target company's disposition of its subsidiary).

(n229)Footnote 229. *Elec. Specialty Corp. v. Int'l Controls Corp.*, 409 F.2d 937, 947 (2d Cir. 1969) .

(n230)Footnote 230. *Mo. Portland Cement Co. v. H.K. Porter Co.* 535 F.2d 388 (8th Cir. 1976) ; *Blanchette v. Providence & Worcester Co.*, 428 F. Supp. 347 (D. Del. 1977) .

See also *Union Commerce Corp. v. Huntington Bancshares, Inc.*, 556 F. Supp. 374, C.C.H. Fed. Sec. L. Rep. P 99,213 (N.D. Ohio 1982) (target company was not entitled to a preliminary injunction against a tender offeror since target was unlikely to prevail on the merits on its claim that Section 14(e) was violated by the tender offer's prorating provisions, when the tender offer complied with the requirements of Section 14(d)(6) by prorating the purchase of shares tendered during the first ten days of the tender offer, but allowed the tender offeror to purchase subsequently tendered shares on a first-come, first-served basis).

(n231)Footnote 231. See, e.g., *Energy Ventures, Inc. v. Appalachian Co.*, 587 F. Supp. 734, C.C.H. Fed. Sec. L. Rep. P 91,556 (D. Del. 1984) , where the court held that irreparable harm had not been shown to justify injunctive relief. See also *Southdown, Inc. v. Moore McCormack Resources, Inc.*, C.C.H. Fed. Sec. L. Rep. P 93,792 (S.D. Tex. 1988) (preliminary injunction granted with respect to a target company's poison pill and proposed recapitalization which, in the view of the court, were being used to insure the incumbency of management).

(n232)Footnote 232. *Rondeau v. Mosinee Paper Co.*, 422 U.S. 49, 95 S. Ct. 2069, 45 L. Ed.2d 12 (1975) . See § 7A.02[3][b][ii] for a more detailed discussion of this case. Prior to the Court's holding in *Rondeau*, the Court of Appeals for the Second Circuit adopted an alternative to the irreparable harm requirement:

"The settled rule is that a preliminary injunction should issue only upon a clear showing of either (1) probable success on the merits *and* possible irreparable injury, *or* (2) sufficiently serious questions going to the merits to make them a fair ground for litigation *and* a balance of hardships tipping decidedly toward the party requesting the preliminary relief."

Sonesta Int'l Hotels Corp. v. Wellington Ass., 483 F.2d 247, 250 (2d Cir. 1973) .

(n233)Footnote 233. See *Florida Commercial Banks v. Culverhouse*, C.C.H. Fed. Sec. L. Rep. P 92,321 (11th Cir. 1985), where the court held that a target company has a private right of action under the Williams Act against a bidder to seek corrective disclosure of the bidder's misstatements on Schedules 13D and Schedule TO distributed to the target's

shareholders. In deciding whether to grant the target company a private cause of action against the bidder, the court balanced the likelihood that shareholders would benefit from the availability of the cause of action to the target against the likelihood that shareholders would be harmed by the misuse of the cause of action by management, and concluded that where the remedy sought was corrective disclosure, there was no chance that shareholders would be harmed by the remedy.

See also *Weeks Dredging & Contracting, Inc. v. Am. Dredging Co.*, 451 F. Supp. 468, 1978-1 Trade Cas. (CCH) P 62010 (E.D. Pa. 1978); *Blanchette v. Providence & Worcester Co.*, 428 F. Supp. 347 (D. Del. 1977) .

(n234)Footnote 234. See *Gearhart Indus., Inc. v. Smith Int'l., Inc.*, C.C.H. Fed. Sec. L. Rep. P 91,667 (5th Cir. 1984), where the court held that the proper remedy for a bidder who violated Section 14(e) by stating in his tender offer materials that he had "meritorious defenses" to a patent suit when in fact he had already admitted patent infringement and only damages remained in contention, was injunctive relief until proper disclosure was made.

See *Schmidt v. Enertec Corp.*, 598 F. Supp. 1528, C.C.H. Fed. Sec. L. Rep. P 91,884 (S.D.N.Y. 1984) , where the court refused to enjoin an offer to exchange debentures for preferred stock, since plaintiff-debentureholders failed to show there was no adequate remedy at law for the alleged injury that would result from continuation of the exchange offer without additional disclosure by the defendants. Declining to adopt a "per se rule," the court required a specific showing of irreparable harm since proof of material omissions or misstatements, standing alone, does not satisfy a plaintiff's burden of proving irrevocable injury.

See also *Corenco Corp. v. Schiavone & Sons, Inc.*, 488 F.2d 207 (2d Cir. 1973) ; *Mo. Portland Cement Co. v. Cargill*, 375 F. Supp. 249, 1974-1 Trade Cas. (CCH) P 75025-75; (2d Cir. 1973) ; *Weeks Dredging & Contracting, Inc. v. Am. Dredging Co.*, 451 F. Supp. 468, 1978-1 Trade Cas. (CCH) P 62010 (E.D. Pa. 1978); *Broder v. Dane*, 384 F. Supp. 1312 (S.D.N.Y. 1974) .

See also *Irving Bank Co. v. Bank of New York Co., Inc.*, C.C.H. Fed. Sec. L. Rep. P 93,786 (S.D.N.Y. 1988) (preliminary injunctive relief appropriate in action by target company to compel additional disclosures by offeror).

See also *American Carriers, Inc. v. Baytree Investors, Inc.*, C.C.H. Fed. Sec. L. Rep. P 94,154 (D. Kan. 1988) (tender offeror enjoined from announcing any tender offers unless prior to such announcement offeror corrects past failure to disclose).

(n235)Footnote 235. See *SEC v. Tex. Int'l Co.*, 498 F. Supp. 1231 , C.C.H. Fed. Sec. L. Rep. P 97,883 (N.D. Ill. 1980) (the defendant's failure to file tender offer materials with the Commission, although violating Section 14(d), did not require the defendant to make a full rescission offer to the target company's former shareholders; noncompliance with the filing and reporting requirements of Section 14(d) does not necessarily result in injury or prejudice to investors when the tender offer materials do not contain any fraudulent misrepresentations or omissions).

See also *Corenco Corp. v. Schiavone & Sons, Inc.*, 488 F.2d 207 (2d Cir. 1973) ; *Broder v. Dane*, 384 F. Supp. 1312 (S.D.N.Y. 1974) ; *Cauble v. White*, 360 F. Supp. 1021 (E.D. La. 1963) .

See *Butler Aviation Int'l, Inc., v. Comprehensive Designers, Inc.*, 425 F.2d 842 (2d Cir. 1970) , where Judge Friendly, after admonishing the district court for not examining whether it could have better protected the rights of the target company's shareholders by allowing them to withdraw their shares, rather than by issuing a preliminary injunction against the exchange offer, reluctantly affirmed its decision because the time remaining on the offer was too short to permit the withdrawal procedure. The court stated that the offeror was free to renew the offer upon proper disclosure.

See *Blanchette v. Providence & Worcester Co.*, 428 F. Supp. 347 (D. Del. 1977) , where the court enjoined an exchange offer because of misleading statements by the offeror where 53% of the target company's stock had already

been acquired. The court did not explain why it did not use the less drastic withdrawal remedy.

(n236)Footnote 236. *Gulf & W. Indus., Inc. v. Great Atl. & Pac. Tea Co., Inc.*, 476 F.2d 687 (2d Cir. 1973) (antitrust violation); *Pargas, Inc. v. Empire Gas Corp.*, 423 F. Supp. 199 (D. Md.) , *aff'd*, 546 F.2d 25 (4th Cir. 1976) (antitrust violation); *Boyertown Burial Casket Co. v. Amedco Co.*, 407 F. Supp. 811 (E.D. Pa. 1976) (antitrust violation); *General Host Co. v. Triumph Am., Inc.*, 359 F. Supp. 749 (S.D.N.Y. 1973) (possible violations of the Shipping Act, the Communications Act, and margin requirements of the Exchange Act.)

(n237)Footnote 237. See *Weeks Dredging & Contracting, Inc., v. Am. Dredging Co.*, 451 F. Supp. 468, 1978-1 Trade Cas. (CCH) P 62010 (E.D. Pa. 1978), where the court ordered the target company to transmit to all its shareholders an explanation of certain statements so as to make them not misleading. In *Emhart Corp. v. USM Corp.*, 403 F. Supp. 660 (D. Mass.) , *later proceeding* 527 F.2d 177 (1st Cir. 1975) , the court found that the target company made misleading statements, but ordered no relief, because the offer had already been enjoined on other grounds. Under such circumstances it was meaningless for the court to order that the misleading statements be corrected.

(n238)Footnote 238. *Boyertown Burial Casket Co. v. Amedco, Inc.*, 407 F. Supp. 811, 813 (E.D. Pa. 1976) , where the court stated that:

"Finally, we turn to the issue of irreparable harm. In this case, we are faced with a proposed acquisition of a company which will have far-ranging consequences should immediate relief not be granted. Briefly spoken, the weight of the evidence establishes irreparable harm in the use of executive time spent in resisting the offer, the effect upon salesmen's performance in the market, the lack of customer confidence in Boyertown's future, the obvious effect upon employee morale and like considerations."

(n239)Footnote 239. *Mo. Portland Cement Co. v. Cargill, Inc.* 498 F.2d 851, 869 (2d Cir.) , *cert. denied*, 419 U.S. 883 (1974) , where the court stated that:

"The argument about disruption of the morale of personnel, which has become standard in take-over cases, has a peculiarly hollow ring in this one. A principal motive for Cargill's desire to enter the cement industry by acquiring an established company was its own lack of know-how and the difficulty of obtaining qualified people; there has been no hurling of pejorative epithets about MP's management and expression of the desire to move in another 'team' such as were present with respect to A & P; see 476 F.2d at 696-697 . Furthermore MP's executives had taken extraordinary precautions to protect themselves. Within a few hours after learning of Cargill's impending offer, the chairman of MP had his board approve a seven-year employment contract at \$118,000 a year; earlier in December the Chairman had signed contracts, similar except for amount, with all the other officers." (footnotes omitted).

See also *Murray Ohio Manufacturing Co. v. AB Electrolux*, C.C.H. Fed. Sec. L. Rep. P 93,776 (M.D. Tenn. 1988) (possible plant closing in Tennessee and shift of production overseas would not support preliminary injunction request).

(n240)Footnote 240. *Davis v. Emerson Ins. Agency*, 423 F. Supp. 561 (D. Neb. 1976) .

(n241)Footnote 241. *SEC v. Wills*, C.C.H. Fed. Sec. L. Rep. P 96,712 (D.D.C. 1978); *SEC v. Stanard*, 2009 U.S. Dist. LEXIS 6068 ; *Fed. Sec. L. Rep. (CCH) P94,053* .

(n242)Footnote 242. See *SEC v. Coven*, 581 F.2d 1020 (2d Cir. 1978) ; *SEC v. Am. Realty Trust*, 586 F.2d 1001 (4th Cir. 1978) ; *SEC v. Savoy Indus., Inc.*, C.C.H. Fed. Sec. L. Rep. P 96,497 (D.D.C. 1978); *SEC v. World Radio Mission*, 544 F.2d 535, 541 n. 10 (1st Cir. 1976) ; *SEC v. Southwest Coal and Energy Co.*, 439 F. Supp. 820 (W.D. La. 1977) .

(n243)Footnote 243. *See, however, SEC v. Tex. Int'l Co.*, 498 F. Supp. 1231, C.C.H. Fed. Sec. L. Rep. P 97,883 (N.D. Ill. 1980), where the court held that Section 14(e) requires the same standard of scienter as applied in Commission injunction actions brought under Section 10(b) *See infra* § 9.03.

But see Caleb & Co. v. E.I. Du Pont de Nemours & Co., 599 F. Supp. 1468, C.C.H. Fed. Sec. L. Rep. P 91,896 (S.D.N.Y. 1984), where the court distinguished between actions brought under Section 14(e) (where proof of scienter is required) and actions under Rule 14e-1(c), and held that proof of scienter was not required to plead a Rule 14e-1(c) violation for failure to meet the obligation of prompt payment. The court stated that the relationship between Section 14(e) and Rule 14e-1(c) (promulgated under Section 14(e)) is not the same as the relationship between Section 10(b) and Rule 10b-5. In the latter case, the Commission, in adopting Rule 10b-5, prohibited fraudulent activity generally, leaving the courts to define what specific practices came within the rule. By contrast, in drafting rules under Section 14(e), the Commission created specific rules and regulations designed to prevent fraud. Therefore Rule 14e-1(c) is an absolute prohibition of certain fraudulent practices, whether scienter was present or not.

(n244)Footnote 244. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed.2d 668 (1976). *See* § 5.

(n245)Footnote 245. The Supreme Court held that the Commission must establish scienter in civil enforcement actions brought under Section 10(b). *Aaron v. SEC*, 446 U.S. 680, 100 S. Ct. 1945, 64 L. Ed.2d 611, C.C.H. Fed. Sec. L. Rep. P 97,511 (1980), discussed in *infra* § 9.03 at ns. 37-46.

See also SEC v. Cenco, 436 F. Supp. 193 (N.D. Ill. 1977); *SEC v Southwest Coal and Energy Co.*, 439 F. Supp. 820 (W.D. La. 1977); *SEC v. Am. Realty Trust*, 429 F. Supp. 1148 (N.D. Va. 1977), *rev'd*, 586 F.2d 1001 (4th Cir. 1978).

(n246)Footnote 246. *See, e.g., Vucinich v. Paine Webber, Jackson & Curtis, Inc.*, 739 F.2d 1434, C.C.H. Fed. Sec. L. Rep. P 91,610 (9th Cir. 1984); *Kennedy v. Tallant*, 710 F.2d 711, C.C.H. Fed. Sec. L. Rep. P 99,428 (11th Cir. 1983).

(n247)Footnote 247. *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), *cert. denied* 414 U.S. 910 (1973). *See also Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 605 (5th Cir.), *cert. denied* 419 U.S. 873 (1974), where the court stated:

"Congress adopted in Section 14(e) the substantive language of the second paragraph of Rule 10b-5 and in so doing accepted the precedential baggage those words have carried over the years."

The court held that under Section 14(e) "some culpability beyond mere negligence is required." *Id.* at 606.

(n248)Footnote 248. *A & K R.R. Materials v. Green Bay & W.R. Co.*, 437 F. Supp. 636, 642 (E.D. Wis. 1977).

(n249)Footnote 249. *See Plaine v. McCabe*, C.C.H. Fed. Sec. L. Rep. P 92,749 (9th Cir. 1986), where the court held that a determination by the California Corporation Commissioner that a tender offer price was in the range of fairness did not preclude recovery of damages by a non-tendering shareholder, since the shareholder may prove injury other than failure to receive a fair price in her Section 14(e) fraud claim, and the measure of damages in a federal action may be different from a damage determination under state law.

See Horowitz v. Pownall, 582 F. Supp. 665, C.C.H. Fed. Sec. L. Rep. P 91,445 (D. Md. 1984), where the court held that a nontendering shareholder filing an action against an opponent of the tender offer must show she was injured as a result of retaining the stock instead of selling it at the premium offered by the tender offeror. The court pointed out that unless the defendant could show that a rise in the stock price was due to its actions, thereby offsetting plaintiff's loss of the tender offeror's premium, the plaintiff could show injury. However, in this case, the price of the stock did not rise to the level of the tender offeror's highest offer until six months after the deal was consummated. Therefore, the nontendering shareholder had a private cause of action under Section 14(e) against the defendant for its failure to

disclose material facts in the Schedule 14D-9 filed in opposition to the tender offer.

(n250)Footnote 250. 430 U.S. 1, 97 S. Ct. 926, 51 L. Ed.2d 124 (1977) . See *supra* § 7A.03[3][a].

(n251)Footnote 251. *Emmi v. First Mfr. Nat'l Bank*, 336 F. Supp. 629 (D. Me. 1971) .

(n252)Footnote 252. See *Valente v. Pepsico, Inc.*, 454 F. Supp. 1228 1246-247 (D. Del. 1978) , where the court refused to dismiss a tender offer claim brought under *Rule 10b-5*:

"In the case of a tender offer, the concept of causation is somewhat complex. A plaintiff must prove not only that a defendant's misstatements or omissions caused shareholders to accept the tender offer ('transaction causation'), but also that the violations caused the injuries of which the plaintiff complains ('loss causation'). (cites omitted). When the tender offer is conducted by a controlling shareholder, and is followed by a merger, the chain of causation becomes even more complex.

* * * * *

Defendants argue that even if it is assumed that shareholders relied on the omissions from the tender materials and that the tender offers would not have succeeded but for the omissions, the plaintiffs still cannot prove a causal connection between the alleged violations and the injuries suffered by the shareholders. This is because PepsiCo could have executed the merger without successful tender offers, or without any tender offers at all, and all minority shareholders would have been forced to surrender their shares at the time of the merger. Defendants argue that when a parent corporation owns enough shares prior to a tender offer to assure approval of a merger with a subsidiary, there can be no showing of a causal relationship, because the tender offer is not an 'essential link in the accomplishment of the transaction.' (cite omitted).

As to the shareholders who elected to accept the tender offer, defendants' argument is faulty. As a result of their acceptance, those shareholders lost at least their right to obtain an appraisal at the time of the subsequent merger. This loss would not have occurred if PepsiCo had executed a merger without prior tender offer." (footnotes omitted).

The court also found it possible that causation might exist with respect to the non-tendering shareholders.

See also *Schreiber v. Burlington Northern, Inc.*, C.C.H. Fed. Sec. L. Rep. P 91,407 (3d Cir. 1984) (bidder's failure to disclose golden parachute benefits offered to target company's executives, and the fact that such benefits persuaded target company's management to approve a second tender offer, were not causally connected to plaintiff-shareholder's injuries that resulted from rescission of an earlier offer).

(n253)Footnote 253. *Affiliated Ute Citizens v. U.S.*, 406 U.S. 128, 92 S. Ct. 1456, 31 L. Ed.2d 741 (1972) .

(n254)Footnote 254. *Zuckerman v. Franz*, 573 F. Supp. 351 , C.C.H. Fed. Sec. L. Rep. P 91,478 (S.D. Fla. 1983); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.) , cert. denied, 414 U.S. 910 (1973) ; *Bertozzi v. King Louie Int'l, Inc.*, 420 F. Supp. 1166 (D.R.I. 1976) ; *Berman v. Gerber Prod. Co.*, 454 F. Supp. 1310 (W.D. Mich. 1978) .

(n255)Footnote 255. *Rifkin v. Crow*, 574 F.2d 256 (5th Cir. 1978) . See *supra* § 5.04.

(n256)Footnote 256. In another case, *Hundahl v. United Benefit Life Insurance Co.*, 465 F. Supp. 1349 , C.C.H. Fed. Sec. L. Rep. P 96,815 (N.D. Tex. 1979), the court held that shareholders, who are not misled by the

misrepresentations of a bidder, and consequently do not tender their shares, cannot maintain a claim that they were injured by a loss of value in their stock following the completion of the offer. The court stated that to permit such a suit would violate the spirit of the Supreme Court's decision in *Piper v. Chris-Craft*. This reasoning is questionable. *Electronic Specialty*, 409 F.2d 937, 943 (2d Cir. 1969), long ago established the right of a non-tendering shareholder to sue a successful bidder for the loss of value in his stock. Denying this right because of a non-tendering shareholder's lack of reliance upon the bidder's misrepresentations overlooks: (1) the purpose of proving reliance, i.e. to establish a causal connection between the defendant's misdeeds and the plaintiff's injury, and (2) that such a connection is present if the injury alleged results from a tender offer owing its success to materially misleading statements. It also seems anomalous to use *Piper v. Chris-Craft*, which stressed that Section 14(e) was enacted for the benefit of the shareholder, to support a holding that greatly restricts the rights of shareholders. See also *Vine v. Beneficial Finance Co.*, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967), where the court held that reliance was not a necessary element under Rule 10b-5 where the plaintiff alleged that as a result of the defendant's fraud, of which he had knowledge, he was forced to sell his stock.

But see *Osofsky v. J. Ray McDermott & Co., Inc.*, 725 F.2d 1057, C.C.H. Fed. Sec. L. Rep. P 99,656 (2d Cir. 1984) (although a reasonable jury could have found that an acquiring company's tender offer contained misleading statements as to the tender prices, the target company's shareholders failed to show reliance on the statements).

(n257)Footnote 257. *Lowenschuss v. Kane*, 520 F.2d 255 (2d Cir. 1975).

(n258)Footnote 258. *Id.* at 269.

(n259)Footnote 259. *Berman v. Gerber Prod., Co.*, 454 F. Supp. 1310 (W.D. Mich. 1978).

(n260)Footnote 260. See also *Panther v. Marshall Field & Co.*, 646 F.2d 271, C.C.H. Fed. Sec. L. Rep. P 97,929 (7th Cir.), cert. denied, 454 U.S. 1092 (1981), where the court held that the shareholders of a target company failed to state a claim under Section 14(e) against the target company and its directors for alleged misrepresentations that:

(1) resulted in the tender offer being withdrawn, denying the plaintiffs the opportunity to tender their shares; and

(2) caused the plaintiffs not to sell their shares in the market, which were rising in value on news of the takeover attempt,

since Section 14(e) does not provide a damages remedy for misrepresentations or omissions if the tender offer is withdrawn before it becomes effective and the shareholders, never having had the opportunity to tender their shares, could not claim reliance on the target management's misstatement.

(n261)Footnote 261. *Berman v. Gerber Prod. Co.*, 454 F. Supp. 1310, 1325 (W.D. Mich. 1978), where the court found no liability on this ground either, since it found that the defendants had not made any material misstatements or omissions.

(n262)Footnote 262. *Petersen v. Federated Dev. Co.*, 387 F. Supp. 355 (S.D.N.Y. 1974).

(n263)Footnote 263. *Wulc v. Gulf & W. Indus., Inc.*, 400 F. Supp. 99 (E.D. Pa. 1975).

(n264)Footnote 264. *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir.), cert. denied, 419 U.S. 873 (1974) (defendant not culpable); *Chris-Craft Indus., Inc. v. Piper Aircraft Corp.*, 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910 (1973); *Broder v. Dane*, 384 F. Supp. 1312 (S.D.N.Y. 1974).

(n265)Footnote 265. But see *SEC v. Wills*, C.C.H. Fed. Sec. L. Rep. P 96,712 (D.D.C. 1978), discussed in §

2-7A Federal Securities Exchange Act of 1934 § 7A.03

7A.03[3][d] (holding that negligence is sufficient in a Section 14(e) action brought by the Commission).

(n266)Footnote 266. *Osofsky v. J. Ray McDermott & Co., Inc.*, 725 F.2d 1057, C.C.H. Fed. Sec. L. Rep. P 99,606 (2d Cir. 1984) (no credible evidence of scienter).

See *Pryor v. U. S. Steel Corp.*, C.C.H. Fed. Sec. L. Rep. P 91,568 (S.D.N.Y. 1984), where the court denied the defendant's motion to dismiss since the facts alleged permitted an inference of knowledge or recklessness just as easily as an inference of negligence.

See also *Chris-Craft Indus., Inc. v. Piper Aircraft Co.*, 480 F.2d 341 (2d Cir.) ; *Cauble v. White*, 360 F. Supp. 1021 (E.D. La. 1973) .

(n267)Footnote 267. See, e.g., *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579 (5th Cir.) , cert. denied, 419 U.S. 873 (1974) ; *Sonesta Int'l Hotels Corp. v. Wellington Ass.*, 483 F.2d 247 (2d Cir. 1973) ; *Valente v. PepsiCo, Inc.*, 454 F. Supp. 1228 (Del. 1978) .

(n268)Footnote 268. See *supra* Chapter 5.

(n269)Footnote 269. See *supra* § 5.05.

(n270)Footnote 270. *Piper v. Chris-Craft*, 430 U.S. 1, 45, 97 S. Ct. at 951, 51 L. Ed. at 155-56.

(n271)Footnote 271. *Crane Co. v. Am. Standard, Inc.*, 439 F. Supp. 945, C.C.H. Fed. Sec. L. Rep. P 96,160, (S.D.N.Y. 1977) .

(n272)Footnote 272. See *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787, C.C.H. Fed. Sec. L. Rep. P 92,532 (2d Cir. 1969) , cert. denied, 400 U.S. 822 (1970) .

Exchange Act, Section 9 is discussed in *supra* § 6.02.

(n273)Footnote 273. Rule 14d-1 *et seq.*

(n274)Footnote 274. Commission Guidance on Mini-Tender Offers and Limited Partnership Tender Offers, Exchange Release No. 34-43069 (July 31, 2000) [IC-24564].

(n275)Footnote 275. Rule 14e-1 *et seq.* See also *Exchange Act Release No. 16384* (Nov. 29, 1979) [44 FR 70326] . Note that the antifraud provisions of Section 10(b) of the Exchange Act and *Rule 10b-5* also apply to all tender offers, including mini-tender offers. 15 U.S.C. 78(j); *Rule 10b-5*.

(n276)Footnote 276. See *supra* § 7A.03.

(n277)Footnote 277. *Id.*

(n278)Footnote 278. *Id.*

(n279)Footnote 279. *Id.*

(n280)Footnote 280. *Id.*

(n281)Footnote 281. *Id.*

(n282)Footnote 282. *Id.*

(n283)Footnote 283. *Id.*

(n284)Footnote 284. Rule 14d-4(b).

(n285)Footnote 285. Commission Guidance on Mini-Tender Offers and Limited Partnership Tender Offers, Exchange Release No. 34-43069 (July 31, 2000) [IC-24564].

(n286)Footnote 286. Section 14(e) of the Exchange Act and Rule 14e-3; Section 10(b) of the Exchange Act and *Rule 10b-5*.

(n287)Footnote 287. Commission Guidance on Mini-Tender Offers and Limited Partnership Tender Offers, Exchange Release No. 34-43069 (July 31, 2000) [IC-24564].

(n288)Footnote 288. *Id.*



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Federal Securities Exchange Act of 1934

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CHAPTER 7A The Williams Act Amendments-- Controlling Shareholders and Tender Offers

2-7A Federal Securities Exchange Act of 1934 § 7A.04

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§ 7A.04 Issuer Repurchases, Issuer Self-Traders, and Section 14(f)

Where the issuer seeks to acquire its own shares, either through a "going private" transaction or an issuer tender offer, the issuer must provide its shareholders with substantially the same information as would be required from an outside bidder. n1

Further, if the issuer's directors will be elected other than at a meeting of security holders as a result of a tender offer, or a transaction in which a person acquires more than five percent of a class of the issuer's equity securities, the security holders must be provided with information substantially equivalent to the information that would be required under the proxy rules.

[1] Issuer Purchases of its own Securities--Section 13(e).

The beneficial ownership disclosure requirements of Section 13(d) do not apply to acquisitions of equity security by the issuer of that security. n2 Furthermore, issuers making tender offers for their own securities are exempt from the provisions of Section 14(d), although they are subject to the antifraud provisions of Section 14(e). n3 Section 13(e)(1) authorizes the Commission to regulate the purchase of any equity security by the issuer of such security, provided the issuer has a class of equity securities registered under Section 12 of the Exchange Act, n4 or is a closed-end investment company registered under the Investment Company Act of 1940. The Commission has the authority to define and prescribe fraudulent, deceptive, or manipulative acts or practices. n5 The Commission may also require the issuer to provide information about its purchase(s) to its equity security holders. Section 13(e)(2) states that:

"[A] purchase by or for the issuer, or any person controlling, controlled by, or under common control with the issuer, or a purchase subject to control of the issuer or any such person, shall be deemed to be a purchase by the issuer."

Rule 13e-1, adopted under Section 13(e), provides that an issuer subject to Section 13(e) may not purchase its own equity securities during the period a tender offer for such securities is open, if it has received notice that it is the subject

of a tender offer made under Section 14(d)(1) of the Exchange Act, n6 unless the issuer files a statement containing the following information with the Commission:

- (1) The title and amount of securities to be purchased, the names of the persons or classes of persons from whom, and the market in which, the securities are to be purchased, including the name of any exchange on which the purchase is to be made;
- (2) The purpose for which the purchase is to be made and whether the securities are to be retired, held in the treasury of the issuer or otherwise disposed of, indicating such disposition; and
- (3) The source and amount of funds or other consideration used or to be used in making the purchases, and if any part of the purchase price or proposed purchase price is represented by funds or other consideration borrowed or otherwise obtained for the purpose of acquiring, holding, or trading the securities, a description of the transaction and the names of the parties thereto;

[a] Going Private Transactions--Rule 13e-3 and Schedule 13E-3. In 1979, the Commission adopted Rule 13e-3 and Schedule 13E-3 to govern going private transactions by issuers of equity securities and their affiliates. n7 Rule 13e-3 and Schedule 13E-3 contain definitions, specific disclosure and dissemination requirements, and particular antifraud provisions with respect to going private transactions. Primarily, the rule focuses on the fairness of the transaction concerning shareholders who are not directly affiliated with the issuer. n8

The application of Rule 13e-3 depends upon three factors: (1) whether the transaction is included within the definition of a Rule 13e-3 transaction; n9 (2) whether an exception from the application of Rule 13e-3 is available; n10 and (3) when no exception is available, whether the equity securities that are the subject of the Rule 13e-3 transaction are of a class that is registered pursuant to Section 12 of the Exchange Act or of a class of an issuer that is required to file periodic reports pursuant to Section 15(d) of the Exchange Act. n11

A "Rule 13e-3 transaction" is defined as any transaction or series of transactions that involve one or more specified transactions n12 that has either a reasonable likelihood or purpose of producing, directly or indirectly, any specified effects. n13 Although these "tests" operate as alternative standards, both may be satisfied in particular instances. However, the "reasonable likelihood" test focuses on the *circumstances* of the issuer or its affiliate(s), while the "purpose" test concentrates on the *reasons* for the transaction (*i.e.*, is the transaction designed to produce a specific result).

Although a Rule 13e-3 transaction or series of transactions may be involved, an exception to the rule may be available. The first exception applies to particular transactions by or on behalf of a person, that occur within one year of the date of termination of a tender offer, in which such person was the bidder and became an affiliate of the issuer as a result of the tender offer, provided that the equal consideration, disclosure, and other requirements of the section are met. n14 The second exception applies to transactions that, among other things, offer an equity security to security holders that is either common stock or has essentially the same attributes as the equity security that is the subject of the Rule 13e-3 transaction. n15 The other exceptions apply to redemptions, calls, or similar purchases of an equity security by an issuer pursuant to specific provisions set forth in the instrument(s) creating or governing that class of equity securities, n16 and certain solicitations by an issuer with respect to a plan of reorganization under Chapter XI of the Bankruptcy Act. n17

Under Rule 13e-3, various filing, disclosure, and dissemination requirements must be satisfied if (i) a Rule 13e-3 transaction exists, (ii) no exception applies, and (iii) the security must be registered pursuant to Section 12 or the issuer must file periodic reports pursuant to Section 15(d). Under the rule, n18 the issuer or the affiliate engaged in a Rule 13e-3 transaction must file a Transaction Statement on Schedule 13E-3. The Schedule sets forth different times for filing the Transaction Statement depending upon the nature of the particular Rule 13e-3 transaction. n19 Regardless of

the transaction involved, the Schedule 13E-3 must be filed with the Commission. Any material change must also be noted by filing with the Commission an amendment on Schedule 13E-3. n20 In addition, a final amendment to the schedule must promptly be filed with the Commission disclosing the result of the Rule 13e-3 transaction. n21

Rule 13e-3(e) governs the information required to be included in the disclosure document furnished to holders of the class of equity securities that is the subject of the transaction. n22 The disclosure provision includes the information required by Items 1 through 6 and 10 through 15 of Schedule 13E-3, or a fair and adequate summary thereof, and the information called for by Items 7, 8 and 9 of Schedule 13E-3 (*i.e.*, the purpose for and fairness of the transaction, and certain reports, opinions, appraisals, and negotiations of special concern to investors). The outside front cover of any disclosure document transmitted to security holders must bear a legend that is written in clear plain English. The legend should state that the transaction has not been approved or disapproved by the Commission, and that the Commission has not judged the merits or fairness of the transaction, or the accuracy or adequacy of the disclosure document. The legend should also state that any representation to the contrary is a criminal offense. n23 In addition, if the Rule 13e-3 transaction involves a registered security offering, the legend required by Item 501(b)(7) of Regulation S-K must also follow the legend requirements discussed above.

Rule 13e-(f) prescribes the methods of, and time limitations on, the dissemination of the information required to be disclosed to the security holders of the class of equity securities that is the subject of the Rule 13e-3 transaction. As mentioned earlier, n24 Schedule 13E-3 established specific disclosure requirements for Rule 13e-3 transactions, and contains the following items:

Item 1, "Summary Term Sheet," requires a brief description, in bullet point format, of the essential features of the proposed transaction.

Item 2, "Subject Company Information," requires the name of the issuer; the address of its principal executive offices; the title of the securities, the amount of securities outstanding; the identity of the principal market in which the securities are traded; dividends paid during the last two years and the possibility of future inability to pay dividends; details of any underwritten public offering of such securities during the past three years if registered under the Securities Act or exempt from registration pursuant to Regulation A; and a description of any purchases of such securities made by the issuer or affiliate since the commencement of the issuer's second full fiscal year preceding the date of this schedule.

Item 3, "Identity and Background of Filing Person," calls for various identification and background information depending upon whether the person filing this statement is the issuer, an affiliate of the issuer that is not a natural person, or an affiliate of the issuer that is a natural person. n25

Item 4, "Terms of the Transaction" necessitates stating the material terms of the Rule 13e-3 transaction, as well as describing any arrangement concerning the transaction that relates to any security holder of the issuer, when such arrangement is not identical to that relating to other security holders of the same class of securities of the issuer.

Item 5, "Past Contracts, Transactions or Negotiations and Agreements," requires an affiliate filing this schedule to briefly state the nature and approximate dollar value of any transaction, or to describe any contacts, negotiations, or other transactions concerning a merger, consolidation, acquisition, tender offer, election of directors, or sale of assets of the issuer or one of its subsidiaries, that have occurred between the issuer and the affiliate since the commencement of the issuer's second full fiscal year preceding the date of the schedule. Similarly, an affiliate must describe any contracts or negotiations referred to above that have been entered into or that have occurred since the commencement of the issuer's second full fiscal year preceding the schedule between any affiliates of the issuer, or between the issuer of any of its affiliates and any person who is unaffiliated with the issuer and who would have a direct interest in such matters. In addition, the filing person must describe any agreement between the filing person and any other person with respect to any securities of the subject company.

Item 6, "Purpose of the Transaction and Plans or Proposals," requires a description of any plan or proposal of the issuer or affiliate regarding activities or transactions that are to occur after the Rule 13e-3 transaction that relate to or would result in certain extraordinary corporate transactions n26 or other material changes in the issuer's obligations, corporate structure, management or assets.

Item 7, "Purposes, Alternatives, Reasons, and Effects," requires a discussion of the purposes for the transaction (including its structure), any alternatives considered instead of the Rule 13d-3 transaction chosen, and the contemplated effects of the transaction on the issuer, its affiliates, unaffiliated security holders and tax consequences. n27

Item 8, "Fairness of the Transaction," requires the issuer or affiliate to state whether it reasonably believes the transaction is fair or unfair to unaffiliated security holders and the factors upon which that belief is based. This item also necessitates statements concerning: (i) whether the transaction is structured so that approval of at least a majority of unaffiliated security holders is required; (ii) whether the majority of nonemployee directors has retained an unaffiliated representative to act solely on behalf of unaffiliated security holders for the purposes of negotiating the terms of the transaction and/or preparing a report concerning the fairness of the transaction; (iii) whether the transaction was approved by a majority of the directors of the issuer who are not employees of the issuer; and (iv) the material factors upon which the belief required to be stated by Item 8 is based. n28

Item 9, "Reports, Opinion, Appraisals and Negotiations," calls for disclosure of any report, opinion, or appraisal by an outside party with respect to the Rule 13e-3 transaction (other than an opinion of counsel) including background information concerning the person responsible for the report and a summary of certain information in the report such as the procedures followed, the findings and recommendations, and any instructions received from, or limitations imposed by, the issuer or affiliate in connection with the report. There must also be a statement to the effect that the report will be available for inspection and copying at the principal executive offices of the issuer or affiliate during its regular business hours by any interested security holder or his representative.

Item 10, "Source and Amounts of Funds or Other Consideration," calls for a statement concerning the source and total amount of the funds to be used in the Rule 13e-3 transaction including expenses (incurred or estimated to be incurred) and the identity, amount, and terms of any loan, the money from which is to be used for the Rule 13e-3 transaction.

Item 11, "Interest in Securities of the Subject Company," requires that, with respect to the class of equity securities to which the Rule 13e-3 transaction relates, the aggregate amount and percentage of securities beneficially owned by the person filing the schedule (except the issuer) be made known. This item also calls for a description of any transaction in the same class of equity securities that was effected during the past sixty days by the issuer or by persons named as beneficial owners.

Item 12, "The Solicitation or Recommendation," would obligate the person filing the schedule, after reasonable inquiry, to disclose the present intention and recommendations of certain prescribed people with regard to the Rule 13e-3 transaction.

Item 13, "Financial Statements," would require (i) certain historical financial information concerning the issuer, and, where material, pro forma data regarding certain effects of the Rule 13e-3 transaction on the issuer's balance sheet; (ii) the issuer's statement of income, earnings per share amounts, and ratio of earning per fixed charges; and (iii) the issuer's book value per share.

Item 14, "Persons/Assets, Retained, Employed, Compensated or Used," requires the identification and description of the purpose for which certain persons or corporate assets are employed by the issuer or the affiliate in connection with the Rule 13e-3 transaction. Additionally, this item requires disclosure and identification of all persons retained by the person filing the schedule (excluding those required to be disclosed by the issuer) including a summary of the material

terms of the employment, retainer or arrangement for compensation.

Item 15, "Additional Information," calls for any additional information as may be necessary to make the statements required by the other items in the schedule, in light of the circumstances under which they are made, not misleading.

Item 16, "Exhibits," requires the filing person to furnish a copy of: (i) all material sent to the security holders in connection with the Rule 13e-3 transaction; (ii) any loan agreement for financing the Rule 13e-3 transaction; (iii) any report or opinion referred to in Items 8 and 9 above; (iv) any document setting for the terms of any agreement referred to in Items 5 and 15 above; (v) a detailed description of security holder's appraisal rights and the procedures for exercising those appraisal rights; and (vi) any written instruction or other materials furnished to persons making oral solicitations of security holders on behalf of the filing person.

[b] Issuer Tender Offers-Rule 13e-4 and Schedule TO. Shortly after the adoption of the "going private" Rule and Schedule discussed *supra*, the Commission announced the adoption of Rule 13e-4 and Schedule 13E-4. n29 Subsequently, Schedule 13E-4 was combined with Schedule 14D-1 into Schedule TO. n30 Both the Rule and the Schedule are designed to regulate tender offers and other exchange offers by certain issuers n31 and their affiliates for their own equity securities. In addition, the rule defines certain fraudulent, deceptive, and manipulative acts or practices in connection with these offers, n32 and prescribes filing, disclosure, disseminations, and other requirements reasonably designed to prevent such acts and practices. n33

Rule 13e-4(c) requires four filings by the issuer or any affiliate subject to its provisions. First, all written communications made by the issuer or affiliate relating to the issuer tender offer, from and including the first public announcement, must be filed with the Commission as soon as practicable on the date of the communication. Second, the Schedule TO must be filed with the Commission by the party subject to the rule prior to, or as soon as practicable on, the date of commencement n34 of the tender offer. n35 Third, any material changes must also be noted by filing with the Commission the amendments to the Schedule TO. n36 Fourth, the person making the tender offer must disclose the results of the tender offer by filing with the Commission a final amendment to the Schedule TO promptly after termination n37 of the tender offer. n38

Rule 13e-4(d) governs the disclosure of certain information in the manner prescribed to the security holders by the issuer or affiliate. The issuer or affiliate must disclose the information required by Items 1 through 11 of Schedule TO (not including Item 12 (exhibits)) or a fair and adequate summary of such information. n39 Furthermore, if any material change occurs in information already disclosed to the security holders, the issuer or affiliate must promptly notify the security holders of the change in a manner reasonably calculated to inform them of such change. n40

The dissemination of the actual tender offer to security holders by the issuer or affiliate may be accomplished by multiple methods. Dissemination of all cash issuer tender offers by *long-form publication* is satisfied by making adequate publication n41 of the information required by Rule 13e-3(d)(1) n42 in a newspaper or newspapers, on the date of commencement of the tender offer. Other cash tender offers may be made by *summary publication* by making adequate publication n43 of certain specified information, n44 and by mailing or otherwise furnishing any material required to be disclosed, together with a transmittal letter to any security holder who requests either a copy of such statement or a transmittal letter. n45 The final method of dissemination is available when *shareholder and other lists* are utilized. This method is accomplished by: (i) mailing the disclosure statement to each security holder whose name appears on the most recent shareholder list of the issuer; (ii) contacting each participant named on the most recent security position listing of any clearing agency within the possession or access of the issuer or affiliate making the tender offer, and making inquiry of each such participant as to the approximate number of beneficial owners of the securities for which the offer is made which are held by the participant; (iii) furnishing to each participant a sufficient number of disclosure statements for transmittal to the beneficial owners; and (iv) agreeing to reimburse promptly each participant for reasonable expenses incurred in forwarding the disclosure statement to the beneficial owners. n46

The provisions concerning the manner in which the tender offer is made, including time limits, withdrawal rights, pro rata acceptance rules, provisions concerning an increase in the consideration offered, payment for the securities, and post tender offer restrictions are all governed by Rule 14e-4(f). n47 Rule 13e-4 requires that an issuer tender offer, unless withdrawn, remain open for at least twenty business days from the date of commencement of the offer, n48 and at least ten business days from the date that notice of an increase or decrease in the percentage of the class of securities being sought or the consideration offered or the dealer's soliciting fee is communicated to security holders. n49 For the purposes of Rule 13e-4(f)(1)(ii), the issuer's acceptance for payment of an additional amount of securities sought in the tender offer not exceeding two percent of the class of securities sought, is not deemed to be an increase. n50

Tendering security holders may withdraw securities tendered at any time during the period that the tender offer remains open n51 and at any time after forty business days from the time the offer commenced. n52 These provisions avoid security holders being "locked in" for an inordinate period of time, and enable them to respond to competing offers.

Rule 13e-4 requires that:

- (1) issuer tender offers be open to all holders of the class of securities sought by the offer, n53 and
- (2) the consideration paid to any security holder in the tender offer be the highest consideration paid to any other security holder. n54

Under Rule 13e-4(f)(10), the issuer may offer more than one type of consideration, but security holders must be afforded an equal right to elect among alternative considerations, and the highest consideration of each type paid to any security holder must be paid to any other security holder.

Further, Rule 13e-4 does not prohibit an issuer from excluding from a tender offer security holders in a state where the issuer, after making a good faith effort to comply with state law, is prohibited from making the offer. n55 If the form of consideration offered is prohibited by state law, the issuer may offer an alternative form of consideration in that state without making the alternative consideration available to security holders in other states. n56

The situation may arise where a greater number of securities are offered than the issuer is prepared to accept. If this situation should occur within ten business days from the commencement of the tender offer, or within ten business days from the date of notice of an increase in consideration being offered to securities holders, the issuer or affiliate must accept the tendered securities as nearly as practicable on a pro rata basis (disregarding fractions). n57 However, in recognition of the conflict between pro rationing and the elimination of odd lots, the rule permits the issuer or affiliate to accept odd lots in full, prior to accepting other securities on a pro rata basis. n58

Rule 13e-4 also contains a "best-price" provision which provides that if the issuer or affiliate making the tender offer increases the consideration being offered after the tender offer is commenced, the increased consideration must be paid to *all* security holders whose tendered securities are accepted for payment. n59

The party making the tender offer must either pay the consideration offered, or return the tendered securities, promptly after termination of the offer. n60

Furthermore, Rule 13e-4 provides for post-tender offer considerations. These prohibit purchases, other than pursuant to the tender offer, by the issuer or affiliate of securities that are the subject of the tender offer of the same class and series, or any right to purchase any such securities, for at least ten business days after termination of the offer. n61

In addition, Rule 13e-4 exempts from its application issuer tender offers to purchase shares from all security holders of the class of securities subject to the tender offer, exclusive of participants in an issuer's stock purchase, dividend reinvestment, or similar plan (as that term is defined in Rule 100 of Regulation M-A) or exclusive of security holders

who do not own their shares as of a specified date determined by the issuer or who own an aggregate of not more than a specified number of shares that is less than one hundred provided that the offer complies with Rule 13e-4(f)(8)(ii) or the consideration paid pursuant to the offer is determined on the basis of a uniformly applied formula based on the market price of the subject security. n62 The rule also exempts issuer tender offers made solely to effect a rescission offer. n63

Rule 13e-4 also does not apply to: (i) calls or redemptions of any security in accordance with the terms and conditions of its governing instruments; n64 (ii) offers to purchase securities evidenced by a scrip certificate, order form or similar document which represents a fractional interest in a share of stock or similar security; n65 (iii) offers to purchase securities pursuant to a statutory procedure for the purchase of dissenting security holders' securities; n66 (iv) any tender offer subject to Section 14(d) of the Exchange Act; n67 (v) offers by closed-end management investment companies to repurchase equity securities pursuant to Rule 23c-3 of the Exchange Act; n68 or (vi) certain cross-border tender offers. n69

Pursuant to the filing requirements discussed earlier, the issuer or affiliate must file a Schedule TO Tender Offer Statement with the Commission. n70 Schedule TO requires disclosure of the following information:

Item 1, "Summary Term Sheet," requires a brief description, in bullet point format, of the essential features of the proposed transaction.

Item 2, "Subject Company Information," requires the name of the issuer; the address of its principal executive offices; the title and amount of securities outstanding of the class of security being sought; and information about the principal market and exchanges where the securities are traded.

Item 3, "Identity and Background of Filing Person," requires the name, address and telephone number of the filing person, and, if the filing person is an affiliate of the subject company, the nature of the affiliation must be disclosed.

Item 4, "Terms of the Transaction," requires, among other things, a description of the total number and class of securities sought in the offer, the type and amount of consideration offered, the scheduled expiration date, whether a subsequent offering period will be available, whether and how the offer will be extended, the dates before and after which security holders may withdraw tendered securities, the procedures for tendering and withdrawing securities and a brief description of the accounting treatment and financial income tax consequences of the transaction, if material. Also required, is a statement whether any securities are to be purchased from any officer, directors or affiliate of the subject company and the details of any such transactions.

Item 5, "Past Contacts, Transactions, Negotiations and Agreements," requires the disclosure of any agreement between the filing person and any other person with respect to any securities of the subject company.

Item 6, "Purpose of the Transaction and Plans or Proposals," necessitates disclosing the purpose(s) for the tender offer, the planned disposition of tendered securities, and any extraordinary corporate transactions n71 or other material changes in the issuer's obligations, corporate structure, management, or assets that would result from the disposition of the tendered securities.

Item 7, "Source and Amount of Funds or Other Consideration," mandates identifying the source and total amount of funds to be used to purchase the maximum number of tendered securities; and, if the source is a loan, a summary of the loan agreement and the arrangements for refinancing or repayment must also be disclosed.

Item 8, "Interest in the Securities of the Subject Company," requires each person named in Item 3 (and each associate and majority owned subsidiary of such person) to state his beneficial ownership, in both numbers and percentage, of any class of securities issued by the subject company. Any transaction in such securities by the same people during the past sixty days must also be described. If this information is not available at the time the Schedule TO is initially filed, it

may be filed up to three business days after the initial filing.

Item 9, "Persons/Assets Retained, Employed, Compensated or Used," provides for the identification of all persons or classes of persons to be retained or compensated by the person filing the statement (or by any person on their behalf) in connection with solicitations of, or recommendations for, the tender offer, as well as the terms of such employment or retainer.

Item 10, "Financial Statements," calls for essentially the same data as Item 13 under Schedule 13E-3.

Item 11, "Additional Information," requires the description of any material information necessary for the security holders to decide whether to sell, tender, or hold the securities being sought. This information includes, but is not limited to, certain contracts or arrangements between the issuer and its executive officers, directors, or affiliates, and any regulatory requirements that must be complied with.

Item 12, "Exhibits," requires furnishing copies of the following:

- (1) Tender offer material provided to security holders by or on behalf of the person filing the Schedule TO concerning the issuer tender offer.
- (2) Any loan agreement mentioned in response to Item 2 of the Schedule.
- (3) Any document containing the terms of any contract, arrangements, understandings or relationships referred to in response to Items 5 or 11 of Schedule TO.
- (4) Any written opinion of legal counsel as to the tax consequences of the issuer tender offer, the opinion having been prepared at the request of, and communicated to, the person filing the Issuer Tender Offer Statement.
- (5) In an exchange offer where securities of the issuer have been or are to be registered under the Securities Act, any prospectus filed with the Commission as part of or in connection with the registration statement.
- (6) If any oral solicitation of security holders is to be made by or on behalf of the person filing the Schedule TO, any written instruction, form, or other material furnished to the persons making the actual oral solicitation for their use, directly or indirectly, in connection with the tender offer.

[c] Limited Tender Offers

The Commission has established a pattern of providing no-action letter relief from the requirements of Rule 13e-4 for certain issuer offers and repurchases possessing limited tender offer characteristics which might otherwise cause them to become subject to Rule 13e-4. While such tender offers may trigger many of the *Wellman* test factors used to establish the existence of a tender offer, n72 the Commission has provided some guidance that illuminates which issuer offers and repurchases may expect to be granted relief.

In a 2006 no-action letter, the Commission granted Westamerica Bancorporation an exemption from Rule 13e-4 for a proposed stock repurchase program designed to allow employees of the company to sell shares of company stock free from charges and brokerage commissions. The Commission granted relief to the proposed buy-back program on the basis that (i) the program would be open solely to current employees of Westamerica who own common stock in the company; (ii) the program would be open during periods of a minimum of 20 business days; (iii) decisions regarding whether to participate in the program and the amount of shares to be tendered would be at the sole discretion of the

employee; (iv) the company would not encourage or discourage participation in the plan; (v) the annual amount of purchases by the company would be limited to a maximum of five percent of the company's total common stock outstanding; (vi) the consideration to be paid pursuant to the program would be determined by a uniformly applied formula based on the market price of the common stock; and (vii) the company would settle with participating employees within the time frame required by Rule 15c6-1 under the Exchange Act. n73

In a separate 2003 no-action letter, the Commission also granted Microsoft Corp. an exemption from Rules 13e-4(f)(8)(i) and (ii) (the all-holders and best price rules) pursuant to Microsoft's planned option purchase program. The Commission permitted Microsoft to terminate withdrawal rights for tendered options at the end of the election period, to exclude certain options and certain option holders from the stock offer transfer program, and to pay holders of certain options less for those options than other options with similar terms. In so doing, the Commission took note specifically of the compensatory objectives of the option transfer program and the level of information that would be available to employees regarding the program. n74

In granting these and other exemptions from Rule 13e-4, the Commission often notes as significant considerations that such programs (i) apply to a relatively small percentage of the issuer's shares (ii) will serve a legitimate employee service or compensation purpose, (iii) offer to repurchase shares at their current market price and without a premium and (iv) are generally not open to the wider body of shareholders or to the investing public. n75

In 2001, the Commission issued an exemptive order for issuer exchange offers that are conducted to reprice employees' stock options. n76 The order exempts these exchange offers from Rules 13e-4(f)(8)(i) and 13e-4(f)(8)(ii) (the all-holders rules and best price rules) so long as the following conditions are met:

1. the issuer is eligible to use Form S-8, the options subject to the exchange offer were issued under an employee benefit plan as defined in Rule 405 under the Securities Act, and the securities offered in the exchange offer will be issued under such an employee benefit plan;
2. the exchange offer is conducted for compensatory purposes;
3. the issuer's offer to purchase discloses the essential features and significance of the exchange offer, including risks that option holders should consider in deciding whether to accept the offer; and
4. except as exempted in the 2001 exemptive order, the issuer complies with Rule 13e-4. n77

[2] Changes in Boards of Directors--Section 14(f)

Section 14(f) of the Exchange Act and accompanying Rule 14f-1 provide that if, pursuant to any arrangement or understanding with a tender offer acquirer, any persons are elected or appointed as directors of an issuer other than at a meeting of the issuer's security holders, and such new directors will constitute a majority of the board, then, not less than 10 days following their taking of office, the issuer must file and distribute to all holders of record who would be entitled to vote at a meeting, proxy material substantially equivalent to the material which would be required under Schedule 14A of Regulation 14A if such appointed persons were nominees for election as directors at an annual meeting of security holders. n78 Section 14(f) contemplates a scenario in which, by prearrangement, an incumbent board resigns en masse following successful completion of a tender offer, thereby delivering immediate control of the board to the acquirer without the formality of holding a board meeting. The purpose of this section is to regulate the use of the authority of directors to fill vacancies by having the entire board resign upon a change of control by requiring the issuer to file with the Commission and transmit to all holders of record entitled to vote, information that is substantially equivalent to the information which would be required by Section 14(a) or 14(c) if the directors were to be elected at a shareholder meeting, before a new director takes office. n79 Generally, Section 14(f) will not apply to hostile takeovers because only friendly or negotiated transactions will contain the "arrangement or understanding" between the offeror

and the incumbent directors contemplated by the section. In negotiated transactions, which do trigger Section 14(f), proxy information required to be delivered to target shareholders will usually be contained within the issuer's Schedule 14D-9 rather than within the acquirer's Schedule TO or any separate issuer filing.

FOOTNOTES:

(n1)Footnote 1. See K&L Gates, Securities Practice Guide § 9.05 and § 9.04 (2009 Edition)

(n2)Footnote 2. Section 13(d)(6)(C). *See supra* § 7A.02.

(n3)Footnote 3. Section 14(d)(8). *See supra* § 7A.03.

(n4)Footnote 4. Registration pursuant to Section 12 of the Exchange Act is discussed in *supra* § 4.01.

(n5)Footnote 5. *See also* Fisher v. Plessey Co., Ltd., C.C.H. Fed. Sec. L. Rep. P 99,246 (S.D.N.Y. 1983), in which the court held that under the Supreme Court's standards in *Cort v. Ash*, an investor has implied a private right of action for damages under Section 13(e) since the statute specifically refers to a group of investors to be protected by its antifraud and disclosure requirements and imposes a duty on issuers or tender offerors to ensure that target investors receive all material information needed to decide whether to tender.

But see Kalmanovitz v. G. Heileman Brewing Co., Inc., 595 F. Supp. 1385, C.C.H. Fed. Sec. L. Rep. P 91,851 (D. Del. 1984) (no private right of action for damages exists either express or implied, under Section 13(e)).

(n6)Footnote 6. *See supra* § 7A.03[2][a].

(n7)Footnote 7. The adoption of Rule 13e-3 and concomitant Schedule 13E-3 was announced in Part 240--General Rules and Regulations, Securities Exchange Act of 1934, Exchange Act Release No. 16075, 17 SEC Docket 1449 (Aug. 2, 1978), effective 30 days after publication in the Federal Register.

(n8)Footnote 8. *See* Woodward & Lothrop, Inc., v. Schnabel, C.C.H. Fed. Sec. L. Rep. P 91,658 (D.D.C. 1984), where the court held that since Rule 13e-3 applies only to transactions by issuers and their affiliates, the filing requirements of the Rule did not apply to a merger transaction involving a non-affiliate. To establish that one issuer is an affiliate of another, a control relationship must be found. Control did not exist in this case because:

(1) the pre-merger agreement lacked any evidence of the alleged affiliate's ability to direct the target company's management or policies;

(2) covenants in the merger agreement preventing the target company from taking any extraordinary action without the alleged affiliate's approval did not rise to the level of control; and

(3) even after acquiring 32% of the target company's outstanding shares, the alleged affiliate still lacked Rule 13e-3 control, as evidenced by the target company Board's continued independence and willingness to develop competing merger offers.

The existence of a merger agreement between two issuers will not make one issuer an affiliate of the other issuer for the purpose of Rule 13e-3 if the merger agreement was the product of arms-length negotiations. *Radol v. Thomas*, 534 F. Supp. 1302, C.C.H. Fed. Sec. L. Rep. P 98,693 (S.D. Ohio 1982) .

See also Howing Co., Inc. v. Nationwide Corp., C.C.H. Fed. Sec. L. Rep. P 94,858 (S.D. Ohio 1989) (Omissions of a

defendant majority shareholder's assessment of book, liquidation, and going concern values from the proxy statement issued in connection with a going private transaction were held not material. Although dissenting shareholders had alleged that the proxy statement violated Rule 13e-3 disclosure requirements, the court found that because all of the omitted values would have resulted in payouts less than the cash out merger price, there was no substantial likelihood that a reasonable shareholder would have considered them important in deciding how to vote on the merger issue).

(n9)Footnote 9. *See* Rule 13e-3(a)(3).

(n10)Footnote 10. *See* Rule 13e-3(g).

(n11)Footnote 11. A Rule 13e-3 transaction by an issuer required to file periodic reports pursuant to Section 15(d) of the Exchange Act (*see supra* § 4.02) or by an affiliate of such issuer for equity securities of the issuer are subject only to the filing, disclosure, and dissemination requirements of the rule.

A Rule 13e-3 transaction by an issuer with a class of equity securities registered pursuant to Section 12 of the Exchange Act (*see supra* § 4.01) or by an affiliate of such an issuer is subject to particular antifraud provisions (*see* Rule 13e-3(b)) as well as the filing, disclosure, and dissemination requirements. These antifraud provisions prohibit fraudulent, deceptive, or manipulative acts or practices in connection with a Rule 13e-3 transaction. Part 240--General Rules and Regulations, Securities Exchange Act of 1934, Exchange Act Release No. 16075, 17 SEC Docket 1449 (Aug. 2, 1979).

(n12)Footnote 12. The transactions referred to are:

"(A) A purchase of any equity security by the issuer of such security or by an affiliate of such issuer;

(B) A tender offer for or request or invitation for tenders of any equity security made by the issuer of such class of securities or by an affiliate of such issuer; or

(C) A solicitation subject to Regulation 14A [§§ 240.14a-1 to 240.14a-103] of any proxy, consent or authorization of, or a distribution subject to Regulation 14C [§§ 240.14c-1 to 14c-101] of information statements to, any equity security holder by the issuer of the class of securities or by an affiliate of such issuer, in connection with: a merger, consolidation, reclassification, recapitalization, reorganization or similar corporate transaction of an issuer or between an issuer (or its subsidiaries) and its affiliate; a sale of substantially all the assets of an issuer to its affiliate or group of affiliates; or a reverse stock split of any class of equity securities of the issuer involving the purchase of fractional interests. Rule 13e-3(a)(3)(i)."

See *Pin v. Texaco, Inc.*, C.C.H. Fed. Sec. L. Rep. P 92,823 (5th Cir. 1986), where the court held that the payment by an issuer of "greenmail" to holders of a large bloc of the issuer's stock, by purchasing their stock at a premium to avert a challenge to the issuer's management, was not an issuer tender offer under Section 13(e) and Rule 13e-4, since:

(1) the offer to purchase was made privately to a very small percentage of the issuer's stockholders;

(2) the selling shareholders were highly sophisticated; and

(3) there was no active or widespread advance publicity or public solicitation.

See also *Am. Can Co.*, 14 B.N.A. Sec. Reg. & L. Rep. 667 (Div. Corp. Fin. 1982), in which the Division of Corporation Finance took the position that Rule 13e-3 did not apply to a two-step, acquisition and merger transaction, noting that:

- (1) there was no prior affiliation between the acquiring company and the issuer;
- (2) the two-step transaction was publicly announced before the initial premerger acquisition of stock;
- (3) the second-step merger would be effected within a relatively short period of time after the first-step premerger acquisition of stock;
- (4) the issuer's board of directors or management would not be altered by the acquiring company before completing the second-step merger;
- (5) the basic terms of the publicly announced merger would not be changed in the final merger agreement; and
- (6) the first-step premerger acquisition of stock and the second-step merger acquisition of stock would be made under an agreement in principle to purchase all of the issuer's company stock at the same price.

(n13)Footnote 13. The effects are:

"(A) Causing any class of equity securities of the issuer which is subject to Section 12(g) or Section 15(d) of the Act to become eligible for termination or registration under Rule 12g-4 or Rule 12h-6, or causing the reporting obligations with respect to such class to become eligible for termination under Rule 12h-6; or suspension under Rule 12h-3 or section 15(d); or

(B) Causing any class of equity securities of the issuer which is either listed on a national securities exchange or authorized to be quoted in an inter-dealer quotation system of a registered national securities association to be neither listed on any national securities exchange nor authorized to be quoted on an inter-dealer quotation system of any registered national securities association."

Rule 13e-3(a)(3)(ii).

See Shamrock Ass. v. Horizon Corp., C.C.H. Fed. Sec. L. Rep. P 92,711 (S.D.N.Y. 1986), where the court held that for purposes of Rule 13e-3(a)(3)(ii)(B) there was a "reasonable likelihood" that an issuer's securities would be delisted where the New York Stock Exchange had commenced delisting proceedings. The court held as well that the mere possibility that the issuer's shares would be listed on another exchange or over-the-counter did not preclude the application of Rule 13e-3 since "the language of the Rule appears to speak in terms of present possibilities not future potentialities."

(n14)Footnote 14. *See* Rule 13e-3(g)(1).

A condition for the availability of the Rule 13e-3(g)(1) exception is that the acquiring entity not change the management of the board of directors or otherwise exercise control of the issuer before the completion of the second step of the transaction, *i.e.*, the merger. *See, e.g.*, *General Steel Indus., Inc. & Lukens Steel Co.*, C.C.H. Fed. Sec. L. Rep. P 77,211 (Div. Corp. Fin. 1982) (since the acquiring corporation installed its representatives on the issuer's board of directors before the merger transaction was completed, the Division of Corporation could not conclude that the Rule 13e-3(g)(1) exception was available).

(n15)Footnote 15. *See* Rule 13e-3(g)(2).

(n16)Footnote 16. *See* Rule 13e-3(g)(4).

(n17)Footnote 17. *See* Rule 13e-3(g)(5).

(n18)Footnote 18. *See* Rule 13e-3(e).

(n19)Footnote 19. *See* General Instruction D to Schedule 13E-3 for the appropriate filing times.

(n20)Footnote 20. *See* Rule 13e-3(d)(2).

(n21)Footnote 21. *See* Rule 13e-3(d)(3).

(n22)Footnote 22. *See* Rule 13e-3(e).

(n23)Footnote 23. *See* Rule 13e-3(e)(i)(iii).

(n24)Footnote 24. *See* Rule 13e-3(d).

(n25)Footnote 25. Such information may include the issuer or affiliate's name; address (or residence); present principal occupation or employment; criminal convictions during the past five years; any civil judgments, decrees, or final orders against the party filing the statement that occurred within the last five years; and citizenship.

(n26)Footnote 26. These extraordinary corporate transactions include mergers, reorganizations or liquidations involving the issuer or one of its subsidiaries.

(n27)Footnote 27. The effects should be described in reasonable detail and should include a discussion of the benefits and detriments of the transaction to the issuer, its affiliate, and unaffiliated shareholders.

(n28)Footnote 28. To minimize boilerplate responses concerning the issue of fairness, Instruction (3) to Item 8(b) specifies that conclusory statements are not considered sufficient disclosure to this Item.

(n29)Footnote 29. The adoption of the Issuer Tender Offer rule and Schedule was announced in Exchange Act Release No. 16112, 66 SEC Docket 67 (Aug. 16, 1979), effective 30 days after publication in the Federal Register.

(n30)Footnote 30. *See* Regulation of Takeovers and Security Holder Communications, Exchange Act Release No. 42055, 70 SEC Docket 2229 (Oct. 22, 1999).

(n31)Footnote 31. As defined in the rule, the term "issuer" means "any issuer which has a class of equity security registered pursuant to Section 12 of the Act, or which is required to file periodic reports pursuant to Section 15(d) of the Act, or which is a closed-end investment company registered under the Investment Company Act of 1940." Rule 13e-4(j)(1).

(n32)Footnote 32. Rule 13e-3(b) states that:

(1) It shall be a fraudulent, deceptive or manipulative act or practice, in connection with a Rule 13e-3 transaction, for an issuer which has a class of equity securities registered pursuant to Section 12 of the Act or which is a closed-end investment company registered under the Investment Company Act of 1940, or an affiliate of such issuer:

(i) To employ any device, scheme or artifice to defraud any person;

(ii) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under

which they were made, not misleading; or

(iii) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.

(2) As a means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices in connection with any Rule 13e-3 transaction, it shall be unlawful for an issuer which has a class of equity securities registered pursuant to Section 12 of the Act, or an affiliate of such issuer, to engage directly or indirectly, in a Rule 13e-3 transaction unless:

(i) Such issuer or affiliate complies with the requirements of paragraphs (b), (c), (d), (e) and (f) of this rule; and

(ii) The Rule 13e-3 transaction is not in violation of paragraph (b)(1) of this section.

Paragraphs (d), (e) and (f) refer to the filing, disclosure, and dissemination respectively.

See Lessner v. Casey, C.C.H. Fed. Sec. L. Rep. P 93,932 (E.D. Mich. 1988) (ruling that the allegation that issuer and its presidents did not consider fairness in making a self-tender offer did not state a claim under Rule 13e-4(b)).

(n33)Footnote 33. *See SEC v. Carter Hawley Hale Stores*, C.C.H. Fed. Sec. L. Rep. P 92,038 (9th Cir. 1985), where the Court held that a target company's purchase of over 50 percent of its shares during an attempted takeover by a third party was an issuer repurchase under Rule 13e-1, rather than an issuer tender offer under Rule 13e-4, since the repurchases were made after public announcement, in the open market, at the open market price, without fixed terms, not contingent upon the tender of fixed minimum number of shares, and for the purpose of defeating the pending tender offer. *See also supra* § 7A.03[1].

See Merrill Lynch, Pierce, Fenner and Smith, C.C.H. Fed. Sec. L. Rep. P 78,318 (Div. Mkt. Reg. 1986), where the staff took the position that where an issuer was distributing to its employees certain of the issuer's shares credited to employees' accounts in an employee savings plan, an odd lot program under which a broker-dealer would aggregate odd lot shares of employees, sell them and remit to employees an amount per share equivalent to the average selling price of all odd lot shares on the date of sale constituted an issuer tender offer subject to Rule 13e-4. However, based on representations that the distribution resulted from a court ordered divestiture and was the last such distribution that would be made, the Commission granted an exemption from Rule 13e-4. In the staff's opinion, however, the requirements of Rule 14(e) must be complied with in connection with the offer, including the requirements that the offer remain open for at least twenty days and that each employee be provided with adequate information to determine whether to sell or retain his shares.

See also Capital Cities Commc'n., Inc., C.C.H. Fed. Sec. L. Rep. P 78,320 (Div. Mkt. Reg. 1986), in which the staff took the position that where upon conclusion of a tender offer the target company became a wholly-owned subsidiary of the offeror, and shareholders of the target, as partial payment for their shares, received warrants to purchase the offeror's shares which the offeror agreed to repurchase from warrant holders at a fixed price, the repurchase option covering the warrants may constitute an issuer tender offer subject to Rule 13e-4. The Commission granted an exemption from Rule 13e-4; however, based upon its conclusion that the repurchase option did not appear to present any of the abuses that Rule 13e-4 was designed to prevent, and on the offeror's representation that it would file a registration statement covering the warrants and would distribute copies of the amended registration statement to warrant holders at the time the repurchase option became effective.

For a discussion of a transnational tender offer where the Commission allowed the transaction to go forward with

certain exemptions from Rule 13e-4, *see* Procordia Aktiebolag and Aktiebolaget Volvo, Securities Exchange Act Release No. 34-27671, C.C.H. Fed. Sec. L. Rep. P 84,514 (1990). The transaction was structured as two concurrent offers, one made outside the U.S. and not open to U.S. persons and the other made to U.S. stockholders, with both subject to the same terms and conditions.

(n34)Footnote 34. The term "commencement" is defined to mean "the date the issuer or affiliate has first published, sent or given the means to tender to security holders." Rule 13e-4(a)(4).

(n35)Footnote 35. *See* Rule 13e-4(b) and Rule 13e-4(c)(2).

(n36)Footnote 36. *See* Rule 13e-4(c)(3).

(n37)Footnote 37. The term "termination" is defined to mean "the date after which securities may not be tendered pursuant to an issuer tender offer." Rule 13e-4(a)(5).

(n38)Footnote 38. *See* Rule 13e-4(c)(4).

(n39)Footnote 39. *See* Rule 13e-4(d)(1)(ii). If any issuer tender offer involves the registration of securities pursuant to the Securities Act of 1933 and the rules and regulations thereunder, any prospectus relating thereto must include the information required by paragraph (d) of Rule 13e-4, if not otherwise required to be included in the prospectus. Rule 13e-4(d)(1). *See infra* for a description of the Items of Schedule TO.

(n40)Footnote 40. *See* Rule 13e-4(d)(2), (e)(2).

(n41)Footnote 41. Adequate publication for this method of dissemination as well as for certain cash issuer tender offers by summary publication, is satisfied, depending on the facts and circumstances involved, by publication in a nationally circulated newspaper, a metropolitan or regional newspaper, or both. *See* Rule 13e-4(e)(1).

(n42)Footnote 42. *See* Rule 13e-4(e)(1)(i).

(n43)Footnote 43. *See* Rule 13e-4(e)(1).

(n44)Footnote 44. This information includes: the identity of the issuer or affiliate making the tender offer, the amount and class of securities being sought and the price being offered, a statement of the purpose of the issuer tender offer, and the information required to be disclosed by this rule. *See* Rule 13e-4(d)(3).

(n45)Footnote 45. *See* Rule 13e-4(e)(1)(iii). However, summary publication is not permitted if the tender offer is also subject to the provisions of Rule 13e-3. *See* Rule 13e-3(e), (f).

(n46)Footnote 46. *See* Rule 13e-4(e)(1)(ii).

(n47)Footnote 47. *See generally* Rule 13e-4(f).

(n48)Footnote 48. *See* Rule 13e-4(f)(1)(i).

(n49)Footnote 49. *See* Rule 13e-4(f)(1)(ii).

(n50)Footnote 50. *See* Rule 13e-4(f)(1)(i).

(n51)Footnote 51. *See* Rule 13e-4(f)(2)(i).

(n52)Footnote 52. *See* Rule 13e-4(f)(2)(ii).

(n53)Footnote 53. *See* Rule 13e-4(f)(8)(i).

(n54)Footnote 54. *See* Rule 13e-4(f)(8)(ii).

(n55)Footnote 55. *See* Rule 13e-4(f)(9)(ii).

(n56)Footnote 56. *See* Rule 13e-4(f)(11).

(n57)Footnote 57. *See* Rule 13e-4(f)(3).

(n58)Footnote 58. *See* Rule 13e-4(f)(3)(i).

(n59)Footnote 59. *See* Rule 13e-4(f)(4).

(n60)Footnote 60. *See* Rule 13e-4(f)(5).

(n61)Footnote 61. *See* Rule 13e-4(f)(6)(i). A similar provision applies to tender offers that are exchange offers. *See* Rule 13e-4(f)(6)(ii). In Revlon, Inc., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2629 at *1 (July 21, 1983), the Division of Market Regulation determined that an issuer could privately purchase shares of its stock immediately after termination of an issuer tender offer involving shares of the same class despite the ten day waiting period requirement of Rule 13e-4 since the private purchases were not likely to result in the manipulative practices contemplated by the Rule.

(n62)Footnote 62. *See* Rule 13e-4(h)(5). *See also* LA-MAN Corp., C.C.H. Fed. Sec. L. Rep. P 78,102 (Div. Mkt. Reg. 1985), where the staff indicated that it would not recommend enforcement action if an issuer failed to file a Schedule 13E-4 or otherwise comply with Rule 13e-4 in connection with an offer to repurchase its shares from shareholders who purchased the shares from the issuer in transactions that may have violated the Securities Act, because:

- (1) the repurchase offer was contingent on sales of the issuer's securities in connection with a public offering reaching a certain minimum level;
- (2) the repurchase offer and the new offering were described in the same prospects; and
- (3) it was unlikely that any securities would be tendered under the repurchase offer.

See also Merrill Lynch, Pierce, Fenner & Smith, Inc., C.C.H. Fed. Sec. L. Rep. P 78,318 (Div. Mkt. Reg. 1986), where the staff granted an exemption from Rule 13e-4 for transactions arising from the court ordered divestiture by American Telephone and Telegraph Company (AT&T) of regional telephone companies. The staff granted the exemption in connection with an odd lot program allowing employees receiving distribution of AT&T and regional telephone company shares from an employee savings plan to sell those shares in the open market at lower transaction costs than generally applicable in odd lot transactions, since the program resulted from the court ordered divestiture, and involved a one-time distribution.

(n63)Footnote 63. *See* Rule 13e-4(h)(6).

(n64)Footnote 64. *See* Rule 13e-4(h)(1).

(n65)Footnote 65. *See* Rule 13e-4(h)(2).

(n66)Footnote 66. *See* Rule 13e-4(h)(3).

(n67)Footnote 67. *See* Rule 13e-4(h)(4).

(n68)Footnote 68. See Rule 13e-4(h)(7).

(n69)Footnote 69. See Rule 13e-4(h)(8).

(n70)Footnote 70. The filing of Schedule TO must be accompanied by a fee of one-fiftieth of one percent of the value of the securities proposed to be purchased provided that the fee shall be reduced in an amount equal to any fee paid for securities in connection with the proposed transaction under the registration provisions of Securities Act Section 6(b), or the fee paid under Securities Act Section 6(b) shall be reduced in an amount equal to the fee paid with the filing of Schedule TO. See Rule 0-11.

See *Shamrock Holdings, Inc. v. Polaroid Corp.*, C.C.H. Fed. Sec. L. Rep. P 94,370 (D. Del. 1989), where litigation arising from a defensive self-tender offer by defendant Polaroid in the context of a takeover effort by the Shamrock plaintiffs, characterization of the "objective" and the "primary purpose" of the self-tender offer in terms of shareholder investment benefit, adding lastly that the self-tender offer was also a "partial response" to Shamrock's offer, was not materially false and misleading for failure to state that the principal purpose of the self-tender offer was to fend off Shamrock by entrenching Polaroid's management in anticipation of the annual meeting. The court stated that investors were "charged with knowledge" of management's "universal" interest in preserving corporate control, besides which there was "regular media coverage" of Shamrock's continued efforts to take over Polaroid. *Id.* at P 92,439.

(n71)Footnote 71. The extraordinary corporate transactions refer, but are not limited to, mergers, reorganizations or liquidations involving the issuer or any of its subsidiaries. See Item 1006(c) of Regulation M-A.

(n72)Footnote 72. For a discussion of *Wellman* and the identifications of tender offers, see *supra* § 7A.03[1].

(n73)Footnote 73. SEC No-Action Letter, Fed. Sec. L. Rep. P 77228 (June 20, 1996).

(n74)Footnote 74. Microsoft Corp., SEC No-Action Letter (October 15, 2003).

(n75)Footnote 75. See *Jaclyn, Inc.*, SEC No-Action Letter, (March 10, 2005) (noting that shares eligible to be purchased constituted approximately 1.97% of the company's issued and outstanding shares); *Boston Capital Real Estate Investment Trust, Inc.*, SEC No-Action Letter, (February 10, 2005) (noting that the number of shares repurchased by the company would not exceed 3% of the weighted average number of shares of outstanding common stock in that calendar year).

(n76)Footnote 76. Division of Corporation Finance, Exemptive Order, Repricing (March 21, 2001) available at <http://www.sec.gov/divisions/corpfin/repricing.htm>.

(n77)Footnote 77. *Id.*

(n78)Footnote 78. Rule 14f-1.

(n79)Footnote 79. See SECURITIES REGULATION (Louis Loss, Joel Seligman, & Troy Paredes ed, CCH supplemented Nov. 2008).



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Federal Securities Exchange Act of 1934

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CHAPTER 7A The Williams Act Amendments-- Controlling Shareholders and Tender Offers

2-7A Federal Securities Exchange Act of 1934 § 7A.05

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§ 7A.05 Cross-Border Tender Offers

On September 19, 2008, the Commission published changes to the rules governing cross-border tender offers and business combinations involving foreign private issuers. n1 The amended rules became effective on December 8, 2008.

The Commission's amendments were intended to expand the scope of exemptions for cross-border transactions involving foreign private issuers from certain tender offer rules and regulations. The amendments also allow certain non-U.S. institutions to report their share ownership on Schedule 13G, rather than Schedule 13D, to the same extent as would be permitted for similar U.S. institutions.

Regulation 14D and Regulation 14E under the Exchange Act set forth a complex set of tender offer rules and requirements intended to ensure that all security holders in the context of a tender offer are treated equally and are provided with sufficient time and information in deciding whether or not to participate in the tender offer. The regulation of cross-border tender offers under the U.S. securities laws contains two tiers of exemptions and regulatory relief which are primarily based upon the level of ownership by United States shareholders of the securities of the foreign target company. The "Tier I" exemptions apply where U.S. holders own no more than 10 percent of the securities of the subject foreign company and exempt such offer from most of the rules and requirements under Regulation 14D and Regulation 14E. The "Tier II" exemptions apply when U.S. holders account for between 10 percent and 40 percent of the foreign target company's share ownership and provide more limited exemptions from certain tender offer regulations.

Under the Commission's amendments, the underlying Tier I and Tier II exemption structure remains in place. The amendments instead alter the process by which share ownership calculations are performed for the purposes of determining eligibility and further expand the scope of the exemptions to provide relief from additional regulatory requirements.

Rule 14d-1 under the Exchange Act has been amended to alter the "look-through" analysis of target record holders to determine levels of U.S. beneficial ownership. Acquirers may now calculate U.S. ownership levels as of any date that is

no more than 60 days before and no more than 30 days after public announcement of the offer. Prior rules required calculation as of the 30th day prior to the commencement of the offer. In addition, the Commission has abandoned its requirement that holders of more than 10 percent of the subject securities be excluded from the calculation. In the past, the exclusion of 10 percent or greater holders served to significantly inflate the calculated percentage of U.S. holders in the case of target companies whose shares were held by one or more significant shareholders. Lastly, in the case of hostile tender offers or tender offers for which look-through analysis of the subject company's record holders cannot be conducted, the amendments provide an alternative test based upon the average daily trading volume of the target securities in the United States and worldwide.

The Commission's amendments made a number of other modifications and adjustments to the regulatory requirements of cross-border offers designed to reduce conflict between U.S. tender offer regulation and common foreign regulatory structures and market practices, including, among other changes, the following:

- **Withdrawal Rights.** The amendments permit relief from Section 14(d)(5) and Rule 14d-7 withdrawal rights such that the bidder may terminate withdrawal rights at the end of the initial offering period while tendered shares are counted and the offeror determines whether a subsequent offering period will be necessary.
- **Multiple Non-U.S. Offers.** Prior rules permitted a bidder to separate its offer into only two separate offers, a U.S. offer and a non-U.S. offer. The amendments recognize the need of many bidders to comply with multiple non-U.S. jurisdictions by allowing multiple foreign offers to be conducted contemporaneously with the U.S. offer.
- **Tier II Subsequent Offering Periods.** The amendments permit Tier II cross-border offers to extend subsequent offering periods which last beyond 20 business days.
- **Foreign Holders of ADRs.** The amendments permit the inclusion of foreign holders of ADRs within a U.S. offer. In addition, under certain circumstances U.S. holders will be permitted to participate in foreign offers.

The Commission's amendments also modify the treatment of certain foreign entities under Sections 13(d) and 13(g) of the Exchange Act. Under the earlier Rule 13d-1(b), the class of institutional investors eligible to use Schedule 13G (rather than the more burdensome Schedule 13D) to report their beneficial ownership of registered securities, was limited to investment companies, investment advisors, brokers and dealers which were U.S. institutions registered with the Commission, as well as entities such as insurance companies, banks and pension plans which were regulated under the laws of the United States. The Commission's new regulations permit comparable non-U.S. institutions to report their beneficial ownership of securities on Schedule 13G to the same extent as similar U.S. entities. Foreign institutions desiring to use Schedule 13G must (i) certify that they are subject to a home country regulatory scheme substantially comparable to the regulatory scheme applicable to functionally equivalent U.S. institutions, (ii) assert that the subject securities are acquired and held in the ordinary course of business and without the purpose or effect of influencing control over the issuer, and (iii) be willing to furnish to the Commission, upon request, information that would otherwise be disclosed in a Schedule 13D filing.

FOOTNOTES:

(n1)Footnote 1. Commission Guidance and Revisions to the Cross-Border Tender Offer, Exchange Offer, Rights Offerings, and Business Combination Rules and Beneficial Ownership Reporting Rules for Certain Foreign Institutions, Exchange Act Release No. 34-58597 (Sept. 19, 2008).



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CHAPTER SA-8 SPECIAL ALERT TO CHAPTER 8

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CHAPTER SA-8 SPECIAL ALERT TO CHAPTER 8

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SEC Requires Electronic Filing of Section 16(a) Reports_and_@_)_and_footnotes(n2);.vk n*

Rules Mandate Electronic Filing and Website Posting of Change of Beneficial Ownership Reports Required to be Filed by Officers, Directors and Principal Security Holders Pursuant to Section 16(a) of the Exchange Act

On April 24, 2003, the United States Securities and Exchange Commission (the "Commission") adopted rules requiring electronic filing and website posting of forms filed under Section 16(a) of the Securities Exchange Act reporting corporate insiders' ownership and transactions in company securities. These rules implement Section 403 of the Sarbanes-Oxley Act of 2002 and complement the accelerated two-day reporting requirement adopted by the Commission in August 2002. Mandatory electronic filing and website posting requirements become effective on June 30, 2003, a month earlier than required under the Sarbanes-Oxley Act.

Directors, executive officers and 10% owners of a class of securities (collectively, "Insiders") are required to file Forms 3, 4 and 5 ("Section 16 Reports") pursuant to Section 16(a) of the Exchange Act of 1934 and the rules thereunder. Forms 4 generally are required to be filed within two business days after a reportable transaction. Currently, Section 16 Reports can be filed electronically or by paper. The rules adopted today (i) require Insiders to file all Section 16 Reports electronically, and (ii) require issuers to post Section 16 Reports on their websites by the end of the business day following the filing date. A company can satisfy the website posting requirement by linking to filings on the SEC's Edgar database or to other third-party databases if certain conditions are satisfied.

These rules also provide that, effective June 30, 2003:

- The deadline for electronic filing of Section 16 Reports will be extended from 5:30 p.m. Eastern Standard Time on the date on which a Section 16 Report is due to 10:00 p.m. Eastern Standard Time. Thus, if a Form 4 is filed electronically before 10:00 p.m. EST on its due date, it will be treated as timely filed. (This extended filing deadline will not be available for other SEC filings, such as Forms 8-K, 10-K and 10-Q or for registration statements. Although those reports currently can be submitted electronically between 5:30 and 10:00 p.m. EST, they are not deemed to be filed until the next business day.)
- For a period of one year, companies will not be required to report an Insider's late Section 16 Report

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filings in their Forms 10-K or proxy statements, **if** the Section 16 Report is filed only one day late.

- Insiders or issuers who encounter technical difficulties in filing Section 16 Reports will not be able to file a Form TH, which provides an automatic deadline extension, for late Section 16 Reports. Instead, they will need to request that the Commission adjust the filing date under Rule 13 of Regulation S-T if they can demonstrate to the Commission staff that they meet the requirements for an adjusted filing date.

The Commission is developing special features for the EDGAR filing system that will facilitate electronic filing of Section 16 Reports. On March 24, 2003, the Commission established a test system providing an easy, on-line template system for EDGAR filings of Section 16 Reports. Under the new EDGAR filing system for Section 16 Reports, Insiders can type Section 16 transaction data into an on-line template, add any applicable attachments and file the Report. The Commission is currently adjusting this system to reflect comments that have been suggested by trial users. However, we expect that this system will be operational in early May 2003 to make actual electronic filings of Section 16 Reports. From that date until June 30, 2003, Insiders may file Section 16 Reports through the new EDGAR filing system or by making a paper filing. After the June 30, 2003 effective date of today's rules, Insiders will be required to file Section 16 Reports through the new EDGAR filing system. In addition, a number of vendors have announced that they are developing filing programs that will interface with the new EDGAR filing system for Section 16 Reports.

FOOTNOTES:

(n2)Footnote *. This Special Alert was adapted from a client memo of Gibson, Dunn & Crutcher LLP and provided by the author, Ronald O. Mueller who is a partner in the Washington D.C. office.



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CHAPTER 8 Insider Reporting and Short-Swing Trading

2-8 Federal Securities Exchange Act of 1934 8.syn

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FOOTNOTES:

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CHAPTER 8 Insider Reporting and Short-Swing Trading

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Summary of This Chapter

Exchange Act Section 16 was enacted to curb the abuse of inside information by corporate insiders. In general, Section 16 sets forth disclosure requirements for corporate insiders, imposes strict liability for the profits realized by insiders' short-swing trading, prohibits short sales by corporate insiders, and provides various exemptions from these provisions. See § 8.01 *infra*.

The provisions of Section 16 apply to the corporate insider, defined as a person or entity that is the beneficial owner of more than ten percent of any equity security registered under Exchange Act Section 12, or a director or officer of the issuer of any equity security registered under Exchange Act Section 12. Persons or entities that may be considered insiders under Section 16 include corporations, trusts (treated as a separate entity for this purpose), trustees, beneficiaries, and settlors thereof, partnerships, individual partners, and limited liability companies. See § 8.02 *infra*.

Insiders are required to file public reports detailing their holdings and transactions in the equity securities of their corporations. Initial reports of securities beneficially owned (including information as to puts, calls, options, and other rights or obligations) are made on Form 3. Certain changes in beneficial ownership of such securities are required to be reported promptly on Form 4. Previously unreported transactions and a narrow class of transactions that are exempt from current reporting on Form 4 are reportable on a year end Form 5. Failure to disclose the required information can result in civil or criminal proceedings. See § 8.03 *infra*. In addition, issuers must disclose the names of delinquent filers and other information in proxy statements relating to annual meetings of shareholders and in the Annual Report on Form 10-K (or Form 10-KSB).

An insider is subject to liability under Section 16(b) for profits realized from the purchase and sale, or sale and purchase, of any equity security of the issuer within any period of less than six months. A voluntary cash-for-stock transaction constitutes a purchase or sale for purposes of Section 16(b), but more exotic exchanges and changes in ownership interests may also be subject to Section 16(b). An issuer may bring an action under Section 16(b) to recover profits realized by an insider's short-swing trades; or, if the issuer declines to bring suit or does not diligently prosecute a Section 16(b) action, any security holder of that issuer may institute an action on behalf of the issuer. Section 16(b)

imposes strict liability on insiders who violate its provisions, if the statutory terms are met. Unless an exemption takes a transaction out of the scope of Section 16(b), no defenses are available to the insiders except for the running of the statute of limitations. See §§ 8.04 and 8.06 *infra*.

Under Section 16(c), an insider is prohibited from engaging in 'short sales' (selling equity securities of his company that he does not own at the time of sale). An insider who sells a security must deliver the security within a specified time, unless the required delivery would cause undue inconvenience or expense. See § 8.05 *infra*.

The Commission has exempted from all or some of the provisions of Section 16 certain transactions. Transactions exempted from both Section 16(a) reporting and Section 16(b) liability include certain transactions arising from a pro rata stock split, stock dividend, or rights distribution, acquisitions under dividend or interest reinvestment plans, or under certain tax-qualified employee benefit plans, transactions pursuant to divorce decrees, dispositions upon expiration of a call option, certain pre-insider transactions, transactions by fiduciaries during the 12 months after appointment involving securities held by an estate, certain transactions by dealers and underwriters in connection with a distribution, and odd-lot transactions by an odd-lot dealer (also exempted from Section 16(c)). Certain small acquisitions are exempted from the requirement that they be reported currently on a Form 4 under Section 16(a), but such transactions are reportable on the year-end Form 5 and remain subject to potential Section 16(b) liability. Certain transactions between an issuer and its officers and directors (including transactions under employee benefit plans that do not satisfy the tax-qualified plan exemption) and transactions involving exercises and conversions of options and other derivative securities are exempt from potential Section 16(b) liability, but nevertheless must be reported on a Form 4. Certain transactions exempted only from Section 16(b) liability and not from Section 16(a) reporting include certain transactions by registered investment companies, registered public utility holding companies, and companies subject to the Interstate Commerce Act, certain issuer redemptions, bona fide gift and inheritance transactions, and dispositions of derivative securities where no value is received, certain transactions resulting from mergers and related transactions between a parent company and a subsidiary at least 85%-owned by the parent, certain transactions relating to the deposit of securities in or withdrawal of securities from a voting trust, and acquisitions in connection with a debt previously contracted. In addition, Section 16 provides an exemption for market makers and foreign and domestic arbitrage transactions, and the Commission has adopted a complete exemption for the securities of certain foreign issuers. Exemptions from Section 16(c)'s short-sale prohibition are also provided for brokers acting in an agency capacity, dealers participating in a distribution, sales of 'when-issued' or 'when-distributed' securities, and fully-hedged short sales resulting from transactions in put and call options. See § 8.06 *infra*.



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CHAPTER 8 Insider Reporting and Short-Swing Trading

2-8 Federal Securities Exchange Act of 1934 § 8.01

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§ 8.01 Introduction

Exchange Act Section 16 was enacted to curb the abuse of inside information by corporate insiders. In general, Section 16 sets forth disclosure requirements for corporate insiders, imposes strict liability for the profits realized by insiders' short-swing trading, prohibits short sales by corporate insiders, and provides various exemptions from these provisions.

Section 16 was enacted, and later amended, in response to a history of abuse of inside information by corporate insiders. n1 The types of short-swing transactions that prompted the enactment of Section 16 included:

- (1) transactions in which insiders, with advance knowledge of information that would produce a rise in the market price of their company's stock, bought company stock at current market prices and then sold when publication of the information caused the anticipated rise in the price of the stock;
- (2) transactions in which insiders, with advance knowledge of information that would depress the market price of their company's stock, sold their stock at current market prices and then purchased company stock when publication of the information caused the anticipated depressing effect in the price of the stock; and
- (3) manipulation by insiders of the market price of their company's stock by causing their company to pursue financial policies calculated to produce sudden fluctuations in market prices and then timing their purchases and sales of company stock accordingly. n2

Congress sought to curb insider trading abuses by:

- (1) encouraging the maintenance of proper fiduciary standards by insiders through the publication of the holdings and transactions of insiders in the securities of their corporations; and
- (2) imposing strict liability for the profits realized by insiders from matching purchases and sales or sales and purchases of their corporations' securities within a period of less than six months. n3

In addition, the modifications to Section 16(a) mandated under the Sarbanes-Oxley Act of 2002 were effectuated to make information available to all investors on a more timely basis to increase market transparency and to enhance market efficiency and liquidity. n4

The disclosure requirements for corporate insiders are set forth in Section 16(a) and require the filing of statements of beneficial ownership of an issuer's equity securities. n5 Section 16(b) creates an action for the recovery of profits realized from an insider's short-swing trading. n6 Section 16(c) prohibits a corporate insider from engaging in 'short sales.' n7 Section 16(d) and Section 16(e), and rules promulgated under Section 16, however, provide various exemptions to these provisions. n8

During 1991, the Commission adopted major amendments to its rules and forms under Section 16. n9 The 1991 Section 16 rules generally became effective on May 1, 1991, except that, for transactions under employee benefit plans, issuers could continue to rely on exemptions from short-swing profits liability under the old rules during a "phase-in period." The phase-in period lasted until November 1, 1996, when further rule revisions (primarily relating to employee benefit plan transactions) became fully effective. See § 8.06[7] *infra*. The 1991 Rules represented the first comprehensive revision of the Section 16 rules ever. The principal revisions to the rules were as follows: (i) definitions of who are officers and ten-percent shareholders subject to Section 16 are set forth, (ii) broader definitions of securities "beneficially owned" are set forth, thus expanding reporting and potential liability, (iii) a tiered reporting scheme, under which some transactions were reported annually on the specially created Form 5, was established, (iv) in an effort to reduce noncompliance with the Section 16(a) reporting requirements, issuers are required to name in proxy statements and Form 10-Ks (or Form 10-KSBs, if applicable) insiders who have been delinquent in their Section 16 filings, (v) acquisitions of options and other 'derivative securities' (as defined) are treated as 'purchases' of the underlying equity securities for purposes of Section 16(b), which makes it clear that transactions in standardized options are subject to Section 16 reporting and liability, (vi) most exercises of options and other derivative securities are exempted from Section 16(b) liability because, in the SEC's view, such transactions lack the potential for speculative abuse, and (vii) the exemptions for employee benefit plans and other transactions between an issuer and its officers and directors were revised and simplified, a development taken even further through additional amendments to Rule 16b-3 that were adopted in 1996.

Changes in the reporting system under Section 16(a) resulted from amendments to the statute adopted in 2002. While always an element of Section 16, the requirements under Section 16(a) that insiders report their transactions through reports filed with the Commission has taken on increasing significance in recent years, as officers' and directors' access to company stock has increased through equity compensation arrangements and investors' interests in information on such transactions has increased. These trends, together with perceived abuses of the reporting system, culminated with the adoption of amendments to Section 16(a) as part of the Sarbanes-Oxley Act of 2002. Under those amendments, Forms 4 are generally required to be filed within two business days of the triggering transaction and electronic filing and company website disclosures of such filings was mandated.

Section 16(b) is a "crude rule-of-thumb" n10 developed to prevent the unfair use of inside information, with predictability and certainty, by prohibiting all short-swing trading by an insider within a period of less than six months. Section 16(b) has been criticized for not requiring proof that an insider intended to use or actually knew of inside information in engaging in short-swing trades. n11 However, Section 16(b) reflects a Congressional belief that the unfair use of inside information could be effectively curbed only by the imposition of strict liability for short-swing transactions. n12 Section 16(b) is not arbitrary, however, liability may be imposed upon an innocent violator of its provisions but not upon a manipulator of inside information who intentionally times transactions to avoid liability.

The intention of Congress in enacting Section 16(b) was to create limited areas of clear and unambiguous liability for engaging in certain transactions. n13 In practice, however, the objective and mechanical nature of Section 16(b) continues to be defined by the courts. Some courts have inquired into whether a particular transaction provided the opportunity for the abuse of inside information that Section 16(b) seeks to prevent before determining whether the

requirements of the section should be applied to those transactions, while others have attempted to expand the scope of some of its terms to encompass perceived potential abuses of the type Section 16 was intended to address. n14 As a result, counsel may be uncertain as to his client's liability under Section 16(b) for engaging, or planning to engage, in a particular transaction. This uncertainty as to Section 16's applicability is contrary to the intention of Congress.

Short-swing trading not only comes within the purview of Section 16(b), but could also involve a violation of Exchange Act Section 10(b) and *Rule 10b-5* promulgated thereunder, which provide a remedy for the employment of any manipulative or deceptive device or contrivance "in connection with the purchase or sale of a security." n15 Moreover, some state courts have held that insiders who trade for their own benefit on the basis of inside information are deemed to have breached their corporate fiduciary duty and may be held accountable to the corporation for any profits received. n16

The adoption of a corporate policy imposing restrictions on trading in the securities of the corporation by insiders helps to eliminate an insider's risk of incurring liability for short-swing trading. The New York Stock Exchange Company Manual makes the following observations, among others, regarding insiders' purchases and sales of stock:

- (1) One appropriate method of purchase might be a periodic investment program where the directors or officers make regular purchases under an established program administered by a broker and where the timing of purchases is outside the control of the individual.
- (2) It would also seem appropriate for officials to buy or sell stock in their companies for a 30-day period commencing one week after the annual report has been mailed to shareholders and otherwise broadly circulated (provided, of course, that the annual report has adequately covered important corporate developments and that no new undisclosed developments occur within that period).
- (3) Transactions may also be appropriate under the following circumstances, provided that prior to making a purchase or sale a director or officer contacts the chief executive officer of the company to be sure there are no important developments pending which need to be made public before an insider could properly participate in the market--
 - (a) Following a release of quarterly results, which includes adequate comment on new developments during the period.
 - (b) Following the wide dissemination of information on the status of the company and current results. For example, transactions may be appropriate after a proxy statement or prospectus which gives such information in connection with a merger or new financing.
 - (c) At those times when there is relative stability in the company's operations and the market for its securities. Under these circumstances, timing of transactions may be relatively less important. Of course such periods of relative stability will vary greatly from time to time and will also depend to a large extent on the nature of the industry or the company.
- (4) Where a development of major importance is expected to reach the appropriate time for announcement within the next few months, transactions by directors and officers should be avoided.
- (5) Corporate officials should wait until after the release of earnings, dividends, or other important developments have appeared in the press before making a purchase or sale. This permits the news to be widely disseminated and negates the inference that officials had an inside advantage. Similarly, transactions just prior to important press releases should be avoided. n17

FOOTNOTES:

(n1)Footnote 1. Among the most vicious practices unearthed at the hearings before the subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their position of trust and the confidential information which came to them in such positions, to aid them in their market activities. Closely allied to this type of abuse was the unscrupulous employment of inside information by large stockholders who, while not directors and officers, exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others. Stock Exchange Practices, Report of the Committee on Banking and Currency, S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934). Section 16 was amended in 2002 as part of the Sarbanes-Oxley Act of 2002, in an attempt to curb further corporate corruption and abuse.

The definition of an insider for purposes of Section 16 is discussed in § 8.02 *infra*.

(n2)Footnote 2. S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 7 (1934); H.R. Rep. No. 1303, 73d Cong., 2d Sess. 13 (1934).

(n3)Footnote 3. Section 16(a). *See also* H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934).

(n4)Footnote 4. *See* Exch. Act Rel. No. 34-46421 (Aug. 29, 2002).

(n5)Footnote 5. Section 16(a) is discussed in § 8.03 *infra*.

(n6)Footnote 6. Section 16(b) is discussed in § 8.04 *infra*.

(n7)Footnote 7. Section 16(c) is discussed in § 8.05 *infra*.

(n8)Footnote 8. The exemptions from the requirements of Sections 16(a), (b), and (c) are discussed in § 8.06 *infra*.

(n9)Footnote 9. *See* the Adopting Release at Exch. Act. Rel. No. 28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709 (Feb. 8, 1991). *See also* Exch. Act Rel. No. 34-26333 (Dec. 2, 1988), C.C.H. Fed. Sec. L. Rep. P 84,343, at 89,596 (the 'Proposing Release') and Exch. Act Rel. No. 34-27148 (Aug. 18, 1989), C.C.H. Fed. Sec. L. Rep. P 84,439, at 80,380 (the 'Reproposing Release').

(n10)Footnote 10. Hearings on Stock Exchange Practices before the Committee on Banking and Currency, 73d Cong., 2d Sess. 6557 (1934).

(n11)Footnote 11. *See e.g.*, Note, "Beneficial Ownership" Under Section 16(b) of the Securities Exchange Act of 1934, 77 Colum. L. Rev. 446 (1977).

(n12)Footnote 12. "The corporate official and director has his problems and they are not just problems of his business. He has to worry about his responsibilities as a fiduciary-at times he has been called a trustee. He must conduct his business under complex rules in many areas which require nice judgments and subtle distinctions as to appropriate and inappropriate action. As to short-term trading, however, Section 16(b) relieves him of that worry. There is little need to make judgments. Section 16(b) is about as subtle as a sledge hammer, and perhaps this is why people tend to get a little emotional about it. It doesn't leave much room for argument. Therein, in part, lies its virtue. The clamor for certainty is pretty well satisfied in this section of the law. It does not make short-swing trading illegal. It does not prohibit. It merely says that if you trade, pay over the profit. It speaks with an eloquence not often misunderstood.' Woodside, *Resume of the Report of the Special Study of Securities Markets and the Commission's Legislative Proposals*, 19 Bus. Law. 463, 476-77 (1964).

(n13)Footnote 13. *Blau v. Lehman*, 368 U.S. 403 (1962) .

(n14)Footnote 14. *See* § 8.04[2] *infra*.

(n15)Footnote 15. Section 10(b) and *Rule 10b-5* are discussed in § 5.04 *supra*.

(n16)Footnote 16. *See* 10 Cavitch, *Business Organizations* §127.02.

(n17)Footnote 17. N.Y.S.E. *Company Manual* § 309.00.



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Federal Securities Exchange Act of 1934

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CHAPTER 8 Insider Reporting and Short-Swing Trading

2-8 Federal Securities Exchange Act of 1934 § 8.02

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§ 8.02 Who is an Insider?

The provisions of Section 16 apply to the corporate insider, i.e., a person or entity who is a beneficial owner of more than ten percent of any equity security registered under Exchange Act Section 12 or a director or officer of the issuer of any equity security registered under Exchange Act Section 12.

Section 16(a)'s reporting requirements, Section 16(b)'s short-swing profits liability provisions, and Section 16(c)'s prohibition of short sales apply to a person or entity that is:

- (1) directly or indirectly the beneficial owner n1 of
 - (a) more than ten percent n2 of
 - (b) any class n3 of any equity security n4
 - (c) other than an exempted security n5
 - (d) registered under Section 12 of the Exchange Act, n6
- (2) a director n7 of the issuer of any equity security (other than an exempted security) registered under Section 12 of the Exchange Act, or
- (3) an officer n8 of the issuer of equity security (other than an exempted security) registered under Section 12 of the Exchange Act. n9

Among the persons or entities that may be considered to be insiders under Section 16 are corporations, n10 persons in control of corporations, n11 trusts n12 and the trustees, settlors, and beneficiaries thereof, n13 partnerships, n14 individual partners, n15 and others, including limited liability companies. n16

[1] Directors and Officers

A primary aim of Congress in enacting Section 16 was to deter and to prevent individuals who, because of their corporate position, have access to confidential information from using such information to engage in profitable securities transactions. n17

[a] Directors. The term "director" is defined by Section 3(a)(7) of the Exchange Act to mean a director of a corporation or a person performing similar functions with respect to any incorporated or unincorporated organization.

Because the term director encompasses persons performing similar functions, it would appear to encompass trustees of business trusts, members of committees issuing certificates of deposit, and trustees of voting trusts. n18 In addition, the Commission staff takes the position that general partners of a limited partnership which has equity securities registered under Exchange Act Section 12 perform the functions of directors with respect to the publicly held limited partnership. n19

Advisory or emeritus directors will be considered a director under Commission and staff interpretations if such persons are "invited to attend board meetings of the issuer to assist in policy formation and, therefore, ... have access to material, non-public information." n20 The Commission has suggested, however, that honorary directors usually are not deemed to be directors under this test, while advisory and emeritus directors generally are (even though they do not vote as directors). n21

A person or entity that has authorized an individual to serve on the board of directors of an issuer may also be deemed to be a "director" of that issuer for purposes of Section 16. The individual actually serving as director is deemed to have been "deputized" by the other person or entity, so that the deputizing person or entity is deemed also to be a director. As a result, transactions by the deputizing person or entity are subject to potential short-swing profits liability under Section 16(b). n22

Although the standards for determining whether a director has been "deputized" are somewhat unclear, a finding of deputization under Section 16(b) generally rests on a showing that:

- (1) the deputizing entity intended the director to act as its representative on the board of directors of the issuer; and
- (2) the transactions of the deputizing entity in the issuer's equity securities were made with the advice of the deputizing entity's deputy and this advice was based on the deputy's knowledge of inside information about the second corporation. n23

The Commission has also stated that a director for the purposes of Section 16(a) includes a person who has the power by agreement or otherwise to designate another to be a director of a corporation because that person is likely to have access to inside information by reason of his relationship to the designated director. n24 Other than reaffirming this position, the Commission did not attempt to codify the law of deputization in the 1991 Section 16 rules. n25

The Commission staff will no longer express a view on the factual question of whether a particular person is a director for the purposes of Section 16(a), n26 leaving the determination to the issuer, and ultimately to courts.

[b] Officers. Effective May 1, 1991, the Commission adopted a new definition of the term "officer" for purposes of Section 16. n27 Under Rule 16a-1(f), the term "officer" includes (i) an issuer's president, (ii) any vice president in charge of a principal business unit, division or function (such as sales, administration, or finance), (iii) the principal accounting officer (or, if none, controller) and principal financial officer, and (iv) any other person (including an officer of a parent or subsidiary) who performs for the issuer a policy-making function that is significant.

The Rule 16a-1(f) definition of "officer" is essentially the same as the definition of "executive officer" in existing Exchange Act Rule 3b-7, except that the principal accounting officer (or controller) and principal financial officer are specifically included as "officers" under Rule 16a-1(f). n28 Issuers already must include beneficial ownership information for this "executive officer" group in their proxy statements pursuant to Item 403 of Regulation S-K and identify "executive officers" in their Annual Reports on Form 10-K pursuant to Item 401(b) of Regulation S-K. Indeed, a note to Rule 16a-1(f) sets forth a "presumption" that "executive officers" identified pursuant to Item 401(b) of Regulation S-K are also "officers" for purposes of the Rule 16a-1(f) definition. n29

Rule 16a-1(f)'s definition of the term officer in effect sets forth three ways for a person to qualify as an officer. First, certain persons are deemed to be officers based primarily upon their title, including a president, principal accounting officer (or controller) and principal financial officer. Second, certain vice presidents of the issuer are deemed to be "officers" if they are in charge of a principal business unit, division or function (such as sales, administration, or finance). Third, any other person who performs a significant policy-making function is an officer. n30

The new definition of "officer" under Rule 16a-1(f) that became effective May 1, 1991, resulted in some persons being deemed to be Section 16 officers for the first time, and others ceasing to be subject to Section 16. n31

An officer of the issuer's parent or a subsidiary may be deemed a Section 16 "officer" of the issuer if the person has a significant policy-making function. n32 The Commission has also taken the position that, for purposes of Section 16, an assistant to an officer will not be considered an officer if he regularly performs only routine administrative duties rather than significant policy-making functions. n33 In addition, an assistant who performs some of the duties of his superior will not be considered to be an officer if those duties are performed under the supervision of the officer he assists. n34 If, however, the assistant regularly performs a substantial part of the duties of his chief, he may be considered to be an officer under Section 16. n35

If an issuer is a limited partnership, limited liability company, or a trust, officers or employees of any general partner, managing member, or trustee who perform policy-making functions for the issuer are deemed officers of the issuer. n36

Significantly, the definition of the term "officer" (as well as other definitions under the 1991 rules) apply for purposes of Section 16(b) as well as Section 16(a). n37 This raises a question as to the continuing validity of holdings in the prior cases that have examined who is an "officer" for purposes of Section 16(b). It appears, however, that the Commission's focus on "policy-making" functions is generally consistent with the prior cases.

The courts, in determining liability under Section 16(b), had generally looked to the relationship of an individual with the issuer to determine whether the individual would have access to the type of inside information the abuse of which Section 16 seeks to prevent. The judicial trend had been to avoid the automatic imposition of Section 16(b) liability simply because an individual had a title listed in Rule 3b-2. n38

The courts had also attempted to prevent the intentional structuring of corporate offices through the formalities of titles to avoid Section 16(b) liability. In *Colby v. Klune*, n39 the court, on appeal, found that the trial court improperly granted summary judgment because there was an issue of fact as to whether defendant, a "production manager" was an officer of the corporation. The court refused to be limited by the labeling of functions or the corporate bylaws' definition of the position. n40

For the purposes of determining liability under Section 16(b), the courts had made factual inquiries, beyond the fact that a person has a title and therefore nominally possesses officer status, to determine whether access to inside information actually accompanies the position. This was especially true with respect to vice presidents, some of whom may possess few of the executive responsibilities suggested by their titles. In *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Livingston*, n41 the court stated that the title of vice president "does no more than raise an inference that the person who holds the title has the executive duties and the opportunities for confidential information that the title implies." n42 The

case involved an account executive whose honorary promotion pursuant to a company program for rewarding outstanding executives did not change the nature of his work or access to inside information. The court concluded that the defendant was not an officer for the purposes of Section 16(b), because liability under Section 16(b) did not follow from a person's title, but rather was based on "the existence of a relationship with the corporation that makes it more probable than not that the individual has access to insider information." n43

Although Rule 16a-1(f) changed the focus of the inquiry to the specific tests set forth in the Rule, particularly "policy-making," the Commission made it clear that the Rule was intended to codify the principles developed by the courts. n44 Accordingly, some cases pre-dating the 1991 Rules should continue to provide guidance as to the meaning of the term "officer" under Section 16.

The staff will not give advice in response to questions of whether a particular person is an officer under Rule 16a-1(f), stating that the determination is to be made by the issuer and its counsel. n45

[2] Principal Security Holders

In addition to directors and officers of an issuer, every individual who directly or indirectly is the beneficial owner of more than ten percent of any registered class of equity security of an issuer is considered to be an insider who is subject to the provisions of Section 16. n46 Congress included stockholders with significant beneficial stock ownership within the coverage of Section 16 since they "exercised sufficient control over the destinies of their companies to enable them to acquire and profit by information not available to others." n47

In adopting the new Section 16 rules in 1991, the Commission radically altered the method by which a person's status as a 10% shareholder is determined. Under the new rules, a person becomes a 10% shareholder subject to Section 16 if he becomes a beneficial owner of more than 10% of an outstanding class of equity securities under the "beneficial ownership" rules under Section 13(d) of the Exchange Act, subject to certain limited exceptions for institutional shareholders. n48 Reliance on the Section 13(d) rules defining beneficial ownership, which focus on a security holder's ability to influence or control an issuer as a result of equity ownership, is appropriate, the Commission reasoned, because Congress intended Section 16 "to reach those persons who could be presumed to have access to inside information because of their interest in the issuer's securities." n49

It is crucial to understand that the Section 13(d) rules are used only to determine who has the *status* of a 10% shareholder subject to Section 16. A person who has such status, like a person who is a director or officer, is a Section 16 insider who must file Forms 3, 4, and 5 to report "beneficial ownership" and changes in "beneficial ownership" of equity securities of the issuer under Section 16(a). For purposes of determining the securities holdings to be disclosed on such reports -- indeed, for all purposes under Section 16 other than determining who is a 10% shareholder -- the Section 13(d) concepts of "beneficial ownership" are irrelevant. Rather, "beneficial ownership" for these other Section 16 purposes, as defined under Rule 16a-1(a)(2), depends on the insider having or sharing a direct or indirect "pecuniary interest" in equity securities, a definition much closer to the historic interpretation of the term "beneficial ownership" under Section 16. n50

This dual definition of "beneficial ownership" can result in some anomalies, because a person may have Section 13(d) beneficial ownership over more than ten percent of an outstanding class, and therefore be a Section 16 insider, and yet have reportable beneficial ownership (in the "pecuniary interest" sense) over fewer or no shares. n51 For example, a trustee could have voting or dispositive power over securities held in trust so that he would be deemed a 10% shareholder (unless he qualifies for one of the exceptions under Rule 16a-1(a)(1), as discussed below). Such trustee would not be deemed a "beneficial owner" of trust securities for reporting purposes if he did not have a "pecuniary interest" in such shares. n52 In such case, the trustee would have to file an initial Form 3, indicating on such Form that he is a "10% Owner" (in Box 5 on the Form), but he would not list any of the trust securities in Table I and Table II of the Form. n53 Exceptions under Rule 16a-1(a)(1), however, prevent many institutional investors who have voting or

dispositive power in securities held for others from being deemed 10% shareholders, as discussed below. n54

[a] Beneficial Ownership For Purposes of Determining 10% Shareholder Status.

[i] Incorporation of Section 13(d) Beneficial Ownership Principles. As noted above, Rule 16a-1(a)(1) provides that, solely for purposes of determining whether a person has insider status as a 10% shareholder, the term "beneficial owner" under Section 16 means any person who is deemed a beneficial owner pursuant to Section 13(d) of the Exchange Act and the rules thereunder, subject to certain exceptions. Prior to adoption of Rule 16a-1(a)(1) in 1991, the Commission had not formally defined terms relating to "beneficial ownership" for Section 16 purposes, and no clear distinction was made between "beneficial ownership" for purposes of determining who is a 10% shareholder and "beneficial ownership" for other Section 16 purposes. n55

Under Section 13(d), a person is a "beneficial owner" of equity securities as to which he directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise, has or shares voting power or investment power. n56 A person is also deemed to beneficially own equity securities if he has a right to acquire voting or investment power over such equity securities within 60 days through exercise of an option, warrant, or right or conversion of a security, pursuant to the power to revoke a trust, discretionary account, or similar arrangement, or pursuant to the automatic termination of a trust, discretionary account, or similar arrangement. n57 In addition, if a person becomes a member of a "group" for purposes of Section 13(d) through an agreement to act together with others for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, such person is deemed to beneficially own equity securities that are held by other group members and are subject to such agreement. n58

Although the rules under Section 13(d) have evolved over the years since the 1968 enactment of Section 13(d), application of the Section 13(d) rules under Section 16 poses a number of difficulties. First, the Section 13(d) rules deliberately use broad language applicable to a wide range of arrangements and relationships in order to promote the filing of Schedules 13D and 13G, disclosing securities holdings that could affect control of an issuer. Under Rule 16a-1(a)(1), these same broad rules now dictate whether a person is subject to potential strict liability for short-swing transactions under Section 16(b). Arguably, rules that impose strict liability should be drafted more narrowly than rules that promote disclosure. Second, litigation involving the rules under Section 13(d) has, in the past, generally been limited to issues relating to corporate control contests, with "beneficial ownership" issues only occasionally being of central importance. Technical issues regarding "beneficial ownership" have now become a more significant focus of litigation because the imposition of potential short-swing profits liability on would-be 10% shareholders will turn on such issues. In fact, most litigation over the Section 13(d) standard of beneficial ownership occurs in the context of Section 16(b) claims. Finally, determining who is a 10% shareholder under Section 13(d) rules may cause the transaction that results in a person becoming a 10% shareholder being treated as a separate event from a Section 16 purchase, subjecting the purchase to possible short-swing profits liability. n59

[ii] Exclusion of Certain Securities Held by Institutional Investors. Rule 16a-1(a)(1) provides an exclusion for certain equity securities held by specified institutional investors, so that, even though such securities are deemed to be "beneficially owned" for purposes of Section 13(d), n60 they are not deemed to be "beneficially owned" for purposes of the 10% shareholder calculation. n61 The exclusion applies to the same institutional investors that are eligible to file a short-form Schedule 13G in lieu of a Schedule 13D under Rule 13d-1(b)(1). n62 In this regard, the Commission staff has interpreted Rule 16a-1(a)(1) in a manner consistent with past interpretations under Rule 13d-1(b)(1), making the exclusion available to certain foreign institutions who control eligible institutions that do not otherwise qualify under the literal terms of the Rule. n63 The exclusion under Rule 16a-1(a)(1), like eligibility to file the short-form Schedule 13G under Rule 13d-1(b)(1), is available only if the equity securities were acquired "without the purpose or effect of changing or influencing control of the issuer," n64 or engaging in any arrangement having the purpose or effect of divesting such person of beneficial ownership as part of a plan or scheme to evade reporting requirements. n65

An institutional investor eligible to file the short-form Schedule 13G under Rule 13d-1(b)(1) may not, in determining its

status as a 10% shareholder under Rule 16a-1(a)(1), exclude all equity securities of the issuer that it beneficially owns, but may only exclude equity securities "held for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business." n66 In other words, certain equity securities holdings of institutional investors are not excluded under Rule 16a-1(a)(1) even though they are reportable on a short-form Schedule 13G. For example, securities held by a broker-dealer or investment adviser in its own investment or proprietary account or by an insurance company in its general account would be reportable on the short-form Schedule 13G but probably could not be excluded from that institution's beneficial ownership under Rule 16a-1(a)(1). But, the Commission and its staff have concluded that equity securities held in the following ways are eligible to be excluded under Rule 16a-1(a)(1):

- (1) in an insurance company's "separate accounts," in which assets are segregated for the exclusive benefit of specified customers; n67
- (2) as portfolio securities held by mutual funds or most other registered investment companies; n68
- (3) as portfolio securities held by an endowment fund for the benefit of the organization for which the fund was created; and n69
- (4) as portfolio securities held by a master trust that serves as a funding vehicle for defined benefit pension plans subject to ERISA. n70

[iii] Attribution of Beneficial Ownership to Group Members. As noted above, each member of a Section 13(d) group is, for purposes of Rule 16a-1(a)(1), deemed to beneficially own the shares beneficially owned by the group. n71 This position effectively overrules a number of court rulings that members of a group that held more than 10% of an outstanding class of equity securities are not, due to such group membership, deemed to be subject to Section 16 as 10% shareholders, if such members did not have a pecuniary interest in other group members' shares. n72 In a departure from the Section 13(d) rules relating to groups, the Commission does not treat the group itself as a separate entity subject to Section 16, so no separate Form 3, 4, or 5 filing by the group is required. n73 Rather, for purposes of determining whether the individual member is a 10% shareholder, the equity securities beneficially owned by the group must be included in calculating the number of shares beneficially owned by any individual member. n74

Attribution of beneficial ownership of group shares to individual group members for purposes of the 10% shareholder calculation may result in a greater number of Section 16 insiders in some circumstances. Because the test for whether a group has been created--whether two or more persons have entered into any agreement to act together for the purpose of acquiring, voting, holding, or disposing of equity securities--is very broad, a party to a shareholder agreement, a voting trust, or even a standstill agreement will run the risk of becoming a Section 16 insider if the group's beneficial ownership (plus any separate beneficial ownership) exceeds ten percent of an outstanding class. n75 The Commission staff has taken the position, based on the particular facts presented, that an individual is not deemed to be a member of a group where he became subject to the agreement relating to shares not as a result of his voluntary act. n76

Although equity securities beneficially owned by a group are attributed to individual members for purposes of the 10% shareholder calculation, a group member who is deemed to be an insider would report, on any Form 3, 4, or 5, beneficial ownership of, and transactions relating to, only equity securities in which he has a "pecuniary interest." n77

[iv] 10% Shareholder Status of Trusts, Trustees, Beneficiaries, and Settlor. Although for most purposes a trust is not treated as a legal entity, Rule 16a-8(a)(1) n78 treats a trust as an entity that can beneficially own the shares held in the trust. n79 Accordingly, a trust can become subject to Section 16 as a distinct 10% shareholder, with Form 3, 4, and 5 filing obligations separate from the obligations of any trustee, settlor, or beneficiary of the trust. n80

The beneficial ownership rules under Section 13(d), as modified under Rule 16a-1(a)(1), apply for purposes of determining whether a trust is a 10% shareholder. n81 In this regard, the exclusion under Rule 16a-1(a)(1) for employee

benefit plans or pension funds subject to ERISA is available to a trust holding assets for such a plan. n82 The Rule 16a-1(a)(1) exclusion provides that equity securities that would otherwise be attributed to a plan and its related trust will not be counted for purposes of determining whether such plan or trust is a 10% shareholder if the securities are allocated to plan participants where participants have voting power. n83 As in the case of the Rule 16a-1(a)(1) exclusion for other kinds of institutional investors, the exclusion is available to plans and trusts only if the issuer's equity securities were acquired by the plan or trust without the purpose or effect of changing or influencing control of the issuer or engaging in an arrangement intended to evade the reporting requirements. n84

In addition to the Section 16 obligations that may be imposed on a trust as an entity, a trustee that has or shares voting or dispositive power over equity securities held in trust must include such equity securities with other equity securities he beneficially owns (in the Section 13(d) sense) in determining whether he is a 10% shareholder under Rule 16a-1(a)(1). n85 Of course, a trustee that is an institutional investor eligible for the exclusion under Rule 16a-1(a)(1) would be able to exclude the trust shares in determining whether it is a 10% shareholder, if the requirements of the exclusion are met. n86 The Commission and its staff have suggested that an individual who is one of several trustees will be attributed beneficial ownership (in the Section 13(d) sense) of trust securities for purposes of Rules 16a-8(a)(2) and 16a-1(a)(1), but this position appears to be at odds with the staff's prior interpretation of the Section 13(d) rules. n87

Beneficiaries and settlors of a trust are deemed to beneficially own securities held in the trust, for purposes of determining their status as 10% shareholders, if they have voting or dispositive power or otherwise have beneficial ownership of such shares under the Section 13(d) rules, except to the extent the Rule 16a-1(a)(1) exclusion might apply to an institutional investor. n88 In addition, Rule 16a-8(a)(2)(ii) attributes beneficial ownership of trust shares to a settlor that has the power to revoke the trust without the consent of another person. n89

[v] Disclaiming Beneficial Ownership. A person filing a Form 3, 4, or 5 may state that the filing shall not be deemed an admission that such person is, for purposes of Section 16, or otherwise, the beneficial owner of any equity securities of the issuer. n90

[b] Determining Percentage of a Class of Equity Securities Registered Under Section 12 For Purposes of Determining 10% Shareholder Status. For purposes of determining whether the equity securities beneficially owned by a person constitute more than ten percent of an outstanding class of equity securities, in order to determine whether such person is a 10% shareholder subject to Section 16, the rules under Section 13(d) apply. n91

Significantly, under the Section 13(d) rules, the term "equity security" is narrower than under the Section 16 rules, because securities that would otherwise constitute equity securities but which do not carry the right to vote are not deemed to be a separate class of equity securities for Section 13(d) purposes. n92

As discussed above, a right to acquire equity securities that is exercisable within 60 days (or, if the right is acquired in a transaction having a control purpose or effect, exercisable at any time) constitutes beneficial ownership of the equity securities that could be acquired. n93 The reference to a 13(d) standard to determine beneficial ownership represented a significant departure from the standard that beneficial ownership for Section 16 purposes derived only if a person derived a pecuniary benefit from such ownership. n94 Moreover, potential liability under Section 16(b) has been broadened because these definitions, unlike the former rules, apply for purposes of determining who is subject to Section 16(b) as well as Section 16(a). n95

Accordingly, a holder of more than ten percent of an outstanding class of Section 12-registered convertible debentures convertible (within 60 days) into less than ten percent of an outstanding class of Section 12-registered common stock would not be subject to Section 16 as a 10% shareholder, assuming no other holdings of the common stock. n96 If such person held convertible debentures (whether or not Section 12-registered) convertible (within 60 days) into an amount of Section 12-registered stock that, by itself or together with his other beneficial ownership of such common stock, would constitute more than ten percent of the outstanding class of common stock, such person would be subject to

Section 16 as a 10% shareholder (with respect to the common stock). n97 If a person beneficially owns a convertible security that is itself a Section 12-registered equity security, such as a convertible preferred stock carrying voting rights, n98 such person would be a 10% shareholder, if his holdings of preferred stock constituted more than ten percent of the outstanding class of preferred stock or if the amount of common stock he could acquire upon conversion of the preferred stock, by itself or together with his other beneficial ownership of such common stock, would constitute more than ten percent of the outstanding class of common stock. n99

To compute the percentage of an outstanding class of equity securities a person beneficially owns, any equity securities such person is deemed to beneficially own because the person could acquire them upon exercise of a right to acquire (including a conversion privilege) are added to the number of equity securities outstanding, but equity securities that would be issued upon exercise of rights to acquire held by other persons are not added to the number of equity securities outstanding. n100 To determine the amount of outstanding securities of a class of equity securities, a person may rely on information set forth in the issuer's most recent quarterly report on Form 10-Q (or Form 10-QSB), annual report on Form 10-K (or Form 10-KSB), and current report on Form 8-K filed with the Commission, unless the person knows or has reason to believe that the information contained therein is inaccurate. n101

Questions can also arise as to what constitutes a "class" of equity securities, such as in cases involving multiple series of voting preferred stock or multiple classes of common stock. n102 Section 12(g)(5) of the Exchange Act defines the term "class" to include for Section 12(g) purposes.

all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. n103

The Commission has taken the position that two series of registered preferred stock that differ only with respect to dividend rate and redemption price would be treated as part of a single class for purposes of determining whether a person is a 10% shareholder. n104 The staff has taken the position that separate classes of common stock that carry different voting rights will each be considered to be a distinct class, and in a number of cases, courts have held that securities with similar voting and other rights are to be treated as different "classes" for purposes of Section 16. n105

Whether equity securities are registered under Section 12 of the Exchange Act is an objective question. n106 The requirements of Section 16 apply at any time after such registration, even if the issuer may have voluntarily registered the class of equity it was not in fact required to do so. n107

[3] Certain Trusts With Insider Trustees Deemed Indirect Insiders

From February 1991 until August 1996, a SEC rule provided that, in certain circumstances, a trust could be subject to Section 16 even if not a beneficial owner of 10% of an outstanding class of equity securities. This rule was repealed in 1996, largely because it only resulted in duplicative reporting. n108 Prior to its repeal, former Rule 16a-8 (a)(1)(ii) subjected a trust to Section 16, if the following conditions existed:

- (1) the trustee of the trust was a director, officer, or 10% shareholder subject to Section 16; n109
- (2) the trustee exercised or shared investment control over the issuer's equity securities held by the trust;
and
- (3) either the trustee or a member of the trustee's immediate family had a pecuniary interest in the issuer's securities held by the trust. n110

Under this rule, the trust was treated as a distinct entity, separate from the insider trustee, even though any Form 3, 4, or 5 would have been signed by the insider trustee on behalf of the trust. n111

Rule 16a-8(a)(1)(ii) contained two exceptions. First, a trust would not be subject to Section 16 if the trustee was an entity or person that in the ordinary course of business acted as a trustee and was an entity or person specified under Rule 16a-1(a)(i)-(viii).ⁿ¹¹² Second, a trust would not be subject to Section 16 if the trustee was an officer or director of the issuer serving as trustee for the issuer's employee benefit plan trust.ⁿ¹¹³

FOOTNOTES:

(n1)Footnote 1. The definition of beneficial ownership for these purposes is discussed in § 8.02[2][a] *infra*.

(n2)Footnote 2. Determination of the more than ten percent beneficial ownership requirement is discussed in § 8.02[2][b] *infra*.

(n3)Footnote 3. The definition of class is discussed in § 8.02[2][b] *infra*.

(n4)Footnote 4. The definition of equity security for these purposes is discussed in § 8.02[2][b] *infra*.

(n5)Footnote 5. The term "exempted security" includes government securities, municipal securities, certain common and collective investment funds of banks, and other securities, including securities exempted by the Commission. See Exch. Act § 3(a)(12); Rules 3a12-1 through 3a12-10. In most cases, securities that are "exempted securities" would not, in any event, come within the definition of "equity securities" for purposes of determining status as a 10% shareholder subject to Section 16. The one exception to this can arise in the case of securities of certain foreign issuers, exempt under Rule 3a12-3, discussed in § 8.06[17] *infra*.

(n6)Footnote 6. Registration of securities under Section 12 of the Exchange Act is discussed in § 4.01 *supra*.

(n7)Footnote 7. The definition of a director is discussed in § 8.02[1][a] *infra*.

(n8)Footnote 8. The definition of an officer is discussed in § 8.02[1][b] *infra*.

(n9)Footnote 9. Exch. Act §§ 16(a)-(c).

Pursuant to Section 30(h) of the Investment Company Act of 1940, the provisions of Section 16 of the Exchange Act also apply to direct or indirect beneficial owners of more than ten percent of any class of outstanding securities, other than short term paper, issued by a registered closed-end investment company, officers and directors of that company, and members of an advisory board, investment advisors, or affiliates of an investment adviser of the registered closed-end investment company.

Section 17 of the Public Utility Holding Company Act of 1935 is substantially identical to Section 16 of the Exchange Act although its applicability is limited to directors or officers of a registered public utility holding company. Section 17 is, however, broader than Section 16 in that it applies to transactions by those directors and officers in any securities, rather than to just equity securities, of the holding company or any subsidiary of the holding company.

The rules promulgated under Section 16(a) of the Exchange Act apply to persons filing reports under Rule 30f-1(a) of the Investment Company Act, see Rule 30h-1, 17 C.F.R. § 270.30h-1, and Rule 72(a) of the Public Utility Holding Company Act, see Rule 72, 17 C.F.R. § 250.72.

(n10)Footnote 10. See § 8.02[2] *infra*.

(n11)Footnote 11. See § 8.02[2][a] *infra*.

(n12)Footnote 12. See §§ 8.02[2][a][iv] and 8.02[3] *infra* .

(n13)Footnote 13. See § 8.02[2][a][iv] *infra*.

(n14)Footnote 14. See § 8.02[2] *infra*.

(n15)Footnote 15. See § 8.02[2] *infra*.

(n16)Footnote 16. See § 8.02[2] *infra*.

(n17)Footnote 17. "Among the most vicious practices unearthed at the hearings before the Subcommittee was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities." S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934).

(n18)Footnote 18. Cook & Feldman, *Insider Trading Under the Securities Exchange Act*, 66 Harv. L. Rev. 385, 400 (1953).

(n19)Footnote 19. See Integrated Resources American Insured Mortgage Investors--Series 85, SEC No-Action Letter (available March 25, 1986). In that interpretive letter, the staff stated that, in its view, even a general partner that was disabled by contract from participating in the management of the issuer was a Section 16 insider. See *id*. Similarly, managing members of limited liability companies or trustees of business trusts may be considered the equivalent of corporate directors.

(n20)Footnote 20. Exch. Act Rel. No. 34-26,333, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343 at 89,602 (Dec. 2, 1988). The staff further indicated that the determination as to whether a particular advisory, emeritus or honorary director should be treated as a director under Section 16 would be dependent on such person's underlying responsibilities, privileges and access to insider information. *Id*. In the Adopting Release, *supra* at note 9, the Commission stated that the new Rules do not change prior staff interpretations, which are set out in Exch. Act Rel. No. 34-18,114. Fed. Sec. L. Rep. (CCH) P 26,062, at 19,063-6 (Sept. 23, 1981) (question 2), and that a person's title would not be determinative as to whether such person was a director for Section 16 purposes.

(n21)Footnote 21. Exch. Act Rel. No. 34-26,333, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343, at 89,601 (Dec. 2, 1988). Compare Associated Madison Cos., Inc., SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,705, at 80,728 (Jan. 7, 1972) (members of advisory council, who did not attend board meetings and who had no voice in management decisions, not deemed directors) with Fort Worth National Corporation, SEC No-Action Letter, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 78,309, at 80,728 (July 8, 1971) (members of advisory board, who attended board meetings to assist in the formulation of company policy, deemed directors).

(n22)Footnote 22. The application of the concept of deputization for the imposition of Section 16(b) liability was recognized by the Supreme Court in *Blau v. Lehman*, 368 U.S. 403 (1962), although the Court in *Blau* held that the defendant-partnership was not liable.

(n23)Footnote 23. In *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969), *cert. denied*, 396 U.S. 1036 (1970), the court concluded that the president of the defendant corporation, who had been asked to join the board of directors of the issuer and who then received regular reports on the issuer's progress while at the same time supervising the defendant's investments, was a deputy of the defendant.

See also *Blau v. Lehman*, 368 U.S. 403, 82 S.Ct. 451, 7 L.Ed. 2d 403 (1962) (director of issuer who was a partner of defendant-partnership not deemed a deputy of the defendant-partnership where transactions in issuer securities by the defendant-partnership were made independently and without the specific knowledge of the partner); *Rattner v. Lehman*,

193 F.2d 564 (2d Cir. 1952) (defendant-partnership not liable under Section 16(b) where its transactions in issuer securities were made without any advice or concurrence from the defendant's partner sitting on the board of the issuer); *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965) (a corporation whose stock was held in trusts of which the defendant was trustee was not liable for transactions in the plaintiff's stock resulting in profits to the corporation made by the defendant-trustee while a director of the issuer); *Lasker v. Pyle-National Co.*, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 91,684 at 95,499 (S.D.N.Y. 1966) (underwriter not deemed to be a director merely because one of its general partners was also a director of the issuer).

(n24)Footnote 24. Exch. Act Rel. No. 34-18,114, Fed. Sec. L. Rep. (CCH) P 26,062, at 19,063-7 (Sept. 23, 1981) (question 3). Thus, if Company X and Company Y enter into a loan agreement whereby Company X is expressly given the right to designate a person to serve on the board of directors of Company Y, and Company X subsequently designates its vice president to sit on Company Y's board of directors, Company X may be deemed to be a director of Company Y for the purposes of Section 16(a). *Id.* Smaller, less seasoned issuers commonly agree to contractual terms allowing lenders or underwriters to designate directors, raising these Section 16 issues for the lender or underwriter. *See Roth v. Parseus L.L.C.*, 2006 U.S. Dist. LEXIS 52321 (S.D.N.Y. July 28, 2006) (deputization found where Board representatives gave deputizing entity access to inside information); *see also, Segen v. CDR-Cookie Acquisitions, L.L.C.*, 2006 U.S. Dist. LEXIS 3053 (S.D.N.Y. Jan 4, 2006) (defendants found to be directors by deputization when right to appoint three directors was exercised).

Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,251, n.27 (Feb. 8, 1991); Exch. Act Rel. No. 34-26,333, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343, at 89,602 (Dec. 2, 1988).

(n25)Footnote 25. The Commission affirmed that this interpretation remains valid under the Section 16 rules adopted in 1991. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,251 n.27 (Feb. 8, 1991).

(n26)Footnote 26. Exch. Act Rel. No. 34-18,114, Fed. Sec. L. Rep. (CCH) P 26,062, at 19,063-6 (Sept. 23, 1981).

(n27)Footnote 27. Rule 16a-1(f). *See* Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,251 (Feb. 8, 1991).

The term "officer" is not defined in the Exchange Act. Prior to the effectiveness of Rule 16a-1(f), the definition of the term officer under Exchange Act Rule 3b-2 applied for purposes of Section 16. Rule 3b-2 defines an officer as a president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer of an issuer, whether incorporated or unincorporated, or any other persons who routinely perform functions corresponding to those performed by the specifically mentioned individuals.

(n28)Footnote 28. As a practical matter, the class of "officers" for purposes of Section 16 typically includes the same officers who are treated as "affiliates" for purposes of Rule 144 under the Securities Act of 1933, as amended.

(n29)Footnote 29. Thus, except to the extent that certain persons are not deemed to be Rule 3b-7 "executive officers," an issuer's "executive officers" and Section 16 "officers" should be identical.

(n30)Footnote 30. The determination of whether a given vice president's duties put him or her in charge of a principal business unit, division, or function, or whether a person has significant policy-making function, involves factual determinations. A determination on these questions by the issuer's board of directors, which assigns functions of the officers to begin with, should be entitled to a presumption of validity. *See* Rule 16a-1(f) (Note).

(n31)Footnote 31. *See* Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,251 (Feb. 8, 1991). Any person who was deemed to be an "officer" for the first time under this definition

was required to file a Form 3 on or before May 1, 1991. Such a person, however, was not required to report transactions that occurred during the six months before May 1, 1991, and was not subject to short-swing profits liability with respect to such transactions. *See* Exch. Act Rel. No. 234-8,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,275-76 (Feb. 8, 1991). The old requirements for Section 16 insiders to report transactions that occurred before they became insiders were deleted under the 1991 rules, except in the case of a person's becoming a Section 16 insider due to the issuer's first registration of a class of equity securities under Section 12 of the 1934 Act. *See* Rule 16a-2(a).

A person who ceased being a Section 16 officer as a result of the 1991 definitions (an "exiting" insider) was not required to file Forms 4 to report transactions occurring on or after May 1, 1991. The Commission staff took the position that exiting insiders are not subject to Section 16(b) liability with respect to transactions following the effectiveness of the 1991 Rules. *See* Bryan, Cave, McPheeters & McRoberts, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,679, at 78,087 (Apr. 25, 1991); Joseph A. Grundfest, et al., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. P 79,678, at 78,085 (Apr. 25, 1991).

(n32)Footnote 32. Rule 16a-1(f). *See* Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,281 (Feb. 8, 1991) (revised response to question 1(b)); Exch. Act Rel. No. 18,114, Fed. Sec. L. Rep. (CCH) P 26,062, at 19,063-5-19,063-6 (Sept. 23, 1981) (question 1).

Under prior law, one court had concluded that Section 16(b) does not permit the recovery of short-swing profits where the defendant was an officer of the wholly owned subsidiary of the issuer and was not functioning as an officer of the issuer. *Lee Nat'l Corp. v. Segur*, 281 F. Supp. 851 (E.D. Pa. 1968).

See also Associated Bank & Services Inc., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) P 78, 334 (June 23, 1971) (officers and directors of subsidiary banks, wholly owned by the issuer, did not have to file Section 16(a) reports because they served administrative functions rather than having policy-making responsibilities; the Commission's staff stated, however, that this position should not be construed as a determination that officers and directors of subsidiary banks are not subject to Section 16(a)).

(n33)Footnote 33. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,281 (Feb. 8, 1991) (revised response to question 1(a)); Exch. Act Rel. No. 18,114, Fed. Sec. L. Rep. (CCH) P 26,062, at 19,063-5-19,063-6 (Sept. 23, 1981).

(n34)Footnote 34. *Id.* *See also* the opinion of the General Counsel of the Commission, Sec. Exch. Act Rel. No. 34-2,687, Fed. Sec. L. Rep. (CCH) P 26,058 (1940), stating that an assistant who performs the duties of an officer during the temporary absence or brief vacation of the officer was not an officer under the Exchange Act.

(n35)Footnote 35. Exch. Act Rel. No. 34-18,114, Fed. Sec. L. Rep. (CCH) P 26,062, at 19,063-6-19,063-7 (Sept. 23, 1981).

(n36)Footnote 36. Rule 16a-1(f). Presumably, this rule applies only if such policy-making functions are "significant," as with officers of corporate entities.

(n37)Footnote 37. *Compare Colby v. Klune*, 178 F.2d 872 (2d Cir. 1949) (concluding that definition of the term "officer" not limited by Rule 3b-2 for purposes of Section 16(b)).

(n38)Footnote 38. *See C.R.A Realty Corp. v. Crotty*, 878 F.2d 562 (2d Cir. 1989), in which the court held that a vice-president was not a company "officer" for the purposes of the Exchange Act's short swing trading provisions since, despite his title, his actual functions were of a middle management employee with no access to the company's financial or operational plans. The court added that the actual functions of an employee and not his corporate title determine status as an 'officer' within the purview of Section 16(b), a position endorsed by the Commission under the 1991 Rules.

Exch. Act Rel. No. 28,869 [1990 - 1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709 at 81,251 (Feb. 6, 1991).

See also *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Livingston*, at 8.02[1] *infra* .

(n39)Footnote 39. 178 F.2d 872 (2d Cir. 1949) .

(n40)Footnote 40. 178 F.2d at 873 . The court refused to be limited by the Commission's definition of "officer" in Rule 3b-2. *Id.* *Colby* was cited with apparent approval by the U.S. Supreme Court in *Reliance Electric Co. v. Emerson Electric Company*, 404 U.S. 418, 424, n.4. But see *Lockheed Aircraft Corp. v. Rathman*, 106 F. Supp. 810 (S.D. Cal. 1952) (the court, relying on Rule 3b-2, concluded that an assistant treasurer was not an officer).

(n41)Footnote 41. 566 F.2d 1119 (9th Cir. 1978).

(n42)Footnote 42. 566 F.2d at 1122.

(n43)Footnote 43. *Id.* Insider information is the type of confidential information that would assist a corporate employee in market decisions in his employer's securities; the term does not refer to all information about the company that is not public knowledge. *Id.* The 1991 Rules may overturn cases such as *National Medical Enterprises, Inc. v. Small*, 680 F.2d 83 (9th Cir. 1982), in which the court held that whether a person is an "officer" for the purposes of Section 16(b) is determined by the title held and that the factual inquiry engaged in by the court in *Merrill Lynch* is a limited exception applicable only when the title is essentially honorary or ceremonial.

See also *Gold v. Scurlock*, 324 F. Supp. 1211 (E.D. Va. 1971), *aff'd in part and rev'd in part sub. nom.* *Gold v. Sloan*, 486 F.2d 340 (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974) (vice president with mere staff functions and routine administrative chores not an officer under Section 16(b)); *Schimmel v. Goldman*, 57 F.R.D. 481 (S.D.N.Y. 1973) (vice president may raise issue as to whether he was an officer for purposes of Section 16(b) notwithstanding his having filed reports as an officer pursuant to Section 16(a)); *Morales v. Holiday Inns, Inc.*, 366 F. Supp. 760 (S.D.N.Y. 1973) (vice president who was "Director of Inn Operations" was in a position to acquire inside information); *Selas Corp. of America v. Voogd*, 365 F. Supp. 1268 (E.D. Pa. 1973) (executive vice president for international operations who was the chief operating officer of the most important section of the company's business and was one of the most active members on its executive committee liable under Section 16(b)).

(n44)Footnote 44. See Exch. Act Rel. No. 34-27,148, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,439, at 80,383-80,384 (Aug. 18, 1989).

(n45)Footnote 45. Exch. Act Rel. No. 34-18,114, Fed. Sec. L. Rep. (CCH) P 26,062, at 19,063-6 (Sept. 23, 1981); American Bar Association Joint Committee on Employee Benefits, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,719, at 78,252 (July 3, 1991) (declining to express a view on whether a general counsel constitutes an officer under Rule 16a-1).

The staff's position that the issuer and its counsel must make the determination, as well as the Note to Rule 16a-1(f) giving presumptive deference to the Board's determination of executive officer status, present a potential conflict with the fact that obligations under Section 16 fall on the director or officer, not on the issuer and its counsel. The issuer and its counsel, however, also have legal responsibility in shaping the issuer's disclosure under Item 405 of Regulation S-K of any delinquency by a director, officer, or 10% shareholder in complying with such person's reporting obligations under Section 16(a). As a practical matter, officers often look to the issuer for guidance on whether they are subject to Section 16. Regardless, the filing of Section 16 reports does not preclude a person from later challenging their status under Section 16, *Schimmel v. Goldman*, *supra* 8.02[1].

(n46)Footnote 46. Section 16(a)-(c).

(n47)Footnote 47. S. Rep. No. 1455, 73d Cong., 2d Sess., 55 (1934).

(n48)Footnote 48. Rule 16a-1(a)(1). *See* Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,252-53 (Feb. 8, 1991).

The rules defining "beneficial ownership" under Section 13(d) are discussed in §§ 7A.02[2] *supra*.

(n49)Footnote 49. Exch. Act Rel. No. 34-26,333, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343, at 89,602-89,603 (Dec. 2, 1988).

(n50)Footnote 50. *See* Rule 16a-1(a)(1) (Section 13(d) tests apply "solely for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered pursuant to Section 12"); Rule 16a-1(a)(2) (pecuniary interest tests apply "[o]ther than for purposes of determining whether a person is a beneficial owner of more than ten percent of any class of equity securities registered pursuant to Section 12").

(n51)Footnote 51. *See* Rule 16a-1(a)(1), Note.

(n52)Footnote 52. *See* Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254-81,256 (Feb. 8, 1991). *See also id.* at 81,254 (persons deemed 10% shareholders as a result of membership in a group holding 10% of a registered class of equity securities report beneficial ownership of shares in which they have a pecuniary interest on Forms 3, 4, and 5).

(n53)Footnote 53. If the trustee did not beneficially own (in Rule 16a-1(a)(2)'s "pecuniary interest" sense) any other equity securities of the issuer, the trustee would still be required to file the Form 3, but it should state that no securities are beneficially owned. If the trustee did beneficially own (in Rule 16a-1(a)(2)'s "pecuniary interest" sense) equity securities outside of the trust, his Form 3 would have to report beneficial ownership of such equity securities.

(n54)Footnote 54. *See* § 8.02[a][ii], *infra*.

(n55)Footnote 55. *See* Exch. Act Rel. No. 34-26,333, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343, at 89,602 (Dec. 2, 1988); Exch. Act Rel. No. 18,114, Fed. Sect. L. Rep. (CCH) P 26,062, at 19,063-7 & n.17 (Sept. 23, 1981).

Prior to adoption of new Rule 16a-1(a), some, but not all, courts applied the same standards for purposes of determining whether a person was a 10% shareholder and for purposes of attributing purchases and sales of equity securities to an insider for purposes of Section 16(b). *See, e.g.,* Whittaker v. Whittaker Corp., 639 F.2d 516 (9th Cir. 1981); Whiting v. Dow Chemical Co., 523 F.2d 680 (2d Cir. 1975). *But see* CBI Industries, Inc. v. Horton, 682 F.2d 643 (7th Cir. 1982)(court concluded that fact that old Rule 16a-8 attributed "beneficial ownership" of trust securities to trustee where trust beneficiary was an immediate family member was irrelevant in determining whether profits were realized by the trustee for stock purchases made by the trust within six months of sales made by the trustee, because the purpose of Rule 16a-8 was limited to determination of insider status as a 10% shareholder and trustee was in any event an insider by virtue of his being a director).

(n56)Footnote 56. Rule 13d-3(a). "Voting power" includes the power to vote, or to direct the voting of, a security, and "investment power" includes the power to dispose, or direct the disposition, of a security. *Id.*

(n57)Footnote 57. Rule 13d-3(d)(1). Significantly, such a right to acquire (except for the automatic termination of a trust, discretionary account, or similar arrangement) will represent beneficial ownership even if not exercisable within 60 days *if* it was acquired with the purpose or effect of changing or influencing the control of the issuer or in connection with or as a participant in a transaction having such purpose or effect. *Id.*

In a significant interpretation, the staff took the position that a right to acquire shares at a future date upon conversion of preferred stock, where the amount of shares would be based on the extent to which their market price was less than \$6.00 at the determination date, would not represent beneficial ownership, for purposes of Rule 16a-1(a)(1), of any of

the shares that might potentially be acquired until the amount of shares would become fixed at the determination date. See Realty South Investors, Inc., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,219, at 76,817 (June 17, 1992). The staff apparently reasoned that, even during the 60-day period (as specified under Rule 13d-3(d)(1)) prior to the specified determination date, there could be no certainty as to the number of shares that could be acquired, if any, so no quantifiable right to acquire the shares existed. However, the underlying preferred stock and the acquisition of a put equivalent security related to the initial strike price was reportable.

A related issue is whether a right to acquire shares that is subject to significant conditions or contingencies that are outside of the control of the person who is to acquire the shares does not represent a right to acquire, for purposes of Rules 16a-1(a)(1) and 13d-3(d)(1), until such conditions or contingencies are eliminated. The Commission staff has confirmed this view in private telephone interpretations, but has not published an interpretive letter clearly stating the conclusion. The staff has, however, taken the view that, for reporting purposes, a right to acquire that is subject to conditions other than the passage of time, continued employment, or changes in the market value of the securities does not constitute a "derivative security" that carries beneficial ownership of the underlying securities. See, e.g., Certilman Balin Adler & Hyman, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,144, at 79,338 (Apr. 20, 1992), discussed in § 8.03[2][c][i] & [ii] *infra*. Presumably, the staff will reach the same conclusion for purposes of Rules 16a-1(a)(1) and 13d-3(d)(1). See *Levner v. Prince Bin Talal Bin Abdulaziz Al Saud*, 61 F. 3d 8 (2d Cir. 1995) (affirming decision of no beneficial ownership where conversion of preferred stock was contingent upon Federal Reserve Board approval).

(n58)Footnote 58. Section 13(d)(3); Rule 13d-5(b). In a departure from the Section 13(d) and 13(g) rules, the "group" is not itself viewed as a separate person subject to Section 16. Instead, the members of the group are viewed as having beneficial ownership of all shares beneficially owned by other group members and subject to the agreement that creates the group. See Exch. Act Rel. No. 28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254, n.54 (Feb. 8, 1991).

(n59)Footnote 59. Rule 16a-2(c) states that the transaction that results in a person becoming a 10% shareholder is not subject to Section 16 (assuming the person was not otherwise subject to Section 16). This Rule in effect codifies the Supreme Court's holding in *Foremost-McKesson, Inc. v. Provident Securities Co.*, 423 U.S. 232 (1976). If, however, under new Rule 16a-1(a)(1) a person enters an agreement to acquire more than ten percent of an outstanding class of securities and obtains an irrevocable proxy giving him voting power over such securities, such person would then become a 10% shareholder. If the agreement represents a right to acquire securities at an exercise price that is not fixed, the "purchase" of the equity security under Rule 16b-6(a) (or acquisition of beneficial ownership under Rule 16a-1(a)(2)) may not occur until such contingencies are eliminated. Under these circumstances, it is unclear whether Rule 16a-2(c) and *Foremost-McKesson* would protect the entire transaction from Section 16(b), or whether there would be deemed to be a "purchase" subject to potential Section 16(b) liability.

(n60)Footnote 60. The rules under Section 13(d) provide other exclusions that may, in specified circumstances, prevent institutional investors from being deemed "beneficial owners" of securities for Section 13(d) purposes, which exclusions would have the same effect for purposes of determining status as a 10% shareholder under Section 16(a). See, e.g., Rule 13d-3(d)(2) (national securities exchange member firm not deemed beneficial owner of shares solely because of power to vote shares held for customers for which no voting instructions received); Rule 13d-3(d)(4) (underwriters acquiring securities in good faith in firm commitment underwriting registered under the Securities Act of 1933, as amended, not deemed beneficial owner of shares for forty days after acquisition); Rule 13d-3(d)(3) (certain pledgees not deemed beneficial owners until there is a default and the ability to exercise power to vote or dispose of pledged shares); Rule 13d-5(b)(2) (group not deemed to have acquired beneficial ownership solely by virtue of concerted action in connection with private placement by issuer if certain conditions met).

(n61)Footnote 61. See Exch. Act Rel. No. 28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,253 (Feb. 8, 1991); Exch. Act Rel. No. 34-27,148, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,439, at 80,385 (Aug. 18, 1989).

(n62)Footnote 62. As amended in 1998 in connection with amendments to Regulation 13D-G, those institutional investors are as follows:

- (1) A broker or dealer registered under Section 15 of the Exchange Act;
- (2) A bank as defined in Section 3(a)(6) of the Exchange Act;
- (3) An insurance company as defined in Section 3(a)(19) of the Exchange Act;
- (4) An investment company registered under Section 8 of the Investment Company Act of 1940;
- (5) An investment adviser registered under Section 203 of the Investment Advisers Act of 1940;
- (6) An employee benefit plan which is subject to the provisions of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") or any such plan that is not subject to ERISA that is maintained primarily for the benefit of state or local government employees, or an endowment fund;
- (7) A parent holding company or controlling person (including an individual), provided the aggregate amount of equity securities held directly by the parent or control person, and directly and indirectly by its subsidiaries and affiliates that are not persons specified in (1) through (6) above, or in (8) or (9) below, does not exceed one percent of the securities of the subject class;
- (8) A savings association as defined in Section 3(b) of the Federal Deposit Insurance Act;
- (9) A church plan, excluded from the definition of "investment company" under Section 3(c)(14) of the Investment Company Act of 1940; and
- (10) A group, all the members of which are persons specified in (1) through (9) above.

The Commission staff has confirmed that a trust holding securities for an employee benefit plan or pension fund subject to ERISA may be eligible for the Rule 16a-1(a)(1) exclusion, even if the trustee is not itself an institution that is eligible for the exclusion. See American Bar Association Joint Committee on Employee Benefits, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,719, at 78,252 (July 3, 1991). However, Section 16 continues to apply to greater than 10% beneficial owners who did not acquire such securities with the purpose or effect of changing or influencing the control of the issuer, even though the Commission adopted amendments to the Section 13(d) rules allowing such persons to file on Schedule 13G instead of on Schedule 13D. Exch. Act Rel. No. 39,538 (Jan. 12, 1998).

(n63)Footnote 63. See Invesco MIM PLC, SEC No-Action Letter (available Sept. 17, 1992); CS Holding, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,070, at 79,072 (Jan. 16, 1992).

In *CS Holding* Group, a group of foreign banks, broker-dealers, investment advisers, and an insurance company sought relief from Schedule 13D filing obligations. Such entities were similar to the type of entities eligible under Rule 13d-1(b)(1) to file a Schedule 13G in lieu of Schedule 13D, but were not eligible to use the Schedule 13G because Rule 13d-1(b)(1) (like the exclusion under Rule 16a-1(a)(1)) is available only to institutions subject to regulatory oversight under United States federal and state law. The staff advised the CS Holding Group that it would not recommend enforcement action if members of the group reported beneficial ownership of more than 5% of an outstanding class of

registered equity securities (a "subject class") on Schedule 13G rather than Schedule 13D. The staff's no-action relief was conditioned on the following: (1) the aggregate holdings of group members that were not institutions of the kind eligible for the exemption under Rule 13d-1(b) could not exceed one percent of the subject class; (2) the acquisition of shares could not have been made for the purpose of or with the effect of changing or influencing the control of the issuer; and (3) CS Holding Group undertook to furnish and make available to the Commission information to verify the foregoing, and material that would otherwise be disclosed or filed had a Schedule 13D been filed.

Although such relief has been consistently granted by the staff in the past, *see, e.g.*, Prudential Corp., SEC No-Action Letter (available July 5, 1991); Goldman Sachs Equity Securities (U.K.), Limited, SEC No-Action Letter (available Mar. 6, 1991); Hamblin Watsa Investment Counsel Ltd., SEC No-Action Letter (available Sept. 21, 1993); Mitsubishi UFJ Financial Group, Inc. and Designated Subsidiaries, SEC No-Action Letter (available Jan. 23, 2006); Burns Fry Cos., SEC No-Action Letter (available Dec. 4, 1990), it appears to be necessary for any foreign entity or group wishing to rely on this position under Rule 13d-1(b)(1) to obtain its own no-action letter. This is because only no-action relief has been granted under Rule 13d-1(b)(1), and such relief has been conditioned upon the making of an explicit undertaking to the staff.

In *CS Holding Group*, the staff also concluded, as an interpretive matter, that a foreign entity permitted to file a Schedule 13G under Rule 13d-1(b)(1) in reliance on the staff's no-action position would likewise qualify for the exclusion under Rule 16a-1(a)(1).

Prior to 1998, individuals who controlled eligible institutions were not eligible for the exclusion under the terms of Rule 16a-1(a)(1). However, consistent with its interpretations under Rule 13d-1(b)(1), the Commission staff typically granted no-action relief to such individuals to allow them, subject to certain conditions, to rely on the institutional investor exclusion under Rule 16a-1(a)(1). Edward C. Johnson 3d, SEC No-Action Letter [1991 Transfer Binder], Fed. Sec. L. Rep. (CCH) P 79,767 (Aug. 20, 1991); Warren E. Buffet and Berkshire Hathaway, Inc., SEC No-Action Letter [1986-1987 Transfer Binder], Fed. Sec. L. Rep. (CCH) (Dec. 18, 1987); *but see* Mario J. Gabelli, SEC No-Action Letter [1990-1991 Transfer Binder], Fed. Sec. L. Rep. (CCH) §79,682 (Apr. 30, 1991) (denying availability of exclusion). In 1998, such individuals were added to the list of persons eligible to rely on the exclusion, provided such individuals are not seeking to acquire or influence control of the issuer and own less than 20% of the class of securities. Exch. Act Rel. No. 34-39,538 (Jan. 12, 1998).

(n64)Footnote 64. There is, unfortunately, little guidance available on when an institutional investor's holdings of more than 10% of an outstanding class will be deemed to have the "purpose or effect of changing or influencing control of the issuer." In *American Bar Association Joint Committee on Employee Benefits*, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,719, at 78,252 (July 3, 1991), the staff did not state that an employee benefit plan's holding of more than 50% of an issuer's voting securities would, in all cases, be deemed to have the effect of "influencing control" of an issuer, although it would seem obvious that such a substantial holding would have that effect. The staff did point out, however, that a control purpose or effect may exist even if the amount held represents less than 50% of an issuer's voting securities. *See id.*

See Exch. Act Rel. No. 34-26,598, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,410, at 80,070 (Mar. 6, 1989). In that release, the Commission proposed that any person, including an institutional investor otherwise eligible to file a short-form Schedule 13G, be required to file a Schedule 13D upon reaching a beneficial ownership threshold of 20% of an outstanding class. When the Commission subsequently adopted this proposal, it stated: "[T]he Commission does not intend these new rules to create a presumption that beneficial ownership of 20 percent or more indicates control or a control person." Exch. Act Rel. No. 34-39,538 at N. 20 (Jan. 12, 1998).

The staff has also taken the position that even a gradual accumulation of securities to a level greater than 10% of an outstanding class may be deemed to involve acquisitions having the purpose or effect of changing or influencing control, although no particular acquisition, viewed in isolation, might appear to have such a purpose or effect. *See*

Hewitt Associates, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,688, at 78,114 (May 1, 1991).

(n65)Footnote 65. Although Rule 16a-1(a)(1) merely refers to Rule 13d-3(b), the exclusion may not be available where securities are acquired in transactions undertaken as part of a scheme to evade reporting obligations under Section 16(a).

(n66)Footnote 66. Rule 16a-1(a)(1).

In the case of an employee benefit plan subject to ERISA, equity securities may be excluded only if they are "allocated to plan participants where participants have voting power." Rule 16a-1(a)(1). This pass-through voting requirement applies only to a defined contribution plan holding equity securities of an employer that sponsors the plan, and does not apply to a defined benefit pension plan. See Master Pension Trust of AT&T, SEC No-Action Letter, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,641, at 77,719 (June 30, 1993). It appears from this interpretive letter that, in the case of a defined benefit pension plan, there need be no pass-through voting with respect to equity securities of an issuer that is a plan sponsor in order to qualify for exclusion under Rule 16a-1(a)(1).

(n67)Footnote 67. Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,253, n.39 (Feb. 8, 1991).

(n68)Footnote 68. Mario J. Gabelli, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,682, at 78,096 (Apr. 30, 1991). This interpretive position does not apply to "employees securities companies" as defined under the Investment Company Act of 1940. See *id* at 78,098-9.

(n69)Footnote 69. Harvard University, SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,228, at 76,849 (July 8, 1992).

(n70)Footnote 70. Master Pension Trust of AT&T, SEC No-Action Letter, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,641, at 77,719 (June 30, 1993). In this interpretive letter, the staff focused on the fact that the master trust did not exercise day-to-day investment control with respect to securities purchases and sales and that no single investment manager had investment responsibility for more than 4% of the assets. It is unclear whether these facts are determinative with respect to the conclusion that the trust's portfolio securities are held "for the benefit of third parties or in customer or fiduciary accounts."

(n71)Footnote 71. See *Roth v. Jennings*, 489 F.3d 499, 508 (2d Cir. 2007) (stating that if two or more persons acted as a "group," then they must be treated as a single person, and "each person in the group 'shall be deemed to be the beneficial owner' of all equity securities of that issuer beneficially owned by any 'member of that group'" (citing 15 U.S.C. § 78m(d)(3) and 17 C.F.R. § 240.13d-5(b)(1)); Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254 (Feb. 8, 1991). See generally Section 13(d)(3); Rule 13d-5(b).

(n72)Footnote 72. See *Mayer v. Chesapeake Insurance Co., Ltd.*, 877 F.2d 1154 (2d Cir. 1989), *cert. denied*, 493 U.S. 1021 (1990); *Morales v. Quintel Entertainment, Inc.*, 249 F.3d 115 (2d Cir. 2001); *C.R.A. Realty Corp. v. Goodyear Tire & Rubber Co.*, 705 F. Supp. 972 (S.D.N.Y. 1989); *Rothenberg v. Jacobs*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,199 at 91,735 (S.D.N.Y. 1989).

(n73)Footnote 73. Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254, n.54 (Feb. 8, 1991).

(n74)Footnote 74. See *id*. Of course, the number of shares beneficially owned by a given individual that are also included in the group's beneficial ownership should not be double counted when determining whether such individual is a 10% shareholder.

(n75)Footnote 75. See Rule 13d-5(b).

(n76)Footnote 76. The Taylor Voting Trust, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,051, at 79,000 (Jan. 3, 1992) (beneficiaries of voting trust not deemed to be members of a Section 13(d) group solely because of their beneficiary status, where (i) the trust was organized by an agreement between persons other than the beneficiaries, (ii) the beneficiaries were not parties to that agreement; and (iii) the beneficiaries cannot continue to hold shares withdrawn from the trust); Alex Brown Incorporated, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,725, at 78,264 (July 22, 1991) (employees subject to voting agreement as condition of employment not deemed to be members of a group where (i) participation in such agreement is solely because of status as employees and essentially involuntary, (ii) terminated employees are no longer subject to the agreement, and (iii) each employee's individual beneficial ownership is, in most cases, less than one percent of the outstanding class). See also Morgan Stanley Group Inc., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,681, at 78,091 (Apr. 30, 1991). In the *Alex Brown Incorporated* and *Morgan Stanley Group Inc.* interpretive letters, the staff expressed the view that the facts and circumstances presented were "unique," and that only different facts might give rise to another result.

(n77)Footnote 77. See Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254 & n.53 (Feb. 8, 1991).

(n78)Footnote 78. In adopting Rule 16a-8(a)(1), the Commission implied that the new Rule simply carried forward the requirements of old Rule 16a-8(c). See Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254-55 (Feb. 8, 1991). In fact, the new Rule greatly expands the burden on trusts. Old Rule 16a-8(c) required a trust to file reports under Section 16(a) if it "held" more than 10% of an outstanding class of equity security. The Rule did not deem the trust to be a "beneficial owner" of the securities it "held," so a trust was free to defend any claim that it was liable for short-swing profits by asserting that it was not subject to Section 16(b) because it was not a 10% beneficial owner. Indeed, in adopting old Rule 16a-8(c), the Commission had recognized this distinction, stating that the imposition of a filing requirement on trusts should not give rise to any presumption that transaction by trusts were subject to potential Section 16(b) liability. See Exch. Act Rel. No. 34-4801 (1953). In contrast, a trust may be deemed a "beneficial owner" under new Rule 16a-1(a)(1), and to be subject to Section 16 for all purposes, including potential Section 16(b) liability, under Rules 16a-8(a) and (d). See Exch Act Rel. No 34-37,260 (1996).

(n79)Footnote 79. In Proskauer Rose Goetz & Mendelsohn, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,683, at 78,099 (Apr. 30, 1991), inquiring counsel argued that, under the Section 13(d) rules, trusts had not in the past been regarded as distinct entities having Schedule 13D and 13G filing obligations apart from the obligations of trustees or others who have voting or dispositive power over trust shares. The staff concluded, however, that a trust is deemed to be a distinct "beneficial owner" under Section 13(d), and therefore may be subject to Section 16 as an entity separate from its trustee under Rules 16a-8(a) and 16a-1(a)(1).

(n80)Footnote 80. See Rule 16a-8(a); See Exch. Act Rel. No. 34-37,260 (1996); SEC Exch. Act Rel. No. 28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254-55 (Feb. 8, 1991); Proskauer Rose Goetz & Mendelsohn, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,683, at 78,099 (Apr. 30, 1991). For a time, the 1991 rules provided that a trust could be subject to Section 16 (with certain exceptions) if a trustee of the trust is a Section 16 insider, the trustee exercises or shares investment control over issuer securities in the trust, and the insider trustee or a member of his immediate family has a pecuniary interest in the issuer's securities held by the trust. But this Rule 16a-8(a)(1)(ii) was repealed in 1996, largely because it resulted in duplicative reporting by trusts and trustees in the family trust context. See § 8.02[3], *infra*.

(n81)Footnote 81. See Rule 16a-8(a)(1); Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254-55 (Feb. 8, 1991).

In Chandler Trust No. 2, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,750, at 78,389 (Aug. 14, 1991) the staff took the position that, in the case of a trust that included a number of subtrusts, the securities held in the subtrusts would be aggregated for purposes of determining whether the trust was a 10% shareholder, and no separate analysis of the holdings of each subtrust was required. The staff, in reaching its conclusion, noted the fact that both voting and dispositive power with respect to the issuer shares held directly or indirectly by the trust must be exercised by the trustees as a body, without regard to the subtrust involved, and that the securities held in the subtrusts remain in the trust.

(n82)Footnote 82. See American Bar Association Joint Committee on Employee Benefits, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,719, at 78,252 (July 3, 1991). The exclusion is available to such a plan trust even if the trustee is not a person eligible for the exclusion under Rule 16a-1(a)(1), provided, among other things, the securities are allocated to plan participants and voting power is passed through to participants. See *id.*

(n83)Footnote 83. See Rule 16a-8 (b)(1). The exclusion for plans and related trusts is narrower than the exclusion available to other institutional investors under Rule 16a-1(a)(1) for securities held for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business. See Rule 16a-1(a)(1). The limitation of the exclusion to allocated shares reflects the view of the Commission staff (based on the view of the Department of Labor) that a trustee's fiduciary obligations under ERISA override express provisions of a plan, so that, even if the plan provides for "pass-through" voting by plan participants as to *unallocated* shares, the trustee in fact retains voting power with respect to such shares. Exch. Act Rel. No. 28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,253, n.42 (Feb. 8, 1991); Rio Grande Industries, Inc., SEC No-Action Letter (available Apr. 5, 1989) (trustee is the beneficial owner where trustee has voting and investment power over unallocated shares); Merchants National Bank & Trust Company, SEC No-Action Letter (available June 24, 1991).

In Cigna Corp., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,747, at 78,381 (Aug. 6, 1991), the staff concluded that issuer securities held in the trust holding the portfolio of an ERISA qualified defined benefit plan that allocated cash balances to participants rather than issuer securities are deemed to be unallocated for purposes of Rule 16a-1(a)(1). Thus, such securities would not be excluded under the Rule 16a-1(a)(1) exclusion. Cf. Hewitt Associates, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,688, at 78,113 (May 1, 1991) (trustees of defined contribution plans are assumed to have investment control over unallocated shares).

(n84)Footnote 84. See *id.* For a discussion of this requirement, see § 8.02[2][a][ii], *supra*.

(n85)Footnote 85. Rule 16a-8(a)(2). Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254 (Feb. 8, 1991). Conversely, if trustees do not have or share voting or investment power, they will not be deemed beneficial owners of securities held in the trust. See The Taylor Voting Trust, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,051, at 79,000 (Jan. 3, 1992).

A trustee of an ERISA trust apparently is viewed by the Commission as having a "residual and overriding" voting or investment control--and thus beneficial ownership--over shares not allocated to trust beneficiaries (plan participants), even if the plan and trust's provisions do not confer such explicit powers on the trustee, as a result of the stringent fiduciary duties imposed under ERISA. Exch. Act Rel. No. 28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,253, n.42 (Feb. 8, 1991). In contrast, in the case of allocated shares, explicit plan provisions vesting voting and investment powers in participants rather than the trustee are not overridden by ERISA fiduciary duties, in the Commission's view. See *id.* While these positions are consistent with staff interpretations under Section 13(d), as stated in Rio Grande Industries, Inc., SEC No-Action Letter (available Apr. 5, 1989), the Commission has allowed for more lenient treatment in the case of allocated shares that are generally subject to participant control but which, in cases in which participants fail to give instructions to a trustee, may be voted by the trustee. *Id.* Under Rule 16a-1(a)(1), such shares will not be deemed beneficially owned by the trustee if limited voting or dispositive power becomes exercisable by the trustee, but such trustee will still be deemed to beneficially own such shares for other purposes under Rule 13d-3. See *id.*; American Bar Association Joint Committee on Employee Benefits, SEC No-Action

Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,719, at 78,252 (July 3, 1991).

(n86)Footnote 86. See Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254-55 (Feb. 8, 1991); Proskauer Rose Goetz & Mendelsohn, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,683, at 78,099 (Apr. 30, 1991). Securities held in trust should normally qualify as securities "held for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business" for purposes of Rule 16a-1(a)(1). As noted above, even if the trustee may exclude the trust securities in calculating whether it is a 10% shareholder, if the trustee has voting or investment control over those shares the trust itself will have to count such shares toward its beneficial ownership unless it qualifies for the narrow exclusion for employee benefit plan trusts subject to ERISA.

For a discussion of the Rule 16a-1(a)(1) exclusion, see § 8.02[2][a][ii] *supra*.

(n87)Footnote 87. Compare American Bar Association Joint Committee on Employee Benefits, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,719, at 78,252 (July 3, 1991) with Chandler Trust No. 2, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,750, at 78,389 (Aug. 14, 1991) and Chandler Trust No. 2 (Aug. 14, 1991) with Southland Corp., SEC No-Action Letter (available Aug. 10, 1987). It may still be possible for the staff to reconcile these positions. In *Southland Corp.*, the staff concluded that an individual who, together with four others, served as the trustee of a trust was not a beneficial owner of trust securities under Rule 13d-3 in view of the fact that a majority of the five trustees was required for investment decisions, and that none of the individuals could act alone to vote or dispose of trust securities. In *American Bar Association Joint Committee on Employee Benefits*, the staff concluded that an individual trustee is attributed beneficial ownership to the extent he has or shares voting or dispositive power. In private discussions, the staff has affirmed that it continues to adhere to its position in *Southland Corp.* that an individual trustee who does not have the power to act alone with respect to voting or disposing of trust securities, but rather such decisions require the consent of three or more individuals, is not deemed to have or share voting or dispositive power over the trust securities.

(n88)Footnote 88. See Rule 16a-8(a)(2).

(n89)Footnote 89. An employer-registrant would not be deemed to be a ten percent beneficial owner where, subject to the provisions of ERISA, the employer-registrant as the settlor has the right to revoke the trust. See Hewitt Associates, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,688, at 78,114 (May 1, 1991).

(n90)Footnote 90. Rule 16a-1(a)(4).

(n91)Footnote 91. See Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,252-53 (Feb. 8, 1991).

(n92)Footnote 92. See Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,252-53, n.36 (Feb. 8, 1991).

The term "equity security" is defined under Section 3(a)(11) and Rule 3a11-1 of the Exchange Act. See § 4.01 *supra*.

(n93)Footnote 93. See Rule 13d-3(d)(1). See also Rule 16a-4(a) (derivative securities deemed to be the same class of equity securities as the underlying equity securities).

(n94)Footnote 94. See old Rule 16a-2(b).

Nevertheless, with reference to derivative securities, the Commission noted that the approach under the Section 13(d) rules and Rule 16a-4(a) essentially codifies the holding in *Chemical Fund, Inc. v. Xerox Corp.*, 377 F.2d 107 (2d Cir. 1967). Exch. Act Rel. No. 28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,252-53, n.36

(Feb. 8, 1991). In *Chemical Fund, Inc. v. Xerox*, the defendant held more than ten percent of a corporation's non-voting convertible debentures, but the conversion of such debentures would have given the defendant not more than 2.72 percent of the corporation's common stock. The court held that the defendant was not liable under Section 16(b) because a hypothetical conversion of the debentures would not result in the defendant becoming a more than ten percent common stockholder. 377 F.2d at 110-11. In addition, the court held that the debentures were not a class of equity securities because a holder had no standing beyond that of a creditor entitled to specified payments of interest at specified intervals, would not be familiar with the day-to-day workings of the corporation and therefore would be unlikely to receive inside information, unlike a holder of more than ten percent of the voting stock of the company. *Id.*

Cf. American Standard, Inc. v. Crane Co., 346 F. Supp. 1153, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,551 (S.D.N.Y. 1972), *rev'd on other grounds*, 510 F.2d 1043, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,924 (2d Cir. 1974), *cert. denied*. 421 U.S. 1000 (1975) (court relied on the "hypothetical conversion" test adopted in *Chemical Fund* to hold that trading in preferred stock that could have been converted into more than ten percent of the common stock of the issuer was subject to Section 16(b)); *Simon v. Sunasco, Inc.*, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 92,547 (S.D.N.Y. 1970) (holder of unregistered "special stock" with voting rights presently convertible into more than ten percent of a company's registered common stock subject to liability under Section 16(b) as a more than ten percent holder of a registered equity security of an issuer).

Notably, the Commission itself had not acquiesced in the decision in *Chemical Fund v. Xerox Corp.*, but limited its applicability to a determination of liability for short-swing profits under Section 16(b), and not for reporting purposes under Section 16(a). Thus, under the old Section 16 rules, a person owning more than ten percent of a class of registered convertible debentures was required to file ownership reports under Section 16(a) even though upon conversion he would own less than ten percent of the class of underlying equity securities. *See* Sec. Exch. Act Rel. No. 34-8202, 1967 SEC LEXIS 112 (Dec. 6, 1967). *See also* Sec. Exch. Act Rel. No. 34-18,114, Fed. Sec. L. Rep. P 26,062, at 19,063-16, n. 57 (Sept. 23, 1981).

(n95)Footnote 95. Rule 16a-1 (introductory text).

This implicitly overrules *Colan v. Monumental Corp.*, 713 F.2d 330 (7th Cir. 1983). In that case, the owners of options to purchase stock who may have been more than 10% "beneficial owners" for purposes of the reporting requirements of Section 16(a) were deemed not to be such "beneficial owners" for purposes of the short-swing trading prohibitions of Section 16(b), because, in the courts view, a contractual right to acquire stock in the future does not provide access to inside information and the potential for speculative abuse that Section 16(b) is meant to curb. *See also* *Seinfeld v. Hospital Corp. of America*, 685 F. Supp 1057 (N.D. Ill. 1988) (option holder may be deemed beneficial owners of underlying stock if option holder acquires access to inside information and influence).

(n96)Footnote 96. Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,252-53, n.36 (Feb. 8, 1991).

(n97)Footnote 97. *See id.*

(n98)Footnote 98. Non-voting preferred stock would not constitute an equity security for purposes of determining whether a person is a 10% shareholder under Rule 16a-1(a)(1). *See* Rule 13d-3(d)(1).

(n99)Footnote 99. *See id.*

(n100)Footnote 100. Rule 13d-3(d)(1)(i). For example, Issuer A has outstanding a registered class of 100,000 shares of common stock, and a class of warrants exercisable for 10,000 shares of common stock. Ms. Smith directly owns 9,000 shares of common stock (and is a beneficial owner thereof), and holds warrants exercisable within 60 days for 1,800 shares of common stock (representing beneficial ownership of the 1,800 underlying shares of common stock). To calculate Ms. Smith's percentage of beneficial ownership, she must divide the number of shares she beneficially

owns, 10,800 (consisting of the 9,000 owned directly and the 1,800 that she has the right to acquire), by the number of shares deemed to be outstanding, 101,800 (consisting of the 100,000 actually outstanding and the 1,800 issuable upon exercise of Ms. Smith's warrants). Thus, Ms. Smith's percentage of beneficial ownership is 10.6%, so she is subject to Section 16 as a 10% shareholder. Significantly, shares that persons other than Ms. Smith can acquire by exercise of the warrants are not added to the number of shares outstanding (the denominator).

(n101)Footnote 101. Rule 13d-1(j). Of course, a person may seek more up-to-date information directly from the issuer. However, the ability to obtain such information may be limited as a result, in part, of Regulation FD; although the accelerated filing requirements under the Form 8-K rules may render any such attempt moot. If the number of share outstanding is reduced through an issuer repurchase or otherwise, resulting in an increase in a holder's percentage of beneficial ownership from less than ten percent to more than ten percent, such person will not become subject to Section 16 as a 10% shareholder until the issuer files a quarterly, annual, or current report setting forth the number of securities outstanding that would permit the holder to determine that the holder is a 10% shareholder, even if in fact that person's beneficial ownership exceeded ten percent of the outstanding class at an earlier date. *C.R.A. Realty Corp. v. Enron Corp.*, 842 F. Supp. 88 (S.D.N.Y. 1994)

(n102)Footnote 102. The conclusion that ownership of a right to acquire an equity security can constitute beneficial ownership of the underlying equity security, as provided in Rule 13d-3(d)(1), is reinforced by Rule 16a-4(a), which provides that a derivative security and the underlying equity security shall be deemed to be the same class of equity securities.

(n103)Footnote 103. See *Shaffer v. Dickstein & Co., L.P.* 1996 U.S. Dist. LEXIS 4009 (S.D.N.Y. 1996) (definition of class under Section 12(g)(5) does not apply when calculating beneficial ownership under Section 16).

(n104)Footnote 104. See Sec. Exch. Act Rel. No. 34-18,114, Fed. Sec. L. Rep. P 26,062, at 19,063-15 (Sept. 23, 1981) (question 36). The Commission implicitly confirmed that this interpretation was unaffected by the adoption of the new Section 16 rules in 1991. Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,281 (Feb. 8, 1991).

In *Ellerin v. Massachusetts Mutual Life Insurance Co.*, 270 F.2d 259 (2d Cir. 1959), the court held that two series of preferred stock, although differing as to dividend rights, redemption prices, sinking fund accumulation rights, dates of issuance, nevertheless constituted a single class for purposes of determining whether the owner was a 10% shareholder subject to Section 16. Each of the series of preferred stock carried no voting rights, except that holders of a given series had a right to vote, as a series, if the rights or preferences of that series would be adversely affected. The Commission took the position, in that case, that the series constituted separate classes, but it has apparently abandoned that view since the time of that case.

(n105)Footnote 105. See Crawford & Co., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,673, at 78,079 (Apr. 19, 1991). The staff refused to take a position, however, on whether the classes would be considered distinct for purposes of Section 16(b). Thus, although a beneficial owner of more than ten percent of either class would be considered an insider, he is faced with uncertainty whether his sales of one class could be matched with purchases of the other within six months.

The staff had taken a similar position, under the old Section 16 rules, that classes of common stock with different voting rights would be viewed as distinct classes for reporting purposes. See *Turner Broadcasting System, Inc.* SEC No-Action Letter (available) (Feb. 6, 1990).

See *Morales v. New Valley Corp.*, 936 F. Supp. 119 (S.D.N.Y. 1996) (Class B convertible preferred shares that voted with Class A preferred shares on most issues were deemed not substantially similar and treated as a separate class); *Shaffer v. Dickstein & Co., L.P.*, 1996 U.S. Dist. LEXIS 4009 (S.D.N.Y. 1996) (convertible preferred a separate class from common stock although "substantially similar" as to voting and dividend rights.)

(n106)Footnote 106. For a discussion of the circumstances in which registration under Section 12 is required, see § 4.01 *supra*.

(n107)Footnote 107. Indeed, a transaction by an insider prior to registration under Section 12 may be matched with a transaction that occurs after registration but within six months of the earlier transaction. See Rule 16a-2(a). Note, however that a holder of securities not registered under Section 12 is not subject to Section 16, even though the issuer has another class of equity registered under Section 12 (provided, of course, that the ownership of the unregistered class does not give rise to beneficial ownership of the registered class.)

(n108)Footnote 108. Rule 16 a-8(a)(1)(ii) was repealed in Exchange Act Rel. No. 34-37260. According to one SEC staff member, the purpose of the rule was to reverse *CBI Industries v. Horton*, 682 F.2d 643 (7th Cir. 1982), in which trust transactions were not attributed to an insider who was co-trustee of a trust of which the insider's adult sons were beneficiaries because the insider had no duty to support the sons.

(n109)Footnote 109. A trust did not become subject to Section 16 under Rule 16a-8(a)(1)(ii) due to the fact that a trustee is a 10% shareholder and thus an insider if the trustee would not be a 10% shareholder but for his beneficial ownership of the securities held by the trust resulting from his service as trustee. See *Kirkland & Ellis, SEC No-Action, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,139, at 79,366 (Mar. 26, 1992)*. Such trustee would, however, apparently still be deemed a 10% shareholder subject to Section 16.

(n110)Footnote 110. The term "immediate family" means any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, and includes adoptive relationships. Rule 16a-1(e). Significantly, although the presumption that an insider beneficially owns equity securities held by family members under Rule 16a-1(a)(2) is limited to family members who share the same household as the insider, this limitation does not apply under Rule 16a-8.

(n111)Footnote 111. Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254-56 (Feb. 8, 1991).

(n112)Footnote 112. Rule 16a-8(a)(1)(ii)(A). This exception was probably of only limited usefulness, however, because such persons or entities normally would become subject to Section 16 not as directors or officers, but as 10% shareholders. The exclusion under Rule 16a-1(a)(1) generally should allow such persons or entities to exclude shares held in trusts when calculating whether they are 10% shareholders, and thereby avoid becoming Section 16 insiders in the first place. Of course, this exception to Rule 16a-8 will be needed only if the trustee is otherwise deemed an insider.

(n113)Footnote 113. Rule 16a-8(a)(1)(ii)(B).



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Federal Securities Exchange Act of 1934

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CHAPTER 8 Insider Reporting and Short-Swing Trading

2-8 Federal Securities Exchange Act of 1934 § 8.03

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§ 8.03 Reporting Requirements Under Section 16(a)

Insiders are required to file reports with the Commission, which are publicly available, detailing their beneficial ownership of equity securities of the issuer, and changes in such beneficial ownership. Reporting is required for all equity securities of the issuer, including options and other rights to acquire or dispose of equity securities that come within the definition of "derivative securities." Initial reports are filed on Form 3 at the time a person first becomes an insider or the issuer first registers a class of equity securities under Exchange Act Section 12. Changes in beneficial ownership that are not exempt from liability or that are exempt from liability under Rule 16b-3 (transactions between issuers and officers or directors) or Rule 16b-6 (exercises or conversions of derivative securities) must be reported on Form 4. In 2002, in response to perceived abuses in insiders' trading activity and recognition of investors' interest in such transactions, Congress mandated that these transactions generally be reported within two (2) business days. Gifts and several other narrow categories of transactions that are exempt from Section 16(b) must be reported on a year-end Form 5, unless earlier reported voluntarily on a Form 4. The year-end Form 5 must also report prior failures to file required Forms 3, 4, or 5. Failure to disclose required information can result in civil or criminal proceedings. In addition, delinquent or late filers must be disclosed in an issuer's annual report and proxy statement.

[1] Section 16(a) Reporting Requirements Generally

Exchange Act Section 16(a) and the rules thereunder require every person who is a Section 16 insider n1 to file with the Commission an "Initial Statement of Beneficial Ownership of Securities" on Form 3 at the time such person first becomes subject to Section 16(a), and to thereafter file a "Statement of Changes in Beneficial Ownership" on Form 4 or an "Annual Statement of Changes in Beneficial Ownership" on Form 5 to report any changes in such person's beneficial ownership of the issuer's equity securities. n2

In addition to introducing the Form 5 filing requirement, the Commission's complete revision of the rules under Section 16 in 1991 introduced significant new definitions and requirements relating to reporting under Section 16(a). The most far-reaching of these changes are rules defining the term "equity securities of such issuer" to include options, convertible securities, and other rights relating to equity securities, discussed in *Section 8.03[2]* below, and rules defining the concept of when an insider is deemed the "beneficial owner" of equity securities, discussed in *Section 8.03[3]* below. Further, in 2002, pursuant to the Sarbanes-Oxley Act of 2002, Section 16 and the rules thereunder were

amended such that transactions required to be reported on Form 4 must now be filed within two business days after the date of the transaction. n3 Prior to the 2002 amendments, a Form 4 was required to be filed only on or before the tenth day of the month following the month in which the transaction was effected. Additionally, as a result of the 2002 amendments, certain transactions once eligible for deferred reporting on Form 5 must now be reported on Form 4. n4

[a] Purpose. Section 16(a) was intended by Congress to require complete publicity as to the security holdings and transactions of anyone in a position of control in a corporation, in order to discourage abuse of insider information and encourage the maintenance of proper fiduciary standards. n5 Congress also sought to provide information to public investors concerning purchases and sales by insiders that might indicate such insiders' private opinions of the issuer's prospects. n6 In operation, reports filed under Section 16(a) have come to be used as a means to identify transactions that give rise to short-swing profits liability under Section 16(b) n7 and violations of other provisions of the Exchange Act and rules thereunder relating to abuse of inside information and market manipulation, n8 and for analysts and investors "to detect early warning signs of trouble or positive trends" with respect to a given issuer or group of issuers. n9 To increase the visibility of this information, in 2003 the Commission under a mandate from Congress implemented a mandatory electronic filing system for Section 16 reports and required companies with websites to post copies of their insiders' filings. n10

[b] Related Statutory Provisions. Other statutes impose reporting requirements substantially the same as those under Section 16(a). For example, Section 17(a) of the Public Utility Holding Company Act of 1935, as amended, requires directors and officers (but not ten-percent shareholders) of holding companies registered under the Holding Company Act to file the same general reports as are required under Exchange Act Section 16(a). n11 Likewise, with respect to closed-end investment companies registered under the Investment Company Act of 1940, as amended, Section 30(h) of that Act requires directors, officers, beneficial owners of more than ten percent of any outstanding class of securities (other than short-term paper) of such issuer, members of an advisory board, investment advisers, and affiliated persons of investment advisers of such issuer to file the reports required by Exchange Act Section 16(a). n12 Filings under these provisions are made on Forms 3, 4, and 5 and are generally subject to the rules under the Exchange Act. n13 In addition, state laws regulating insurance companies impose reporting requirements that closely parallel those of Section 16(a). n14

[c] Administration. While the Commission administers Section 16(a) with respect to insiders of non-bank issuers, Exchange Act Section 12(i) confers administrative and enforcement authority with respect to securities issued by banks and savings associations with respect to Section 16 upon four different federal banking agencies depending upon the nature of the banks. These agencies are the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision. The regulations of each of these agencies incorporate the Commission's Section 16 rules and forms. n15

[2] "Equity Securities of Such Issuer" and "Derivative Securities"

[a] Equity Securities Generally. Section 16(a) requires that insiders of an issuer that has a class of equity securities registered under Exchange Act Section 12 report beneficial ownership of "equity securities of such issuer," and changes in such beneficial ownership. This means that an insider's Forms 3, 4 and 5 must report beneficial ownership with respect to all equity securities of the issuer, not just those equity securities that are registered under Section 12. n16

Exchange Act Section 3(a)(11) defines the term "equity security" broadly, as follows:

The term 'equity security' means any stock or similar security; or any security future on any such security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors,

to treat as an equity security.

As authorized by Section 3(a)(11), the Commission has expanded the definition of "equity security." In Rule 3a11-1 under the Exchange Act, the term "equity security" is defined to include any limited partnership interest, interest in a joint venture, certificate of interest in a business trust, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, and securities convertible into, and warrants and other rights to acquire, such equity securities.

Rule 3a11-1 also defines as an "equity security" any "put, call, straddle, or other option or privilege of buying such a security from or selling [such a] security to another without being bound to do so." This definition, adopted in 1973, n17 clearly treats a right to acquire or dispose of equity securities as a kind of equity security.

An issue existed under the pre-1991 Section 16 rules as to whether an option contract, conferring a right to acquire or dispose of the issuer's equity securities, was an equity security "of such issuer" if the person obligated under such option (the "writer") was not the issuer but was instead a third party. n18 The Commission and its staff had historically taken the position that an insider was obligated to report beneficial ownership of such options and rights to acquire. n19 This position was apparently based on the theory that transactions in such options and rights effected a change in "beneficial ownership" of the underlying equity securities. There was no question but that such underlying equity securities were equity securities "of such issuer."

To eliminate any question in this regard, the Section 16 rules adopted by the Commission in 1991 includes the following definition:

The term "equity security of such issuer" shall mean any equity security or derivative security relating to an issuer, whether or not issued by that issuer.

Rule 16a-1(d). The meaning of the term "derivative security" is discussed in *Section 8.03[2][b]* below.

In adopting Rule 16a-1(d), the Commission appears to have been more concerned with assuring that transactions in options and other rights within the meaning of the term "derivative securities" could give rise to potential liability under Section 16(b) than with promoting reporting under Section 16(a). As noted above, such transactions generally had been reportable under the pre-1991 version of Rule 16a-6(a), and the Commission could have easily broadened the reporting requirements of that Rule without defining derivative securities to be "equity securities of such issuer." n20 But, despite the fact that such transactions were reportable as changes in beneficial ownership of the underlying shares, the courts had generally not treated transactions in options and other rights to acquire equity securities as "purchases" and "sales" of the underlying equity securities that could give rise to Section 16(b) liability. n21 The Commission, by defining derivative securities to be "equity securities of the issuer" under Rule 16a-1(d), has created the potential for Section 16(b) matching of "purchases" and "sales" of options and other derivative securities without regard to whether such transactions effected "purchases" and "sales" of the underlying equity securities. n22

One issue, not clearly addressed as yet by the Commission or its staff, is whether a right to acquire that is not a "derivative security" might separately come within the definition of "equity security." n23 The issue is likely to arise in the case of instruments excluded from being deemed "derivative securities" under the several exclusions contained in Rule 16a-1(c). n24 The definition of the term "derivative securities" is apparently intended to be broader than the provisions of Section 3(a)(11) and Rule 3a11-1 that would cause rights to acquire to be deemed "equity securities," so any instrument specifically excluded from being a derivative security under paragraphs (1) through (6) of Rule 16a-1(c) probably should be viewed as not being an equity security, either.

The Commission staff has also addressed questions as to where to draw the line between derivative securities and equity securities. For example, an insider may need to determine whether an award under an executive compensation plan

providing for the delivery of common stock at a specified future date is a derivative security reportable on Table II of Forms 3, 4, and 5 or instead is an equity security reportable on Table I of such Forms. n25 Initially, the Commission staff expressed the view that such an award should be viewed as beneficial ownership of the actual common stock reportable on Table I (like a restricted stock award), even though the common stock would not be issued and delivered to the insider for several years, and in the mean time the insider had no rights to vote, receive dividends on, or transfer the shares. n26 Subsequently, the Commission staff appeared to soften this position, permitting awards of this type to be reported as either beneficial ownership of actual shares or beneficial ownership of a derivative security. n27

[b] Derivative Securities Generally

[i] Introduction. As noted above, the Section 16 rules adopted in 1991 defined the term "equity security of such issuer" to include any "derivative security" relating to the issuer. n28 The new rules also included, as Rule 16a-1(c), a broad definition of the term "derivative securities."

The definition of the term "derivative securities" adds a great deal of complexity to reporting and liability issues under Section 16. Most of the Commission's explanation of its rationale for the new definition and other requirements relating to derivative securities focused on exchange-traded options, which the Commission recognized as having potential for insider abuse. n29 Unfortunately, the new rules apply equally to insiders' awards and rights under employee benefit plans which, while not historically viewed as being useful for short-swing speculation, appear to be far more commonly held by insiders than exchange-traded options. Even though the situation was alleviated somewhat by the Commission's revisions in 1996 expanding and simplifying the rules exempting employee benefit plan transactions and other transactions between issuers and officers or directors, the scope of the derivative security concept continues to significantly impact employee benefit plan design.

Rule 16a-1(c)'s broad definition of "derivative securities" contains two distinct parts, which require separate analysis. First, in the beginning portion of the Rule (before the numbered subsections), the Rule sets out a broad, general definition of "derivative securities," listing several types of rights and instruments that can qualify as derivative securities. Second, in paragraphs (1) to (7) under the Rule, rights and instruments that may come within the general definition but which are *excluded* from being deemed derivative securities are listed. n30

As discussed below, the breadth of Rule 16a-1(c)'s definition is such that great caution must be exercised when an insider deals in rights related to shares. In particular, rights under employee benefit plans that relate to equity securities of the issuer must be analyzed to determine whether a derivative security is present. n31 Similarly, any rights created under contracts entered into by insiders, whether or not those rights are denominated by a name commonly recognized to be a derivative security (such as options or conversion rights), must be analyzed to determine if the rights constitute a derivative security. n32 Significantly, not only is an insider deemed to acquire a derivative security when the instrument in question gives the insider the right to exercise or convert, but the insider may be deemed to have a transaction in a derivative security when he is a party to an instrument that obligates him to acquire or dispose of equity securities, even though the insider does not control the exercise or conversion of the instrument. n33 For example, an insider who writes a call option, and thus is obligated to sell equity securities upon exercise of the option by the optionee, is deemed to have had a transaction in a derivative security. Similarly, an insider may be deemed to have engaged in a derivative security transaction, and thus a purchase or sale, with rights that are settled only for cash and that never involve the issuance of common stock.

In this regard, the rules and forms can be very confusing, largely because the distinction between a derivative security and a derivative security "position" is poorly explained. The notion of a derivative security "position" is woven into the rules in order to classify *transactions* in derivative securities as purchases or sales, mainly for purposes of assigning liabilities under Section 16(b). Thus, a "call equivalent position" means that the insider's rights relating to a derivative security will become more valuable to him as the value of the underlying equity security *increases*. n34 Conversely, a "put equivalent position" means that the insider's rights relating to a derivative security will become more valuable to

him as the value of the underlying equity security *decreases*. n35 The crucial point is that, under Rule 16b-6(a), an insider who establishes or increases a "call equivalent position" or liquidates or decreases a "put equivalent position" is deemed to have a "purchase" for purposes of Section 16(b), while a person who establishes or increases a "put equivalent position" or liquidates or decreases a "put equivalent position" is deemed to have a "sale" for purposes of Section 16(b). n36

[ii] Interpretations Limiting Scope of Definition for Policy Reasons. The Commission staff has been forced to recognize that the extremely broad definition of "derivative securities" can subject transactions to reporting and liability when such results are unexpected and undesirable. Therefore, the staff has granted interpretive relief concluding that rights that otherwise appeared to constitute derivative securities would not be treated as derivative securities in the following cases:

(1) An insider's right of first refusal and a right to participate in a sale by another stockholder that arose under a stockholders' agreement were not viewed as "derivative securities" even at the point such rights are triggered. n37 When triggered, it appeared that such rights would constitute a right to acquire or dispose of equity securities at a fixed price which would have, absent staff relief, constituted a derivative security reportable under Section 16(a). As in the case of overallotment options, n38 the fact that the rights would have sprung to life as derivative securities and, if not exercised, expired within less than six months could have given rise to short-swing profits liability under Rules 16b-6(a) and 16b-6(d) (deeming the acquisition of such rights to be a purchase or sale, and the expiration of such derivative security unexercised as a matchable sale or purchase), absent interpretive relief.

(2) An insider's award that, under Rule 16a-1(c), becomes a derivative security but is then exercised on the same day has been treated as not constituting a separate reportable derivative security, but instead as simply a single transaction in which beneficial ownership of shares is acquired. n39

[iii] "Grandfathering" of Instruments Granted Before May 1, 1991 as Non-Derivative Securities.

The 1991 definition of "derivative securities" caused many kinds of instruments, particularly rights that could be settled only for cash under employee benefit plans, to become subject to Section 16 reporting and liability for the first time. Under transition provisions announced by the Commission, these rights are "grandfathered" as being not subject to Section 16 if the rights were granted before May 1, 1991 or, in certain cases, before August 15, 1996.

Under the pre-1991 version of the Section 16 rules, the question had frequently arisen whether interests with a value measured by reference to equity securities (such as "phantom shares") under an incentive or deferred compensation plan represented "beneficial ownership" of "equity securities" that was reportable under Section 16(a) (on Forms 3 and 4) and subject to potential short-swing profits liability under Section 16(b). No rule specified the treatment of these interests, but the Commission staff consistently concluded, in a long line of interpretive letters, that rights to future payments valued by reference to common stock but which could only be settled in cash did not represent reportable beneficial ownership of equity securities. n40 In some cases under the old rules, plan interests that were not strictly "cash-only" were also treated as not constituting beneficial ownership of equity securities. Thus, the Commission staff occasionally granted reporting relief where insiders acquired plan interests that could be settled in issuer stock, although this line of interpretive letters was not consistent (unlike the cash-only letters), and, even when it issued a favorable interpretive letter, the SEC staff often insisted that it did not necessarily agree with the legal analysis put forward by issuer's counsel. n41

The Commission took two steps to ameliorate the effect of its 1991 rules on cash-only employee benefit plan arrangements. First, the Commission announced a transition provision that grandfathered, as not subject to Section 16, all cash-only employee benefit plan instruments that had been awarded prior to May 1, 1991 in reliance on the prior staff interpretations. n42 No similar relief has been provided in the case of instruments granted prior to May 1, 1991 that

are not strictly cash-only, and the staff has taken the position that such instruments became reportable as derivative securities under the new rules. n43 Second, the Commission adopted two exclusions from the definition of "derivative securities" for certain "cash-only arrangements". These exclusions, originally set forth in Rule 16a-1(c), were repealed in 1996 in connection with the Commission's amendments to expand the Rule 16b-3 exemptions. Again, however, the Commission grandfathered instruments that had been issued prior to August 15, 1996 in reliance on the two exclusions.

[A] The 1991-1996 Exclusions for Certain Cash-Only Rights. The two exclusions from the definition of derivative security originally adopted in 1991 covered "securities that may be redeemed or exercised only for cash" and that either satisfied certain (but not all) of the conditions of Rule 16b-3 as it existed during the time of the exclusion, or that had a "fixed" date of redemption. The Commission staff took the position that these exclusions were available only for employee benefit plan arrangements. n44 Although repealed in 1996, the exclusions have continued significance in light of the number of incentive and deferred compensation plans implemented in reliance on the exclusions and the continued "grandfathered" status of instruments and rights issued before August 15, 1996 under such arrangements.

The threshold issue in the application of the two exclusions is whether a right that might otherwise be a derivative security is a "cash-only" right. To qualify, the right must have been redeemable or exercisable "only for cash and... not permit the receipt of equity securities in lieu of cash." Thus, not only must the right not be settleable in actual shares of common stock, but the right must not be in tandem with other awards that could be exercised to acquire common stock. n45

The first exclusion, ("Exclusion (i)") applied to rights awarded under an employee benefit plan that meet three of the requirements then available to exempt employee benefit plan transactions. n46 The first requirement was that a plan be in writing and set forth the "means or basis for determining eligibility to participate" as it applies to directors and officers, and "either the price at which the securities may be offered and the amount of securities to be awarded or the method by which the price and the amount of the award are to be determined." n47 The second requirement was that either the plan or a written agreement with the director or officer impose transfer restrictions on the rights issued under the plan. Finally, the exclusion required that the plan either be administered by disinterested directors or that grants or awards be made pursuant to a formula that eliminates discretion from the award process. n48 Of significance of the time, the exclusion did not require the plan to have been approved by shareholders.

Under the second exclusion, ("Exclusion (ii)"), cash-only securities which "may be redeemed or exercised only upon a fixed date or dates at least six months after award, or incident to death, retirement, disability or termination of employment" were excluded from the definition of "derivative securities." Exclusion (ii) was widely relied upon to exclude deferred compensation plan interests, including phantom shares, from the definition of "derivative securities."

The Commission staff took the position that Exclusion (ii) was available to cover interests acquired as a result of a participant's election to defer compensation. n49 This appears to be a broader interpretation of the term "award" than will be given that term under Exclusion (i) or under Rule 16b-3(c)'s exemption for "grant or award" transactions.

In stretching the term "award" under Exclusion (ii), however, the staff may have exacted a price. The staff stated:

Deferred compensation arrangements not otherwise viewed as awards nonetheless may satisfy the requirements of [old] Rule 16a-1(c)(3)(ii) if the deferred compensation is paid automatically upon death, disability or termination of employment, or upon the occurrence of a fixed date at least six months after acquisition of the cash-only right received from the issuer in a compensatory arrangement (see also footnote 136 of Release No. 34-28869). The participant may not have any further discretion once the decision to defer a specified amount has been made, other than to cease deferral or change the level of future deferrals. n50

The staff consistently took the position that participants can have little or no discretion in electing to redeem or exercise

rights under a deferred compensation plan meeting the requirements of Exclusion (ii), including positions that:

- discretion to switch the form of investment of deferred compensation did not satisfy Exclusion (ii)'s "fixed date" requirement; n51
- payouts triggered by a change in control did not satisfy Exclusion (ii)'s "fixed date" requirement (at least in the absence of an actual termination); n52
- payouts in the discretion of an administrator, based on the participant's severe financial hardship, did not satisfy Exclusion (ii)'s "fixed date" requirement; n53 and
- the ability of the participant to elect a payout on one of two or more fixed dates did not satisfy Exclusion (ii)'s "fixed date" requirement. n54

In view of the stringent restrictions required for compliance with Exclusion (ii), issuers sought to limit the application of such restrictions under deferred compensation plans only to insiders, and then only for the period of time that such participants were insiders. The Commission staff agreed that awards subject to such restrictions met the requirements of Exclusion (ii). n55

[B] Scope of the Grandfather for Cash-Only Rights.

Both when it first adopted the definition of derivative security that covered cash-only rights and when it repealed the two initial exclusions from that definition, the Commission announced that cash-only instruments issued prior to the effective dates of the respective rule changes would remain exempt from Section 16. Nevertheless, a significant interpretive issue remained as to the scope of "instruments" entitled to enjoy grandfathered status. Typically, cash-only interests in the nature of phantom shares would provide that the participant is credited with additional phantom shares as a deemed reinvestment of "dividend equivalents" on each dividend payment date. Thus, participants who acquired such cash-only plan interests before the grandfathered cut-off date, could expect to receive additional cash-only plan interests thereafter on quarterly dividend payment dates. Moreover, some plans allow participants to switch the method by which the cash-only interests are valued, from phantom shares to other forms of investment and back into phantom shares. If these and other kinds of transactions were viewed as involving new acquisitions of instruments not covered by the Commission's "grandfathering" position, such instruments might represent derivative securities subject to reporting and potential liability (unless excluded under the more stringent provisions of new Rule 16a-1(c)(3)).

The Commission staff resolved these issues by issuing the following interpretation:

Phantom units issued prior to May 1, 1991 pursuant to deferred compensation plans deemed to be cash-only by staff interpretation are not subject to Section 16. With respect to pre-May 1 account balances in such plans, transactions occurring on or after May 1 involving either transfers between a phantom stock unit and a cash account, the crediting of dividend equivalents, or the distribution of compensation previously deferred upon the occurrence of specified change in control events will continue not to be subject to Section 16. n56

The Commission took the same position in 1996 when it repealed the two exclusions for cash-only employee benefit plan instruments. At that time, citing the foregoing staff interpretation, the Commission stated:

Cash-only instruments excludable from the definition of "derivative security" under current Rule 16a-1(c)(3) originally issued before the Effective Date [August 15, 1996] will remain exempt from the reporting requirements of Section 16(a) after the Effective Date. With respect to such cash-only securities, a transaction on or after the Effective Date that is consistent with the conditions of the

exclusion pursuant to which the security was issued also will not be subject to Section 16. n57

In effect, the staff has concluded that cash-only interests granted in reliance on the old interpretive letters should be immune from regulation under the new Rules through the "life-cycle" of the interest.

[c] Scope of General Definition of "Derivative Securities." New Rule 16a-1(c) generally defines the term "derivative securities" to mean:

any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security...

This general definition contains two distinct tests: First, a right could be a "derivative security" because it is a right to acquire, by exercise or conversion, actual shares of common stock or some other equity security (which includes other derivative securities.) n58 Second, a right could be a "derivative security" because it has a "value derived" from the value of common stock or some other equity security. Of course, instruments that come within the general definition of derivative securities may still be excluded by the "exclusions" contained in Rule 16a-1(c)(1) through (7), discussed in § 8.03[2][d] below. n59

[i] Exercisable and Convertible Instruments. The first part of Rule 16a-1(c)'s general definition specifies that certain instruments with an exercise or conversion privilege at a price related to an equity security are derivative securities. Under this test, the following instruments have been deemed to be derivative securities:

- Stock options, including market-traded standardized options and options issued under employee benefit plans. n60
- Warrants. n61
- Convertible debentures, stocks with conversion privileges, options and other rights to exchange. n62
- Stock appreciation rights. n63
- Rights, in the nature of stock depreciation rights, that provide for payments in the event of a decrease in market value of shares over a period of time. n64
- Dividend equivalent rights, entitling holders to receive additional shares or options at times dividends are otherwise paid on shares, with values equal to the amount of such dividends. n65
- A non-recourse note given for the purchase of stock, where the note is secured by the stock. n66

A number of interpretive difficulties have arisen over the years in applying the definition of "derivative security" to a wide variety of situations. The treatment of stock appreciation rights ("SARs") as a separate kind of derivative security has raised some difficult issues for the Commission and its staff. Of course, because an SAR allows the holder to profit from appreciation in the market price of the issuer's stock, there can be no doubt that a derivative security is present. But, of the economic rights and obligations that comprise an SAR, only one component would appear to be a derivative security. In other words, a SAR could be viewed as an option to acquire stock at a fixed price coupled with a right to resell some or all of such stock to the issuer at an unfixed price. n67 A right to sell shares at a price that is not fixed does not, by itself, represent a derivative security. n68 In contrast to this approach in which the complex economic rights and obligations making up an SAR are examined as separate components, Rule 16a-1(c)'s general definition of "derivative securities" simply includes SARs as a distinct type of derivative security.

Interpretive difficulties have resulted because the Commission and staff have not been consistent in treating an SAR as a complex right with a derivative security component or as a unitary derivative security. For example, the Commission and its staff have insisted that exercises of SARs for cash be reported in three "component" parts. n69 This method of reporting assumes that an exercise of an option for shares, and payment of the exercise price, is implicit in the exercise of an SAR for cash. The Commission and staff have also concluded that the exemption under Rule 16b-6(b) for exercises of derivative securities would exempt the component of an SAR exercise that resembles an exercise of an option for stock, but would not exempt the component that resembles an implicit sale of such stock. n70

In contrast, the Commission has taken the position that the exercise of an SAR for stock would be reported as a unitary transaction, in the same manner as an option exercise, and that the acquisition of stock upon such exercise would be exempt under Rule 16b-6(b). n71 This position ignores the economic components of the SAR exercise, distinguished with such care in the case of SARs exercised for cash. The only economic difference between the exercise of an SAR for stock and an exercise for cash is that the number of shares assumed to be sold in the exercise for stock is limited to the number required to pay the exercise price of the deemed option.

The Commission and staff have alternated between these two positions, generally looking at components of SAR-like rights in order to restrict relief under the Rule 16b-6(b) exemption for exercises but treating cash-out rights as unitary SARs, separate from other derivative securities, in order to broaden reporting requirements and the risk of liability for separate "grants" of SARs.

One area where these competing interests emerged was the treatment of cashless withholding rights which are commonly granted to insiders to enable them to elect to have shares issuable upon exercise of an option withheld to satisfy tax obligations. n72 The insider already has one reportable derivative security, the option to which the cashless withholding rights relate. Rather than viewing the cashless withholding right as merely an added component to the option which simply allows the resale of the option shares to the issuer at the market price prevailing at the date of exercise--a right exercisable at an unfixed price and thus not a separate derivative security--the Commission staff initially took the position that the cashless withholding right as a whole is a separate derivative security for which separate reporting is required. n73

The staff carried this interpretation over to the context of restricted stock, even concluding that cashless withholding rights relating to restricted stock constitute a derivative security. n74

In 1996, the Commission reversed the staff's interpretation as to tax withholding rights n75 Stating that such rights "as well as the right to have securities withheld in satisfaction of an exercise price, properly may be viewed as an integral feature of the related security," the Commission adopted an amendment to expressly exclude such rights from the definition of "derivative security." n76

The Commission staff has confirmed that a broker-assisted cashless exercise feature will not be viewed as a tandem cash component that rises to the level of a separate, SAR-like derivative security. n77 Under this kind of feature, the issuer coordinates option exercises with the optionee's broker, enabling the broker to immediately resell some or all of the option shares and to pay over to the issuer a portion of the proceeds (or an advance thereon) sufficient to cover the exercise price and, in some cases, withholding taxes. Because neither the issuer nor the broker is contractually bound to repurchase the shares, this kind of feature clearly should not be considered a derivative security. n78 The staff also appears to have taken the practical position that rights to cash in lieu of fractional shares need not be treated as tandem cash components and SARs if the shares to be cashed out were acquired in exempt transactions. n79

Another area where the staff has issued interpretations that, while pragmatic, may not be consistent with the definition of "derivative security" is where there are conditions to the ability to profit from a derivative security position. The staff has stated that an instrument that is subject to certain conditions which, if not satisfied, will preclude exercise,

conversion, or exchange will cause the instrument not to be considered a derivative security. Thus, if performance conditions must be met in order for an option to become exercisable, such option will not be deemed a derivative security until such conditions are satisfied. n80 Similarly, rights to acquire an unfixed or "floating" amount of shares, where the amount of shares to be acquired is determined by performance measures, are not considered derivative securities. n81 If a decision-maker independent of the insider has the power to determine whether or not the insider may exercise, convert or exchange his rights, such rights will not be deemed derivative securities prior to a decision. n82 However, conditions to exercise, conversion, or exchange that merely require the passage of time, continued employment, or the increases or decreases in the market prices of equity securities will not prevent such instruments from being deemed derivative securities. n83 Although not free from doubt, it appears that rights that can be exercised only in the event of a change in control of the issuer will constitute derivative securities, despite the conditional nature of such rights. n84

[ii] Instruments With Value Derived From Equity Securities. Under the second test of the general definition of "derivative securities" in Rule 16a-1(c), rights that are "similar" to those specified in the Rule may also be derivative securities if they have "a value derived from the value of an equity security." While this definition is clearly quite broad, the Commission staff has taken interpretive positions that have defined some of the boundaries of this definition.

The Commission staff initially took a position that performance awards that provide for varying levels of payment based on the issuer's earnings per share, return on equity, or other financial performance ratios could constitute "derivative securities" because reference to such ratios allowed the awards to "derive value" from equity securities. n85 The Commission staff apparently reasoned that, while market prices of equity securities are not directly linked to financial performance measures, the indirect links were strong enough to justify treating such measures as "components" of equity securities.

Subsequently, the Commission staff reversed this position, recognizing that rights to payments linked to financial performance measures (other than market prices of equity securities) should not be deemed "derivative securities" under the Rule 16a-1(c)'s general definition. n86 Subsequently, the staff extended this position, concluding that even where the changes in market price are considered in an award valuation formula, if factors unrelated to market price also substantially affect the valuation, such award will not be deemed a "derivative security." n87

Nevertheless, it remains clear that instruments, such as "phantom shares," that have a value that is linked directly to market values of issuer (and which are not subject to performance conditions) stock, will be deemed derivative securities under the general definition of Rule 16a-1(c). n88

[d] Exclusions From the Definition of "Derivative Securities." New Rule 16a-1(c) contains six specific exclusions from the definition of "derivative securities." Excluded are:

- (1) rights of a pledgee of securities to sell the pledged securities; n89
- (2) rights of all holders of a class of securities of an issuer to receive securities pro rata, or obligations to dispose of securities, as a result of a merger, exchange offer, or consolidation involving the issuer of the securities; n90
- (3) rights or obligations to surrender a security, or have a security withheld, upon the receipt or exercise of a derivative security or the receipt or vesting of equity securities, in order to satisfy the exercise price or tax withholding consequences of receipt, exercise or vesting; n91
- (4) interests in broad-based index options, broad-based index futures, and broad-based publicly traded market baskets of stocks approved for trading by the appropriate federal governmental authority; n92

- (5) interests or rights to participate in employee benefit plans of the issuer; n93
- (6) rights with an exercise or conversion privilege at a price that is not fixed; n94 or
- (7) options granted to an underwriter in a registered public offering for the purpose of satisfying over-allotments in such offering. n95

[3] Beneficial Ownership

[a] Beneficial Ownership Generally. The concept of beneficial ownership is central to the reporting requirements imposed by Section 16(a) of the Exchange Act. Section 16(a) requires any person who is a Section 16 insider to file with the Commission an initial statement of all equity securities of which he is the "beneficial owner," and, generally within two business days of any change in such "ownership," a statement reporting such change in beneficial ownership and the amount of equity securities owned following the reported transaction.

Thus, the equity securities (and derivative securities) n96 beneficially owned by an insider must be listed on the initial Form 3, and changes in such ownership typically will trigger the need to file subsequent Form 4s. n97 Under the rules adopted in 1991, some changes in beneficial ownership that might otherwise trigger Form 4 filing obligations are now reportable instead on a year-end Form 5. n98 As a result of perceived abuses arising from this delayed reporting and investor interest in learning of insiders' transactions, in 2002 Congress amended Section 16(a) and the Commission adopted revised reporting rules. These changes had the effect of requiring most Forms 4 to be filed within two business days of a transaction and requiring exercises and conversions of derivative securities as well as most employee benefit plan and other transactions covered by Rule 16b-3 to be subject to this two business day reporting requirement, instead of being eligible for delayed reporting on Form 5. n99 However, the rules allow modified two-day reporting in two specific circumstances. n100 Pursuant to Rule 16a-3, transactions pursuant to trading plans that satisfy the affirmative defense conditions of Rule 10b5-1(c) must be reported on the earlier of two business days after the date on which the broker or stock option plan administrator notifies the insider of the execution or five business days after the trade date. n101 Discretionary transactions must be reported on the earlier of two business days after the date on which the stock option plan administrator notifies the insider of the execution or five business days after the trade date. n102 Neither of these special rules are available, however, if the insider directly or indirectly selects or controls the date of the transaction.

Without formally defining additional terms, the Commission and its staff have come to use the term "holdings" to refer to the beneficial ownership of equity securities reported in initial Form 3s and the month-end and year-end beneficial ownership reported on Forms 4 and 5, and the term "transactions" to describe changes in beneficial ownership that trigger Form 4 or Form 5 filing obligations. n103

Section 16(a) uses the term "beneficial owner" in an additional sense, to define who is a Section 16 insider. Section 16(a) states that persons who are directly or indirectly the "beneficial owner" of more than ten percent of any class of equity securities registered under Section 12 of the Exchange Act are, like directors and officers of the issuers of such equity securities, subject to reporting obligations. n104 This statutory provision would give the impression that a single concept of beneficial ownership applies for both purposes, but, as discussed above, the Commission has adopted a special definition of "beneficial owner" for purposes of determining who is an insider, with a separate definition of "beneficial owner" to be used "for all other purposes." n105

The definitions of "beneficial ownership" were added to the rules under Section 16 in 1991. n106 Before the adoption of Rule 16a-1(a), no formal definition of "beneficial ownership" had been put forth by the Commission, and no precise definition had evolved in the cases. n107

The Commission not only sought to define the term "beneficial ownership," it sought also to read the term into the

statutory provisions of Section 16(b), and to do so in a way that would broaden short-swing profits liability. n108 Section 16(b) itself uses the term "beneficial owner" only as a convenient reference to persons who are, as 10% shareholders, insiders subject to potential short-swing profits liability. The substance of Section 16(b) is that an insider must disgorge any "profit realized by" the insider from purchases and sales of equity securities within less than six months. While courts have recognized that "profit realized by" the insider equates to a concept of "beneficial ownership," it is questionable whether such courts will regard the Commission's definition of an "unexpressed" term of Section 16(b) as binding on such courts' interpretations of the terms actually appearing in Section 16(b). n109

Possibly recognizing that an expanded definition of "beneficial ownership" might not assure expanded liability under Section 16(b), the Commission took additional steps to extend the reach of Section 16(b). For example, the Commission did not simply rely on Rule 16a-1(a)(2)(ii)(F)'s definition of "beneficial owner" of an equity security as including any equity securities that may be acquired by exercise or conversion of derivative securities, the Commission provided specifically in Rule 16b-6(a) that transactions in derivative securities would be deemed to be "purchases" and "sales" of the related equity securities. Similarly, Rule 16a-8's provisions depart from the concept of "beneficial ownership" in the case of interests in securities held by trusts, instead specifying when such interests are subject to reporting under Section 16(a) and providing that any insider subject to such reporting is likewise subject to liability under Section 16(b). n110

Beneficial ownership issues arise principally when an insider has a relationship to another person or entity who owns equity securities of the issuer or has rights akin to ownership of such equity securities. Beneficial ownership through another person or entity is termed "indirect" beneficial ownership. n111 In 1991, the Commission likewise expanded the scope of Section 16(b) in the context of indirect interests. Under Rule 16a-1(a)(2), an insider may be deemed the indirect beneficial owner of equity securities held by immediate family members sharing the same household, held by a corporation, partnership, or trust, and as a result of other legal relationships and rights. n112

The breadth of the definition of "beneficial owner" can cause more than one person to be deemed to be the beneficial owner of the same shares. In the case of such overlapping beneficial ownership, the amount of short-swing profit recoverable is limited to the amount that potentially could be recovered if only one person was the beneficial owner of the equity securities involved in the purchase and sale. n113

[b] Pecuniary Interest. In determining which equity securities are beneficially owned by a Section 16 insider for reporting and other purposes (but not for determining whether a person is a 10% shareholder), an insider generally is a beneficial owner of equity securities in which he or she has, directly or indirectly, a "pecuniary interest." n114 The Commission has stated that this approach is generally consistent with cases interpreting the terms of Section 16(b). n115

The term "pecuniary interest" means, with respect to equity securities,

the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities. n116

The focus on "beneficial ownership" and "pecuniary interest" makes other indicia of ownership of little relevance. For example, voting and dispositive power, which are crucial to the definition of beneficial ownership for purposes of determining who is a 10% shareholder and thus an insider subject to Section 16, n117 do not, by themselves, constitute a pecuniary interest. n118 Likewise, record ownership may be of no significance to the question whether an insider is a beneficial owner of equity securities. n119

The Commission staff has recognized a limited number of situations in which, although an insider's interest may relate to issuer stock, the value of such interest is so little affected by transactions in such stock that the insider has no opportunity to "profit" and therefore no pecuniary interest. In one case, if an insider is a participant in a defined benefit pension plan, under which the amount of benefits to be paid as a pension to the insider is not based on the value of the assets of the trust holding plan assets, the insider is not viewed as having a pecuniary interest in the trust. n120 In a

somewhat similar situation, the staff concluded that a participant in a non-tax qualified plan for which a rabbi trust served as a funding vehicle did not have a pecuniary interest in issuer stock held in the trust because the amount ultimately payable was determined solely under the terms of the plan and not with reference to the value of the assets in the rabbi trust. n121 Finally, even where the value of the insider's interest as a trust beneficiary varies with the value of the trust assets, the staff took the position that, in the case of a trust for a tax-qualified plan subject to ERISA, if less than 20% of trust assets consist of issuer stock held in a mixed-equity fund managed by a trustee (such percentage measured at the end of the plan's latest fiscal year), an insider-beneficiary will not be deemed to have a pecuniary interest in issuer stock held in such fund. n122

One question not yet addressed by the Commission staff is whether the existence of conditions that could result in forfeiture of stock will cause an insider not to have a pecuniary interest in such stock. In an analogous area, the staff has taken the position that conditions that must be satisfied before a right that would otherwise be a derivative security will be exercisable or be deemed to have value will prevent such right from being a derivative security, under Rule 16a-1(c)(3), until such conditions are satisfied. n123 In one interpretive letter, the staff concluded that a right to receive a specified number of shares at a future date if certain performance conditions were met neither involved a derivative security or any other reportable interest. n124 In view of the staff's position that similar rights to future delivery of shares, unencumbered by performance conditions, represent a pecuniary interest and thus beneficial ownership of such shares, n125 it would appear that the existence of performance and other conditions may vitiate any "opportunity to profit" from the shares and therefore preclude the existence of a pecuniary interest in such shares. n126

Although Rule 16a-1(a)(2) distinguishes between "direct" and "indirect" pecuniary interests, the Rule does not in fact define "indirect" pecuniary interests. While Rule 16a-1(a)(2)(ii) sets forth a list of examples of indirect pecuniary interests, this list is not exhaustive, and the possibility exists that interests of types not listed might be deemed to constitute an indirect pecuniary interest. n127

[c] Family Relationships. An insider is presumed to have an indirect pecuniary interest in securities held by members of such insider's immediate family n128 sharing the insider's household, but this presumption is rebuttable by the insider. n129

In its 1988 proposals, the Commission sought to broaden this rule by treating it as a *per se* rule rather than just a presumption. n130 When commentators strongly opposed this change, the Commission concluded to retain the concept that indirect pecuniary interest is only presumed, similar to the Commission's position under the old Section 16 rules. n131 Thereafter, the language describing the rule as only a presumption was inadvertently dropped from the Rule in the release adopting the 1991 version of the Section 16 rules, n132 but the Commission subsequently reinserted the language in Rule 16a-1(a)(2)(ii)(A) before the Rule became effective. n133

The Commission has not interpreted the reporting requirements in light of the right to rebut the presumption of a pecuniary interest in securities held by immediate family members in the same household. Presumably, the insider who in good faith believes he or she can rebut such a presumption need not report such family members' securities on Forms 3, 4, and 5; if challenged in an enforcement action or short-swing profits liability claim, the burden of rebutting the presumption would fall on the insider. n134 The Rule does not appear to require the insider to report all such family members' holdings on his or her Forms and either rebut the presumption by means of a footnote or save the rebuttal arguments for any litigation. n135

The only other place in the rules under Section 16 in which the term "immediate family" is used is under Rule 16a-8, in defining which securities held by trusts are reportable by an insider. Significantly, in that context, the concept is not limited to immediate family members that share the insider's household. n136

Although Rule 16a-1(a)(2)(ii)(A) refers to securities "held by" family members, that undefined term appears to mean "beneficially owned" in its broad sense under Rule 16a-1(a)(2). Thus, if an immediate family member sharing an

insider's home has an "indirect pecuniary interest" in equity securities, the insider would apparently likewise be deemed (rebuttably) to have such indirect pecuniary interest.

[d] Partnerships. An insider is deemed to have an indirect pecuniary interest in equity securities held in the portfolio of certain partnerships.

Under Rule 16a-1(a)(2)(ii)(B), an insider who is a general partner of a general or limited partnership is deemed to have an indirect pecuniary interest in the partnership's portfolio securities to the extent of the insider's "proportionate interest." Such Rule deems the partner's "proportionate interest" to be the greater of:

"(1) the general partner's share of the partnership's profits, including profits attributed to any limited partnership interests held by the general partner and any other interests in profits that arise from the purchase and sale of the partnership's portfolio securities; or

(2) the general partner's share of the partnership capital account, including the share attributable to any limited partnership interests held by the general partner."

These interests are measured based on the partnership agreement in effect at the time of a transaction in issuer equity securities and the partnership's most recent financial statements. n137

Fortunately, an insider general partner need not become entangled in the complexities of measuring his partnership interests when simply filing a Form 3, 4, or 5. The instructions to such Forms allow a partner, in lieu of reporting the number of shares of issuer stock held by the partnership in which he is deemed to have an indirect pecuniary interest, to simply report the aggregate number of shares held by the partnership. n138 Not only does this simplify preparation of the Forms, but it also appears to avoid the need for the insider to file additional Forms 4 and 5 to report changes in his beneficial ownership resulting from changes in his proportionate interest, at least when such changes are outside of his control. n139

Although Rule 16a-1(a)(2)(ii)(B) addresses only general partners, the possibility remains, under the general definition of "pecuniary interest," that an insider who is only a limited partner would be deemed to have an indirect pecuniary interest in portfolio securities of a limited partnership. In the usual case, the "safe harbor" set forth in Rule 16a-1(a)(2)(iii) should preclude this result, n140 because a limited partner who can exercise only a limited partner's powers under state law should not be viewed as a "controlling shareholder" or as having or sharing investment power over the partnership's portfolio securities. n141

[e] Corporations. The Commission declined to propose or adopt a rule specifying to what degree an insider would be deemed to have an indirect pecuniary interest in issuer stock held by a corporation of which the insider is a shareholder, stating that such determination of indirect pecuniary interest generally should be left to the courts. n142 The Commission did, however, adopt a "safe harbor" provision that, if complied with, assures an insider that he will not be deemed to have an indirect pecuniary interest through a corporation. n143

Under the Rule 16a-1(a)(2)(iii) safe harbor, the insider is deemed not to have an indirect pecuniary interest in portfolio securities held by a corporation in which the insider owns securities if the insider is not a controlling shareholder of the entity and does not have or share investment control over the entity's portfolio. n144 The insider would not be deemed a controlling shareholder if such insider's power to control the corporation arises because the insider serves as a director or officer rather than through the insider's security holdings, n145 but service as a director or officer might be viewed as giving the insider sole or shared investment control. n146

As discussed above in the case of partnership holdings, an insider is permitted to report on Forms 3, 4, and 5 the aggregate amount of issuer stock held by a corporation through which the insider has an indirect pecuniary interest, rather than reporting the precise number of shares in which the insider has a pecuniary interest. n147

Where the safe harbor is not available, there remains the open question of how to calculate profits "realized by" an insider through other entities. In *Feder v. Frost*,ⁿ¹⁴⁸ the court held that an insider may have a pecuniary interest in stock of one company through his interests in a partnership (of which he was the sole general partner) and his ownership of stock of another publicly held corporation that -- in turn -- owned stock of the insider's company. The court stated, "at worst, Rule 16a-1(a)(2) gives a slightly expansive reading to the term 'profit realized,' as used in Section 16(b), by extending it to increases in the value of shares of a corporation dealing in portfolio securities rather than limiting it to cash-in-hand profits. This reading, however, does not even strain the ordinary or natural meaning of 'profits realized' and seems well within the Commission's discretion, although many wrinkles in interpretation and application may have to be confronted"^{n148.1}

[f] Trusts

[i] Overview. Rule 16a-8 sets forth the rules under which an insider is deemed to have an interest in shares of issuer stock held in a trust such that the insider must report transactions in and holdings of such shares under Section 16(a) and is subject to potential liability with respect to such shares under Section 16(b). The Rule, as interpreted by the Commission staff, is especially complex and is designed to do several things at once.ⁿ¹⁴⁹

Although Rule 16a-1(a)(2)(ii)(E) specifies that an insider has an "indirect pecuniary interest" in trust shares to the extent specified by Rule 16a-8, Rule 16a-8 does not actually specify when an insider has a "pecuniary interest" in shares held by a trust. Instead, Rule 16a-8 specifies when an insider has reporting obligations with respect to shares held in a trust.ⁿ¹⁵⁰ Significantly, the Commission staff has concluded that a trust beneficiary who does not have investment control will have no reporting obligations or short-swing profit liability with respect to trust shares.ⁿ¹⁵¹

Rule 16a-8 separately provides that a person required to report trust shares will also be subject to potential liability under Section 16(b) and the prohibition on sales in the nature of short sales under Section 16(c).ⁿ¹⁵²

Rule 16a-8 substantially expands reporting and potential liability with respect to trust shares far beyond the reach of old Rule 16a-8 in effect before May 1991. For one thing, the most common way in which insiders have a beneficial interest in trusts is as participants in employee benefit plans in trust form. Old Rule 16a-8 provided an exemption that in almost all cases applied to tax-qualified employee benefit plan trusts, and as so applied, relieved trust beneficiaries of all reporting of trust shares.ⁿ¹⁵³ Thus, as of May 1, 1991, insiders became subject to broad reporting requirements with respect to employee benefit plan trusts for the first time.ⁿ¹⁵⁴ Moreover, old Rule 16a-8 did not purport to impose Section 16(b) liability, in contrast to the new Rule.ⁿ¹⁵⁵

As discussed below, the role and identity of the trustee is important to the application of Rule 16a-8 in several respects, so the Commission staff has interpreted the term broadly to mean not only the person or persons who are designated as trustee, but also persons who perform the "functions of a trustee."ⁿ¹⁵⁶ The key trustee function, in the staff's view, is investment control. Thus, if an insider's spouse is the trustee of a trust and the insider in fact exercises investment control over the trust through the spouse, the insider will be deemed to be the trustee.ⁿ¹⁵⁷ If a committee has administrative powers over an employee benefit plan trust which includes investment control, the committee will be deemed to be a trustee for purposes of Rule 16a-8,ⁿ¹⁵⁸ although a committee that is only empowered to appoint others to make investment decisions regarding securities held by a trust will not be deemed to be a trustee solely for that reason.ⁿ¹⁵⁹ An investment manager or other person who is appointed to make investment decisions regarding securities held by a trust may be deemed to be performing a trustee function and thus to be a trustee for purposes of Rule 16a-8.ⁿ¹⁶⁰

[ii] Obligations of Trusts. If a trust is subject to Section 16 as a greater than ten percent beneficial shareholder,ⁿ¹⁶¹ the trustee is required to file on behalf of such trustⁿ¹⁶² Forms 3, 4, and 5 to report transactions in and holdings of equity securities of the issuer.ⁿ¹⁶³ This requirement is subject to three exceptions:

(1) A trust for an employee benefit plan subject to ERISA need not report transactions and holdings if no trustee exercises investment control. n164 This exception relieves a trust from reporting participant-directed transactions under tax-qualified plans, such as 401(k) plans. n165

(2) A trust need not report transactions over which a beneficiary has investment control without consultation with the trustee. n166 It is unclear whether this exclusion would relieve a trust of the obligation to file a Form 3, which reports "holdings" but not "transactions," if the beneficiaries had exclusive investment control. n167

(3) A trust need not report transactions and holdings if an insider is settlor, has or shares investment control, and has reserved the right to revoke the trust without the consent of another person. n168

These exceptions had great significance prior to the August 1996 repeal of a provision under Rule 16a-8 that resulted in trusts being insiders in certain cases when the trustee was an insider and an immediate family member of the trustee was a beneficiary of the trust. Nevertheless, current Rule 16a-8 makes a trust subject to Section 16 when the trust is a 10% shareholder and the trustee has or shares voting or investment control over shares held by the trust. In this context, it must be emphasized that a trust is viewed as a separate insider with separate filing obligations from those of insiders who may serve as trustees or be beneficiaries, settlors, or remainderpersons. Insiders in such other capacities may also have the obligation to report transactions and holdings in the trust shares. The reporting by another insider on his or her own Forms 3, 4, and 5 of trust transactions and holdings generally will not relieve a trust of its separate filing obligations. n169

[iii] Obligations of Trustees. An insider who is a trustee of a trust n170 and who has a pecuniary interest in any transaction in or holding of issuer stock held by the trust must report such transaction or holding on the trustee's individual Forms 3, 4, and 5. n171

Unlike the provisions relating to beneficiaries, settlors, and remainderpersons, nothing in Rule 16a-8(b)(2) explicitly requires that a trustee have investment control before the trustee will be required to report trust transactions and holdings. The Commission apparently presumed that a trustee would have such investment control, as is usually the case.

Obviously, an insider trustee will have a pecuniary interest when the insider is a beneficiary of the trust. n172 In addition, Rule 16a-8(b)(3) specifies that an insider will be deemed to have a pecuniary interest in issuer stock held by the trust if the insider receives a performance fee that does not comply with the safe harbor under Rule 16a-1(a)(2)(ii)(C) n173 or if a member of the insider's immediate family is a beneficiary of the trust. n174 If an immediate family member has a pecuniary interest in issuer stock held by a trust, the insider trustee must report only transactions in and holdings of issuer shares only to the extent of such pecuniary interest.

[iv] Obligations of Beneficiaries. An insider who is a beneficiary of a trust must report transactions in issuer stock held by a trust if the beneficiary is the "beneficial owner" of the issuer stock and has or shares investment control over the issuer stock. n175

In requiring reporting only by insider-beneficiaries who have investment control, the Commission

recogniz[ed]... that it is inappropriate to require beneficiaries to incur reporting and short-swing profit obligations for transactions beyond their control. n176

Valuable as such recognition may be, n177 the Commission and its staff have undercut this position in two important ways. First, transactions in which insiders initially acquire an interest in a trust are viewed as transactions that may be

controlled by beneficiaries and which are governed by Rule 16a-8(b)(3). n178 Second, the Commission and its staff have assumed that insider participants in employee benefit plans have investment control over most transactions in which they initially acquire an interest, although in many cases such participants clearly do not. n179

An insider beneficiary of a trust may have investment control in two common situations, although (as indicated above) these are not the only forms of investment control. First, the insider beneficiary may have the ability to direct the trustee in transactions in issuer stock, a typical feature of 401(k) plans and similar plans. n180 Second, the insider may himself be the trustee or an administrator of a trust and, in such capacity, have investment control. n181

Rule 16a-8(b)(3) requires an insider beneficiary to report transactions over which he has or shares investment control if the insider is a "beneficial owner" of the issuer stock held by the trust. Rule 16a-8(b)(3)(iii) specifies that a beneficiary will be deemed to have a "pecuniary interest" (and thus be a beneficial owner, under Rule 16a-1(a)(2)'s definition) in issuer stock held by the trust to the extent of the beneficiary's *pro rata* interest in the trust. n182

In interpreting this pecuniary interest requirement, the staff has indicated that the allocation of issuer stock to beneficiaries is the key determinant, but it is clearly possible for an insider to have a pecuniary interest in issuer stock held in a trust without such securities being allocated to the insider. n183 The key determinant of pecuniary interest is that, if the value of an insider's interest as a trust beneficiary varies with changes in the value of issuer stock held by the trust and transactions in such stock, the beneficiary will be deemed to have a "pecuniary interest" under Rule 16a-8(b)(3)(iii), and if the value of such interest does not have such a relationship to the value of issuer stock, the beneficiary will not have a pecuniary interest. n184

[v] Obligations of Settlers. An insider must report trust transactions and holdings if the insider

- is the settlor of the trust; n185
- reserves the right to revoke the trust without the consent of another person; n186 and
- has or shares investment control over issuer stock held by the trust. n187

[vi] Obligations of Remainderpersons. Rule 16a-8(c) provides that an insider who has a remainder interest in a trust is not deemed to be a beneficial owner of issuer stock held by the trust if the insider does not have or share investment control. This provision is in the nature of an exemption. It does not affirmatively say that an insider-remainderperson who does have or share investment control over issuer stock held in a trust will have reporting obligations, but the Commission apparently intended that result. n188 If Rule 16a-8 is taken at face value, such obligations would have to be determined under the provisions of Rule 16a-8(b).

[g] Performance Fees. Certain money managers and fiduciaries, including broker-dealers, banks, insurance companies, investment advisers, investment managers, trustees, and persons performing similar functions, are deemed to have an indirect pecuniary interest in--and thus beneficial ownership of--equity securities held in a managed portfolio if they receive fees that are based on the performance of the assets under management (including the equity securities). n189 Fees based on a percentage of asset value, and other fees not related to performance of the securities under management, do not give rise to a pecuniary interest. n190 Moreover, performance-related fees do not give rise to beneficial ownership if the issuer's equity securities represent less than ten percent of the market value of the managed portfolio and the performance-related fee is calculated based on performance of the manager or fiduciary over a period of one year or longer. n191

[h] Certain Other Interests. Rule 16a-1(a)(2) identifies certain other interests as possibly giving rise to an indirect pecuniary interest. In some cases, however, the Rule is drafted as a "safe harbor," specifying that interests meeting the Rule's requirements will *not* be deemed to constitute an indirect pecuniary interest in securities. n192

These other possible interests that may or may not constitute indirect pecuniary interests include the following:

- (1) If a right to dividends is separated or separable from the underlying equity securities, such a right would constitute an indirect pecuniary interest in equity securities. n193 A right to receive dividends is not otherwise deemed to represent a pecuniary interest in equity securities. n194
- (2) Ownership of interests in portfolio securities of a public utility holding company registered under the Public Utility Holding Company Act of 1935, as amended, does not give rise to a pecuniary interest in the portfolio securities held by such holding company. n195
- (3) Ownership of interests in portfolio securities of an investment company (e.g., mutual fund shares) registered under the Investment Company Act of 1940, as amended, does not give rise to a pecuniary interest in the portfolio securities held by such investment company. n196
- (4) Ownership of interests in a broad-based, publicly traded market basket or index of stocks, approved for trading by the appropriate federal authority, does not give rise to a pecuniary interest in any equity security that is part of the market basket or index. n197

[4] Forms and Filings

[a] Overview of the Reporting System. The reporting system under Section 16(a) was dramatically changed under the 1991 Rules and then, partly as a result of abuses under the 1991 reporting regime, was dramatically altered again in 2002 and 2003 pursuant to the Sarbanes-Oxley Act of 2002. Since 1991, there have been three Forms for reporting under Section 16(a), Form 3, Form 4, and Form 5. n198 Form 3 is filed by an insider to report his beneficial ownership of equity securities of the issuer at the time he first became an insider. Form 4 is filed by an insider to report "transactions" which change his beneficial ownership of equity securities of the issuer. Form 5 is used to report a narrow categories of transactions eligible for delayed reporting and for late transaction reporting. Commencing August 30, 2002, most transactions are required to be reported on Form 4 within two business days of the transaction, although certain transactions are eligible for an additional three business day extension. n198.1 As of June 30, 2003, all Section 16 forms are required to be filed electronically through the Commission's Edgar system. n199

One of the Commission's primary goals in overhauling the reporting system in 1991 was to reduce the rate of late and missed filings under Section 16(a). n200 The Commission implemented a number of new requirements intended to reduce the number of delinquencies, including the following:

- (1) A new filing, the Form 5, was introduced, requiring any person who was an insider at any time during an issuer's most recent fiscal year to disclose transactions and holdings that should have been reported during that fiscal year on Forms 3, 4, or 5 but were not. n201
- (2) Copies of Forms 3, 4, and 5 must be filed with the issuer as well as the Commission. n202
- (3) The issuer is required, under Item 405 of Regulation S-K, to review the filed Forms 3, 4, and 5 and disclose the names of any insiders who failed to file on a timely basis, the number of late reports, and any known failure to file a required Form. Such disclosure is required in the issuer's Form 10-K and in any proxy statement relating to an election of directors. n203
- (4) To facilitate monitoring of delinquencies and Item 405 disclosures thereof, the cover page of a Form 10-K (or Form 10-KSB) contains a box which serves to alert the Commission staff that the issuer's Form 10-K and proxy statement may contain Item 405 disclosure of one or more delinquencies. n204

In addition, Congress enhanced the Commission's enforcement powers by enacting the Securities Enforcement Remedies and Penny Stock Reform Act of 1990. n205 That Act gave the Commission power to issue cease and desist orders in administrative actions and to seek substantial fines in civil actions in federal district courts for Section 16(a) reporting violations. n206

[b] Events Triggering Filings of Forms; Filing Deadlines.

[i] Form 3 Filings. A Form 3 filing generally will be triggered at the following times:

- (1) when a person is elected or appointed as a director or officer of an issuer that has a class of equity securities registered under Section 12 of the Exchange Act;
- (2) when a person (including a trust) becomes a beneficial owner (as defined in Rule 16a-1(a)(1)) of more than ten percent of an outstanding class of equity securities that have been registered under Section 12 of the Exchange Act; and n207
- (3) when an issuer first registers a class of equity securities with the Commission under Section 12 of the Exchange Act, thereby subjecting existing directors, officers, and 10% shareholders to Section 16 for the first time. n208

An insider must file a Form 3 even if the insider does not beneficially own any equity securities. n209

Once a person has become an insider and therefore filed an initial Form 3, if such person (while still an insider) attains an additional insider status (e.g., if an officer is elected or appointed as a director or becomes a 10% shareholder), no additional Form 3 is required. n210 Likewise, no additional Form 3 is required if the issuer registers an additional class of equity securities under Section 12 of the Exchange Act. n211

The filing deadlines for Form 3s are as follows: When the Form 3 filing is triggered by the issuer's initial registration of equity securities under Section 12 (see (4) above), the Form 3 is due at the effective date of the Exchange Act registration statement. n212 When the Form 3 filing is triggered by any other event, the Form 3 is due within ten days after such event. n213

[ii] Form 4 and Form 5 Filings. Form 4 and Form 5 filings are required to report most transactions that represent a change in an insider's beneficial ownership of equity securities. n214

Every transaction is required to be reported on a Form 4 or Form 5 unless the Commission has adopted a rule under Section 16(a) exempting the transaction from reporting. [See 8.03[4][b][iii], below]. If a transaction is subject to potential liability under Section 16(b) -- that is, if it is not exempted from reporting by a Commission rule under Section 16(a) and is not exempted from potential liability by a Commission rule adopted under Section 16(b) -- then the transaction is required to be reported on Form 4. Transactions that are exempted from potential liability by a rule under Section 16(b) are required to be reported on either a Form 4 or Form 5, depending on the nature of the transaction. Since 1991, exercises or conversions of derivative securities that are exempted under Rule 16b-3 or Rule 16b-6(b) have been reportable on Form 4. Since August 29, 2002, transactions between an issuer and an officer or director (including employee benefit plan transactions) that are exempt from potential liability under Rule 16b-3(d) or (e) and "discretionary transactions," which are transactions defined in Rule 16b-3(b)(1) that occur under participant directed individual account plans, n215 have been reportable on Form 4. n216

All Forms 4 are due on the second business day after the transaction is executed, subject to two narrow exceptions. n217 The Commission staff provided a limited extension of time for Form 4 reporting for "discretionary transactions" (described above), and for transactions pursuant to Rule 10b5-1(c) trading plans provided in both cases that the insider

does not select the date the transaction is to occur. n218 Under the limited extension, the two business day deadline is counted from a "deemed" transaction date, which is the earlier of (i) the date the insider receives notice that the transaction was executed, or (ii) the third business day after the date the transaction is executed. n219 Consequently, the latest a Form 4 can be timely filed for these transactions is on the fifth business day after the transaction. n220 The extended time period for these transactions is not available if the insider has selected the date for transaction execution. n221 For example, if an employee benefit plan operates such that a discretionary transaction occurs on a date determined by the day the insider provides instructions authorizing the transaction (as opposed to being executed on a date selected in the discretion of the plan administrator), the insider arguably has selected the date for execution of the transaction, and consequently the limited filing extension would not be available. In these circumstances, the insider will need to receive information from the plan administrator to complete and file a Form 4 reporting the transaction within the normal two business day deadline.

Three types of transactions are required to be reported on Form 5: (1) small acquisitions eligible for deferred reporting under Rule 16a-6, other than acquisitions directly from the issuer or from an employee benefit plan sponsored by the issuer, which are required to be reported on Form 4; n222 (2) certain narrow categories of transactions that are exempt from Section 16(b) liability, and that are not otherwise required to be reported on Form 4, such as gifts or inheritances; and (3) as noted above, transactions and holdings that should have been previously reported but which were not. n223 A Form 5 is required to be filed within 45 days after the issuer's fiscal year end. n224 No Form 5 need be filed to report transactions if an insider has previously reported such transactions on Form 4s (which may include voluntary Form 4s, discussed below). n225 The use of Form 5 for reporting transactions that should have been reported earlier in effect imposes an obligation on the insider to review his prior year's transactions and Section 16(a) reports and to file a Form 5 to correct any filing delinquency. As a practical matter, however, the Form 5 requirement does not allow an insider who discovers delinquencies to put off correcting them until the due date of the Form 5. n226

Voluntary Form 4s may be filed to report any transaction the reporting of which could otherwise be deferred, as long as the Form 4 is filed before the due date of the Form 5. n227 A Form 4 filed to voluntarily report a transaction need not be filed within two business days after the transaction occurred; such a Form may be filed any time before the due date of the Form required to be filed to report the transaction. n228 The filing of voluntary Form 4s to report all transactions, which obviates the need for a Form 5, has become a common practice. n229 Because delinquencies disclosed in a Form 5 must be disclosed by the issuer under Item 405 of Regulation S-K, the question of what is to be viewed as an unreported "holding" or "transaction" that triggers a Form 5 filing can be significant. It is clear from the reference to "holdings and transactions" that errors in other kinds of information required on a Form 3 or 4 (such as transaction codes, dates, and nature of beneficial ownership) would not trigger a Form 5 filing. n230 On the other hand, a failure to report beneficial ownership of any equity securities of an issuer in a Form 3 would trigger a Form 5 filing. n231 In the not uncommon situation in which post-transaction "holdings" of equity securities are not accurately reported on a Form 4, no Form 5 filing should be triggered, because Form 5's reference to unreported "holdings" apparently should be read as referring only to Form 3 reports of holdings and not to the Form 4 requirement to show "beneficial ownership" of equity and derivative securities. n232

[iii] Transactions Not Required to be Reported. In addition to prescribing the foregoing reporting requirements, various rules under Section 16(a) exempt certain transactions from triggering reports on Forms 4 or 5. Insiders are not completely relieved from monitoring the effects of such transactions, however, as changes in their holdings that result from Section 16(a)-exempt transactions should be reflected on otherwise required Forms 4 and 5. While insiders should reflect the change in ownership from such transactions in the post-transaction holdings column of a Form 4 or Form 5, there no need for the insider to report the transaction in a line entry on the Form 4 or 5, there also is no obligation to footnote the Form or otherwise describe or reconcile the reported holdings. n233 Moreover, the holding information is required only when the Form otherwise is required to report a transaction in the same class of securities, and the holdings reported may be a "best estimate." n234

Transactions that are not required to be reported are:

- (1) the increase or decrease in the number of securities held as a result of a stock split or stock dividend applying equally to all securities of a class, including a stock dividend in which equity securities of a different issue are distributed; n235
- (2) acquisitions of pro-rata rights, such as in rights offerings; n236
- (3) acquisitions under broad-based dividend or interest reinvestment plans that do not discriminate in favor of the issuer's employees; n237.
- (4) acquisitions or dispositions pursuant to a domestic relations order incident to a divorce; n238
- (5) changes in the form of ownership that do not change a person's pecuniary interest, such as changes from indirect to direct ownership, other than pursuant to exercise of a derivative security or transfers into or out of a voting trust; n239
- (6) miscellaneous specialized exemptions for underwriter n240 and odd-lot dealers; n241 and
- (7) transactions under Rule 16b-3(c)'s definition of a "tax-conditioned plan," including purchases under tax-qualified employee stock purchase plans, allocations and forfeitures under 401(k) and other ERISA individual account plans and transactions under non-ERISA excess benefit plans, in each case other than "discretionary transactions." n242

Complications that arise because of this three-tiered reporting scheme are discussed in *Section 8.03[4][d]* below.

[iv] Changes to the Reporting Regime under the Sarbanes-Oxley Act of 2002. As noted above, Section 403 of the Sarbanes-Oxley Act mandated several changes in the Section 16(a) reporting regime. First, it required Section 16(a) transaction reports to be filed "before the end of the second business day following the day on which the subject transaction has been executed, or at such other time as the Commission shall establish, by rule, in any case in which the Commission determines that such 2-day period is not feasible." n243 This reporting change became effective on August 29, 2002 less than 60 days after the Sarbanes-Oxley Act was signed into law. Second, it required that, within one year of enactment, the Commission establish a system and mandate that Section 16(a) reports be filed electronically, and that issuers be required to post copies of those filings on their corporate websites, if they have one. n244 As discussed below in 8.03[e], the Commission's rules mandating electronic filing and website posting went into effect on June 30, 2003.

The Act's mandate that transaction reports generally be filed within two business days was in part a reaction to one aspect of the scandals that plagued corporate America in 2000 and 2001. Often, one element of the scandal would be revelations that insiders had sold millions of dollars of company stock prior to the stock price crashing, and it often emerged that those transactions had not been reported at all under Section 16, or had been reported on a year-end Form 5 as a result of the transactions being exempt under Rule 16b-3 because they occurred between the company and the insider. However, the amendments also reflected the growth in insiders' access to and dealings in company stock as a result of the explosion in equity compensation arrangements and developments in the electronic availability of information, such that investors were clamoring for more timely and readily available information on insider trades. One benefit of Congress' amendments to Section 16(a) is that it appears to have side-lined a Commission proposal that, in the absence of statutory authority to mandate two business day reporting of Forms 4, would have mandated that issuers' disclose their insider trades within two days on Form 8-K.

There have been a number of steps that companies have taken to reflect the implications of two business day reporting under Section 16. Among these are:

(1) Increase Compliance Programs for Insiders. Companies have actively informed insiders of the two day deadlines for Form 4 reporting. To the extent that a company is undertaking various steps to assist insiders in Section 16 compliance, the company should describe those steps to their insiders. Insiders should inform family members and others whose holdings or transactions are attributed to them of the new reporting deadlines.

(2) Designate Several Compliance Officers. The two business day reporting deadlines mean that the timing of transaction reports is less predictable. Therefore, it is helpful for companies to designate individuals to be available at all times to assist insiders with their Section 16 reports. Each company should designate at least two people for this responsibility, to accommodate times when one is on vacation or otherwise is absent. Files should be established with respect to each insider so that the compliance officers may keep track of past Section 16(a) filings and other vital reporting information.

(3) Coordinate with Plan Administrators. Companies should contact plan administrators inside and outside of the company to ensure that they are aware of the reporting deadlines, especially the fact that administrators need to report execution of trades on an expedited basis. While the three business day extension may be available in some instances, as noted above, if the insider knows when the plan administrator executes orders (for instance, by the business day after the order is placed), the three business day extension may not be available, and the administrator would need to provide information on the trade within one business day to enable the insider to meet the two business day deadline. Companies should consider asking insiders to request that a copy of their plan account statements be sent to the company, after talking with the administrators to be sure that they can accommodate such requests. Companies should inquire of plan administrators as to how discretionary transactions are processed and how quickly they can be reported.

(4) Tighten Preclearance Procedures. More than ever, it is important for companies that assist their insiders with Section 16 filings to know of proposed transactions in advance. A preclearance process should be implemented to gather information necessary to assist in prompt reporting of transactions. Specifically, preclearance procedures should capture information on the size and terms of the proposed transaction (for example, whether it involves a limit order), the exact date the order is to be placed and contact information for the broker who is responsible for the order. Companies and insiders should begin to prepare the Form 4 at the same time an order is placed. The insider should instruct the broker to promptly report execution of the trade (whether executed in whole or in part) to the company's compliance officers.

(5) Obtain Powers of Attorney. Given the short reporting deadlines, a company may need to file reports on behalf of an insider without time for obtaining the insider's review of or signature on a Form 4. In order to establish their authority to make those filings, companies should obtain a power of attorney from their insiders. As with the compliance officers, several individuals should be authorized to act under an insider's power of attorney. A company may wish to ensure that the authorized individuals (as well as any compliance officers) are included or added to the company's D&O insurance policy as covered persons or, alternatively, may wish to include an indemnification provision in the power of attorney.

(6) Catalog Insiders' Holdings. In order to track transactions and accurately report holdings, insiders (and companies assisting them) should catalog all of their holdings (including holdings of family members) and their on-going stock purchase arrangements (401(k) plans, dividend reinvestment plans, employee stock purchase plans, stock fund accruals under non-qualified deferred compensation plans) and should understand who has authority over the shares. Obtain copies of any trading plans established under Rule 10b5-1(c). Contact information (telephone numbers, fax numbers and email addresses) should be obtained for brokers and any others whose assistance is necessary to prepare insiders' reports.

(7) Consider Establishing Shortened Trading Windows. In the past, companies typically restricted insider transactions to a limited open window trading period (such as the traditional "ten business days following the second business day after an earnings announcement"). In recent years, however, the trend has been to lengthen trading windows or to eliminate trading windows completely and instead apply only a strict preclearance policy. In light of the demands on coordinated reporting that the two business day requirement will produce and the fact that investors are more focused on tracking insiders' transaction reports, some companies have shortened open trading windows. Some companies will find this approach preferable to prevent information on transactions from dribbling into the marketplace over extended periods.

(8) Consider the Reporting Implications of Compensation Practices. Companies need to bear in mind the implications on their compensation practices of accelerated reporting. Two business day reporting of employee stock option and restricted stock grants may affect the timing or frequency of such awards. For example, if directors receive a stock grant in connection with each Board meeting, then investors would have close to real-time information on the frequency of those meetings by monitoring Section 16 filings. Companies may need to revise the manner in which such grants are announced internally in light of the prompt public disclosure obligations. Transactions pursuant to Rule 10b5-1(c) trading plans may become more commonplace because of the view that sophisticated investors will not seek to read meaning into individual transactions once the existence of the trading program has been publicly disclosed.

[c] Reporting of Transactions Before Becoming an Insider and After Ceasing To Be an Insider; Simultaneous Transactions.

[i] Pre-Insider Transactions. With one exception, a person who becomes an insider will not be required to report transactions that occurred in the six months before the date he became an insider. n245 The one exception arises in the case of a director or officer (but not a 10% shareholder) that becomes subject to Section 16 solely as a result of the issuer registering a class of equity securities under Section 12 of the Exchange Act. n246 In such case, a director or officer must report any transaction that occurred before he became subject to Section 16 if such transaction occurred within six months before a transaction giving rise to a Form 4 filing obligation after he was subject to Section 16. n247

[ii] Post-Insider Transactions; "Exiting" Insider Disclosures. Directors and officers are required to report certain transactions after ceasing to be insiders but 10% shareholders who cease being insiders have no reporting obligations with regard to post-insider transactions. n248

A former director or officer must report a transaction after ceasing to be a director or officer only if the transaction is not exempt from Section 16(b) liability and is executed within six months after an "opposite way" transaction that was not exempt from Section 16(b) liability and that occurred while such person was a director or officer. n249

Under Rule 16a-2(c), a person who was an insider as a 10% shareholder need not report any transaction that occurs after such person ceases to be a 10% shareholder-insider. n250

Forms 4 and 5 contain a box, in the upper left corner of the front page, to be checked by "persons no longer subject to Section 16." n251 This "exit box" has created confusion in the following respects:

(1) No Form 4 or 5 filing is required simply to report that a person is no longer an insider subject to Section 16. The exit box is to be checked only if a Form 4 or 5 is otherwise required to be filed after a person has ceased being an insider. n252

(2) It is a misnomer for a person who has ceased being a director or officer to check a box stating that he

or she is "no longer subject to Section 16," because (as the Instructions to Forms 4 and 5 indicate) such person may well be subject to Section 16(a) filing requirements and possible Section 16(b) liability for up to six months after ceasing to be a director or officer.

(3) While a Form 5 specifies actual dates of transaction, and appears to provide other information as of the end of the year for which the Form is filed, the exit box probably should be checked if the reporting person has ceased being an insider as of the date of the filing.

[iii] Simultaneous Transactions. Although it is clear that a transaction which causes a person to become an insider as a 10% shareholder is not reportable or subject to liability, n253 it is unclear whether a transaction simultaneous with a person becoming a director or officer is reportable and subject to liability. n254 This has particularly become an issue after the 2002 reporting rule changes, because a Form 4 transaction report can become due before the Form 3 reporting that the person has become an insider. In these situations, careful analysis is required to determine whether a transaction is reflected as a *fait accompli* on the Form 3 filing or whether a separate Form 4 is required. In the latter case, it is good practice to file both the Form 3 and Form 4 on or prior to the Form 4 two-business day due date. Transactions that are simultaneous with cessation of insider status would generally be subject to reporting and liability regardless of the type of insider involved, because the insider would clearly have the access to inside information through his insider status at the time the decision to engage in the transaction is made. n255

[d] Problem Areas of Form 3, 4, and 5 Reporting. A number of issues have arisen relating to reporting under Forms 3, 4, and 5, including the following:

(1) Certain transactions that need not be reported until a year-end Form 5 result in changes in the insider's beneficial ownership, but Form 4s filed before the year-end Form 5 must set forth the insider's beneficial ownership at the end of a month, so the Commission found it necessary to reconcile these two requirements. To accomplish this, the Commission amended the instructions to Form 4 to indicate that insiders need not adjust the amounts shown as their post-transaction beneficial ownership of equity securities on any Form 4 in order to reflect exempt transactions that were not yet reportable or voluntarily reported. n256

(2) If, however, a transaction occurs that is reportable on a Form 4 involving securities acquired earlier that year in a not-yet-reported exempt transaction, further deferral of reporting of the exempt acquisition is no longer permitted. n257

(3) On the other hand, if a transaction is exempt from reporting on Form 4 and Form 5, the effect of that transaction should be reflected in the end-of-period holdings reported on the next otherwise required Form 4 or Form 5. n258

(4) If reporting of a transaction is deferred because the transaction is exempt, but a subsequent event causes the exemption to be lost retroactively, the transaction must be reported in a Form 4 filed for the month in which the exemption was retroactively lost. n259

(5) Forms 4 and 5 must show the insider's beneficial ownership as of the completion of the transaction and as of the end of the year, respectively, of equity securities of each class of securities for which a transaction is reported, although holdings need not be reported for other classes. n260 For reporting purposes, derivative securities are not considered to be the same class of security as their underlying equity securities. n261 Moreover, the Commission staff has taken the helpful position that derivative securities are not of the same class for reporting purposes unless they have "identical characteristics." n262

(6) The Commission provided little explanation of how to report derivative securities "positions," such as "call equivalent positions" and "put equivalent positions," on Table II of Forms 3, 4, and 5. n263 The instructions do instruct an insider to indicate, next to the title of the derivative security, whether it represents a "right to buy," "right to sell," "obligation to buy," or "obligation to sell." n264 But, insiders are also instructed to report "acquisitions" and "dispositions" of derivative securities in other columns of Table II, n265 which begs the question of whether an insider who "establishes" a "call equivalent position" by writing a put option has "acquired" or "disposed of" the derivative security. Odd as it may seem, an insider who in effects create the derivative security by "writing" it probably should report that he "disposed of" the derivative security. n266 These issues remain to be clarified by the Commission staff.

(7) The Commission has taken the position that, in the case of certain reorganizations in which a new issuer is the successor to a predecessor issuer that had securities registered under Section 12 of the Exchange Act, insiders need not file new Form 3s or Form 4s to report the transactions in securities of the old issuer or the new issuer. n267

[e] Filing Procedures.

[i] When to File. The deadlines for filing Forms 3, 4, and 5 are discussed in *Section 8.03[4][b]* above. If a filing deadline falls on a Saturday, Sunday, or holiday, the filing deadline will be the next following business day. n268 As of June 30, 2003, all filings must be made through the Commission's Edgar electronic filing system. n269 The Commission developed and continues to refine special features for the Edgar filing system that will facilitate electronic filing of Section 16 forms. On March 24, 2003, the Commission established a test system providing an on-line template system for Edgar filings of Forms 3, 4 and 5. Under the new Edgar filing system for these forms, it is possible to type Section 16 transaction data into an on-line template, add any applicable attachments and file the form. n270 The system became operational in early May 2003 to make actual electronic filings of Section 16 forms, and became mandatory on June 30, 2003. n271 In addition, a number of vendors have developed filing programs that will interface with the Edgar filing system for Section 16 forms. These systems provide assistance in generating the form in advance so that it can be reviewed and then provide assurance that the template used for filing through Edgar is populated with the proper information.

The Commission made a number of adjustments to its Edgar filing rules that apply only to Section 16 filings. These changes reflect the fact that the filing obligation often falls upon an individual. Even though insiders typically work with their companies to coordinate and make Section 16 filings, the personal nature of the information to be disclosed often makes it more difficult to obtain all the necessary information, as opposed to information on corporate developments that companies typically are responsible for reporting in Commission filings.

(1) The deadline for electronic filing of Section 16 Reports was extended from 5:30 p.m. Eastern time on the date on which a Section 16 form is due to 10:00 p.m. Eastern time. n272 Thus, if a Form 4 is filed electronically before 10:00 p.m. EST on its due date, it will be treated as timely filed. (As noted above, this extended filing deadline is not available for other SEC filings, such as Forms 8-K, 10-K (10-KSB) and 10-Q (10-QSB) or for registration statements. Although those reports currently can be submitted electronically between 5:30 and 10:00 p.m. Eastern time, they are not deemed to be filed until the next business day.).

(2) Until June 30, 2004, one year after mandatory Edgar filing was required, companies are not required to report an insider's late Section 16 filings in their Forms 10-K (or Form 10-KSB) or proxy statements, *if* the Section 16 filing is only one day late. n273 A one day late report is still treated as late, and the Commission theoretically could bring an enforcement action against insiders who miss the two-day filing deadline, although as a practical matter the Commission likely would pursue such an action only in

egregious cases.

(3) In light of these allowances, the Commission did not permit persons who encounter technical difficulties in filing Section 16 form to obtain an automatic hardship filing extension by filing a Form TH. Instead, in such circumstances the filer may request that the Commission adjust the filing date under Rule 13 of Regulation S-T if they can demonstrate to the Commission staff that they meet the requirements for an adjusted filing date. n274

Each insider is to obtain his own Edgar filer's number in order to make electronic filings. This has caused some problems because of a quirk in the Edgar system. Specifically, if a person applies for Edgar codes for an insider, and that insider already has Edgar codes (likely because of his insider status with respect to a different company), the first set of filing codes are deactivated when the second set of codes are issued. This may cause late filings if the other company where the individual is an insider seeks to make a Section 16 filing through Edgar on the individual's behalf, because the filing will not be accepted if the filing codes have been deactivated. In order to address this problem, the Commission's Edgar filer support attempts to determine first whether Edgar codes have already been issued with respect to an individual, and if filing codes have already been issued to an individual with a similar name, often the Commission staff will ask applicants whether an individual is the same person as the one for which codes have already been issued. In order to avoid delays from this process, companies that apply for filing codes on behalf of their insiders in order to be able to assist their insiders with Section 16 filings should (1) search the Edgar database under the individual's name to see if previous filings have been made on behalf of the individual, and (2) inquire whether the individual is an insider at any other companies and ask both the insider and the corporate secretary at such other company(ies) whether filing codes have been applied for or obtained on behalf of the individual.

[ii] Supplying Copies of Filed Forms. As of June 30, 2003, companies that maintain corporate websites are required to post copies of any Section 16 filings made by their insiders. n275 Companies may satisfy this requirement by linking to the Commission's Edgar database, or by coordination with the individual so that the company obtains copies of any filings by the individual, whether by filing on the individual's behalf or through coordination with the individual. Section 16(a) also requires that copies of forms filed under that provision be filed with any national security exchange on which the issuer has listed any class of equity securities. Nasdaq was converted from a trading association to a national securities exchange effective August 1, 2006; and as a consequence Section 16(a) reports with respect to Nasdaq listed issuers must be filed with Nasdaq. However the Commission staff has indicated that filers using the EDGAR system need not file separate copies of their reports with Nasdaq. Foreign securities exchanges have not been recognized as national securities exchanges. Both the New York Stock Exchange and the American Stock Exchange have adopted rules that deem any filing made through the Commission's Edgar system to be treated as a filing with the Exchange. n276

[iii] Signatures on Filed Forms. Electronic filings by necessity have conformed, typed signatures. Nevertheless, as with other electronically filed forms, rules require that an insider retain a manually signed original of the form for five years. Because Section 16 filings are an insider's responsibility and can provide evidence of transactions creating short-swing liability, it is not appropriate for a company making electronic filings on behalf of an insider to insert the insider's name on the signature line unless the insider has reviewed and authorized filing of the form. Companies may wish to obtain and retain manually signed copies of forms they file on behalf of insiders, to be able to substantiate the insiders' authorizations.

It is possible for a company to file a Section 16 form on an insider's behalf pursuant to a power of attorney.

In addition to signing by the insider himself, a Form may be signed on behalf of an individual insider by another person. n277 Although the evidence of the authority of another to sign on behalf of such an insider must be furnished to the Commission, it may be furnished after the filing of the Form. In such case, the Form should be amended, as promptly as practicable, by refiling the original Form (with the amendment box completed) with the signing authorization attached.

n278 If the document conferring signing authority was previously filed with the Commission, a Form should simply indicate when and with what document the evidence of signing authority was filed.

There are no fees to be paid upon becoming an insider or filing any Form 3, 4, or 5.

[iv] Amendments. Forms 3, 4, and 5 may be amended to make corrections or reflect information not known to the insider at the time of the original filing. n279 A box on the cover page of the Forms should be completed to indicate that a filing is an amendment, and all other information from the original Form plus any changed or updated information should be set forth on the Form. If information that changes or is added by an amendment would affect Forms filed after the date of the original Form filing, such subsequent Forms apparently need not be amended solely to reflect the changed or added information. n280

[v] Disclaimers. A person filing a Section 16(a) report may include a statement on the Form that the filing, or specific statements on the filing, shall not be deemed an admission that such person is, for purposes of Section 16 or otherwise, an admission that the filing person is a beneficial owner of equity securities reported on the Form. n281

FOOTNOTES:

(n1)Footnote 1. For purposes of this discussion, the term "insider" (which does not appear in Section 16) is used to refer to a director or officer of an issuer that has a class of equity securities registered under Exchange Act Section 12, or a person who is directly or indirectly the beneficial owner of more than ten percent of an outstanding class of Section 12-registered equity securities, who is subject to reporting requirements of Section 16(a) and other provisions of Section 16. In addition, certain trusts are deemed to be separate Section 16 insiders if the trustee thereof is an insider with a pecuniary interest in equity securities held by the trust under Rule 16a-8(a). The question of who is considered to be an insider subject to Section 16 is discussed in *Section 8.02 supra*.

(n2)Footnote 2. *See* Exchange Act § 16(a); Rule 16a-3.

Exchange Act Section 16(a) requires only the filing of an initial statement of beneficial ownership and filings of statements of changes in beneficial ownership within two business days after the date of the transaction. The Commission apparently relied on its authority under Section 23(a) of the Exchange Act to make rules and regulations necessary to "implement the provisions" of the Exchange Act as a basis for promulgating the Form 5 year-end filing requirements and to extend in certain cases the two business day Form 4 deadline. *See* Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,284 (Feb. 8, 1991).

(n3)Footnote 3. *See* Rule 16a-3.

(n4)Footnote 4. *See id.*

(n5)Footnote 5. H.R. Rep. No. 1381, 73d Cong., 2d Sess. 13 (1934). The House Report stated:

Because it is difficult to draw a clear line as a matter of law between truly inside information and information generally known by the better informed investors, the most potent weapon against the abuse of inside information is full and prompt publicity. For that reason, the bill requires the disclosure of the corporate holdings of officers and directors and stockholders owning more than 10 percent of any class of stock, and prompt disclosure of any changes that occur in their corporate holdings.

(n6)Footnote 6. *See id.* at 13, 24.

(n7)Footnote 7. For discussion of Section 16(b), *see* § 8.04 *infra*.

(n8)Footnote 8. For discussion of provisions of the Exchange Act and rules relating to insider trading, including Sections 10(b) and 21A and Rule 10b-5, *see* § 5.04 *supra*. For discussion of provisions of the Exchange Act and rules relating to market manipulation, including Section 9(b) and Rule 10b-5, *see* § 6.02 *supra*.

(n9)Footnote 9. Exch. Act Rel. No. 26,333, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343, at 89,600 (Dec. 2, 1988). The Commission stated in 1988:

In light of the importance of the information provided by Form 4 filings to investors, many major newspapers routinely publish information gleaned from the reports filed by insiders of selected companies, such as those of local interest. Moreover, there are a number of private newsletters and services that analyze or report trades by reporting persons.

Id. (footnotes omitted). Computerized database and internet services providing summaries of information reported under Section 16(a) have emerged in recent years as well.

(n10)Footnote 10. *See* Exch. Act Rel. No. 34-47,809 [2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 86,918 (May 7, 2003).

(n11)Footnote 11. Holding Company Act Section 17(a) requires broader reporting than Exchange Act Section 16(a), in that all securities, rather than just "equity securities," are reportable and securities of any subsidiary of the registered holding company are reportable. *See also* Exch. Act Rule 16a-2.

(n12)Footnote 12. Investment Company Act Section 30(a) requires broader reporting than Exchange Act Section 16(a), in that all securities, rather than just "equity securities," are reportable. *See also* Rule 16a-2.

The terms "advisory board," "affiliated person," and "investment advisor" are defined in Section 2(a) under the Investment Company Act.

Investment Company Act Rule 30h-1 relieves an affiliated person of an investment adviser of a registered closed-end investment company of filing obligations if such person is merely an employee and not an officer of the investment adviser.

(n13)Footnote 13. *See* Holding Company Act Rule 72; Investment Company Act Rule 30h-1; Exch. Act Rule 16a-2.

(n14)Footnote 14. *See, e.g.,* NY CLS INS § 1221.

When insurance companies are subject to state law regulation "substantially in the manner provided" in Exchange Act Section 16 (including both reporting and short-swing profits liability requirements), and meet certain other requirements, such companies are relieved of the obligation to register securities issued by the insurance company with the Commission under Exchange Act Section 12(g). *See* Exch. Act § 12(g)(2)(G).

(n15)Footnote 15. *See* 12 C.F.R. § 11.410 (Comptroller of the Currency); 12 C.F.R. § 208.16 (Board of Governors of the Federal Reserve System); 12 C.F.R. § 335.410 (Federal Deposit Insurance Corporation); 12 C.F.R. § 563d.1 (Office of Thrift Supervision).

(n16)Footnote 16. *See* Rule 16a-2 (introductory text). Under Rule 16a-1(a)(1), a person (not otherwise a director or officer) does not become an insider by acquiring beneficial ownership of more than ten percent of an outstanding class of equity securities if such class is not registered under Exchange Act Section 12. But, if such a person becomes an

insider by acquiring more than ten percent of a Section 12-registered class of equity securities (or by becoming a director or officer), such person's Forms 3, 4, and 5 would have to report beneficial ownership of any other class, including unregistered classes, of equity securities.

(n17)Footnote 17. *See* Sec. Exch. Act Rel. No. 34-10,129 [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,356, at 83,058 (Apr. 27, 1973) (clarifies that the term "equity securities" under the Exchange Act specifically includes calls and puts).

(n18)Footnote 18. *See* Sec. Exch. Act Rel. No. 34-26,333, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343, at 89,609 (Dec. 2, 1988).

(n19)Footnote 19. *See* Rule 16a-6(a) (as in effect prior to May 1, 1991); Sec. Exch. Act Rel. No. 34-26,333, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343 at 89,603 (Dec. 2, 1988); Exch. Act Rel. No. 34-18,114, Fed. Sec. L. Rep. (CCH) P 26,062 at 19,063-3 (Sept. 23, 1981) (Questions 21 & 54).

Under the pre-1991 version of Rule 16a-6(a), reporting was required only when the option or right had become exercisable.

(n20)Footnote 20. The pre-1991 version of Rule 16a-6(a) did not require reporting of any options and rights granted under plans meeting the requirements of Rule 16b-3, and did not require reporting of options and rights that were not yet exercisable. The 1991 rules require such reporting. *See* Rule 16a-1(a)(2)(ii)(F); Rule 16a-3; Rule 16a-4; Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709 at 81,282 (Feb. 8, 1991), (Question 54).

(n21)Footnote 21. *See, e.g.,* Kern County Land Co. v. Occidental Petroleum Corp., 411 U.S. 582 (1973) (writing of an option generally not treated as a sale for purposes of Section 16(b)).

(n22)Footnote 22. *See also* Rule 16b-6(c)(1) (short-swing profits in transactions involving purchase and sale of derivative securities with identical characteristics measured by the actual prices paid or received in the transactions).

Of course, the Commission has also sought to have transactions in derivative securities matched, for purposes of Section 16(b), with transactions in the underlying equity securities that occur within six months. *See* Rule 16b-6(a), 16b-6(c)(2). This kind of matching relies on the theory that transactions in the derivative securities can also constitute purchases and sales of the underlying equity securities.

(n23)Footnote 23. *See generally* Emerson Electric Co., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699F at 78,183 (May 10, 1991) (Staff unable to conclude that phantom units awarded under plans were not derivative securities since value was derived from equity securities).

(n24)Footnote 24. For example, an option that does not have a fixed exercise price is excluded from being deemed a derivative security under Rule 16a-1(c)(6), but might be considered a "right" that would make it an "equity security" under the general definitions.

(n25)Footnote 25. *See, e.g.,* Becton Dickinson and Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,081 at 79,154 (Nov. 6, 1991). Reporting such beneficial ownership as a Table I equity security rather than as a Table II derivative security, for purposes of Forms 3, 4, and 5, may offer an advantage, in that the ultimate delivery of shares would not trigger further reporting if originally reported on Table I, but would be treated as an "exercise" of a derivative security triggering further reporting if originally reported on Table II. Conversely, exemptions under Rule 16b-3 may be available for transactions in derivative securities (such as surrenders in exchange for new derivative securities under Rule 16b-3(f)(1)) more broadly than for transactions in equity securities. Likewise, the exemption under Rule 16b-6(b) would be available for most "exercises" of derivative securities, while an election to receive equity securities that does not represent an exercise of a derivative security may be subject to additional

requirements in order to be exempt (such as Rule 16b-3(f)'s requirement that elections for "discretionary transactions" occur more than six months after the last election for an "opposite way" discretionary transaction).

(n26)Footnote 26. See Dynamics Corporation of America, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,098 at 79,208 (Feb. 11, 1992); Becton Dickinson and Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. P 76,081 at 79,154 (Nov. 6, 1991). Although dividends were not paid on the common stock to be delivered to settle plan awards described in these interpretive letters, amounts equal to dividends (so-called "dividend equivalents") were paid under such awards.

(n27)Footnote 27. See Lincoln National Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,133 at 79,345 (Mar. 20, 1992).

(n28)Footnote 28. Rule 16a-1(d)

(n29)Footnote 29. See, e.g., Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709 at 81,258-63 (Feb. 8, 1991).

(n30)Footnote 30. Definitional "exclusions" under Rule 16a-1(c) are different from "exemptions" under other rules. If an instrument is excluded from being a "derivative security" under Rule 16a-1(c), it is not subject to any reporting or liability under Section 16(a) or (b) (assuming the instrument is not otherwise an "equity security"). Exemptive rules provide more limited relief for specific transactions. For example, Rules 16b-3 and 16b-6(b) provide protection from potential liability for certain employee benefit plan transactions and exercises of derivative securities, but do not eliminate reporting requirements under Section 16(a).

(n31)Footnote 31. It may be equally important to identify the time when such rights became a derivative security, so that transactions will be properly reported on a Form 4 or 5, and any applicable six-month holding period, such as that imposed under Rule 16b-3(d)(3) will be observed. See, e.g., Certilman Balin Adler & Hyman, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,144 at 79,388 (Apr. 20, 1992) (options that do not become exercisable unless performance conditions are met do not become derivative securities until they become exercisable). In *Certilman*, the staff noted that exercisability was not tied to the market price of the equity security, and that exercisability was not tied to the passage of time and continued employment. *Id.* at 79,390. See also GFC Financial Corp., SEC No-Action Letter [1994 Transfer Binder.] Fed. Sec. L. Rep. (CCH) P 76,841 (Apr. 11, 1994) (restrictive stock that has a performance component deemed a derivative security where holders have voting rights and the right to receive dividends prior to vesting).

(n32)Footnote 32. See, e.g., Hechinger Co., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,772 at 78,464 (Sept. 17, 1991) (rights to exchange class A and class B common stock under a stockholders' agreement acknowledged as derivative securities). See also, NACCO Industries Inc., SEC No-Action Letter, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,958 at 78,766 (Jan 17 1995) (voluntary conversion of different classes of common stock acknowledged as derivative securities).

(n33)Footnote 33. See Rule 16b-6(a); Rule 16a-1(b); Rule 16a-1(h); Exch. Act Rel. No. 28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709 at 81,248 (Feb. 8, 1991). In contrast, the definition of "equity securities" under Exchange Act Rule 3a11-1 includes only an "option or privilege of buying [such a] security from or selling [such a] security to another without being bound to do so."

(n34)Footnote 34. Rule 16a-1(b). Examples of "call equivalent positions" include a "long call option" (an option under which the insider has the *right to exercise* to purchase stock at a fixed price) and a "short put option" (an option under which the insider has the *obligation* to purchase stock at a fixed price upon exercise by the option holder). See *id.*

(n35)Footnote 35. Rule 16a-1(h). Examples of "call equivalent positions" include a "long put option" (an option under which the insider has the *right to exercise* to sell stock at a fixed price) and a "short call option" (an option under

which the insider has the *obligation* to sell stock at a fixed price upon exercise by the option holder). *See id.*

The Commission's definitions are imprecise in one sense. If an insider "writes" a put option (a "call equivalent position"), the insider typically will be paid an amount (called the "premium") at the time the option is written. Contrary to Rule 16a-1(b), the insider's derivative security position thereafter will *not* become more "valuable" as the market price of the stock increases; rather, the position will become potentially less costly, because the likelihood that the holder of the put option will exercise it will go down, and the value of the stock the insider will be forced to acquire upon exercise, as compared to the option's fixed "strike price" the insider must pay upon exercise, will go up. Similarly, in the normal course of events, the insider who writes a call option will not receive any additional "value" after the premium is paid, even if the price of the underlying stock falls; rather, the insider's risk and potential cost that would be incurred upon exercise by the option holder will go down.

(n36)Footnote 36. For a discussion of the treatment of derivative securities that may represent "sales" of the underlying stock under Section 16(c), which prohibits transactions in the nature of "short" sales by insiders, see § 8.05 *infra*.

(n37)Footnote 37. Hechinger Co., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,248 at 76,918 (Sept. 10, 1992). In granting relief, the staff acknowledged that the rules might otherwise lead to unintended and undesirable results. The staff noted

particularly [inquiring counsel's] representations that the Rights lack many of the economic components and consequences of market-oriented derivative securities, such that application of the Section 16 rules to the Rights would not be consistent with the purposes of Section 16.

(n38)Footnote 38. See the exemption for over-allotment options, derived from staff interpretations, codified in Rule 16a-1(c)(7)

(n39)Footnote 39. *See* American Stores Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,150 at 79,404 (May 5, 1992).

(n40)Footnote 40. *See, e.g.,* Tiger Int'l, Inc., SEC No-Action Letter (available Sept. 14, 1988); Digital Equipment Corp., SEC No-Action Letter (available Sept. 4, 1987); Consumers Water Co., SEC No-Action Letter (available Sept. 4, 1987); Control Data Corp., SEC No-Action Letter (available June 19, 1987); Hana Biologics, Inc., SEC No-Action Letter (available June 3, 1987); J.C. Penney Co., Inc., SEC No-Action Letter (available Nov. 26, 1984); The One Bancorp, SEC No-Action Letter (available June 22, 1984); SmithKline Beckman Corp., SEC No-Action Letter (available Dec. 27, 1983); Pfizer Inc., SEC No-Action Letter (available June 3, 1983).

Although these interpretive letters addressed only Section 16(a) reporting and not potential Section 16(b) liability, and the Commission staff never explained the basis for its grant of relief from Section 16(a) reporting requirements, the issuers' letters of inquiry indicated that such issuers believed cash-only plan interests did not give rise to beneficial ownership of an equity security and that, therefore, such interests did not give rise to potential Section 16(b) liability. This conclusion was significant because the only other practical method to protect plan participants acquiring such interests from liability risks under Section 16(b) generally would have been to qualify the plan under Rule 16b-3, which would have required submission of the plan to shareholders for approval.

(n41)Footnote 41. *See, e.g.,* PPG Industries, Inc., SEC No-Action Letter (available May 2, 1989) (reconsideration); PPG Industries, Inc., SEC No-Action Letter (available July 28, 1988); American Cyanamid Co., SEC No-Action Letter (available Mar. 8, 1988) New England Savings Bank, SEC No-Action Letter (available Oct. 24, 1988); CRS Serrine, Inc., SEC No-Action Letter (available Nov. 2, 1987); Oglebay Norton Co., SEC No-Action Letter (available Sept. 9, 1983). While an insider's decision not to report such a right to future delivery of actual shares as beneficial ownership of

an equity security was arguably correct based on these letters, this view was far from certain under the old rules.

(n42)Footnote 42. Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709 at 81,248 (Feb. 8, 1991), Pt. VII.B (the "Adopting Release").

(n43)Footnote 43. See Cravath, Swaine & Moore SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699B, at 78,170 (May 6, 1991).

The Commission staff has also declined to extend pre-May 1, 1991 staff interpretations permitting deferred reporting of transactions relating to these kinds of plan interests, unless the transaction is exempt under an explicit exemptive rule. See Simpson Thacher & Bartlett, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,716, at 78,245 (June 27, 1991).

(n44)Footnote 44. See old Rule 16a-1(c)(3)(i); Marion Merrell Dow Inc., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,082, at 79,157 (Jan. 24, 1992); Sullivan & Cromwell, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,687, at 78,107 (Apr. 30, 1991).

(n45)Footnote 45. See old Rule 16a-1(c)(3)(i). See also Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,272 & n.210 (Feb. 8, 1991); Thacher, Proffitt & Wood, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,045, at 78,786 (Dec. 20, 1991). It apparently does not make a difference if the choice of cash or stock is made by the issuer rather than the participant, either. See Cravath, Swaine & Moore, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699B, at 78,170-72 (May 6, 1991).

The Commission staff has concluded, however, that a right to receive cash in addition to actual stock, but not in lieu of such stock, can qualify as a cash-only right. See Frederic W. Cook & Co., Inc., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,047, at 78,995 (Dec. 20, 1991); CSX Corp., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,758, at 78,429 (Aug. 30, 1991).

The staff's interpretation in *Frederic W. Cook & Co., Inc.*, now codified at Rule 16a-1(c)(3) in place of the original two cash-only rights exclusions, was that a tax-offset bonus--a cash payment equal to an optionee's tax liability paid at the time of an exercise of an option for actual shares--is a cash-only award that can be excluded under old Rule 16a-1(c)(3)(i). As in the case of *CSX Corp.*, the staff reached this conclusion even though the Section 16 insider would receive actual shares in the same transaction as the cash payment. The staff stated that the tax-offset bonus payment would be "in addition to (but not in lieu of) the shares purchased through an option exercise."

(n46)Footnote 46. To a limited degree it was also possible to rely on the pre-1991 version of Rule 16 b-3. See The Kansas Power and Light Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,137, at 79,360 (Mar. 25, 1992).

(n47)Footnote 47. A plan would need to expressly limit the number of cash-only awards to satisfy this requirement. The staff has stated that a plan intended to comply with Exclusion (i) "must include a maximum number of units to be issued either annually or over the life of the plan, or provide the method by which the amounts of awards are to be determined." Cravath Swaine & Moore, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,002, at 78,822 (Oct. 22, 1991). See Merrill Lynch & Co., Inc., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,242, at 76,893 (Aug. 28, 1992).

(n48)Footnote 48. Compliance with this condition could be accomplished by either having a plan administered by a committee of two or more directors who are "disinterested persons," or by eliminating discretion from the plan by making awards pursuant to a "formula." In the case of an incentive award plan for executive officers, assigning to a disinterested board committee that administers the issuer's discretionary plans the duty to administer an Exclusion (i)

plan should satisfy this requirement. Incentive awards could also be made in compliance with the "formula"-plan requirements. In addition to formulas specifying the amount, price, and timing of grants, such plans must contain specific language limiting the frequency of plan amendments (other than those to conform with tax or other law changes) to no more than once every six months. *See* Rule 16b-3.

(n49)Footnote 49. *See* Anheuser-Busch Cos., Inc., [1991 Transfer Binder] *See* Rule 166.3. Fed. Sec. L. Rep. (CCH) P 79,748, at 78,387 (July 29, 1991); Emerson Electric Co., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699F, at 78,183-84 (May 10, 1991).

(n50)Footnote 50. Emerson Electric Co., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699F, at 78,183-84 (May 10, 1991). The staff reiterated some of these statements in Anheuser-Busch Cos., Inc., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,748, at 78,387 (July 29, 1991). *See also* American Bar Association Joint Committee on Employee Benefits, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,719, at 78,252 (July 3, 1991) ("[a]ny discretion over timing is inconsistent with the exemption"); Emerson Electric Co., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699F, at 78,183 (May 10, 1991) ("[t]he participant may not have any further discretion once the decision to defer a specified amount has been made, other than to cease deferral or change the level of future deferrals").

Arguably, the staff's "automatic" requirement is a condition required by the staff so that "deferred compensation arrangements not otherwise viewed as awards (because of an election by the participant)" can be viewed as "awards" under Exclusion (ii), and not a requirement applicable to all other kinds of "awards" under Exclusion (ii). If so, this requirement should not apply to more conventional incentive awards, such as a discretionary award of phantom shares.

(n51)Footnote 51. *See* First Union Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,151, at 79,412 (May 5, 1992).

Other issuers seeking interpretive advice under Exclusion (ii) had apparently assumed that such switching transactions must occur at fixed dates under a plan, however. *See* Consolidated Edison Company of New York, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,033, at 78,937 (Nov. 13, 1991) (amending plan to provide automatic switching out of phantom shares on fifth anniversary award, if elected by participant prior to receipt of award); Anheuser-Busch Cos., Inc., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,748, at 78,387 (July 29, 1991) (issuer had adopted plan rule precluding participants from electing switching while they were subject to Section 16(a) reporting).

(n52)Footnote 52. *See* Emerson Electric Co., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699F, at 78,183 (May 10, 1991); Cravath, Swaine & Moore, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699B, at 78,172 (May 6, 1991); American Bar Association, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,689, at 78,116 (May 2, 1991).

(n53)Footnote 53. *See* Emerson Electric Co., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699F, at 78,183 (May 10, 1991).

(n54)Footnote 54. *See* American Bar Association Joint Committee on Employee Benefits, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,719, at 78,252 (July 3, 1991).

In *American Bar Association Joint Committee on Employee Benefits*, the Commission staff also clarified the meaning of a statement in the release adopting Exclusion (ii) stating that "a series of fixed dates of partial redemption" satisfies Exclusion (ii)'s "fixed date" requirement. *See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,264, n.136 (Feb. 8, 1991). Inquiring counsel asked whether Exclusion (ii) would be applicable if the participant could elect to redeem or exercise the security in fixed percentages over a period of years, beginning at least six months after award (*e.g.*, phantom stock awarded on January 1, 1992 could be redeemed 20% on

December 31, 1992, 20% on December 31, 1993, and so on). The staff responded that the exclusion would be available provided that "(1) the recipient cannot choose between redeeming and realizing an alternative benefit; and (2) the unredeemed amounts cannot be redeemed later." American Bar Association Joint Committee on Employee Benefits, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,719, at 78,252 (July 3, 1991).

One common plan feature that uses alternative "redemption" dates has apparently been approved by the Commission staff under Exclusion (ii). Deferred compensation may be distributed under a plan on the *earlier* of a fixed date or termination of employment. Although termination serves to accelerate the distribution, and termination is to some extent under the control of the participant, the staff took the position that a plan containing this feature complied with an unrelated requirement of Exclusion (ii). See Consolidated Edison Company of New York, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,033, at 78,937 (Nov. 13, 1991).

In Anheuser-Busch Cos., Inc., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,748, at 78,387 (July 29, 1991), inquiring counsel asked whether the date for redemption of phantom stock would be deemed a "fixed date" for purposes of Exclusion (ii) if the participant selected that date by irrevocably specifying such date at the time the participant elected to defer his compensation. In agreeing that this was permissible, the staff stated:

The fact that the distribution date or dates are chosen by the participant in a deferred compensation plan does not prevent satisfaction of the fixed date requirement, but any discretion over timing or ability to change the selection is inconsistent with the exemption... In this regard, we specifically note your representation that upon selection, the date of distribution is neither contingent nor subject to discretion or variation except upon death, retirement, disability or termination of service as a director.

Similarly, in Consolidated Edison Company of New York, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,033, at 78,937 (Nov. 13, 1991), the issuer proposed to amend a deferred compensation plan to allow a participant, prior to receipt of an award, to elect to have mandatorily deferred awards automatically switched out of phantom shares on the fifth anniversary of the award. The staff agreed that the switch would be deemed to occur on a "fixed date" under Exclusion (ii).

(n55)Footnote 55. See Citizens Utilities Co., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,232, at 76,866 (Aug. 5, 1992); Sonnenschein Nath & Rosenthal, SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,226, at 76,841 (July 6, 1992). See also Anheuser-Busch Cos., Inc., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,748, at 78,387 (July 29, 1991) (inquiring counsel stated that switching elections would not be permitted by participants during time such persons are subject to Section 16(a) reporting requirements; staff response did not address this feature).

(n56)Footnote 56. Cravath, Swaine & Moore, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699B, at 78,172 (May 6, 1991).

The staff subsequently confirmed that cash-only plans could be amended after May 1, 1991 to provide additional participant rights to elect "switching" the form of investment of cash account balances, including switches into and out of phantom shares, without losing the benefits of the "grandfathering" of the pre-May 1, 1991 cash-only interests. See Consolidated Edison Company of New York, Inc., [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,033 at 78,937 (Nov. 13, 1991).

(n57)Footnote 57. Exch. Act Rel. No. 34-37,260 at part VII.A (Aug. 15, 1996).

(n58)Footnote 58. See, e.g., The Hillhaven Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,146, at 79,393 (Apr. 22, 1992); National Medical Enterprises, Inc., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,672, at 78,075 (Apr. 23, 1991).

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(n59)Footnote 59. *See* § 8.03[2][d] *infra*. The Commission staff has concluded that, for policy reasons, certain rights that otherwise might come within the general definition should not be considered to be "derivative securities." These interpretations are discussed in § 8.03[2][b][ii] *supra*.

(n60)Footnote 60. Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,258-63 (Feb. 8, 1991).

(n61)Footnote 61. *See* Jenny Craig, Inc., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,086, at 79,167 (Jan. 30, 1992).

(n62)Footnote 62. *See, e.g.,* Hechinger Co., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,772, at 78,464 (Sept. 17, 1991); Lilly Industrial Coatings, Inc., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699E, at 78,175 (May 9, 1991); National Medical Enterprises, Inc., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,672, at 78,075 (Apr. 23, 1991).

(n63)Footnote 63. Cravath, Swaine & Moore, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699B, at 78,170-72 (May 6, 1991). Typically, a stock appreciation right is a right, granted under an executive compensation plan, entitling the holder to be paid an amount equal to appreciation in market value of stock from the date of grant to the date of exercise, with payment either in cash or stock.

The Commission staff has taken the position that, for reporting purposes, the exercise of a stock appreciation right for cash must be reported in three "component" parts: the exercise of the derivative security is reported on Table II of Form 4, the acquisition of all shares to which the stock appreciation right relates is reported on Table I of Form 4, and the disposition of such shares for cash is reported in Table I of Form 4 or 5. *See id.* This method of reporting assumes that an exercise of an option for shares (and payment by the insider of the exercise price) is implicit in the exercise of a stock appreciation right for cash. The exemption for exercises of derivative securities under Rule 16b-6(b) applies only to the disposition of the stock appreciation right and the deemed acquisition of shares, and *not* to the deemed sale of shares. *See id.* Rule 16b-3(e) can, however, provide an exemption for the deemed sale of shares. *See id.*

(n64)Footnote 64. *See* Realty South Investors, Inc., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,219, at 76,817 (June 17, 1992); Marion Merrell Dow Inc., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,082, at 79,156 (Jan. 24, 1992) (discussing contingent value rights).

(n65)Footnote 65. O'Connor, Cavanaugh, Anderson, Westover, Killingsworth & Beshears, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,040, at 78,965-67 (Dec. 11, 1991); Davis Polk & Wardwell, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,769, at 78,460 (Aug. 23, 1991).

(n66)Footnote 66. *See* CSX Corp., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,758, at 78,429 (Aug. 30, 1991). In *CSX Corp.*, the Commission staff noted that the non-recourse nature of the note, and the fact that the note was secured by the underlying stock, imposed no obligation on the participant to pay off the note, so that the participant had the right but not the obligation to complete the purchase of the underlying stock. This, the staff concluded, is the "economic equivalent of a traditional stock option." *Id.*

The note and underlying common stock should be viewed as an option with a fixed exercise price under Rule 16a-1(c) and a cash-only right relating to common stock that is acquired upon an award exercise. *Id.*

(n67)Footnote 67. In exercising an SAR, the proceeds of this deemed resale of stock are treated as paying the exercise price. If the SAR is exercised for cash, any remaining proceeds of the deemed resale are paid over to the person exercising. If the SAR is exercised for stock, the deemed resale covers only enough shares to pay the exercise price, with any remaining shares delivered to the person exercising.

(n68)Footnote 68. Rule 16a-1(c)(6). *See* Section 8.03[2][d] below.

(n69)Footnote 69. See Cravath, Swaine & Moore, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699B, at 78,172 (May 6, 1991). Under this approach, the exercise of the derivative security is reported on Table II of Form 4 or 5, the acquisition of all shares to which the SAR relates is reported on Table I of Form 4 or 5, and the disposition of such shares for cash is reported in Table I of Form 4 or 5. Deferred reporting on Form 5 is permitted for any component of the exercise that is exempt (except components exempted solely by Rule 16b-6(b) must be reported on the earlier of the next required Form 4 or the year-end Form 5). See Kirkpatrick & Lockhart, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,099, at 79,208-09 (Feb. 11, 1992); Simpson Thacher & Bartlett, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,686, at 78,105 (Apr. 30, 1991).

See also Realty South Investors, Inc., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,219, at 76,817 (June 17, 1992) (exercise of "reset" right, representing a right to receive a number of shares having a value equal to amount by which stock price depreciated from date of grant of right, reportable as separate components).

(n70)Footnote 70. See Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,272 (Feb. 8, 1991); Cravath, Swaine & Moore, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699B, at 78,172 (May 6, 1991); Simpson Thacher & Bartlett, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,686, at 78,105 (Apr. 30, 1991).

(n71)Footnote 71. See Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,273, 81,283 (Feb. 8, 1991) (stating that SARs settled in stock accorded same treatment as option; revised response to question 114 in Exch. Act Rel. No. 34-18,114, Fed. Sec. L. Rep. (CCH) P 26,062, at 19,063-44 (Sept. 23, 1981) stating exercises of SARs for stock exempt under Rule 16b-6(b)). See also Xerox Corp., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,227, at 76,845 (July 7, 1992) (where cashless tax withholding feature of derivative securities is mandatory rather than elective, such feature is not a separate derivative security; as an inseparable feature of the derivative security, withholding of shares upon exercise is exempt by Rule 16b-6(b)); CSX Corp., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,758, at 78,429 (Aug. 30, 1991) (referring to a right to have underlying shares withheld to repay a non-recourse purchase note treated as a kind of stock option as a "cashless exercise of the Option for stock," and implying that such right is not reportable as an SAR exercised partly for cash).

(n72)Footnote 72. See Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,272 & n.213 (Feb. 8, 1991).

The Commission and its staff have termed SAR-like features that permit plan participants to elect to surrender derivative securities and equity securities for cash or a benefit measured in cash as "tandem cash components." See *id.*; Stook & Stook & Lavan, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,718, at 78,249 (July 3, 1991).

(n73)Footnote 73. See Clorox Company, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,140, at 79,367-69 (Mar. 27, 1992). Previously, Commission staff members had taken the oral position that no separate reporting of cashless withholding rights was required.

In view of the fact that cashless withholding rights are so common, the staff granted some relief from its new position. The staff advised that, instead of reporting cashless withholding rights as separate derivative securities (on separate lines of the Form 3, 4, or 5), insiders could note the existence of such rights in a footnote to the related option. See *id.* With respect to those insiders who had failed to report cashless withholding rights as separate derivative securities or to note their existence as features of reported derivative securities, the staff concluded that no disclosure of a filing delinquency would be required by the issuer in its Form 10-K or proxy statements under Item 405 of Regulation S-K. See Skadden, Arps, Slate, Meagher & Flom, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,169, at 79,482 (June 8, 1992). Since a feature of an option or restricted stock which permits withholding of

shares otherwise issuable upon exercise of the option or vesting of the restricted stock to satisfy the income tax withholding requirements of exercise or vesting may be properly viewed as a feature of the instrument to which it relates, failure to report the feature does not give rise to a disclosure obligation under Item 405 of Regulation S-K. *Id.*

The Commission staff has granted favorable interpretive positions with respect to alternative features that can achieve cashless withholding without creating a separate derivative security. In *Xerox Corp.*, SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,227, at 76,845 (July 7, 1992), the staff concluded that a provision requiring cashless withholding upon exercise of an option is not a tandem cash component that would constitute a separate derivative security.

In contrast to the *Xerox Corp.* interpretive letter, in *Frederic W. Cook & Co., Inc.*, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,047, at 78,995-96 (Dec. 20, 1991), the staff concluded that a tax-offset bonus comes within the general definition of a derivative security. A tax-offset bonus provides for a payment to an optionee, upon exercise of an option, of a cash amount sufficient to pay taxes resulting from the exercise of the option. When tax-offset rights are awarded pursuant to an employee benefit plan satisfying the provisions of Rule 16b-3(a)(1), (a)(2) and (c)(2), the tax-offset rights would be excluded from the definition of a derivative security pursuant to Rule 16a-1(c)(3)(i). *Id.*

The staff has taken the position that, if an issuer has a policy of repurchasing shares (for tax withholding purposes or otherwise) that is informal and not a contractual right of the optionee, such general policy is not a separate derivative security. See *Safeco Corp.*, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,768, at 78,456 (Aug. 23, 1991).

(n74)Footnote 74. See *Clorox Company*, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,140, at 79,367 (Mar. 27, 1992):

This conclusion seems to derive from the fact that former Rule 16b-3(e), which provides an exemption for certain SAR exercises and cashless withholding transactions, states in pertinent part:

the cash settlement of an equity security to satisfy the tax withholding consequences of either the receipt or vesting of the equity security or the exercise of a derivative security related to the equity security... shall be deemed a stock appreciation right.

This language was included in former Rule 16b-3(e), which at the time provided a basis for exempting SAR exercises and which in its pre-1991 version had been interpreted to exempt tax withholding rights, in order to ensure that an exemption would be available for surrenders of restricted stock and other equity securities to pay tax withholding and other obligations. It has resulted, however, in expanding the definition of the term "stock appreciation right."

(n75)Footnote 75. Exchange Act Rel. No. 34-37,260 at Part III.C. (Aug. 15, 1996).

(n76)Footnote 76. *Id.* This action also clarified the theretofore uncertain treatment of stock withholding to pay the exercise price of an option.

The uncertain treatment of stock withholding to pay the exercise price arose prior to the amendment of the Section 16 rules in 1991. Compare *BMA Corp.*, SEC No-Action Letter (available Apr. 6, 1989) and *Rohr Indus., Inc.*, SEC No-Action Letter (available Feb. 2, 1989) (withholding of option stock to pay exercise treated exempted by introductory paragraph of Rule 16b-3 in the same way and to the same extent as an ordinary stock-swap) with *Peoples Energy Corp.*, SEC No-Action Letter (available Dec. 31, 1990), *C.R. Bard, Inc.*, SEC No-Action Letter (available Mar. 3, 1989), *The Pittston Company*, SEC No-Action Letter (available Feb. 8, 1989), and *Santa Anita Realty Enterprises, Inc.*, SEC No-Action Letter (available Oct. 27, 1988) (withholding of option stock to pay exercise price required to comply with

old Rule 16b-3(e) in order for deemed cash sale of shares withheld to be exempt).

One way to avoid this result is to permit a "pyramiding" option exercise, in which portions of an option are exercised in sequence, with the shares acquired upon exercise of each portion immediately surrendered to pay the exercise price of an additional portion of the option. The right to engage in a pyramiding option exercise is apparently not a separate derivative security, and the surrender of shares in such a transaction is exempt under Rule 16b-3(f)(2) (and the introductory paragraph of old Rule 16b-3) without complying with the additional requirements applicable to cash exercises of SARs. *See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,283 (Feb. 8, 1991) which indicates that interpretations in Nixon, Hargrave, Devans & Doyle, SEC No-Action Letter (available Feb. 8, 1982) (also cited as "Gannett Co., Inc.") and Debevoise & Plimpton, SEC No-Action Letter (available Feb. 8, 1982) (also cited as "David V. Smalley") that pyramiding is exempt under introductory paragraph of old Rule 16b-3 are unchanged under new Rule 16b-3; Sec. Exch. Act Rel. No. 34-19,756, Fed. Sec. L. Rep. (CCH) P 26,086, at 19,091-4 (May 11, 1983) in which the Commission stated that surrenders of shares in pyramiding transactions are exempt under introductory paragraph of old Rule 16b-3.

(n77)Footnote 77. *See* Ware & Friedenrich, P.C., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,069, at 79,072 (Jan. 10, 1992).

(n78)Footnote 78. *See also* Safeco Corp., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,768, at 78,454-56 (Aug. 23, 1991) (issuer policy of repurchasing option shares, where issuer not contractually bound to do so, not a separate derivative security).

(n79)Footnote 79. *See* Health Management Associates, Inc., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,120, at 79,290 (Mar. 6, 1992); Merrill Lynch & Co., Inc., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,243, at 76,899-900 (Sept. 1, 1992); Simpson Thacher & Bartlett, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,712, at 78,241 (June 19, 1991).

(n80)Footnote 80. *See* Certilman Balin Adler & Hyman, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,144, at 79,388 (Apr. 20, 1992).

(n81)Footnote 81. *See, e.g.,* Ecolab Inc., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,066, at 79,067-69 (Jan. 9, 1992); Ford Motor Co., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,724, at 78,261 (July 18, 1991).

(n82)Footnote 82. *See* Merrill Lynch & Co., Inc., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,242, at 76,893 (Aug. 28, 1992); Cigna Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,132, at 79,338 (Mar. 20, 1992); Boston Edison Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,128, at 79,327 (Mar. 19, 1992).

(n83)Footnote 83. *See, e.g.,* Certilman Balin Adler & Hyman, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,144, at 79,388 (Apr. 20, 1992); Jenny Craig, Inc., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,086, at 79,167 (Jan. 30, 1992). While not clear, this suggests that performance units that are settled in cash upon vesting are never reportable under Section 16.

(n84)Footnote 84. *See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,283 (Feb. 8, 1991) (revised response to question 129 in Sec. Exch. Act Rel. No. 34-18,114, Fed. Sec. L. Rep. P 26,062, at 19,063-43 (Sept. 23, 1981)); William M. Mercer, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,121, at 79,293 (Mar. 6, 1992). In William M. Mercer, the staff took the position that limited SARs are separate derivative securities even if they are only exercisable in lieu of exercise of a stock option. The limited SARs in question could only be exercised following the occurrence of a change in control of the issuer. *But cf.* The Kansas Power and Light Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P

76,137, at 79,356 (Mar. 25, 1992) (units having a value equal to shares of common stock would be settled upon a change-in-control, apparently without consideration of performance valuation measures that affect units' value in other circumstances, not deemed to be derivative securities).

(n85)Footnote 85. *See* General Mills, Inc., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699D at 78,173 (available May 7, 1991).

(n86)Footnote 86. *See* General Mills, Inc., SEC No-Action Letter (reconsideration), [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,087, at 79,171 (Jan. 31, 1992).

(n87)Footnote 87. *See, e.g.,* The Kansas Power and Light Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,137, at 79,356 (Mar. 25, 1992); Boston Edison Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,128, at 79,327 (Mar. 19, 1992). *See also* Ford Motor Co., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,724, at 78,261 (July 18, 1991).

The Commission staff's position that performance valuation measures and performance conditions will prevent a right from being a derivative security until valuation or satisfaction of the conditions could have potentially adverse consequences. The greatest risk is that awards under executive incentive plans subject to such performance valuation or conditions will be viewed as being "granted" at the end of a performance period rather than at the beginning, which "grant" might be viewed as a purchase for Section 16(b) purposes. To avoid this Section 16(b) risk, the award could be conformed to an exemption under Rule 16b-3. If the date of "grant" is the date of valuation or the date conditions are satisfied, this six-month holding requirement will extend past the point at which rights under such plans have typically been settled. In addition, a requirement to report on Form 4 or Form 5 the "grant" of a derivative security that occurs at the time of valuation or satisfaction of conditions could be easily overlooked.

(n88)Footnote 88. *See, e.g.,* Thacher, Proffitt & Wood, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,045, at 78,986 (Dec. 20, 1991); Anheuser-Busch Cos., Inc., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,748, at 78,384 (July 29, 1991); Emerson Electric Co., SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,699F, at 78,183 (May 10, 1991).

Similarly, if a right has conditions unrelated to stock price that might increase its value, but has a minimum value tied to stock price that is not subject to any performance condition, such right will be deemed a derivative security to the extent of the minimum value. *See* AMP Inc., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,201, at 76,711 (June 12, 1992).

(n89)Footnote 89. Rule 16a-1(c)(1).

(n90)Footnote 90. Rule 16a-1(c)(2).

(n91)Footnote 91. Rule 16a-1(c)(3). This provision was adopted in 1996 to reverse the staff's interpretation in Clorox Company, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,140 at 76,367 (March 27, 1992). *See* Exchange Act Rel. No. 34-37,260 (May 31, 1996); and 8.03 [2][c][i] *supra*.

(n92)Footnote 92. Rule 16a-1(c)(4). This exclusion is intended to parallel the exclusion from the definition of "beneficial owner" of interests in broad-based, publicly traded market baskets and indexes of stocks under Rule 16a-1(a)(5)(iii). *See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,264, n.138 (Feb. 8, 1991). For further discussion, *see* § 8.03[3][g] *infra*.

The Commission pointed out that, if issuer stock is a component of a basket traded independent of the basket, such transaction is subject to Section 16. *See id.*

(n93)Footnote 93. Rule 16a-1(c)(5). Excluded under this Rule are only general rights to participate in an issuer

plan, but not "rights, options, or other derivative securities awarded under a plan." *See* Exch. Act Rel. No. 28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,264, n.139 (Feb. 8, 1991). This Rule is primarily a variation on the principle that rights that are not exercisable at a fixed price or valued by reference to a fixed number of shares of issuer stock will not be viewed as derivative securities. The exclusion extends to interests or rights to participate in employee benefit plans of direct and indirect majority-owned subsidiaries of the issuer.

(n94)Footnote 94. Rule 16a-1(c)(6).

(n95)Footnote 95. Rule 16a-1(c)(7). This rule, adopted in 1996, codifies the staff's prior interpretation in Video Technology (Overseas) Ltd., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P§76,220 at 76,823 (June 17, 1992). Absent this position, the grant of an overallotment option by an insider typically would have been a non-exempt sale, and the expiration of such option unexercised less than six months later (which likely would occur only if the issuer's stock price had declined) would have resulted, under rule 16b-6(d), in recoverable profits under Section 16(b).

(n96)Footnote 96. The terms equity securities and derivative securities are discussed in § 8.02[2] *supra*. Note that an insider must report beneficial ownership and changes in such ownership with respect to all equity securities of the issuer, not just equity securities registered under Section 12 of the Exchange Act. Exch. Act § 16(a); Rule 16a-2 (introductory paragraph).

(n97)Footnote 97. Rule 16a-3(a),(f).

(n98)Footnote 98. Rule 16a-3(a),(f),(g). The requirements for filing Forms 4 and 5 are discussed in § 8.02[4] *supra*.

(n99)Footnote 99. *See* Rules 16a-3(f) and 16a-3(g).

(n100)Footnote 100. *See* Rule 16a-3(g).

(n101)Footnote 101. *See* Rule 16a-3(g)(2).

(n102)Footnote 102. *See* Rule 16a-3(g)(3).

(n103)Footnote 103. *See, e.g.*, Rule 16a-2 ("Persons and Transactions Subject to Section 16"); Rule 16a-3 ("Reporting Transactions and Holdings"); Rule 16a-8(b) ("Trust Holdings and Transactions").

(n104)Footnote 104. Sections 16(b) and (c) go on to refer to such insiders as "such beneficial owner."

(n105)Footnote 105. *See* Rule 16a-1(a). The definition of the term "beneficial ownership" for purposes of determining who is a 10% shareholder subject to Section 16 is discussed in § 8.02[2][a] *supra*.

(n106)Footnote 106. Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,252-53 (Feb. 8, 1991).

(n107)Footnote 107. Sec. Exch. Act Rel. No. 34-26,333 [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343, at 89,602 (Dec. 2, 1988); Exch. Act Rel. No. 34-18,114, Fed. Sec. L. Rep. P 26,062, at 19,063-7 and n.17 (Sept. 23, 1981). In Release 18,114, the Commission did point out the "generally accepted indicia of beneficial ownership," for purposes of Section 16(a), which include rights to vote or transfer the securities and receive income or the proceeds of a disposition of securities. *See id.*

(n108)Footnote 108. *See* Sec. Exch. Act Rel. No. 34-26,333 [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343, at 89,603 & n.57 (Dec. 2, 1988) where the Commission stated:

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Rule 16a-1(a)(2), therefore, would define beneficial ownership for purposes of Section 16(a) reports and Section 16(b) profit recovery in terms of pecuniary interest, thereby codifying case law. Inclusion of a specific definition of beneficial ownership for reporting and profit recovery purposes, particularly those provisions of the definition that address specific situations such as family and trust ownership, will provide for greater certainty. It will, however, substantially reduce the flexibility of the courts to take into account the facts and circumstances of a specific case that might militate against a finding of beneficial ownership. For example, one court found beneficial ownership for reporting purposes and not recovery purposes. Under the proposed definition that would no longer be possible. (Footnotes omitted.)

The Commission admitted, in a footnote referring to the case law assertedly being codified, that the definition of "beneficial owner" goes "beyond most of the judicial decisions and state[s] that an indirect pecuniary interest is sufficient to convey beneficial ownership." *Id.*

(n109)Footnote 109. In *Whiting v. Dow Chemical Co.*, 523 F.2d 680, 689 (2d Cir. 1975), the court concluded that, if an insider is "the beneficial owner" of his wife's securities "for Section 16(b) purposes," such insider is chargeable with all profits realized from a sale of such shares.

In *Whittaker v. Whittaker Corp.*, 639 F.2d 516, 526 (9th Cir.), cert. denied, 454 U.S. 1031 (1981), the court stated that the court in *Whiting v. Dow Chemical Co.* "recognized" that [a] definition of 'beneficial ownership' may be broad enough to require reporting for purposes of public exposure but too broad for the imposition of liability under § 16(b). 523 F.2d at 685 n.8. But, the *Whiting* court still ended with a general proposition that, if one is the 'beneficial owner,' one is chargeable with the profits. 523 F.2d at 689. The *Whiting* court apparently created an unexpressed new term, "beneficial ownership for § 16(b) purposes." The court then took the defining characteristics of beneficial ownership in Release 34-7793 [Exch. Act Rel. No. 34-7,793, Fed. Sec. L. Rep. (CCH) P 26,031 at 19,056 (Jan. 19, 1966)] and applied them to the facts of the particular case, as Release 7824 advised [Exch. Act Rel. No. 34-7,824, Fed. Sec. L. Rep. (CCH) P 26,030, at 19,056 (Feb. 14, 1966)]. This application was done not simply to find if beneficial ownership for § 16(a) reporting was met, but to determine if the actual rewards of ownership were sufficiently present to warrant attributing the stock to the insider-spouse for § 16(b) liability. See 523 F.2d at 688-89 ... It was this "beneficial ownership for § 16(b)" which was dispositive in determining what profits were "realized by him."

In one of the releases cited by the *Whittaker* and *Whiting* courts, the Commission had taken the position that the concept of "beneficial ownership" for purposes of Section 16(a) was broader than the similar concept embodied in the language of Section 16(b). See Sec. Exch. Act Rel. No. 34-7,824, Fed. Sec. L. Rep. (CCH) P 26,030, at 19,056 (Feb. 14, 1966). As indicated by the quotation above, both courts apparently approved of this distinction.

By attempting to define the term "beneficial owner" for purposes of both reporting and liability under Sections 16(a) and (b), the Commission has sought to, in effect, exclude the traditional inquiry by the courts into whether given facts and circumstances should give rise to short-swing profits liability. It is questionable whether a court will accept that the Commission has done an adequate job in this regard. Because the Commission has sought to accomplish this end by defining an "unexpressed" term, with no comprehensive definition of the terms such as "profit realized by [the insider]" that actually appear in Section 16(b), the way appears open for a court to continue to apply the terms of Section 16(b) without being constrained by the definition of "beneficial owner" in Rule 16a-1(a)(2). See also *Colan v. Monumental Corp.*, 713 F.2d 330, 334 (7th Cir. 1983) (even though old Rule 16a-2(b) deemed holder of option the "beneficial owner" of underlying shares for purposes of determining whether he was a 10% shareholder, such rule applied only for purposes of Section 16(a) reporting; court concluded that shares underlying the option in question did not count for purposes of determining whether person is a 10% shareholder subject to short-swing profits liability provisions of Section 16(b)).

(n110)Footnote 110. See Rule 16a-8(d).

(n111)Footnote 111. *See, e.g.*, Rule 16a-1(a)(2)(ii).

(n112)Footnote 112. The principal circumstances in which indirect beneficial ownership have been viewed as arising are discussed in § 8.03[3][c] *infra*.

(n113)Footnote 113. Rule 16a-1(a)(3).

(n114)Footnote 114. Rule 16a-1(a)(2).

(n115)Footnote 115. *See* Sec. Exch. Act Rel. No. 34-26,333 [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343, at 89,603 (Dec. 2, 1988). *See also* *CBI Indus., Inc. v. Horton*, 682 F.2d 643, 646 (7th Cir. 1982) (profit realized by insider under Section 16(b) requires "direct pecuniary" interest).

Although the notion of "pecuniary interest" or economic benefit is central to court decisions relating to whether an insider realized profits from purchases and sales, the circumstances under which an indirect pecuniary interest will be deemed to exist under Rule 16a-1(a)(2) go well beyond the holdings of prior cases. *See* Sec. Exch. Act Rel. No. 34-26,333, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343, at 89,604 and n.68 (Dec. 2, 1988).

(n116)Footnote 116. Rule 16a-1(a)(2)(ii).

(n117)Footnote 117. *See* Rule 16a-1(a)(1).

(n118)Footnote 118. *See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,252-53, 81,254 (Feb. 8, 1991). Thus, for example, a trustee of a trust holding more than ten percent of the outstanding equity securities of an issuer would be a Section 16 insider, assuming he had voting and dispositive power over trust shares (as a trustee typically would) and assuming that the trustee could not qualify for an exclusion under Rule 16a-1(a)(1). *See* § 8.02[2][a] *supra*. Any Form 3, 4, or 5 filed by such trustee would only report beneficial ownership of shares as to which the trustee has a pecuniary interest, which number may be far fewer than ten percent of the outstanding class. If neither the trustee nor members of his immediate family are beneficiaries of the trust, and the trustee did not separately beneficially own any of the issuer's equity securities, the trustee's Form 3 would indicate in Box 5 ("Relationship of Reporting Person to Issuer") that the trustee is a "10% owner," but would report no beneficial ownership of equity securities on Table I or derivative securities on Table II of the Form.

(n119)Footnote 119. *See* Exch. Act Rel. No. 34-18,114, Fed. Sec. L. Rep. P 26,062, at 19,063-7 (Sept. 23, 1981) (question 4), implicitly reaffirmed in Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709 at 81,281 (Feb. 8, 1991).

(n120)Footnote 120. *See* Cigna Corp., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,747 at 78,381 (Aug. 6, 1991); Hewitt Associates, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,688, at 78,113 (May 1, 1991).

(n121)Footnote 121. Thacher, Proffitt & Wood, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,045, at 78,986 (Dec. 20, 1991).

A rabbi trust is a trust that holds assets for the purpose of funding an issuer's obligation to make future payments of deferred compensation. Typically used for deferred compensation arrangements with executives, a rabbi trust's terms permit creditors of the issuer to attach the trust assets to satisfy a judgment against the issuer. As a result, the executive's rights are deemed to be no greater than those of any other unsecured creditor of the issuer, so the deposit of assets in the rabbi trust does not cause the executive to be deemed to have "constructively received" the deferred compensation, for federal income tax purposes, prior to actual payment of the compensation.

(n122)Footnote 122. American Bar Association, SEC No-Action Letter [1993 Transfer Binder] Fed. Sec. L. Rep.

(CCH) P 76,694 at 77,998 (June 28, 1993). The staff indicated that this relief would not necessarily be available to an insider-trustee who managed such a mixed-equity fund.

The American Bar Association interpretive letter provides relief from a more stringent position taken in *Oglebay Norton Co.*, SEC No- Action Letter [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,777, at 78,485-86 (Sept. 23, 1991). In *Oglebay Norton Co.*, the staff concluded that an insider making a plan contribution to a mixed-equity fund that, by its terms, could invest not more than 50% of its assets in issuer stock, would acquire a pecuniary interest in issuer stock held in such fund. Instead of focusing on the potential percentage of issuer stock in the mixed equity fund, as in *Oglebay Norton Co.*, the *American Bar Association* interpretive letter focused on the actual percentage as of the end of the plan's last fiscal year. The relief granted by the staff in *American Bar Association* is available whether or not there is any explicit limit on the percentage of issuer stock that can be held in the mixed-equity fund. American Bar Association, SEC No-Action Letter, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,694 at 77,998 (available June 28, 1993).

(n123)Footnote 123. See, e.g., Certilman Balin Adler & Hyman, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,144, at 79,388 (Apr. 20, 1992); The Kansas Power and Light Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,137, at 79,356 (Mar. 25, 1992); Boston Edison Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,128, at 79,330 (Mar. 19, 1992). This issue is discussed in § 8.03[2] *supra*.

(n124)Footnote 124. See Ford Motor Co., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,724, at 78,261 (July 18, 1991).

(n125)Footnote 125. See Lincoln National Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,133, at 79,346 (Mar. 20, 1992); Dynamics Corporation of America, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,098, at 79,207 (Feb. 11, 1992); Becton, Dickinson and Co., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,081, at 79,154 (Nov. 6, 1991).

(n126)Footnote 126. As discussed in § 8.03[2] above, the Commission staff has concluded that conditions that could preclude exercisability of a right or prevent a right from having value will cause a right not to be deemed a derivative security, unless such conditions relate solely to passage of time, continued employment, or achievement of specified market prices. See, e.g., Certilman Balin Adler & Hyman, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,144, at 79,388 (Apr. 20, 1992).

(n127)Footnote 127. In the case of insiders who are trust beneficiaries, the Commission staff has taken a position that, in effect, treats the list under Rule 16a-1(a)(2)(ii) as exclusive. Rule 16a-1(a)(2)(ii)(E) refers to Rule 16a-8 as setting forth circumstances in which an insider's interest in a trust will be give rise to an indirect pecuniary interest in issuer stock. Rule 16a-8(b)(3) specifies that a trust beneficiary cannot have an indirect pecuniary interest unless he has investment control. Although the non-exclusive nature of Rule 16a-1(a)(2)(ii) would seem to allow for the possibility that a trust beneficiary might have a pecuniary interest without investment control, under an analysis separate from that under Rule 16a-8(b)(3), the staff has taken the clear position that a beneficiary will not be viewed as having an indirect pecuniary interest if such beneficiary does not have or share investment control. See Fulbright & Jaworski, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,126, at 79,319 (Mar. 13, 1992); Sullivan & Cromwell, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,687, at 78,107 (Apr. 30, 1991); Hewitt Associates, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,688, at 78,112-13 (May 1, 1991).

(n128)Footnote 128. Members of an insider's "immediate family" include "any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, and shall include adoptive relationships." Rule 16a-1(e).

(n129)Footnote 129. Rule 16a-1(a)(2)(ii)(A). *See also* Rule 16a-1(a)(4).

(n130)Footnote 130. Sec. Exch. Act Rel. No. 34-26,333 [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343, at 89,603-04 (Dec. 2, 1988).

(n131)Footnote 131. *See* Sec. Exch. Act Rel. No. 34-27,148 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,439, at 80,386 (Aug. 18, 1989).

As discussed in § 8.03[a] *supra*, the Commission and the courts had considered a number of issues related to beneficial ownership of shares held by family members prior to adoption of Rule 16a-1(a)(2)(ii)(A). The Commission's attempt to adopt a rigid and non-rebuttable presumption was part of a broader effort, under the new rules, to extend Section 16(b) liability beyond existing limits established in the case law.

(n132)Footnote 132. *See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,286 (Feb. 8, 1991).

(n133)Footnote 133. *See* Sec. Exch. Act Rel. No. 34-29,131, Fed. Sec. L. Rep. (CCH) P 26,086A, at 19,091-11 (Apr. 26, 1991).

(n134)Footnote 134. Obviously, if an insider does not report such family members' securities on his Forms, his risk of litigation under Section 16(b) will be reduced.

(n135)Footnote 135. *But cf.* Exch. Act Rel. No. 27,148 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,439, at 80,388 (Aug. 18, 1989) ("Given the change from mandated to presumed attribution, the revised proposed rules would allow an insider to disclaim beneficial ownership of immediate family holdings").

(n136)Footnote 136. The Commission questioned whether an insider should not be viewed as having a pecuniary interest in equity securities held by anyone sharing the insider's household (other than employees and tenants), regardless of family relationships. *See* Sec. Exch. Act Rel. No. 34-26,333 [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343, at 89,603-04 (Dec. 2, 1988). The Commission backed away from this position, in response to negative comment, but stated that an insider might, in given facts and circumstances, have such an indirect pecuniary interest (under the general definition of the term) even in the absence of a family relationship. *See* Sec. Exch. Act Rel. No. 34-27,148 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,439, at 80,386 (Aug. 18, 1989).

(n137)Footnote 137. Rule 16a-1(a)(2)(ii)(B). "The term 'indirect pecuniary interest' in any class of equity securities shall include, but not be limited to ... (B) a general partner's proportionate interest in the portfolio securities held by a general or limited partnership..." *Id.*

Treating partners as having such a pecuniary interest in portfolio securities of the partnership is generally consistent with prior case law and Commission positions. *See, e.g., Blau v. Lehman*, 368 U.S. 403 (1962) ; *Rattner v. Lehman*, 193 F.2d 564, (2d Cir. 1952) ; Sec. Exch. Act Rel. No. 34-18,114, Fed. Sec. L. Rep. P 26,062, at 19,063-7 (Sept. 23, 1981) (question 7). The Commission extended its prior positions in one sense, however, concluding that the general partner of a limited partnership should be deemed to have an indirect pecuniary interest the same as a general partner of a general partnership. *See* Sec. Exch. Act Rel. No. 34-27,148, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,439, at 80,387 (Aug. 18, 1989). *See also* Rule 16a-1(a)(2).

(n138)Footnote 138. *See* Form 3, Instr. 5(b)(iv); Form 4, Instr. 4(b)(iv); Form 5, Instr. 4(b)(iv). *See also* Shea & Gould, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,670, at 78,074 (Apr. 23, 1991) (aggregate reporting permitted by insider of portfolio shares held by a corporation when insider does not have pecuniary interest in all such shares). *See also* Rule 16a-1(a)(2).

As permitted by Rule 16a-1(a)(4), the insider-partner probably should include a footnote stating that he disclaims

beneficial ownership in any shares held by the partnership in which he does not have a pecuniary interest.

(n139)Footnote 139. The Commission staff has not addressed whether changes within the control of the insider would be deemed reportable transactions, or exactly when or how a partner reports changes in its pecuniary interests. For example, if an insider-partner acquires additional partnership interests at a time that the partnership is holding issuer stock so that his proportionate interest increases, one could see the analysis being different than what may apply if an insider-partner's proportionate interest decreases because the partnership issues additional interests to third-parties, or if other partners' withdrawals result in the partnership selling or distributing portfolio securities.

(n140)Footnote 140. Rule 16a-1(a)(2)(iii) provides:

A shareholder shall not be deemed to have a pecuniary interest in the portfolio securities held by a corporation or similar entity in which the person owns securities if the shareholder is not a controlling shareholder of the entity and does not have or share investment control over the entity's portfolio.

The Commission staff has confirmed that, despite the references in Rule 16a-1(a)(2)(iii) to "a shareholder," the safe-harbor under this Rule is available to a limited partner of a limited partnership. Widett, Slater & Goldman, P.C., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,135, at 79,348-49 (Mar. 25, 1992). This conclusion follows from the Rule's reference to "a corporation or similar entity."

(n141)Footnote 141. *See generally* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254, n.49 (Feb. 8, 1991) (term "controlling shareholder" refers to power to exercise control by virtue of securities holdings).

(n142)Footnote 142. *See, e.g.,* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254 (Feb. 8, 1991); Exch. Act Rel. No. 27,148 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,439, at 80,388 (Aug. 18, 1989).

(n143)Footnote 143. *See* Rule 16a-1(a)(2)(iii); Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254 (Feb. 8, 1991).

(n144)Footnote 144. *See* L.B. Smith and A.O. Smith, SEC No-Action Letter [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,676, at 78,083 (Apr. 19, 1991).

(n145)Footnote 145. *See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254, n.49 (Feb. 8, 1991).

(n146)Footnote 146. Under the safe-harbor Rule, it makes no difference whether the corporation in question is a publicly held corporation. *See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254 (Feb. 8, 1991). Prior staff interpretations had attached significance to this fact. *See* Sec. Exch. Act Rel. No. 34-18,114, Fed. Sec. L. Rep. P 26,062, at 19,063-8 (Sept. 23, 1981) (questions 8, 9).

The Commission's approach in Rule 16a-1(a)(2)(iii) is a more refined (and possibly more inclusive) version of the analysis by the courts, which have examined whether a corporation serves as a "personal holding company" or "alter ego" of the insider. *See* *Blau v. Mission Corp.*, 212 F.2d 77, 81 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); *Popkin v. Dingman*, 366 F. Supp. 534, 538 (S.D.N.Y. 1973) ; *Blau v. Lamb*, 242 F. Supp. 151, 158 (S.D.N.Y. 1965) , *aff'd in part, rev'd in part*, 363 F.2d 507 (2d Cir. 1966) , *cert. denied*, 385 U.S. 1002 (1967) .

(n147)Footnote 147. *See* Form 3, Instr. 5(b)(iv); Form 4, Instr. 4(b)(iv), Form 5, Instr. 4(b)(iv); Shea & Gould, SEC No-Action Letter [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,670, at 78,074 (Apr. 23, 1991).

As noted above, the insider probably should include in his Forms a footnote stating that he disclaims beneficial ownership in any shares held by the corporation in which he does not have a pecuniary interest, as permitted by Rule 16a-1(a)(4).

If an insider has elected aggregate reporting, an issue can arise as to whether the insider needs to report changes in the number of shares of issuer stock in which he has a pecuniary interest due to changes in the distribution of ownership of the corporation holding the issuer stock rather than changes in the number of shares of issuer stock actually held by such corporation. *See § 8.03[3][d] supra*.

(n148)Footnote 148. 220 F.3d 29 (2d. Cir. 2000) .

(n149)Footnote 148.1. *Id.* at 36.

(n150)Footnote 149. In addition to specifying what trust shares are beneficially owned by an insider who is a trustee, beneficiary, settlor, or remainderperson of a trust, Rule 16a-8 is intended to specify when such persons will be subject to Section 16.

Even the Commission had difficulty keeping the various threads straight, so that, as initially adopted, the Rule failed to specify when an insider trustee, beneficiary, or settlor must report beneficial ownership of trust shares if the trust itself was not at the same time an insider. *See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,291 (Feb. 8, 1991). The Commission amended the Rule shortly before it became effective to indicate that insiders could be required to report trust shares whether or not the trust was itself separately subject to reporting requirements. *See* Sec. Exch. Act Rel. No. 34-29,131, Fed. Sec. L. Rep. (CCH) P 26,086A, at 19,091-11 (Apr. 26, 1991).

(n151)Footnote 150. *See* Sullivan & Cromwell, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,687, at 78,107 (Apr. 30, 1991). In *Sullivan & Cromwell*, inquiring counsel questioned a statement by the Commission that an insider who, as a trust beneficiary, could receive income from trust shares in the discretion of an independent trustee would be deemed to have a pecuniary interest in such shares. Such counsel pointed out, correctly, that because such insider appeared to lack investment control, he would not under Rule 16a-8(b) have any obligation to report such shares and, therefore, should not be viewed as a beneficial owner of the shares. The staff responded that such an insider could be the "beneficial owner" of trust shares in many circumstances other than those in which the beneficiary has investment control. The staff went on to say that a beneficiary will only have reporting obligations over such trust shares in cases where the beneficiary has investment control.

Rather than clarify a confused statement, the staff by this response only compounded the confusion. The rules and forms require a person to report "holdings" of shares of which the person is a "beneficial owner." *See, e.g.*, Rule 16a-3(a); Form 3, Instr. 5(b). The Commission staff clearly stated in *Sullivan & Cromwell* that investment control has nothing to do with determining beneficial ownership of trust shares, then goes on to immediately state that nothing need be reported by a trust beneficiary if he does not have investment control. The SEC reply stated that for purposes of reporting and short-swing profit recovery, an insider beneficiary must have or share investment control and have a pecuniary interest in issuer's securities held by the trust. As helpful as this second interpretation is, it must be pointed out that nothing in the rules or forms appears to give Rule 16a-8 primacy over the general obligation to report beneficial ownership. The staff apparently views Rule 16a-8 as implicitly exempting from reporting any form of beneficial ownership of trust shares that the Rule does not affirmatively require to be reported. It would have been even more helpful if the Rule had included words that would have made this important point.

(n152)Footnote 151. *See* Fulbright & Jaworski, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,126, at 79,319 (Mar. 13, 1992); Sullivan & Cromwell, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,687, at 78,107 (Apr. 30, 1991); Hewitt Associates, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,688, at 78,113 (May 1, 1991). This position is discussed in

§ 8.03[3][b] *supra*.

As discussed below, although the Commission staff position tends to reduce reporting burdens, the staff has undercut the position by presuming a trust beneficiary under employee benefit plans to have investment control in certain situations in which they would appear not to have such control.

(n153)Footnote 152. Rule 16a-8(d). A trust, trustee beneficiary or settlor subject to Section 16(a) of the Exchange Act also shall be subject to Sections 16(b) and 16(c) of the Exchange Act. Clearly the Commission intended that such a person be subject to Sections 16(b) and 16(c) with respect to trust transactions required to be reported under Rule 16a-8, but, typical of the standards of draftsmanship throughout Rule 16a-8, Rule 16a-8(d) does not actually say this.

(n154)Footnote 153. Old Rule 16a-8, in conjunction with old Rule 16a-10, likewise relieved such participants of potential liability under Section 16(b).

(n155)Footnote 154. The Commission never has justified the complexity and resulting cost of complying with rules under Section 16 applicable to employee benefit plan trusts by pointing to any instance of speculative abuse involving such trusts under the old rules.

(n156)Footnote 155. As discussed below, the Commission staff has taken somewhat harsh positions in this regard, particularly with respect to transactions in which issuer stock is initially acquired by a trust or initially allocated to an insider beneficiary of a trust. *See, e.g.*, American Bar Association Joint Committee on Employee Benefits, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,719, at 78,252 (July 3, 1991); Thompson, Hine and Flory, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. P 79,658, at 78,021 (Mar. 29, 1991).

(n157)Footnote 156. Bryan, Cave, McPheeters & McRoberts, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,713, at 78,241 (June 20, 1991). The references to trustees throughout Rule 16a-8, including Rule 16a-8(a)(ii), include persons who directly or indirectly perform the functions of a trustee.

(n158)Footnote 157. *See id.* The Commission staff originally had established that an insider would be "presumed" to have investment control over shares in a trust of which the insider's spouse is trustee, but the staff abandoned this presumption. *See id.*; Ralston Purina Co., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,714, at 78,244 (June 20, 1991) (reconsideration).

Upon reconsideration, the Commission staff will not presume an insider to be acting as a trustee for a trust in which the insider's spouse is the named trustee. Analysis depends upon the particular facts and circumstances.

(n159)Footnote 158. *See* Fulbright & Jaworski, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,126, at 79,319 (Mar. 13, 1992); Ventura County National Bancorp, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,757, at 78,420 (Aug. 30, 1991); Cigna Corp., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,747, at 78,381 (Aug. 6, 1991).

(n160)Footnote 159. *See* Toys 'R' Us, Inc., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,756, at 78,419 (Aug. 30, 1991). *See also* Rule 16a-8(b)(3).

(n161)Footnote 160. The investment managers, although not named trustees, may be deemed trustees for purposes of Rule 16a-8 because of their functions with respect to the trust. *See id.*

(n162)Footnote 161. *See* § 8.02[2][a][iv] and § 8.02[3] *supra*.

(n163)Footnote 162. For most legal purposes, a trust is not an entity, but is instead a legal relationship. The Commission and its staff usually treat trusts as entities, although Rule 16a-8(b)'s reference to the trustee reporting on behalf of the trust departs from this practice. In order to clearly distinguish instances in which a trustee has obligations

in the trustee's own right, the fiction that a trust is an entity will be respected herein.

(n164)Footnote 163. Rule 16a-8(b).

If a trust has multiple trustees, only one trustee is required to file Forms 3, 4, and 5. *See* American Bar Association, SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,225, at 76,839 (July 2, 1992); Chandler Trust No. 2, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,750, at 76,389 (Aug. 14, 1991). If a trust with multiple trustees is subject to Section 16 because an insider trustee has a pecuniary interest in issuer stock held by the trust, the insider trustee, and not other trustees, is the trustee obligated to file Forms 3, 4, and 5. *See* American Bar Association, SEC No-Action Letter, *supra*.

(n165)Footnote 164. Rule 16a-8(b)(1). The trust need not report holdings and transactions in the issuer's securities held by the trust in an employee benefit plan subject to ERISA. If a trustee shares investment control with a third party, this exception will not apply. *See* Cravath Swaine & Moore, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,002, at 78,822 (Oct. 22, 1991).

(n166)Footnote 165. *See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,255 and n.72 (Feb. 8, 1991); Ventura County National Bancorp, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,757, at 78,420 (Aug. 30, 1991).

As discussed in § 8.03[3][f][iv] below, the Commission and its staff do not regard certain allocations of securities to the account of participants as a transaction requiring reporting by a trust for an ERISA plan, apparently based on the view that the transaction is invariably controlled by the trust beneficiary/plan participant. *See, e.g.,* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,255-56 (Feb. 8, 1991).

This exception would appear to be unnecessary in most cases, for two reasons. First, the exception set forth in Rule 16a-8(b)(3)(ii) (discussed immediately below) will apply to relieve a trust of any reporting obligation with respect to transactions over which a beneficiary has exclusive investment control (which is the case for participant-directed transactions under 401(k) plans). (As noted below, such relief may not relieve trusts of Form 3 filing obligations.) Second, in any case in which the investment control is not exercised by either the trustee or a beneficiary, the person exercising the investment control probably will be deemed to be a trustee and therefore no relief will be available under Rule 16a-8(b)(1) in any case.

(n167)Footnote 166. Rule 16a-8(b)(3)(ii). If a beneficiary has investment control with respect to a trust transaction without consultation with the trustee, the transaction shall be attributed to and reported by the beneficiary only. *Id. See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,255 (Feb. 8, 1991); The Taylor Voting Trust, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,051, at 79,000 (Jan. 3, 1992); Ventura County National Bancorp, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,757, at 78,420 (Aug. 30, 1991).

This result follows from the fact that Rule 16a-8(b)(3)(ii) states that such a "transaction shall be attributed to and reported by the beneficiary *only*." (Emphasis added.) For further discussion of Rule 16a-8(b)(3)(ii), see § 8.03[3][f][iv] *infra*.

(n168)Footnote 167. Although the voting trust in The Taylor Voting Trust, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,051, at 79,000 (Jan. 3, 1992), provided an example of a trust in which only beneficiaries had investment control, a Form 3 had apparently already been filed for the voting trust, so the staff did not address the "holdings" issue. Because it is fair to assume that the Commission and its staff would read Rule 16a-8(b)(3) to require insider-beneficiaries with investment control over trust shares to report those trust shares as "holdings," it would be equally fair to conclude that a trust need not report such "holdings." The staff's position in certain no-action letters interpreting Rule 16a-8 prior to its amendment in 1996 would appear to read Rule

16a-8(b)(3)(ii) to relieve trusts of the need to file a Form 3 to report "holdings." *See, e.g.*, Manatt, Phelps & Phillips, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,745, at 78,379 (Aug. 5, 1991).

(n169)Footnote 168. Rule 16a-8(b)(4).

This result follows from the fact that Rule 16a-8(b)(4) states that such "holdings and transactions shall be attributed to and reported by the settlor *instead of the trust*." (Emphasis added.) For further discussion of Rule 16a-8(b)(4), see § 8.03[3][f][v] *infra*.

(n170)Footnote 169. Rule 16a-8(b). However, the trust need not report holdings and transactions in the issuer's securities held by the trust in an employee benefit plan subject to ERISA over which no trustee exercises investment control. *See* Rule 16a-8(b)(1).

(n171)Footnote 170. As discussed in § 8.03[3][f][i] *supra.*, an insider who has investment control over trust shares may be deemed to be the trustee even if the insider does not formally serve as trustee. *See, e.g.*, Ventura County National Bancorp, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,757, at 78,420 (Aug. 30, 1991).

(n172)Footnote 171. Rule 16a-8(b)(2). A trustee subject to Section 16 of the Exchange Act has a pecuniary interest in any holding or transaction in the issuer's securities held by the trust, such holding or transaction shall be attributed to the trustee and shall be reported by the trustee in the trustee's individual capacity, as well as on behalf of the trust. *Id.* *See* Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,256 (Feb. 8, 1991).

(n173)Footnote 172. *See* Rule 16a-8(b)(3). A beneficiary subject to Section 16 of the Exchange Act shall have or share reporting obligations with respect to transactions in the issuer's securities held by the trust, if the beneficiary is a beneficial owner of the securities pursuant to Rule 16a-1(a)(2). *Id.* *See* Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,256 (Feb. 8, 1991). *See* Ventura County National Bancorp, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,757, at 78,420 (Aug. 30, 1991); Munger, Tolles & Olson, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,039, at 78,964 (Dec. 10, 1991).

(n174)Footnote 173. *See* EnergyNorth, Inc., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,293, at 77,158 (November 4, 1992); Sullivan & Cromwell, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,687, at 78,107 (Apr. 30, 1991).

The performance fee safe harbor is discussed in § 8.03[3][g] *infra*.

(n175)Footnote 174. *See* Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,256 (Feb. 8, 1991). Although the Rule appears to treat the status of an immediate family member as a beneficiary as the equivalent of the family member having a pecuniary interest, this is not always the case. *See, e.g.*, Cigna Corp., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,747, at 78,384 (Aug. 6, 1991). Clearly, Rule 16a-8(b) requires a true pecuniary interest.

The term "immediate family member" as used in Rule 16a-8(b)(2) is not limited to members of the insider's immediate family who share the insider's household; this is in contrast to Rule 16a-1(a)(2)(ii)(A), which attributes to an insider issuer stock held by immediate family members who share the same household. *See* Fulbright & Jaworski, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,126, at 79,319 (Mar. 13, 1992). In that letter, the staff rejected the suggestion that the reference in Rule 16a-8(b)(2) to Rule 16a-1(a)(2)(ii) may have implicitly incorporated the same household limitation.

(n176)Footnote 175. Rule 16a-8(b)(3). Pursuant to note to Paragraph (b)(3) of Rule 16a-8, "Transactions and holdings attributed to a trust beneficiary may be reported by the trustee on behalf of the beneficiary, provided that the report is signed by the beneficiary or other authorized person. Where the transactions and holdings are attributed both to the trustee and trust beneficiary, a joint report may be filed in accordance with § 240.16-3(j)." *See* The Taylor Voting Trust, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,051, at 79,000 (Jan. 3, 1992); Ventura County National Bancorp, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,757, at 78,420 (Aug. 30, 1991); Chandler Trust No. 2, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,750, at 78,389 (Aug. 14, 1991).

If one insider beneficiary of a trust has investment control but another insider beneficiary does not, only the insider beneficiary with investment control will be required to report issuer stock held by the trust. *See* Sullivan & Cromwell, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,687, at 78,107 (Apr. 30, 1991).

(n177)Footnote 176. Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,256 (Feb. 8, 1991).

(n178)Footnote 177. As discussed in § 8.03[3][b] and [f][i] *supra*, the staff has concluded that Rule 16a-8(b)(3) and its requirement of investment control will be viewed as the exclusive way in which beneficiaries will have reporting obligations and potential short-swing profits liability. *See* Fulbright & Jaworski, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,126, at 79,319 (Mar. 13, 1992); Sullivan & Cromwell, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,687, at 78,107 (Apr. 30, 1991); Hewitt Associates, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,688, at 78,113 (May 1, 1991). In so doing, the staff has forsworn any theory that the trust shares over which a beneficiary does not have investment control might still be reportable as a result of Rule 16a-1(a)(2)(ii)'s general definition of "indirect pecuniary interest." Absent this staff interpretation, Rule 16a-8(b)(3) would appear to be nothing more than a non-exclusive *example* of how a beneficiary might beneficially own trust shares.

(n179)Footnote 178. The following are examples of such transactions:

(1) Allocation of issuer stock under a tax-qualified plan. *See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,255-56 (Feb. 8, 1991);

(2) Deferral of compensation under a non-qualified plan in which the participant elects deferral at least one year in advance, the amount deferred is deposited in trust, and the trustee makes open-market purchases of issuer stock in the trustee's discretion. Eaton Corp., SEC No-Action Letter, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,409, at 77,237 (Jan. 19, 1993);

(3) Investment of participant contributions at the direction of the participant under a tax-qualified defined contribution plan in an equity fund which could include issuer stock as up to 50% of fund assets. Oglebay Norton Co., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,777, at 78,485-86 (Sept. 23, 1991); and

(4) Acquisition of issuer stock under a tax-qualified profit-sharing plan, whether as a grant or award transaction or as a participant-directed transaction. Southwest Airlines, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,721, at 78,258 (July 17, 1991). Plan participants must report only those securities that are allocated to their account and any subsequent transactions involving the securities. Although the acquisition of securities under the plan has aspects of both a grant and participant-directed transaction, it should be reported as one transaction. *Id.*

The position of the Commission staff attributing to an insider transactions in which the insider acquires an interest in a

trust is logical, but it leads to odd results in some cases. If the insider, as a trust beneficiary, has no investment control over issuer stock held in the trust, his Forms 4 or 5 will have reported an acquisition and a holding of the trust shares, but the number of such shares may later increase or decrease due to transactions not within the insider's control. In that event, it appears that no Form 4 or 5 need be filed to report the transaction; while the insider must report, post-transaction or year-end beneficial ownership on Forms 4 and 5, the number of his trust shares over which he continues to have any investment control, it is questionable whether the insider must continue to report shares over which he has no investment control, and in any case he need not explain why the number of trust shares he "beneficially owns" has changed when the cause of such change is not his own exercise of investment control. *See generally* Oglebay Norton Co., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,777, at 78,485-86 (Sept. 23, 1991) (once insider-participant has directed investment in equity fund holding issuer stock, subsequent changes in amount of issuer stock held for participant under such fund resulting from purchases and sales by the fund itself need not be reported).

(n180)Footnote 179. *See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,255-56 (Feb. 8, 1991). The Commission and its staff have focused on allocations of issuer stock to participant accounts in defined contribution plans as transactions over which an insider participant is deemed to have investment control. In most cases, the plans were employee stock ownership plans ("ESOPs"), in which the participant made no contributions or elections to receive the allocation. *See* Hewitt Associates, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,688, at 78,112-13 (May 1, 1991); Thompson, Hine and Flory, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. P 79,658, at 78,021 (Mar. 29, 1991).

The staff has expanded this position to 401(k) plans in which an insider makes cash contributions and receives matching cash contributions from the employer, which are then invested in the discretion of an administrative committee in issuer stock. Fulbright & Jaworski, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,126, at 79,319 (Mar. 13, 1992); Ventura County National Bancorp, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,757, at 78,420 (Aug. 30, 1991).

In Hewitt Associates, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,688, at 78,113 (May 1, 1991), the staff stated:

Once shares are allocated to participants, the investment control ordinarily will be viewed as having shifted to the participant, and accordingly participants who are subject to Section 16 will be responsible for reporting such holdings and transactions, beginning with the allocation of the securities to the individual account.

In Thompson, Hine and Flory, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. P 79,658, at 78,021 (Mar. 29, 1991), the staff went so far as to term this transaction a "purchase" by the participant. It seems obvious, however, that participants in ESOPs and some other trustee plans do not have any investment control over allocation transactions. Accordingly, the staff's position that participant investment control will be assumed almost certainly reflects the staff's desire that wide-spread holdings of issuer stock under ESOPs and other trustee plans should be reported by somebody on Section 16(a) forms, rather than fall through the cracks in the reporting system.

Not only is the staff's premise, that a participant who does not have investment control over issuer stock in a trust should still have to report such stock and be subject to liability for such stock, questionable, ("inappropriate" in the words of the Commission as quoted in the text accompanying n.176 *supra*), but it is doubtful that the Commission or its staff have the power to utterly contradict the meaning of the words of Rule 16a-8(b)(3) to require reporting of allocations of issuer stock under trustee employee benefit plans where participants in fact have no investment control.

(n181)Footnote 180. *See* Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,255, n.72 (Feb. 8, 1991).

(n182)Footnote 181. *See, e.g.*, Ventura County National Bancorp, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,757, at 78,420 (Aug. 30, 1991). In this case, reporting obligations will also be imposed on the insider as trustee, under Rule 16a-8(b)(2). *See id.*

(n183)Footnote 182. The definition of a trust beneficiary as "beneficial owner" applies only "where the trustee does not exercise exclusive investment control." Rule 16a-8(b)(3)(iii). When determining whether the beneficiary is the beneficial owner of the securities, beneficiaries shall be deemed to have a pecuniary interest in the issuer's securities held by the trust to the extent of their pro rata interest in the trust where the trustee does not exercise exclusive investment control. *Id.* The Commission staff has confirmed that these words do not require reporting of trust transactions by beneficiaries where parties other than the trustee or the beneficiary exercise some investment control. *See* Cravath Swaine & Moore, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,002, at 78,822 (Oct. 22, 1991). As indicated by Rule 16a-8(b)(3)(i) and (ii), the focus is on whether the beneficiary has investment control (whether solely or jointly).

(n184)Footnote 183. In Cigna Corp., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,747, at 78,381 (Aug. 6, 1991) and Hewitt Associates, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,688, at 78,112-13 (May 1, 1991), the Commission staff concluded that plans that "allocate cash balances" and do not have "individual accounts" do not give rise to a "pecuniary interest." These references are misleading, because they do not go to the question of whether the insider beneficiary could profit from transactions by the trust in issuer stock. The staff has recognized, in other letters, that if a beneficiary is allocated a cash balance determined by reference to the value of issuer stock held by a trust, such beneficiary will have a "pecuniary interest" in the issuer stock. *See* Fulbright & Jaworski, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,126, at 79,319 (Mar. 13, 1992); Thacher, Proffitt & Wood, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,045, at 78,986 (Dec. 20, 1991); Oglebay Norton Co., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,777, at 78,485-86 (Sept. 23, 1991). Similarly, the existence of an individual account is significant only if it provides a means to value the beneficiary's interest by reference to the value of trust assets, including issuer stock.

Although the Commission staff has not yet addressed the issue, a participant in a leveraged ESOP probably should not be viewed as having a pecuniary interest in unallocated shares held by an ESOP trust. (In such case, investment control might exist if the participant also served as a trustee.) Under such an ESOP, the increase in value of the unallocated stock could ultimately yield additional value to the participant. But, prior to an allocation to the participant's account, there exist substantial conditions that might preclude allocation or vary the amount of the allocation. These considerations strongly argue against the view that the beneficiary of an ESOP trust has a pecuniary interest in unallocated shares held by the ESOP trust.

(n185)Footnote 184. *See, e.g.*, Eaton Corp., SEC No-Action Letter, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,409, at 77,237 (Jan. 19, 1993) (insiders have a pecuniary interest as trust beneficiaries where issuer stock is the only kind of asset held by the trust). In American Bar Association, SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,225, at 76,839 (July 2, 1992), the Commission staff concluded that interests in a trust which held issuer stock as less than 20% of its assets would not involve a pecuniary interest, in view of the attenuated affect of issuer stock on the overall value of the trust interest. Similarly, in Hewitt Associates, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,688, at 78,113 (May 1, 1991), the staff concluded that interests in a trust for defined benefit pension plans did not involve a pecuniary interest where the benefits payable from the trust would not be determined based on the value of trust assets. If the participant has no investment control he or she has no reporting obligation. *Id.*

Although the similar staff position in Cigna Corp., SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,747, at 78,384 (Aug. 6, 1991), that a beneficiary of a defined benefit pension plan has no pecuniary interest in the plan addressed only trustee reporting obligations under Rule 16a-8(b)(2), the Commission staff has orally

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confirmed that the position applies equally for purposes of Rule 16a-8(b)(3). *See also* Thacher, Proffitt & Wood, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,045, at 78,986-92 (Dec. 20, 1991) (insider plan participant entitled to benefits based on plan formula, where rabbi trust created to fund payment of benefits but calculation of benefits was not dependent on assets in rabbi trust, not deemed to have a "pecuniary interest" in rabbi trust assets for purposes of Rule 16a-1(a)(2); Rule 16a-8(b)(3)(iii) not addressed).

(n186)Footnote 185. An insider who makes contributions to an employee benefit plan trust will not be deemed a settlor. *See* Eaton Corp., SEC No-Action Letter, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,409, at 77,237 (Jan. 19, 1993).

(n187)Footnote 186. The power to remove a trustee without approval of beneficiaries is not a power to revoke the trust for purposes of this Rule. *See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,282 (Feb. 8, 1991) (revising the response to question 59 contained in Sec. Exch. Act Rel. No. 34-18,114, Fed. Sec. L. Rep. P 26,062, at 19,063-22 (Sept. 23, 1981)).

(n188)Footnote 187. Rule 16a-8(b)(4). If the settlor does not exercise or share investment control over the issuer's securities held by the trust, the trust holdings and transactions shall be attributed to and reported by the trust instead of the settlor. *Id.* *See* Sonnenschein Nath & Rosenthal, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,134, at 79,347 (Mar. 23, 1992).

Interpretations of this Rule have generally arisen in the context of completely excluding the trust from reporting.

(n189)Footnote 188. *See* Sec. Exch. Act Rel. No. 34-27,148 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,439, at 80,389, n.77 (Aug. 18, 1989).

(n190)Footnote 189. *See* Rule 16a-1(a)(2)(ii)(C). Rule 16a-8(b)(2) reinforces the point that a trustee who receives a performance fee, other than a fee that is excluded, will cause the trustee to be viewed as having a pecuniary interest in the trust securities. *See* Sullivan & Cromwell, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,687, at 78,107 (Apr. 30, 1991). What remains unclear, however, is when and how reporting and potential liability arise under such arrangements. For example, whether the insider reports actual share transactions, or accrual or payment of annual fees or transactions only if they result in a fee being earned.

(n191)Footnote 190. Rule 16a-1(a)(2)(ii)(C)(2). A right to nonperformance-related fee alone shall not represent a pecuniary interest in the securities. *Id.*

In EnergyNorth, Inc., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,293, at 77,158 (Nov. 4, 1992), the Commission staff concluded that a trustee's fee based on income (dividends and interest on portfolio securities) and assets, but not on net capital gain or net capital appreciation or overall performance, was not a "performance-related" fee).

(n192)Footnote 191. *See* Rule 16a-1(a)(2)(ii)(C)(2). Although this safe-harbor refers to performance measures based upon either "net capital gains and/or net capital appreciation generated" from the managed portfolio or "overall performance," these may not be requirements of the safe-harbor so much as a listing of the types of performance measures that are viewed as giving rise to an indirect pecuniary interest absent the safe-harbor. *See* EnergyNorth, Inc., SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,293, at 77,158 (Nov. 4, 1992).

A performance fee can qualify for this safe-harbor even if fees are paid more often than once per year. *See* Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254 (Feb. 8, 1991). The adopted rules clarify that asset-based fees do not create a pecuniary interest in the securities managed and that advisors or trustees may be paid more than once during a year, as long as the fee is related to performance for a year or more. *Id.*

(n193)Footnote 192. See Rule 16a-1(a)(5).

(n194)Footnote 193. Rule 16a-1(a)(2)(ii)(D). By "separated or separable," the Commission means a right to dividends that is a "separate security or traded as a separate right or security." Sec. Exch. Act Rel. No. 34-27,148 [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,439, at 80,388 (Aug. 18, 1989). The Commission expressed a belief that such rights have "the same potential for speculative profit as the related equity security." *Id.* The Commission also suggested that a right to vote or dispose of an equity security that is tradable separately from the equity security could represent an indirect pecuniary interest in the equity security, although this position is not codified in a Rule. See *id.* at 80,386.

(n195)Footnote 194. Rule 16a-1(a)(2)(ii)(D). The staff has in several interpretive letters addressed the related question of whether dividend equivalent rights ("DERs") constitute a derivative security. In approaching these letters, it should be recognized that the DER label has been applied to rights that have very different terms. In any case, the staff has confirmed that a DER that only confers a right to receive an amount equal to cash dividends paid on common stock does not represent a derivative security under Rule 16a-1(c), any more than it would represent a pecuniary interest in the equity security under Rule 16a-1(a)(2)(ii)(D). See Cigna Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,132, at 79,340 (Mar. 20, 1992). In other letters, where the DER was credited at the rate of payment of cash dividends but then deemed to be applied to purchase common stock at either the then prevailing market price or the original exercise price of options to which the DER was attached, the allocation of shares was deemed an acquisition of derivative securities. See, e.g., American Home Products Corp., SEC No-Action Letter, [1992-1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,403, at 77,221 (Dec. 15, 1992); Skadden, Arps, Slate, Meagher & Flom, SEC No-Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,221, at 78,828 (June 23, 1992); O'Connor, Cavanaugh, Anderson, Westover, Killingsworth & Beshears, SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,040, at 78,967 (Dec. 11, 1991); Davis Polk & Wardwell, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,769, at 78,460 (Aug. 23, 1991). The Commission staff deems the date of the acquisition to relate back to the date of acquisition of the security in which DER is paid. Exchange Act Rel. No. 34-37,260 at Part II.D.2.

(n196)Footnote 195. Rule 16a-1(a)(5)(i). See § 8.03[1][b] *supra*.

(n197)Footnote 196. Rule 16a-1(a)(5)(ii).

(n198)Footnote 197. Rule 16a-1(a)(5)(iii). See Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,254 (Feb. 8, 1991). The Commission staff has stated that a transaction involving a security that is a component of a market basket that is traded independent of the basket would be subject to Section 16. See *id.* n.138. Rule 16a-1(c)(4) excludes interests in broad-based index options, broad-based index futures, and broad-based publicly traded market baskets of stocks approved for trading by the appropriate federal governmental authority.

(n199)Footnote 198. See Rule 16a-3 (reporting transactions and holdings).

(n200)Footnote 198.1. The Commission proposed its new rules in Release No. 34-46313 (2002) and adopted them in Release No. 34-46421 (Aug. 29, 2002). Section 16(a) requires insiders to report transactions in issuer securities by the end of the second business day following execution of the transactions, "or at such other time as the Commission shall establish by rule, in any case in which the Commission determines that such 2-day period is not feasible."

(n201)Footnote 199. The rules were proposed in Release No. 34-47069 (Dec. 20, 2002) and adopted in Release No. 34-47809 (May 7, 2003).

(n202)Footnote 200. The delinquency rate ranged between 21% and 48% in prior years, according to the Commission. See Sec. Exch. Act Rel. No. 34-28,869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,274 & n.227 (Feb. 8, 1991); Sec. Exch. Act Rel. No. 34-27,148, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH)

P 84,439, at 80,398 & n.148 (Aug. 18, 1989); Sec. Exch. Act Rel. No. 34-26,333, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,343, at 89,625-26 & n.208 (Dec. 2, 1988).

(n203)Footnote 201. See Rule 16a-3(f)(1).

A Form 5 filing is required to report a complete failure to file, but not to report the fact that a Form 3, 4, or 5 was filed late. A Form 5 filed to report transactions or holdings that should have been reported on an earlier Form 3 is deemed to represent the delinquent Form 3 or 4, so no separate filing of the Form 3 or 4 is required. See Form 5, Note to Instr. 4(a)(i).

(n204)Footnote 202. Rule 16a-3(e).

(n205)Footnote 203. See Form 10-K, Item 10; Regulation 14A, Item 7(b).

As a practical matter, the substance of an Item 405 disclosure may not appear in the Form 10-K, because an issuer is permitted to incorporate into its Form 10-K by reference the disclosure that appears in a proxy statement relating to an election of directors (typically, the proxy statement relating to the issuer's annual meeting of stockholders). See Form 10-K, General Instr. G(3).

(n206)Footnote 204. See Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,275 (Feb. 8, 1991).

(n207)Footnote 205. Pub. L. No. 101-429, 104 Stat. 931.

The Securities Enforcement Remedies and Penny Stock Reform Act of 1990 vests the Commission with the general power to seek civil money penalties in enforcement cases against corporate issuers.

(n208)Footnote 206. See Exch. Act §§ 21C & 21(d)(3).

A cease-and-desist order requires the respondent to cease and desist from committing or causing any present or future violation of Section 16(a). See Section 21C, 15 U.S.C. § 78u(a)(1). The Exchange Act empowers federal courts (and the Commission in certain limited circumstances not relevant to Section 16) to impose civil money penalties for violation of securities laws. See generally Section 21(d)(3) and 21B of the Exchange Act.

(n209)Footnote 207. Note that, because beneficial ownership is defined differently for purposes of determining ten percent beneficial ownership than for determining *what* to report, the Form 3 filing obligation may occur before or after acquisition of a reportable pecuniary interest.

(n210)Footnote 208. See Exch. Act § 16(a); Rule 16a-2.

Although there will be no Form 3 filing requirement unless an issuer has at least one class of equity securities registered under Section 12 of the Exchange Act, and a 10% shareholder will become subject to a Form 3 filing requirement only if the shareholder holds more than 10% of the class that is registered under Section 12, the Form must also disclose the insider's holdings of non-registered equity securities. See Exch. Act § 16(a); Rule 16a-2; Form 3, Instr. 4(a)(i).

(n211)Footnote 209. See Form 3, Instr. 1(c). In such case, if an insider does not beneficially own any securities required to be reported, see Rule 16a-1 and Form 3, Instr.5, the insider should file Form 3 stating that no securities are beneficially owned. See *id.*

It is possible even for a 10% shareholder to report beneficial ownership of no equity securities. See § 8.03[3][b], *supra*.

(n212)Footnote 210. Rule 16a-3(b).

(n213)Footnote 211. Rule 16a-3(b)(2)

(n214)Footnote 212. See Rule 16(a)-2. Where a person is an officer, director, or ten percent owner of an issuer that does not have a class of equity securities registered under Section 12 of the Exchange Act, and the issuer registers a class of its equity securities under Section 12, the insider's Form 3 is due on the effective date of the issuer's registration under Section 12. *Id.* Form 3, Instr. 2(b). Note that initial registration under Section 12 of the Exchange Act is common in connection with an initial public offering of equity securities under the Securities Act of 1933, as amended. In such cases, the effectiveness of the Exchange Act registration statement may occur prior to the closing date of the offering.

(n215)Footnote 213. Form 3, Instr. 2(a). The ten-day period is calculated using calendar days, not business days. Note that this deadline is ten days after the event, in contrast to the Form 4 filing deadline, which is generally two business days after the reportable transaction occurred. Inadvertent late Form 4 filings can result from confusion on this point when an insider has a transaction on the day that he becomes subject to Section 16, since the Form 4 in that case is due even before the Form 3. The Commission staff suggests early filing of Form 3 in these circumstances.

(n216)Footnote 214. Rule 16a-3(f)(1) & (g)(1); Form 4, Instr. 4(a)(i); Form 5, Instr. 4(a)(i).

However, Rule 16a-13 exempts reporting transactions(s), other than the exercise or conversion of a derivative security or deposit into or withdrawal from a voting trust, that effects only a change in the form of the beneficial ownership (such as from indirect to direct) without changing a person's pecuniary interest in the subject equity securities. *Id.*

(n217)Footnote 215. A "discretionary transaction" is a participant-directed movement of a portion of his or her account balance into or out of a company stock fund under a deferred compensation plan. The term does not include transactions made in connection with the plan participant's death, disability, retirement or termination of employment, or that are required to be provided under IRS regulations. Discretionary transactions may occur in a tax-qualified plan, such as a 401(k) plan, or in a non-tax qualified plan, such as a SERP or a directors' fee deferral arrangement.

(n218)Footnote 216. See Rule 16a-3(g)(1).

(n219)Footnote 217. See *id.* See also Form 4, Instr. 1(a).

(n220)Footnote 218. See Rule 16a-3(g)(2)(ii) and Rule 16a-3(g)(3).

(n221)Footnote 219. See Rule 16a-3(g)(4).

(n222)Footnote 220. See *id.*

(n223)Footnote 221. See Rule 16a-3(g)(2)(ii) and Rule 16a-3(g)(3).

(n224)Footnote 222. See Rule 16a-6(a). A "small acquisition" eligible for deferred reporting is an acquisition, other than from the issuer or an employee benefit plan sponsored by the issuer, that together with acquisitions of equity securities of the same class in the prior six months, other than acquisitions exempt from Section 16(b) or non-exempt transactions that were previously reported, does not exceed \$10,000 in market value, provided that the insider does not make any non-exempt disposition in the six months following the acquisition. See Form 5, Instr. 4(a). See also Rule 16a-3(f)(1)(iv).

(n225)Footnote 223. Rule 16a-3(f). The Form 5 contains boxes, in the upper left corner of the front page, which must be checked if the Form reports delinquent "Form 3 Holdings" or "Form 4 Transactions."

(n226)Footnote 224. Rule 16a-3(f)(1).

(n227)Footnote 225. Rule 16a-3(f)(2); Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,252 (Feb. 8, 1991). This assumes that the insider has not failed to report any transactions and holdings required to be reported during the most recent fiscal year, which can separately trigger the need to file a Form 5. Rule 16a-3(f)(1). The Form 5 requirements relating to such delinquencies are discussed below.

(n228)Footnote 226. Obviously, the usual delinquency is inadvertent. Once an insider becomes aware of a delinquency, any continuing failure to promptly file the required Form would become willful, which (if discovered) could be expected to result in more vigorous enforcement action and potentially stronger sanctions. *See, e.g.*, Exch. Act § 21(d)(3)(B) (specifying higher potential fines where violation involves "deliberate or reckless disregard of a regulatory requirement").

Accordingly, an insider who, before the due date of the Form 5, discovers that he missed a Form 3 or 4 filing, or failed to report a Form 3 holding or Form 4 transaction on a Form otherwise filed, probably should promptly file or amend the Form 3 or 4. An insider who discovers such a delinquency during the 45 days after the end of the issuer's fiscal year could instead file the Form 5, but he should do so without delay. If an insider discovers, after the due date for a Form 5, that he missed a Form 3 or 4 filing, or failed to report a Form 3 holding or Form 4 transaction on a Form otherwise filed, he will have two violations to correct, the original Form 3 or 4 and the Form 5 that would have been required to correct the Form 3 or 4 delinquency. In such case, the insider might as well file only the Form 5 late, without separately filing or amending the Form 3 or 4, because the single Form 5 filing will redress both delinquencies.

(n229)Footnote 227. *See* Rule 16a-3(a) & (g)(3); and Note to Form 4, Instr. 4(a)(i); Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,256 (Feb. 8, 1991).

(n230)Footnote 228. *See* Rule 16a-3(a) & (g)(3); Pettit & Martin, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,675, at 78,081 (Apr. 18, 1991). Thus, for exempt transactions other than exercises or conversions, voluntary Form 4s may be filed any time before the due date of the Form 5 (45 days after the issuer's fiscal year ends). *See* Gibson, Dunn & Crutcher, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,711, at 78,238 (June 12, 1991).

(n231)Footnote 229. This is particularly true where issuers assist insiders by preparing the Forms required under Section 16(a).

(n232)Footnote 230. Of course, a Form 3 or 4 containing such errors should be amended to correct them.

(n233)Footnote 231. If, however, an error was made in reporting the exact number of shares beneficially owned, arguably an error overreporting the number would not trigger a Form 5 filing because all actual "holdings" were reported as part of the too-large number. An underreporting error would represent unreported "holdings" that would apparently trigger the Form 5 filing. Nevertheless, Commission staff have indicated orally that there may be leeway for "inadvertent and insignificant" errors in reporting numbers.

(n234)Footnote 232. There is ample evidence for this conclusion on the Form 5 itself. For example, the boxes to be checked on the cover page to indicate that the Form 5 corrects a delinquency list "Form 3 Holdings Reported" and "Form 4 Transactions Reported." Similarly, Form 5, Instrs. 4(a)(i)(C) and 8, clearly associated unreported "holdings" only with Form 3 and unreported "transactions" only with Form 4. As indicated in the Note to Form 5, Instr. 4(a)(i)(C), a required Form 3 or Form 4 must be filled within the time specified by the Form. Form 3 holdings or Form 4 transactions reported on Form 5 represent delinquent Form 3 and Form 4 filings.

The conclusion of the Commission staff in American Society of Corporate Secretaries, Inc., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,083, at 79,161 (Jan. 24, 1992), is consistent. In that interpretive letter, the staff concluded:

2-8 Federal Securities Exchange Act of 1934 § 8.03

A Form 4 or 5 filed only for the purpose of reporting exempt employee benefit plan transactions will not be deemed untimely if the month-end or year-end holdings column includes only employee benefit plan securities, and omits other holdings of the same class. However, an amendment should be filed to reflect all holdings of the class.

While the wording of this response may suggest that the fact that the Form 4 or 5 was being filed to report employee benefit plan transactions may have been the basis for the relief, the relief is nevertheless consistent with the view that an unreported holding in a Form 4 would not be viewed as a failure to report a "holding" that would trigger a Form 5 filing.

(n235)Footnote 233. Exch. Act Rel. No. 34-37,260 at Part IV.A. The Commission notes that "insiders may choose, but are not required, to include footnote disclosure indicating the date and nature of transactions not required to be reported." *Id.* The purpose is not indirectly to require insiders to report transactions exempt from Section 16(a), but rather, to provide users of Section 16 information with holdings information that is as accurate as reasonably possible. *Id.*

(n236)Footnote 234. *Id.* See also Form 4 Instr. 4(a)(i).

(n237)Footnote 235. Rule 16a-9(a).

(n238)Footnote 236. See Rule 16a-9(b). The exercise of such rights typically will be exempt under Rule 16b-6(b), but their sale would typically not be exempt unless to the issuer under Rule 16b-3.

(n239)Footnote 237. See Rule 16a-11

(n240)Footnote 238. See Rule 16a-12.

(n241)Footnote 239. See Rule 16a-13. Transactions that effect only a change in the form of beneficial ownership without changing a person's pecuniary interest in the subject equity securities are exempt. This rule codifies and expands the staff's interpretive position in Munger, Tolles & Olson, SEC No-Action Letter [1991-1992 Transfer Binder], Fed. Sec. L. Rep. (CCH) P 76,039 at 78,964 (Dec. 10, 1991). Exercises and conversions of derivative securities, as noted above, must be reported on Form 4, even though they involve a change from indirect to direct beneficial ownership. See Rules 16a-3(g)(1) and Rule 16a-4(a). Transfers into or out of a voting trust are reportable on a Form 5 pursuant to Rule 16b-8.

(n242)Footnote 240. Rule 16a-7.

(n243)Footnote 241. Rule 16a-5.

(n244)Footnote 242. See Rule 16a-3(f)(1)(i)(B) and Rule 16b-3(c).

(n245)Footnote 243. See Section 16(a)(2)(c).

(n246)Footnote 244. See Section 16(a)(4).

(n247)Footnote 245. Rule 16a-2(a) & (c). No reporting of transactions that occurred more than six months before the insider became subject to Section 16 would ever be required.

Rule 16a-2 provides that a person's transactions in the six months before he becomes an insider, except in the case of a person who becomes an insider because the issuer registers equity securities under Section 12 for the first time, are not subject to any provision of Section 16, including potential liability under Section 16(b). See *id.* See also Rule 16a-10 (providing exemption from Section 16(b) liability for any transactions completely exempted from reporting under the Section 16 rules).

(n248)Footnote 246. Rule 16a-2(a). By narrowing this requirement only to the case of Section 12 registration by the issuer, the Commission narrowed its existing reporting rule for directors and officers and overruled pre-May 1, 1991 court cases that consistently held directors and officers liable under Section 16(b) for sales after they became insiders within six months of purchases that occurred before they became insiders. *See, e.g.,* old Rule 16a-1(d); *Adler v. Klawans*, 267 F.2d 840, 845 (2d Cir. 1959) ; *Marquette Cement Mfg. Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965) ; *Blau v. Allen*, 163 F. Supp. 702 (S.D.N.Y. 1958) .

(n249)Footnote 247. *Id.* Note that even exempt pre-insider transactions can become reportable under this Rule. *See* Garvey, Schubert & Barer, SEC No- Action Letter, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,240, at 76,884 (Aug. 14, 1992). But, such reporting of exempt or non-exempt pre-insider transactions will only be triggered by a post-insider transaction "giving rise to [a] Form 4 obligation," which can only mean a derivative security exercise or a transaction not exempt from Section 16(b) liability. *See* Rule 16a-2(a).

Rule 16a-2(a) requires that the insider's Form 4 report the pre-insider transaction as well as the transaction that triggers the Form 4 filing. This is apparently required even though the pre-insider transaction is exempt from Section 16(b) liability and thus would normally be eligible for year-end Form 5 reporting.

Note that a transaction is not reportable simply because it occurred during the six months before a director or officer became subject to Section 16 (as a result of the issuer's Section 12 registration); only if the insider has a transaction reportable on Form 4 and, looking back six months from the date of such transaction, he had a pre-insider transaction will the pre-insider transaction be reportable.

(n250)Footnote 248. *See* Rule 16a-2(b) & (c).

(n251)Footnote 249. Rule 16a-2(b). A purchase is an "opposite way" transaction from a sale, and vice versa. This rule, which was adopted in 1996, reversed the 1991 provision to the effect that the post-insider transactions to be reported and the pre-termination transactions that begin the six-month reporting period included exempt transactions that are eligible for Form 5 reporting. But, a pre-termination transaction that is not reportable does not trigger a six-month reporting period. *See* Unisys Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,117, at 79,276 (Feb. 27, 1992).

Rule 16a-2(b) purports to subject reportable post-insider transactions to potential liability under Section 16(b) as well. This is generally consistent with case law holding that a sale occurring after a person ceases to be a director or officer is matchable under Section 16(b) with a purchase that occurred during the previous six months and at a time that the person was a director or officer. *See Winston v. Federal Express Corp.*, 853 F.2d 455 (6th Cir. 1988) ; *Feder v. Martin Marietta Corp.*, 406 F.2d 260, 266 (2d Cir. 1969) , *cert. denied*, 396 U.S. 1036 (1970) .

The Commission took the position, however, that persons who ceased to be insiders as a result of changes in the Section 16 rules effective May 1, 1991, had no reporting obligations regarding post-April 30, 1991 transactions. *See* Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,276 (Feb. 8, 1991). Although the Commission did not state that such transactions would likewise be exempt from Section 16(b), the staff subsequently took the position that Rule 16a-10, in combination with the Commission's "exemption" from reporting, exempted such transactions from Section 16(b) liability. *See* Bryan, Cave, McPheeters & McRoberts, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,679, at 78,089 (Apr. 25, 1991). Persons ceasing to be insiders by operation of the Section 16 rules are not required to report post termination transactions. However, transactions conducted prior to termination must be reported, and, to the extent these transactions have not been reported, a person ceasing to be an insider continues to have a reporting obligation on Form 4 or Form 5.

(n252)Footnote 250. Although Rule 16a-2(c) does not explicitly remove such transactions from the ambit of Section 16(b), it is clearly an exemption from reporting for pre- and post-insider transactions for persons who were insiders due to their status as 10% shareholders. Rule 16a-10 provides that transactions completely exempt from

reporting are also exempt from Section 16(b) liability. This exemption for 10% shareholders is consistent with decisions of the Supreme Court and other courts construing the language of Section 16 itself. *See, e.g., Foremost-McKesson, Inc. v. Provident Securities Co., 423 U.S. 232, 249-50 (1976)*.

(n253)Footnote 251. *See* Form 4, Instr. 1(b); Form 5, Instr. 1(b); Sec. Exch. Act Rel. No. 34-28,869 [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,709, at 81,258 (Feb. 8, 1991).

(n254)Footnote 252. The reporting requirements of Section 16(a) are so specific that it is questionable whether the Commission would have the authority to require a filing solely to report that a person has ceased having the status of an insider.

(n255)Footnote 253. Rule 16a-2(c); *Foremost-McKesson, Inc. v. Provident Securities Co., 423 U.S. 232, 249-50 (1976)*.

As discussed in § 8.02[2][a], the fact that status as a 10% shareholder is now determined under Section 13(d) principles creates a much greater risk that a person may become a 10% shareholder-insider at a point in a complex transaction before the Section 16 purchase occurs. Prior to adoption of the new rules in 1991, status as a 10% shareholder generally was determined by the same analysis as that used to identify the purchase. Now, it is unclear under Rule 16a-2(c) whether the exemption from reporting and liability (in conjunction with Rule 16a-10) applies if the purchase is a discrete step in a complex transaction that occurs after the point at which the person became a 10% shareholder.

(n256)Footnote 254. This issue can arise in two different ways. First, a person may become a director or officer as part of a transaction in which such person, or an entity which such person represents, acquires equity securities. In such case, it might be argued that a right to be appointed as a director or officer is not tantamount to being a director or officer, because the right itself does not give access to insider information. But, that question aside, the same logic would suggest that, if a transaction during the six months before a person becomes a director or officer, or a transaction before or simultaneous with becoming a 10% shareholder, should not be subject to reporting and liability because the person lacks access to inside information before the transaction, the same should be true of a transaction that had to be arranged before the person became a director or officer, even if transaction and the appointment were to be simultaneous.

Second, a person may acquire beneficial ownership at the time an issuer first registers equity securities under Section 12 of the Exchange Act. In such case, the transaction would be subject to possible reporting and liability even if it were deemed to have occurred before the Section 12 registration statement became effective. Nevertheless, it is unclear whether a simultaneous transaction would be reported on a Form 4, as a post-insider transaction, without showing the resulting beneficial ownership on the insider's initial Form 3, or whether the beneficial ownership would be shown on the initial Form 3 but reported only on a subsequent Form 4 filed to report a transaction in the six months following Exchange Act registration.

(n257)Footnote 255. *See* Rule 16a-8(b) & (c).

(n258)Footnote 256. *See* Sec. Exch. Act Rel. No. 34-28869B (Apr. 4, 1991). The amendment added the following note at the end of Form 4, Instr. 4(a)(i):

The amount of securities beneficially owned following the reported transaction(s) specified in Column 5 of Table I and Column 9 of Table II should reflect holdings reported or required to be reported by the date of the Form. Transactions and holdings eligible for deferred reporting on Form 5 need not be reflected in the month end total unless the transactions were reported earlier or are included on this Form.

(n259)Footnote 257. *See* Exchange Act Rel. No. 34-37,260 at n. 126. Thus, for example, if shares received as a gift

are sold, the sale would trigger a Form 4 filing and the gift would be reportable on the same Form 4 (rather than deferred until the year-end Form 5). *See id.*

(n260)Footnote 258. *See § 8.03 [4][b][ii], supra.*

(n261)Footnote 259. *See Simpson Thacher & Bartlett, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,686, at 78,105 (Apr. 30, 1991).*

(n262)Footnote 260. Form 4, Instr. 4(a)(i); Form 5, Instr. 4(a)(i). This means that, if an insider reports a purchase of common stock which is owned directly by the insider, the Form 4 must also show his indirect beneficial ownership of common stock, such as through a trustee employee benefit plan. *See, e.g., American Society of Corporate Secretaries, Inc., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 76,083, at 79,161 (Jan. 24, 1992).*

(n263)Footnote 261. Rule 16a-4(a) (the acquisition or disposition of a derivative security must be separately reported). *See Bell, Boyd & Lloyd, SEC No-Action Letter, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,703, at 78,215 (June 3, 1991).* For purposes other than reporting, the derivative security is deemed both to be of the same class as the underlying equity security and to constitute beneficial ownership of any equity security that could be acquired by exercising the derivative security. *See Rule 16a-1(a)(2)(ii)(F); Rule 16a-4(a).* The effect of this reporting rule is that reporting of acquisitions and dispositions of derivative securities takes place only on Table II of the Forms, with reporting of acquisitions and dispositions of underlying equity securities upon exercise or conversion of derivative securities taking place on Table I of the Forms.

Some securities, such as convertible preferred stock, may constitute both an equity security and a derivative security. Such a security is reported on Table II of Forms 3, 4, and 5, with no Table I reporting until such time as the securities are exercised or converted for an equity security that is not also a derivative security. Form 3, Instr. 5(c)(i); Form 4, Instr. 4(c)(i); Form 5, Instr. 4(c)(i).

(n264)Footnote 262. *See Thompson, Hine and Flory, SEC No-Action Letter, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. P 79,658, at 78,019-21 (Mar. 29, 1991).* Thus, for example, an option exercise which is the only transaction reported on Table II of Form 4 would show, as beneficial ownership following the transaction in column 9, the number of shares as to which such option remains unexercised, but none of the insider's other options (unless they happened to have identical exercise prices, expiration dates, and other characteristics) are required to be listed on such Table or included in the number of unexercised derivative securities listed in column 9.

(n265)Footnote 263. As discussed in § 8.03[2], *supra.*, the Commission's primary concern in drafting the rules relating to these "positions" appears to have been to broaden liability under Section 16(b), which may have led to a failure to focus on how such positions should be reported.

(n266)Footnote 264. *See Form 3, Instr. 5(c)(ii); Form 4, Instr. 4(c)(ii); Form 5, Instr. 4(c)(ii).*

(n267)Footnote 265. *See Form 4, Table II; Form 5, Table II, Form 4, Instr. 4(c)(i); Form 5, Instr. 4(c)(i).*

(n268)Footnote 266. If so, however, it probably follows that the "Number of Derivative Securities Beneficially Owned Following Reported Transaction(s)" to be filled in under Column 9 of Table II of Form 4 or 5 would be a negative number for such an insider.

If this is the proper treatment, then any time the insider is the party *obligated* to purchase or sell--rather than the party with the right to exercise--he should report that he "disposed of" the derivative security. Such an insider in effect has a "short" derivative security position. When such a derivative security is closed (by exercise or otherwise), the insider would report that he "acquired" the derivative security.

(n269)Footnote 267. *See, e.g., Varsity Corp., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep.*

(CCH) P 76,166, at 79,467 (October 15, 1991). These positions represent broad relief, because they would appear to, in effect, exempt the surrender of securities of the old issuer and the acquisition of securities of the new issuer from short-swing profits liability as well.

(n270)Footnote 268. Exch. Act 0-3.

(n271)Footnote 269. *See* Exch. Act Rel. No. 34-47809 (May 7, 2003).

(n272)Footnote 270. *See id.*

(n273)Footnote 271. *See id.*

(n274)Footnote 272. *See* Regulation S-T, Rule 13(a).

(n275)Footnote 273. *See* Exch. Act Rel. No. 34-47809 (May 7, 2003).

(n276)Footnote 274. Rule 13(b) of Regulation S-T provides, "If an electronic filer in good faith attempts to file a document with the Commission in a timely manner but the filing is delayed due to technical difficulties beyond the electronic filer's control, the electronic filer may request an adjustment of the filing date of such document. The Commission, or the staff acting pursuant to delegated authority, may grant the request if it appears that such adjustment is appropriate and consistent with the public interest and the protection of investors." This is the same standard that applies for the automatic extension available for other Edgar filings under Form TH.

(n277)Footnote 275. *See* Rule 16a-3(k).

(n278)Footnote 276. *See* New York Stock Exchange, SEC No-Action Letter, 1998 Transfer Binder Fed Sec. L. Rep. (CCH) P 77,456 (July 22, 1998), American Stock Exchange, SEC No-Action Letter, 1998 Transfer Binder Fed. Sec. L. Rep. (CCH) P 77,455 (July 22, 1998). *See* The Nasdaq Stock Market LLC No-Act, WSB File No. 0731200610, NASDAQ Stock Market LLC (Aug. 1, 2006).

(n279)Footnote 277. *See* Form 3, Instr. 7; Form 4, Instr. 7; Form 5, Instr. 7. This flexibility is not explicitly available if the insider is an entity. Signatures on behalf of an entity should indicate the capacity in which the signing person is acting on behalf of the entity.

(n280)Footnote 278. This is typically accomplished by means of a power of attorney or a document styled as a "signing authorization." In either case, the written authorization should state its duration. It is often useful to have the authorization cover subsequent Form 4 and Form 5 filings.

(n281)Footnote 279. *See* Form 3, Instr. 8; Form 4, Instr. 9; Form 5, Instr. 9.

(n282)Footnote 280. Only the line item or other information being amended should be set forth in the amendment. *Id.*

(n283)Footnote 281. Rule 16a-1(a)(4).



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Federal Securities Exchange Act of 1934

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CHAPTER 8 Insider Reporting and Short-Swing Trading

2-8 Federal Securities Exchange Act of 1934 § 8.04

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§ 8.04 Liability for "Short-Swing" Profits Under Section 16(b)

An insider is subject to civil liability under Section 16(b) for profits realized from the purchase and sale, or sale and purchase, of any equity security of the issuer within any period of less than six months. A voluntary cash-for-stock transaction constitutes a purchase and sale for purposes of Section 16(b). An issuer may bring an action under Section 16(b) to recover profits realized by an insider's short-term trades or, if the issuer declines to bring suit or does not diligently prosecute a Section 16(b) action, any security holder of that issuer may institute an action on behalf of the issuer. Section 16(b) imposes strict liability on insiders who violate its provisions if the statutory terms are met. No defenses are available to the insiders except for the running of the statute of limitations.

Section 16(b) imposes civil liability on:

- (1) an officer, director, or beneficial owner of more than ten percent of any class of equity security (other than an exempted security) registered under Section 12, *i.e.*, an insider, of an issuer; n1
- (2) who realizes a profit; n2
- (3) from any purchase and sale, or any sale and purchase; n3
- (4) of any equity security of the issuer n4 (other than an exempted security); n5
- (5) within any period of less than six months; n6
- (6) unless the security was acquired in good faith in connection with a debt previously contracted. n7

The purpose of Section 16(b) is to prevent the unfair use of inside information obtained by a person because of his relationship to an issuer for that person's personal gain. n8 This purpose is accomplished by denying the insider the right to keep any profits realized from his short-term trading in the securities of his corporation; the profits instead inuring to, and being recoverable by, the issuer. n9 The application of Section 16(b), however, is automatic and without regard to

the insider's state of mind. It is not conditioned on proof that an insider acted in bad faith, *i.e.* that he intended to make a profit from the use of the inside information. It is sufficient that the statutory conditions of Section 16(b) are present for liability to be imposed. n10

Although Congress believed that the only effective method of preventing insider trading abuses was through the imposition of the objective "crude rule of thumb" n11 of Section 16(b), on occasion courts have adopted a subjective approach with respect to certain "unorthodox transactions," *e.g.*, exchanges pursuant to mergers or conversions of securities, to determine whether the particular transaction violates the policy of Section 16(b) against the speculative abuse of inside information.

[1] "Who is Subject to Liability?"

Any insider-- *i.e.*, beneficial owner of more than ten percent of any class of an issuer's equity securities, other than exempted securities, registered under Section 12--or a director or officer of that issuer n12 is subject to the liability provisions for short-swing trading under Section 16(b). The duty to report transactions under Section 16(a), however, was not considered to be coextensive with liability under Section 16(b) n13 until the Commission, in 1991, added the definition of "beneficial ownership" and sought to read that definition into the statutory provisions of Section 16(b) to enlarge the number of persons potentially liable for short-swing profits. n14 Despite this attempt to broaden Section 16(b) liability, courts have been unwilling to impose Section 16(b) liability merely because a person was deemed to be an "beneficial owner" for the purposes of the reporting requirements of Section 16(a). n15 Transactions in securities that are exempt from the reporting requirements of Section 16(a), however, are also exempt from liability under Section 16(b). n16

[a] Directors and Officers. A director or officer of an issuer need not occupy that status at the time of both the purchase and sale of the transaction that is subject to Section 16(b). n17 It is sufficient if the director or officer is an insider at the time of the sale, but not at the time of the purchase, n18 or at the time of the purchase, but not at the time of the sale, n19 for Section 16(b) liability to be imposed. However, under the 1991 Rules, the Commission exempted from both Section 16(a) and Section 16(b) transactions that occur prior to a person becoming a director or officer, but not transactions by such persons that occurred prior to the issuer having a class of securities registered under Section 12. n20 A former director or officer continues to be potentially liable if one part of the transaction occurs after he ceases to hold that position. n21 Section 16(b) also does not place liability on a director or officer if both the sale and purchase or both the purchase and sale occurred after he no longer occupied his insider corporate position. n22

[b] Principal Security Holders. Section 16(b) demonstrates a clear Congressional intent to distinguish between corporate directors and officers and principal security holders when determining liability for short-swing trading. n23 The last sentence of Section 16(b) states, in part, that the coverage of Section 16(b) does not extend to any transaction where the more than ten percent beneficial owner "was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved"

The Supreme Court, in *Reliance Electric Co. v. Emerson Electric Co.*, n24 held that a person who purchases more than ten percent of an issuer's stock may reduce his holdings to less than ten percent in an initial transaction and then proceed to sell his remaining holdings in a second transaction, all within a period of less than six months, without incurring liability for the second transaction under Section 16(b), since that person would no longer be an insider at the time of the second sale. In *Reliance*, for example, the defendant had acquired 13.2 percent of a company's outstanding common stock on June 16, reduced its holdings to 9.96 percent of the stock through a sale on August 28, and was held liable for the profits realized pursuant to that sale. The sale of the remaining shares of stock, however, which were sold on September 11, did not subject the defendant to short-swing trading liability, although the sale occurred within the "less than six months" time period, because the defendant was no longer a ten percent beneficial owner at the time of the September 11th sale. n25

The Supreme Court further limited the applicability of Section 16(b) in *Foremost-McKesson, Inc. v. Provident Securities Co.* n26 by requiring that an individual, who is not a director or officer, be a more than ten percent security holder *before* any purchases and sales can be matched for Section 16(b) liability to be imposed. The Court held that the phrase "at the time of the purchase" in Section 16(b) means "before the purchase" and not "immediately after the purchase." n27

An individual, therefore, who acquires more than ten percent of the equity securities of an issuer, and who makes no acquisitions after attaining that percentage, will not be subject to liability under Section 16(b) if he were to make any sales of those securities thereafter. To illustrate, if a person, other than an officer or director, who owns 5 percent of a corporation's outstanding equity securities, acquires an additional 6 percent on January 1, and sells 2 percent of the securities on February 1, he would not be required to account for any profits realized by that sale since he was not a ten percent holder "at the time of purchase" on January 1.

A security holder who is neither a director nor an officer can therefore avoid the applicability of Section 16(b) by carefully structuring his securities transactions to meet the strict statutory requirements of Section 16(b). However, as noted in Section 8.02[2][a][i], addressing this issue has become more complicated, now that the Section 13(d) beneficial ownership standard is applied for purposes of determining insider status and the pecuniary interest standard is applied for purposes of determining which transactions are potentially subject to short-swing liability under Section 16(b). For example, if a person acquires an option that is exercisable for more than 10 percent of a company's equity securities but the option has a floating exercise price, then that person may be subject to Section 16 as a result of the shares underlying the option, but may not be deemed to have purchased those shares for purposes of liability under Section 16(b) until the option is exercised or has a fixed exercise price.

[2] "Purchase and Sale"

Section 16(b) requires that there be a purchase and sale, or sale and purchase, of the equity securities of an issuer registered under Section 12 of the Exchange Act. In determining whether a transaction constitutes a purchase and sale for purposes of Section 16(b), courts have adopted two approaches:

- (1) the objective or mechanistic approach that applies to "ordinary" and voluntary cash-for-stock transactions, and
- (2) the subjective or pragmatic approach that applies to "unorthodox" transactions, *i.e.*, transactions to which it would be unfair to apply Section 16(b).

Since the statutory definition of sale n28 and purchase n29 are broad enough to reach transactions not usually considered to be a sale or purchase, a court in analyzing a "borderline" transaction will look to "whether the transaction may serve as a vehicle for the evil which Congress sought to prevent," *i.e.*, the use of inside information to realize short-swing profits. n30 *After determining that a transaction is "unorthodox," a court, before imposing Section 16(b) liability, will examine the following factors to determine whether the particular transaction provides the opportunity for speculative abuse:*

- (1) whether the defendant had access to inside information, although actual possession of insider information is irrelevant; and
- (2) whether the defendant controlled or influenced the timing of the particular transaction.

Security conversions, exchanges pursuant to mergers and other corporate reorganizations, stock reclassifications, and

dealings in options, rights, and warrants have been defined as unorthodox transactions, n31 although the application of the unorthodox transaction doctrine to convertible securities and options appears to have been preempted by the derivative security rules adopted by the Commission in 1991. The pragmatic approach, however, has never been applied in cases of "garden-variety" cash-for-stock transactions where a purchase or sale has clearly occurred. n32

[a] Gifts. A bona fide gift is not a purchase or sale under Section 16(b) because it does not involve the transfer of value in exchange for a security. n33 In addition, the subsequent sale of securities by the donee would not be attributed to the donor unless the donee had functioned merely as an "alter ego" of the donor. n34

[b] Conversions of Securities. Under the derivative security framework adopted by the Commission in 1991, the conversion of a security into another equity security of a Section 12 issuer (*e.g.*, the conversion of debentures or preferred stock into common stock) is exempt, under most circumstances, from the provisions of Section 16(b). n35 Prior to 1991, the Commission's rules held that a conversion was exempt only if no consideration was paid in connection with the conversion, although courts had, in other circumstances, also held that conversions were not purchases or sales. n36

[c] Corporate Recapitalizations and Simplifications. A recapitalization, in which a corporation exchanges a new security for one of its outstanding securities, typically has not been considered a purchase or sale of new stock under Section 16(b) since:

- (1) all similarly situated shareholders are treated equally;
- (2) shareholder approval of the recapitalization plan is usually required; and
- (3) each shareholder is merely continuing his investment in the issuer in a different form. n37

Such transactions now will typically be exempt under Rule 16a-9, exempting stock dividends including spin-offs, and Rule 16b-7, discussed *infra* at § 8.06[12].

[d] Transfers of Securities Between Affiliates. In *Blau v. Lamb*, n38 the purchase of securities by a corporation that was wholly owned by the defendant insider from a corporation owned 97 percent by the defendant insider was held not to be a purchase under Section 16(b) since no real change in the insider's investment position resulted. In *Blau v. Mission*, n39 the defendant owned more than 10 percent of the shares of an issuer and on two occasions, between which the stock of the subsidiary became listed on the New York Stock Exchange, transferred some of those holdings to its subsidiary in exchange for stock in its subsidiary. n40 The court concluded that while the first exchange was a mere transfer between corporate pockets and was therefore not subject to Section 16(b), n41 the second was a sale for the purposes of that provision, since the subsidiary was no longer an alter ego of its parent and the subsidiary's stock had an independent market value. n42

[e] Stock Options. n43 Prior to 1991, the acquisition of a stock option was not typically viewed as involving a purchase by the optionee under Section 16(b), since receipt of an option does not impose a liability on the grantee to take and pay for the underlying stock, n44 unless the terms of the option leave no doubt that it would be exercised. n45 It was generally held to be the case, however, that the exercise of an option constituted a purchase that was subject to Section 16(b), so that the exercise of an option and sale of the underlying shares within six months could result in short-swing liability.

In 1991, however, the Commission reversed the previous scheme by adopting the derivative security "framework," n46 which equated equity securities with options or other rights to acquire equity securities or rights with a value based on equity securities. n47 The Commission treated a transaction in a derivative security as a transaction in the underlying security because, at least when the derivative security has a fixed exercise price, the derivative security transaction locks in the opportunity to profit from a transaction in the underlying security. n48 In implementing the derivative security

rules, the Commission went so far as to state that *any* acquisition or disposition of a derivative security involves either a purchase or sale. n49 The quid pro quo was that the Commission exempted from Section 16(b) most exercises and conversions of derivative securities. n50 An open issue exists as to whether courts will feel constrained to accept the characterization of every derivative security transaction as involving a purchase or sale, even in the absence of voluntariness and the payment of consideration, or whether some derivative security transactions remain where the unorthodox transaction doctrine would have continued viability. n51

[f] Corporate Reorganizations. The exchange of stock pursuant to a corporate merger is often considered to be a purchase or sale under Section 16(b) since there is the possibility of insiders engaging in speculative abuse through the use of inside information acquired during the course of the merger negotiations.

In *Newmark v. RKO General, Inc.*, n52 RKO, which controlled Frontier Airlines, obtained an option to purchase the controlling shares in Central Airlines and then concluded an agreement to merge Central into Frontier, with Central shareholders to be paid in Frontier stock. The court held that the acquisition of Central stock pursuant to the option, and the subsequent exchange of that stock as a result of the merger, were subject to liability under Section 16(b) since the circumstances indicated an opportunity for speculative abuse. n53 The court based its decision on RKO's position in the merger negotiations that permitted it to take advantage of inside information and influence whether and when the merger took place. n54

Similarly, directors and officers who are involved in merger negotiations can be subject to liability under Section 16(b) concerning the shares acquired in the merger exchange. In *Gold v. Sloan*, n55 two officers who sold shares within six months of a merger were exonerated while a third officer was found liable under Section 16(b). The two officers who escaped liability did not have any connection with the merger negotiations. n56 The third defendant, however, as chief executive officer of the company, was intimately involved in the merger discussions and possessed specific financial information that permitted the possibility of speculative abuse. n57

There is no clear test as to the amount of control of, or involvement in, merger negotiations necessary to impose liability under Section 16(b). An insider who acquires shares as a result of a merger should refrain from any sales during the six month period after the merger, and should have refrained from any purchases during the six month period prior to the merger, to avoid Section 16(b) liability. n58

[g] Tender Offers and Defensive Mergers. n59 The unsuccessful tender offeror that has acquired more than ten percent of the securities of the company that was the subject of the tender offeror's takeover bid may find itself subject to the provisions of Section 16(b).

For instance, if the tender offeror sells the shares acquired in its takeover attempt within six months of their purchase, the tender offeror will be liable for any profits realized from the purchase and sale. n60

In addition, if the target company defeated the takeover attempt by merging defensively with a third corporation, the tender offeror may be required to exchange its shares in the target company for shares in the surviving corporation, in which case the exchange may be deemed a "purchase" and Section 16(b) liability could ensue.

Furthermore, hostile circumstances surrounding many takeover attempts make it likely that a target company will institute a Section 16(b) proceeding to recover profits realized by the tender offeror. n61 Since the tender offeror is usually an outsider, however, the tender offeror may not have had access to the inside information the abuse of which Section 16(b) is designed to prevent. n62

In *Kern County Land Co. v. Occidental Petroleum Corp.*, n63 Kern sought a defensive merger with Tenneco after Occidental had made a tender offer for Kern stock. Occidental, after realizing that its tender offer would be unsuccessful, entered into an option agreement with a subsidiary of Tenneco that gave the subsidiary the right to

purchase the Tenneco stock that Occidental would have been entitled to receive in exchange for its Kern stock holdings when the merger was closed. These stock holdings amounted to more than ten percent of Kern's common stock. Upon the closing of the merger Tenneco's subsidiary exercised this option.

The Supreme Court held that neither the execution of the option agreement nor the exchange by Occidental of Kern stock for shares of Tenneco pursuant to the terms of the merger agreement between Kern and Tenneco constituted a sale by Occidental under Section 16(b).ⁿ⁶⁴ In concluding that the merger exchange did not present the possibility of speculative abuse, the Court relied on two factors:

- (1) the unlikelihood of any access to inside information by Occidental, which as an outsider, was operating in an atmosphere of hostility towards its takeover attempts; and
- (2) the complete inability of Occidental to control the events that resulted in the exchange of Kern stock for shares of Tenneco.ⁿ⁶⁵

The Supreme Court, however, made it clear that its decision in *Kern* did not provide an exemption from Section 16(b) for all exchanges of stock pursuant to a merger.ⁿ⁶⁶

Section 16(b) applies to purchases and sales of securities of the same issuer. Thus, an unsuccessful tender offeror's purchase of stock in the target corporation and subsequent sale of the stock in the successor corporation that it received upon the completion of a defensive merger can not be matched to impose Section 16(b) liability because the securities purchased and the securities sold were not of the same issuer.ⁿ⁶⁷ It may be possible for officers and directors to avoid liability under Section 16(b) for securities disposed of in or acquired through a merger, as a result of the exemption provided under Rule 16b-3, discussed below at Section 8.06[9][b][D].

[h] "Forced" Cash Transactions; Sale by Pledgee. Courts have uniformly rejected "forced sale" defenses to Section 16(b) liability with respect to cash-for-stock transactions by applying a strict test for voluntariness: the seller or purchaser must not retain any degree of control over the transaction.ⁿ⁶⁸ Thus, economic necessityⁿ⁶⁹ or the threat of litigationⁿ⁷⁰ have been held to be insufficient factors for upholding a claim of involuntariness.

The sale of pledged securities by a pledgee-bank to meet the loan obligations of an insider has also been found to have been sufficiently within the insider's control for imposition of liability on the insider under Section 16(b).ⁿ⁷¹

[3] "Any Period of Less Than Six Months"

Under Section 16(b), any purchase and sale, or sale and purchase, of securities occurring within a period of less than six months may be matched to impose liability. Purchases six months prior to and six months after a sale may be matched to that sale.ⁿ⁷² Section 16(b), however, does not take into account fractions of days.ⁿ⁷³ A period of less than six months therefore commences at 12:01 AM on one day and ends at midnight on the day two days prior to the corresponding date on the sixth succeeding month.ⁿ⁷⁴

[a] Time of Purchase or Sale.

Under Section 16(b), the passage of title, the execution of an agreement, or the date selected by the parties to the transaction does not automatically determine when a purchase or sale has occurred. Rather, a purchase occurs when a buyer incurs an irrevocable liability to take and pay for a security, and a sale occurs when a seller incurs an irrevocable liability to deliver and accept payment for a security.ⁿ⁷⁵ The rights and obligations of both parties to the transfer, therefore, must be fixed.ⁿ⁷⁶

[i] Contingent or Conditional Agreements. A contract to purchase or sell securities is not a purchase or sale of those securities under Section 16(b) until there is a firm commitment evidencing that both parties are bound by the

terms of the agreement. n77 If there is a significant condition precedent in an agreement, the purchase or sale will be deemed to occur at the time the transaction is actually closed rather than at the time the agreement was executed. n78 A purchase, for example, is not deemed to have occurred at the time of the agreement to purchase if the agreement is conditioned on the acquisition of a loan from a bank. n79

A division of authority exists on whether shares to be delivered as part of a purchase price based on future contingent events are "purchased" on the date of contract or the date of delivery. In *Booth v. Varian Associates*, n80 the court held that an agreement that committed both parties to an eventual exchange of shares was incomplete since it left the purchase price unfixed. The purchase was held to have occurred on the date of the delivery of the shares because the agreement provided that the price of the shares would be determined on the day prior to closing, which was almost three and one-half years after execution, "thus making the purchase under the contract as much as possible *like a market purchase at the time of closing*." n81 In *Prager v. Sylvestri*, n82 however, the court expressly rejected *Booth* and held that the date of purchase was the date of the merger agreement, although the number of shares to be received in the future was contingent on corporate earnings exceeding specified sums of money.

[b] Rescissions. When both parties agree to rescind a contract for the sale of securities because of incomplete performance, a sale and purchase will not be deemed to have occurred under Section 16(b). n83 If, however, the parties rescind a completed agreement in an attempt to avoid Section 16(b) liability, a sale and purchase will still be considered to have occurred. n84

[4] "Profit Realized"

[a] From the Purchase and Sale of Securities.

The profits realized in a Section 16(b) action are calculated by arbitrarily matching purchases of securities with sales of securities within a six month period to obtain the maximum profit. n85 Profit is calculated by matching the "lowest price in" with the "highest price out" of all transactions within the six month period. n86

Section 16(b) does not require that the shares sold by an insider be identical to those purchased, n87 and it is of no consequence that an insider had an overall loss on all of his combined purchases and sales within a six month period as long as any of the insider's purchases and sales in that period could be matched to reflect a profit. n88 The insider, however, is entitled to a deduction from the calculation of profits for any expenses incurred in conducting the transactions held to be in violation of Section 16(b). n89

If consideration other than cash is given in exchange for a security, the value of that consideration represents the cost of a purchase or sale in computing the profits realized and that value is included in the computation of profits. n90

[i] Prejudgment Interest. Although Section 16(b) does not provide for recovery of interest on profits realized, the allowance of prejudgment interest is within the discretion of the trial court based on considerations of fairness. n91

In general, courts will award interest unless it is shown n92 *that the transactions in violation of Section 16(b) were conducted in "good faith,"* n93 *e.g.,* an innocent or unknowing violation of Section 16(b). n94 Some courts, however, have applied a more stringent standard, requiring that a showing of an "overriding inequity" be made before awarding prejudgment interest. n95 Unexcused or inordinate delay in the litigation of a Section 16(b) claim may result in a denial of prejudgment interest. n96

Interest will usually be accrued from the time of the transaction from which an illegal short-swing profit was realized. n97 Some courts, however, have awarded interest computed from the date of the commencement of the Section 16(b) action. n98

[ii] Dividends. Dividends received on securities held during a six month period in which short-swing trading

occurred will not be part of the profit realized when they are:

(1) declared on stock prior to the purchase of the stock by the insider; or

(2) declared prior to the security holder becoming an insider. n99

There is, however, a division of authority as to whether dividends declared on shares held by the insider during the six month period are recoverable by the issuer in a Section 16(b) action. Some courts have held that dividends are not recoverable unless they are "inextricably connected" with the decision to engage in a short-swing transaction. n100 Thus, if dividends received reflect what would normally be expected to be received by investors, they may not be recovered in a Section 16(b) action. n101 Other courts have held that dividends declared on the actual shares sold at a profit while the defendant was an insider are part of the profit realized. n102 In addition, one court has held that dividends received on the amount of shares equivalent, although not identical, to the amount sold were part of the profit realized. n103

[iii] Control Premiums. Some courts have added a control premium to the computation of profits when a transaction in securities involves the acquisition of control over a company. n104 The premium represents the special value the acquired securities have in granting the insider control over the issuer that the securities would not otherwise have for the ordinary investor. n105

[b] From the Purchase or Sale of Options. The valuation of any profit from the purchase or sale of an option or other derivative security, including a warrant or convertible note, is governed by Rule 16b-6(c). The rule provides that, when matching a purchase and sale of derivative securities with identical characteristics, one looks strictly to the transaction prices. However, when matching transactions in two different securities, or a transaction in a derivative security with an opposite transaction in the underlying security, Rule 16b-6(c)(2) provides that the recoverable profit "shall not exceed" the difference in the underlying security's price on the day of the two transactions. In addition, one "may" value the profits from any such transactions by looking only at the price on the respective trade dates of a derivative security involved in the transaction. n106 Presumably this permissive alternative rule would be used only if it produced a smaller profit than that determined by looking at the prices of the underlying security. In adopting this rule, the Commission noted that "[i]f an insider can demonstrate that the amount of profit was less, then a court can order a lesser recovery." n107 The Commission gave, as an example of an instance where a lesser recovery may be appropriate, an instance where a portion of the profit represented an issuer's matching contribution or other form of compensatory subsidy. n108 Defendants would no doubt also argue that prices paid for the derivative security, representing the value of the right itself as opposed to the value of the underlying security, should be excluded from the calculation. n109

[5] Procedure

[a] Proper Forum.

An action under Section 16(b) "may be instituted at law or in equity in any court of competent jurisdiction." Service of process may be made in any district where the insider is an inhabitant, or is found. n110

[i] Jurisdiction. Section 27 grants exclusive jurisdiction to the federal courts for any action based upon a violation of Section 16(b) or the rules promulgated thereunder.

[ii] Venue. Section 27 provides that an action based upon a violation of Section 16(b) may be brought in any district where:

(1) the defendant is found, is an inhabitant, or transacts business n111 or

(2) any act or transaction constituting the violation took place.

Thus, if either the purchase or sale of securities occurred in a particular district, venue is proper in that district. n112

Venue, however, will not be laid in a district where acts preliminary to the purchase or sale of stock have occurred. n113 There is some question whether venue is limited to the district in which the transaction is consummated, *i.e.*, where both parties made a firm commitment to transfer the securities. n114 If, however, the transaction was executed on a securities exchange, an action under Section 16(b) may be brought in the district where the exchange is located. n115 In addition, an action for attorney's fees under Section 16(b) can be maintained in any district where the substantive Section 16(b) suit could have been brought. n116

[6] Who May Institute an Action?

An issuer may bring an action under Section 16(b) to recover profits realized by an insider on short-swing trades. If the issuer declines to bring a Section 16(b) suit within sixty days after being requested by a security holder to do so, n117 or if the issuer does not diligently prosecute a Section 16(b) action, the owner of *any security* of that issuer may institute the action on behalf of the issuer. n118

Section 16(b)'s requirement that the security holder request the issuer to institute an action to recover profits will be waived if the security holder can establish that a request upon the issuer for the institution of the action would be futile, n119 *e.g.*, when the insiders accused of short term transactions are in control of the issuer. n120 In addition, if the statute of limitations would bar a Section 16(b) action before the expiration of the sixty day period, the security holder will be relieved of complying with the demand requirement. n121

Section 16(b) permits a security holder to intervene in an action brought by the issuer if the issuer fails to diligently prosecute the suit. The courts have adopted a liberal policy of permitting intervention in Section 16(b) cases. n122

A security holder has the right to institute a Section 16(b) action regardless of the good faith or reasonable business judgment of the issuer's board of directors in deciding not to bring the suit. n123 The Commission, however, has no authority to seek any relief under Section 16(b). n124

An action brought under Section 16(b) is not subject to Rule 23.1 of the Federal Rules of Civil Procedure, regulating derivative actions by shareholders, which requires the plaintiff to be a security holder at the time the transactions constituting the violation of Section 16(b) occurred. n125 The plaintiff may therefore purchase a security subsequent to the time of the alleged illegal transactions and still have standing to institute a Section 16(b) action. The motive of the plaintiff in acquiring the securities is irrelevant, even if he makes a token purchase merely to bring a Section 16(b) action. n126 It is also of no consequence for the purposes of a Section 16(b) action that the plaintiff's interest in the issuer is insubstantial n127 or that the plaintiff purchased the securities on a margin account and those securities remained in the name of the broker until that account was settled. n128 Finally, ownership of an issuer's debt securities constitutes a sufficient interest to institute a suit. n129

A Section 16(b) cause of action has been held to be a property right and assignable by the issuer. n130 The cause of action also can not be abated by the death of the defendant. n131

Since Section 16(b) grants standing after demand on the issuer to owners of any security *of the issuer*, there was a question whether a security holder that has instituted an action under Section 16(b) must maintain his status as a security holder of that issuer throughout the pendency of the suit. In *Rothenberg v. United Brands Company*, n132 the Second Circuit, in dismissing the complaint, held that the plaintiff lost his status as a security holder of the issuer, and therefore his standing to maintain an action under Section 16(b), when he accepted cash for his stock upon the merger of the issuer into another corporation. n133 However, in *Gollust v. Mendell*, the Supreme Court held that a security holder of the issuer who commenced an action under Section 16(b) could maintain that action after his interest in the issuer

was exchanged in a merger for stock in the issuer's new parent company. n134 However, the Supreme Court made it clear that a shareholder of a parent of an issuer would not have standing to commence an action under Section 16(b). n135

[7] Defenses; Counterclaims; Settlements

Since Section 16(b) imposes strict liability on insiders who violate its prohibition on short-swing trading, if all the terms of the statute are met, there are no defenses available except for the running of the statute of limitations.

[a] Statute of Limitations. Section 16(b) provides that no suit may be brought more than two years after an insider has realized a profit on short-term trading, that is, the date on which the second of a matched pair of transactions, either a purchase or sale, is completed. The statute of limitations begins to operate from the time the consideration for the transaction is received by the insider, not the time when the consideration is reduced to cash. n136 The statute of limitations, however, may be tolled if the insider has not filed the reports required to be filed under Section 16(a). n137

[b] Demand Upon the Issuer. Although Section 16(b) permits a shareholder to bring an action only if the issuer has not instituted the action within sixty days of being requested to do so, the demand requirement exists for the benefit of the issuer. The insider-defendant, therefore, cannot claim as a defense that the plaintiff failed to make a demand upon the issuer. n138

[c] Waiver and Estoppel. Section 29(a) of the Exchange Act prohibits an issuer from waiving compliance with any of the Exchange Act's provisions, including Section 16(b). n139

The defense of equitable estoppel also is not available in a Section 16(b) action, so that claims that the prohibited transaction occurred at the initiative of the issuer, n140 was participated in by the issuer, n141 or benefited the issuer n142 *are insufficient as a matter of law to defend a Section 16(b) claim. Similarly, the approval by the shareholders of the issuer of the prohibited transaction is not a defense available to the insider.* n143 However, transactions between an officer or director and the issuer occurring after August 15, 1996 that are approved by shareholders, may be exempt under Rule 16b-3. n144

[d] Counterclaims. A defendant in Section 16(b) action will not be permitted to file a counterclaim against the issuer for whose benefits the action was commenced if the counterclaim is unrelated to the transactions that are the subject of the action. n145

[e] Settlements. The settlement of a Section 16(b) action will be permitted upon a finding by a court that the settlement is fair and reasonable n146 and the result of a compromise through good faith negotiations. n147 In general, however, a settlement for an amount less than the maximum potential amount recoverable under the Section 16(b) action will not be approved unless a significant obstacle to recovery by the plaintiff or "sufficiently substantial defenses," or both, exist. n148 Payment by an insider of an issuer's claims under Section 16(b), outside of a judicially-approved settlement, will not bar a subsequent action by a stockholder for the recovery of the profits that were the subject of the suit for which the settlement was made, although the settlement payment may be deducted from any amount for which the insider may be found liable. n149

Some courts have added two requirements from Rule 23 of the Federal Rules of Civil Procedure, governing settlement of class actions, to the process of settling Section 16(b) claims: notice of the proposed settlement to all other security holders of the issuer, usually by newspaper publication, and the opportunity for a hearing prior to the approval of the settlement. n150

[8] Attorney's Fees

A security holder and his attorney are entitled to recover the reasonable value of attorney's fees incurred in the recovery

of profits realized by an insider in violation of Section 16(b). n151 In addition, reimbursement for work performed in discovering and informing a corporation of an insider's violations of Section 16(b) may be obtained by the security holder and his attorney, even if the corporation recovered the profits without bringing a suit, when it appears that the corporation would not otherwise have discovered the violation. n152

To encourage enforcement of the statute, courts have granted substantial allowances for attorney's fees in proportion to the time spent on and the complexity of the litigation, and the profits recovered. n153 If intervention by a security holder in a Section 16(b) action is permitted, the allocation of attorneys' fees is dependent upon the relative contribution of each attorney to the proceedings. n154

Since a security holder's interest in any ultimate corporate recovery is usually too small to provide an incentive to institute an action under Section 16(b), the possibility of attorney's fees will often be the sole motivation for bringing a suit. n155 A suit for attorney's fees is a remedial incident of an action brought under Section 16(b) and is not separately subject to the requirements for federal jurisdiction. n156

FOOTNOTES:

(n1)Footnote 1. For discussion of who is subject to liability under Section 16(b), *see* § 8.04[1] *infra*.

(n2)Footnote 2. For discussion of the manner of computing profits realized under Section 16(b), *see* § 8.04[4] *infra*.

(n3)Footnote 3. For discussion of "purchase" and "sale" for purposes of Section 16(b), *see* § 8.04[2] *infra*.

(n4)Footnote 4. For discussion of an issuer's equity securities, *see* § 8.03[2] *supra*.

(n5)Footnote 5. For discussion of exempted securities for purposes of Section 16(b), *see* § 8.06 *infra*.

(n6)Footnote 6. For discussion of the "less than six months" time period, *see* § 8.04[3] *infra*.

(n7)Footnote 7. Section 16(b). *See also*, § 8.06[15] *infra* (discussing the exemption for securities acquired in connection with a debt previously contracted).

(n8)Footnote 8. Section 16(b).

In addition to Section 16(b), Section 10(b) and *Rule 10b-5* promulgated thereunder, which prohibits "any manipulative or deceptive device or contrivance," also serves to curb insider trading abuse, although *Rule 10b-5* is in many respects much broader in scope than the provisions of Section 16(b):

- (1) *Rule 10b-5* applies to *any* person, not merely to a statutory insider;
- (2) *Rule 10b-5* applies to the purchase or sale of *any* security and is not limited to an equity security that is registered pursuant to Section 12;
- (3) *Rule 10b-5* requires a purchase *or* a sale of any security for liability to be imposed; Section 16(b) requires both a purchase *and* a sale; and
- (4) A violation of *Rule 10b-5* is not limited to a transaction occurring "within any period of less than six

months" as would be required for an action under Section 16(b).

The burden of proof in an action under Section 16(b), however, is easier to satisfy than in an action under Rule 10b-5. A plaintiff under Section 16(b) need only show that a purchase and a sale occurred within a period of less than six months for absolute liability to be imposed, see § 8.04[3] *infra*, while under Rule 10b-5 the plaintiff must show that the insider actually traded on the basis of inside information.

See Feldman & Teberg, *Beneficial Ownership Under Section 16 of the Securities Exchange Act of 1934*, 17 W. Res. L. Rev. 1054, 1064 (1966); Note "Beneficial Ownership" Under Section 16(b) of the Securities Exchange Act of 1934, 77 Colum. L. Rev. 446, n.5 (1977).

For a detailed discussion of civil liability under Rule 10b-5, see § 5.04 *supra*.

In addition to an action under Section 16(b) or Rule 10b-5, insider trading abuse may be subject to liability under state law. See, e.g., *Diamond v. Oreamuno*, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969); 10 Cavitch, *Business Organizations*, § 127.02[2].

(n9)Footnote 9. Section 16(b).

For discussion of the institution of an action by the corporation, or by a security holder on the corporation's behalf, to recover an insider's short-swing profits, see § 8.04[6] *infra*.

(n10)Footnote 10. See *supra* text accompanying notes 1-7.

Attacks on the constitutionality of Section 16(b) on the grounds that it allows the taking of property without due process has been rejected by the courts. See *Gratz v. Claughton*, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947); *Smolowe v. Delendo Corp.*, 46 F. Supp. 758 (S.D.N.Y. 1942), *aff'd*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

For discussion of the Insider Trading and Securities Fraud Enforcement Act of 1988, see § 1.01[2][J] *supra*.

(n11)Footnote 11. "You hold the director, irrespective of any intention or expectation to sell the security within six months after, because it will be absolutely impossible to prove the existence of such intention or expectation, and you will have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing." Hearings on Stock Exchange Practices before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 6557 (1934); See also S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934).

(n12)Footnote 12. For discussion of who is an insider under Section 16, see § 8.02 *supra*.

(n13)Footnote 13. Note, "Beneficial Ownership" under Section 16(b) of the Securities Exchange Act of 1934 *supra*, note 8, at 456.

See *Lewis v. Mellon Bank*, 513 F.2d 921, 923 (3d Cir. 1975) ("We believe that Congress intended Sections 16(a) and 16(b) to operate independently."); *Marquette Cement Manufacturing Co v. Andreas*, 239 F. Supp. 962, 967 (S.D.N.Y. 1965) ("Section 16(a) and the regulations thereunder establish reporting standards for insiders. They have only slight significance in assessing insider liability under Section 16(b)" (emphasis supplied)); *Schafer ex rel. Hill Stores Co. v. Dichenstein & Co.*, 1996 U.S. Dist. LEXIS 4009, at *16.

But see, *Whiting v. Dow Chemical Co.*, 386 F. Supp. 1130, 1137 (S.D.N.Y. 1974), *aff'd*, 523 F.2d 680 (2d Cir. 1975)

("The policies of automaticity and prophylaxis which underlie § 16(b) demand that the financial dealings of each spouse in the securities of a corporation of which one is an insider be attributable to the insider, where it is shown that the insider beneficially owns the spouse's stock for purposes of § 16(a) reports.").

For discussion of the reporting requirements of beneficial ownership of a spouse's stock, see § 8.02[2][a][i] *supra*.

For discussion of the broad scope of Section 16(a), which includes discovery of short-swing trading under Section 16(b), see § 8.03. *supra*.

(n14)Footnote 14. See § 8.03[3][a] *supra*.

(n15)Footnote 15. See *e.g.*, *Mendell v. Gollust*, 793 F. Supp. 474, 481 (S.D.N.Y. 1992) (citing cases in which the Supreme Court has declined opportunities to broaden § 16(b) liability: *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232 (1976); *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973); *Reliance Elec. Co. v. Emerson Elec. Co.*, 404 U.S. 418 (1972); and *Blau v. Lehman*, 368 U.S. 403 (1962)); Sec. Exch. Act Rel. No. 34-9499, Fed. Sec. L. Rep. (CCH) P 78,553 (1972).

(n16)Footnote 16. Rule 16a-10.

For discussion of the exemptions from Section 16(b), see § 8.06 *infra*.

(n17)Footnote 17. *But see* *Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc.*, 527 F.2d 335, (7th Cir. 1975), *cert. denied*, 423 U.S. 1078 (1976), in which the court indicated in dicta that it would not hold a director or officer liable unless he was an insider prior to the initial purchase or sale. The Supreme Court in *Foremost-McKesson, Inc. v. Provident Securities Co.*, however, would not express its views with respect to this reasoning, relying instead on the exemptive provision in Section 16(b) as to more than ten percent security holders. *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. at 243, n.16.

(n18)Footnote 18. See *Steel Partners II, L.P. v. Bell Indus.*, 315 F.3d 120, 127 n.1 (2d Cir. 2002); *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959); *Marquette Cement Manufacturing Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965); *Blau v. Allen*, 163 F. Supp. 702 (S.D.N.Y. 1958).

(n19)Footnote 19. *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir. 1969).

In *Sullair Corp. v. Hoodes*, Fed. Sec. L. Rep. (CCH) P 93,568 (N.D. Ill. 1987), the court granted plaintiff's motion for summary judgment and awarded the plaintiff \$11,350 from insider profits realized by the company's former chairman and chief executive officer. The court noted that the defendant's contention that he should not be liable because the corporation had made up its mind to terminate him three days prior to his initial sale ignored the strict nature of Section 16(b).

(n20)Footnote 20. See Rule 16a-2(a) and § 8.03[4][c][i] *supra*.

(n21)Footnote 21. See Rule 16a-2(b) and § 8.03[4][c][ii] *supra*.

(n22)Footnote 22. See *Lewis v. Mellon Bank*, 513 F.2d 921 (3d Cir. 1975); *Lewis v. Varnes*, 505 F.2d 785 (2d Cir. 1974).

However, in *Winston v. Federal Express Corp.*, Fed. Sec. L. Rep. (CCH) P 93,948 (6th Cir. 1988), the court held that a senior vice president who resigned on August 27, 1985, effective September 30, 1985, and had no contact with the company in the interim period was liable for short swing profits on stock he purchased from the company on September 30, 1985 and sold on March 26, 1986. It was uncontroverted that the officer did not receive any confidential information between his resignation and its effective date, but the court found that this was inconsequential since he did not carry

the burden of proof to overcome the strong presumption that he had potential *access* to confidential information during the interim period and that had he requested such information it would not have been withheld from him.

(n23)Footnote 23. See Hearings on Stock Exchange Practices, *supra* note 11, at 6556.

In *Foremost-McKesson, Inc. v. Provident Securities Co.*, 423 U.S. 232, 96 S. Ct. 508, 46 L. Ed. 2d 464 (1976), the Supreme Court stated:

"The legislative discourse revealed that Congress thought that all short-swing trading by directors and officers was vulnerable to abuse because of their intimate involvement in corporate affairs. But trading by mere stockholders was viewed as being subject to abuse only when the size of their holdings afforded the potential for access to corporate information." (Footnote omitted.)

423 U.S. at 253-54.

(n24)Footnote 24. 404 U.S. 418 (1972).

(n25)Footnote 25. The Court applied an "objective standard" interpretation of Section 16(b) in holding that the statute was designed to curb insider abuse regardless of the intent of the insider or the existence of speculative abuse provided the statutory conditions of Section 16(b) were met. 404 U.S. at 422. On the other hand, the Court would not impose liability simply because the insider "structured his transaction" with the intent of avoiding liability if the method of avoidance was permitted by statute. *Id.*

The Court also noted that the Commission's rules required the same interpretation. 404 U.S. at 426, *C.C.H. Fed. Sec. L. Rep. at p. 91,753*. The Commission's reporting rules now clearly limit a 10% shareholder's liability to transactions occurring while it holds such status. See Rule 16a-2(c). A Form 4 would not have had to be filed when the defendant's holdings dropped to 9.96% of the outstanding shares. Since a transaction that is exempt from the reporting requirements of Section 16(a) is exempt from liability under Section 16(b), see Rule 16a-10, the defendant could not incur Section 16(b) liability when he made the September 11th sale. 404 U.S. at 425, *C.C.H. Fed. Sec. L. Rep. at p. 91,753*.

However, in *Reece Corporation v. Walco National Corporation*, Fed. Sec. L. Rep. (CCH) P 98,289 (S.D.N.Y. 1981), the first reported case since *Reliance* dealing with an attempt to structure a sale of stock in phases to avoid Section 16(b) liability, the court found the division of a single transaction into two "sales" to be "wholly artificial and contrived" since, unlike *Reliance*, in which there were two separate sales to two different buyers that were not tied together in any manner, the *Reece* transaction involved a single plan of disposition negotiated by the defendant with the same buyer. Fed. Sec. L. Rep. (CCH) at 91,846. In *Reece* the transaction was structured so that one "sale" would not be carried out without the other, although there had been no "express legal tie" between the two phases. *Id.*

(n26)Footnote 26. 423 U.S. 232 (1976).

(n27)Footnote 27. The Court traced the legislative history of the exemptive provision of Section 16(b) to find that in a purchase-sale sequence, a beneficial owner would be liable only if he was a beneficial owner "before the purchase," *i.e.*, a time when he presumptively had access to inside information:

"... the crucial point in the acquisition of securities is not the technical 'purchase,' but rather the decision to make the acquisition. In the case of an acquisition of a large block of a corporation's stock, that decision may precede the 'purchase' by a considerable period of time ... well in advance of the event that is presumed to afford access to inside information."

423 U.S. at 254 n. 28.

In *Piano Remittance Corp. v. Reliance Financial Services Corp.*, 618 F. Supp. 414, Fed. Sec. L. Rep. (CCH) P 92,320 (S.D.N.Y. 1985), the court held that a holder of 9.3% of an issuer's shares who placed an order with its broker for a block purchase of an additional one million shares that raised the shareholder's interest in the issuer to 12.2% could be liable for Section 16(b) short swing profits since:

(1) the block buy was executed in separate purchases over a period of several days and could not therefore be treated as a unified transaction; and

(2) the plaintiff may be able to show that the purchaser was not irrevocably committed to the entire purchase when all the orders were placed and that the purchaser was liable for profits on shares acquired after the ten percent level was reached.

(n28)Footnote 28. "The terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of." Section 3(a)(14).

In *Colan v. Cutler-Hammer, Inc.*, Fed. Sec. L. Rep. (CCH) P 92,826 (N.D. Ill. 1986), *aff'd*, 812 F.2d 357 (7th Cir. 1987), the court found that the evidence did not support the plaintiff's allegation that pursuant to a secret agreement between a tender offeror and a shareholder of the target company, the merger between the companies was delayed to avoid liability of the shareholder under Section 16(b). The court observed, however, that even if the existence of a secret agreement was proved, no "sale" of the target's shares was made, since there was no "irrevocable commitment" and no fixing of the rights and obligations of the target company shareholder with respect to the sale of its shares.

In *Lewis v. Bradley*, 599 F. Supp. 327 (S.D.N.Y. 1984), the court held that an informal agreement to sell a director's shares to the issuer after the director's retirement as a director did not constitute a sale within the meaning of Section 16(b). The court observed that whether a "sale" has been made depends on whether an insider has incurred an "irrevocable liability" to dispose of his stock, so that his rights and obligations have become fixed. Applying that standard, the court declined to find that a sale had been made, since the parties had never discussed price. In the absence of a fixed price, the court found, the seller's rights and obligations could not be determined in any meaningful sense in terms of the statute's purpose to thwart short-swing speculation based on inside information. *See also Tristar Corp. v. Freitas*, 867 F. Supp. 149, 152-53 (E.D.N.Y. 1994) (finding that a loan agreement had the indicia of an installment sales contract and was a sale for 16(b) purposes where defendants were contractually bound to purchase).

(n29)Footnote 29. "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire." Section 3(a)(13).

(n30)Footnote 30. *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 594 (1973), discussed in § 8.04[2][g] *infra*.

(n31)Footnote 31. II Loss, *Securities Regulation* (2d ed. 1961, Supp. 1969), at 1069.

See Pay Less Drug Stores v. Jewel Cos, Inc., 579 F. Supp. 1396 (N.D. Cal. 1984) (stock option); *see also Kay v. ScienTex Corp.*, 719 F.2d 1009 (9th Cir. 1983) (overissuance of 673,000 shares to an insider in connection with a stock ownership dispute was an unorthodox transaction that constituted a purchase under Section 16(b) since the transaction was voluntary and the recipient engaged in short-swing sales within a six-month period).

But see Colan v. Prudential-Bache Securities, Inc., 557 F. Supp. 1074 (N.D. Ill. 1983), discussed in note 66 *infra* (pragmatic approach applied to merger that was characterized as an unorthodox transaction).

In *Heit v. Katz*, Fed. Sec. L. Rep. (CCH) P 96,405 (S.D.N.Y. 1978), the court concluded that a transfer of stock to an

insider by an issuer in return for a non-recourse note payable in five years was an unorthodox transaction since it was the equivalent of a call option. Although the stock was transferred to the defendant's name and he could vote the stock, it was not "an instrument with potential for speculative abuse" since he could not dispose of it and was not entitled to distributions or dividends on the stock. *Id.* at 93,448.

(n32)Footnote 32. *Tyco Laboratories, Inc. v. Cutler-Hammer, Inc.*, Fed. Sec. L. Rep. (CCH) P 97,370, at 97,474 (S.D.N.Y. 1980).

In *Super Stores, Inc. v. Reiner*, 737 F.2d 962 (11th Cir. 1984), the court held that a transaction involving short swing profits, in which a corporate officer/director facing defeat in a tender offer battle voluntarily tendered his stock acquired less than six months earlier to his opponents for cash, was subject to Section 16(b) liability.

See also *Gund v. First Florida Banks, Inc.*, 726 F.2d 682 (11th Cir. 1984), discussed in note 36 *infra*; *Lane Bryant, Inc. v. Hatleigh Corp.*, 517 F. Supp. 1196 (S.D.N.Y. 1981) (sale of stock for cash by an insider to the issuer following the insider's decision not to pursue a contest for control was an orthodox transaction subjecting the insider to automatic Section 16(b) liability).

In *Cutler-Hammer, Inc. v. Leeds & Northrup Co., Inc.*, 469 F. Supp. 1021 (E.D. Wis. 1979), the court held that a purchase and sale of securities by an insider were subject to Section 16(b) although

(1) the purchase and sale was subject to the approval of the issuer, and

(2) the sale was prompted by the issuer's intent to merge, an action over which the insider had no control.

See also *Blau v. Albert*, 157 F.Supp. 816 (S.D.N.Y. 1957) (transfer of stock for services provided subject to Section 16(b)); *Lewis v. Adler*, 331 F.Supp. 1258 (S.D.N.Y. 1971)(transfer of stock as compensation for money loaned subject to Section 16(b)).

(n33)Footnote 33. *Portnoy v. Memorex Corp.*, 667 F.2d 1281 (9th Cir. 1982) (bank's transfer of warrants to a charitable organization was not a "sale," and charitable organization's acquisition of warrants was not a "purchase," for the purposes of Section 16(b), since the definitions of purchase and sale do not include gifts); *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949); *Blau v. Albert*, 157 F. Supp. 816 (S.D.N.Y. 1957); *Lewis v. Adler*, 331 F. Supp. 1258 (S.D.N.Y. 1971).

In *Truncale v. Blumberg*, 80 F. Supp. 387 (S.D.N.Y. 1948), the court rejected the argument that a gift to a charitable foundation should be considered a sale since the donor received a tax deduction for the transaction.

(n34)Footnote 34. *Truncale v. Blumberg*, 83 F. Supp. 628 (S.D.N.Y. 1949) .

(n35)Footnote 35. Rule 16b-(6)(b).

(n36)Footnote 36. In *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (1965 3d Cir.), the court strictly applied the definitions of "purchase" and "sale" and the provisions of Section 16(b) to hold that the conversion of convertible debentures into common stock involved a "sale" of the debentures and the "purchase" of the common. This reasoning was rejected by the Second Circuit in *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966) , *cert. denied*, 385 U.S. 1002 (1967) .

In *Gund v. First Florida Banks, Inc.*, 726 F.2d 682 (11th Cir. 1984), the court held that the sale by an insider of a convertible security followed within six months by the purchase of the underlying security was subject to Section 16(b). The court also held that the transaction clearly fell within the language of Section 16(b) and refused to apply the pragmatic approach and to analyze whether there was a potential for speculative abuse.

In *Ferraiolo v. Newman*, 259 F.2d 342 (6th Cir. 1958), cert. denied, 359 U.S. 927 (1959), a conversion of convertible preferred stock into common stock was held not to be subject to Section 16(b) since the insider had no control over the decision of the issuer to call convertible securities for redemption and the failure of the security holder to convert would have resulted in his losing a substantial portion of his investment. The court also noted that the securities exchanged were economic equivalents, all preferred shareholders were treated alike, full disclosure was made to them, and the conversion did not materially change the proportional equity ownership in the issuer. 259 F.2d at 345-46.

See also *Petteys v. Butler*, 367 F.2d 528 (8th Cir. 1966), cert. denied, 385 U.S. 1006 (1967); *Lynam v. Livingston*, 276 F. Supp. 104 (D. Del. 1967).

In *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir.), cert. denied, 332 U.S. 761 (1947), the court held that a redemption of preferred stock for common stock was a "purchase." The insiders in *Park & Tilford*, however, had complete control of the issuer and could therefore determine when the redemption would be called. 160 F.2d at 986.

In *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966), defendant Lamb had received convertible preferred stock in Air-Way Industries, Inc., a corporation that he controlled as a result of a merger of another Lamb company into Air-Way. The Second Circuit refused to infer the existence of an opportunity for speculative profit from control alone, and examined the transaction to determine whether the possibility of speculative abuse existed. 363 F.2d at 521. The court concluded, after focusing on the economic equivalence of the transactions, that the new stock was not appreciably more marketable than the old stock and, although the new stock increased the voting power of the insiders and paid greater dividends than the preferred, the exchange did not present the insiders with trading advantages. 363 F.2d at 522-23.

See also *Hayes v. Sampson*, Fed. Sec. L. Rep. (CCH) P 97,693 (S.D.N.Y. 1980), in which the court held that the conversion of "Old Debentures" into "New Debentures" was not subject to Section 16(b) although the "New Debentures" differed in repayment characteristics. Specifically, the "New Debentures"

- (1) were not convertible into common stock,
- (2) had a lower face value principal amount,
- (3) had a higher interest yield, and
- (4) had a different maturity date.

Fed. Sec. L. Rep. (CCH) at 98,644.

See also *Blau v. Max Factor & Co.*, 342 F.2d 304, (9th Cir. 1965), in which the court concluded that an exchange of common stock for substantially similar Class A stock pursuant to a conversion right by members of a family that controlled the issuer was not subject to Section 16(b) since

- (1) the insiders' investment in the issuer was long term,
- (2) the exchange did not interrupt the continuity of the insiders' investment or increase or decrease the amount invested, and
- (3) no investment risk was taken by the insiders.

(n37)Footnote 37. *See Roberts v. Eaton*, 212 F.2d 82 (2d Cir.), *cert. denied*, 348 U.S. 827 (1954), the court described the third factor listed in the text above as essential, although it relied on the cumulative effect of all three factors in reaching its decision. 212 F.2d at 86 .

See also *Rothenberg v. United Brands Co.*, Fed. Sec. L. Rep. (CCH) P 96,045 (S.D.N.Y.), *aff'd*, 573 F.2d 1295 (2d Cir. 1977) , which involved a recapitalization plan approved by the shareholders subsequent to a successful tender offer, in which the tender offeror's shares were converted into "Class A Common Stock" with greater voting rights, while all other outstanding stock was converted into "special convertible cumulative and preferred" with greater dividend rights. The court, relying on the continued investment position of the tender offeror and that the conversion did not involve a new investment, held that the conversion was not a "sale" under Section 16(b), although the tender offeror received significant economic benefits as a result of the exchange in that it was entitled to file a consolidated tax return permitting it to obtain enormous tax savings in addition to being able to elect 80% of the board of directors. Fed. Sec. L. Rep. (CCH) at 91,694.

In *Blau v. Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951), the receipt of stock in a parent corporation in exchange for stock in a subsidiary pursuant to a plan of corporate simplification was held to be a "purchase" under Section 16(b) where the insider had the option to dissent from the plan and receive cash instead.

(n38)Footnote 38. *See supra* note 36.

(n39)Footnote 39. 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954).

(n40)Footnote 40. 212 F.2d at 79 .

(n41)Footnote 41. *Id. at 80* . The defendants's beneficial interest in the issuer was not changed since it received an indirect interest exactly equal in value to what it gave up in direct interest. *Id.*

(n42)Footnote 42. *Id. at 81* .

(n43)Footnote 43. *See* § 8.06[9][c] & [d] *infra*, for discussion of rule 16b-3, exempting from Section 16(b) the acquisition of stock, stock options, and stock appreciation rights in transactions between an officer or director and an issuer.

(n44)Footnote 44. *See* *B.T. Babbitt, Inc. v. Lachner*, 332 F.2d 255 (2d Cir. 1964); *Silverman v. Landa*, 306 F.2d 422 (2d Cir. 1962); *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir. 1949); *Levy v. Seaton*, 358 F. Supp. 1 (S.D.N.Y. 1973).

See also *Heit v. Katz*, Fed. Sec. L. Rep. (CCH) P 96,405 (S.D.N.Y. 1978), discussed in note 31 *supra* (transaction in which a note given for securities construed to be a call option).

The grant or acquisition of a stock option must be reported by an insider under Section 16(a). Rule 16a-6(a).

(n45)Footnote 45. *See Bershad v. McDonough*, 428 F.2d 693 (7th Cir. 1970), the court listed the following circumstances as indicating that the stock was effectively transferred at the grant rather than at the exercise of the option:

- (1) a \$350,000 binder paid for the option that represented over 14 percent of the total purchase price of the stock;
- (2) the placement of the stock in escrow;
- (3) the vesting of the voting rights of the stock in the optionee; and

(4) the resignation of the optioner from the board of directors and the appointment of optionee representatives to the board.

(n46)Footnote 46. Exch. Act Rel. No. 28869, Part III (Feb. 8, 1991) (the Commission noted that the derivative security framework "not only reverses the Commission's own [prior] regulatory approach but also differs from a line of cases ...").

(n47)Footnote 47. See Rule 16a-4.

(n48)Footnote 48. "Just as an insider's opportunity to profit commences when he purchases or sells the issuer's common stock, so too the opportunity to profit commences when the insider engages in transactions in options or other derivative securities that provide an opportunity to obtain or dispose of the stock at a fixed price." Exch. Act Rel. No. 28869, at n.97.

(n49)Footnote 49. Rule 16b-6(a).

(n50)Footnote 50. Rule 16b-6(b).

(n51)Footnote 51. The staff has acknowledged that the unorthodox transaction doctrine has some continued validity. ConAgra, SEC No-Action Letter (Jan. 2, 1992).

(n52)Footnote 52. 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970).

(n53)Footnote 53. 425 F.2d at 354.

In *Colan v. Cutler-Hammer, Inc.*, Fed. Sec. L. Rep. (CCH) P 98,294 (N.D. Ill. 1981), the court found that the defendant-insider, who was an ally of the issuer in the issuer's campaign to retain control, sold its stock in the issuer at the time the issuer became irrevocably bound to a merger, although the defendant-insider was unable to control the course of events leading to the merger with another company. The court found that a strong possibility for speculative abuse of inside information existed under the circumstances since the chairman of the board of the issuer was also on the board of the defendant-insider. Fed. Sec. L. Rep. (CCH) at 91,860.

(n54)Footnote 54. 425 F.2d at 354. The "economic equivalence" test applied in *Blau v. Lamb* could not be applied in this instance since the test is applicable only to exchanges of securities of the same issuer. *Id.*

(n55)Footnote 55. 486 F.2d 340 (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974).

(n56)Footnote 56. 486 F.2d at 351. It is doubtful whether these two individuals would be considered insiders under the Commission's 1991 rule revisions that defined "officer" to mean "executive officer." Rule 16a-1(f).

See also *Morales v. Arlen Realty & Development Corp.*, Fed. Sec. L. Rep. (CCH) P 93,730 (S.D.N.Y. 1973).

(n57)Footnote 57. 486 F.2d at 351-52.

(n58)Footnote 58. Dietz, *A Practical Look at Section 16(b) of the Securities Exchange Act*, 43 *Ford. L. Rev.* 1, 30 (1974).

(n59)Footnote 59. See, generally, Ribstein, *The Application of Section 16(b) of the Securities Exchange Act of 1934 to Tender Offers*, 31 *Sw. L. J.* 503 (1977).

(n60)Footnote 60. The tender offeror, however, must be a more than ten % shareholder *before* the purchase that is

being matched with a subsequent sale for Section 16(b) purposes. See § 8.04[1] *supra*. Thus, if all the acquisitions made pursuant to a tender offer are deemed to be a single purchase, a tender offeror who was not a more than ten % shareholder prior to the making of the tender offer would not be liable under Section 16(b) for any subsequent sales of shares acquired pursuant to the tender offer. Whether tender offer acquisitions constitute a single purchase or a series of purchases is still unresolved. Ribstein, *supra* note 59, at 506.

In *Sterman v. Ferro Corp.*, Fed. Sec. L. Rep. (CCH) P 92,503 (6th Cir. 1986), the court held that where an issuer repurchased the shares of a principal security holder to avoid a potential tender offer by that security holder, and an amount was added to the base repurchase price equivalent to the amount that the security holder would be required to disgorge under Section 16(b) as a result of the repurchase, and after completion of the transaction the security holder repaid the latter amount to the issuer, the security holder had no further liability under Section 16(b).

See also *Morales v. Lukens, Inc.*, Fed. Sec. L. Rep. (CCH) P 91,676 (S.D.N.Y. 1984).

(n61)Footnote 61. *Ribstein, supra*, note 59, at 503.

(n62)Footnote 62. *Id.* at 504.

(n63)Footnote 63. 411 U.S. 582 (1973).

(n64)Footnote 64. 411 U.S. at 590-91. No liability was asserted by Kern as to the exercise of the option by Tenneco's subsidiary since the exercise occurred more than six months after Occidental's last purchase of Kern stock. *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. at 596, n.28 (1973).

(n65)Footnote 65. 411 U.S. at 600. The court found that Occidental had no real alternative to the exchange, *e.g.*, the merger did not provide for appraisal rights once the merger had been approved. *Id.*

(n66)Footnote 66. *Id.*

In *Heublein, Inc. v. General Cinema Corp.*, 722 F.2d 29 (2d Cir. 1983), the court held that as a matter of law, there was no "sale" for purposes of creating short-swing sale liability under Section 16(b) where a shareholder who owned more than 10% of a company's stock was forced to exchange that stock as the result of merger. The Court stated that where the exchange is the involuntary result of a merger, and there is not likelihood of access to material inside information, Section 16(b) will not apply.

See also *Texas International Airlines v. National Airlines, Inc.*, Fed. Sec. L. Rep. (CCH) P 99,488 (5th Cir. 1983) in which the court held that the defendant, a more than ten % owner of an issuer's stock, could not claim lack of access to inside information as a defense to a Section 16(b) action when the defendant, realizing it had lost a battle for control of the issuer, sold shares of the issuer to the issuer's merger partner prior to the merger "going through" and within six months of purchases since the *Kern* exception to Section 16(b) liability for unorthodox transactions does not apply to traditional cash-for-stock transactions.

See also *Pay Less Drug Stores v. Jewel Cos, Inc.*, 579 F. Supp. 1396 (N.D. Cal. 1984), in which the court held that although no stock changed hands, an unsuccessful tender offeror's attempted exercise of an option to acquire shares in a target company and the subsequent settlement of the contract constituted a purchase for purposes of Section 16(b). However, there was no liability despite the voluntary nature of the transaction, since the defendant's decision to exercise its options was not based on inside information that might have been used at the public's expense in violation of Section 16(b). The rate of exchange had been fixed by the option before the defendant ever became a statutory insider.

See also *Colan v. Prudential-Bache Securities, Inc.*, 557 F. Supp. 1074 (N.D. Ill. 1983), in which the court held that an exchange of shares was not a "sale" but rather an unorthodox transaction not subject to Section 16(b) liability for

short-swing profits. Applying the pragmatic *Kern* analysis, the court stated that the beneficial owners of more than 10% of a target company's stock were not liable for short-swing profits realized as a result of exchanging the shares pursuant to a merger since it was a forced, involuntary exchange. Furthermore, the existence of an atmosphere of hostility rendered it unlikely that the shareholders had access to inside information in a way that would raise the possibility of speculative abuses.

See also *Pier I Imports of Georgia, Inc. v. Wilson*, 529 F. Supp. 239 (N.D. Tex. 1981), in which the court applied the rationale of *Kern* to hold that a vice-president who sold his shares after a tender offer for his company was made was not liable under Section 16(b) because:

(1) the sale was an unorthodox transaction, since the transaction was pursuant to a tender offer and the vice-president believed he had no alternative to tendering his shares, *i.e.*, the president informed him that he was required to tender and that his continued employment depended upon tendering;

(2) the sale did not present the opportunity for speculative abuse since the vice-president did not attend board of directors meetings and was not informed of, or had access to, confidential and relevant financial aspects of the company.

See also *American Standard, Inc. v. Crane Co.*, 510 F.2d 1043, (2d Cir. 1974), *cert. denied*, 421 U.S. 1000 (1975) (exchange of stock in target company by unsuccessful tender offeror following a defensive merger not a sale under Section 16(b)).

A cause of action under Rule 10b-5 for the abuse of inside information and the regulation of tender offers under the Williams Act, discussed in Ch. 7A *supra*, lessen the need to rely on Section 16(b) in merger exchanges. *American Standard, Inc. v. Crane Co.*, 510 F.2d at 1063. Strict application of Section 16(b) to the exchange of stock by a tender offeror subsequent to a defensive merger would also discourage tender offers to the detriment of target company stockholders. *Abrams v. Occidental Petroleum Corp.*, 450 F.2d 157, 163-64 (2d Cir. 1971), *aff'd*, *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973).

Exchanges of stock arising out of tender offer situations are not in and of themselves "unorthodox transactions." *See* *Lane Bryant, Inc. v. Hatleigh Corporation*, 614 Sec. Reg. & L. Rep. A-4 (BNA July 29, 1979) (sale of stock by a more than ten% security holder pursuant to an agreement settling a proxy fight for control is a simple cash-for-stock stock sale subject to Section 16(b) liability); *Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc.*, 527 F.2d 335 (7th Cir. 1975), *cert. denied*, 423 U.S. 1078 (1978) (voluntary disposition of shares acquired during a tender offer subject to Section 16(b) liability).

See also *Bunker Ramo-Eltra Corp. v. Fairchild Industries, Inc.*, Fed. Sec. L. Rep. (CCH) P 93,125 (D. Md. 1986), in which the court distinguished *Kern* and held that the exemption from Section 16(b) for exchanges of stock pursuant to a merger did not apply to a cash for stock merger, even though a promissory note was given for a portion of the purchase price.

(n67)Footnote 67. *American Standard, Inc. v. Crane Co.*, 510 F.2d at 1058.

(n68)Footnote 68. The Supreme Court, however, has indicated that a subjective analysis of the transaction is unnecessary with respect to an orthodox transaction since Section 16(b) applies automatically. *Kern County Land Co.*, 411 U.S. at 593-94.

But see *Pier I Imports of Georgia, Inc. v. Wilson*, 529 F. Supp. 239 (N.D. Tex. 1981) (discussed in note 66 *supra*) (a cash-for-stock transaction was deemed unorthodox).

(n69)Footnote 69. See *Oliff v. Exchange International Corporation*, Fed. Sec. L. Rep. (CCH) P 97,634 (7th Cir. 1980) (repurchase of shares sold by a defendant estate to a foundation as a corrective transaction to avoid a tax penalty of 205% on the sale price for self-dealing was a purchase under Section 16(b)); *Makofsky v. Ultra Dynamics Corp.*, 383 F. Supp. 631 (S.D.N.Y. 1974) (sale of securities to raise cash to avoid default on contractual obligations subject to Section 16(b)); *Volk v. Zlotoff*, 285 F. Supp. 650 (S.D.N.Y. 1968) (sale of securities to raise working capital for issuer subject to Section 16(b)).

Involuntariness based on economic necessity has, however, been a factor in determining that a conversion of securities was not subject to Section 16(b). See *supra* note 66.

(n70)Footnote 70. See *American Standard, Inc. v. Crane Co.*, 346 F. Supp. 1153, (S.D.N.Y. 1973)], *rev'd on other grounds*, 510 F.2d 1043, (2d Cir. 1974), *cert. denied*, 421 U.S. 1000 (1975) (sale of securities compelled by threat of antitrust litigation subject to Section 16(b)); *Western Auto Supply v. Gamble-Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966) (sale of securities in accordance with Department of Justice antitrust consent decree subject to Section 16(b)).

(n71)Footnote 71. *Alloys Unlimited, Inc. v. Gilbert*, 319 F. Supp. 617 (S.D.N.Y. 1970) (the bank had notified the insider that it intended to sell the securities and the insider had not attempted to prevent the sale through refinancing).

(n72)Footnote 72. In *Arrow Distributing Corp. v. Baumgartner*, 738 F.2d 1274 (5th Cir. 1986), the court held insiders liable under Section 16(b) for purchasing stock by exercise of a stock option less than six months after they sold stock, despite the fact that the issuer's stock was not registered under the Act at the time of the insiders' sales.

See also *Gratz v. Claughton*, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951).

(n73)Footnote 73. *Morales v. Reading & Bates Offshore Drilling Co.*, 392 F. Supp. 41, 45 (N.D. Okla. 1975).

(n74)Footnote 74. *Id.* (a sale on April 17 must be followed at the latest by a purchase on October 15 for Section 16(b) liability to ensue); see also *Colonial Reality Corp. v. MacWilliams*, 381 F. Supp. 26 (S.D.N.Y. 1974), *aff'd*, 512 F.2d 1187 (2d Cir. 1975) (sale by officer on December 20 and subsequent purchase on June 19, and sale by another officer on December 22 and subsequent purchase on June 21, did not constitute sales and purchases within a period of less than six months); *Stella v. Graham-Paige Motors Corp.*, 132 F. Supp. 100 (S.D.N.Y. 1955), *rev'd on other grounds*, 232 F.2d 299, (2d Cir.), *cert. denied*, 352 U.S. 831 (1956) (sales made before August 8 were within statutory period when purchases were made on preceding February 10); *Jammies International, Inc. v. Nowinski*, Fed. Sec. L. Rep. (CCH) P 94,099 (S.D.N.Y. 1988) (sale by officer on April 29 was not within six months of purchase on October 31 because it was plausible for officer to pick the last day of April, April 30, as the most logical date to correspond to the last day of October, and then subtract one day to arrive at the first legally permissible sale date).

(n75)Footnote 75. See Sec. Exch. Act Rel. No. 34-116, Fed. Sec. L. Rep. (CCH) P 26,026 (1935); *Blau v. Ogsbury*, 210 F.2d 426, (2d Cir. 1954); see also *Piano Remittance Corp. v. Reliance Financial Securities Corp.*, 618 F. Supp. 414 (S.D.N.Y. 1985), discussed in note 27 *supra*.

See also *Freeman v. Decio*, 584 F.2d 186 (7th Cir. 1978) (purchase occurred at time stock was contracted and paid for, not five years later when restrictions on resale lapsed); *Champion Home Builders Co. v. Jeffress*, 490 F.2d 611 (6th Cir. 1974) (preliminary handshake agreement and subsequent board of directors authorization to negotiate sale did not constitute an irrevocable commitment to sell for purposes of Section 16(b); sale occurred at time of board of directors acceptance of offer to sell).

(n76)Footnote 76. See e.g., *Lewis v. Realty Equities Corp.*, 373 F. Supp. 829 (S.D.N.Y. 1974).

In *Morales v. Gould Investors Trust*, 445 F. Supp. 1144 (S.D.N.Y. 1977), *aff'd*, 578 F.2d 1369 (2d Cir. 1978), the

court held that a sale had occurred although there was a family relationship between the parties, the "seller" remained liable on notes with reference to the shares transferred, and the transfer might have been unenforceable under the statute of frauds.

(n77)Footnote 77. *Stella v. Graham-Paige Motors Corp.*, 132 F. Supp. 100 (S.D.N.Y. 1955), discussed in note 74 *supra*.

Sections 3(a)(13) and 3(a)(14) of the Exchange Act define a "purchase" and a "sale," respectively, to include a contract to purchase or sell. *See supra* notes 28 & 29.

See also Bershad v. McDonough, 428 F.2d 693, 697, C.C.H. Fed. Sec. L. Rep. P 92,683, p. 99,004 (7th Cir. 1970) , cert. denied, 400 U.S. 992 (1971) :

"The phrase 'any purchase and sale' in Section 16(b) is ... not to be limited or defined solely in terms of commercial law of sales and notions of contractual rights and duties."

(n78)Footnote 78. In *Portnoy v. Revlon*, Fed. Sec. L. Rep. (CCH) P 98,020 (7th Cir. 1981), an insider that pledged stock in support of a merger was held not to have sold stock until the closing of the merger rather than at the time of the execution of the merger agreement since the merger agreement contained several conditions precedent to closing, specifically:

- (1) receipt from the Internal Revenue Service of a ruling that the merger would qualify as a tax-free reorganization;
- (2) receipt of an opinion from an accounting firm that the merger would be treated as a pooling of interests for accounting purposes;
- (3) the exercise of appraisal rights by some stockholders;
- (4) the consummation of certain employment agreements; and
- (5) the consummation of noncompetition undertakings by certain stockholders.

Although the insider had no control over the consummation of the merger and the insider had completed whatever steps it could take for closing, the transaction was not finalized since there was no irrevocable commitment to exchange shares until these conditions were fulfilled. Fed. Sec. L. Rep. (CCH) at 98,275; *see also Staffin v. Greenberg*, 672 F.2d 1196 (3d Cir. 1982) (since defendant's proxy provided that his shares should be voted for or against the merger according to the wishes of the majority of other shareholders, he was not "irrevocably bound" to sell his shares to the acquiring corporation until the other shareholders approved the merger); *Kramer v. Ayer*, 317 F. Supp. 254 (S.D.N.Y. 1976) (purchase of stock occurred at time merger was complete rather than at the time of shareholder approval of the merger, since the merger agreement allowed either corporation to cancel the agreement until all acts necessary for the completion of the merger had been performed).

However, in *Provident Securities Co. v. Foremost-McKesson, Inc.*, 506 F.2d 601 (9th Cir. 1974), *aff'd on other grounds*, 423 U.S. 232 (1976), the court concluded that a sale had occurred upon the execution of a merger agreement, not at the time of closing, because the price was fixed thereby removing the potential to use inside information to manipulate the terms and conditions of the agreement, and there were only the usual conditions precedent to closing.

See also Morales v. Gulf Energy & Development Corp., Fed. Sec. L. Rep. (CCH) P 96,222 (D. Col. 1977) (purchase

of stock pursuant to agreement conditioning the transfer on the effective date of a registration statement occurred upon the effective date).

(n79)Footnote 79. *Stella v. Graham-Paige Motors Corp.*, 132 F. Supp. 100 (S.D.N.Y. 1955), discussed in note 74 *supra*.

(n80)Footnote 80. 334 F.2d 1 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965).

(n81)Footnote 81. *Booth v. Varian Associates*, 334 F.2d 1 (1st Cir. 1964) (emphasis in original). The seller's right to accelerate the date of closing indicated that the date of purchase was not the date of the execution of the contract. *Booth v. Varian Associates*, 334 F.2d at 5.

In *Riseman v. Orion Research, Inc.*, 749 F.2d 915 (1st Cir. 1984), the First Circuit distinguished its holding in *Varian*, and held that a director and 10% holder had "purchased" shares pursuant to an option for purposes of Section 16(b) when he paid for the shares on the last day of his directorship, and not seven months later when the share certificates were delivered to him, although he did not make the investment representation required under the option agreement (a condition precedent to the purchase and sale of shares was the optionee providing the issuer with a written representation that the shares acquired would be held for investment and not distributed). Since by tendering the purchase price the director sought to make the issuer's obligation to deliver the shares irrevocable and since the director alone had the power to satisfy the condition precedent, it would be inconsistent with the purposes of the Act to allow him to postpone his "purchase" date by deliberately refusing to comply with the terms of the option.

(n82)Footnote 82. 449 F. Supp. 425 (S.D.N.Y. 1978).

(n83)Footnote 83. *Kahansky v. Emerson Radio & Phonograph Corporation*, 184 F. Supp. 90 (S.D.N.Y. 1960); *see also* *Lewis v. Riklis*, 446 F. Supp. 582 (S.D.N.Y. 1978) (an agreement to transfer stock for an unsecured promissory note was not a sale under Section 16(b) when the alleged seller did not receive any payments on the note and had possession of the stock and title at the time of rescission); *Morales v. Gulf Energy & Development Corp.*, Fed. Sec. L. Rep. (CCH) P 96, 222 (D. Colo. 1977) (a second agreement to purchase shares rescinded rather than amended the first agreement to purchase when the first was not completed because of an inability to perform).

(n84)Footnote 84. *Volk v. Zlotoff*, 285 F. Supp. 650, (S.D.N.Y. 1968); *see also* *Lewis v. Mason*, Fed. Sec. L. Rep. (CCH) P 90,915 (S.D.N.Y. 1959) (agreement that gives a purchaser the right to rescind within two years of the sale is within Section 16(b) coverage since the agreement had been completed and a profit had been realized).

But see *Morales v. Great American Corp.*, 445 F. Supp. 869 (M.D. La. 1978) (rescinded sale was not a sale for the purposes of Section 16(b) since the defendant-officers had made a full account of the profits to the corporation and the rescission was not motivated by a desire to avoid liability under Section 16(b), *i.e.*, the sale was rescinded because relations between the buyers and sellers had become strained, there was an indication that some of the buyers might have difficulty paying installments as they came due on notes that were part of the purchase price, and the sale had become the subject of litigation that might have resulted in bad publicity for the issuer); *Hennesey v. Fein*, 184 F. Supp. 86 (S.D.N.Y. 1958) (purchases of stock that had been rescinded were not purchases for the purposes of Section 16(b) since they had been rescinded pursuant to a judicially approved settlement that was binding on the issuer and its shareholders and since there was no fraudulent intent to frustrate the purposes of the Exchange Act).

(n85)Footnote 85. *Smolowe v. Delendo Corp.*, 136 F.2d 231, 237 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943); *see also* *Gratz v. Claughton*, 187 F.2d 46, 51 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); *Segen v. Westcliff Capital Mgmt. LLC*, 299 F.Supp. 2d 262, 268 (S.D.N.Y. 2004)

In *Herrmann v. Steinberg*, Fed. Sec. L. Rep. (CCH) P 92,748 (S.D.N.Y. 1986), the court held that in calculating short swing profits to be disgorged following an abandoned tender offer, the profits realized by the tender offeror for purpose

of Section 16(b) should be the selling price of the shares less the purchase price, and less expenses incidental to the purchase and sale such as brokerage commissions and transfer taxes. The court held that amounts reimbursed the tender offeror by the target to offset the offeror's fees to its attorneys, investment bankers and lenders should not be considered in computing the offeror's profits.

In *Herrmann v. Steinberg*, Fed. Sec. L. Rep. (CCH) P 93,136 (2d Cir. 1987), the court vacated and remanded the ruling of the Southern District of New York. Although the Court of Appeals did not take issue with the district court's conclusion that tender offer expenses such as fees to attorneys, investment bankers, and lenders should not be considered in computing the tender offeror's short swing profits, the district court was instructed to determine whether any part of the payment by the target to the tender offeror represented reimbursement for expenses incurred in the actual purchase of shares, or consideration for the sale by the tender offeror of its holdings of the target's shares, and to include in its computation of profits any amounts found to have been paid for those purposes.

In *Morales v. Consolidated Oil & Gas, Inc.*, Fed. Sec. L. Rep. (CCH) P 98,796 (S.D.N.Y. 1982), the court held that the maximizing profits principle prevented a reduction in the amount of profits to be disgorged by the defendant for a short-swing purchase and sale of stock although for tax purposes the defendant was deemed to have incurred incentive income in the transaction effectively raising his basis in the stock and resulting in a net tax loss on the transaction.

If an insider is held to be the beneficial owner of securities, see § 8.02[2][a] *supra*, he is liable for *all* profits made on transactions in those securities pursuant to Section 16(b). See *Walet v. Jefferson Lake Sulphur Co.*, 104 F. Supp. 20 (D. La. 1952), *aff'd*, 202 F.2d 433 (5th Cir.), *cert. denied*, 346 U.S. 820, (1953) (insider liable under Section 16(b) for all short-swing profits although under the community property law of Louisiana securities and profits made thereon belonged to the marital community); *Mouldings, Inc. v. Potter*, 465 F.2d 1101 (5th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973) (although an insider designated others to whom profits would go to on his trading transactions, under Section 16(b) the profits were attributable to the insider in their entirety).

(n86)Footnote 86. *Smolowe v. Delendo Corp.*, 36 F.2d at 237.

As an example, assume that the insider bought 100 shares at \$30 on April 1, sold 200 shares at \$35 on June 1, sold 200 shares at \$38 on July 1, and bought 300 shares at \$34 on November 1. His profit would be computed as follows:

Sold 100 at \$38	3800	
Bought 100 at \$30	3000	
		800
Sold 100 at \$38	3800	
Bought 100 at \$34	3400	
		400
Sold 200 at \$35	7000	
Bought 200 at \$34	6800	
		200

TOTAL

—
1400

In *Gund v. First Florida Banks, Inc.*, 726 F.2d 682, (11th Cir. 1984), the court held that although the district court applied the method of computation used for calculating profits from sales of employee stock options under former Rule 16b-6(b) to the purchase and sale of securities, the result was consistent with the Exchange Act's remedial purpose. Accordingly, the court upheld the district court's award of damages, computed by matching the price paid for the common stock with the highest market price of the common stock within six months of when the debentures were sold.

See also *Morales v. Lukens, Inc.*, Fed. Sec. L. Rep. (CCH) P 91,676 (S.D.N.Y. 1984), in which short swing profits recoverable under Section 16(b) were calculated at the average price received by the tender offeror for all the stock purchased within a six month period rather than the highest price paid during the short swing period because the sales were part of an agreement to end the offeror's takeover bid and help facilitate the target's merger with a friendly bidder. Although the stock sales were treated as two separate parts for bookkeeping and appearance purposes, they were actually parts of one transaction. Therefore, the individual prices paid did not reflect the true sales prices and an averaging of the prices was the appropriate way to determine short swing profits.

(n87)Footnote 87. *Smolowe v. Delendo Corp.*, 136 F.2d at 237; *Gratz v. Claughton*, 187 F.2d at 50-51.

(n88)Footnote 88. *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); *Makofsky v. Ultra Dynamics Corp.*, 383 F. Supp. 631 (S.D.N.Y. 1974).

(n89)Footnote 89. In *Reece Corp. v. Walco National Corp.*, Fed. Sec. L. Rep. (CCH) P 99,226 (S.D.N.Y. 1983), the court held that brokerage commissions incurred on short-swing stock purchases are deductible from the computation of profits realized, but legal fees incurred by the defendant when the plaintiff was attempting to prevent the defendant from purchasing the stock are not. The court also held that the defendant-insider was not entitled to a reduction in its profits realized on the sale of securities to the issuer for the value of the insider's covenants to take no action that might affect the control of the issuer or its management by tender offer, exchange offer, or otherwise since such apportionment of the price of the securities was inconsistent with the purpose of Section 16(b), *i.e.*, to squeeze all possible profits out of transaction coming within its scope.

See also *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954) (expenses of transfer are those actually incurred and not mere possibilities that might have been incurred had equivalent stock been sold); *Falco v. Donner Foundation, Inc.*, 208 F.2d 600 (2d Cir. 1953); *Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc.*, 372 F. Supp. 570 (N.D. Ill. 1974), *rev'd in part and remanded*, 527 F.2d 335 (7th Cir. 1975), *cert. denied*, 423 U.S. 1078 (1976); *Arkansas Louisiana Gas Co. v. W.R. Stephens Investment Co.*, 141 F. Supp. 841 (W.D. Ark. 1976) (court included automobile, general overhead, office rent, office salaries, office supplies, postage, telephone, teletype, and telegraph expenses, but disallowed claimed expenses for the salaries of salesmen since no sales campaign was conducted to sell the securities in question).

However, *Lane Bryant, Inc. v. Hatleigh Corp.*, 517 F. Supp. 1196, (S.D.N.Y. 1981) the court refused to deduct from profits realized from purchases and sales in violation of Section 16(b), which were made in the course of a contest for control of the issuer:

(1) a bank's administrative charges for handling the defendant's account or its interest charges on loans which the defendant secured to finance the purchases;

(2) lawyers' fees and costs of litigation seeking control of the issuer; and

(3) office overhead for the six-month period involved

because to permit these deductions would encourage the type of transactions Section 16(b) seeks to deter.

In *Oliff v. Exchange International Corp.*, 449 F. Supp. 1277, (N.D. Ill. 1978), the court refused to reduce the judgment by the expenses incurred by the insider in conducting the purchase and sale, including attorney's fees arising in connection with a probate court proceeding, since to do so would frustrate the penal and remedial purposes of Section 16(b).

(n90)Footnote 90. *See, e.g., Marquette Cement manufacturing Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965); *see also Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc.*, 527 F.2d 335 (7th Cir. 1975), *cert. denied*, 423 U.S. 1078 (1976) (valuation of unregistered stock at 75% of volume-weighted average price of identical registered shares traded on New York Stock Exchange on the date of the sale).

But see Rule 16b-6(c)(2) (providing that for purposes of determining the purchase or sale price for a derivative security the market price of the underlying securities may be relied upon).

(n91)Footnote 91. *Blau v. Lehman*, 368 U.S. 403 (1962).

(n92)Footnote 92. Some courts require that the defendant carry the burden of proving good faith. *See Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir. 1981).

(n93)Footnote 93. *See Gold v. Sloan*, 486 F.2d 340 (4th Cir. 1973), *cert. denied*, 419 U.S. 873 (1974) (interest not awarded since defendant did not act willfully); *Lewis v. Levinson*, Fed. Sec. L. Rep. (CCH) P 96,430 (S.D.N.Y. 1978) (award of prejudgment interest denied when insider was under the mistaken assumption that his sales had occurred more than six months before his purchases); *Oliff v. Exchange International Corp.*, 449 F.Supp. 1277 (N.D. Ill. 1978) (since violation of Section 16(b) was inadvertent, interest awarded from date of judgment and not from the date of the sale of the securities that resulted in the realization of short-swing profits); *Morales v. Gould Investors Trust*, 445 F. Supp. 1144 (S.D.N.Y. 1977), *aff'd*, 578 F.2d 1369 (2d Cir. 1978) (in the absence any showing of bad faith and in consideration of the unique relationships and transactions involved, *i.e.*, the transfer of equal number of shares between two family members who were trustees of a Massachusetts trust, the award of prejudgment interest was denied); *Volk v. Zlotoff*, 318 F. Supp. 864 (S.D.N.Y. 1970) (no prejudgment interest awarded since there was no substantial showing of bad faith or other inequitable conduct by the defendants); *Marquette Cement Manufacturing Co. v. Andreas*, 239 F.Supp. 962 (S.D.N.Y. 1965) (since the transaction was innocent, interest was not added to the judgment).

But see *Champion Home Builders Co. v. Jeffress*, 385 F. Supp. 245 (E.D. Mich. 1974) (interest granted from the date of the commencement of the suit regardless of whether the violation of Section 16(b) may have been inadvertent).

See also *Perfect Photo, Inc. v. Grabb*, 205 F. Supp. 569 (E.D. Pa. 1962) (interest awarded although there was no indication that the defendant acted in bad faith).

(n94)Footnote 94. *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir. 1981).

(n95)Footnote 95. *See Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736, C.C.H. Fed. Sec. L. Rep. P 91,556 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966); *Perfect Photo, Inc. v. Grabb*, 205 F.Supp. 569 (E.D. Pa. 1962).

See also *Lane Bryant, Inc. v. Hatleigh Corp.*, 517 F. Supp. 1196 (S.D.N.Y. 1981)(prejudgment interest not assessed since no substantial showing of bad faith or other inequitable conduct by defendant).

(n96)Footnote 96. *Lewis v. Realty Equities Corp.*, 396 F. Supp. 1026 (S.D.N.Y. 1975) (plaintiff not entitled to prejudgment interest when there was a three and one half year time lapse between the filing of the complaint and the summary judgment motion and there was no indication that the insider was responsible for the delay or that the plaintiff had an excuse for it); *Blau v. Lamb*, 242 F. Supp. 151 (S.D.N.Y. 1965), *aff'd in part, rev'd in part*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967) (plaintiff's claim for interest was inequitable considering the protracted litigation).

(n97)Footnote 97. *See e.g.*, *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir. 1981); *Stella v. Graham-Paige Motors Corp.*, 232 F.2d 299 (2d Cir.), *cert. denied*, 352 U.S. 831 (1956); *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.) *cert. denied*, 347 U.S. 1016 (1954).

(n98)Footnote 98. In *Lane Bryant, Inc. v. Hatleigh Corp.*, 517 F. Supp. 1196, (S.D.N.Y. 1981), the court stated that an assessment of prejudgment interest would involve interest from either the date:

- (1) demand for repayment of profits realized was served, *i.e.*, the date of service of the complaint; or
- (2) the answer denying liability under Section 16(b) was filed.

The court, however, declined to award prejudgment interest.

See also *Champion Home Builders v. Jeffress*, 385 F.Supp. 245 (E.D. Mich. 1974); *Schur v. Salzman*, 365 F. Supp. 725 (S.D.N.Y. 1973); *Abbe v. Goss*, Fed. Sec. L. Rep. (CCH) P 95,319 (S.D.N.Y. 1975) (interest not allowed when most of profits realized on short-swing trades were paid to the issuer prior to service of the complaint).

(n99)Footnote 99. *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959).

(n100)Footnote 100. *Blau v. Lamb*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967); *Cutler-Hammer, Inc. v. Leeds & Northrup Co., Inc.*, 469 F. Supp. 1021 (E.D. Wis. 1979).

(n101)Footnote 101. In *Blau v. Lamb*, the cash dividend received was only 30cent(s) per share, an increase of 5cent(s) per share on the regular quarterly dividend paid prior to the acquisition of the securities and was therefore excluded from the Section 16(b) recovery. 363 F.2d at 528. The issuer, however, was entitled to recover a 100% stock dividend declared near the time of the stock conversion since the dividend was substantial and coincided with the conversion. 363 F.2d at 527. In *Cutler-Hammer, Inc. v. Leeds & Northrup Co., Inc.*, quarterly dividends were 15cent(s) per share prior to the acquisition of the securities and 18cent(s) per share after the acquisition of the securities by the insider; the court held that the dividends were not recoverable. 469 F. Supp. at 1024.

See also *Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc.*, 372 F. Supp. 570 (N.D. Ill. 1974), *rev'd in part and remanded*, 527 F.2d 335 (7th Cir. 1975), *cert. denied*, 423 U.S. 1078 (1976) (dividends are not profits realized from the purchase and sale of the securities, but rather from the holding of the stock in the manner of operational earnings or income).

(n102)Footnote 102. *Adler v. Klawans*, 267 F.2d 840 (2d Cir. 1959) (the dividends paid combined with the loss on the sale did not result in a profit); *Marquette Cement Manufacturing Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965).

(n103)Footnote 103. *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d at 744 (holding that interest on the dividends ran from the date of the sale of the stock, not the date on which the dividends were paid).

(n104)Footnote 104. *Mueller v. Korholz*, 449 F.2d 82 (7th Cir. 1971), *cert. denied*, 405 U.S. 922 (1972) (shares had a premium value of 20%); *Newmark v. RKO General, Inc.*, 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970) (15% of purchase price of securities added as a control premium); *Blau v. Lamb*, 242 F. Supp. 151 (S.D.N.Y.

1965), *aff'd in part, rev'd in part*, 363 F.2d 507 (2d Cir. 1966), *cert. denied*, 385 U.S. 1002 (1967) (premium of \$2.50 added to book value of \$6.00 per share).

See also Lewis v. The Dekcraft Corporation, Fed. Sec. L. Rep. (CCH) PP 94,855, 94,905 (S.D.N.Y. 1974) (no control premium added since there was no value attributable to the purchaser's grant of an irrevocable proxy to vote the controlling securities one year after the sale to the selling insider).

(n105)Footnote 105. Newmark v. RKO General, Inc., 425 F.2d at 357 (evidence of special value to the insider consisted of expert testimony on the value of obtaining legal control and 15% to 26% premiums on prior purchases of the issuer's stock that had been conferred on the purchaser.)

(n106)Footnote 106. Rule 16b-6(c)(2).

(n107)Footnote 107. Exch. Act Rel. No. 28869, text accompanying note 156.

(n108)Footnote 108. *Id.*

(n109)Footnote 109. *But see* Gund v. First Florida Banks, Inc., 726 F.2d 682 (11th Cir. 1984) (court refused to reduce profit from trades in convertible notes to reflect that their price was being affected by the level of interest they paid and their maturity value, given that the conversion price was above the underlying common stock's price at the time of the transactions).

(n110)Footnote 110. Section 27.

(n111)Footnote 111. In Gilson v. Pittsburgh Forgings Co., 284 F. Supp. 569 (S.D.N.Y. 1968), the court concluded that the listing of the defendant company's stock on the New York Stock Exchange, the trading of its shares on the Exchange, and the defendant's appointment of a registrar and transfer agent in New York did not constitute transacting business in New York.

See also Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc., 309 F. Supp. 75 (E.D. Wis. 1970) (corporation does not do business where its wholly-owned subsidiary does business as long as the subsidiary is a distinct corporate organization and that distinction is bona fide).

(n112)Footnote 112. Fred S. James Co., Inc. v. Rathmell, Fed. Sec. L. Rep. (CCH) P 98,749 (S.D.N.Y. 1982); Peyser v. Meehan Fund, Inc., 264 F. Supp. 1 (S.D.N.Y. 1966).

(n113)Footnote 113. *See* Abrams v. McDonough & Cudahy Company, Fed. Sec. L. Rep. (CCH) P 92,271 (S.D.N.Y. 1968) (preliminary communications occurring in, or the drawing of a check in payment on a bank located in, a district not sufficient to lay venue in that district); Rothenberg v. Silberman, 278 F. Supp. 116 (S.D.N.Y. 1968) (venue in New York not established by the retention of any telephone communications, correspondence, and visits with New York counsel with respect to the transaction).

Unlike Section 10(b), an action brought under Section 16(b) does not require proof of the use of the mails or interstate facilities. Therefore communications that may be essential for proof of the use of interstate facilities of an action under Section 10(b) are insufficient for that purpose to confer venue in a Section 16(b) proceeding. Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc., 309 F. Supp. at 80; Rothenberg v. Silberman, 278 F. Supp. at 119.

For other differences between actions brought under Section 16(b) and Section 10(b), see *supra* note 8.

(n114)Footnote 114. In Rothenberg v. Silberman, the court stated in dictum that venue would be laid if some operative act constituting part of the purchase or sale occurred in the forum district, including the

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- (1) making and transmitting of an offer or order to purchase or sell the securities;
- (2) acceptance of the offer;
- (3) confirmation;
- (4) record transfer of the security;
- (5) delivery of the certificates;
- (6) payment; and
- (7) execution by the parties of the purchase and sale instruments.

278 F. Supp. at 119. This dictum was expressly rejected by the court in *Allis-Chalmers Manufacturing Co. v. Gulf & Western Industries, Inc.*, in which venue was held to be limited to the district in which the transaction was consummated. The court concluded that the solicitation, tender, and consummation of a stock exchange offer and the registration of warrants and debentures used in the exchange in Wisconsin did not constitute a purchase of the stock there. 309 F. Supp. at 81.

(n115)Footnote 115. *Gratz v. Claughton*, 187 F.2d 46 (2d Cir.), *cert. denied*, 341 U.S. 920 (1951); *Roth v. The Fund of Funds, Ltd.*, 279 F. Supp. 935 (S.D.N.Y.), *aff'd*, 405 F.2d 421 (2d Cir. 1968), *cert. denied*, 394 U.S. 975 (1969).

(n116)Footnote 116. *Morales v. Gearhart-Owen Industries, Inc.*, Fed. Sec. L. Rep. (CCH) P 95,922 (S.D.N.Y. 1977); *Blau v. Tool Research & Engineering Corp.*, 330 F. Supp. 1374 (S.D.N.Y. 1971).

For discussion of an action for recovery of attorney's fees, see § 8.04[8] *infra*.

(n117)Footnote 117. The request is usually made by a letter to the corporation listing the transactions that are in violation of Section 16(b). *Cook & Feldman, Insider Trading Under the Securities Exchange Act*, 66 Har. L. Rev. 385, 412 (1953).

However, in *Jones v. Fremont Energy Corporation*, 537 F. Supp. 300, (D. Col. 1982), the court tolled the sixty day period after the plaintiff's initial demand on the issuer to bring suit under Section 16(b) from the date of the issuer's letter to the plaintiff indicating insufficient information of the plaintiff's shareholder identity until the plaintiff responded with information as to her true shareholder identity.

(n118)Footnote 118. A corporation that was nominally a defendant could change to a plaintiff in a Section 16(b) suit to ensure vigorous prosecution of the suit when it believed that the security holder who instituted the suit was not diligent, although at the time the change in status from defendant to plaintiff was sought, the corporation was barred by the statute of limitations from bringing a new and separate action. *Silverman v. Re*, 194 F. Supp. 540 (S.D.N.Y. 1961).

(n119)Footnote 119. *Weisman v. Spector*, 158 F. Supp. 788 (S.D.N.Y. 1958) .

(n120)Footnote 120. *Abbe v. Goss*, 411 F. Supp. 923 (S.D.N.Y. 1975); *Netter v. Ashland Paper Mills*, 19 F.R.D. 529 (S.D.N.Y. 1956); *Henss v. Schneider*, 132 F. Supp. 60 (S.D.N.Y. 1955); *Benisch v. Cameron*, 81 F. Supp. 882 (S.D.N.Y. 1948); *Grossman v. Young*, 72 F. Supp. 375 (S.D.N.Y. 1947).

Although a corporation must be granted the right to conduct litigation on its own behalf, Section 16(b)'s provision for security holder standing recognizes that a corporation will generally be reluctant to sue its directors, officers, and principal shareholders. *Pellegrino v. Nesbit*, 203 F.2d 463 (9th Cir. 1953).

(n121)Footnote 121. *Morales v. Mylan Laboratories*, 443 F. Supp. 778 (W.D. Pa. 1978) ; *Benisch v. Cameron*, 81 F.Supp. 882 (S.D.N.Y. 1948).

(n122)Footnote 122. *See Park & Tilford v. Schulte*, 160 F.2d 984 (2d. Cir.), *cert. denied*, 332 U.S. 761 (1947); *Twentieth Century-Fox Film Corp. v. Jenkins*, 7 F.R.D. 197 (S.D.N.Y. 1947).

See also Miracle Mart, Inc. v. Margolis, 46 F.R.D. 458 (D. Mass. 1968) (proposed intervenor need not show conclusively that the issuer has been less than diligent in prosecuting action); *Nedick's Stores, Inc. v. Genis*, 34 F.R.D. 235 (S.D.N.Y. 1963)(intervention permitted on basis that representation of intervenor's interest by issuer might not be adequate notwithstanding the issuer's statement that the claims of the proposed intervenor had been rejected as being without merit); *Molybdenum Corp. of America v. International Mining Corp.*, 32 F.R.D. 415 (S.D.N.Y. 1963) (intervention permitted although the Section 16(b) action appeared to have been instituted on the issuer's own initiative); *Pellegrino v. Nesbit*, 203 F.2d 463 (9th Cir. 1953) (stockholder intervention for the purpose of perfecting an appeal from a trial court judgment granted when that judgment raised important and substantial questions of law relating to the correctness of the judgment).

But see Heit v. Gulf & Western Industries, Inc., 321 F. Supp. 921 (D. Del. 1971) (time lapse of 81 days between the date of demand by security holder to sue and date that issuer brought Section 16(b) action insufficient to show lack of diligence on issuer's part); *Arthur G. McKee & Company v. Gulf & Western Industries, Inc.*, 52 F.R.D. 332 (D. Del. 1971) (intervention not granted when it was not proposed until two years after corporation filed suit and there was no evidence of a lack of diligence by the corporation in prosecuting the suit or the possibility of inadequate representation).

Some commentators have argued that Section 16(b) grants security holders an absolute right to intervene without complying with the requirements of the Federal Rules of Civil Procedure for intervention, although the courts have not yet accepted this proposition. *Cook & Feldman, Insider Trading Under the Securities Exchange Act*, 66 *Har. L. Rev.* 385, 414-15 (1953):

"The many opportunities for less than vigorous prosecution in the course of litigation, the amicable nature of many section 16(b) claims by a corporation against its own officers and directors, the possibility of subtle conflicts of interest, and the public enforcement of the sanction all require free intervention by minority interests."

(n123)Footnote 123. *Pellegrino v. Nesbit*, 203 F.2d 463 (9th Cir. 1953).

See also Grynberg v. Farmer, Fed. Sec. L. Rep. (CCH) P 97,683 (D. Col. 1980) (a shareholder's Section 16(b) action could not be dismissed by a special litigation committee of the issuer acting with reasonable business judgment because the members of the committee were biased in favor of the defendant-directors).

(n124)Footnote 124. Since Congress left the enforcement of Section 16(b) to private parties, the Commission's staff will not take no-action or interpretive positions on the scope of liability under Section 16(b). *Sec. Exch. Act Rel. No. 34-18114*, Fed. Sec. L. Rep. (CCH) P 26,062 (1981).

(n125)Footnote 125. *Mendell v. Gollust*, 909 F.2d 724, 728 (2d Cir. 1990); *Dottenheim v. Murchison*, 227 F.2d 737 (5th Cir. 1955), *cert. denied*, 351 U.S. 919 (1956); *Blau v. Mission Corp.*, 212 F.2d 77 (2d Cir.), *cert. denied*, 347 U.S. 1016 (1954); *Pellegrino v. Nesbit*, 203 F.2d 463 (9th Cir. 1953); *Morales v. Great American Corp.*, 445 F. Supp. 869 (M.D. La. 1978); *Blau v. Oppenheim*, 250 F. Supp. 881 (S.D.N.Y. 1966); *Blau v. Albert*, 157 F. Supp. 816

(S.D.N.Y. 1957); *Benisch v. Cameron*, 81 F. Supp. 882 (S.D.N.Y. 1948).

Rule 23.1 of the Federal Rules of Civil Procedure applies to derivative actions. Section 16(b) grants a primary right of action to security holders of the issuer. *Blau v. Oppenheim*, 250 F. Supp. 881 (S.D.N.Y. 1966).

(n126)Footnote 126. *Morales v. Great American Corp.*, 445 F.Supp. 869 (M.D. La. 1978); *see also Magida v. Continental Can Co.*, 231 F.2d 843 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956) (alleged collusive arrangement between a stockholder and his attorney would not defeat a Section 16(b) action since the relationship could not defeat the rights of the corporation or its stockholders).

(n127)Footnote 127. *Pellegrino v. Nesbit*, 203 F.2d 463 (9th Cir. 1953); *Twentieth Century-Fox Film Corp. v. Jenkins*, 7 F.R.D. 197 (S.D.N.Y. 1947).

(n128)Footnote 128. *Blau v. Lamb*, 314 F.2d 618 (2d Cir.), *cert. denied*, 375 U.S. 813 (1963) (the court concluded that "owner of any security" was not limited to a beneficial owner, instead implying a broader meaning to carry out the remedial purpose of the statute).

(n129)Footnote 129. *Gollust v. Mendell*, 501 U.S. 115 (1991).

(n130)Footnote 130. *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966)).

(n131)Footnote 131. *Epstein v. Shindler*, 200 F. Supp. 836 (S.D.N.Y. 1961).

(n132)Footnote 132. Fed. Sec. L. Rep. (CCH) P 96,045 (S.D.N.Y.), *aff'd*, 573 F.2d 1295 (2d Cir. 1977) .

(n133)Footnote 133. *See also Portnoy v. Kawecky Berylco Industries, Inc.*, 607 F.2d 765 (7th Cir. 1979).

(n134)Footnote 134. *Gollust v. Mendell*, 501 U.S. 115, (1991).

In *C.R.A. Realty Corp. v. American Express*, Fed. Sec. L. Rep. (CCH) P 91,528 (S.D.N.Y. 1984), the court held that unless further discovery shows that a wholly owned subsidiary has survived as a separate corporation, a shareholder of the parent corporation has standing to bring suit against a former director of an issuer that became the subsidiary of the company pursuant to a merger for short-swing profits in violation of Section 16(b), even though the shareholder did not own the subsidiary's stock, since, under *Blau*, the term issuer could be interpreted to include the subsidiary's successor in interest.

See also Schur v. Salzman, 365 F. Supp. 725 (S.D.N.Y. 1973) (successor corporation in a merger succeeded to the assets of the issuer, including the chose in action based on the Section 16(b) claim; plaintiff security holder of issuer who became a security holder of the successor upon the merger not required to file a new demand on the successor corporation); *Western Auto Supply Co. v. Gamble-Skogmo, Inc.*, 348 F.2d 736 (8th Cir. 1965), *cert. denied*, 382 U.S. 987 (1966). (Section 16(b) cause of action survived the absorption of the issuing corporation and was properly exercisable by the surviving corporation).

However in *Lewis v. McAdam*, 762 F.2d 800, Fed. Sec. L. Rep. (CCH) P 92,072 (9th Cir. 1985) , the court, rejecting the *Blau* doctrine, held that a shareholder of a parent corporation who never held stock in either the acquired company or the acquiring company, a wholly owned subsidiary of the parent corporation, lacked standing to bring an action for short-swing profits under Section 16(b) against a director of the corporation acquired by the subsidiary of the parent where the subsidiary was the surviving corporation since

(1) the parent was not an issuer within the meaning of Section 16(b); and

(2) any rights against the directors of the acquired company were, inherited upon merger by the surviving subsidiary into which the acquired company was merged.

See also *Bunker Ramo-Eltra Corp. v. Fairchild Industries, Inc.*, 639 F.Supp. 409 (D. Md. 1986) (successor by merger to an original issuer of securities has standing to assert any claim under Section 16(b) that the original issuer could have asserted).

See also *Untermeyer v. Valhi, Inc.*, Fed. Sec. L. Rep. (CCH) P 93,690 (2nd Cir. 1988) (court found that shareholder of parent does not have standing in action for recovery of short-swing profits on behalf of either the parent or the subsidiary with respect to transactions on stock of the subsidiary and said such ruling is consistent with *Blau* where issuer was merged out of existence).

See also, *Mendell v. Gollust*, Fed. Sec. L. Rep. (CCH) P 94,086 (S.D.N.Y. 1988).

(n135)Footnote 135. *Gollust v. Mendell*, 111 S. Ct. at 2179. In *Portnoy v. Kaweck Berylco Industries, Inc.*, the court stated that because the issuer still existed, its sole shareholder was the only person with standing to bring a Section 16(b) action. The court conceded, however, that the sole shareholder was unlikely to bring a Section 16(b) action since among other things, it was on the purchasing end of the short-swing transaction. 607 F.2d at 769.

(n136)Footnote 136. For discussion of the time a purchase or sale occurs for purposes of Section 16(b), see § 8.04[3][a] *supra*.

(n137)Footnote 137. *Whittaker v. Whittaker Corp.*, 639 F.2d 516 (9th Cir. 1981); *Roth v. Reyes*, 2007 U.S. Dist. LEXIS 14532, at *12 (N.D. Cal. Feb. 13, 2007) *Shattuck Denn Mining Corp. v. LaMorte*, Fed. Sec. L. Rep. (CCH) P 94,429 (S.D.N.Y. 1974); *Blau v. Albert*, 157 F. Supp. 816 (S.D.N.Y. 1957); *Grossman v. Young*, 72 F. Supp. 375 (S.D.N.Y. 1947).

The court in *Whittaker*, reasoned that the main source of information for individual shareholders to bring an action under Section 16(b) is the reports filed under Section 16(a); to hold otherwise would reward violations of the statute. 639 F.2d at 528. In addition, the court rejected an interpretation of Section 16 whereby the statute of limitations would be tolled until the time the short-swing trades were discovered or should have been discovered since this interpretation would undermine the mechanistic functioning of Section 16(b). 639 F.2d at 528-29.

However, in *Carr-Consolidated Biscuit Company v. Moore*, 125 F. Supp. 423 (M.D. Pa. 1954), the court refused to toll the statute of limitations for a failure by the insiders to file reports required by Section 16(a). The court in *Whittaker* distinguished *Carr-Consolidated* on the basis that the *Carr-Consolidated* decision relied on a theory, since discarded by the United States Supreme Court in *American Pipe & Construction Co. v. Utah*, 414 U.S. 538 (1974), that substantive statutes of limitation are entitled to literal, strict application by the courts and cannot be tolled. 639 F.2d at 529.

See *Kay v. ScienTex Corp.*, 719 F.2d 1009 (9th Cir. 1983) (failure to file insider reports does not toll statute of limitations where information regarding insider's trading was known, *i.e.*, since the moving party was the issuer of stock allegedly sold in violation of Section 16, its own records contained the information that should have been disclosed in insider reports under Section 16(a)); see also *Rogers v. Valentine*, 37 F.R.D. 231 (S.D.N.Y. 1964) (the failure of an insider to file reports does not affect the requirement that the matched pair of transactions occur within a period of less than six months).

For discussion of the reporting requirements under Section 16(a), see § 8.03[2][b] *supra*.

(n138)Footnote 138. *Colan v. Monumental Corp.*, 524 F. Supp. 1023 (N.D. Ill. 1981) (since the demand requirement of Section 16(b) is designed to benefit the corporation and the public interest, insider-defendants lacked

standing to complain of any deficiencies in the demand made by the plaintiff upon the corporation's directors); *Prager v. Sylvestri*, 449 F. Supp. 425 (S.D.N.Y. 1978); *Morales v. Mylan Laboratories*, 443 F. Supp. 778 (W.D. Pa. 1978); *Schur v. Salzman*, 365 F. Supp. 725 (S.D.N.Y. 1973); *Benisch v. Cameron*, 81 F. Supp. 882 (S.D.N.Y. 1948); *Grossman v. Young*, 72 F.Supp. 375 (S.D.N.Y. 1947).

(n139)Footnote 139. *Allied Artists Picture Corp. v. Giroux*, 312 F. Supp. 450 (S.D.N.Y. 1970); *Volk v. Zlotoff*, 285 F. Supp. 650 (S.D.N.Y. 1968); *Jefferson Lake Sulphur Co. v. Walet*, 104 F. Supp. 20, *aff'd*, 202 F.2d 433 (5th Cir.), *cert. denied*, 346 U.S. 820 (1953).

See also *Bunker Ramo-Eltra*, Fed. Sec. L. Rep. (CCH) P 93,125 (D. Md. 1986) (the court, relying on Section 29(a), refused to enforce an agreement by an issuer's parent to indemnify a hostile tender offeror for the issuer's stock from liabilities under Section 16(b) arising from sale of the offeror's stock following its unsuccessful tender offer.)

(n140)Footnote 140. *Roth v. The Fund of Funds, Ltd.*, 405 F.2d 421 (2d Cir. 1968), *cert. denied*, 394 U.S. 975 (1969); *see also* *Tyco Laboratories, Inc. v. Cutler-Hammer, Inc.*, 490 F. Supp. 1 (S.D.N.Y. 1980) (claim that the prohibited transaction resulted from the conduct of the issuer in a control contest not a defense to a Section 16(b) action).

(n141)Footnote 141. *Schur v. Salzman*, 365 F.Supp. 725 (S.D.N.Y. 1973); *see also* *Texas International Airlines v. National Airlines, Inc.*, 714 F.2d 533 (5th Cir. 1983) (more than ten% owner of an issuer's stock who sold those shares within six months of their purchase could not assert as an equitable defense to a Section 16(b) action the fact that the shareholder who traded with him was the issuer's controlling shareholder who later merged the issuer into itself and who would be the only beneficiary of a recovery).

(n142)Footnote 142. *Magida v. Continental Can Co., Inc.*, 231 F.2d 843 (2d Cir.), *cert. denied*, 351 U.S. 972 (1956); *Allied Artists Picture Corp. v. Giroux*, 312 F.Supp. 450 (S.D.N.Y. 1970); *Volk v. Zlotoff*, 285 F.Supp. 650 (S.D.N.Y. 1968).

(n143)Footnote 143. *Newmark v. RKO General, Inc.*, 294 F. Supp. 358 (S.D.N.Y. 1968), *aff'd*, 425 F.2d 348 (2d Cir.), *cert. denied*, 400 U.S. 854 (1970); *see also* *Marquette Cement Manufacturing Co. v. Andreas*, 239 F. Supp. 962 (S.D.N.Y. 1965) (no defense to a Section 16(b) action that the issuer concurred in the short-swing transaction).

(n144)Footnote 144. *See* § 8.06[8] *infra*.

(n145)Footnote 145. In *Epstein v. Shindler*, 26 F.R.D. 176 (S.D.N.Y. 1960), the court did not permit defendant's claim for sums allegedly due for past services rendered to the issuer, since it would not be in the interest of the policy of Section 16(b) to discourage security holders from bringing actions under the statute by confronting them with the possibility of having to defend claims against the issuer for conduct unrelated to the action brought. The court stated that the policy of Rule 13 of the Federal Rules of Civil Procedure, of avoiding a multiplicity of actions through the use of permissive counterclaims, should not be extended in this case to thwart the substantive policies of Section 16(b). 26 F.R.D. at 178-79.

(n146)Footnote 146. *See, e.g.,* *Morales v. Geothermal International, Inc.*, Fed. Sec. L. Rep. (CCH) P 98,038 (S.D.N.Y. 1981); *Matas v. Siess*, Fed. Sec. L. Rep. (CCH) P 97,325 (S.D.N.Y. 1980); *Olin v. Ginsberg*, Fed. Sec. L. Rep. (CCH) P 92,872 (S.D.N.Y. 1970); *Blau v. Kagan*, Fed. Sec. L. Rep. (CCH) P 92,119 (S.D.N.Y. 1968).

See also *Peyser v. Meehan Fund*, 271 F. Supp. 271 (S.D.N.Y. 1967) (valuation of stock must be determined before a settlement may be found to be fair).

(n147)Footnote 147. *See* *Lewis v. Levinson*, Fed. Sec. L. Rep. (CCH) P 96,430 (S.D.N.Y. 1978) (potential liability two and a half times greater than settlement amount indicates that the settlement was not the result of compromise).

(n148)Footnote 148. See *Morales v. Holiday Inns, Inc.*, Fed. Sec. L. Rep. (CCH) P 94,219 (S.D.N.Y. 1973) (settlement for 70% of maximum potential recovery not approved when the defendant, a vice-president of the issuer, contended that he was not an officer for the purposes of Section 16(b), since this defense was not sufficiently substantial considering the defendant had access to inside information with respect to the financial and operational performance of establishments owned by the issuer; waiver of interest on a potential recovery, however, was permitted since legal expenses were saved and the court was willing to give some credence to the defense); *Lewis v. Wells*, 325 F. Supp. 382 (S.D.N.Y. 1971) (although counsel for the issuer waived its fee, estimated at 20% of recovery, a settlement for 82% of the profits realized by the defendants not approved when there was no substantial defense to recovery); *Pappas v. Moss*, 257 F. Supp. 345 (D.N.J. 1966), *rev'd and remanded on other grounds*, 393 F.2d 865 (3d Cir. 1968) (settlement for an amount substantially less than the amount that would be recoverable under Section 16(b) not approved as against public policy).

See also *Morales v. Geothermal International, Inc.*, Fed. Sec. L. Rep. (CCH) P 98,038 (S.D.N.Y. 1981) (settlement approved after the court weighed the probability of recovery against the benefit of the proposed settlement agreement); *Matas v. Siess*, Fed. Sec. L. Rep. (CCH) P 97,325 (S.D.N.Y. 1980) (court approved settlement after finding that the settlement had been negotiated at arms length after completion of substantial discovery, the plaintiff had substantial obstacles to overcome, and the defendant had several defenses); *Schimmel v. Goldman & Banner Industries, Inc.*, Fed. Sec. L. Rep. (CCH) P 93,736 (S.D.N.Y. 1973) (settlement for 72% of possible maximum amount recoverable approved since defendant's contention that he was not an officer for purposes of Section 16(b), although he was a titular vice-president, may have had merit).

But see *Blau v. Kagan*, Fed. Sec. L. Rep. (CCH) P 92,119 (S.D.N.Y. 1968) (court approved settlement of \$28,001 out of a maximum total potential recovery of \$42,404, finding the settlement to be fair, adequate, and reasonable since long, protracted, and expensive litigation would be avoided and the issuer and its officers would be permitted to devote their attention to the issuer's business); *Blau v. Allen*, 171 F. Supp. 669 (S.D.N.Y. 1959) (settlement of \$45,000 out of maximum total potential recovery of \$75,000 approved).

(n149)Footnote 149. *Blau v. Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y. 1951) (the court emphasized that the potential liability amounted to ten times the settlement payment made).

But see *National Westminster Bancorp NJ v. Leone*, Fed. Sec. L. Rep. (CCH) P 94,301 (D.N.J. 1988) (issuer could not recover claimed short-swing profits from director and her family in trades allegedly made upon inside information where SEC had already brought and settled by consent judgment an action for disgorgement in connection with which the defendants had been required to pay a civil penalty).

(n150)Footnote 150. In *Kaplan v. Lipman*, Fed. Sec. L. Rep. (CCH) P 92,732 (S.D.N.Y. 1970); *Blau v. Brown & Western Nuclear, Inc.* Fed. Sec. L. Rep. (CCH) P 92,263 (S.D.N.Y. 1968), the courts reasoned that settlements of Section 16(b) claims were similar enough to settlements of class actions for the notice and opportunity for a hearing requirements in settlements of class actions to be applied to Section 16(b) claims.

(n151)Footnote 151. See *e.g.*, *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943) (a corporation that has received the benefit of an attorney's services should pay for the reasonable value of them); *FTR Consulting Group, Inc. v. Advantage Fund II, Ltd.*, 2005 U.S. Dist. LEXIS 20013, at 8 (S.D.N.Y. Sept. 13, 2005).

(n152)Footnote 152. *Blau v. Rayette-Faberge, Inc.*, 389 F.2d 469 (2d Cir. 1968); *Gilson v. Chock Full O' Nuts Corp.*, 331 F.2d 107 (2d Cir. 1964); *Lewis v. L.B. Nelson Corp.*, Fed. Sec. L. Rep. (CCH) PP 97,554, 97,621 (S.D.N.Y. 1980).

(n153)Footnote 153. *Cook & Feldman, Insider Trading Under the Securities Exchange Act*, 66 *Har. L. Rev.* 385, 421 (1953).

See, e.g., Morales v. Geothermal International, Inc., Fed. Sec. L. Rep. (CCH) P 98,038 (S.D.N.Y. 1981) (attorney's fees granted at rate of \$88 per hour); Matas v. Siess, Fed. Sec. L. Rep. (CCH) P 97,325 (S.D.N.Y. 1980) (37% of profits recovered awarded for attorney's fees); Blau v. Kagan, Fed. Sec. L. Rep. (CCH) P 92,119 (S.D.N.Y. 1968) (attorney's fees amounting to 20% of profits recovered); Blau v. Brown & Western Nuclear, Inc., Fed. Sec. L. Rep. (CCH) P 92,263 (S.D.N.Y. 1968) (attorney entitled to a \$7500 fee out of \$38,000 profits recovered although the services performed by the attorney were brief and uncomplicated, i.e., it was indicated that only thirty hours of time was needed on the case).

But see Blau v. Allen, 171 F.Supp. 669 (S.D.N.Y. 1959) (attorney's fees amounting to 40% of settlement seemed exorbitant).

In Blau v. Berkey and Berkey Photo, Inc., Fed. Sec. L. Rep. (CCH) P 92,264 (S.D.N.Y. 1968) and *Blau v. Brown & Western Nuclear, Inc.*, Fed. Sec. L. Rep. (CCH) P 92,263 (S.D.N.Y. 1968); the court emphasized that the most important factor in its determination of a reasonable attorney's fee was the corporation's windfall benefit that resulted directly from the plain tiff bringing the claim shortly before the statute of limitations had run.

But see Portnoy v. XTAL., 638 F. Supp. 489 (N.D. Ill. 1986), in which the court refused a claim for plaintiff's attorney's fees in the amount of approximately \$5,000, where a settlement agreement was reached under which the alleged insider would pay the issuer \$15,000, and the issuer would reimburse the insider for his attorney's fees. In the court's view, assuming that the insider's attorneys would also claim fees of approximately \$5,000, the proceeds remaining for the issuer, after payment of both fees, would be negligible.

(n154)Footnote 154. *Miracle Mart, Inc. v. Margolis*, 46 F.R.D. 458 (D. Mass. 1968) ; Molybdenum Corp. of America v. International Mining Corp., 32 F.R.D. 415 (S.D.N.Y. 1963).

(n155)Footnote 155. *Smolowe v. Delendo Corp.*, 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

(n156)Footnote 156. *See* A+ Network v. Shapiro, 960 F.Supp. 123, 125 (M.D. Tenn. 1997); *Lewis v. L.B. Nelson Corp.*, 510 F.Supp. 332, 333 (S.D.N.Y. 1980); *Lewis v. L.B. Nelson Corp.*, Fed. Sec. L. Rep. (CCH) P 97,554 (S.D.N.Y. 1980); *see also* 15 U.S.C. § 78aa; 28 U.S.C. § 1331.



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Federal Securities Exchange Act of 1934

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CHAPTER 8 Insider Reporting and Short-Swing Trading

2-8 Federal Securities Exchange Act of 1934 § 8.05

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§ 8.05 Prohibition of "Short Sales" and Restrictions on "Short Sales Against the Box" and Delayed Deliveries--Section 16(c)

Under Section 16(c), an insider is prohibited from engaging in "short sales" (selling equity securities of his company that he does not own at the time of the sale) and is subject to strict time limitations within which to deliver shares or deposit them for delivery following a sale, unless the required delivery would cause undue inconvenience or expense. The time limitations applicable to deliveries severely limit an insider's ability to engage in "short sales against the box" (selling equity securities that he owns but delivering borrowed securities to the buyer). Transactions involving options and other derivative securities entitling or obligating an insider to sell equity securities may represent "sales" subject to Section 16(c)'s restrictions, but whether the reverse situation--sales of actual equity securities at a time when the insider has a right to acquire the equity securities through exercise or conversion of derivative securities--represents a prohibited "short sale" under Section 16(c) is uncertain.

Section 16(c) prohibits any director, officer, or 10 percent shareholder subject to Section 16 n1 from selling, directly or indirectly, any equity security of the issuer (other than an exempt security) if the insider or his principal

(1) does not own the security sold n2; or

(2) owns the security sold but does not deliver it within twenty days after the sale, or does not deposit it in the mails or other usual channel of transportation within five days after the sale, n3 unless the insider or his principal can show

(a) that in good faith he was unable to make the delivery within twenty days or the deposit within five days; or

(b) that to make the delivery within twenty days or the deposit within five days would cause undue inconvenience or expense. n4

Section 16(c) sets forth an outright prohibition on insiders' sales of equity securities that are not owned or are not

delivered or deposited within the prescribed times. In contrast, Section 16(b) prohibits nothing, instead making insiders liable for disgorgement of "profits" from short-swing transactions. n4.1 Accordingly, violations of Section 16(c) are subject to enforcement action by the Commission or even criminal prosecution while, under Section 16(b), the Commission has no authority to bring any enforcement action. n5 Courts have held that there is not a private right of action under Section 16(c). n6

[1] "Short Sales"

Section 16(c)(1) prohibits an insider from selling an equity security that he (or his principal) does not own at the time of the sale, *i.e.*, engaging in a "short sale." n7 Section 16(c) does not, however, preclude an insider from selling securities as an agent for another party that in fact owns a number of equity securities at least equal to the number sold. n8

Section 16(c)(1) requires only that the insider "own" the equity securities sold, so that an ownership interest in equity securities that does not rise to the level of "beneficial ownership" required to be reported under Section 16(a) may be enough to permit an insider to enter into a sale of such securities. For example, in *Fuller v. Dilbert*, n9 the court held that, for purposes of Section 16(c), legatees under a will "owned" stock bequeathed to them even though legal ownership of such stock was vested in executors, the legatees' ultimate receipt of the stock was subject to their paying substantial estate taxes, and the legatees had never reported "beneficial ownership" of the legacy shares on a Form 4. n10 Whether Section 16(c)'s ownership requirement is satisfied if the insider has a right to acquire the equity security being sold is discussed in *Section 8.05[3]* below.

Section 16(c)(1) prohibits an insider from entering into a sale of equity securities if he does not "own" such securities, but it does not prohibit the insider from delivering "borrowed" equity securities--that is, equity securities other than the ones that the insider owns--to settle the sale. n11 Thus, Section 16(c)(1) does not itself forbid "short sales against the box," in which the insider, though owning the equity securities sold, delivers borrowed equity securities rather than his own. n12 Of course, as discussed in *Section 8.05[2]* below, Section 16(c)(2) imposes separate requirements that strictly limit an insider's ability to satisfy obligations under a sales contract by delivery of "borrowed" shares. n13

[2] "Short Sales Against the Box" and Delayed Delivery

Section 16(c)(2) prohibits an insider from selling an equity security if he (or his principal) owns the security but does not deliver it within twenty days after the sale, or does not deposit it in the mails or other usual channel of transportation within five days after the sale, except in specified circumstances (discussed below). n14 This provision is intended to prevent an insider from entering a contract for the sale of stock while keeping the stock registered in his name for an extended period to conceal the change in his holdings, n15 or from settling the sale by delivering, twenty or more days after the sale, stock purchased after the sale at a price lower than the sale price. n16

Section 16(c)(2) permits "short sales against the box," but severely limits an insider's ability to make use of this technique. A "short sale against the box" is one in which the seller owns an amount of securities equal to the number he sells short but nevertheless asks his broker to borrow the necessary number of shares to deliver to the buying broker; the seller later will cover his short position by directing his broker either to replace the borrowed securities with the ones owned all along by the seller or to purchase securities in the market to replace the borrowed securities. n17 Under Section 16(c), an insider may execute a sale and have his broker deliver borrowed shares, but he must deliver the securities that he owns to close out the short position within twenty days or deposit such securities in the mails or other usual channel of transportation within five days in order to comply with Section 16(c)(2). n18 Obviously, this requirement strictly limits the period in which an insider may be "short" issuer securities "against the box."

Although the Commission and its staff have generally focused on Section 16(c)(2) as it affects open-market transactions executed through brokers--the typical situation in which "short" sales may occur--the provision's prompt delivery requirement also applies to transactions not effected through a broker or in a trading market. Thus, insiders who contract

to sell equity securities privately generally may not delay delivery beyond the twenty-day delivery or five-day deposit period. The issue that will arise is whether contract terms that do not themselves require delivery of the equity securities for more than twenty days can relieve the insider of the obligation imposed by Section 16(c)(2).

An insider is not subject to Section 16(c)(2)'s twenty-day delivery/five-day deposit requirements if he or his principal can show that "in good faith he was unable to make such delivery or deposit within such time or that to do so would cause undue inconvenience or expense." n19 The courts have generally concluded that sales contracts that explicitly provided for delivery more than twenty days after the date of the contract do not violate Section 16(c)(2) because the insider is "unable" to deliver in good faith or because earlier delivery would cause "undue inconvenience or expense." n20

[3] Derivative Securities Under Section 16(c)

As a result of the Commission's adoption of the new rules under Section 16 that became effective May 1, 1991, n21 the treatment of options, warrants, and other derivative securities n22 under Section 16(c) has become more unsettled. Two distinct questions can arise:

- (1) Does Section 16(c) forbid an insider from "writing" a derivative security obligating or permitting the insider to sell equity securities if he does not own the number of equity securities which he may be required to deliver or if delivery will occur more than twenty days after the contract is entered into?
- (2) Does an insider's right to acquire equity securities by exercise of a derivative security represent "ownership" of such equity securities so that a sale of not more than that number of equity securities by the insider would not be deemed a "short sale" in violation of Section 16(c)(1)?

[a] Status of Acquisitions of Derivative Securities as Sales for Purposes of Section 16(c). An insider engaging in certain derivative securities transactions may acquire the legal obligation or right to sell equity securities of the issuer. For example, the insider may "write" a call option, which would obligate the insider to sell equity securities to the person who holds the option at a specified price during the term of the option. n22.1 Similarly, the insider might acquire a put option, which would give the insider the right to sell equity securities to the person who "wrote" the option at a specified price during the term of the option. n23

An insider's obligation or right to sell equity securities under a derivative security would appear to come within the broad definition of the term "sale" under the Exchange Act. Section 3(a)(14) of the Exchange Act provides that "[t]he terms 'sale' and 'sell' each include any contract to sell or otherwise dispose of."

Despite the breadth of the definition of the term "sale," in *Silverman v. Landa* n24 a district court and court of appeals concluded that an insider who had written both put option and a call option (a "straddle") had not engaged in a sale for purposes of Section 16(c). The district court reasoned that, although a call option might appear to fall within the general definition of the term "sale," that definition would not apply if "the context otherwise required" (quoting the introductory language of Exchange Act Section 3(a)); the "context" under Section 16(c) required that a call option be viewed only as an irrevocable offer to sell that would not become a "sale" until the option was exercised. n25 The court of appeals likewise concluded that the call option did not represent a "sale" under Section 16(c), based on prior holdings that a "sale" does not occur for Section 16(b) purposes until the insider's rights and obligations become fixed, which in the context of options was deemed to occur upon exercise. n26

Of course, for purposes of Section 16(b), the Commission's 1991 Section 16 rules turned on its head the traditional view of the courts that no "sale" occurs until an option is exercised. n26.1 In order to overrule the courts, the Commission adopted Rule 16b-6(a), which states in pertinent part:

The establishment of or increase in a call equivalent position or liquidation of or decrease in a put equivalent position shall be deemed a purchase of the underlying security for purposes of Section 16(b) of the Act, and the establishment of or increase in a put equivalent position or liquidation of or decrease in a call equivalent position shall be deemed a sale of the underlying securities for purposes of Section 16(b) of the Act... .

For reasons not explained by the Commission, neither Rule 16b-6(a) nor any other rule overrules the holdings of *Silverman v. Landa* with respect to whether derivative securities will be deemed a "sale" for purposes of Section 16(c). The Commission did, however, clearly indicate that it thought it was treating acquisitions of put equivalent positions as "sales" for purposes of Section 16(c). n27 In proposing Rule 16c-4, the Commission stated:

The proposed treatment of derivative securities is intended to subject derivative securities to the short sale prohibitions of section 16(c). The potential for abuse is not less when insiders establish put equivalent positions, rather than selling short underlying securities. Indeed, options were instrumental to insiders in the notorious "bear raids" of the early 1930's. A reading of the legislative history indicates the Congress did not want insiders, with access to inside information, speculating in their company's stock by acquiring short positions. Further, Congress did not want insiders to take short positions in conflict with their fiduciary duties, because insiders could use short positions to manipulate a stock price or to profit by a fall in the price of their company's stock. Derivative securities can be used to establish a short position, even where the insider has large stock holdings. The proposed rule thus would ensure that an insider does not have an economic interest in the poor performance of the issuer's stock. n28

The Commission was mistaken as to the effect of its adoption of Rule 16c-4 in 1991. n29 Rule 16c-4 merely provides an exemption from Section 16(c) for "establishing or increasing a put equivalent position ... so long as the amount of securities underlying the put equivalent position does not exceed the amount of underlying securities otherwise owned." An exemptive rule that defines a class of transactions that are not subject to Section 16(c) does not operate to make any transaction outside the scope of the exemption a violation of Section 16(c). n29.1 Thus, the Commission's failure to adopt a Rule affirmatively defining the term "sale" for purposes of Section 16(c), in the way Rule 16b-6(a) defines the term for purposes of Section 16(b), leaves it to the courts to determine whether to overrule *Silverman v. Landa*.

[b] Status of Rights to Acquire Equity Securities as "Ownership" of the Equity Securities for Purposes of Section 16(c). A distinct question under Section 16(c) is whether an insider's right to acquire equity securities under an option or other derivative security represents "ownership" of the underlying security so that a sale of an equal number of equity securities would not violate Section 16(c)(1).

The Commission deliberately designed Rule 16c-4 to not provide an exemption for this kind of transaction. n30 The logic of the current Section 16 rules would appear to support the view that an insider "owns" securities underlying derivative securities. Under these Rules, an insider's right to acquire equity securities at a fixed price represents "beneficial ownership" of the underlying equity securities for virtually all other purposes. n31

The only court to address the issue concluded that Section 16(c) was not violated where the insiders agreed, in a sales contract, to either exercise their right of conversion upon request of the purchaser or to deliver the derivative securities themselves (convertible preferred stock) together with documents transferring title thereto. n32

Of course, even if the insider were deemed to own equity securities acquirable through the exercise or conversion of a derivative security so that his sale of no greater a number of equity securities would not be deemed a short sale in violation of Section 16(c)(1), the delivery requirements of Section 16(c)(2) in most cases would still require the insider to deliver the equity securities he owns within twenty days of the sale or deposit them for delivery within five days. n33

Finally, the Commission staff has recognized, in the narrow context of broker-assisted cashless exercise transactions,

n34 that an insider's right to receive delivery of equity securities after he has duly exercised an option issued by the issuer should be viewed as "ownership" of the equity securities under Section 16(c). n35 The staff took this position even though the equity securities might not even be issued until several days after the sale. n36

FOOTNOTES:

(n1)Footnote 1. For discussion of who is an insider under Section 16(c), see § 8.02 *supra*.

(n2)Footnote 2. Section 16(c)(1).

"Short sales" are discussed in § 8.05[1] *infra*.

(n3)Footnote 3. Section 16(c)(2).

"Short sales against the box" and delayed deliveries are discussed in § 8.05[2] *infra*.

(n4)Footnote 4. Section 16(c)(2).

(n5)Footnote 4.1. *United States v. Chestman*, 947 F.2d 551, 572 (2d Cir. 1991) (stating that Section 16(b) regulates short-swing trading by insiders and requires that they disgorge any profits from such trading to the corporation).

(n6)Footnote 5. *See* Sec. Exch. Act § 21(d)(1) & (e) (authority to seek injunctive relief in federal district and territorial courts); Sec. Exch. Act § 21C (authority to issue cease and desist orders and require an accounting and disgorgement); Exch. Act § 21(d)(3) (authority to seek fines in federal district courts for violations of Section 16(a) and (c) of the Exchange Act, rules and regulations thereunder, or any cease and desist order).

Remedies under Sections 21C and 21(d)(3) were added by the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931. Prior to enactment of these provisions, enforcement action under Section 16(c) generally took the form of injunctive actions. *See, e.g., SEC v. Gillette*, Litig. Rel. No. 11502 (S.D. Fla. July 27, 1987); *SEC v. Tate*, Litigation Rel. No. 11485 (S.D. Fla. July 14, 1987).

(n7)Footnote 6. *See* *Executive Telecard, Ltd. v. Mayer*, 941 F.Supp. 435, 437 (S.D.N.Y. 1996) (finding that plaintiff did not carry its heavy burden of showing that Congress intended to create a private right of action to enforce Section 16(c)); *Silverman v. Landa*, 200 F. Supp. 193, 198 (S.D.N.Y. 1961), *aff'd*, 306 F.2d 422 (2d Cir. 1962) (same).

(n8)Footnote 7. Thus, for example, an officer of an issuer who has acquired unfavorable inside information that will result in a decrease in the price of his corporation's stock cannot agree to sell stock he does not own and then cover that sale by purchasing stock after the stock's price has dropped. *See, e.g., SEC v. Gillette, supra*

Section 16(c)(1) does not in fact use the term "short sale."

"Short sales" are regulated under Section 10 of the Exchange Act and the rules promulgated thereunder. *See* § 6.02[3], *supra*.

(n9)Footnote 8. *Rogers v. Valentine*, 306 F. Supp. 34, 38 (S.D.N.Y. 1969).

(n10)Footnote 9. 244 F. Supp. 196 (S.D.N.Y. 1965), *aff'd per curiam sub nom. Righter v. Dilbert*, 358 F.2d 305 (2d Cir. 1966) .

(n11)Footnote 10. *244 F. Supp. at 214-15*. The court emphasized that the insiders were specific legatees of the stock, and pointed out that

- (1) the claims of creditors that might result in the legatees not receiving the stock were in fact negligible compared with the assets in the estate;
- (2) claims of other would-be beneficiaries were insubstantial and had been withdrawn;
- (3) the proceeds of the sale alleged to violate Section 16(c)(1) were sufficient to provide for taxes due; and
- (4) the taxes due had in fact been paid.

Id.

(n12)Footnote 11. Sec. Act Rel. No. 6099, C.C.H. Fed. Sec. L. Rep. P 2,705H, Pt. II.H.2 (1979); SEC Letter to Michael G. Marks (Div. Corp. Fin., Mar. 26, 1980). In the Michael G. Marks interpretive letter, the Commission staff rejected the suggestion of inquiring counsel that delivery of borrowed securities would represent a sale of securities not owned by the insider regardless of the insider's other holdings.

(n13)Footnote 12. Sec. Exch. Act Rel. No. 34-18114, Fed. Sec. L. Rep. (CCH) P 26,062, Question 18 & 30 (1981).

(n14)Footnote 13. Indeed, the basis for concluding that Section 16(c)(1) does not preclude delivery of borrowed shares would appear to be that, because Section 16(c)(2) imposes a separate and strict limitation on delivery against a sale, it is unnecessary to interpret Section 16(c)(1) narrowly on this point. *See* SEC Letter to Michael G. Marks, *supra* (Commission staff conceded that a prior Commission statement summarizing Section 16(c)(2) had "assumed" that Section 16(c)(1) does not forbid short sales against the box, but concluded that that interpretation is in fact correct).

(n15)Footnote 14. Section 16(c)(2). It appears that an insider avoids a violation of this provision if he either makes delivery within twenty days or makes the deposit within five days; failure to do one but not the other does not apparently violate the statute. Michael G. Marks Letter to SEC (Div. Corp. Fin., Dec. 19, 1979).

(n16)Footnote 15. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 25 (1934).

(n17)Footnote 16. S. Rep. No. 1455, 73d Cong., 2d Sess. 52 (1934).

(n18)Footnote 17. *See* United States v. Wood, 364 F.3d 704, 718 (6th Cir. 2004)(defining short sales against the box); *see also* Sec. Exch. Act Rel. No. 34-18114, Fed. Sec. L. Rep. (CCH) P 26,062, Question 18 & n.30 (1981); Sec. Act Rel. No. 6099, Fed. Sec. L. Rep. (CCH) P 2,705H, Pt. II.H.2, n.37 (1979).

(n19)Footnote 18. Michael G. Marks Letter (Div. Corp. Fin., Dec. 19, 1979).

The Commission staff introduced confusion on this point in Sec. Exch. Act Rel. No. 34-18114, Fed. Sec. L. Rep. (CCH) P26,062, Question 18 n.30 (1981). There, the staff stated:

A short sale against the box is a brokerage transaction in which the seller already owns an amount of securities at least equal to the amount he wishes to sell short. While Section 16(c) of the Exchange Act prohibits insiders from making short sales, i.e., the sale of a security which the seller does not own, this prohibition does not extend to short sales against the box where the securities ultimately to be delivered already belong to the seller. *See* letter to Michael G. Marks dated February 26, 1980.

By completely failing to point out that Section 16(c)(2) imposes strict time limits on the delivery of the equity securities owned by the insider in the case of a short sale against the box, the Commission staff seemed to say in footnote 30 that short sales against the box are permitted without restriction under Section 16(c). This is clearly not the case. Sec. Act Rel. No. 6099, Fed. Sec. L. Rep. (CCH) P 2,705H, Pt. II.H.2, n.38 (1979).

(n20)Footnote 19. Section 16(c)(2).

(n21)Footnote 20. See *Silverman v. Landa*, 306 F.2d 422, 425, Fed. Sec. L. Rep. (CCH) P 91,173 (2d Cir. 1962) (insider who writes a call option is unable to deliver the underlying securities until called on to do so, i.e., when the optionee exercises the option); *Fuller v. Dilbert*, 244 F. Supp. 196, 215-16, (S.D.N.Y. 1965) ("undue inconvenience" shown where contract called for delayed delivery to permit sellers to effect a release of bequeathed shares from estate, raise funds to pay estate taxes, take other usual steps in estate administration, and obtain the return of pledged securities), *aff'd per curiam sub nom. Righter v. Dilbert*, 358 F.2d 305 (2d Cir. 1966) .

Significantly, the Commission filed an *amicus curiae* brief in *Fuller v. Dilbert* arguing that Section 16(c)(2)'s delivery period should begin to run not on the date of the sale contract but from the date of delivery specified in the contract. 244 F. Supp. at 216 . The court did not decide on the proper construction of Section 16(c)(2), but instead found that delivery within twenty days after execution of the sale contract was excused because such delivery, in that case, would cause "undue inconvenience." *Id.*

(n22)Footnote 21. Sec. Exch. Act Rel. No. 28869, Fed. Sec. L. Rep. (CCH) P 84,709 (Feb. 8, 1991).

(n23)Footnote 22. The term "derivative securities" is generally defined in Rule 16a-1(c) to include

any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security... .

Section 16(c) does not itself make reference to derivative securities.

(n24)Footnote 22.1. *Magma Power Co. v. Dow Chem. Co.*, 136 F.3d 316, 321 (2d Cir. 1998) ("A call option gives the option holder the right to buy shares of an underlying security at a particular price... .").

(n25)Footnote 23. *Id.* ("A put option is the right to sell a security at a specified price.") See generally Sec. Exch. Act Rel. No. 28869, Fed. Sec. L. Rep. (CCH) P 84,709, Pt. III (Feb. 8, 1991).

The right or obligation to deliver equity securities generally is deemed a "put equivalent position" under the above Section 16 Rules. Rule 16a-1(h) defines the term "put equivalent position" to mean

a derivative security position that increases in value as the value of the underlying equity decreases, including, but not limited to, a long put option and a short call option position.

(n26)Footnote 24. 200 F. Supp. 193 (S.D.N.Y. 1961), *aff'd*, 306 F.2d 422 (2d Cir. 1962).

(n27)Footnote 25. 200 F. Supp. at 197-98. The Commission, in an *amicus curiae* brief, reportedly agreed that Section 16(c) was not violated by the writing of a call option, although the Commission apparently emphasized the fact that the insider owned enough of the underlying equity securities to fully "cover" the call option. *Id.* at 198.

(n28)Footnote 26. 306 F.2d at 424-25 (finding no Section 16(b) liability where an insider sold both a call option

and put option within six months)(citing *Blau v. Ogsbury*, 210 F.2d 426, 427 (2d Cir. 1954)); *Falco v. Donner Foundation, Inc.*, 208 F.2d 600 (2d Cir. 1953)) .

(n29)Footnote 26.1. *Magma Power Co.* 136 F.3d at 321 (noting that under Rule 16b-6(a), "the acquisition or disposition of a derivative security with a fixed exercise price is treated just as if the insider had traded the underlying security itself"); *Gryl v. Shire Pharms. Group, PLC*, No. OO-CV-9173(HB), 2001 U.S. Dist. LEXIS 13371, at *5 n.4 (S.D.N.Y. Aug. 31, 2001) ("In 1991, the SEC adopted comprehensive amendments to its rules under Section 16(b) under which the acquisition of derivative securities was held to be equivalent with the acquisition of the underlying securities.")

(n30)Footnote 27. See Sec. Exch. Act Rel. No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 (Dec. 2, 1988), Pt. IV.C.

(n31)Footnote 28. *Id.* (footnote omitted). The Commission also suggested in Sec. Exch. Act Rel. No. 34-26333, C.C.H. Fed. Sec. L. Rep. P 84,343 (Dec. 2, 1988) that, "as a result of" proposed Rule 16c-4, "put equivalent positions will be deemed violations of Section 16(c) in certain circumstances." *Id.*, Pt. XI.

(n32)Footnote 29. For a discussion of the exemption under Rule 16c-4, see § 8.06[19][d] *infra*.

(n33)Footnote 29.1. Merritt B. Fox, *Insider Trading Deterrence Versus Managerial Incentives: A Unified Theory of Section 16(b)*, 92 Mich. L. Rev. 2088, 2203 n. 213 (1994) (stating that the new Rule 16c-4 "implies that an insider does violate 16(c) when she purchases more put options than she owns underlying shares, but nothing in the statute, which by its terms make unlawful a statutory insider selling an equity security 'if the person selling ... does not own the security sold,' or in the 16 rules, directly provides that such a put purchase is a violation").

(n34)Footnote 30. Sec. Exch. Act Rel. No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 (Dec. 2, 1988), Pt. IV.C. The Commission explained that, in adopting Section 16(c), Congress was particularly concerned with this form of transaction, particularly in view of the fact that the insider could repurchase shares in the market to cover his short position. See *id.*

(n35)Footnote 31. Rule 16a-1(a)(2)(ii)(F); Rule 16a-1(d); Rule 16a-4(a). The one exception is that acquisitions and dispositions of derivative securities are reported separately on Forms 4 and 5 (on Table II) from transactions in the underlying securities (reported on Table I). See Rule 16a-4(d); Form 4; Form 5.

(n36)Footnote 32. *Fuller v. Dilbert*, 244 F. Supp. 196 (S.D.N.Y. 1965), *aff's per curiam sub nom. Righter v. Dilbert*, 358 F.2d 305 (2d Cir. 1966) .

(n37)Footnote 33. The issue could arise, however, in the context of a "put equivalent position" that an insider acquires at a time he holds an offsetting "call equivalent position." Rule 16c-4 does not itself exempt this kind of transaction but, as discussed in Section 8.05[2] above, there is support for the view that Section 16(c)(2) would not require prompt delivery prior to the exercise of the put equivalent position derivative security (at least where the time of exercise is outside the control of the insider). If so, the conclusion that such transaction is not regarded as a short sale prohibited by Section 16(c)(1) would mean that an insider could engage in the transaction even in the absence of an explicit exemption under Rule 16c-4.

(n38)Footnote 34. A broker-assisted cashless exercise is a transaction in which a holder of a stock option issued by the issuer (usually under a compensatory option plan) sells shares to be delivered upon exercise of the option in order to pay the exercise price and applicable withholding taxes. To do this, typically the optionee's notice of exercise is delivered to both the issuer and a stock broker, with additional irrevocable instructions given to the broker to sell some or all of the number of shares being acquired by exercise of the option and to pay the exercise price and any withholding taxes to the issuer. The broker will then, in the usual case, immediately sell shares on behalf of the optionee, and will either pay the exercise price and withholding taxes out of the proceeds of such sale or advance immediate payment to

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the issuer against the proceeds of the sale (the immediate payment sometimes being required to comply with corporate law requirements or terms of the option plan). *See generally* Ware & Freidenrich (Div. Corp. Fin., Jan. 10, 1992); Safeco Corp. (Div. Corp. Fin., Aug. 23, 1991); Dean Witter Reynolds Inc., Fed. Sec. L. Rep. (CCH) P 79,684 (Div. Corp. Fin., Apr. 30, 1991); Dean Witter Reynolds Inc., Fed. Sec. L. Rep. (CCH) P 78,676 (Div. Corp. Fin., Dec. 18, 1987).

(n39)Footnote 35. Dean Witter Reynolds Inc., Fed. Sec. L. Rep. (CCH) P 79,684 (Div. Corp. Fin., Apr. 30, 1991). The Commission staff imposed conditions on this interpretive position, however, stating in pertinent part:

[C]ashless stock option exercises made in conformity with current Regulation T [margin regulation] provisions... where settlement occurs no later than regular way will not violate Section 16(c) of the Securities Exchange Act of 1934.

In Safeco Corp. (Div. Corp. Fin., Aug. 23, 1991), the staff imposed conditions similar to the "regular way" settlement requirement imposed in Dean Witter Reynolds Inc. on a program in which the issuer itself would repurchase all of the shares acquired upon exercise of the option at the fair market value of the shares on the date the issuer received the notice of exercise. The staff concluded that this procedure would not be deemed to violate Section 16(c) if settlement occurred within five business days and the optionee received no funds before settlement.

(n40)Footnote 36. *See* Dean Witter Reynolds Inc., Fed. Sec. L. Rep. (CCH) P 79,684 (Div. Corp. Fin., Apr. 30, 1991).

Cf. Rule 16c-3 (exemption from Section 16(c) for sales of "when issued" and "when distributed" equity securities). Rule 16c-3 is discussed in § 8.06[19][c] *infra*.

The staff's position is consistent with revisions of Regulation T adopted by the Federal Reserve Board in 1987 in order to permit brokers to engage in broker-assisted cashless exercise transactions. *See* Fed. Res. Sys. Docket No. R-0611, Order, Fed. Sec. L. Rep. (CCH) P 84,208 (Dec. 18, 1987) (adopting release for amendments to Regulation T to permit broker-dealers to participate in cashless exercise transactions without violating margin rules); Fed. Res. Sys. Docket No. R-0611, Order, Fed. Sec. L. Rep. (CCH) P 84,155 (Aug. 24, 1987) (proposing release for such amendments).



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CHAPTER 8 Insider Reporting and Short-Swing Trading

2-8 Federal Securities Exchange Act of 1934 § 8.06

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§ 8.06 Exemptions

The Commission has exempted certain transactions from all or some of the provisions of Section 16. Transactions exempted from both Section 16(a) reporting and Section 16(b) liability include certain transactions relating to a pro rata stock split, stock dividend, or rights distribution, certain transactions under dividend and interest reinvestment plans, transactions pursuant to a domestic relations order, transactions that effect only a change in the form of beneficial ownership (other than incident to the exercise of a derivative security), transactions by fiduciaries during the twelve months after appointment involving securities held by an estate, certain transactions by dealers and underwriters in connection with a distribution, and odd-lot transactions by an odd-lot dealer (also exempted from Section 16(c)). Certain small acquisitions are exempted from the requirement that they be reported on a month-end Form 4 under Section 16(a), but such transactions are reportable on the year-end Form 5 and remain subject to potential Section 16(b) liability. Transactions exempted only from Section 16(b) liability and not from Section 16(a) reporting (although deferred reporting may be permitted) include certain transactions by registered investment companies, registered public utility holding companies, and companies subject to the Interstate Commerce Act, certain transactions under employee benefit plans, certain issuer redemptions, bona fide gift and inheritance transactions, certain transactions relating to exercises and conversions of derivative securities, and dispositions of derivative securities where no value is received, certain transactions resulting from mergers and related transactions between a parent company and a subsidiary at least 85 percent owned by the parent, certain transactions relating to the deposit or withdrawal from a voting trust, and acquisitions in connection with a debt previously contracted. In addition, Section 16 provides an exemption for market makers and foreign and domestic arbitrage transactions, and the Commission has adopted a complete exemption for the securities of certain foreign issuers. Exemptions from Section 16(c)'s short-sale prohibition are also provided for brokers acting in an agency capacity, dealers participating in a distribution, sales of "when issued" or "when distributed" securities, and fully-hedged short sales resulting from transactions in put and call options.

The Commission has adopted several exemptions from all or some of the provisions of Section 16. These exemptions were, in many cases, substantially revised in connection with the comprehensive revision to the Section 16 rules that became effective May 1, 1991. n1 Further revisions became effective in August 1996. n2 The revisions to the rules under Section 16 that implemented provisions from the Sarbanes-Oxley Act of 2002 altered only the reporting requirements under Section 16(a) and did not affect the exemptive rules under Sections 16(b) and 16(c).

The Commission's authority to adopt rules exempting certain securities and transactions from the statute is based upon:

- (1) the rulemaking power of the Commission under various sections of the Exchange Act to interpret and define the Act's provisions and to exempt securities from any of those provisions, *e.g.*, Sections 3(a)(12), 3(b), and 23(a); and
- (2) the specific power given to the Commission under Section 16(b) to exempt from that subsection "any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of [Section 16(b)]."

In addition, Section 16 itself provides an exemption for market makers (Section 16(d)), and for foreign and domestic arbitrage transactions (Section 16(e)).

Furthermore, Section 12(h) of the Exchange Act grants the Commission the authority to exempt insiders from the provisions of Section 16 if the exemption is consistent with the public interest or the protection of investors. n3

Under this authority, the Commission has adopted three broad classes of exemptions. The series of rules under Section 16(a) exempt certain transactions from the reporting requirements of Section 16. Significantly, under Rule 16a-10, any transaction that is exempt from reporting is also exempt from potential liability under Section 16(b). The series of rules adopted by the Commission under Section 16(b) exempt certain transactions from potential short-swing liability, but not from the reporting obligations of Section 16(a). Finally, under Rule 3a12-3(b), the Commission exempted securities of foreign private issuers from Section 16. n4

[1] Exemption for Stock Splits, Stock Dividends, and Pro Rata Rights Distributions--Rule 16a-9

Rule 16a-9(a) exempts "the increase or decrease in the number of securities held as a result of a stock split or stock dividend applying equally to all securities of a class, including a stock dividend in which equity securities of a different issuer are distributed." No provision under the pre-1991 Section 16 rules explicitly exempted stock splits or dividends, although there was some authority for the proposition that such transactions did not constitute purchases or sales for purposes of Section 16(b). n5

Rule 16a-9(b) exempts the acquisition of rights, such as shareholder or preemptive rights, pursuant to a pro rata grant to all holders of the same class of equity securities registered under Section 12 of the Act. n6 This provision is the successor to old Rule 16b-11, which exempted sales of certain rights to subscribe for equity securities distributed to holders of a class of equity securities. n7 The Rule was intended to exempt not only pro rata grants of subscription rights, but also pro rata grants of repurchase rights and rights granted under a "poison pill" shareholder rights plan. n8 Under Rule 16b-6(a), the acquisition of such rights would apparently constitute a purchase or sale of the equity securities to which the rights relate, absent this exemption. n9 The exercise of such rights would be eligible for exemption under Rule 16b-6(b). n10 In contrast to old Rule 16b-11, no exemption would be available under Rule 16a-9 (or Rule 16b-6(b)) for a sale of such rights. n11

One area of uncertainty when Rule 16a-9 was first adopted was whether the Rule exempted transactions relating to stock dividends and pro rata distributions of rights only if the equity security issued as a dividend, and the equity security to be acquired or sold pursuant to the right, is of the same class as the class of equity security with respect to which the pro rata distribution is made. The issue was resolved in 1996 when the Commission expressly covered securities of a different issuer by adopting the closing phrase of Rule 16a-9(a). n12 Although clause (b) was not likewise amended, its reference to holders of the "same class" should be read to mean that *all* holders of given class must receive the rights in order for the exemption to apply. Otherwise, for the reasons noted above, a distribution of rights could be deemed a "purchase" or "sale" under Rule 16b-6(a), regardless of the fact that the insider might have

exercised no volition in acquiring the rights. n13

The exemption for stock splits, stock dividends, and pro-rata rights applies not only to the short-swing profits liability provisions of Section 16(b), but also to the reporting requirements of Section 16(a) and the short-sale prohibition of Section 16(c). n14 The exemption from reporting creates the somewhat anomalous situation in which, although an insider's beneficial ownership has changed due to a stock split, stock dividend, or rights distribution, nothing requires the insider to explain changes to the number of securities previously reported as beneficially owned on Forms 3, 4, or 5. n15 The Commission acknowledged this result in the adopting release for the 1991 rules, pointing out that an insider may note the reason for such changes in the space provided on Form 4 or 5. n16 The exemption from Section 16(c) would appear to apply to transactions possibly deemed short sales that could result from the acquisition of a right to "put" securities back to the issuer through a rights distribution. n17

[2] Exemption for the Reinvestment of Dividends or Interest--Rule 16a-11

Rule 16a-11 provides that any acquisition of securities by insiders resulting from the reinvestment of dividends or interest on securities of the same issuer will be exempt from reporting and potential liability under Section 16 if made pursuant to a plan that:

- (1) provides for the regular reinvestment of dividends or interest;
- (2) allows for broad-based participation; and
- (3) does not discriminate in favor of employees and operates on substantially the same terms for all plan participants.

In 1996 the Commission returned this exemption to Rule 16a-11, where it had originally been codified prior to 1991. In 1991, the Commission moved the original Rule 16a-11 exemption for dividend and interest reinvestment plans to Rule 16b-2, thereby effectively requiring transactions under such plans to be reported on Form 5. Rule 16b-2 and its predecessor required a dividend or interest reinvestment plan to be available on the same terms to *all* holders of a class of securities. This "all holders requirement" made the exemption unavailable to insiders when issuers excluded foreign shareholders from their plans. The Commission determined in 1996 that Rule 16b-2 was overly restrictive and that the three conditions set forth in its new Rule 16a-11 adequately protected against abuse of the exemption. n18 In 1996, the Commission also moved Rule 16b-2 back to its original location, Rule 16a-11.

The exemption, both in its current and prior versions, has been interpreted to cover arrangements that are separate from, but operate on a similar basis to, an issuer's qualifying dividend or interest reinvestment plan. Thus, dividend reinvestment provisions in employee benefit plans can result in exempt transactions for insiders, even if the "dividends" are accrued on "phantom" stock or derivative securities, provided that the issuer has a qualifying dividend reinvestment plan available for the *underlying* class of securities. n19

The staff also interpreted the exemption to cover dividend and interest reinvestment provisions offered by brokerage firms on securities held in a client account at the firm, provided that the issuer offers a dividend reinvestment plan. n20 Given that such brokerage firm plans typically are made available to all of a firm's clients on the same basis, and the issuers' lack of control over the firms, it is unclear why the staff insisted that the issuer must also operate a plan in order for the brokerage firm's plan to be exempt.

The Rule exempts only the reinvestment of dividends or interest; it does not exempt the acquisition of securities through voluntary cash contributions made by participants in the plan. n21 Moreover, Rule 16a-11 exempts only the acquisition of securities pursuant to a dividend or interest reinvestment plan and not the subsequent disposition of those securities. n22

[3] Exemption for Transactions Pursuant to Domestic Relations Orders--Rule 16a-12

In 1996, the Commission adopted an exemption under Section 16(a) for acquisitions or dispositions pursuant to a "domestic relations order," as defined under the Internal Revenue Code or ERISA. Although the general view among commentators had been that transactions occurring pursuant to a divorce should not be treated as involving a "purchase" or "sale," there had been some uncertainty on this point because the insider often would have some say in negotiating what property would be subject to a domestic relations order. In 1991, the Commission adopted an exemption for dispositions of employee benefit plan securities pursuant to qualified domestic relations orders as defined under ERISA. Rule 16a-12 reflects the Commission's determination that all such transactions are unlikely to be influenced by access to inside information and thus that a broader exemption was warranted. n23

[4] Exemption for Changes in the Form of Beneficial Ownership--Rule 16a-13

Rule 16a-13, also adopted in 1996, exempts any change in the form of an insider's beneficial ownership that does not change the insider's pecuniary interest in the subject securities. Examples of such transactions are distributions from employee benefit plans or transfers to certain "living trusts." The rule expands on and codifies an earlier staff interpretation. n24 As with the exemption for transactions pursuant to a divorce, Rule 16a-13 provides a firm basis for what most commentators believed was the appropriate result for such transactions.

The exemption for changes in the form of beneficial ownership has two exceptions, both involving transactions that can be exempt from Section 16(b) under different rules, but which are still subject to reporting under Section 16(a). First, Rule 16a-13 does not cover the exercise or conversion of a derivative security, which is required to be reported on a Form 4, n25 but typically will be exempt from potential liability under Rule 16b-6(b). Second, Rule 16a-13 does not cover the deposit of securities into or withdrawal of securities from a voting trust, which instead is governed by Rule 16b-8.

[5] Temporary Exemption for Executors and Administrators of Estates--Rule 16a-2(d)

Rule 16a-2(d) n26 provides an exemption from Section 16(a) and Section 16(b) for transactions during the twelve months following appointment and qualification of persons acting in the following capacities, to the extent they are acting in such capacities:

- (1) executors or administrators of the estate of a decedent; n27
- (2) guardians or members of a committee for an incompetent; n28
- (3) receivers, trustees in bankruptcy, assignees for the benefit of creditors, conservators, liquidating agents, and similar persons authorized by law to administer the estate or assets of other persons; n29 and
- (4) fiduciaries acting in similar capacities n30 for a period of twelve months following their appointment and qualification. n31 After the twelve-month period expires, a fiduciary will be subject to the reporting requirements of Section 16(a) and to the liability provisions of Section 16(b) with respect to the securities held by the estate only if the estate is a more than ten percent beneficial owner of any non-exempt class of the issuer's equity security registered under Section 12 of the Act. n32

The primary purpose of Rule 16a-2(d) is to permit the liquidation of an insider's estate, without the filing of reports under Section 16(a), and without the risk of liability under Section 16(b), through any sales of estate securities by the executor or administrator of the estate although the insider may have purchased securities within six months prior to the sales. n33 The Rule 16a-2(d) exemption, however, does not run with the securities, n34 but is applicable only when the securities are held by the persons listed in the Rule. n35

It appears that a fiduciary whose transactions are exempted by Rule 16a-2(d) may nevertheless have to include securities held by the estate over which he has voting or dispositive power with his personal holdings for purposes of determining whether he is a beneficial owner of more than ten percent of an outstanding class of equity securities under Rule 16a-1(a)(1). n36

[6] Section 16(a) and 16(b) Exemptions for Transactions by Market Professionals

[a] Exemption of Certain Transactions Effected in Connection With a Distribution--Rule 16a-7. A person participating in an underwriting may already be an insider of the issuer whose securities he is distributing, or may become one as a result of his participation in the distribution. n37 Rule 16a-7, n38 however, provides an exemption from Section 16(a) reporting and Section 16(b) liability for transactions in connection with a person's participation in an underwriting. n39 An insider can participate in the underwriting of issuer securities without the underwriting transactions being reportable under Section 16(a) or subject to matching under Section 16(b) with the insider's other purchases and sales of the issuer's equity securities if:

(1) he is engaged in the business of distributing securities and is participating in good faith, in the ordinary course of his business, in the distribution; n40

(2) the security involved in the transaction is:

(i) part of the block of securities being distributed and is acquired by the person effecting the transaction, with a view to distribution, from the issuer or other person on whose behalf such securities are being distributed or from a person who is participating in good faith in the distribution; n41 or

(ii) purchased in good faith by or for the account of the person effecting the transaction for the purpose of stabilizing the market price of securities of the class being distributed or to cover an over-allotment or other short position created in connection with the distribution. n42

Each person participating in the underwriting must qualify on an individual basis for the exemption under Rule 16a-7. n43

[b] Exemption for Odd-Lot Dealers--Rule 16a-5. Rule 16a-5 n44 provides an exemption from Section 16(a) reporting and, by virtue of Rule 16a-10, from Section 16(b) liability for purchases and sales of securities by odd-lot dealers n45 if such purchases and sales are:

(1) in odd-lots to the extent reasonably necessary to carry on odd-lot transactions; or

(2) in round lots to offset odd-lot transactions previously or simultaneously executed or reasonably anticipated in the usual course of business.

One who properly performs the functions of an odd-lot dealer is entitled to the exemption, although the exemption is not applicable to an odd-lot dealer who takes a position not reasonably related to his odd-lot business. n46

[7] Reporting Deferral for Small Transactions--Rule 16a-6

Rule 16a-6 n47 provides a deferral from the requirement that a transaction be reported under Section 16(a) on Form 4 within two business days after the transaction occurred. The reporting deferral allows an acquisition to be reported on a Form 5 filed with respect to the fiscal year in which the transaction occurred, if:

(1) total acquisitions of securities of the same class (including securities underlying derivative securities) within the six months preceding the transaction, other than acquisitions that were exempt from Section 16(b) or that were previously reported, do not exceed \$10,000 in market value; n48

(2) the person making the acquisition does not within six months thereafter make any disposition, other than by a transaction exempt from Section 16(b); n49 and

(3) the transaction is not an acquisition from the issuer or an employee benefit plan sponsored by the issuer. n50

The utility of Rule 16a-6 was expanded in 1996 when the Commission adopted the above clause that excludes exempt or previously reported transactions from the \$10,000 limitation.

If an acquisition that was subject to Rule 16a-6's reporting deferral no longer qualifies (for example, if there occurs a non-exempt disposition within the six months after the small acquisition), an acquisition that has not yet been reported must be reported on a Form 4 before the end of the second business day following the day on which the conditions of Rule 16a-6(a) were no longer met. n51

[8] Exemptions for Regulated Entities

[a] Exemption for Certain Transactions by Investment Companies--Rule 16b-1(a). Rule 16b-1(a) n52 exempts a purchase and sale, or sale and purchase, of a security by an investment company from Section 16(b) if:

(1) the investment company is registered under the Investment Company Act of 1940; and

(2) both the purchase and the sale of the security have been exempted from Section 17(a) of the Investment Company Act (prohibiting transactions between affiliated persons and underwriters of a registered investment company, on the one hand, and the registered investment company or a company controlled by the registered investment company, on the other hand) by rule or order of the Commission. n53

[b] Exemption for Certain Transactions by Public Utility Holding Companies and Their Subsidiaries--Rule 16b-1(b). Rule 16b-1(b) n54 exempts a purchase and sale, or sale and purchase, of a security by a public utility holding company or its subsidiary from Section 16(b) if:

(1) the public utility holding company is registered under the Public Utility Holding Company Act of 1935 or is a subsidiary company of a registered holding company; and

(2) both the purchase and sale of the security have been approved or permitted by the Commission under the Public Utility Holding Company Act of 1935 or the rules and regulations promulgated thereunder. n55

[9] Exemptions for Transactions Between an Issuer and Its Officers and Directors--Rule 16b-3

On May 1, 1996, the Commission adopted significant rule changes under Section 16 of the Exchange Act. n56 The most significant aspect of the 1996 amendments n57 were a complete rewrite, and a reorientation, of Rule 16b-3, the rule that traditionally has provided an exemption from Section 16(b) for certain employee benefit plan transactions. The version of Rule 16b-3 adopted in 1996 provides a variety of simple exemptions for most stock-based transactions between a company and its officers and directors, while eliminating many of the restrictions and procedures historically required for employee benefit plan transactions to be exempt. Rule 16b-3 as amended applies to all employee benefit plan

transactions occurring on or after November 1, 1996. n58 Accordingly, transactions occurring after November 1, 1996 under employee benefit plans must satisfy the conditions of Rule 16b-3 as a basis for exempting any post transaction under such plan, award, or arrangement. After May 1, 1997, the six-month anniversary of Rule 16b-3's effective date, most vestiges of the pre-1996 versions of Rule 16b-3 were no longer of importance.

[a] Background of Rule 16b-3. In 1988, n59 the Commission proposed the first comprehensive amendments to Rule 16b-3 since the rule had been adopted. The amendments were proposed in the context of a complete review of the rules and forms under Section 16, and attempted to respond to the profusion of new equity-based compensation arrangements and the accretion of years of no-action letter interpretations which left in jeopardy one who merely read and relied on the text of then-Rule 16b-3. The project resulted in a re-proposal in 1989 n60 and, finally, the adoption of new rules in early 1991. n61 The version of Rule 16b-3 adopted in 1991 attempted to supplement the exemption that had existed for traditional "discretionary award" plans, such as employee stock option plans, and the interpretations applicable to "formula" plans, with rules specifically oriented toward other types of plans, such as "participant-directed" individual savings account plans. n62 Almost immediately after adoption of the 1991 version of Rule 16b-3, the Commission heard complaints that the rules presented substantial administrative burdens for employee benefit plans and, in some cases, simply could not be satisfied. To its credit, the Commission committed to simplify the rules and in the interim allowed companies to elect to rely on the pre-1991 version of Rule 16b-3. n63

With the adoption of the 1996 version of Rule 16b-3, the Commission fulfilled its commitment to provide simple and workable exemptions for employee benefit plan transactions. In lieu of the complex procedural safeguards contained in the 1991 version of Rule 16b-3, the current version of Rule 16b-3 is founded on the premise that transactions between a company and its officers and directors, who owe state law fiduciary duties to the company and its stockholders, n64 do not present the possibility for the type of short-swing trading abuse that Section 16 was designed to address. As a result, Rule 16b-3 now contains few of the procedural safeguards that the pre-1996 versions of the rule contained. For example, it is possible to exempt transactions even if they do not occur under employee benefit plans as compensatory transactions. n65 It is, in fact, possible, to engage in abusive short-swing transactions under the rules. However, the continuing reporting obligations under Section 16(a) and the availability of antifraud enforcement under Exchange Act Rule 10b-5 also operate to deter abusive transactions. n66

[b] Four Broad Categories of Exemptions. To fully appreciate the flexibility that Rule 16b-3 affords, one must largely forget the requirements historically imposed on employee benefit plans under past versions of Rule 16b-3 (most of which have been eliminated), and instead focus on specific categories of transactions. Rule 16b-3 provides an exemption for any transaction between an officer or director and a company if the transaction satisfies the applicable requirements under one of four broad categories: (1) transactions under "tax-conditioned plans" that satisfy certain requirements of the Internal Revenue Code ("IRC"); (2) "discretionary transactions" involving intra-plan transfers of funds into or out of a company stock fund; (3) grants, awards, and other acquisitions from a company; and (4) dispositions to a company. Each of these categories is discussed below.

An overarching requirement of Rule 16b-3 is that it only exempts transactions that occur between an issuer and an officer or director. n67 The origin of this requirement is the Commission's premise that these transactions do not present the same opportunities for insider profit on the basis of non-public information as do market transactions. n68 To reflect the significance of this premise, the Commission renamed Rule 16b-3 to be "Transactions between an issuer and its officers or directors," instead of "Employee benefit plan transactions." The Commission also stated that transactions can be exempt under Rule 16b-3 even if there is no compensatory element to the transaction. n69 However, for purposes of satisfying this requirement, transactions with an employee benefit plan sponsored by the company count as transactions with the company. n70 In contrast, transactions under an employee benefit plan which provides for open market purchases of stock and which are not deemed to involve offers and sales by the company for purposes of the Securities Act of 1933, n71 do not qualify as transactions with the company, and therefore are not covered by Rule 16b-3. Also, the rule does not specifically exempt transactions between an officer or director and a subsidiary or parent of the issuer or an employee benefit plan sponsored by a parent or a subsidiary of the company.

[i] Look-Back Exemption for "Discretionary Transactions." Rule 16b-3(f) provides an exemption for "fund switching" transactions under employee benefit plans. The rule defines these types of transactions as "discretionary transactions." Prior to August 29, 2002, pursuant to Rule 16a-3(f), the exemption granted to "discretionary transactions" also permitted directors and officers to report such transactions on a year-end Form 5, rather than on a Form 4. However, in a response to the enactment of the Sarbanes-Oxley Act, on August 29, 2002 the Commission amended the reporting rules under Section 16(a). As a result, "discretionary transactions" exempt from short-swing matching pursuant to Rule 16b-3(f) must now be reported on a Form 4 within two business days after the date of the transaction. n72 Rule 16a-3(f) specifically states that a Form 4 must be filed to report "all transactions exempt from Section 16(b) of the Exchange Act pursuant to Exchange Act Rule 16b-3(d), 16b-3(e), or 16b-3(f)." n73 Under the rule, a "discretionary transaction" will be exempt if the participant's *election* to effect the transaction (as opposed to the actual occurrence of the transaction) is made at least six months after the last election to effect an "opposite way" discretionary transaction under *any* company-sponsored plan. n74 For these purposes, a transfer into a company stock fund is an "opposite way" transaction from a transfer out of a company stock fund, and vice versa. Because the six-month opposite way transaction condition applies to every plan maintained by a company, a company monitoring satisfaction of the six-month condition will need to review any plan under which a "discretionary transaction" may occur. To ensure compliance with this exemption, companies may want to amend their plans to specifically prohibit insiders from electing to effect transactions in a stock fund within six months of an election to effect an opposite way transaction. Rule 16b-3(b)(1) defines the term "discretionary transaction" to cover a narrow class of transactions effected pursuant to an employee benefit plan that (i) are made at the election of the plan participant, and (ii) result in an intra-plan transfer into or out of a company stock fund (including a cash distribution funded by a volitional sale or other disposition of company securities). n75 However, the term "discretionary transaction" does not include any such transaction that is either (iii) required to be made available under the IRC, n76 or (iv) made in connection with death, disability, retirement, or termination of employment (these two types of transactions instead may be covered by the blanket exemption discussed below for "tax-conditioned plans").

If a discretionary transaction results from an election made within six months of an election to effect an opposite way transaction, the second of the two transactions is not exempt from Section 16(b) and can be matched with any non-exempt opposite way transaction that occurs within six months before or after the non-exempt discretionary transaction. However, the fact that the second transaction may not be exempt does not affect the status of the previous transaction; the previous transaction is exempt as long as there had not been an election to effect an opposite way transaction during the six months preceding it. For example, under the exemption for "discretionary transactions," if an executive officer elects to transfer one-half of his or her account balance under a 401(k) plan from the company stock fund to the money market fund, and four months later elects to transfer his or her account balance from the bond fund to the company stock fund, the transaction resulting from the later election will be a non-exempt purchase because the transfer into the stock fund is an "opposite way" transaction. However, the transfer from the bond fund to the company stock fund will not affect the status of the earlier transfer from the company stock fund to the money market fund. Alternatively, if after making the initial transfer from the company stock fund to the money market fund, the executive officer elects to transfer the remaining balance out of the company stock fund, or waits for seven months before electing to have the bond fund account balance transferred into the company stock fund, the resulting transactions will be exempt.

The "look-back" exemption for "discretionary transactions" is intended primarily to address transactions occurring when a plan participant moves previously deferred amounts into or out of a company stock fund under a 401(k) or similar plan. The term includes transfers out of a company stock fund to provide for a cash distribution or a plan loan. In addition, the term is not limited to transactions under tax-conditioned plans. For example, transfers into or out of a company stock account under a simple non-qualified deferred compensation plan are treated as "discretionary transactions." n77 On the other hand, it appears that the term is not intended to apply to transactions occurring under IRC Section 423 employee stock purchase plans n78 and other plans that are not traditionally viewed as involving a company stock fund account. For example, the SEC staff has interpreted the term as not encompassing the exercise for cash of a stock appreciation right or the cash settlement of a stock option or phantom stock right and as not involving an

election to receive a bonus in cash rather than stock, even though those transactions could be viewed as involving a cash distribution funded by a volitional disposition of company securities. n79 Similarly, the staff has said that the repayment of loans under a tax-qualified plan is not a discretionary transaction. n80

[ii] Blanket Exemption for Tax-Conditioned Plans. Rule 16b-3(c) exempts any transaction occurring under one of three types of so-called "tax-conditioned plans," unless the transaction is a "discretionary transaction" (as discussed above). The three types of plans covered by the exemption are: (1) "qualified" plans, which the rule defines as plans that satisfy the coverage and participation requirements imposed on tax-qualified ERISA plans under IRC Sections 401(a)(26) and 410; (2) "excess" plans that operate in conjunction with qualified plans and provide only the benefits that would be provided under a qualified plan but for benefit or contribution limitations imposed under the IRC; and (3) stock purchase plans that satisfy the coverage and participation requirements of either IRC Section 410 or Section 423.

The exemption for tax-conditioned plans covers, among other things, allocations of stock to an employee's account (*e.g.*, under a 401(k) plan) resulting from the employee's on-going payroll contributions to the plan or from the company's contribution to a plan; roll-over transfers into an employee's account under one plan that are funded from distributions under another plan; transfers into or out of a stock fund resulting from diversification or distribution elections that are "required to be made available to plan participants pursuant to a provision of the [IRC];" n81 distributions and other transactions resulting from elections made in connection with death, disability, retirement, or termination of employment; and reallocations resulting from forfeitures or assessments against plan accounts. The staff has affirmed that loan repayments under a qualified plan are eligible for the blanket exemption, even if the repayment is made through a lump sum transfer into the plan. n82 The only type of transaction occurring in these plans that is not covered by this exemption is a voluntary intra-plan transfer of previously contributed amounts into or out of a company stock fund, *i.e.*, "discretionary transactions" that are conditionally exempted by Rule 16b-3(f) as discussed above.

Significantly, a plan need not be a "tax-qualified plan" under IRC Section 401(a) or a IRC Section 423 employee stock purchase plan in order for the tax-conditioned plan exemption to be available; rather, the plan need only meet the coverage and participation requirements of IRC Section 410. n83 Initially, there was some confusion over whether broker-effected transactions occurring under a payroll deduction open-market purchase plan would qualify as transactions occurring between an employee benefit plan and an employee, n84 because the shares are purchased for the participant on the open market without the involvement of the issuer. However, the staff has indicated that such plans qualify for the exemption so long as the issuer deducts the funds under the plan from the employee's compensation at regular intervals, the funds are used to purchase issuer stock, and plan participation is limited to certain employees of the issuer. n85 Further, the staff stated that subsequent sales of stock acquired under the plan by plan participants would not be eligible for exemption, nor would voluntary contributions by plan participants. n86

The exemption for "excess plans" is available even for transactions that do not "mirror" a transaction in the related qualified plan. n87 However, interpretive issues will arise as to what variations, if any, can exist between an excess plan and a qualified plan without causing the excess plan to be viewed as not providing "only" the benefits or contributions that were limited under the qualified plan. For example, it is unclear whether a plan that allows contributions to be made from salary and bonuses will qualify as an excess plan if the related qualified plan allows contributions to be made only from salary. n88

[iii] Multiple Exemptions for Acquisitions from and Dispositions to the Company. Rule 16b-3 offers a variety of simple alternatives for exempting transactions that, under earlier versions of Rule 16b-3, were known as grant or award transactions and participant-directed transactions (other than "discretionary transactions"). Specifically, Rule 16b-3(d) provides that any acquisition from a company will be exempt if it is approved in advance by either the company's board of directors or by a committee composed solely of two or more "non-employee directors," or if it is approved in advance or ratified by the company's stockholders at or before the next annual meeting of stockholders. As a fourth alternative, any acquisition of securities from a company will be exempt if the acquired securities are held for six months (or in the case of acquisition of an option or other derivative security, if at least six months elapse between

acquisition of the derivative security and disposition of the shares acquired upon exercise or conversion of the derivative security). n89

As to dispositions to an issuer, Rule 16b-3(e) provides that such transactions will be exempt if approved in advance by the company's board of directors, by a committee composed solely of two or more "non-employee directors" or by the company's stockholders. The express exemptions for dispositions to an issuer encompass a number of transactions. First, the delivery to the issuer of already owned shares to pay the exercise price and/or taxes due upon exercise of a stock option constitutes a "disposition to the issuer" of the already owned shares. Similarly, instructing the company to withhold shares otherwise issuable upon exercise of a stock option or vesting of a restricted stock award, in order to pay the exercise price and/or taxes due upon such event, constitutes a disposition. The cash settlement of a stock option or stock appreciation right constitutes a disposition of the underlying security following a deemed exercise for cash that can qualify for the Rule 16b-3(e) exemption. However, as noted above, if a derivative security (including a "phantom stock" or "stock unit" arrangement) is held in a multi-fund deferred compensation account that allows for reallocation of the account balance among various "investment" alternatives, then cashing out of the derivative security account is not treated as a disposition eligible for the Rule 16b-3(e) exemption, but instead is treated as a "discretionary transaction" that must comply with Rule 16b-3(f) to be exempt.

Like the exemption for "discretionary transactions" provided by Rule 16b-3(f), the exemption provided by Rules 16b-3(d) and 16b-3(e) for approved grants and distributions between the issuer and a director or officer no longer translates into an exemption from Form 4 reporting. Prior to August 29, 2002, pursuant to Rule 16a-3(f), transactions exempt from Section 16(b) pursuant to Rules 16b-3(d) or (e) could be reported in a year-end Form 5. As a result of the Sarbanes-Oxley Act, however, Rule 16a-3(f) now states that a Form 4 must be filed to report "all transactions exempt from Section 16(b) of the Exchange Act pursuant to Exchange Act Rule 16b-3(d), 16b-3(e), or 16b-3(f)." n90

[A] Non-Employee Directors. If relying on approval of a committee of the board of directors to exempt acquisitions or dispositions, the committee must be composed solely of two or more "non-employee directors." The qualification of directors under this standard is tested as of the date the directors vote to approve the transaction. "Non-employee director" is defined under Rule 16b-3(b)(3) as a director who, at the time he or she approves a transaction, (i) is not an executive officer or other employee of the company or a parent or subsidiary of the company, (ii) has not received more than \$120,000 per annum for services as a consultant to or in another capacity (other than as a director) with the company or a parent or subsidiary of the company, (iii) and does not possess an interest in a transaction with the company that is disclosable under Item 404(a).

Note that the definition of a "non-employee director" is based in large part on the disclosure requirements of Item 404, which were substantially revised in 2006. Accordingly, the SEC issued conforming amendments to the "non-employee director" definition. Significantly, the compensation threshold described in (ii) above was raised from \$60,000 to \$120,000, and the former requirement that the director not be engaged in any business relationship with the company that would require disclosure under Item 404 was eliminated. n91 While the heightened compensation allowance will likely allow certain directors who were previously excluded from the definition of "non-employee directors" to qualify as such, other amendments to Item 404 will probably exclude some directors who formerly qualified as "non-employee directors." Specifically, the related transactions disclosure requirement of Item 404, which (iii) above is dependent upon, was amended to include the disclosure of certain director indebtedness transactions, which were previously covered by a separate disclosure requirement. Accordingly, directors who have indebtedness subject to disclosure under amended Item 404 and who formally qualified as "non-employee directors" will no longer qualify as such. n92

In determining whether a transaction or relationship between a company and a director will disqualify the director from being a "non-employee director," the company is permitted to rely on the transactions disclosed in the most recent filing requiring Item 404 disclosures. n93 If a transaction disclosed in such filings was terminated before the director serves as a "non-employee director," then the transaction will not disqualify the director. n94 Additionally, a director will not be automatically disqualified from service as a "non-employee director" even though the director is involved in a current

transaction at the time of service; however, in order to avoid disqualification, the issuer must believe in good faith that the transaction will not require Item 404 disclosure. Further, if the issuer later determines that the transaction does require disclosure, then the director will be disqualified from service as a "non-employee director" at that time, but previous transactions approved by the director will remain exempt under Rule 16b-3 despite such disqualification. n95

[B] Satisfying the Advance Approval Requirements. When relying on stockholder, board, or qualifying committee approval under Rule 16b-3(d) or (e) to exempt a transaction from Section 16(b), the required approval must be addressed to the specific transaction; approval of a plan providing broad discretion to the company to set the terms of individual grants will not satisfy the new stockholder approval standard. n96 This raises a number of issues as to when the approval may be given and how specific it must be. A note to Rule 16b-3 indicates that stockholder, board, or qualifying committee approval will be satisfied if the requisite approval is obtained for a plan or arrangement under which the terms and conditions of a transaction are fixed in advance, such as approval of a formula plan under which the timing, size, term, and method for determining the exercise price of stock options all are specified under the plan. Similarly, if a plan provides that optionees shall have the right to deliver already owned shares to pay the exercise price and/or taxes due upon exercise of an option, then any such transaction occurring under an option issued under the plan will be deemed to have been approved in advance when stockholders, the board, or a qualifying committee approved the plan. In contrast, if the plan provides that a committee may grant optionees the right to deliver already owned shares in such circumstances, then shareholder approval of the plan will not of itself be sufficient to exempt such transactions.

Stockholder, board, or qualifying committee approval may encompass a variety of transactions that are provided for under the terms of the approved plan or the approved grant, even if those transactions are not effected immediately and occur only at the election of the executive officer or director. n97 For example, a committee of non-employee directors can approve the grant of a stock option under an agreement that provides for an increase in the number of shares issuable to reflect dividend equivalent rights, a "cashless exercise" (*i.e.*, that allows the exercise price and/or tax withholding obligation to be paid by the company retaining shares otherwise issuable upon exercise of the option) and a "reload" grant of options. Under Rule 16b-3, the committee approval exempts not only the grant of the option, but also the subsequent issuance of the dividend equivalent shares upon exercise of the option, the deemed delivery of shares to the company through the cashless exercise to pay the exercise price and tax withholding amounts, and the grant of the reload option. Similarly, the staff has indicated that stockholder, board, or qualifying committee approval of provisions addressing the deferral and stock account allocation process under a deferred compensation plan that is not a "tax-conditioned plan" n98 will exempt each election by an officer or director to defer amounts into a stock account under that plan; there need not be approval of each subsequent deferral election. n99

In an interpretive letter issued to the ABA, the staff has also addressed the approval requirements in the context of dispositions that occur under deferred compensation arrangements that do not qualify as "tax-conditioned plans." n100 The staff stated that, with one exception, approval of the cash settlement of derivative securities (such as stock options, stock appreciation rights, "phantom stock," and stock unit rights) that occurs at the time the officer's or director's right to acquire the derivative security is approved will not satisfy Rule 16b-3(e) if the derivative security is issued under an arrangement that gives the officer or director discretion as to the number of derivative securities initially obtained. In other words, if stockholder, board, or qualifying committee approval is obtained for a grant of 500 stock options and the options state that the optionee has the right to cash settlement of the options, the disposition of the option upon the optionee's cash settlement election will be exempt without further approval. If, however, the option is issued under a plan where the number of options granted depends on the amount of compensation that the officer or director had determined to defer and receive in the form of options, then approval of the plan will not necessarily constitute approval of the cash settlement of the options.

One exception exists to the foregoing interpretation. Approval of a deferred compensation arrangement by stockholders, the board, or a qualifying committee will also constitute approval of the cash settlement of derivative securities issued thereunder for purposes of Rule 16b-3(e) if either (i) the date on which cash settlement will occur is fixed under the plan, or (ii) at the time the officer or director elects to receive derivative securities under the deferred compensation

arrangement, the officer or director also elects a fixed date on which cash settlement of the derivative securities will occur and, if the plan allows for intra-plan transfers into accounts that are not derivative securities, the officer or director specifically agrees not to engage in intra-plan transfers out of the derivative security account. If the officer or director subsequently changes the fixed payout date, changes the payout schedule (assuming that amounts are paid out in installments) or engages in an intra-plan transfer out of the derivative security account, then further specific approval for the cash settlement of the derivative securities is required to satisfy the Rule 16b-3(e) exemption. n101

[C] Operation of the Exemptions for Acquisitions and Dispositions. It is possible to "mix and match" exemptions. For example, if stockholders have approved a formula plan that provides for the automatic grant of options, but have not approved a cashless exercise feature as part of the plan, cashless exercises can be exempted through board approval of an amendment to the plan adding the cashless exercise feature. The grant of the options will then be exempt on the basis of the stockholder approval, and the delivery of shares in a cashless exercise will be exempt on the basis of the advance board approval.

When determining which of the alternatives to utilize to exempt transactions, various considerations will come into play. Although approval by the full board may be viewed as most expedient, it may not satisfy the requirements for compensation arrangements to be exempt from the \$1 million limitation on deductibility under IRC Section 162(m). In addition, institutional stockholders increasingly have expressed the view that compensation decisions should be made by outside directors. In other cases, the six-month holding period exemption will prove inadequate. First, it is not available to exempt dispositions. For example, the deemed sale that occurs in a cashless exercise will not be exempt just because the option has been held for more than six months prior to exercise. Second, the six-month holding period condition may not be satisfied if there is a forced disposition of the securities prior to satisfying the six-month period, such as upon an acquisition of the company, a termination of the executive's employment, or a court-ordered disposition in a divorce. Third, the six-month holding period requirement may recommence if the terms of a security are changed, for example through an amendment to the post-termination expiration provisions. Thus, while there are times that the six-month holding period will serve as a useful exemption, it appears likely that advance committee approval will develop as the most common basis for exempting acquisitions and dispositions.

[D] Applicability to Mergers. While it is clear that the Commission intended Rules 16b-3(d) and (e) to be available to exempt transactions arising in the context of a merger, the scope and conditions for the availability of the exemptions in the context of mergers continue to be uncertain. In the 1996 Adopting Release, the Commission stated, "In the context of a merger, the new rule will exempt the disposition of issuer equity securities (including derivative securities) solely to the issuer, provided the conditions of the rule are satisfied. Dispositions of such securities to parties other than the issuer, such as an acquirer, are not covered by the rule and consequently would not be eligible for exemption under the rule." n102 In a significant interpretive letter, the staff endorsed the view that the conversion of target company stock into the right to receive merger consideration and the conversion of target company options into acquiring company options or cash constitute dispositions to the issuer that can be covered by the Rule 16b-3(e) exemption, even though the consideration in such transactions is paid by the acquiring company. The staff also confirmed that the acquisition of acquiring company stock and options by target company insiders who become insiders of the acquiring company can be exempt under Rule 16b-3(d). However, the staff stated that in this context the Rule 16b-3(d) and (e) approval by a board of directors or qualifying compensation committee should satisfy a high level of specificity, including specifically indicating that the approval is granted for purposes of exempting the transactions under Rule 16b-3. n103 Members of the staff stated informally at the time that the degree of specificity called for in this interpretive letter reflected concern over the high potential for speculative abuse in the merger context. Subsequent court cases generally have concurred with the staff's views as to the availability of Rule 16b-3 for transactions occurring in the context of a merger, but have declined to read more into the rule as to the level of specificity required of a Board or qualifying compensation committee to exempt such transactions. In *Atlanta Tele-Network v. Prosser*, n104 the court held that dispositions of shares in a merger were exempt, without regard to whether the Board had specifically manifested an intent to exempt the transactions for purposes of Rule 16b-3. In *Gryl v. Shire Pharmaceuticals Group Plc*, n105 the court held that approval of a merger agreement by an acquiring company's Board was adequate to exempt

the resulting transactions under Rule 16b-3(d) because the approved terms operated in a manner comparable to a "formula plan" under the Rule and did not allow any discretion as to amount, price, timing and exercise terms of the option conversions. Notwithstanding these decisions, counsel generally seeks to document approval of insiders' transactions in the merger context to a degree that satisfies the staff's interpretive letter.

In the highly controversial decision *Levy v. Sterling Holding Co., LLC*,ⁿ¹⁰⁶ the Third Circuit Court of Appeals ruled that transactions must have a "compensatory nexus" in order to be exempt under Rule 16b-3. Accordingly, the court held that the disposition of shares by investors in a recapitalization could not be exempt under Rule 16b-3 where the shares involved had been acquired as part of an investment in a leveraged buy-out. In so ruling, the court not only ignored the SEC's statement in the 1996 Adopting Release that a compensatory purpose is not necessary for exemption,ⁿ¹⁰⁷ but the court also denied a motion for rehearing in which the SEC had submitted an amicus brief urging that the court had improperly restricted the scope of the Rule 16b-3 exemption. Thus, the SEC amended Rule 16b-3 in 2005 to make clear that the exemptions under Rule 16b-3(d) and (e) apply "whether or not [the transactions or dispositions are] intended for a compensatory or other particular purpose."ⁿ¹⁰⁸ In doing so, the SEC explained that the amendments were intended to ensure that Rule 16b-3 was given its intended scope and was not limited by decisions such as *Levy*.ⁿ¹⁰⁹ Because the SEC viewed the amendments as mere clarifications of the Rule, as opposed to substantive changes, the SEC stated that such amendments apply retroactively to all transactions occurring since the 1996 Adopting Release.ⁿ¹¹⁰

[c] Elimination of Old Rule 16b-3 Plan Requirements. As noted above, Rule 16b-3 eliminates many of the traditional requirements imposed on employee benefit plans under past versions of Rule 16b-3. Rule 16b-3: (1) no longer requires plans and material plan amendments to be approved by stockholders; (2) no longer requires that a plan specify limitations on the number of shares issuable or the price at which shares may be issued; (3) no longer requires administration by a committee of "disinterested" administrators; (4) no longer requires a six-month holding period; ⁿ¹¹¹ (5) no longer restricts the transferability of options; and (6) no longer requires there to be a written plan. Notwithstanding the elimination of these requirements from Rule 16b-3, many of these provisions will not disappear from plans. Tax and other securities laws, as well as practical considerations, will influence plan design. For example, notwithstanding Rule 16b-3, companies will continue to submit plans for stockholder approval, both because the New York and American Stock Exchanges and the Nasdaq National Market have stockholder approval requirements ⁿ¹¹² and because the IRC requires stockholder approval of a plan in order for grants under it to qualify for an exemption from the \$1 million limitation on deductible compensation under IRC Section 162(m) or for incentive stock option treatment. ⁿ¹¹³ However, once a plan is approved by stockholders, Rule 16b-3 will no longer limit a company's ability to amend the plan without further stockholder approval. For existing plans that have been approved by stockholders, it will be necessary to see if the terms of the plan require stockholder approval of amendments notwithstanding the absence of such a requirement under Rule 16b-3.

Finally, corporate governance and institutional stockholder considerations will also be relevant. Some institutional stockholders object to inside directors making compensation decisions. In addition, many institutions already have voting guidelines requiring a plan to contain certain provisions, such as a prohibition on option repricings. Some institutions may insist that, even though not required under Rule 16b-3, plans have a provision limiting the company's ability to amend these types of provisions without stockholder approval.

[d] Elimination of Old Rule 16b-3 Exemptions. Rule 16b-3 also eliminates some of the exemptions that companies and insiders traditionally relied on. Before the 1996 rule change, Rule 16b-3 provided that the delivery of already owned stock to exercise an option (a "stock-for-stock exercise") was automatically exempt, and that exercise of a stock appreciation right or a cashless exercise right was exempt if the optionee satisfied the requirements for a "window period" exemption or made a six-month advance irrevocable election. However, Rule 16b-3 eliminates the exemption that specifically covered these transactions. Even if an option was granted prior to the current version of Rule 16b-3 becoming effective, stock-for-stock exercises or other disposition transactions that occur upon exercise of an option must now satisfy the current version of Rule 16b-3. Therefore, to ensure that these transactions will be exempt in

the future, companies should make sure that shareholders, the board of directors or a non-employee director committee approves the terms of each option that was granted prior to November 1, 1996 and that permits a stock-for-stock exercise or a cashless exercise and the terms of each stock appreciation right that allows cash settlement (including "limited" stock appreciation rights that are exercisable for cash only following a change of control). n114

[e] Repeal of the Exemption for Cash-Only Rights. At the same time that the current version of Rule 16b-3 was adopted, the Commission repealed an exemption from the definition of "derivative security" that existed for "cash-only" rights granted under an employee benefit plan. n115 Previously, rights that are payable only in cash and that have a value derived from the value of a company's stock were not reportable and not subject to Section 16(b) if they were either (i) paid out only on a fixed date at least six months after grant or in connection with death, disability, retirement, or termination of employment, or (ii) non-transferable and granted under a written plan by a committee of disinterested directors. However, the Commission grandfathered the status of cash-only arrangements that were granted before August 15, 1996 and were exempt from Section 16 under the 1991 rules. These grandfathered cash-only arrangements remain exempt from reporting and from Section 16(b) liability following August 15, 1996. The impact of the repeal of the exclusion for certain cash-only rights is ameliorated by the fact that it should not be difficult for grants and payouts of most cash-only arrangements to qualify for an exemption under Rule 16b-3. The status of cash-only rights granted prior to August 15, 1996 is discussed further at Section 8.03[2][b][iii].

Exempt cash-only rights granted before August 15, 1996 enjoy a complete exemption from reporting. Even if similar cash-only rights are granted on or after August 15, 1996, the pre-August 15 cash-only rights need not be reflected in the "end-of-month" holding column of a Form 4. Post-August 15, 1996 grants of cash-only rights must be reported as derivative security grants on a Form 4, and are subject to Section 16(b) unless an exemption is satisfied. The payout of a cash-only right is treated by the staff as an exercise of a derivative security and sale of the underlying stock, and therefore must be reported on a Form 4 regardless of whether an exemption is available.

[10] Exemption for Directors and Officers for the Acquisition of a Security by Redemption--Rule 16b-4

Former Rule 16b-4, which provided an exemption for redemptions by the issuer, was rescinded in 1996. n116 However, the broader version of Rule 16b-3, which was adopted in 1996, exempts all transactions by directors and officers with the issuer. n117

[11] Exemption for Transactions Relating to Bona Fide Gifts and Inheritance--Rule 16b-5

Rule 16b-5 n118 provides an exemption from Section 16(b) liability for any acquisition or disposition of an equity security that is a bona fide gift or a transfer of securities by will or the laws of descent and distribution. n119

[12] Exemptions for Certain Exercises, Conversions, and Dispositions of Derivative Securities

Perhaps the most striking and controversial new rule adopted by the Commission in the 1991 comprehensive revision of the Section 16 rules was the broad exemption for exercises of derivative securities contained in Rule 16b-6(b). This Rule in effect reverses decades of generally consistent treatment, by the courts and the Commission, of exercises of options and other derivative securities (other than convertible securities) as "purchases" under Section 16(b). n120

The Commission adopted this exemption because it concluded that the opportunity for speculative abuse arises not at the time of exercise of a derivative security with a fixed exercise price, but rather at the time such derivative security was initially acquired. n121 In the Commission's view, an insider's ability to profit from a change in the market price of a given equity security is essentially the same whether he holds the underlying equity security or a derivative security that may be exercised for or converted into the underlying equity security. n122 Therefore, the Commission adopted Rule 16b-6(a), which provides that, for Section 16(b) purposes, acquiring a derivative security in the nature of a call equivalent position n123 is deemed a purchase and disposing of such a derivative security is deemed a sale, and acquiring a derivative security in the nature of a put equivalent position n124 is deemed a sale and disposing of such a

derivative security is deemed a purchase. n125

Except for certain exercises of out-of-the-money options, warrants, and rights (as discussed below), Rule 16b-6(b) exempts from Section 16(b):

- (1) the closing of a derivative security position as a result of its exercise or conversion, and the acquisition of underlying securities at a fixed exercise price due to the exercise or conversion of a call equivalent position, and
- (2) the disposition of underlying securities at a fixed exercise price due to the exercise of a put equivalent position. n126

Accordingly, Rule 16b-6(b) provides an exemption from Section 16(b) liability for most exercises of options, convertible securities, and other derivative securities. n127

The Rule 16b-6(b) exemption generally does not apply to exercises of options, warrants, or rights that are "out of the money"--that is, at a time that the exercise price is greater than the fair market value of the underlying securities. n128 The conversion of an out-of-the-money convertible security is exempted, however. n129

The applicability of Rule 16b-6(b) is potentially quite broad because the definition of the term "derivative securities" is so broad. For example, exercises, conversions, or exchanges of securities pursuant to the terms of other equity or debt securities, agreements relating to corporate acquisitions, trust instruments, shareholders agreements, or other agreements may be exempted under the Rule. n130 In the case of an exercise of a stock appreciation right for cash, however, Rule 16b-6(b) exempts the surrender of the derivative security and the deemed acquisition of the underlying equity securities, but does not exempt the deemed sale of equity securities. n131

[13] Exemptions for Certain Mergers, Reclassifications, and Consolidations--Rule 16b-7

Rule 16b-7 n132 exempts from Section 16(b) certain transactions in connection with the merger n133 or consolidation of companies when prior to the merger or consolidation at least 85 percent of the securities or over 85 percent of the assets of all of the other companies involved in the merger or consolidation (except the resulting company if the transaction is a consolidation) is owned, directly or indirectly, n134 by the acquiring company. n135 Typically, the exemption is relied on when a company reincorporates in a different state or reorganizes its corporate structure. n136

Rule 16b-7 provides that the following transactions will not be considered to be a purchase or sale under Section 16(b):

- (1) an acquisition of a security of a company pursuant to a merger or consolidation in exchange for a security of a company that prior to the merger, reclassification, or consolidation
 - (a) owned at least 85 percent of the equity securities of all other companies involved in the merger, reclassification, or consolidation (not including the resulting company in the case of a consolidation); n137 or
 - (b) owned over 85 percent of the combined assets of all the companies involved in the merger, reclassification, or consolidation, computed according to their book values prior to the transaction by reference to their most recent available financial statements for a twelve-month period prior to the transaction (or such shorter time as the company has been in existence); n138 and
- (2) a disposition of a security, pursuant to a merger, or consolidation, of a company that prior to the

merger, reclassification, or consolidation

(a) owned at least 85 percent of the equity securities of all other companies involved in the merger, reclassification, or consolidation (not including the resulting company in the case of a consolidation); n139 or

(b) owned over 85 percent of the combined assets of all the companies involved in the merger, reclassification, or consolidation, computed according to their book values prior to the merger, reclassification, or consolidation as determined by reference to their most recent available financial statements for a 12-month period prior to the transaction. n140

In addition to mergers and consolidations, Rule 16b-7 is also applicable to transactions structured as statutory mergers. n141 Liquidations, however, are not covered by the Rule since liquidations "in substance and purpose" do not resemble the types of transactions exempt under the Rule. n142

Rule 16b-7 is unavailable to the extent an insider has made any non-exempt purchase of a security in any company involved in the merger, reclassification, or consolidation and any non-exempt sale of a security in any company involved in the merger, reclassification, or consolidation within any period of less than six months during which the merger or consolidation took place. n143

[14] Exemption for Deposits or Withdrawals Under Voting Trusts or Deposit Agreements--Rule 16b-8

Rule 16b-8 provides an exemption from Section 16(b) for the acquisition or disposition of equity securities as a result of withdrawal from or deposit under a voting trust or deposit agreement if substantially all the assets held under the voting trust or deposit agreement immediately before the withdrawal or immediately after the deposit consisted of equity securities of the class withdrawn or deposited. n144

The exemption is unavailable, however, to the extent that, within a six-month period that includes the date of withdrawal or deposit there has been:

(1) a non-exempt purchase of an equity security of the class deposited and a non-exempt sale of any certificate representing an equity security of that class; n145 or

(2) a non-exempt sale of an equity security of the class deposited and a non-exempt purchase of any certificate representing an equity security of that class, n146

other than an actual deposit or withdrawal of the securities to or from the trust. n147

[15] Section 16(b) Exemption for Securities Acquired in Connection With a Debt Previously Contracted

Section 16(b) provides that its provisions do not apply to a security "acquired in good faith in connection with a debt previously contracted." The receipt of securities in connection with the release of a debt, therefore, will not be deemed to be a purchase under Section 16(b). n148 The security must be delivered in payment of an independent and matured obligation n149 that is legally enforceable. n150 In addition neither preferred stock convertible into common stock n151 nor an employment incentive contract providing for regular remuneration in warrants are debts for the purposes of Section 16(b). n152

[16] Exemption for Market Makers--Section 16(d)

Section 16(d) provides an exemption from liability for short-swing trading under Section 16(b) and from the prohibition

of "short sales" and "sales against the box" of Section 16(c) for the trading activities of dealers acting as market makers. n153 Section 16(d) exempts:

- (1) from Section 16(b), the purchase and sale, or sale and purchase, of an equity security, n154 and
- (2) from Section 16(c), the sale of an equity security,

by a dealer in the ordinary course of business and incident to the establishment or maintenance by such dealer of a primary or secondary market, other than on a national securities exchange or an exchange exempted from registration under Section 5, n155 for the equity security. The Section 16(d) exemption is not available with respect to the sale of an equity security that has at any time since its purchase been held by the dealer in an investment account. n156

The Commission has concluded that a transaction on a national securities exchange incident to the establishment or maintenance of a domestic or foreign over-the-counter market is exempted by Section 16(d), if the transaction is in the ordinary course of the market-maker's business in providing liquidity in the over-the-counter market and the securities purchased on a national securities exchange are held in the dealer's trading account to be used solely for providing liquidity and not for investment. n157

Although Section 16(d) does not provide an express exemption from reporting obligations to market-makers, the Commission and its staff have taken the interpretive position that the exemption applies to market-maker's reporting obligations. n158 The Commission had proposed the adoption of a rule to codify these interpretations as part of its comprehensive revision to the Section 16 rules, n159 but the Commission determined not to adopt the proposed exemptive rule. n160

[17] Exemption for Certain Foreign Issuers--Rule 3a12-3

Rule 3a12-3 under the Securities Exchange Act exempts the securities of certain foreign issuers from all requirements under Section 16. The Rule exempts securities of foreign issuers authorized to file registration statements on Form 18 and securities of foreign private issuers eligible to file Form 20-F. n161

[18] Exemption for Arbitrage Transactions--Section 16(e)

Section 16(e) and Rule 16e-1 n162 provide an exemption for foreign and domestic arbitrage transactions effected by:

- (1) holders of more than ten percent of any class of any registered equity security of an issuer, from all the provisions of Section 16; n163 and
- (2) directors and officers of that issuer, from Section 16(c).

There are two forms of arbitrage transactions:

- (1) "place arbitrage," in which a security is purchased and sold in two different markets at about the same time; and
- (2) "kind arbitrage," in which closely related securities, *e.g.*, a convertible security and the security into which it can be converted, are purchased and sold in the same market at about the same time. n164

Since the key feature of an arbitrage transaction is a simultaneous purchase and sale of securities, a substantial interval between the date of the purchase and the date of sale will make the exemption unavailable. n165

[19] Exemptions from Section 16(c)

[a] Exemption for Certain Transactions by Brokers--Rule 16c-1. Rule 16c-1 n166 exempts from the short-sale prohibitions of Section 16(c) transactions by a broker involving the execution of an order for an account in which the broker has no direct or indirect interest. Rule 16c-1 therefore exempts a broker's transactions as agent from Section 16(c).

[b] Exemption from Section 16(c) of Certain Transactions Effected in Connection With a Distribution--Rule 16c-2. Rule 16c-2 n167 exempts the sale of a security by or on behalf of a dealer in connection with the distribution of a substantial block of securities from Section 16(c)'s prohibition of short sales if the sale is represented by an over-allotment in which the dealer is participating as a member of an underwriting group, n168 or the dealer or a person acting on his behalf intends in good faith to offset the sale with a security to be acquired by or on behalf of the dealer as a participant in an underwriting, selling, or soliciting-dealer group of which the dealer is a member at the time of the sale, whether or not the security to be acquired is subject to a prior offering to existing security holders or some other class of persons. n169

[c] Exemption for Sales of Securities to be Acquired--Rule 16c-3. An insider entitled to receive a security as an incident of ownership of an issued security "when issued" or "when distributed" without the payment of consideration may sell the security to be acquired without violating Section 16(c), which prohibits "short sales" and "sales against the box," if:

- (1) the sale of the security to be acquired is subject to the same conditions as those attached to the right of acquisition; n170
- (2) the insider exercises reasonable diligence to deliver the security to the purchaser promptly after the right of acquisition matures; n171 and
- (3) the insider reports the sale under Section 16(a). n172

Rule 16c-3, however, does not exempt a transaction in which both a sale of a security "when issued" or "when distributed" and a sale of securities of the class to be issued or distributed occurs if the two transactions combined result in a sale of more securities than the aggregate of those securities actually owned by the selling insider plus those to be received by the selling insider under his right of acquisition. n173

[d] Exemption for Possible Short Sales Relating to Fully-Hedged Derivative Securities Transactions--Rule 16c-4. Rule 16c-4 provides an exemption from Section 16(c)'s short-sale prohibition for transactions in derivative securities that establish or increase a put equivalent position "so long as the amount of securities underlying the put equivalent position does not exceed the amount of underlying securities otherwise owned." n174 This exemption permits an insider to acquire a put option, write a call option, or otherwise acquire a derivative security that permits or obligates the insider to dispose of underlying equity securities of the issuer without being deemed to violate Section 16(c) if the derivative security position is "fully-hedged" by ownership of the underlying securities.

As an initial matter, it is not clear that transactions in derivative securities represent Section 16(c) "sales" that need an exemption. The Commission apparently intended that, under the current Rules, establishing or increasing a "put equivalent position" (defined in Rule 16a-1(h)) would be treated as a short sale. n175 But, as adopted, the current Rules do not explicitly carry out this intent. n176 Of course, a court might still accept that, under the terms of Section 16(c), the acquisition of a put option or the writing of a call option with a fixed exercise price represents a "sale" of securities not owned for purposes of Section 16(c).

It is clear that an acquisition of a put option or writing of a call option will only be exempt under Rule 16c-4 if the insider "owns" a number of shares equal to the number underlying the put or call option at the time it is acquired or

written. Rule 16c-4's "so long as" phrase may also mean that the exemption could be lost if, after such a put or call option is acquired or written and while it is still outstanding, the insider disposes of securities that underlie the put equivalent position, so that he no longer "owns" securities at least equal to the number of securities underlying the put equivalent position. n177 Rule 16c-4, as originally proposed, clearly provided for such a retroactive loss of the exemption if the insider reduced his ownership of the underlying securities in such manner, but the Commission changed the wording of the final Rule, without explanation, to make the Rule ambiguous on this point. n178

The exemption does not apply to a short sale of actual equity securities of the issuer that are hedged by ownership of a call option or other derivative security entitling the insider to acquire a number of equity securities equal to the short position (an offsetting "call equivalent position" as defined in Rule 16a-1(b)). n179 It is unclear, however, whether Rule 16c-4 exempts acquisitions of put equivalent positions that are fully hedged by call equivalent positions. n180

FOOTNOTES:

(n1)Footnote 1. Sec. Act Rel. No. 34-28869, Fed. Sec. L. Rep. (CCH) P 84,709 (Feb. 8, 1991).

(n2)Footnote 2. Release No. 34-37260 (May 31, 1996).

(n3)Footnote 3. Section 12(h) also provides that the Commission may exempt, in whole or in part, any issuer or class of issuers from Section 12(g), 13, 14, or 15(d) if the exemption is consistent with the public interest or the protection of investors.

(n4)Footnote 4. The term "foreign private issuer" is defined in Rule 3b-4.

(n5)Footnote 5. See Sec. Act Rel. No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. III.B.3 (Dec. 2, 1988). See also *Blau v. Lamb*, 363 F.2d 507, 527 (2d Cir. 1966), cert. denied, 385 U.S. 1002 (1967); *Roberts v. Eaton*, 212 F.2d 82, 85 (2d Cir.), cert. denied, 348 U.S. 827 (1954); *Shaw v. Dreyfus*, 172 F.2d 140, 142 (2d Cir.), cert. denied, 337 U.S. 907 (1949); *Morales v. Lukens, Inc.*, 593 F. Supp. 1209, 1214 n.8 (S.D.N.Y. 1984).

(n6)Footnote 6. Rule 16a-9(b).

(n7)Footnote 7. Sec. Act Rel. No. 34-28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. VIII.B. (Feb. 8, 1991).

(n8)Footnote 8. Sec. Act Rel. No. 34-28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. V.A. (Feb. 8, 1991).

(n9)Footnote 9. See § 8.06[10] *infra*.

(n10)Footnote 10. See Note to Rule 16a-9. The Note also states that the sale or exercise of rights acquired in a pro rata distribution exempt under Rule 16a-9 should be reported on a Form 4 or 5 in accordance with Rule 16a-4.

(n11)Footnote 11. Under Rule 16b-6(a), the sale of a subscription right, representing a right to acquire an equity security, would be deemed a sale of the underlying equity security. A sale of a repurchase right, in which the issuer is obligated to repurchase equity securities at a fixed price, would be deemed a purchase of the underlying equity securities. See § 8.06[12] *infra*.

(n12)Footnote 12. Release No. 34-37260, at Part IV.B.

(n13)Footnote 13. Although the Commission specifically intended Rule 16a-9 to apply to distributions of poison pill shareholder rights, such rights are commonly distributed to holders of common stock entitling the holder, upon occurrence of certain events, to exercise the right for shares of preferred stock (which in turn may then be convertible into common stock). Unless Rule 16a-9 applies to rights relating to any class of equity security, such a pro rata grant of shareholder rights might not be exempt under the Rule.

(n14)Footnote 14. Rule 16a-9. *See* Sec. Act Rel. No. 34-28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. V.A. (Feb. 8, 1991).

(n15)Footnote 15. *See* Rule 16a-9.

(n16)Footnote 16. *See* Rule 16a-9.

(n17)Footnote 17. *See* § 8.06[19] *infra*.

(n18)Footnote 18. Release No. 34-37260, at Part V.A.

(n19)Footnote 19. Dow Jones & Co., SEC No-Action Letter (Dec. 15, 1994);

(n20)Footnote 20. Merrill Lynch, Pierce, Fenner & Smith, SEC No-Action Letter (Mar. 16, 1994).

(n21)Footnote 21. Sec. Act Rel. No. 34-28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. II.C.2 (Feb. 8, 1991); Sec. Exch. Act Rel. No. 34-18114, Fed. Sec. L. Rep. (CCH) P 26,062, Question 78 (1981). Such non-exempt additional purchases must be reported on a month-end Form 4 and may not be reported on an aggregate basis. Release No. 34-28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. II.C.2 (Feb. 8, 1991).

(n22)Footnote 22. Sec. Act Rel. No. 34-18114, Fed. Sec. L. Rep. (CCH) P 26,062, Question 80 (1981). *see* Sec. Act Release No. 34-28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. VIII.C (Feb. 8, 1991) (answer to Question 80 relating to old Rule 16a-11 applies to what was then new Rule 16b-2).

(n23)Footnote 23. Release No. 34-37260, at Part V.B.

(n24)Footnote 24. Munger, Tolles & Olson, SEC No-Action Letter (Dec. 10, 1991).

(n25)Footnote 25. *See* Rules 16a-4, 16a-3(f)(1)(i)(A).

(n26)Footnote 26. Rule 16a-2(d) continues the exemption provided under old Rule 16a-4 with minor changes. *See* Sec. Act Rel. No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. III.B.2 (Dec. 2, 1988).

(n27)Footnote 27. Rule 16a-2(d)(1)(i).

(n28)Footnote 28. Rule 16a-2(d)(1)(ii).

(n29)Footnote 29. Rule 16a-2(d)(1)(iii).

(n30)Footnote 30. Rule 16a-2(d)(1)(iv).

(n31)Footnote 31. For example, on January 1, 1981, E is appointed the executor of the estate of D, who was a director of C, a company with a class of equity securities registered under Section 12. D had purchased 50,000 shares of C stock on December 1, 1980. The estate holds 100,000 shares of common stock of C, representing 10.1% of the outstanding shares of the class. E's sale of 50,000 shares of this stock on February 1, 1981 is not subject to Section 16(a) or Section 16(b). Sec. Exch. Act Rel. No. 34-18114, Fed. Sec. L. Rep. (CCH) P 26,062, Question 42 (1981).

(n32)Footnote 32. Rule 16a-2(d)(2).

Thus, in the example in note 31 *supra*, the executor would not be subject to Section 16(a) or Section 16(b) after the 12-month grace period has expired if the estate is no longer a more than 10% security holder.

(n33)Footnote 33. See Sec. Act Rel. No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. II.B.2 (Dec. 2, 1988). The Commission staff has also taken the position that transactions exempt under Rule 16a-2(d)(1) disposing of securities within six months after the grant of such securities in a transaction intended to be exempted by Rule 16b-3(d)(3) will not cause the loss of the Rule 16b-3(d)(3) exemption for the original *grant* even though the securities were disposed of before the expiration of the six-month holding period required by Rule 16b-3(d)(3). See American Society of Corporate Secretaries, SEC No-Action Letter (Dec. 11, 1996).

(n34)Footnote 34. Sec. Exch. Act Rel. No. 34-4754 (1952).

(n35)Footnote 35. *Id.*

(n36)Footnote 36. A bank (and other possible fiduciaries identified in Rule 16a-1(a)(1)) could possibly exclude the estate's securities from this ten-percent calculation if it is acting as a fiduciary in the ordinary course of business without any purpose or effect of changing or influencing control of the issuer. If the fiduciary becomes a 10% security holder under Rule 16a-1(a)(1), the temporary exemption under Rule 16a-2(d) would apparently allow the fiduciary to not report, and avoid potential liability with respect to, transactions involving securities held by the estate (apparently even if the fiduciary has a pecuniary interest in such transactions), but he would be obligated to file a Form 3 and would be subject to reporting and potential liability with respect to transactions involving other securities in which he has a pecuniary interest. This represents a substantial change from prior law. See *generally* II Loss, *Securities Regulation* at 1110-11 (2d ed. 1961 Supp. 1969).

(n37)Footnote 37. See § 8.02 *supra*. For example, an unaffiliated underwriter could become a more than 10% security holder of an issuer because of its purchase of 25% of a new offering of the issuer on a firm commitment basis. See Sec. Exch. Act Rel. No. 34-018114, Fed. Sec. L. Rep. (CCH) P 26,062, Question 85 (1981). Although Rule 16a-7 provides an exemption from reporting, it would not appear to allow the underwriter to exclude the shares acquired in the distribution from its calculation of beneficial ownership of 10% of the outstanding class for purposes of Rule 16a-1(a)(1). Thus, participation in the underwriting could result in the underwriter becoming a 10% security holder of the issuer required to file a Form 3, and subject to further reporting and potential liability with respect to issuer securities in which it has a pecuniary interest. Even if the Rule 16a-7 exemption were unavailable, an acquisition of securities that causes an underwriter to become an insider (as a 10% security holder) could not be matched with a sale after the underwriter has insider status to yield short-swing profits liability. See *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232 (1976); *Editek, Inc. v. Morgan Capital, LLC*, 150 F.3d 830, 831 (8th Cir. 1998); *Colan v. Monumental Corp.*, 713 F.2d 330, 334 (7th Cir. 1983).

(n38)Footnote 38. Rule 16a-7 is the successor to old Rule 16b-2. Release No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pts. III.B.2 & VI.A.2 (Dec. 2, 1988). The new Rule expands on old Rule 16b-2 by exempting underwriting transactions from reporting as well as liability, and deletes a requirement that persons not subject to Section 16(b) participate in the underwriting on terms at least as favorable as those on which the insider is participating and to an extent at least equal to the combined participation of all persons exempted under old Rule 16b-2. Thus, under new Rule 16a-7 an insider underwriter's participation may exceed 50% of the aggregate offering. See Release No. 34-28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. VIII.C. (Feb. 8, 1991) (overruling prior interpretations in Sec. Exch. Act Rel. No. 34-18114, Fed. Sec. L. Rep. (CCH) P 26,062, Question 84 (1981)).

(n39)Footnote 39. Typically, an underwriter or selling dealer would look to the exemption under new Rule 16a-7. See Sec. Act Rel. No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. III.B.2. (Dec. 2, 1988).

(n40)Footnote 40. Rule 16a-7(a)(1).

(n41)Footnote 41. Rule 16a-7(a)(2)(i).

(n42)Footnote 42. Rule 16a-7(a)(2)(ii).

See also Sec. Exch. Act Rel. No. 34-18114, Fed. Sec. L. Rep. (CCH) P 26,062, Question 82 (1981).

(n43)Footnote 43. Rule 16a-7(b).

(n44)Footnote 44. Rule 16a-5 continues the exemption provided under old Rule 16a-5 without substantive change. *See* Release No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. III.B.2 (Dec. 2, 1988).

(n45)Footnote 45. *See* § 3.02 *supra* for discussion of odd-lot dealers.

(n46)Footnote 46. Sec. Exch. Act Rel. No. 34-18114, Fed. Sec. L. Rep. (CCH) P 26,062, Questions 44, 45 (1981).

An odd-lot dealer who takes a position on the long or short side in excess of that necessary to transact his odd-lot business is not entitled to the exemption. *Id.* at Question 45.

(n47)Footnote 47. Rule 16a-6 is the successor to old Rule 16a-9. The old Rule was styled an "exemption" from Section 16(a) reporting, although, like new Rule 16a-6, the Rule required reporting of small transactions covered by the exemption in the next Form 4 otherwise filed. Although the apparent reporting exemption of old Rule 16a-9 could have been viewed as providing an exemption from Section 16(b) liability in conjunction with old Rule 16a-10, the Commission has indicated that it did not view old Rules 16a-9 and 16a-10 as providing such a liability exemption. *See* Release No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. III.B.3. (Dec. 2, 1988). Rule 16a-10 reflects a change from old Rule 16a-10 specifying that the exemption from Section 16(b) liability for transactions exempted from reporting does not apply to transactions covered by Rule 16a-6. Release No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. VI.A.3 (Dec. 2, 1988).

(n48)Footnote 48. Rule 16a-6(a)(1).

(n49)Footnote 49. Rule 16a-6(a)(2).

(n50)Footnote 50. The exclusion from Rule 16a-6 of transactions with the issuer and under issuer-sponsored employee benefit plans was adopted as of August 29, 2002, as part of the amendments implementing two-business day reporting mandated by the Sarbanes-Oxley Act. One result has been subjecting needlessly small transactions to two-business day reporting, such as acquisitions pursuant to dividend equivalent features under employee benefit arrangements unless the exemption under Rule 16a-11 is available.

(n51)Footnote 51. Rule 16a-6(b).

(n52)Footnote 52. Rule 16b-1(a) is the successor to old Rule 16b-1. Release No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. III.B.1 (Dec. 2, 1988). The new Rule is substantially the same as old Rule 16b-1, except that it has been broadened to codify interpretations of the Commission staff that allowed reliance on exemptive rules under Section 17(a) of the Investment Company Act as well as exemptive orders under Section 17(b) of that Act. *See id.*, *see also* Sec. Exch. Act Rel. No. 34-18114, Fed. Sec. L. Rep. (CCH) P 26,062, Question 81 (1981); Asset Investors Fund, Inc., Fed. Sec. L. Rep. (CCH) P 82,401 (Div. Corp. Fin. 1979).

(n53)Footnote 53. Section 17(b) of the Investment Company Act permits the Commission to exempt a proposed transaction from all or part of Section 17(a) of that Act. Exemptions are also set forth in Rules 17a-1 to 17a-8 under the Investment Company Act.

(n54)Footnote 54. Rule 16b-1(b) is the successor to old Rule 16b-4, and is substantially the same as old Rule. Sec.

Act Rel. No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. VI.B.1 (Dec. 2, 1988).

(n55)Footnote 55. Rule 16b-1(b) does not require a formal order of the Commission to ensure the availability of the exemption. Sec. Exch. Act Rel. No. 34-18114, Fed. Sec. L. Rep. (CCH) P 26,062, Question 132 (1981).

(n56)Footnote 56. Release No. 34-37260, 61 Fed. Reg. 30376 (June 14, 1996) ("1996 Adopting Release").

(n57)Footnote 57. Other amendments to the rules and forms under Section 16 that were adopted at the same time (i) make phantom stock and other "cash only" rights subject to Section 16; (ii) eliminate the reporting requirement for certain transactions, but create an on-going duty to monitor and account for such transactions when filing Forms 4 and 5; (iii) accelerate the reporting of option exercises by requiring them to be reported on Form 4 by the 10th day of the month following the exercise; (iv) require companies disclosing late Section 16 filers in their proxy statements to present the information under a separate caption; and (v) amend various other definitions and exemptions.

(n58)Footnote 58. Companies could elect to rely on the amended rule at any time on or after August 15, 1996.

(n59)Footnote 59. Exchange Act Rel. No. 26333 (Dec. 2, 1988).

(n60)Footnote 60. Exchange Act Rel. No. 27148 (Aug. 19, 1989).

(n61)Footnote 61. Exchange Act Rel. No. 28869, 56 Fed. Reg. 7242 (Feb. 21, 1991).

(n62)Footnote 62. In connection with adoption of the 1991 rules, the exemption that formerly covered transactions occurring in ERISA-qualified employee benefit plan trusts was prospectively repealed.

(n63)Footnote 63. The "phase-in period" during which companies could rely on the pre-1991 version of Rule 16b-3 was extended in five successive years, eventually lasting until November 1, 1996. Release No. 34-37261, 61 Fed. Reg. 30396 (June 14, 1996).

(n64)Footnote 64. *Byrne v. Lord*, Fed. Sec. L. Rep. (CCH) P 98,987 (Del. Ch. 1995) (directors breached fiduciary duty in granting options to themselves).

(n65)Footnote 65. Release No. 34-52202, 70 Fed. Reg. 46080 (Aug. 9, 2005) ("August 2005 Release") (amending sections (d) and (e) of Rule 16b-3 to clarify that qualifying transactions under such sections are exempted "whether or not intended for a compensatory or other particular purpose").

(n66)Footnote 66. See August 2005 Release at n.53 (stating that investors' interests will continue to be protected despite the exemptions of Rule 16b-3 due to the various prohibitions of Rule 10b-5).

(n67)Footnote 67. Though not expressly included within the Rule's definition of "director," the SEC recently submitted an amicus curiae brief to the court in *Dreiling v. American Express Co.*, 458 F.3d 942 (9th Cir. 2006), in which it stated that, for purposes of Rule 16b-3(d), "director" includes "directors by deputization." *Id.* at 952. A director by deputization is "a corporation, partnership, trust or other person [who] has expressly or impliedly 'deputized' an individual to serve as its representative on a company's board of directors." Release No. 34-26333, 53 Fed. Reg. 49997, text following n.49 (Dec. 13, 1988). However, a transaction with a director by deputization will not be exempt if the board did not know of the deputization at the time it approved the transaction. *Dreiling*, 458 F.3d at 952. The Court of Appeals for the Ninth Circuit accepted the Commission's interpretation, holding "directors by deputization are entitled to seek the protection of Rule 16b-3(d) to the same extent, and on the same terms, as an individual director or officer." *Id.* at 953.

(n68)Footnote 68. 1996 Adopting Release at n.17.

(n69)Footnote 69. 1996 Adopting Release, text following n.43; see also August 2005 Release, text following n.40.

(n70)Footnote 70. Adopting Release, text at n.43.

(n71)Footnote 71. Securities Act Release No. 6188, 45 Fed. Reg. 8962 (Feb. 1, 1980), describes certain conditions under which open market purchase plans do not require registration under the Securities Act of 1933.

(n72)Footnote 72. See Rule 16a-3(f).

(n73)Footnote 73. *Id.*

(n74)Footnote 74. The effect of the conditional exemption for "discretionary transactions" will depend on how intra-plan transfers are administered under a particular plan. Under certain plans, participants may only designate the percentage of their account to be invested in various investment funds. Any decision to increase the percent allocated to one investment will result in a prorated reduction of the amounts invested in each other fund. Thus, once a participant has allocated amounts to the company stock fund, any reallocation of account balances will result in a "discretionary transaction." In contrast, discretionary transactions should occur less often if the plan permits participants to choose the account from which an intra-plan transfer will be made.

(n75)Footnote 75. A company stock fund may include a mixed equity fund unless the company's securities did not comprise more than 20% of the fund's assets as of the end of the most recent fiscal year. American Bar Association, SEC No-Action Letter (June 28, 1993).

(n76)Footnote 76. The staff has interpreted this provision liberally to include transactions under tax-qualified plans that satisfy the requirements of IRC Section 401(a)(9) and 401(a)(28) as to timing and amount of distributions, but that are more generous to participants than required under the IRC and that are available to all plan participants on a non-discriminatory basis. American Society of Corporate Secretaries, SEC No-Action Letter, Question 7 (Dec. 11, 1996); American Bar Association, SEC No-Action Letter, Question 3 (Dec. 20, 1996).

(n77)Footnote 77. American Bar Association, SEC No-Action Letter, Question 2 (Dec. 20, 1996) ("[T]he cash-out of a derivative security, such as a phantom stock unit, held in a multi-fund plan that permits fund switching is a Discretionary Transaction. Further, a cash-out from an issuer stock fund, such as a common stock fund,... is a Discretionary Transaction eligible for exemption pursuant to Rule 16b-3(f), whether the plan is single-fund or multi-fund.").

(n78)Footnote 78. Joseph A. Grundfest, *et al.*, SEC No-Action Letter (Aug. 18, 1991).

(n79)Footnote 79. American Bar Association, SEC No-Action Letter, Question 2 (Dec. 20, 1996).

(n80)Footnote 80. American Society of Corporate Secretaries, SEC No-Action Letter, Question 3 (Dec. 20, 1996).

(n81)Footnote 81. Technically, the "required to be made available" standard is an exception from the definition of a "discretionary transaction," discussed above, for a transfer into or out of a company stock fund under a plan. In the context of a tax-conditioned plan, if a transaction is not a "discretionary transaction," it qualifies for the blanket exemption for all other transactions. For an example of IRC provisions permitting transfers out of a company stock fund that is required to be made available, see IRC § 401(a)(28)(B), which provides that ESOP participants age 55 and older must be provided a right to diversify ESOP account into other investments.

(n82)Footnote 82. American Society of Corporate Secretaries, SEC No-Action Letter, Question 3 (Dec. 11, 1996).

(n83)Footnote 83. 1996 Adopting Release n.47; Peter J. Romeo & Alan L. Dye, *The Section 16 Deskbook* § V.C.3.a. (2006)..

(n84)Footnote 84. There was concern that these types of plans may not be viewed as involving transactions with the company because, to avoid registration under the Securities Act of 1933, the company's involvement with such

plans is limited to ministerial functions. Release No. 33-6188, 45 Fed. Reg. 8960, Part III.B.1. (Feb. 1, 1980).

(n85)Footnote 85. American Bar Association, SEC No-Action Letter (Oct. 15, 1999); Peter J. Romeo & Alan L. Dye, *The Section 16 Deskbook* § V.C.3.c.2. (2006).

(n86)Footnote 86. American Bar Association, SEC No-Action Letter (Oct. 15, 1999); Peter J. Romeo & Alan L. Dye, *The Section 16 Deskbook* § V.C.3.c.2. (2006).

(n87)Footnote 87. The new rules thus reverse *Sonnenschein Nath & Rosenthal*, SEC No-Action Letter (July 19, 1995), which stated that the 1991 version of Rule 16b-3 was available for excess plans only if transactions conducted by persons subject to Section 16 mirror those conducted in the qualified plan.

(n88)Footnote 88. In contrast, in *Sonnenschein*, the staff confirmed that distributions from excess plans need not mirror those under the qualified plan. *Sonnenschein Nath & Rosenthal*, SEC No-Action Letter (July 19, 1995).

(n89)Footnote 89. For stock acquired through dividend reinvestments or dividend equivalent rights, the six-month holding period dates from the date of the acquisition of the option or stock to which the dividend relates. The six-month holding period is deemed to be satisfied if the officer or director dies before the six months are over. American Society of Corporate Secretaries, SEC No-Action Letter, Question 6 (Dec. 11, 1996).

(n90)Footnote 90. *See* Rule 16a-3(f).

(n91)Footnote 91. Release Nos. 33-8732A & 34-54302A, 71 Fed. Reg. 56225 (Sept. 26, 2006).

(n92)Footnote 92. *Id.*

(n93)Footnote 93. Rule 16b-3, Note 4; Release Nos. 33-8732A & 34-54302A, 71 Fed. Reg. 53158, text following n.526 (Sept. 8, 2006) ("September 2006 Release").

(n94)Footnote 94. Rule 16b-3, Note 4.

(n95)Footnote 95. Rule 16b-3, Note 4; September 2006 Release, text following n.526.

(n96)Footnote 96. Rule 16b-3, Note 3.

(n97)Footnote 97. *Id.*

(n98)Footnote 98. If the plan is a tax-conditioned plan, then the transactions discussed in these paragraphs could be a "discretionary transaction" that would have to satisfy Rule 16b-3(f) to be exempt. Such transactions can not rely on the approval provisions of Rule 16b-3(e) to be exempt.

(n99)Footnote 99. Statement of Mauri Osherooff, Associate Director, SEC Division of Corporation Finance, at National Association of Stock Plan Professionals teleconference (June 25, 1996).

(n100)Footnote 100. American Bar Association, SEC No-Action Letter, Question 4 (Dec. 20, 1996).

(n101)Footnote 101. *Id.*

(n102)Footnote 102. 61 Fed. Reg. 30376, 30382.

(n103)Footnote 103. Skadden, Arps, Meagher & Flom LLP (Jan. 12, 1999).

(n104)Footnote 104. 151 F. Supp. 2d 633 (D.V.I. 2000).

(n105)Footnote 105. 298 F.3d 136 (2d Cir. 2002).

(n106)Footnote 106. 314 F.3d 106 (3d Cir. 2002).

(n107)Footnote 107. "A transaction need not...to be exempt...specifically have a compensatory element."

(n108)Footnote 108. Release No. 34-52202, 70 Fed. Reg. 46080 (Aug. 9, 2005) ("August 2005 Release").

(n109)Footnote 109. *See id.* (referring to the *Levy* decision as a "restrictive and unintended construction" of the scope of Rule 16b-3's exemptions).

(n110)Footnote 110. *Id.*; *see Tinney v. Geneseo Communs., Inc.*, 457 F. Supp. 2d 495 (D. Del. 2006) (accepting the SEC's interpretation that the amendments apply retroactively). Note that the *Levy* plaintiff has challenged the validity of the amendments in a pending lawsuit. *See Levy v. SEC*, 462 F. Supp. 2d 64 (D.D.C. 2006).

(n111)Footnote 111. The 1991 version of Rule 16b-3 exempting grant and award transactions required a six-month holding period between grant and disposition of any security. As a transition rule, such a six-month holding period was applied to options granted under the pre-1991 version of Rule 16b-3, as a condition to the exercise of such options to be exempt. Release No. 28869 at Part VII.B. Both the 1991 version and the pre-1991 version of Rule 16b-3 imposed a six-month holding period on stock appreciation rights and cashless exercise rights.

(n112)Footnote 112. *See* New York Stock Exchange Listed Company Manual P 312; NASD Manual, Schedule D, Part III § 4(i)1(a) (national market criteria); American Stock Exchange Company Guide § 711.

(n113)Footnote 113. IRC Reg. 1.162-27(3)(4); IRC § 422(b)(1).

(n114)Footnote 114. American Society of Corporate Secretaries, SEC No-Action Letter, Question 2 (Dec. 11, 1996) (approval by committee of directors satisfying requirements under former but not new Rule 16b-3 is not sufficient).

(n115)Footnote 115. *See* Rule 16a-1(c)(3).

(n116)Footnote 116. *See* 1996 Adopting Release.

(n117)Footnote 117. *See* § 8.06[9] *supra*; 1996 Adopting Release.

(n118)Footnote 118. Rule 16b-5, which became effective May 1, 1991, is a successor to old Rule 16a-9(b) as it relates to gifts and is substantially new as it relates to inheritances. *See* Sec. Act Rel. No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 VI.B.2. (Dec. 2, 1988). Significantly, old Rule 16a-9(b) exempted gift transactions only if the aggregate value did not exceed \$10,000 during any six-month period, while new Rule 16b-5 exempts bona fide gift transactions regardless of the value of the securities. *See id.*

Of course, the courts had consistently held that bona fide gift transactions do not constitute "sales" under Section 16(b). *Portnoy v. Memorex Corp.*, 667 F.2d 1281 (9th Cir. 1982); *Shaw v. Dreyfus*, 172 F.2d 140 (2d Cir.), *cert. denied*, 337 U.S. 907 (1949); *Lewis v. Adler*, 331 F. Supp. 1258 (S.D.N.Y. 1971); *Blau v. Albert*, 157 F. Supp. 816 (S.D.N.Y. 1957); *Truncale v. Blumberg*, 80 F. Supp. 387 (S.D.N.Y. 1948). *See also* § 8.04[2][a] *supra* for discussion of the status of gifts as purchases or sales. The Commission asserted that limiting the exemption under old Rule 16a-9(b) to small gifts may have undercut the holdings of these cases, although a court presumably would have recognized that the Commission is free to exempt or not exempt transactions without regard to whether such transactions are purchases or sales. *See* Release No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. VI.B.2 (Dec. 2, 1988).

Transactions relating to bona fide gifts and inheritances that are exempted under Rule 16b-5 need not be reported on a

Form 4 within two business days of the date of the transaction, but must be reported on the year-end Form 5 (unless earlier reported voluntarily on a Form 4). Rule 16a-3(f)(1); Rule 16a-3(g); *see also* § 8.03 *supra* (discussing the filing of Form 4 and Form 5 reports.)

(n119)Footnote 119. The Commission staff has concluded that, where a broker advances funds to the issuer to pay the exercise price of an insider's option, immediately sells the underlying stock (in a cashless exercise transaction), and pays part of the proceeds to offset its advance of the exercise price on behalf of the insider and donates the remaining proceeds to a charity, the portion of the option shares the proceeds of which are donated to the charity may be deemed to be disposed of by a gift transaction exempt under Rule 16b-5, but the portion of the shares the proceeds of which repays the broker its advance of the exercise price is not exempt by Rule 16b-5. *See* Dean Witter Reynolds Inc. (Div. Corp Fin., Jan. 3, 1992). In contrast, the staff concluded that a bona fide gift of equity securities purchased on margin or subject to a loan is eligible for the exemption under Rule 16b-5, even if the donee assumes liability for the loan as part of the gift. *See* Cravath, Swaine & Moore (Div. Corp. Fin., Feb. 25, 1992).

(n120)Footnote 120. *See, e.g., Morales v. Napco, Inc.*, 541 F.2d 233 (10th Cir. 1976) ; *Blau v. Ogsbury*, 210 F.2d 426 (2d Cir. 1954) ; *Morales v. Reading & Bates Offshore Drilling Co.*, 392 F. Supp. 41 (N.D. Okla. 1975) ; *see also* § 8.04[2][e] *supra*.

Once before, in the early 1950s, the Commission attempted to exempt option exercises. *See* Sec. Exch. Act Rel. No. 28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. III.A (Feb. 8, 1991). As originally adopted, Rule 16b-3 exempted exercises of non-transferable options under plans meeting the requirements of the Rule. Several courts concluded that such an exemption was not consistent with the purposes of Section 16 because, in the courts' view, option exercises within six months of sales of the underlying stock could give rise to speculative abuse. *See Greene v. Dietz*, 247 F.2d 689, 696 (2d Cir. 1957) (dicta); *Perlman v. Timberlake*, 172 F. Supp. 246, 251-54 (S.D.N.Y. 1959) . *But see Perlitz v. Continental Oil*, 176 F. Supp. 219 (S.D. Tex. 1959) (upholding the exemption for option exercises). The Commission subsequently amended the Rule to eliminate the exemption for option exercises. *See* Sec. Exch. Act Rel. No. 34-6275 (1960). The Commission pointed out that its comprehensive approach, treating acquisitions of derivative securities as purchases (and, in some cases, sales) provided adequate protection from speculative abuse and therefore distinguished Rule 16b-6(b) from the exemption struck down in the late 1950s. Sec. Exch. Act Rel. No. 34-28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. III.A (Feb. 8, 1991).

(n121)Footnote 121. *See* Sec. Exch. Act Rel. No. 28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. III.A (Feb. 8, 1991).

Subject to certain exceptions, the term "derivative securities" means "any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege at a price related to an equity security, or similar securities with a value derived from the value of an equity security." Rule 16a-1(c). Instruments excluded from the definition of "derivative securities" are described in paragraphs (1) to (7) under Rule 16a-1(c).

(n122)Footnote 122. *See id.*

(n123)Footnote 123. A "call equivalent position" is defined to mean "a derivative security position that increases in value as the value of the underlying equity increases, including, but not limited to, a long convertible security, a long call option, and a short put option position." Rule 16a-1(b).

(n124)Footnote 124. A "put equivalent position" is defined to mean "a derivative security position that increases in value as the value of the underlying equity decreases, including, but not limited to, a long put option and a short call option position." Rule 16a-1(h).

(n125)Footnote 125. Rule 16b-6(a).

(n126)Footnote 126. Rule 16b-6(b).

(n127)Footnote 127. Exercises of convertible securities were generally exempt under old Rule 16b-9, subject to certain conditions. Rule 16b-6(b) is the successor to old Rule 16b-9, which has been deleted.

(n128)Footnote 128. Sec. Exch. Act Rel. No. 28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. III.A (Feb. 8, 1991). An exercise of an option, warrant or right that is "at-the-money"--that is, the same as the market price of the underlying equity securities--is exempt under the Rule. *Id.*

The determination of whether an option, warrant, or right is "out-of-the-money" is a factual one. *See* CSX Corp., Fed. Sec. L. Rep. (CCH) P 79,758 (Div. Corp. Fin., Aug. 30, 1991) (Commission staff refused to state a view on whether favorable financing terms might result in an exercise price, the face amount of which might exceed the market price of the underlying securities on a given exercise date, being deemed to be not "out-of-the-money").

The Rule makes an exception, however, to permit exempt exercises of out-of-the-money options 'necessary to comport' with the sequential exercise requirement applicable to incentive stock options granted before 1987 under then-*Section 422A of the Internal Revenue Code of 1954*, as amended. The old sequential exercise requirement, eliminated for incentive stock options granted after 1986, did not permit the exercise of a later-granted incentive stock option until all previously granted incentive stock options had been exercised.

(n129)Footnote 129. *See* Sullivan & Cromwell, Fed. Sec. L. Rep. (CCH) P 79,687 (Div. Corp. Fin., Apr. 30, 1991).

(n130)Footnote 130. *See, e.g.,* Marion Merrell Dow, Inc. (Div. Corp. Fin., Jan. 24, 1992); The Taylor Voting Trust (Div. Corp. Fin., Jan. 3, 1992); Hechinger Co., C.C.H. Fed. Sec. L. Rep. P 79,772 (Div. Corp. Fin., Sept. 17, 1991); ALZA Corp., C.C.H. Fed. Sec. L. Rep. P 79,720 (Div. Corp. Fin., July 17, 1991); National Medical Enterprises, Inc., C.C.H. Fed. Sec. L. Rep. P 79,672 (Div. Corp. Fin., Apr. 23, 1991).

(n131)Footnote 131. *See, e.g.,* Anheuser-Busch Cos., Inc. (Div. Corp. Fin., Nov. 27, 1991); CSX Corp., C.C.H. Fed. Sec. L. Rep. P 79,758 (Div. Corp. Fin., Aug. 30, 1991); Simpson Thacher & Bartlett, C.C.H. Fed. Sec. L. Rep. P 79,686 (Div. Corp. Fin., Apr. 30, 1991).

See also Marion Merrell Dow, Inc. (Div. Corp. Fin., Jan. 24, 1992) (implying that the deemed purchase upon redemption of a "contingent value right," in the nature of a "stock depreciation right," is not exempt under Rule 16b-6(b), although the staff's position is not at all clear); Cravath, Swaine & Moore, C.C.H. Fed. Sec. L. Rep. P 79,699 (Div. Corp. Fin., May 6, 1991) (reporting of exercise of stock appreciation right requires separate reporting of the deemed acquisition of actual stock and the deemed disposition of the actual stock on Table I of Form 4 or Form 5).

(n132)Footnote 132. Rule 16b-7 is the successor to old Rule 16b-7, which was revised in minor ways in connection with the adoption of the new Section 16 rules in 1991. *See* Release No. 34-28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. VIII.A (Feb. 8, 1991).

(n133)Footnote 133. A "merger" is defined under the Rule as including the sale or purchase of substantially all the assets of one company to or by a second company in exchange for equity securities that are then distributed to the security holders of the company that sold its assets. Rule 16b-7(b).

(n134)Footnote 134. The Division of Corporation Finance has taken the position that the Rule applies to indirect as well as direct ownership if the merger or consolidation does not result in a significant change in the character or structure of the company. Sec. Exch. Act Rel. No. 18114, Fed. Sec. L. Rep. (CCH) P 26,062, Question 143 (1981). For example, Corporation X enters into an agreement with its wholly owned subsidiary, Corporation Y, whereby Y would become the parent of X through an exchange of shares and the merger of a wholly-owned shell subsidiary of Y,

Corporation S, into X. X indirectly owns 100% of the equity securities of S. Although X will merge into S rather than Y, the Rule 16b-7 exemption will still be available because:

- (1) Y, on a consolidated basis, will represent the same business entity as premerger X;
- (2) Y will be managed by the same directors and officers as X; and
- (3) Y will have charter and bylaw provisions the same as those of X.

(n135)Footnote 135. The Rule recognizes that these transactions:

- (1) are of relatively minor importance to the stockholders of a particular company;
- (2) do not present significant opportunities for insiders to profit by inside information with respect to the merger; and
- (3) do not significantly alter economically the kind of security the insiders owned prior to the transaction.

Sec. Exch. Act Rel. No. 34-18114 Pt. IV G, Fed. Sec. L. Rep. (CCH) P 26,062 (1981). *See also* Sec. Exch. Act Rel. No. 4996 (1954).

(n136)Footnote 136. Sec. Exch. Act Rel. No. 34-18114, Fed. Sec. L. Rep. (CCH) P 26,062, n.196 (1981).

For example, C, an insurance company, wants to reorganize as a general business corporation. C intends to transfer all assets and liabilities to new C, a wholly owned subsidiary of C, and then merge into the insurance subsidiary of new C. The merger agreement provides that each share of C stock will be exchanged for a single share of new C stock. The merger exchange would have no effect on the consolidated financial statements, the composition of management, or the rights of C shareholders. Under Rule 16b-7, the acquisition or disposition of securities pursuant to the merger will not be considered to be a purchase or sale under Section 16(b).

(n137)Footnote 137. Rule 16b-7(a)(1)(i).

A language change in this provision seems to suggest that ownership of 85% of the securities of the company resulting from consolidation by the issuer of the securities surrendered will qualify for the exemption even if that issuer does not own 85% of the securities of the other companies in the transaction. In the absence of an indication that this result was intended, the language probably should be read in a manner consistent with old Rule 16b-7 to mean that ownership of 85% of the securities of the company that will result from a consolidation will not be required *prior to the transaction* because that company will not come into existence until the consolidation occurs.

(n138)Footnote 138. Rule 16b-7(a)(1)(ii).

(n139)Footnote 139. Rule 16b-7(a)(2)(i).

(n140)Footnote 140. Rule 16b-7(a)(2)(ii).

(n141)Footnote 141. For example, under Virginia law, Company X, a savings and loan association, is not permitted to acquire stock of other savings and loan associations. X incorporates Company Y, a wholly-owned subsidiary of X, with the intention of creating a holding company that would be able to acquire savings and loan associations. Pursuant to statutory procedures under Virginia law, an exchange is arranged whereby X became a

wholly-owned subsidiary of Y and X shareholders became the owners of all the outstanding shares of Y. The acquisition of Y stock by X shareholders and the disposition of the X stock in the exchange pursuant to this statutory merger is exempt from Section 16(b) by Rule 16b-7. Sec. Exch. Act Rel. No. 34-18114, Fed. Sec. L. Rep. (CCH) P 26,062, Question 142 (1981).

(n142)Footnote 142. *Id.*

For example, X is a holding company whose principal asset is 100,000 shares of Company Y stock, representing approximately six percent of the outstanding Y stock. Pursuant to a plan of liquidation, X shareholders will exchange X stock for Y stock on a pro rata basis. Neither the acquisition nor the disposition of stock pursuant to this exchange is exempt from Section 16(b) under Rule 16b-7 because the conditions of Rule 16b-7(a) have not been met.

(n143)Footnote 143. Rule 16b-7(d).

For example, an officer of a New York corporation makes a non-exempt purchase of 1,000 shares of his company's stock on January 2, bringing his total holdings to 3,000 shares. His company reincorporates through a merger transaction satisfying Rule 16b-7 on March 1, in which transaction he surrenders his 3,000 shares and receives 3,000 shares in a Delaware corporation. He then makes a non-exempt sale of 1200 shares of the Delaware corporation on April 15. Although the officer's participation in the merger exchange is otherwise exempt under the Rule, the exemption is unavailable to the extent of 1,000 shares. *See* Sec. Exch. Act Rel. No. 18114, Fed. Sec. L. Rep. (CCH) P 26,062, Question 144 (1981). As a result, a Section 16(b) claim might be based not only upon matching the April 15 sale with the January 2 purchase, but also by matching the January 2 purchase with the March 1 "sale" in the reincorporation merger, and the March 1 "purchase" in the reincorporation merger with the April 15 sale. The likelihood of success on these theories, even in the absence of the exemption, is uncertain.

(n144)Footnote 144. *See* Rule 16b-8.

(n145)Footnote 145. Rule 16b-8.

(n146)Footnote 146. Rule 16b-8.

(n147)Footnote 147. Rule 16b-8.

The unavailability of the exemption would extend only to the securities involved in the purchases and sales described in the text in (1) and (2) above within six months of withdrawal or deposit. Sec. Exch. Act Rel. No. 34-7826, Fed. Sec. L. Rep. (CCH) P 77,329 (1966).

The purpose of the limitation on purchases and sales of the class of equity securities deposited and certificates representing these equity securities is to exempt only transactions of withdrawal or deposit in the voting trust itself. Sec. Exch. Act Rel. No. 34-18114, Fed. Sec. L. Rep. (CCH) P 26,062, Question 145 (1981).

(n148)Footnote 148. *See, e.g.,* C.R.A. Realty Corp. v. Fremont Gen. Corp., 5 F.3d 1341 (9th Cir. 1993); Portnoy v. Memorex Corp., 667 F.2d 1281 (9th Cir. 1982).

(n149)Footnote 149. C.R.A. Realty Corp. v. Fremont Gen. Corp., 5 F.3d 1341 (9th Cir. 1993); Heli-Coil Corporation v. Webster, 222 F. Supp. 831 (D.N.J. 1963); *see also* Booth v. Varian Associates, 334 F.2d 1 (5th Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943).

(n150)Footnote 150. C.R.A. Realty Corp. v. Fremont Gen. Corp. 5 F.3d 1341, 1342-43 (9th Cir. 1993) (holding that only the portion of stock necessary to satisfy a valid, preexisting debt is exempted from 16(b), but any transfer in excess of the debt is not exempt); Schur v. Salzman, 365 F. Supp. 725, 733 (S.D.N.Y. 1973) (holding that the

repurchase of a security in satisfaction of a debt of honor or moral obligation based on a promise that a director would be able to sell his shares after leaving his position does not constitute a debt previously contracted).

In *Rheem Manufacturing Co. v. Rheem*, 295 F.2d 473 (9th Cir. 1961), the court held that for the purposes of Section 16(b):

(1) a debt previously contracted is an obligation to pay a fixed sum certainly and in all events that existed prior to and apart from the settlement of the obligation by the transfer of the stock; and

(2) a demonstration of good faith does not require that the acquisition of the securities be completely involuntary.

(n151)Footnote 151. *Park & Tilford, Inc. v. Schulte*, 160 F.2d 984 (2d Cir.), *cert. denied*, 332 U.S. 761 (1947).

(n152)Footnote 152. *Truncale v. Blumberg*, 80 F. Supp. 387 (S.D.N.Y. 1948); *see also Rheem Mfg. Co.*, 295 F.2d 473.

(n153)Footnote 153. Section 3(a)(38) defines a market-maker as:

any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer, who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell security for his own account on a regular or continuous basis.

In *C.R.A. Realty Corp. v. Tri-South Investments*, 738 F.2d 73, (2d Cir. 1984), the Second Circuit held that a brokerage firm's common stock trading, that was incidental to and inextricably connected with the firm's market-making activity in the same issuer's debentures that were convertible into the common stock, was exempted by Section 16(d)'s market-maker exemption from the short-swing profits provision of Section 16(b). The court concluded that common stock and securities of the same issuer convertible into the common should be treated as economic equivalents considering the realities of the market place, the congressional goal of facilitating market-making activity, and the Commission's rules.

(n154)Footnote 154. Both the purchase and sale, or sale and purchase, must have been made as a market making transaction if Section 16(d) is to apply. Sec. Exch. Act Rel. No. 34-7905, Fed. Sec. L. Rep. (CCH) P 77,355 (1966).

(n155)Footnote 155. There are currently no exchanges exempted from registration under Section 5. *See* § 2.02 *supra*.

(n156)Footnote 156. Section 16(d). The Commission may, by rule and regulation, define and prescribe (1) the terms and conditions concerning the securities held in an investment account, and (2) transactions made in the ordinary course of business and incident to the establishment or maintenance of a primary or secondary market. *Id.*

(n157)Footnote 157. Release No. 34-28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. V.D. (Feb. 8, 1991) *see* *Normura Securities Co., Ltd.* (Div. Corp. Fin. 1990).

(n158)Footnote 158. *See* Sec. Act Rel. No. 34-28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. V.D. (Feb. 8, 1991); Release No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. VI.E (Dec. 2, 1988); *Prudential-Bache Securities Inc.* (Div. Corp. Fin., Dec. 2, 1985); *L.F. Rothschild, Unterberg, Towbin* (Div. Corp. Fin., Oct. 28, 1983). At least one court has also implied that Section 16(d) provides an exemption from Section 16(a) reporting. *See Simon v. Merrill, Lynch, Pierce, Fenner & Smith*, 482 F.2d 880 (5th Cir. 1973).

(n159)Footnote 159. See Sec. Act Rel. No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. VI.E (Dec. 2, 1988).

(n160)Footnote 160. See Sec. Act Rel. No. 34-28869, Fed. Sec. L. Rep. (CCH) P 84,709 Pt. V.D (Feb. 8, 1991). The Commission reaffirmed the vitality of the prior interpretations, but offered no explanation of why it determined not to adopt the proposed rule. See *id.*

(n161)Footnote 161. See also Rule 3b-4 (defining "foreign private issuer").

(n162)Footnote 162. Rule 16e-1 was not amended in connection with the comprehensive revision of the Section 16 rules that became effective May 1, 1991.

(n163)Footnote 163. See *Falco v. Donner Foundation, Inc.*, 208 F.2d 600 (2d Cir. 1953) (Section 16(b) not applicable to the arbitrage transactions of a more than ten percent security holder); see also *Lewis v. Dekcraft Corp.* No. 69 Civ. 2982, 1974 U.S. Dist. LEXIS 7862, at *7 (S.D.N.Y. June 27, 1974) (Rule 16e-1 "in substance exempts from § 16(b) liability bona fide arbitrage transactions effected by 10% beneficial owners but does not exempt transactions effected by directors or officers.").

(n164)Footnote 164. II Loss, *Securities Regulation*, at 3079 n.276 (2d ed. Supp. 1969).

Place and kind arbitrage can be combined, *e.g.*, the purchase of convertible securities in one market and the sale of the securities into which they can be converted in another. *Id.*; see *Lewis v. Dekcraft Corp.*, 1974 U.S. Dist. LEXIS 7862, at *5-7 (discussing the various types of arbitrage and stating that such transactions effected by 10% are exempted from § 16(b) liability); see also *Falco v. Donner Corp.*, 208 F.2d 600 (2d Cir. 1953) (transaction by a more than 10% percent security holder in which he sold shares of the issuer's stock with dividend rights attached and simultaneously purchased the same number of shares without dividend rights, and in which he realized a profit because of the market fluctuation of stock with and without the dividend rights, was exempt from the provisions of Section 16(b) by Section 16(d) [now Section 16(e)]).

(n165)Footnote 165. See *Heli-Coil Corp. v. Webster*, 352 F.2d 156 (3d Cir. 1965); *Falco v. Donner Corp.*, 208 F.2d 600 (2d Cir. 1953).

In *Lewis v. Dekcraft Corp.*, *supra* the court concluded that the Section 16(e) exemption was inapplicable because:

(1) the purchase and sale was not simultaneous; and

(2) the insider's position with respect to the securities did not remain constant, *i.e.*, it purchased 220,000 shares at one time and sold 168,694 shares at the other time.

(n166)Footnote 166. Rule 16c-1 continues the exemption provided under old Rule 16c-1 without substantive change. See Release No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. VI.D (Dec. 2, 1988).

(n167)Footnote 167. Rule 16c-2 is the successor to old Rule 16c-2. see Sec. Act Rel. No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. VI.D (Dec. 2, 1988). The new Rule eliminated a requirement of old Rule 16c-2(b) that persons not subject to Section 16(b) participate in the underwriting on terms at least as favorable as those on which the insider is participating and to an extent at least equal to the combined participation of all persons exempted under old Rule 16c-2. *Id.*

(n168)Footnote 168. The manager of an underwriting group will overalloc to ensure the success of the distribution and so that subsequent covering purchases will tend to stabilize the market. II Loss, *Securities Regulation* at 1120 (2d ed. Supp. 1969).

(n169)Footnote 169. Rule 16c-2.

(n170)Footnote 170. Rule 16c-3(a)(1).

(n171)Footnote 171. Rule 16c-3(a)(2).

(n172)Footnote 172. Rule 16c-3(a)(3).

The reporting requirements under Section 16(a) for the sale of a security by an insider are discussed in § 8.03[2][a][ii] *supra*.

(n173)Footnote 173. Rule 16c-3(b).

(n174)Footnote 174. Rule 16c-4.

(n175)Footnote 175. *See* Sec. Exch. Act Rel. No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. IV.C (Dec. 2, 1988). The Commission stated:

The proposed treatment of derivative securities is intended to subject derivative securities to the short sale prohibitions of section 16(c). The potential for abuse is not less when insiders establish put equivalent positions, rather than selling short underlying securities. Indeed, options were instrumental to insiders in the notorious 'bear raids' of the early 1930's. A reading of the legislative history indicates the Congress did not want insiders, with access to inside information, speculating in their company's stock by acquiring short positions. Further, Congress did not want insiders to take short positions in conflict with their fiduciary duties, because insiders could use short positions to manipulate a stock price or to profit by a fall in the price of their company's stock. Derivative securities can be used to establish a short position, even where the insider has large stock holdings. The proposed rule thus would ensure that an insider does not have an economic interest in the poor performance of the issuer's stock.

Id. (footnote omitted). Elsewhere in the Proposing Release, the Commission suggested that, "as a result of" proposed Rule 16c-4, "put equivalent positions will be deemed violations of Section 16(c) in certain circumstances." *Id.* at Pt. XI. There would appear to be no basis for this statement; the fact that the Commission adopts an exemptive rule would not dictate that the transaction that is the subject of the rule must be treated as a purchase or sale in any circumstance in which the exemption did not apply.

(n176)Footnote 176. The Commission could have simply drafted a Rule similar to Rule 16b-6(a) to provide that the establishment or increase in a put equivalent position would be deemed a "sale" of the underlying securities for purposes of Section 16(c). Rule 16b-6(a), as drafted, deems such transactions to be a "sale" only for purposes of Section 16(b).

(n177)Footnote 177. A separate issue might arise as to whether a sale of underlying securities which, when viewed together with outstanding derivative securities then owned by the insider, creates a "net short position" might be deemed a violation of Section 16(c).

(n178)Footnote 178. *Compare* Sec. Exch. Act Rel. No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. XIV (Dec. 2, 1988) (proposed Rule 16c-4), *with* Rule 16c-4.

In the Proposing Release, the Commission stated:

[Rule 16b-4's] exemption would be lost if the insider later sold enough underlying securities that the securities underlying the put equivalent positions exceeded the number of underlying securities otherwise

owned.

Id. at Pt. IV.C.

Although the language of Rule 16c-4 changed between the proposal and adoption to make it unclear whether the hedging position must be maintained at all times while the put equivalent position is outstanding, the Commission did not explain the change. *See* Sec. Exch. Act Rel. No. 34-28869, Fed. Sec. L. Rep. (CCH) P 84,709 (Feb. 8, 1991); Sec. Exch. Act Rel. No. 34-27148, Fed. Sec. L. Rep. (CCH) P 84,343 (Aug. 18, 1989).

(n179)Footnote 179. *See* Sec. Exch. Act Rel. No. 34-26333, Fed. Sec. L. Rep. (CCH) P 84,343 Pt. IV.C (Dec. 2, 1988). The Commission explained that, in adopting Section 16(c), Congress was particularly concerned with this form of transaction, particularly in view of the fact that the insider could repurchase shares in the market to cover his short position. *See id.* As a practical matter, because insiders often hold options and other call equivalent positions under employee benefit plans, an exemption for this kind of transaction could have permitted wide-spread short selling.

(n180)Footnote 180. *See id.*

The Rule itself uses the undefined term "owns" rather than the defined term "beneficially owns." Clearly, an insider who acquires a call equivalent position thereby acquires "beneficial ownership" of the underlying equity securities. *See* Rule 16a-1(a)(2)(ii)(F); Rule 16a-1(d); Rule 16a-4(a). Thus, the use of the different term "owns" under Rule 16c-4 may have been intended to denote ownership of the actual underlying equity securities and not derivative securities exercisable for the underlying equity securities.



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CHAPTER SA-9 SPECIAL ALERT TO CHAPTER 9

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CHAPTER SA-9 SPECIAL ALERT TO CHAPTER 9

2- Federal Securities Exchange Act of 1934

Impact of the Sarbanes-Oxley Act of 2002 on SEC Enforcement_and_@_)_and_footnotes(n2);vk n*

On July 30, 2002, President signed into law The Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act is probably the newest piece of federal securities legislation in more than 60 years and will directly impact the SEC enforcement process in a number of ways. These impacts include:

- §307, which required the SEC to adopt professional standards for attorneys who appear and practice before the Commission in the representation of an issuer, including a requirement that such attorneys report "evidence of a material violation" up the ladder of an issuer's organization. Effective August 5, 2003, the SEC adopted Part 205 of 17 CFR, implementing Sarbanes-Oxley §307. Under certain circumstances, Part 205 will impose new obligations on attorneys who represent issuers in SEC investigations, including the law department attorneys who supervise such representations.
- §1105, which authorizes the SEC to issue orders barring an individual from serving as an officer and director of a public company. Previously, the SEC could only obtain an officer-and-director bar from a federal court.
- §305, which changed the showing that the SEC must make to obtain an order barring an individual from serving as an officer and director of a public company. The provision changed the standard from "substantial unfitness" to "fitness." This change is widely viewed as having lowered the required showing.
- §305(b), which authorized the SEC to seek, and courts to grant, any equitable relief that may be appropriate or necessary for the benefit of investors. This provision confirms the authority of the courts to fashion a wide variety of equitable relief.
- § 1103, which authorizes the Commission to seek from a federal court a form of emergency relief previously not expressly authorized by statute. Specifically, this section authorizes, in certain circumstances, the issuance of a court order freezing extraordinary payments by an issuer.

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Sarbanes-Oxley §304 may also have a significant impact on the enforcement process. This section provides that if an issuer is required to restate its financial statements due to material noncompliance of the issuer, as a result of misconduct with any financial reporting requirement under the federal securities laws, the CEO and CFO must reimburse the issuer for (1) any bonus or other incentive-based or equity-based compensation received by that person during the 12-month period following the first issuance of the restatement and (2) any profits realized from the sale of securities during that 12-month period.

Similarly, Sarbanes-Oxley §§806 and 1107 may also impact the enforcement process. These provisions provide for civil and criminal penalties against issuers and issuer personnel who retaliate against whistleblowers.

FOOTNOTES:

(n2)Footnote *. This Special Alert was prepared by Kenneth Winer of Foley & Lardner, Washington D.C. A former official of the SEC Division of Enforcement, Kenneth Winer is a partner at Foley & Lardner, who represents individuals and entities in SEC investigations and conducts internal investigations into potential violations of the federal securities laws.



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CHAPTER 9 SEC Enforcement--Legal Considerations

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AUTHOR: Theodore Altman and Joshua S. Sohn

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Theodore Altman and Joshua S. Sohn n*

FOOTNOTES:

(n1)Footnote *. This chapter was prepared by Theodore Altman and Joshua Sohn. Mr. Altman is a partner at DLA Piper LLP (US) and is a former Assistant Director of the Securities and Exchange Commission's Division of Enforcement. Mr. Sohn, also a partner at DLA Piper, devotes a substantial part of his practice to Securities Litigation. They were assisted by Robert Johnston, a DLA Piper associate, and Kerry Anne Harnett, a DLA Piper summer associate. The initial edition of this chapter was prepared by Mr. Altman in collaboration with the late Bernard Wexler. Mr. Wexler was the Director of the Securities and Exchange Commission's Office of Opinions & Review.



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CHAPTER 9 SEC Enforcement--Legal Considerations

*2-9 Federal Securities Exchange Act of 1934 § 9.01***AUTHOR:** Theodore Altman and Joshua S. Sohn**§ 9.01 Introduction**

The Securities and Exchange Commission (the "SEC" or "Commission") consists of five members appointed by the President with the advice and consent of the Senate for staggered five-year terms. n1 The President designates a member of the Commission as Chairman. n2 Although the Commission is a collegial body on which the Chairman has only one vote, the position has been described as "at least primus inter pares and sometimes a good deal more than that." n3

The Commission keeps a very watchful eye on its enforcement program, and the Commissioners devote much time and energy to this phase of their duties. However, the Commission's role is essentially that of policy maker, supervisor, monitor, and ultimate decision maker. The laboring oar is borne by a staff of professional employees who do the investigating and the litigating.

As its name suggests, the Division of Enforcement is the staff unit responsible for conducting investigation and enforcement work under the Acts administered by the Commission. n4 As stated in the Division's Enforcement Manual ("SEC Enforcement Manual"), its mission is "to protect investors and the markets by investigating potential violations of the federal securities laws and litigating the SEC's enforcement actions." n5

Although the Division, like the Commission itself, is located in Washington, D.C., its activities are nationwide and much of the actual enforcement work is performed by regional offices. The Division's relationship to the regional offices is comparable in some ways to the Commission's relationship to the Division. n6

The Commission's chief legal officer is the General Counsel, whose office figures prominently in enforcement matters. The views of the General Counsel's Office on legal and policy questions are solicited by the Division and by the Commission itself. The General Counsel's Office conducts all of the Commission's appellate litigation, defends all actions against the Commission, and supervises other civil litigation. It also reviews the Enforcement Division's recommendations that cases be referred to the Department of Justice for criminal prosecution.

Finally, in response to the 2008-2009 Financial Crisis and high profile scandals such as the Madoff Ponzi scheme, there has been a recent increased push for more vigilant securities enforcement. For example, in its 2009 Performance and

Accountability Report, the SEC announced that it had enacted enforcement reforms in response to the Madoff fraud, including: a restructuring of the Enforcement Division to reduce bureaucracy and accelerate the enforcement process, the creation of specialized units within the Enforcement Division which will enable the SEC to prepare and bring cases more quickly, the recruitment of more staff with specialized industry experience, and the creation of a new division of Risk, Strategy, and Financial Innovation, which will study emerging trends and financial products in order to "proactively uncover potential risks to investors." n7 Indeed, the SEC devoted nearly fifty five percent of its FY 2009 budget, or approximately \$531 million, to enforcement and examination efforts. n8 Furthermore, "[i]n FY 2009, the SEC opened about 6 percent more investigations when compared to FY 2008 and about 22 percent more investigations when compared to FY 2007." n9 Additionally, as discussed in this chapter, the enactment of the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* will arm the SEC with more powerful enforcement tools. Accordingly, the recent trend of increased regulatory vigilance by the SEC can be expected to continue, if not increase, in the near future.

FOOTNOTES:

(n1)Footnote 1. Section 4 of the Exchange Act, 15 U.S.C. § 78d. The section also provides that "[n]ot more than three of such commissioners shall be members of the same political party, and in making appointments members of different political parties shall be appointed alternately as may be practicable."

(n2)Footnote 2. Reorganization Plan No. 10 of 1950, 15 Fed. Reg. 3,175 (1950) .

(n3)Footnote 3. Garrett and Weaver, *The Securities Exchange Commission and the Code*, 30 Vand. L. Rev. 441, 445 (1977). The senior author of this article, the late Ray Garrett, Jr., a former Chairman of the Commission who had also held high-ranking staff positions, knew whereof he spoke.

(n4)Footnote 4. The present arrangement under which the entire enforcement function is vested in a single Division has been in effect since 1972. Before that time, the Division responsible for administering the particular statute involved was also responsible for its enforcement.

(n5)Footnote 5. Securities and Exchange Commission Division of Enforcement, Enforcement Manual, dated January 13, 2010, revised March 3, 2010, available at <http://www.sec.gov/divisions/enforce.shtml>. The SEC Enforcement Manual is intended to be a reference for the staff and contains general policies and procedures relating to investigations of potential securities laws violations. It does not create any rights and is not enforceable at law.

(n6)Footnote 6. Compare 17 C.F.R. § 200.19b ("The Director of the Division of Enforcement is responsible to the Commission for the supervision and conduct of all... enforcement activities under each of the acts administered by the Commission and the investigations relating thereto."), with 17 C.F.R. § 200.27 ("Each Regional Administrator is responsible for executing the Commission's programs within his geographic region... subject to policy direction and review by the Division Directors, the General Counsel, and the Chief Accountant.").

(n7)Footnote 7. U.S. Securities and Exchange Commission, "Message from the Chairman," *Putting Investors First--2009 Performance and Accountability Report*, available at <http://www.sec.gov/about/secpar/secpar2009.pdf#chairmanmessage>

(n8)Footnote 8. U.S. Securities and Exchange Commission, "Management Discussion and Analysis," *Putting Investors First--2009 Performance and Accountability Report*, p. 15 available at <http://www.sec.gov/about/secpar/secpar2009.pdf#mda>.

(n9)Footnote 9. *Id.* at p. 18 .



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.02

AUTHOR: Theodore Altman and Joshua S. Sohn

§ 9.02 Statutory Authority to Investigate

The federal securities laws bestow upon the SEC broad investigatory powers. Section 20(a) of the Securities Act of 1933 (the "1933 Act" or "Securities Act")ⁿ¹ grants the Commission authority to investigate when the Act or the rules or regulations thereunder appear to have been or are about to be violated. Section 21(a) of the Securities Exchange Act of 1934 (the "1934 Act" or "Exchange Act") enables the Commission, in its discretion, to investigate as it deems necessary to determine whether any person has violated, is violating, or is about to violate any provision of the Exchange Act, the rules and regulations thereunder, or the rules of a national securities exchange.ⁿ² Investigations under Section 21(a) need not be predicated on possible violations--they may be made to obtain information relevant to the promulgation of rules and regulations or to make legislative recommendations. Section 21(b) of the Exchange Act provides the Commission with subpoena power. Sections 19 and 20 of the Securities Act, Section 42 of the Investment Company Act of 1940 (the "Investment Company Act"),ⁿ³ and Section 209 of the Investment Advisers Act of 1940 (the "Investment Advisers Act")ⁿ⁴ give the Commission similar powers to investigate possible violations of those Acts.

Finally, the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"), perhaps the most important addition to the arsenal of securities laws since the Exchange Act, was enacted in July 2002.ⁿ⁵ Impetus for passage of the law came from an extraordinary string of accounting scandals and alleged corporate fraud episodes beginning in 2001. Some breathtaking in their magnitude, the most notable of these are the following: Enron,ⁿ⁶ Arthur Anderson,ⁿ⁷ Global Crossing,ⁿ⁸ Adelphi Communications,ⁿ⁹ and WorldCom.ⁿ¹⁰

The run of corporate scandals, bankruptcies, and the losses to investors which followed made clear to many that, in addition to any possible individual wrongdoing, the system of watchdogs and regulators--officers, directors, auditors, and the SEC--had simply failed and needed strengthening. The resulting Sarbanes-Oxley Act attempted to fill that need through a combination of increased disclosure requirements and management certifications, corporate governance changes, increased penalties for securities laws violations, and the creation of a new Public Company Accounting Oversight Board ("PCAOB") to oversee the audit profession.

Section 3(b) of the Sarbanes-Oxley Act provides that violations of the Act, any rules or regulations of the Commission passed pursuant to the Act, or any rules of the PCAOBⁿ¹¹ are to be treated "for all purposes" as violations of the Exchange Act or the rules and regulations issued thereunder. The Sarbanes-Oxley Act also (perhaps redundantly)

extends the Commission's investigative powers under Section 21(a) of the Exchange Act to potential violations of the rules of the PCAOB.

Sarbanes Oxley's regulatory structures have been criticized as being unnecessarily restrictive for foreign companies listed on United States' exchanges and harmful to capital formation. n12 As a consequence, the SEC adopted amendments to the rules governing those companies' requirements to register their securities and ease the barriers to deregistration. n13

The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* made some changes to Sarbanes-Oxley. For example, non-accelerated filers now have an exemption from the Sarbanes-Oxley § 404(b) auditor-attestation requirements, and the SEC is required to conduct a study on reducing the compliance burden of § 404(b) for other issuers. Specifically, the SEC's study is to seek to reduce compliance burdens for companies with a market capitalization between \$75 million to \$250 million. n14 Under Sarbanes-Oxley § 304, CEO and CFO bonuses paid or earned in the twelve-month period preceding an accounting restatement revealing misconduct may be subject to clawback. By contrast, Dodd-Frank obligates "the SEC to adopt rules requiring national securities exchanges to require every listed company, as a condition of listing, to adopt a policy for the claw back of executive compensation" from the previous three years where there is material noncompliance (even if no misconduct) by any executive officer. n15

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 77a et seq.

(n2)Footnote 2. 15 U.S.C. § 78a et seq.

(n3)Footnote 3. 15 U.S.C. § 80a-1 et seq.

(n4)Footnote 4. 15 U.S.C. § 80b-1 et. seq.

(n5)Footnote 5. Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002); 15 U.S.C. § 7201 et. seq.

(n6)Footnote 6. In October 2001, Enron Corp. ("Enron"), a former small-time natural gas company turned energy/commodity trading giant, announced an extraordinary earnings charge of \$544 million and a \$1.2 billion reduction in stockholder equity. Much of the write-down was tied to off-balance-sheet partnerships that resulted in significant financial risk to the company. Enron subsequently restated its earnings for 1997 to 2001 by an aggregate of \$586 million and, following an unsuccessful attempt to salvage a merger with Dynegy Corp., declared bankruptcy on December 2, 2001--at that time the largest bankruptcy in U.S. history. Prior to its collapse, Enron boasted a peak market capitalization of approximately \$70 billion. The prosecutions against Enron executives have had mixed results. On January 31, 2007 a federal judge vacated the conviction of former Enron chief financial officer, Kevin A. Howard, Kate Murphy, *Judge Throws Out a Conviction in Enron Case*, NY TIMES, Feb. 1, 2007. The first trial of Mr. Howard ended in hung jury. *Id.* Another former chief financial officer of Enron, Andrew Fastow was sentenced to six years in prison on September 27, 2006. Kate Murphy & Alexei Barrionuevo, *Fastow Sentenced to 6 Years*, NY TIMES, Sept. 27, 2006. Richard Causey, the former Enron chief accounting officer was sentenced to five and a half years and began serving his sentence on Jan. 3, 2007. Associated Press, *Ex-Enron Executive Reports to Prison*, January 4, 2007. Finally, Jeffrey Skilling and Kenneth Lay, both former Enron chief executives were convicted of conspiracy, fraud and insider trading on Oct. 24, 2006. Alexei Barrionuey, *Skilling Sentenced To 24 Years*, N.Y. TIMES, Oct. 24, 2006, at C1. Mr. Lay died of heart disease shortly after being convicted on ten counts of fraud and conspiracy. After his death, Judge Simeon T. Lake acted in conformity with established precedent by dismissing the indictment against Mr. Lay, thereby expunging Mr. Lay's convictions, Carrie Johnson, *Judge Revokes Lay's Conviction*, WASH, POST, Oct. 182006, at D01, 544 U.S. 696 (2005), *Id.* at 706-08.

(n7)Footnote 7. In connection with the Enron scandal, "Big Five" accounting firm Arthur Andersen, LLP (Enron's auditor) revealed that certain of its partners and employees had destroyed documents related to Enron at around the time

the SEC had begun its investigation into Enron's problems. Subsequently, the U.S. Department of Justice indicted the firm: a jury found it guilty of obstruction of justice on June 15, 2002, and the firm announced its dissolution that same day--leaving today's "Big Four" accounting firms. Arthur Andersen's conviction was reversed by the *Supreme Court in Arthur Andersen v. United States*, 2005 U.S. LEXIS 4348 (May 31, 2005). The Court held that the jury instruction did not adequately convey the requisite nexus between the persuasion to destroy documents and the prospective official proceeding.

(n8)Footnote 8. This fiber-optics telecommunications company (also an Arthur Andersen client) declared bankruptcy in January 2002--wiping out what had been, at its peak, a market capitalization of some \$50 billion--amidst an investigation into its revenue recognition practices related to swapping fiber-optic network capacity with other companies.

(n9)Footnote 9. The nation's sixth-largest cable television operator declared bankruptcy in June 2002 following the disclosure of some \$2.3 billion in off-balance-sheet debt co-borrowed with entities controlled by founder John Rigas and his family and following significant restatements of its prior earnings. Rigas and his sons were indicted on fraud charges in September 2002. On April 25, 2005, Adelphia agreed to a settlement with the SEC and the US Attorney's Office regarding the fraud of its prior management.

(n10)Footnote 10. On June 25, 2002, telecommunications giant WorldCom, Inc. ("WorldCom") disclosed that it had overstated its cash flow for the previous five quarters by some \$3.8 billion, primarily by improperly booking operating costs as capital expenses. The SEC filed fraud charges the next day, and within a month WorldCom, which at its height reached a market capitalization of over \$175 billion, had filed for bankruptcy protection--which at that time was the largest such filing in history. Despite this colossal fraud, the SEC took a less punitive approach in an effort to preserve more than 50,000 jobs at WorldCom. The SEC, therefore, settled with WorldCom for an overall monetary penalty of \$2.25 billion. *See SEC v. WorldCom, Inc.*, No. 02 Civ. 4963 (S.D.N.Y. July 7, 2003) (order approving of settlement between SEC and WorldCom). WorldCom's fraud also generated several class action lawsuits brought by shareholders, mostly mutual funds. The lawsuits resulted in several billion dollar settlements. *See In re WorldCom, Inc. Secs. Litig.*, No. 02 Civ. 3288 (S.D.N.Y. Sept. 21, 2005).

(n11)Footnote 11. *See* § 9.10[6][b] *infra*.

(n12)Footnote 12. Greg Ip et al., *In Call to Deregulate Business, a Global Twist*. Wall ST. J., Jan. 25, 2007.

(n13)Footnote 13. TERMINATION OF A FOREIGN PRIVATE ISSUER'S REGISTRATION OF A CLASS OF SECURITIES UNDER SECTION 12(g) AND DUTY TO FILE REPORTS UNDER SECTION 13(a) OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934, Release No. 34-55540; INTERNATIONAL SERIES Release No. 1301; 17 CFR Parts 200, 232, 240 and 249; 2007 SEC LEXIS 570 (Mar. 27, 2007).

(n14)Footnote 14. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 989G

(n15)Footnote 15. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 951 *et seq.*



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.03

AUTHOR: Theodore Altman and Joshua S. Sohn

§ 9.03 Inspections of Regulated Entities

Unlike its power to investigate, which reaches all persons, the Commission's power to inspect extends only to professionals in the securities business, n1 registered investment companies, n2 and investment advisers other than those specifically exempted from registration. n3 Pursuant to the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, this list now also includes credit ratings agencies. Inspection powers are also granted to self-regulatory organizations and others under the provisions that are discussed *infra*. The power to investigate is not unfettered, however, as inspections of these entities must be reasonable.

The Commission's inspections, which have much in common with those made by the banking authorities, are essentially regulatory audits of a company's books and records to ensure compliance with the law. Although an important enforcement tool, inspections lead more frequently to informal conferences and cautionary letters than to formal enforcement proceedings. The primary emphasis of the inspection program is educational, not punitive.

Inspections of stock exchanges and other self-regulatory organizations, including the Financial Industry Regulatory Authority ("FINRA"), are elaborate affairs that consume much time and energy. These examinations are made by the Commission's Division of Trading and Markets, not the Division of Enforcement and enable the Commission to monitor the quality of self-regulatory performance and to suggest improvements. n4 Since the self-regulatory organizations also make inspections, the Commission's inspections of the self-regulating bodies are, among other things, inspections of the inspectors.

FOOTNOTES:

(n1)Footnote 1. Section 17(b) of the Exchange Act.

(n2)Footnote 2. Section 31(b) of the Investment Company Act.

(n3)Footnote 3. Section 204 of the Investment Advisers Act.

(n4)Footnote 4. For a description of this phase of the Commission's activities, see 52 SEC Ann. Rep. 40-43 (1986).



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.04

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§ 9.04 Informal Investigations

Normally, though not invariably, activity of the Commission's enforcement staff begins with an informal inquiry. The stimulus for this may be an investor's complaint, a news article, a referral from a stock exchange or from the NASD, or a document filed with the Commission that suggests a potential problem area. Inquiries are also touched off by inspections, contacts with other governmental agencies, tips from informants, communications from corporate dissidents, and patterns of trading activity that suggest possible irregularity. For example, contests for corporate control sometimes lead each side to tell the Commission about its adversary's derelictions. Voluntary disclosures often cause the staff to probe further. Nevertheless, the Commission emphasizes that self-policing and voluntary cooperation may yield substantial benefits for potential enforcement targets, in the form of reduced charges or sanctions or, in the unusual case, the avoidance of enforcement action altogether. n1 Broadly speaking, in determining whether a company's conduct warrants the exercise of favorable enforcement discretion, the Commission assesses self-policing prior to the discovery of the misconduct; self-reporting of the misconduct when it is discovered; remediation measures, including disciplining wrongdoers and modifying or improving internal controls; and cooperation with law enforcement authorities, including providing the Commission's enforcement staff with all relevant information about the company's violations and remedial efforts. n2 In April 2010, the U.S. Sentencing Commission proposed rules that will eliminate the bar to credit for having a compliance program, expand the circumstances under which credit for having a compliance program is available, and detail the remedial mechanisms and steps necessary to receive sentencing credit when wrongdoing is discovered. n3 Absent Congressional action, the proposed sentencing rules will take effect in November 2010.

Whatever the stimulus for the inquiry, the staff needs no authority from the Commission to investigate informally. Though unable to compel testimony or to issue process when it proceeds on this basis, the staff's informal investigation is often extensive. n4 An informal investigation that reveals evidence of wrongdoing need not be followed by a formal investigation of the matter. Administrative or judicial proceedings can be instituted on the basis of information that has been discovered informally. n5

Informal investigations present counsel with questions of judgment. There is much to be said for cooperating fully with the staff, satisfying its concerns, and bringing the inquiry to an expeditious conclusion. However, the exigencies of the particular situation sometimes warrant narrow responses. Whatever the approach, an informal SEC inquiry is an

intensely serious matter.

Though staff members are not authorized to administer oaths in an informal inquiry, they may ask a court reporter to do so, which triggers the applicability of perjury laws. n6 Moreover, 18 U.S.C. § 1001, which criminalizes false statements to federal officers, applies to unsworn as well as to sworn statements. Finally, the staff's view of the total situation and the course it eventually elects to pursue will be influenced in large measure by impressions derived from the informal investigation.

Persons asked to voluntarily provide information in an informal investigation are furnished with a written summary of their rights and other important procedural information. n7 This summary advises the witness of various protections pertaining to the giving of testimony, including the right to counsel, the right to inspect and purchase a copy of any transcript of the testimony, and the right to invoke the *Fifth Amendment* privilege against self-incrimination. n8 The summary also contains an extensive list of the Commission's routine potential uses of information supplied to the enforcement staff. The Commission advises witnesses that it may use such information for the following purposes, among others: to coordinate law enforcement activities between the Commission and other federal, state, local, or foreign law enforcement agencies; to conduct other Commission investigations of possible securities law violations; to assist licensing or professional oversight bodies in performing disciplinary functions; to respond to inquiries from Members of Congress; to assist any court-appointed trustee or receiver appointed under the securities laws or under the Bankruptcy Code; and to respond to subpoenas in any litigation or other proceeding. n9

FOOTNOTES:

(n1)Footnote 1. *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions*, SEC Release No. 44969 (Oct. 23, 2001).

(n2)Footnote 2. SEC Release No. 44969; *see also* Press Release, *SEC Issues Report of Investigation and Statement Setting Forth Framework for Evaluating Cooperation in Exercising Prosecutorial Discretion* (Oct. 23, 2001).

(n3)Footnote 3. Proposed amendments available at http://www.ussc.gov/2010guid/20100503_Reader_Friendly_Proposed_Amendments.pdf

(n4)Footnote 4. *See* 17 C.F.R. § 202.5(a) on the voluntary nature of the inquiry. *See also Philadelphia v. SEC*, 434 F. Supp. 281, 286 (E.D. Pa. 1977). However, witnesses may choose to testify and to produce documents voluntarily.

(n5)Footnote 5. Indeed, judicial proceedings or administrative proceedings of an adjudicative nature can be instituted without a prior investigation of any sort. The Commission may investigate first and it almost invariably does. but it is under no compulsion to do so. Nor is it essential that an investigation begin informally; that stage can be omitted. *Consolidated Mines v. SEC*, 97 F.2d 704 (9th Cir. 1938).

(n6)Footnote 6. Court reporters are generally notaries public and thus authorized to place people under oath.

(n7)Footnote 7. This written summary is contained on SEC Form 1662, entitled *Supplemental Information for Persons Requested to Supply Information Voluntarily or Directed to Supply Information Pursuant to a Commission Subpoena*. SEC 1662 (7-98). The form is also used in formal investigations.

(n8)Footnote 8. *Id.*

(n9)Footnote 9. *Id.* Other matters touched upon in SEC Form 1662 are written submissions to the Commission advocating the interest or position of a person involved in an investigation; settlement with the Commission; procedures for requesting non-disclosure under the Freedom of Information Act of information supplied to the Commission; the Commission's authority for soliciting information voluntarily and pursuant to subpoena, and the effect of not supplying

information requested by the Commission.



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.05

AUTHOR: Theodore Altman and Joshua S. Sohn

§ 9.05 Formal Investigations

[1] Formal Order for Investigation

If an informal investigation or information obtained from other sources suggests a need for further inquiry, the staff asks the Commission for a "formal order of investigation." The formal order of investigation serves two functions: (1) it generally describes the nature of the authorized investigation; and (2) it designates specific staff members as officers for the investigation and authorizes these staff members to administer oaths, subpoena witnesses, take evidence, and seek the production of documents. n1 These requests are made *ex parte* and are typically made by providing the Commission with an action memorandum describing the known facts, the potential violation, entities or individuals involved, and highlighting any special issues or exigent circumstances. n2 The Commission considers requests for formal orders at closed meetings. In January 2009, the SEC launched a series of initiatives intended to facilitate and accelerate investigations. One of these initiatives was the delegation of the authority to initiate formal orders of investigation to the Division of Enforcement in order to "ensure that subpoena power is available to the staff as soon as it is needed." n3

[2] Investigations Conducted Privately

Most of the Commission's investigations are non-public. n4 This is true even under the Securities Act, although Section 21 of that statute directs that "[a]ll hearings shall be public." The reason is that investigations are not considered "hearings" within the statutory meaning of that term. n5 Rather, they are viewed as preliminary inquiries in which the staff tries to find out whether a "hearing" is warranted. The statutory scheme does not require that the preliminary pre-hearing inquiry be private. Though exceedingly rare, public investigations are permissible. n6 Despite the non-public nature of formal investigations, pursuant to Rule 7(a) of the SEC's Rules Relating to Investigations, a person or entity that is required to produce documents or provide testimony at a formal investigative proceeding will, upon request, be shown the Commission's formal order. n7

[3] Broad Authority to Investigate

The Commission's investigatory powers are broad. It "can investigate merely on the suspicion that the law is being violated, or even just because it wants assurance that it is not." n8 It can also conduct an investigation to determine whether the regulation of a particular activity is within its authority. n9 Arguments that an investigation is a general,

roving inquiry or a "fishing expedition" have rarely succeeded. n10

However, a much discussed Third Circuit decision, *SEC v. Wheeling-Pittsburgh Steel Corp.*, n11 suggests that there is a good faith limitation on the Commission's investigative power that can bar it from proceeding when the decision to investigate was tainted by improper influences. *Wheeling-Pittsburgh* involved a formal order of investigation issued under questionable circumstances at the request of a United States Senator. n12 A closely divided *en banc* court held:

The SEC order must be supported by an independent agency determination, not one dictated or pressured by external forces. If an allegation of improper influence and abdication of the agency's objective responsibilities is made, and supported by sufficient evidence to make it facially credible, respondents are entitled to examine the circumstances surrounding the SEC's private investigative order. n13

Wheeling-Pittsburgh was an unusual case in which the investigated party established that the Senator's communication led to the virtually instantaneous entry of a formal order of investigation. Accordingly, *Wheeling-Pittsburgh* stands for the proposition that there are some good-faith limitations to the exercise of the SEC's broad powers.

Although the SEC did initiate an investigation at the direction of the senator in *Wheeling-Pittsburgh*, a much more common situation involving tippers or informants is when the Commission declines to investigate. The informant cannot compel it to do so. n14 This is because the governing statutes do not direct the Commission to investigate. They say only that it may do so. n15 The courts' traditional reluctance to review the agencies' exercise of their prosecutorial discretion is also relevant. n16 Administrative investigations are not adjudications. n17 As the Commission said early in its history:

An investigation [is] ... simply a preliminary inquiry... to determine whether grounds exist for the institution of formal proceedings... . It is not a hearing. It is not in any sense an adversary proceeding. There are no parties. There are no issues. n18

The Commission's view is that a witness who testifies at the investigative stage need not be told that he or she is considered a potential defendant or respondent. n19

[4] Subpoenas

The power to investigate, which is provided under Section 19(b) of the Securities Act, Section 21(b) of the Exchange Act, Section 42(b) of the Investment Company Act, and Section 209(b) of the Investment Advisers Act, is accompanied by the power to compel testimony and the production of documents.

There are two principal points to note about the power conferred by those sections. First, it is not self-executing. To enforce a subpoena against a recalcitrant witness, the Commission must invoke the aid of the courts. n20 Second, it is nationwide. All of the sections cited above provide that "[s]uch attendance of witnesses and the production of any such records may be required from any place in the United States or any State at any designated place of hearing." n21

FOOTNOTES:

(n1)Footnote 1. SEC Enforcement Manual Section 2.3.4.

(n2)Footnote 2. *Id.*

(n3)Footnote 3. U.S. Securities and Exchange Commission, "Management Discussion and Analysis," *Putting Investors First--2009 Performance and Accountability Report*, p. 8, available at <http://www.sec.gov/about/secpar/secpar2009.pdf#mda>

(n4)Footnote 4. 17 C.F.R. § 202.5(a). Persons being investigated have a right to privacy regarding certain non-public information obtained over the course of an SEC investigation. See *Hunter v. Heffernan*, 879 F. Supp. 494 (E.D. Pa. 1995), 1996 U.S. Dist. LEXIS 14071 (E.D. Pa. Sept. 26, 1996), where plaintiff alleged that an SEC investigator violated his right to privacy by disclosing to his girlfriend confidential financial information obtained during the investigation. There, the court dismissed on summary judgment upon a determination that the information had previously been disclosed.

(n5)Footnote 5. See *Woolley v. United States*, 97 F.2d 258 (9th Cir. 1938), cert. denied, 305 U.S. 614 (1938).

(n6)Footnote 6. *SEC v. Harrison*, 80 F. Supp. 226 (D.D.C. 1948). "Quasi-public" investigations may also be made. See *Transactions in Washington Public Power Supply Systems Securities*, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,481 (1984). Although this was done because of a special problem with respect to subpoenas and although the Commission made the investigation nonpublic as soon as that problem was resolved (Sec. Act Rel. No. 33-6541, 30 SEC Docket 1065 (1984)), the Commission could choose to use this procedure again where the inquiry is of great public interest.

(n7)Footnote 7. SEC Enforcement Manual Section 2.3.4.2.

(n8)Footnote 8. *Nelson v. U.S. S.E.C.*, No. C08-80080MISC JF (HRL), 2008 U.S. Dist. LEXIS 51035 (N.D. Cal. June 16, 2008), quoting *United States v. Morton Salt Co.*, 338 U.S. 632, 634 (1950) (administrative agencies held to "possess a power of original inquiry analogous to that of a grand jury"); *Sandsend Financial Consultants, Ltd. v. Fed. Home Loan Bank Bd.*, 878 F.2d 875, 882 (5th Cir. 1989) (an administrative agency's "power of inquisition" is a "broad-ranging one which courts are reluctant to trammel").

(n9)Footnote 9. *AVCO Financial Corp. v. Commodity Futures Trading Com'n*, 929 F. Supp. 714, 721 (S.D.N.Y. 1996), quoting *SEC v. Brigadoon Scotch Distributing Co.*, 480 F.2d 1047 (2d Cir. 1973), cert. denied, 415 U.S. 915 (1974) ("The [Securities Exchange] Commission must be free without undue influence or delay to conduct an investigation which will adequately develop a factual basis for a determination as to whether particular activities come within the Commission's regulatory authority."); see, e.g., *SEC v. Howatt*, 525 F.2d 226 (1st Cir. 1975) (investigation permissible where SEC's regulatory jurisdiction over transactions "unclear"); *SEC v. Savage*, 513 F.2d 188 (7th Cir. 1975) (Commission could investigate without first establishing that the commodity futures contracts in question were "securities"); *SEC v. Wall Street Transcript Corp.*, 422 F.2d 1371 (2d Cir.), cert. denied, 398 U.S. 958 (1970) (investigation to determine whether publisher might be an "investment adviser" within the meaning of the Investment Advisers Act).

(n10)Footnote 10. See *Enterra Energy, LLC v. U.S. S.E.C.*, No. 08-mc-00011- TCK-PJC, 2008 U.S. Dist. LEXIS 22727 (N.D. Okla. March 21, 2008) ("fishing expedition" challenge rejected because "so long as the material requested 'touches a matter under investigation' it will survive a relevancy challenge"), quoting *F.T.C. v. Texaco, Inc.*, 555 F.2d 862, 872 (D.C. Cir.), cert. denied, 431 U.S. 974 (1977); *S.E.C. v. Badger*, No. 2:97-CV-963K, 2008 U.S. Dist. LEXIS 24022 (D. Utah 2009) ("fishing expedition" challenge against subpoena of defendant's wife rejected because the subpoena was necessary to determine whether and to what extent her finances were commingled with her husband's); *McGarry v. SEC*, 147 F.2d 389 (10th Cir. 1945) ("fishing expedition" challenge rejected even though the cost of examining and reproducing materials subpoenaed was estimated at \$100,000); *SEC v. Arthur Young & Co.*, 584 F.2d 1018 (D.C. Cir. 1978), cert. denied, 439 U.S. 1071 (1979) (but appellant afforded opportunity to show that actual expense of compliance was unreasonable).

(n11)Footnote 11. 648 F.2d 118 (3d Cir. 1981), discussed in *SEC v. Wheeling-Pittsburgh Steel Corp. Bad Faith and the Abuse of Process Defense to Administrative Subpoenas*, 82 Colum. L. Rev. 811 (1982) and in Comment, *SEC v. Wheeling-Pittsburgh Steel Corp.--Informant Bad Faith Defense to Enforcement of an Administrative Subpoena*, 6 J. Corp. L. 121 (1981).

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(n12)Footnote 12. 648 F.2d at 122 n.3 .

(n13)Footnote 13. 648 F.2d at 130 .

(n14)Footnote 14. *Leighton v. S.E.C.*, No. 94-1777 1995 U.S. App. LEXIS 15184 (D.C. Cir. 1995) , citing *Crooker v. SEC*, 161 F.2d 944 (1st Cir. 1947) ; see also *SEC v. Tiffany Industries, Inc.*, 535 F. Supp. 1167 (E.D. Mo. 1982) holding that private persons cannot compel the Commission to institute litigation.

(n15)Footnote 15. See § 9.02 *supra*.

(n16)Footnote 16. See, e.g., *Gor v. Holder*, 607 F.3d 180 (6th Cir. 2010) , citing *Heckler v. Chaney*, 470 U.S. 821 (1985) .

(n17)Footnote 17. *S.E.C. v. Rivlin*, No. 99-1455 (RCL), Fed. Sec. L. Rep., P 90,725 (D.D.C. 1999); *SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735 (1984) .

(n18)Footnote 18. *In re White, Weld & Co.*, 1 SEC 574, 575 (1936) .

(n19)Footnote 19. The Court of Appeals for the District of Columbia Circuit agrees. *SEC v. National Student Marketing Corp.*, 538 F.2d 404 (D.C. Cir. 1976) , cert. denied sub nom. *White & Case v. SEC*, 429 U.S. 1073 (1977) .

(n20)Footnote 20. In *SEC v. Knowles*, the District Court held that it did not need personal jurisdiction over the defendant in order to enforce an SEC subpoena because "the Commission may invoke the aid of any court of the United States within the jurisdiction of which such investigation or proceeding is carried on ..." 902 F. Supp. 211 (D. Colo. 1995) quoting 15 U.S.C. § 78u(c). However, on appeal the SEC did not argue personal jurisdiction, but obtained an affirmance based on the Court's holding that the defendant's contacts with the United States were sufficient to invoke the Court's jurisdiction. *SEC v. Knowles*, 87 F.3d 413 (10th Cir. 1996) ; see also *SEC v. Carrillo*, 115 F.3d 1540, 1544 (11th Cir. 1997) .

(n21)Footnote 21. Hence, the 100-mile limitation in Rule 45(e)(1) of the Federal Rules of Civil Procedure is inapplicable.



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CHAPTER 9 SEC Enforcement--Legal Considerations

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§ 9.06 Rules Relating to Investigations

Investigations are governed by a set of rules that relates only to them. n1 These rules stress the confidential, nonpublic character of the normal investigative inquiry. n2 Of course, the limitations that the Commission imposes on itself and on its employees do not extend to others. n3 Hence, the press frequently reports investigations on which the Commission and its staff maintain an inflexible "no comment" posture.

The rules state that "[f]ormal investigative proceedings may be held before the Commission, before one or more of its members, or before any officer designated by it for the purpose." n4 In actual practice, however, investigations are invariably conducted by staff members named in the formal order of investigation. That document outlines the scope of the projected inquiry and cites the statutory provisions the investigators have in mind.

Often, however, the investigators delve into other matters. They have no authority to do so. Hence, counsel can properly direct his client to refuse to answer questions about subjects that are not within the scope of the order. Objections on this ground cannot be counted on to yield any lasting fruit, however, because the staff is almost invariably able to persuade the Commission to amend the order. However, it may elect not to do so. Time can be gained even if the staff opts for a request to amend.

Though the Commission's investigative order is general and subject to amendment, it is a key document that supplies essential information about the thrust of the inquiry. Thus counsel should examine it as soon as possible. Though the rules relating to investigations do not entitle him or her to a copy of the order as a matter of right, access to it can generally be obtained without undue difficulty. n5

[1] Right to Transcript

Witnesses are entitled to inspect transcripts of their own testimony. However, those who want copies have to buy them. While the right to inspect is absolute, requests to purchase can be denied. n6

Strategic decisions not to purchase are sometimes made. These stem from the desire to avoid having to produce the transcript in private litigation. Such production is required because "once the witness has been allowed to obtain the

transcript of his testimony, it is no more privileged or confidential in his hands... than any other record of a previous statement would be." n7

However, the idea that one is better off without a transcript is not foolproof. First, the non-purchase strategy may not work. The court in which the private action is pending may order the witness to buy the transcript. n8 Second, not having the transcript could impede effective representation and effective defense in the Commission's proceeding.

[2] Right to Counsel

Witnesses are entitled to be accompanied, represented and advised by counsel. n9 The attorney can advise, question briefly at the conclusion of the examination in order to clarify, and make notes. Though counsel's role is limited, it is far from perfunctory. n10 The attorney can correct ambiguities, object to questions clearly outside the scope of the formal order, and assert applicable evidentiary privileges. Implications of wrongdoing by his client entitle him to cross-examine, rebut, and submit documentary evidence. n11 That counsel can do these things does not mean that counsel should do them. Ambiguities are sometimes best left unresolved. Steps that open new areas of inquiry may be undesirable. So the lawyer may deem it best to keep a low adversarial profile while remembering that the investigative transcript is an admission that may become crucial in a subsequent adjudicatory proceeding. n12 Hence, a clear statement on the record reserving the right to supplement or correct that transcript is always desirable.

[3] Sequestration and Multiple Representation

The Commission's concern about the ease with which its investigations can be frustrated when witnesses know each other's testimony n13 is reflected in its sequestration rule, which provides:

All witnesses shall be sequestered, and unless permitted in the discretion of the officer conducting the investigation, no witness or counsel accompanying any such witness shall be permitted to be present during the examination of any other witness called in such proceeding. n14

Although witnesses are almost invariably sequestered, the rule is seldom applied to a witness's counsel because of two Court of Appeals decisions that took a jaundiced view of that practice. n15 Sequestering a lawyer effectively bars the lawyer from representing more than one witness. n16 Courts are loath to sanction the view that, absent "concrete evidence," multiple representation will impede the inquiry. n17

Of course, multiple representation often raises ethical issues on which the staff may or may not focus. n18 In any case, counsel's independent ethical and professional obligations require attention to these issues.

Where the case involves the simultaneous representation of corporations, high-ranking corporate officers, and corporate directors, there is no obvious clash of interest. The real issue is potential detriment to the inquiry rather than potential detriment to sophisticated witnesses whose choice of counsel was probably rational and fully informed. n19 Cases in which an employer has a motive for shifting blame to a relatively low-level employee and vice versa present much more troublesome questions. Such cases are complicated by economic exigencies when an employee of modest means has to choose, as often happens, between cost-free representation by his employer's lawyer and independent counsel of his own. The lawyer who represents both employer and employee in such a situation must at a bare minimum take great pains to see to it that the employee's choice is fully informed. Sometimes the interests are so divergent as to require withdrawal. n20 Divergences of that character often become apparent as the case progresses. Hence, a lawyer who represents two or more clients in the same SEC inquiry should reassess the propriety of that course in light of each material development. n21

If questions arise concerning documents prepared by the attorney or advice that he or she has given, the attorney becomes a potential substantive witness. Withdrawal in this situation is not always mandatory; for example, the

documents or the opinions may be only peripheral to the case. However, if they are or appear likely to become central, it is best for counsel to refrain from representing anyone in the investigation. n22

FOOTNOTES:

(n1)Footnote 1. These are in Part 203 of 17 C.F.R. *See also* 17 C.F.R. § 202.5.

(n2)Footnote 2. *See* 17 C.F.R. §§ 203.2, 203.5, and 230.122. Moreover, members and employees of the Commission are prohibited from disclosing nonpublic information or documents, even when served with a subpoena requiring such disclosure. 17 C.F.R. § 200.735-3(b)(7). This rule has been held valid. *Appeal of SEC and Timbers*, 226 F.2d 501 (6th Cir. 1955). However, confidential discussions with persons associated with other government agencies (foreign as well as domestic) and with the securities industry's self-regulatory bodies are permitted and "encouraged." This also extends to receivers, special counsels, and similar persons appointed in litigation initiated by the Commission. 17 C.F.R. § 203.2.

(n3)Footnote 3. In some circumstances the full disclosure provisions of the securities laws require such other persons to reveal information. *See* Item 103 of Regulation S-K, 17 C.F.R. § 229.103. Even when this is not so, voluntary disclosure is often beneficial. It mitigates the damaging effect of leaks. It shows candor and causes the limitation period on certain private actions to begin to run.

(n4)Footnote 4. 17 C.F.R. § 203.4(b).

(n5)Footnote 5. Rule 7(a) of the Rules Relating to Investigations (17 C.F.R. § 203.7(a)) says only that a witness is entitled to see a copy of the order if he asks for it. It also provides that copies for retention "shall not be furnished except with the express approval of a Regional Administrator, or a Director, Associate Director, or Assistant Director of the Division or Divisions conducting the investigation." However, the staff permits counsel to inspect the order and to make notes. It will also generally comply with counsel's request for a copy.

(n6)Footnote 6. 17 C.F.R. § 203.6 (transcript can be withheld "for good cause," which is left undefined and which the Commission has never attempted to define.); *see also* Section 6(b) of the Administrative Procedure Act (5 U.S.C. § 555(c)). The Commission's refusal to permit either the purchase of the transcript or a tape recording of the testimony was sustained in *SEC v. Sprecher*, 594 F.2d 317 (2d Cir. 1979). *See also Commercial Capital Corp. v. SEC*, 360 F.2d 856, 858 (7th Cir. 1966) ("The legislative history of the Administrative Procedure Act shows Congress was aware that investigations by the Commission, like those of a grand jury, might be thwarted in certain cases if not kept secret, and that if witnesses were given a copy of their transcript, suspected violators would be in a better position to tailor their own testimony to that of the previous testimony, and to threaten witnesses about to testify with economic or other reprisals.").

(n7)Footnote 7. *La Morte v. Mansfield*, 438 F.2d 448, 451 (2d Cir. 1971) (footnote omitted); *see also Baxter v. A.R. Baron & Co.*, 1996 U.S. Dist. LEXIS 18242 (S.D.N.Y. Dec. 10, 1996).

(n8)Footnote 8. *See Preservation Products, LLC v. Nutraceuical Clinical Lab's. Int'l, Inc.*, 214 F.R.D. 494 (N.D. Ill. 2003); *Herbst v. Able*, 63 F.R.D. 135 (S.D.N.Y. 1972)

(n9)Footnote 9. 17 C.F.R. § 203.7(c). If the witness is not accompanied by counsel, the witness may advise the enforcement staff that he or she wishes to be accompanied and represented by counsel. The staff will then adjourn the testimony to allow for such representation by counsel. 17 C.F.R. § 203.7(b). Where exceptionally arcane technical matters are involved the witness may have a right to be accompanied by an expert who is not a lawyer. *See SEC v. Whitman*, 613 F. Supp. 48 (D.D.C. 1985).

(n10)Footnote 10. After noting that "Vital desiderata of public policy, Congressional purpose, and statutory interpretation require the courts to deal liberally with the SEC's inquisitorial power," one court pointed out that "this power is not unbridled." It went on to say:

Witnesses... before administrative agencies have the right to be protected against oppressive tactics, unduly repetitive questioning designed to coerce a witness or to compel him to adopt the examiner's language, or any other procedure that violates standards of fundamental fairness and decency. In such a case the courts will not hesitate to give the witness judicial protection.

SEC v. Isbrandtsen, 245 F. Supp. 518, 521 (S.D.N.Y. 1965) .

However, "judicial protection" is rarely sought because it is rarely needed. Counsel generally finds that courteous but firm remonstrances do the trick. When an inexperienced, overzealous investigative attorney persists with tactics that are clearly abusive, the matter should be brought to the attention of the Director of the Division of Enforcement or the Regional Administrator.

(n11)Footnote 11. 17 C.F.R. § 203.7(d).

(n12)Footnote 12. See, e.g., *In re Alessandrini & Co. Inc.*, 45 SEC 399, 409 (1973) (investigative testimony held to have "essentially the same standing" as that given in an adjudication). False investigative testimony can lead to criminal prosecution. See *U.S. v. Stewart*, 433 F.3d 273 (2d Cir. 2006) ; *United States v. Thayer*, 17 B.N.A. Sec. Reg. & L. Rep. 841 (D.D.C. 1985).

(n13)Footnote 13. For a statement of the Commission's traditional position on this score, see *SEC v. Higashi*, 359 F.2d 550, 552 (9th Cir. 1966) .

(n14)Footnote 14. 17 C.F.R. § 203.7(b).

(n15)Footnote 15. *SEC v. Higashi*, 359 F.2d 550 (9th Cir. 1966) ; *SEC v. Csapo*, 533 F.2d 7 (D.C. Cir. 1976) (Commission conceded "that its sequestration rule is only rarely applied"). But see *United States v. Steel*, 238 F. Supp. 575 (S.D.N.Y. 1965) , *aff'd on other grounds*, 359 F.2d 381 (2d Cir. 1966) (earlier version of the present sequestration rule found unobjectionable).

(n16)Footnote 16. It also raises legal costs.

(n17)Footnote 17. *SEC v. Csapo*, 533 F.2d 7, 11-12 (D.C. Cir. 1976) .

(n18)Footnote 18. For a case in which it did so in an adjudicatory proceeding, see *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1973-74 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,608 (1973). Form 1662 advises witnesses that counsel's representation of more than one party involved in an investigation presents a potential conflict of interest, and that in any such multiple representation the Commission will assume that the witness and counsel have "discussed and resolved all issues concerning potential conflicts of interests." SEC Form 1662 (7-98).

(n19)Footnote 19. See *SEC v. Higashi* and *SEC v. Csapo*, n.16 *supra*.

(n20)Footnote 20. *Though Wood v. Georgia*, 450 U.S. 261 (1981) , was a criminal case, the justices' discussion of the divided loyalties of a lawyer who represented employer and employee is instructive and thought-provoking.

(n21)Footnote 21. A former Director of the Division of Enforcement who is now a judge of the United States District Court for the District of Columbia thinks second legal opinions helpful in this context. See Sporkin and Steinberg, *Second Opinion for Lawyers--The "Consultative Attorney,"* N.Y.L.J., Jan. 3, 1983, at 1.

(n22)Footnote 22. See Canons 5 and 9 of the American Bar Association's Code of Professional Responsibility. See also Rules 1.7 and 3.7 of the Association's Model Rules of Professional Conduct (2002). Special heed should be paid to the emphasis in Canon 9 on the importance of avoiding even an appearance of impropriety. The appearance and

sometimes the substance of impropriety can be present even when the lawyer has no reason to think himself a potential target.



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.07

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§ 9.07 Wells Submissions

Post-investigation briefs addressed to the Commission's prosecutorial discretion are commonly called "Wells Submissions." The term reflects the fact that this procedure was recommended by the "Wells Committee," an ad hoc advisory group chaired by the late John A. Wells of the New York bar. n1 The pertinent rule provides that "[p]ersons who become involved in preliminary or formal investigations may, on their own initiative, submit a written statement to the Commission setting forth their interests and position in regard to the subject matter of the investigation." n2

A Wells Submission is "a document filed with the SEC in which a defendant presents the evidence and legal theories he believes the SEC should consider in deciding whether to file an enforcement action." n3 These submissions may be made at any time, but are not particularly useful unless and until one knows that the staff plans to recommend enforcement action to the Commission. Wells submissions are considered in connection with such recommendations. n4

The staff is under no duty to tell the investigated party that it plans to ask the Commission to authorize a proceeding against him. It "may advise... of the general nature of the investigation including the indicated violations... and the amount of time that may be available for preparing and submitting a statement prior to the presentation of a staff recommendation to the Commission for the commencement of an injunction proceeding." n5 However, the determination is discretionary. n6 There is no "Wells submission right." n7 Where immediate enforcement action is believed to be necessary, the staff is unlikely to provide notice of its intention to request authorization to commence a legal proceeding. n8

Note also that the staff exercises its "Wells" discretion "upon request." Thus counsel should tell the staff that he or she wants to be in a position to make a Wells submission at the appropriate time. This normally leads to a "pre-Wells conference" in which the staff describes its view of the case and the enforcement recommendations it proposes to make.

Wells submissions are purely voluntary. Requests for permission to make them impose no duty to file, and there are no formal requirements. n9 In addition, the SEC is under no obligation to accept and respond to the arguments presented in the Wells Submission. n10 In fact, even after submitted, the SEC may reject a Wells submission if it exceeds length limitations agreed upon by the staff, if the party making the submission limits the admissibility of the submission under Federal Rule of Evidence 408, or otherwise purports to limit the Commissions' ability to use the submission. n11

Wells submissions often seek to dissuade the Commission from taking any action at all. The submitting party may point out, for example, that he or she has made restitution, acted in good faith, was victimized by others, played only a peripheral role in the wrongdoing or has already taken other corrective steps. Alternatively, counsel can attempt to persuade the Commission to take an approach gentler than the one its staff recommends. Counsel may, for example, propose that the Commission issue a report instead of litigating, or may seek the deletion of allegations that counsel considers damaging and inappropriate. Finally, counsel may make an offer of settlement.

Securities lawyers differ about the advisability of Wells submissions. Some think them unlikely to accomplish anything because they are considered together with the staff's recommendations at closed meetings at which only the staff is present. In these circumstances, the Commission tends to give the staff the benefit of the doubt. n12 Moreover, the submission often educates the staff about weaknesses in its case that it still has time to cure. n13 It may also give the staff a road map of the defense it will ultimately have to meet.

Others, who acknowledge all this, consider the Wells submission a valuable tool when mitigating circumstances can be pointed to or significant issues of law or policy delineated. However, it is generally agreed that Wells submissions seldom carry the day on purely factual issues. As the Commission said when it adopted this procedure:

It is likely that a disagreement exists between the staff and a prospective respondent or defendant as to factual matters can be resolved in an orderly manner only through litigation. Moreover, the Commission is not in a position to, in effect, adjudicate issues of fact before the proceeding has been commenced and the evidence placed in the record. In addition, where a proposed administrative proceeding is involved, the Commission wishes to avoid the possible danger of apparent prejudgment involved in considering conflicting contentions, especially as to factual matters, before the case comes to the Commission for decision. Consequently, submission by prospective defendants or respondents will normally prove most useful in connection with questions of policy, and, on occasion, questions of law bearing upon the question of whether a proceeding should be initiated, together with considerations relevant to a particular prospective defendant or respondent which might not otherwise be brought clearly to the Commission's attention. n14

Even when fully successful, a Wells submission produces only a discretionary administrative determination not to proceed. Since it is not a decision on the merits, it has no preclusive effect.

That the Commission has chosen not to proceed does not bar private litigants, other law enforcement agencies, or self-regulatory bodies from doing so. Indeed, the pendency of such actions or the likelihood of their initiation may have had much to do with the Commission's conclusion that there was no need for it to act. n15 This is not limited to Wells submissions. It applies to every investigation that is dropped without enforcement action being taken. n16

FOOTNOTES:

(n1)Footnote 1. The body's official name was the Securities and Exchange Commission's Advisory Committee on Enforcement Policies and Processes. Its report, which was published on June 1, 1972, is reprinted in Mathews, Finkelstein and Milstein, *Enforcement and Litigation Under the Federal Securities Laws--1973* at 275 (Practicing Law Institute 1973). Sec. Act Rel. No. 33-5310, [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,010 (1972) adopted the recommendation in modified form.

(n2)Footnote 2. 17 C.F.R. § 202.5(c).

(n3)Footnote 3. *SEC v. Sands*, 902 F. Supp. 1149 (C.D. Cal. 1995) .

(n4)Footnote 4. The Wells submissions should be sent "to the appropriate Division Director or Regional Administrator with a copy to the staff members conducting the investigation and should be clearly referenced to the

specific investigation to which they relate." They are "forwarded to the Commission in conjunction with the staff memorandum." 17 C.F.R. § 202.5(c)

(n5)Footnote 5. 17 C.F.R. § 202.5(c); *see also* SEC Enforcement Manual Section 2.4.

(n6)Footnote 6. Sec. Act Rel. No. 33-5310 [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,010 (1972), explains that "The staff must... have discretion in this regard... to protect the public interest and to avoid not only undue delay, but possible untoward consequences which would otherwise obstruct or delay enforcement action."

(n7)Footnote 7. *See SEC v. National Student Marketing Corp.*, 538 F.2d 404 (D.C. Cir. 1976) , *cert. denied sub nom. White & Case v. SEC*, 429 U.S. 1073 (1977) .

(n8)Footnote 8. SEC Enforcement Manual Section 2.4.

(n9)Footnote 9. The staff should be informed of a decision not to file as soon as it has been made.

(n10)Footnote 10. *SEC v. Sands*, 902 F. Supp. 1149 (D.C. Cal. 1995) .

(n11)Footnote 11. SEC Enforcement Manual Section 2.4.

(n12)Footnote 12. Even a very strong factual case is hard to present effectively in this inherently one-sided context in which the staff has its adversary's presentation, while the adversary has to guess what it will tell the Commission.

(n13)Footnote 13. The SEC can take more testimony and subpoena additional documents.

(n14)Footnote 14. Sec. Act Rel. No. 33-5310, [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,010 (1972).

(n15)Footnote 15. *See* the discussion of "parallel proceedings" in § 9.09[1] *infra* .

(n16)Footnote 16. 17 C.F.R. § 202.5(d) states that the staff's determination not to recommend an enforcement proceeding "must in no way be construed as indicating that the party has been exonerated or that no action may ultimately result from the staff's investigation of the particular matter." For reasons pointed out in the text, the Commission's decision not to proceed is as incapable of exonerating as is the staff's decision not to recommend proceedings. With respect to action by the agency, itself, however, there is probably an administrative distinction between a non-enforcement decision made by the staff and a non-enforcement decision made by the Commission. The staff is always free to reconsider its own prosecutorial judgments and to resume inquiries that it earlier chose to drop. Its freedom to reconsider a prior prosecutorial judgment made by the Commission appears much more limited. But even in the latter situation, the agency would almost certainly maintain that a determination made by the Commission after a Wells submission does not necessarily bar reinvestigation and reassessment.



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.08

AUTHOR: Theodore Altman and Joshua S. Sohn

§ 9.08 Subpoena Enforcement

[1] Generally

As stated above, the Commission's statutory power to compel the attendance of witnesses and the production of documents is not self-enforcing. n1 To enforce its subpoenas, the Commission must go to the courts. However, the courts generally compel compliance. n2 The Commission's power to compel testimony is broad because its power to investigate is broad. n3 In determining whether to enforce an SEC subpoena, courts have generally applied the test set out in *United States v. Powell*, 379 U.S. 48 (1964) . The inquiry involves a four-part test--the SEC must show that "the investigation serves a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the [agency's] possession, and that the administrative steps required by the [agency] have been followed." n4 Therefore, challenges to subpoenas based on the contention that the whole enquiry is improper seldom succeed. n5

Nonetheless, efforts to narrow sweeping requests for documents are occasionally worth making. This is so because it is well established that "the *Fourth Amendment* requires that the subpoena be sufficiently limited in scope, relevant in purpose, and specific in directive so that compliance will not be unreasonably burdensome." n6 The staff knows this. It also knows that subpoena enforcement actions are a drain on its resources. n7 Hence, an accommodation can often be reached.

If not, counsel may decide to wait for a subpoena enforcement action and hope that the court will see things his way or that the Commission's sophisticated litigation judgment will cause it to yield on some points. Another approach is to take the offensive by bringing an action against the Commission to quash or modify the subpoena. n8 This brings the General Counsel's office into the picture. n9 Counsel can hope that the General Counsel's office will be more sympathetic and less adamant than the Enforcement Division.

Litigation about investigative subpoenas in the courts brings what would otherwise be a nonpublic inquiry into the limelight. Investigatees sometimes try to avoid this by asking the Commission to modify or quash a subpoena they consider overly intrusive. Although the Commission's rules do not provide for such applications and although they are seldom entertained, they have occasionally led the staff to modify its demands. n10

However, counsel should remember that the staff's legal position is very strong and that the Commission almost invariably succeeds in sustaining its subpoenas. n11 This is as true of subpoenas addressed to third persons as it is of those addressed to persons being investigated. n12 The Supreme Court has held unanimously that investigative targets have no right to receive advance notice of subpoenas issued to third persons. When it did so, the Court observed that "Congress intended to vest the SEC with considerable discretion in determining when and how to investigate." n13

[2] Territorial Limits on SEC Subpoenas

As has already been noted, the Commission's subpoena power is nationwide. n14 It also has a significant international reach. Witnesses can be required to bring books and records from foreign countries or to permit the Commission to inspect them in such countries. n15 When applicable foreign law prohibits this, the witness can be ordered to use his or her best efforts to obtain such permission to comply with the Commission's subpoena as may be necessary. n16 However, "the Commission has no power to subpoena an alien non-resident to appear before it from a foreign land." n17 Furthermore, the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* explicitly amended the Exchange Act to allow for extra-territorial enforcement by the SEC. n18

[3] International Aspects

Even with Dodd-Frank, there still may be difficulties in compelling non-U.S. persons to comply with SEC subpoenas. Situations in which witnesses are domiciled and evidence is situated in foreign countries are much more frequent than they used to be because of the internationalization of the capital markets. The investigative difficulties these present are complicated by the financial secrecy laws of Switzerland and a number of other countries. However, the Commission has had considerable success in this area. It has, for example, succeeded in compelling a Swiss bank with a New York branch office to disclose the identity of customers who traded through it in Switzerland. n19 It has also entered into agreements for the exchange of information and the lifting of secrecy bars with Switzerland, the United Kingdom, Japan, the Cayman Islands, Germany, and Quebec. n20 These have produced significant results. n21 As discussed, under Dodd-Frank, the SEC now has the power to enforce the Exchange Act extra-territorially. n22

[4] The Right to Financial Privacy Act of 1978

[a] Applicability to the Commission. The Right to Financial Privacy Act of 1978 (the "RFPA") n23 applies to the Commission, except as otherwise provided by Section 21(h) of the Exchange Act. n24 The Commission may, in addition to proceeding under Section 21(h), obtain the financial records of a "customer" n25 from a "financial institution" n26 or transfer such records in accordance with the provisions of the RFPA. n27

A comparison between the provisions of Section 21(h) of the Exchange Act and the RFPA reveals that Section 21(h) only details the procedure by which the Commission may obtain financial records and information pursuant to a judicial subpoena. Therefore, when the Commission issues an *administrative* subpoena, it must proceed pursuant to Section 1105 of the RFPA. n28

[b] Procedure for Commission to Obtain Financial Records Without Prior Notice. Section 21(h)(2) provides that, notwithstanding Sections 1105 or 1107 of the RFPA, n29 the Commission may, without prior notice to the customer, have access to financial records or the information contained therein, of a customer from a financial institution upon an *ex parte* showing to an appropriate United States district court n30 that the Commission seeks such records pursuant to a properly issued subpoena. n31 The Commission must have "reason to believe" that one of the following circumstances is present:

- a delay in obtaining access to the financial records, or the required notice, will result in: flight from prosecution; destruction of or tampering with evidence; transfer of assets or records outside the territorial limits of the United States; improper conversion of investor assets; or impediment of the ability of the

Commission to identify or trace the source or disposition of funds involved in any securities transaction;

- such financial records are necessary to identify or trace the record or beneficial ownership interest in any security;

- the acts, practices, or course of conduct under investigation involve the dissemination of materially false or misleading information concerning any security issuer, or market, or the failure to make disclosures required under the securities laws, which remain uncorrected, or a financial loss to "investors" or "other persons protected under the securities laws" n32 which remains uncompensated; or

- the acts, practices, or course of conduct under investigation involve significant financial speculation in securities, or endanger the stability of any financial or investment intermediary. n33

Although judges and magistrates are not expected to act as mere "rubber stamps" in determining whether notice is to be delayed, n34 their inquiry n35 is limited. n36

The Commission's application for a delay in notice pursuant to Section 21(h)(2) must be made with "reasonable specificity." n37 This requirement is not to be construed to compel the Commission to make out its case-in-chief at the investigatory stage. Rather, the standard the Commission must meet is a "reason to believe" standard, which requires the Commission only to establish a factual basis from which it would be reasonable to infer n38 that one or more of the circumstances set forth Section 21(h)(2)(A)-(D), set forth above, exist. n39

Furthermore, as in cases where the Commission seeks enforcement of its subpoenas, n40 the Commission's investigation must have a "legitimate purpose." n41 An investigation has a legitimate purpose if "the inquiry is within the authority of the agency, the demand is not too indefinite and the information sought is reasonably relevant." n42 The Commission is not required to establish a likelihood that securities law violations have been or may be committed. n43

Once the Commission has made the requisite showing, the presiding judge or magistrate must enter an *ex parte* order granting the requested delay for a period not to exceed 90 days and prohibiting the financial institution involved from disclosing that records have been obtained or that a request for records has been obtained. n44 Extensions of up to 90 days each may be granted by the court upon application in accordance with Section 21(h) or Section 1109(a), (b)(1), or (b)(2) of the RFPA. n45

Once the period of delay (including extensions) expires, the customer must be served with or mailed a copy of the subpoena, insofar as it applies to the customer, n46 together with the following notice:

Records or information concerning your transactions which are held by the financial institution named in the attached subpoena were supplied to the Securities and Exchange Commission on (date). Notification was withheld pursuant to a determination by the (title of court so ordering) under section 21(h) of the Securities Exchange Act of 1934 that (state reason). The purpose of the investigation or official proceeding was (state purpose). n47

[c] Transfer of Records or Information to Other Government Authorities. The Commission is permitted to transfer financial records, or the information contained therein, to any government authority if the Commission proceeds as a transferring agency in accordance with Section 1112 of the RFPA. n48 Pursuant to Section 1112, the Commission may transfer records to another agency or department if it certifies in writing that there is a reason to believe that the records are relevant to a legitimate law enforcement inquiry within the jurisdiction of the receiving agency or department. n49

The customer notice required under Section 1112(b) or (c) of the RFPA may be delayed upon a showing by the

Commission, in accordance with the procedure set forth in Section 21(h)(4)-(5), that one or more of subparagraphs (A) through (B) of Section 21(h)(2) apply. n50

If, however, the financial records or information are transferred to a State securities agency or the Department of Justice, the Commission need not give the notice required by Section 1112 of the RFPA. n51 In this instance, the financial records or information transferred to a State securities agency or the Department of Justice may be disclosed or used by these two entities only in an administrative, civil, or criminal action that arises out of or relates to the acts, practices or courses of conduct investigated by the Commission. n52 Otherwise, if the State securities agency or the Department of Justice determines that the information should be disclosed or used for any other purpose, it may do so if it notifies the customer (except as otherwise provided in the RFPA) within 30 days of its determination, or it complies with the provisions of the RFPA that govern delay of customer notice. n53

[d] Customer Remedies After Expiration of the Delay Period. Once the period of delay of notification expires, the customer may, upon motion, reopen the proceedings in the district court that issued the order. n54 If the judge or magistrate finds that the movant is the customer to whom the obtained records relate and that the Commission obtained the financial records, or the information contained therein, in violation of Section 21(h) (other than paragraph (1)), the court may order that the customer be granted civil penalties against the Commission. n55 In determining whether a customer is entitled to relief under Section 21(h)(7) the court may consider, but is not bound by, the findings it made during the course of the *ex parte* proceedings under Section 21(h)(2). n56

The amount of the civil penalty that may be imposed on the Commission is equal to the sum of \$100, out-of-pocket damages sustained by the customer as a direct result of the disclosure, n57 and, if the violation is found to have been willful, intentional, and without good faith, such punitive damages as the court may allow, together with the costs of the action and reasonable attorneys' fees. n58

Any other government authority that violates Section 21(h)(9), n59 is also subject to the civil penalties and the procedures set forth above. n60

In its discretion, the court may also, or in the alternative, issue injunctive relief to require the Commission to comply with Section 21(h) with respect to any subpoena that the Commission issues in the future for financial records of such customer for purposes of the same investigation. n61

The remedies of the customer are confined to the monetary penalties against the Commission and other government authorities and injunctive relief against the Commission set forth above. n62 There is no "exclusionary rule" remedy for the customer. Section 21(h) specifically states that nothing in the section or in the RFPA shall be deemed to prohibit the use in any investigation or proceeding of the financial records, or the information contained therein, obtained by a subpoena issued by the Commission. n63

In the event the customer is unsuccessful in its action against the Commission under Section 21(h)(7), the court shall award the costs of the action and attorneys' fees to the Commission if the judge or magistrate finds that the customer's claims were made in bad faith. n64

Section 21(h) is not intended to enlarge or restrict any rights of a financial institution to challenge requests for records made by the Commission under existing law, or to entitle a customer to assert any rights of a financial institution. n65 In addition, Section 21(h)(7)-(8) supersedes (but only with respect to actions under Section 21(h)) the provisions of Section 27 of the Exchange Act prohibiting the awarding costs for or against the Commission. n66

FOOTNOTES:

(n1)Footnote 1. See § 9.05[4] *supra*.

(n2)Footnote 2. See *Penfield Co. v. SEC*, 330 U.S. 585 (1947) ; S.E.C. v. Lines Overseas Management, Ltd., No. Civ.A 04- 302 RWR/AK, 2005 U.S. Dist. LEXIS 39425 (D.D.C. Jan. 7, 2005) (the purpose of a subpoena is to "discover and procure evidence, not to prove a pending charge"); *Davidov v. S.E.C.*, 415 F. Supp. 2d 386 (S.D.N.Y. 2006) ; S.E.C. v. Finazzo, 360 Fed. Appx. 169 (2nd. Cir. 2009) ; *McGarry v. SEC*, 147 F.2d 389, 392 (10th Cir. 1945) ("The process is lawful if it confines its requirements within the limits which reason imposes in the circumstances of the particular case.")

(n3)Footnote 3. *United States v. Morton Salt Co.*, 338 U.S. 632, 651-54 (1950) and *Oklahoma Press Pub. Co. v. Walling*, 327 U.S. 186, 209 (1946) established that administrative agencies need not show probable cause before issuing subpoenas. See 1 K. Davis, Administrative Law Treatise 228-241 (1978).

(n4)Footnote 4. *SEC v. Kanter*, 1998 U.S. Dist. LEXIS 10902 (N.D. Ill. July 9, 1998) ; *RNR Enters., Inc. v. SEC*, 122 F.3d 93 (2d Cir. 1997) .

(n5)Footnote 5. But see *SEC v. Wheeling-Pittsburgh Corp.*, 648 F.2d 118 (3d Cir. 1981) (en banc), discussed in § 9.05[3] *supra*.

(n6)Footnote 6. *SEC v. City of Seattle*, 387 U.S. 541, 544 (1967) (footnote omitted), quoted in *U.S. v. Vilar*, No. S305CR621KMK, 2007 U.S. Dist. LEXIS 26993 (S.D.N.Y. Apr. 4, 2007) ; *SEC v. Arthur Young & Co.*, 584 F.2d 1018, 1030 (D.C. Cir. 1978) , cert. denied, 439 U.S. 1071 (1979) ("the need for moderation in the subpoena's call is a matter of reasonableness").

(n7)Footnote 7. Such actions must be authorized by the Commission.

(n8)Footnote 8. Though courts have no jurisdiction to entertain such actions, the Commission's counterclaim for the enforcement of its subpoena creates a justiciable controversy. See, e.g., *SEC v. Isbrandtsen*, 245 F. Supp. 518, 520-521 (S.D.N.Y. 1965) .

(n9)Footnote 9. It defends all actions against the Commission. See § 9.01 *supra*.

(n10)Footnote 10. They also establish an effort to exhaust one's administrative remedies. This can be helpful if litigation ensues.

(n11)Footnote 11. The Commission's capacity to delegate its subpoena power to its employees was established at an early date. *Woolley v. United States*, 97 F.2d 258, 262 (9th Cir.) , cert. denied, 305 U.S. 614 (1938) ; *Penfield Co. of California v. SEC*, 143 F.2d 746, 749-750 (9th Cir.) , cert. denied, 323 U.S. 768 (1944) .

(n12)Footnote 12. *McGarry v. SEC*, 147 F.2d 389 (10th Cir. 1945) .

(n13)Footnote 13. *SEC v. Jerry T. O'Brien, Inc.*, 467 U.S. 735 (1984) .

(n14)Footnote 14. See § 9.02 *supra*.

(n15)Footnote 15. See *Mines and Metals Corp. v. SEC*, 200 F.2d 317 (9th Cir. 1952) , cert. denied, 345 U.S. 941 (1953) (court required production of documents located in Panama). Moreover, the SEC is empowered to subpoena on behalf of foreign securities authorities individual who are suspected of violating foreign securities laws. See 15 U.S.C. 78(u)(a)(1).

(n16)Footnote 16. See *SEC v. Minas de Artemisa, S.A.*, 150 F.2d 215 (9th Cir. 1945) .

(n17)Footnote 17. See *SEC v. Zanganeh*, 470 F. Supp. 1307 (D.D.C. 1978) . However, if a foreign citizen trades securities of a company which are traded exclusively on a United States exchange, the SEC may obtain personal jurisdiction over the foreign citizen on the basis that he "caused consequences" in the United States by virtue of insider

trading activity. *SEC v. Unifund SAL*, 910 F.2d 1028, 1033 (2d Cir. 1990) . Service was properly made through the defendants' broker in New York. *Id.* at 1034 .

(n18)Footnote 18. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 929P.

(n19)Footnote 19. *SEC v. Banca Della Swizzera Italiana*, 92 F.R.D. 111, 112 (S.D.N.Y.1981) ("[C]ompelling the complete discovery demanded is... required to preserve our vital national interest in maintaining the integrity of the securities markets against violations committed or aided and assisted by parties located abroad."). For the way in which this evidence was used to establish illicit insider trading, see *SEC v. Tome*, 638 F. Supp. 596 (S.D.N.Y. 1986) .

(n20)Footnote 20. These are discussed in Report of the SEC to the House Committee on Energy and Commerce on the Internationalization of the Securities Markets (October 9, 1986). SEC, CFTC, Bank of England & Fin. Servs. Auth., *Memorandum of Understanding*, Press Release, Oct. 27, 1998, available at <http://www.sec.gov/news/press/97-96.txt>.

(n21)Footnote 21. The report cited in n.18 *supra* describes three important insider trading cases in which documents were obtained abroad.

(n22)Footnote 22. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 929P.

(n23)Footnote 23. This section is not intended to be a comprehensive discussion of the RFPa. For a detailed discussion of practice and procedure under the RFPa, see 1 G. Trubow, *Privacy Law and Practice* § 3.04[3][Matthew Bender].

Rather, it is intended simply as a discussion of the provisions of Exchange Act § 27(h), which supplement (rather than supplant) the RFPa. As noted in the legislative history of Section 21(h), the general purpose of Section 21(h) make it easier for the Commission to obtain financial records *ex parte* under specified circumstances. See generally H.R. Rep. No. 1321, 96th Cong., 2d Sess. 2-4, reprinted in 1980 U.S. Code Cong. & Admin. News 3874 (hereinafter cited as "1980 House Report" using citations to the original report pages).

(n24)Footnote 24. 12 U.S.C. § 3422; Exch. Act § 21(h)(1). Section 21(h) is codified at 15 U.S.C. § 78u(h). Unless the context otherwise requires, all terms defined in the RFPa that are common to Section 21(h) have the same meaning as in the RFPa. *Id.* § 27(h)(13).

(n25)Footnote 25. The RFPa defines "customer" as "any person or authorized representative of that person who utilized or is utilizing any service of a financial institution, or for whom a financial institution is acting or has acted as a fiduciary, in relation to an account maintained in the person's name." 12 U.S.C. § 3401(5). A "person" is an individual or a partnership of no more than five individuals. 12 U.S.C. § 3401(4).

(n26)Footnote 26. The term "financial institution" includes a variety of financial entities such as banks and credit card companies. See 12 U.S.C. § 3401(1).

(n27)Footnote 27. Exch. Act § 21(h)(11); see also 1980 House Report, n.1 *supra*, at 11.

(n28)Footnote 28. See 12 U.S.C. § 3405; *In re SEC Private Investigation*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,424 (S.D.N.Y. 1990) (motion by customer to quash administrative subpoena issued by the Commission).

(n29)Footnote 29. Sections 1105 or 1107 of the RFPa provide the procedure by which government authorities other than the Commission may obtain financial records and notify customers. See 12 U.S.C. § 3405 (administrative subpoena); 12 U.S.C. § 3407 (judicial subpoena).

(n30)Footnote 30. The legislative history of Section 21(h) states that an "appropriate" court is any court specified in Section 21(c) of the Exchange Act. 1980 House Report, *supra* n.1, at 5. Therefore, it appears as though the

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appropriate court would be any United States district court whose jurisdiction encompasses either (1) the place where the investigation is being carried on, or (2) the place where the customer resides or carries on business. *See* Exch. Act § 21(c).

(n31)Footnote 31. The subpoena must be issued in conformity with the requirements of Section 19(b) of the Securities Act, Section 21(b) of the Exchange Act, Section 18(c) of the Public Utility Holding Company Act, Section 42(b) of the Investment Company Act of 1940, or Section 209(b) of the Investment Advisers Act. Exch. Act § 21(h)(2); *see generally* § 9.05[4] *supra*.

(n32)Footnote 32. The Commission is not required to identify a particular individual who may have been adversely affected by the activities under investigation. 1980 House Report, *supra* n.1, at 7. Rather, it must show that it has reason to believe that those who may have suffered the uncompensated financial loss fall within the categories of persons whom Congress wished to protect under the securities laws. *Id.* In this respect, "investors" includes those who already own securities, those considering whether to buy securities, and those who actually buy or sell securities. *Id.* at 7-8. "[O]ther persons protected under the securities laws" includes a broad category of individuals and entities whose interests are touched by transactions and courses of business occurring in the securities markets. *Id.* at 8 (*citing United States v. Naftalin*, 441 U.S. 768, 777-78 (1979)).

(n33)Footnote 33. Exch. Act § 21(h)(2)(A)-(D).

(n34)Footnote 34. 1980 House Report, *supra* n.1, at 6.

(n35)Footnote 35. The 1980 House Report uses the word "industry." *See* 1980 House Report, *supra* n.1, at 6. It is assumed that use of the word "inquiry" was intended.

(n36)Footnote 36. 1980 House Report, *supra* n.1, at 6.

(n37)Footnote 37. Exch. Act § 21(h)(3).

(n38)Footnote 38. The 1980 House Report uses the phrase "responsible to infer." *See* 1980 House Report, *supra* n.1, at 8. It is assumed that this phrase was meant to read "reasonable to infer."

(n39)Footnote 39. 1980 House Report, *supra* n.1, at 8.

(n40)Footnote 40. *See* § 9.08[1] *supra*.

(n41)Footnote 41. 1980 House Report, *supra* n.1, at 6.

(n42)Footnote 42. 1980 House Report, *supra* n.1, at 6 n.6 (*quoting SEC v. Dresser Indus., Inc.*, 628 F.2d 1368, 1380 n.28 (D.C. Cir. 1980) (en banc)); *see also United States v. Morton Salt Co.*, 338 U.S. 632, 652 (1950); *SEC v. Arthur Young & Co.*, 584 F.2d 1018, 1024 (D.C. Cir. 1978).

(n43)Footnote 43. 1980 House Report, *supra* n.1, at 6 (*citing SEC v. Blackfoot Bituminous, Inc.*, 622 F.2d 512, 514-15 (10th Cir. 1980)). Nor is the court permitted to consider the motives of the Commission's informants. 1980 House Report, *supra* n.1, at 6 (*citing SEC v. Wheeling-Pittsburgh Steel Corp.*, 648 F.2d 118, 126-27 (3d Cir. 1981) (en banc)).

(n44)Footnote 44. Exch. Act § 21(h)(4)(a).

(n45)Footnote 45. Exch. Act § 21(h)(4)(B). Upon application by the Commission, all proceedings to obtain the delay in notification, including proceedings to obtain extensions of the delay period, must be held in camera, and the records of such proceedings must be sealed until the period of delay expires or until such other time as the judge or magistrate directs, *id.* § 21(h)(5), having due regard for the impact on the Commission's investigation and the privacy

rights of the customer. 1980 House Report, *supra* n.1, at 9.

(n46)Footnote 46. Any material in the subpoena that pertains to a different customer need not be furnished to the notified customer. 1980 House Report, *supra* n.1, at 9.

(n47)Footnote 47. 25 Exch. Act § 21(h)(4)(C). The nature of the investigation for which the Commission sought the financial records must be described with "reasonable specificity." *Id.* The "reasonable specificity" standard is met by reference to (1) the statutory provisions pursuant to which the investigation was commenced and (2) the statutory provisions violation of which the Commission is investigating. 1980 House Report, *supra* n.1, at 9.

(n48)Footnote 48. Exch. Act § 21(h)(9)(A).

(n49)Footnote 49. 12 U.S.C. § 3142(a).

(n50)Footnote 50. Exch. Act § 21(h)(9)(A); *see also* § 9.08[4][b] *supra*.

(n51)Footnote 51. Exch. Act § 21(h)(9)(B).

(n52)Footnote 52. Exch. Act § 21(h)(9)(B).

(n53)Footnote 53. Exch. Act § 21(h)(9)(B); *see also* 12 U.S.C. § 3409.

(n54)Footnote 54. Exch. Act § 21(h)(7)(A). The district court that issues the order, not the district in which the bank is located, is the appropriate tribunal. 1980 House Report, *supra* n.1, at 9 n.11.

(n55)Footnote 55. Exch. Act § 21(h)(7)(A).

(n56)Footnote 56. 1980 House Report, *supra* n.1, at 10.

(n57)Footnote 57. "Out-of-pocket damages" is intended to encompass only such injuries to the customer that have been established to have a direct link with the disclosure in question. It is not intended to include "speculative matters" such as injury to reputation and prospective business opportunities. 1980 House Report, *supra* n.1, at 10.

(n58)Footnote 58. Exch. Act § 21(h)(7)(A)(i)-(iii). Section 21(h) further provides for investigation of Commission officers or employees by the Office of Personnel Management if the Court determines that (1) the Commission has violated Section 21(h) (other than paragraph (1)), and (2) the circumstances raise questions of whether the officer or employee acted in a willful and intentional manner and without good faith with respect to the violation. Exch. Act § 21(h)(7)(C).

(n59)Footnote 59. *See* § 9.08[4][c] *supra*.

(n60)Footnote 60. Exch. Act § 21(h)(10).

(n61)Footnote 61. Exch. Act § 21(h)(7)(B).

(n62)Footnote 62. Exch. Act § 21(h)(8). Of course, if there is no period of delay and the customer is notified of the subpoena prior to compliance by the financial institution, the customer may move to quash the subpoena in accordance with Section 1110 of the RFPA. *See* 12 U.S.C. § 3410; *In re* SEC Private Investigation, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 95,424 (S.D.N.Y. 1990).

(n63)Footnote 63. Exch. Act § 21(h)(8); *see also* 1980 House Report, *supra* n.1, at 10.

(n64)Footnote 64. Exch. Act § 21(h)(8).

(n65)Footnote 65. Exch. Act § 21(h)(12).

(n66)Footnote 66. 1980 House Report, *supra* n.1, at 10.



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.09

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§ 9.09 Additional Issues Regarding SEC Investigations

[1] Parallel Proceedings

"Parallel proceedings" have always been a concern in securities law practice, and have become even more frequent over the last thirty years. n1 The Commission can make a two-pronged civil enforcement effort by seeking both injunctive relief in the courts n2 and administrative sanctions before itself. n3 It can also refer the same case to the Department of Justice for criminal prosecution. n4 One who faces all this is also likely to confront proceedings initiated by private litigants, stock exchanges, FINRA, and state regulators. Indeed, as far as private litigants are concerned, the Commission maintains that an essential purpose of its proceedings is to inform injured investors of their rights. n5

The Commission's governing statutes clearly permit such multiplicity of proceedings. Parallel civil and criminal investigations, however, have been challenged on the ground that they force the investigatee to choose between exercising his *Fifth Amendment* right to preserve his position in the criminal case, thus leaving the civil action undefended or inadequately defended, or waiving the *Fifth Amendment* privilege, which protects his position in the civil case but deprives him of a basic constitutional protection. The attack has been unsuccessful. The courts see no constitutional impropriety in this. n6

The prospective defendant faces a difficult, uncomfortable and perplexing choice. However, a different rule would force the government to make a choice of that character between criminal prosecution and civil relief. That, a unanimous Supreme Court has held, "would stultify enforcement of federal law." n7

Because the social interest in the effective enforcement of both the criminal and the civil provisions of important regulatory statutes is so strong and because the government can pursue both avenues simultaneously, documents can be subpoenaed by both the SEC and a grand jury. As the District of Columbia Circuit's *en banc* opinion in *SEC v. Dresser Industries, Inc.* n8 explained:

Effective enforcement of the securities laws requires that the SEC and Justice [Department] be able to investigate possible violations simultaneously... If the SEC suspects that [the company has violated the securities laws], it must be able to respond quickly: it must be able to obtain relevant information concerning alleged violations and to seek prompt judicial redress if necessary. Similarly, Justice must act

quickly if it suspects that the laws have been broken. Grand jury investigation takes time, as do criminal prosecutions. If Justice moves too slowly the statute of limitations may run, witnesses may die or move away, memories may fade, or enforcement resources may be diverted... The SEC cannot always wait for Justice to complete the criminal proceedings if it is to obtain the necessary prompt civil remedy, neither can Justice always await the conclusion of the civil proceedings without endangering its criminal case. Thus, we should not block parallel investigations by these agencies in the absence of "special circumstances" in which the nature of the proceedings demonstrably prejudices substantial rights of the investigated party or the government. n9

Dresser suggests that such "special circumstances" arise after an indictment has been returned. For the Commission to persist with its civil inquiry after that point, "might undermine the party's *Fifth Amendment* privilege against self-incrimination, expand rights of criminal discovery beyond the limits of Federal Rules of Criminal Procedure 16(b), expose the basis of the defense to the prosecution in absence of criminal trial, or otherwise prejudice the case." n10

This does not mean, however, that the Commission's civil inquiry must be aborted following an indictment. Deferral of the civil case or a protective order prohibiting the Commission from divulging information to the Department of Justice may suffice. n11 Absent such a protective order, the defendant would be afforded access to broader civil discovery to be used in the criminal case.

"Special circumstances" that prohibit parallel proceedings may also be found when the civil action has been brought solely to obtain evidence for the criminal prosecution, when the defendant is without counsel, or when the defendant "reasonably fears prejudice from adverse publicity or other unfair injury." n12 Two cases, *United States v. Scrushy* n13 and *United States v. Stringer*, n14 make plain the risks to prosecutors if they commingle SEC and Department of Justice investigations or actions. In both cases, indictments were dismissed because the courts found that the Department of Justice improperly manipulated the SEC's civil actions to collect evidence and set traps for the soon-to-be criminal defendants. n15 The decisions in *Scrushy* and *Stringer* have been criticized as setting forth a standard for identifying bad faith in SEC discovery that "too closely scrutinize[s] interagency communication" and as incompatible with established case law governing parallel proceedings. This concern is belied by the subsequent narrowing of the *Scrushy* holding n16 to instances of singularly egregious behavior by government prosecutors and the Ninth Circuit's decision in *Stringer* vacating the dismissal of the criminal indictment and affirming the broad discretion given to the SEC and government prosecutors in conducting parallel investigations. n17 In doing so, the Ninth Circuit held that the SEC did not conduct its civil investigation solely to obtain evidence for the parallel criminal investigation and did not affirmatively mislead defendants into turning over incriminating evidence.

Since the passage of the Sarbanes-Oxley Act in 2003 the SEC has vigorously employed its penalty authority, such that the largest penalties have been imposed since the passage of SOX. n18 Simultaneously, the Department of Justice has become increasingly aggressive in its pursuit of criminal charges against entities and individuals that commit securities fraud. n19 The increased aggressiveness of the SEC and the DOJ converge with parallel proceedings, heightening the risks that the target may be whipsawed between the two investigations. The SEC proceeding will produce evidence that leads to the target's criminal conviction in the DOJ proceeding, and thus expose the target to further civil liability. *Scrushy* and *Stringer* suggested that the judiciary began pushing back against these encroachments and ensure proper protection of a target's *Fifth Amendment* right against self-incrimination. n20

[2] Double Jeopardy

Defendants in parallel proceedings also have argued that cases involving both criminal and civil enforcement actions violate the *Fifth Amendment*. In those cases the defendants unsuccessfully argued that the *Fifth Amendment's double jeopardy clause* precludes the SEC from imposing sanctions for the same conduct in which criminal penalties have already been imposed. The Supreme Court, however, held that a sanction will be considered a criminal punishment for purposes of the *Fifth Amendment* only if: 1) the legislature indicated that the sanction be considered a criminal

punishment or 2) the statutory scheme is so punitive as to transform a civil remedy into a criminal one. n21 In addition, courts have held that disgorgement is not a criminal penalty for purposes of the *Fifth Amendment*. n22 Accordingly, this argument is almost always unsuccessful.

[3] Privileges

[a] Fifth Amendment. The *Fifth Amendment* privilege against self-incrimination is available to witnesses in SEC investigations. However, it does not permit them to refuse to appear. Rather, they must claim the privilege in response to specific questions. Witnesses must assert that claim themselves; counsel cannot do it for them. n23

Corporations and other collective entities have no *Fifth Amendment* privilege. n24 Since the privilege is personal, a corporation cannot claim it on its employees' behalf. Their books and records, therefore, are subject to compulsory disclosure and must be produced even when their production would tend to incriminate their flesh and blood custodian. n25

Although individual witnesses may invoke their *Fifth Amendment* privilege against self-incrimination, a decision to assert the privilege can have detrimental effects in civil litigation where adverse inferences are permissible. n26 In this context, civil litigation does not only mean private litigation. It also can result in quasi-judicial administrative proceedings, injunctive actions, as well as private litigation. n27

[b] Fourth Amendment. Mention has already been made of the reasonableness limit that the *Fourth Amendment's* ban on unreasonable searches and seizures imposes on the Commission's subpoenas n28 and on its inspections of regulated entities. n29 A person asserting his *Fourth Amendment* right must establish an expectation of privacy and an unreasonable intrusion on that privacy right. n30 Wiretapping and the surreptitious recording of conversations by Commission informants also raise *Fourth Amendment* issues. n31 Witnesses who believe that they have been subjected to these practices can demand that the Commission affirm or deny that this is so. This requires the Commission to make a full factual response before it proceeds with the inquiry. n32

Even if that response indicates that the surveillance was lawful, the witness and his counsel would appear to have a due process right to access the tapes before an interrogation about the conversations in question begins. Otherwise, the witness will have to rely on his fallible recollection of those conversations to answer questions based on the interrogators' actual knowledge of who said what to whom. This seems fundamentally unfair.

[c] Attorney/Client Privilege. Judge Wyzanski's classic formulation of this basic privilege in *United States v. United Shoe Machinery Corp.* n33 states that the attorney-client privilege applies when:

- the person who asserts the privilege is or seeks to become a client;
- the person to whom the communication was made is an attorney or an attorney's agent, functioning as an attorney with respect to the communication;
- the communication relates to a fact of which the attorney was informed by the client in confidence;
- the communication relates to the seeking of legal advice or assistance, and not for the purpose of committing a crime or tort; and
- the privilege has been claimed and not waived. n34

Communications to securities lawyers often fall outside the privilege because they relate to matters intended to be disclosed in prospectuses or other public documents. Thus, the essential element of confidentiality is missing. n35 The traditional view is that the privilege is "waived" whenever the information is imparted to the lawyer for the very purpose

of communicating it to someone else, n36 and that it is also waived whenever the client himself discloses it to another. n37 Hence, it can be argued that there is no privilege for anything divulged or intended to be divulged to the SEC or to other governmental agencies, even if the disclosure was intended to be confidential. n38 Moreover, such disclosure can be deemed to have waived the privilege with respect to other communications about the same general subject. n39

Viewed from the perspective of someone who tells or wants to tell the SEC things to satisfy the agency's enforcement-related concerns or to expedite its review of a disclosure filing but who also wants to shield that information from others, the traditional limitations on the scope of this privilege are most unsatisfactory. The Commission agrees. That is not surprising. It wants people to come forward with material protected by the attorney-client privilege. n40 As a general matter, the staff, however, is directed not to ask a party to waive the attorney-client privilege. n41

Efforts have been made to develop a limited-waiver doctrine under which confidential communications to the Commission would be privileged from discovery by others, including other governmental agencies. The results have been mixed. n42 Some courts reject the idea. n43 Others accept it. n44 In 2003 a bill was introduced to the House of Representatives that would have provided for a selective waiver of the attorney-client privilege. n45 Under the proposed law, which was never passed, disclosure to the SEC would only waive the attorney-client privilege as to the SEC and not a third party. n46 Similarly, an intermediate approach is that disclosure to the Commission is "a complete waiver of the attorney-client privilege unless the right to assert the privilege in subsequent proceedings is specifically reserved at the time the disclosure is made." n47 Subsequent decisions, however, have cast doubt on the continued viability of the limited-waiver doctrine. n48

Disclosures to special counsels appointed at the SEC's suggestion or behest have also led to a division of authority. Two courts found the privilege unavailable. One did so on the ground that the special counsel was not retained to render legal advice. n49 The other found special counsel's obligation to notify the Commission and the corporation's Board of Directors of securities-related derelictions inconsistent with any "legitimate expectation of confidentiality." n50 A third court broke with the traditional theories to encourage "this developing procedure of negotiated corporate self-investigation" and because it thought that discovery "would have immediate adverse impact on the ongoing investigation." n51 In addition, reports of internal investigations, which were produced to the SEC or released to the public, have been held to have lost any privilege. n52

[d] Work Product. The work product doctrine is codified in Fed. R. Civ. P. 26(b)(3), which provides that:

- (1) Documents or tangible things,
- (2) Prepared in anticipation of litigation or trial,
- (3) By or for an other party, or by or for that party's representative, including the party's "attorney, consultant, surety, indemnitor, insurer or agent,"
- (4) Are protected against discovery unless the party seeking disclosure can demonstrate:
 - (a) substantial need, and
 - (b) undue hardship. n53

Documents prepared in anticipation of litigation other than the particular case in which the work product claim is asserted are generally held to be privileged work product. n54 Materials prepared in anticipation of SEC investigations have been protected under the work product doctrine. n55

As to the issue of waiver, when a corporation discloses work product to a government agency, the court may permit private parties and other government agencies access to the materials. n56

[4] Immunity

If a witness invokes the *Fifth Amendment* privilege against self-incrimination, the SEC with the approval of the Attorney General, under certain circumstances, may grant use immunity and thereby compel the witness to testify. n57

Title 2 of the Organized Crime Control Act of 1970 n58 applies to SEC investigations. The statute provides that if an individual is called to testify before a federal agency, the agency may, with the approval of the Attorney General, issue an order requiring the individual to give testimony regarding the basis of his privilege against self-incrimination. n59 The order to testify may also include an order granting the witness immunity, such that "no testimony or other information compelled under the order ... may be used against the witness in any criminal case, except a prosecution for perjury, giving a false statement, or otherwise failing to comply with the order." n60 Thus, once immunity is granted to a witness in an SEC investigation, the witness may not refuse to testify on the basis of the privilege against self-incrimination.

The statute gives only "use immunity." A witness may still be prosecuted for transactions about which he or she has testified if the prosecution can show that the evidence used to convict the defendant was obtained from an independent source. n61 "Transactional immunity," which bars any prosecution for any crime related to the immunized witness's testimony or to the information he or she furnishes, can be granted only by the Attorney General. n62 Since even the narrower use immunity requires the Attorney General's consent, the Commission has no authority to bind the Department of Justice with respect to immunity and the Commission's employees certainly have no power to do so. n63

The Commission has, however, permitted its staff to experiment with consensual arrangements that fall short of immunity but that offer significant inducements to testify. These agreements between the staff and the witness call for a two-stage process. The first stage is that the staff agrees not to use a statement in any action or proceeding the Commission may bring. This undertaking relates only to the statement itself. It does not preclude the staff from using the witness's statement as a lead to other evidence that it can offer against the witness. The second stage arrives if and when the staff tells the witness that it will not recommend any enforcement action against him or her. At that point, the agreement binds the witness to cooperate fully. Should the witness fail to honor that commitment, the Commission is free to take whatever enforcement action it deems appropriate and to use the witness's first-stage statement in any such action or proceeding.

[5] Perjury, Obstruction of Justice and False Statements

18 U.S.C. § 1621 provides that:

Whoever, having taken an oath before a competent tribunal, officer, or person, in any case in which a law of the United States authorizes an oath to be administered, that he will testify, declare, depose, or certify truly or that any written testimony, declaration, deposition, or certificate by him subscribed, is true, willfully and contrary to such oath states or subscribes any material matter which he does not believe to be true, is guilty of perjury, and shall, except as otherwise provided by law, be fined not more than \$2,000 or imprisoned not more than five years, or both. n64

An attorney on the staff of the Commission may be designated an officer of the Commission and be empowered to administer oaths and take evidence for the purpose of an investigation. n65 Even if the testimony at an investigation is provided voluntarily, perjury is committed when false statements are made willfully and are material. n66 The *ex parte* character of the inquiry is no bar to a perjury prosecution. n67 In addition, 18 U.S.C. § 1001 criminalizes "false statements" in SEC investigations, regardless of whether given under oath. n68

As to obstruction of SEC proceedings, 18 U.S.C. §§ 1501-1515 prohibit conduct that tends to disrupt the administrative process. n69

[6] Statute of Limitations

With the exception of a five-year statute of limitations for civil penalties imposed pursuant to the insider trading provisions of the Exchange Act, there is no express statute of limitations governing SEC enforcement actions. In 1993, the Ninth Circuit interpreted Congress' silence to mean that no statute of limitations should apply to SEC enforcement actions. n70 In 2004 the Eleventh Circuit concurred with the Ninth Circuit's ruling, holding that, generally, there is no statute of limitations placed on SEC enforcement actions. n71 However, in 1994 the D.C. Circuit held that the five year statute of limitations of 28 U.S.C. § 2462, for proceedings for the enforcement of any civil fine, penalty or forfeiture, applied to both judicial and administrative proceedings. n72 In 1996 the D.C. Circuit held that § 2462's five-year statute of limitations applied to an SEC administrative proceeding to censure and suspend for six months a securities branch manager. n73 In applying the statute of limitations to the SEC enforcement action, the court reasoned that the sanction imposed on the branch manager constituted a penalty under § 2462. n74

Courts, however, are not unanimous in this view. In *SEC v. Pinchas*, the Southern District of New York strongly suggested that § 2462 does not apply to summary proceedings brought by the SEC to enforce its orders. n75 In addition, Section 2462's five-year statute of limitations does not apply when the SEC seeks equitable relief.

[7] Temporary Freeze Authority

One complaint that had arisen about Commission enforcement authority in the past was that assets could often be dissipated before judgment could be reached against violators. In one attempt to correct this situation, Section 1103 of the Sarbanes-Oxley Act n76 gives the Commission the authority, where the Commission is investigating an issuer (or one of its directors, officers, partners, controlling persons, agents or employees) for possible securities violations and it appears to the Commission likely that the issuer will make "extraordinary payments (whether compensation or otherwise)" to any of the foregoing persons, to petition a federal court for an order requiring the issuer to escrow those payments for up to forty-five days (with the possibility of one forty-five-day extension). The Commission does not have to demonstrate any likelihood that the person to whom such payments are directed has actually violated the securities laws, only that there is a "lawful investigation." If actual charges are filed while a temporary escrow order is in effect, that order remains in effect until resolution of those charges. The Commission used this authority in its action against HealthSouth Corporation and its CEO, Richard Scrushy. n77

FOOTNOTES:

(n1)Footnote 1. *See generally* Pickholz, *The Expanding World of Parallel Proceedings*, 53 *Temp. L.Q.* 1100 (1982); Pickholz, *Parallel Proceedings: Guidelines for the Corporate Lawyer*, 7 *Sec. Reg. L. J.* 99 (1979); Alvin K. Hellerstein & Gary P. Naftalis, *Defending Parallel Civil and Criminal Proceedings*, ALI-ABA Course of Study (2006).

(n2)Footnote 2. *See* § 9.11 *infra*.

(n3)Footnote 3. *See* § 9.10 *supra*.

(n4)Footnote 4. *See* § 9.14 *supra*. It can do so before it reaches a decision with respect to civil enforcement action. *In re Clinton Engines Corporation*, 41 *S.E.C.* 408, 413 (1963) : "[T]hat we have referred evidence to the Attorney General does not mean that we are incapable of weighing all of the evidence deliberately and impartially... in our quasi-judicial capacity." *See generally Withrow v. Larkin*, 421 *U.S.* 35, 47-50 (1975) .

(n5)Footnote 5. *See, e.g., Angelastro v. Prudential-Bache Secs., Inc.*, 764 *F.2d* 939 (3rd Cir. 1985) ; *In re Franchard Corporation*, 42 *S.E.C.* 163, 185 n.58 (1964) . Parallel enforcement proceedings by the Commission and

other regulatory bodies may be closely coordinated, as was the case in related enforcement actions by the Commission and National Association of Securities Dealers ("NASD") Regulation, Inc. against Credit Suisse First Boston Corporation, arising from the latter's allocation of shares in "hot" initial public offerings. See Press Release, *SEC Charges CSFB with Abusive IPO Allocation Practices* (Jan. 22, 2002) (hereafter, "SEC Press Release") (characterizing joint effort as "a model of effective cooperation and parallel investigation" by Commission enforcement staff and the staff of NASD Regulation); see also SEC Litigation Release No. 17327 (Jan. 22, 2002). Indeed, at the culmination of the parallel investigation, the Commission commenced an enforcement proceeding in federal court to enjoin violations by Credit Suisse First Boston of the NASD's rules prohibiting profit sharing with customers by allegedly extracting inflated commissions from customers in return for preferential allocations of certain initial public offerings. See *SEC v. Credit Suisse First Boston Corp.*, No. 02 CV 00090 (D.D.C.) (complaint filed Jan. 22, 2002). The SEC observed that it had "taken the unusual step of seeking a federal court injunction to enforce NASD rules," in view of the nature and scale of Credit Suisse First Boston's alleged misconduct. SEC Press Release (Jan. 22, 2002). Related administrative proceedings charging similar violations were commenced by NASD Regulation, Inc. See Press Release, *NASD Regulation Charges Credit Suisse First Boston with Siphoning Tens of Millions of Dollars of Customers' Profits in Exchange for "Hot" IPO Shares* (Jan. 22, 2002) (hereafter, "NASD Press Release"). In order to resolve the parallel proceedings, Credit Suisse First Boston agreed to a consent judgment in the federal court action enjoining it from further violations of the NASD rules and also agreed to monetary penalties totaling \$100 million, half to be paid to the Commission and half to be paid to NASD Regulation, Inc. See *SEC v. Credit Suisse First Boston Corp.*, No. 02 CV 00090 (D.D.C.) (consent judgment entered Jan. 22, 2002); NASD Press Release. This type of coordinated resolution between the SEC and other regulatory agencies, such as FINRA, may often be the most favorable resolution from the target's perspective, as well.

(n6)Footnote 6. *United States v. Kordel*, 397 U.S. 1 (1970) , cited in *S.E.C. v. Brown*, No. 06-1213 (PAM/JSM), 2007 U.S. Dist. LEXIS 98410 (D. Minn. July 16, 2007) .

(n7)Footnote 7. *United States v. Kordel*, 397 U.S. 1, 11 (1970)

(n8)Footnote 8. 628 F.2d 1368 (D.C. Cir. 1980) , cert. denied, 449 U.S. 993 (1980) .

(n9)Footnote 9. *Id.* at 1377 . *Dresser* also held the restrictive rule of *United States v. La Salle National Bank*, 437 U.S. 298 (1978) with respect to Internal Revenue Service summonses inapplicable "to the securities laws in which the SEC's civil enforcement authority continues undiminished after Justice initiates a criminal investigation by the grand jury." 628 F.2d at 1378 ; see also, *SEC v. First Financial Group of Texas, Inc.*, 659 F.2d 660, 666-68 (5th Cir. 1981) .

(n10)Footnote 10. 628 F.2d at 1376 ; see also *SEC v. Oakford Corp.*, 1998 U.S. Dist. LEXIS 12314 (S.D.N.Y. 1998) .

(n11)Footnote 11. *Id.* But see the brief concurring opinion of Judge Edwards: "I express no opinion as to whether the summons authority of a government agency may continue once an indictment has been issued or, if it may, whether protective conditions need be placed on the exercise of that power." 628 F.2d at 1391 .

(n12)Footnote 12. *United States v. Kordel*, 397 U.S. 1, 11-12 (1970) . Kordel also indicates that special circumstances may be present when the Government "has failed to advise the defendant in its civil proceeding that it contemplates his criminal prosecution." But this is not always so. Compare *United States v. Rodman*, 519 F.2d 1058 (1st Cir. 1975) (criminal prosecution barred where SEC staff member breached promise to recommend against criminal proceedings) with *United States v. Fields*, 592 F.2d 638 (2d Cir. 1978) , cert. denied, 442 U.S. 917 (1979) (isolated instance of misconduct by SEC staff members who did not tell target that they envisaged a criminal proceeding did not warrant dismissal of the indictment so as to deter official wrongdoing).

(n13)Footnote 13. *United States v. Scrushy*, 366 F. Supp. 2d 1134, 1139 (N.D. Ala. 2005) (finding that "the government manipulated the simultaneous proceedings for its own purposes" by setting a perjury trap for the defendant

through coordinated efforts of the SEC and Department of Justice and throwing out perjury counts based on testimony elicited through the improper scheme).

(n14)Footnote 14. *United States v. Stringer*, 408 F. Supp. 2d 1083, 1089 (D. Or. 2006) (dismissing indictment because the Department of Justice spent years "hiding behind the civil investigation to obtain evidence, avoid criminal discovery rules, and avoid constitutional protections.").

(n15)Footnote 15. According to one commentator, these two cases stand for the proposition that the courts continue to rubber stamp the procedure by which the SEC and the Department of Justice share information. Ralph C. Ferrara & David A. Garcia, *Meeting in Dark Corners and Strange Places: Scheming Between the SEC and the Department of Justice*, 1557 PLI/Corp 515, 531 (2006). However, courts will scrutinize the relationship between the DOJ and the SEC when the "parallel investigations have advanced beyond the initial sharing of information" to "examine whether the investigations have improperly merged, whether the defendant has received adequate notice that he could be subject to criminal charges, and whether the liberal rules of civil discovery are being abused to gain an advantage in a parallel criminal investigation." *Id.*

(n16)Footnote 16. Eli Ewing, Comment, *Too Close for Comfort: United States v. Stringer and United States v. Scrusby Impose a Stricter Standard on SEC/DOJ Parallel Proceedings*, 25 YALE L. & P OL'Y REV. 217 (2006)).

(n17)Footnote 17. *United States v. Stringer*, 521 F.3d 1189 (9th Cir 2008) .

(n18)Footnote 18. Similarly, as previously discussed, the SEC touts that it "has returned more than \$6.6 billion to harmed investors since the passage of the Sarbanes-Oxley Act" under provisions allowing the SEC to redirect penalties collected from securities violators to harmed investors.

(n19)Footnote 19. Eli Ewing, Comment, *Too Close for Comfort: United States v. Stringer and United States v. Scrusby Impose a Stricter Standard on SEC/DOJ Parallel Proceedings*, 25 YALE L. & P OL'Y REV. 217 (2006). Alvin K. Hellerstein & Gary P. Naftalis, *Defending Parallel Civil and Criminal Proceedings*, ALI-ABA 777 (2006).

(n20)Footnote 20. *E.g.*, *United States v. Luce*, No. 05 CR 340, 2006 U.S. Dist. LEXIS 76052, at *16 (N.D. Ill. Sept. 26, 2006) (holding no violation of *Fifth Amendment* because defendant was provided with sufficient notice that criminal prosecution may occur through service of grand jury subpoena and the government had not "affirmatively concealed" the existence of parallel investigations); *United States v. Mahaffy*, 446 F. Supp. 2d 115 (E.D.N.Y. 2006) (limiting the holdings of *Stringer* and *Scrusby* to when the government engages in such "egregious conduct as to constitute a violation of the universal sense of justice."); *SEC v. Sandifur*, No. C05-1631C, 2006 U.S. Dist. LEXIS 40716, at *7 (W.D. Wash. June 19, 2006) (holding that interaction between SEC and DOJ a rises to violation of Due Process if SEC virtually becomes a tool of DOJ).

(n21)Footnote 21. *Hudson v. United States*, 118 S. Ct. 488 (1997) .

(n22)Footnote 22. *U.S. v. Perry*, 152 F. 3d 900 (8th Cir. 1998) ; *SEC v. Palmisano*, 135 F.3d 860, 865-866 (2d Cir. 1998) ; *SEC v. Monarch Funding Corp.* No. 85 Civ. 7072, 1995

(n23)Footnote 23. *SEC v. First Financial Group of Texas, Inc.*, n.9 *supra*, 659 F.2d at 668-69 , reviews the authorities.

(n24)Footnote 24. *SEC v. Brown*, No. 06-1213 (PAM/JSM), 2007 U.S. Dist. LEXIS 98410 2007 WL4192000 (D. Minn. July 16, 2007), citing *Bellis v. United States*, 417 U.S. 85 (1974) (holding that this principle was applicable to a law firm).

(n25)Footnote 25. *SEC v. Brown*, No. 06-1213 (PAM/JSM), 2007 U.S. Dist. LEXIS 98410 (D. Minn. July 16, 2007) citing *Bellis v. United States*, 417 U.S. 85 (1974)

(n26)Footnote 26. *Baxter v. Palmagiano*, 425 U.S. 308 (1976) ; *Lefkowitz v. Cunningham*, 431 U.S. 801, 809 n.5 (1977) .

(n27)Footnote 27. *Pagel, Inc. v. SEC*, 803 F.2d 942, 946-47 (8th Cir. 1986) approved this practice. See also *N. Sims Organ & Co. v. SEC*, 293 F.2d 78, 80 (2d Cir. 1961) , cert. denied, 368 U.S. 968 (1962) . *SEC v. Tome*, 638 F. Supp. 596, 610 (S.D.N.Y. 1986) (opinion on the merits) and *SEC v. Tome*, 638 F. Supp. 629, 631 (S.D.N.Y. 1986) (memorandum on evidentiary matters). See Heidt, *The Conjurer's Circle: The Fifth Amendment Privilege in Civil Cases*, 92 Yale L. J. 1062 (1982). As Justices Brennan and Marshall, staunch defenders of the privilege, said in *Baxter v. Palmagiano*, 425 U.S. 308, 335 (1976) (dissenting opinion): "In a civil suit involving only private parties, no party brings to the battle the awesome powers of the government, and therefore, to permit an adverse inference to be drawn from exercise of the privilege does not implicate the policy considerations underlying the privilege."

(n28)Footnote 28. See § 9.08[1] *supra*.

(n29)Footnote 29. The statutory provisions cited in § 9.03 *supra* all require that inspections be reasonable. In *S.E.C. v. Lazare*, No. 3: CV-96-0705, 2007 U.S. Dist. LEXIS 71409 (M.D. Pa. Sept. 26, 2007) , the court rejected the defendants' allegations that staff members made an unreasonable seizure when they took evidence from the defendants' personal residence. The Third Circuit affirmed. *SEC v. Lazare*, 294 Fed.Appx. 711 (3d. Cir. 2008) . In *Wolf Corp. v. SEC*, 317 F.2d 139, 142 (D.C. Cir.1963) , an issuer of securities alleged that staff members made an unreasonable search when they examined records at its premises. The court held that the issue had to be raised before the Commission and that judicial review was available only by way of an appeal from a final order of the Commission. Settlement ultimately rendered the point moot. *In re The Wolf Corporation*, 42 S.E.C. 1042 (1966) .

(n30)Footnote 30. *U.S. v. Szur*, 1998 U.S. Dist. LEXIS 3519 (S.D.N.Y. Mar. 18, 1998) .

(n31)Footnote 31. See *Smith v. SEC*, 129 F.3d 356 (6th Cir. 1997) in which a taped conversation was suppressed.

The latter technique is said to have figured prominently in certain SEC inquiries. N.Y. Times, Mar. 26, 1987, § D, at 2 . See also *id.*, Nov. 22, 1986, at 35; *Id.*, Nov. 24, 1986, § A, at 1 ; Wash. Post, Nov. 19, 1986, at 1.

(n32)Footnote 32. 18 U.S.C. § 3504. On the right to refuse to answer questions based on illegal electronic surveillance, see *Gelbard v. United States*, 408 U.S. 41, 52 (1972) . For the nature of the required governmental response, see *United States v. Alter*, 482 F.2d 1016, 1027 (9th Cir. 1973) . In *SEC v. Brown*, Civil Action No. 81-532 (D.D.C., January 6, 1982), the court ordered the Commission to make such a response. And the agency did so. A controversy about the adequacy of the response was rendered moot by settlement.

(n33)Footnote 33. 89 F. Supp. 357, 358-59 (D. Mass. 1950) ; see also 8 J. Wigmore, Evidence § 2291 at 554 (McNaughton rev. ed. 1961).

(n34)Footnote 34. Regarding the last element, the SEC and the Department of Justice have promulgated policies controlling when the two agencies may demand targets of investigations waive the attorney-client privilege. The SEC policy is set forth in the so-called Seaboard Report, a cease and desist order issued by the SEC in October 2001, alia, the company "did not invoke the attorney-client privilege, work product protection or other privileges or protections with respect to any facts uncovered in the investigation."

The Department of Justice counterparts to the Seaboard Report are the Thompson Memorandum of January 20, 2003 and the McNulty Memorandum of December 12, 2006. See Larry D. Thompson, *Principles of Federal Prosecution of Business Organizations* 3 (Jan. 20, 2003) and Paul J. McNulty, *Principles of Federal Prosecution of Business Organizations* 8 (Dec. 12, 2006).

Consistent with the SEC's Seaboard Report, the Thompson Memorandum prescribed guidelines that encouraged target

companies to waive the attorney-client privilege in order to escape indictment: "In ... determining whether to bring charges ... prosecutors should consider the following factors in reaching a decision ... the corporation's timely and voluntary disclosure of wrongdoing ... including, if necessary, the waiver of corporate attorney-client and work product protection" The McNulty Memorandum revised the Thompson Memorandum by limiting when a prosecutor may broach the subject of attorney-client privilege waiver in lieu of an indictment. The Thompson Memorandum omitted reference to waiver of the attorney-client privilege as a factor properly considered in the charging decision. Instead, the Thompson Memorandum stated, "Prosecutors may only request waiver of attorney-client or work product protections when there is a legitimate need for the privileged information to fulfill their law enforcement obligations."

(n35)Footnote 35. See *Cowan Liebowitz & Latman, P.C. v. Kaplan*, 902 So.2d 755 (Fla. 2005) , citing *U.S. v. Moscony*, 927 F.2d 742 (3d Cir. 1991) and *In re Grand Jury Proceedings*, 727 F.2d 1352 (4th Cir.1984) ; *United States v. Tellier*, 255 F.2d 441 (2d Cir. 1958) , cert. denied, 358 U.S. 821 (1958) . Judge Lumbard's dissent in *Tellier*, 255 F.2d at 451 , shows how close the confidentiality questions can become in the financing context. The case involved a lawyer's warning to his client that a proposed financing might be a criminal fraud. The majority rejected the claim of privilege on the ground "that this advice was not understood... to be confidential." A telephone conversation in which the lawyer characterized the deal as a "Ponzi scheme" was found outside the privilege even if there was no intent to communicate it further because "[i]t was too closely connected with the information which was intended to be communicated."

(n36)Footnote 36. *In re Grand Jury Proceedings*, 33 F.3d 342 (4th Cir. 1994) ("[I]f a client communicates information to his attorney with the understanding that the information will be revealed to others, that information ... will not enjoy the privilege.")

(n37)Footnote 37. *In re Horowitz*, 482 F.2d 72, 82 (2d Cir.) , cert. denied, 414 U.S. 867 (1973) (affirmative action to preserve confidentiality required).

(n38)Footnote 38. *In re Penn Central Commercial Paper Litigation*, 61 F.R.D. 453, 463-64 (S.D.N.Y. 1973) .

(n39)Footnote 39. *Duplan Corp. v. Deering Milliken, Inc.*, 397 F. Supp. 1146, 1161-62 (D.S.C. 1974) .

(n40)Footnote 40. On September 19, 2008, Congress passed legislation that amends the Federal Rules of Evidence 502 to state that the disclosure of privileged material in a government investigation waives the privilege unless the disclosure was inadvertent and the disclosing party had taken reasonable steps to prevent disclosure. See Public Law No. 110-322, 122 Stat. 3537 (2008).

(n41)Footnote 41. SEC Enforcement Manual Section 4.3.

(n42)Footnote 42. *In re Columbia/HCA Healthcare Corp. Billing Practices Litigation v. Columbia/HCA Healthcare Corp.*, 293 F.3d 289, 294-95 (6th Cir. 2002) ("[U]nfortunately, 'the case law addressing the issue of limited waiver [is] in a state of hopeless confusion.'"), citing *In re M&L Business Machine Co. Inc.*, 161 B.R. 689, 696 (D. Col. 1993) .

(n43)Footnote 43. *Permian Corp. v. United States*, 665 F.2d 1214 (D.C. Cir. 1981) ; *In re Subpoenas Duces Tecum to Fulbright & Jaworski*, 738 F.2d 1367, 1370 (D.C. Cir. 1984) ; *In re Penn Central Commercial Paper Litigation*, 61 F.R.D. 453,463-467 (S.D.N.Y. 1973) . *Permian* held documents given to the SEC to expedite the processing of a registration statement discoverable by the Department of Energy because "Important though the SEC's mission may be, we are aware of no congressional directive or judicially-recognized priority system that places a higher value on cooperation with the SEC than on cooperation with other regulatory agencies, including the Department of Energy." 665 F.2d at 1222 . *Fulbright & Jaworski* held the privilege waived by disclosure to the SEC even though the transmittal letter had stated that the documents were confidential and that their delivery to the SEC was not a waiver of the privilege. However, the court suggested that a "promise of confidentiality before disclosure to the SEC" would have made for a different result. 738 F.2d at 1375 . *Penn Central* ordered the production of an attorney's testimony before

the SEC as well as documents given the Commission. *See also, In re Sealed Case*, 676 F.2d 793 (D.C. Cir. 1982) (requiring production of documents missing from file turned over to the SEC); *In re Weiss*, 596 F.2d 1185, 1186 (4th Cir. 1979) (attorney who had testified before the SEC "would be questioned by the grand jury regarding the areas and subject matter touched on by his testimony before the SEC").

(n44)Footnote 44. *Diversified Industries, Inc. v. Meredith*, 572 F.2d 596, 611 (8th Cir.1977) (*en banc*): "As Diversified disclosed these documents in a... nonpublic SEC investigation, we conclude that only a limited waiver of the privilege occurred... To hold otherwise, may have the effect of thwarting the developing of procedures of corporations to employ independent outside counsel to investigate and advise them in order to protect stockholders, potential stockholders and customers." *See also In re Grand Jury Subpoena*, 478 F. Supp. 368 (E.D. Wis. 1979) ; *Byrnes v. IDS Realty Trust*, 85 F.R.D. 679 (S.D.N.Y. 1980) ; *Salomon Bros. Treasury Litig. v. Steinhardt Partners L. P.*, 9 F.3d 230, 235 (2d Cir. 1993) .

(n45)Footnote 45. H.R. 2179, 108th Cong. (2003). *Id.*

(n46)Footnote 46. However, disclosure to the SEC runs the risk of waiving the attorney-client privilege as to the disclosed information, increasing an individual's liability in a subsequent private action. *See, e.g., SEC v. Beacon Hill Asset Management, Inc.* 231 F.R.D. 134 (S.D.N.Y. 2004) (holding that the SEC's contention regarding waiver of attorney-client privilege is overbroad and not in line with established precedent).

(n47)Footnote 47. *Teachers Insurance & Annuity Ass'n of America v. Shamrock Broadcasting Co., Inc.*, 521 F. Supp. 638, 645 (S.D.N.Y. 1981) .

(n48)Footnote 48. *See, e.g., In re Columbia/HCA Healthcare Corp. Billing Practices Litigation v. Columbia/HCA Healthcare Corp.*, 293 F.3d 289, 294-95 (6th Cir. 2002) (plaintiffs in multidistrict action against health services provider entitled to documents health services previously provided to the federal government); *In re Steinhardt Partners, L.P.*, 9 F.3d 230, 233 (2d Cir.1993) (noting a circuit split on the issue of selective waiver) (holding that trader's voluntary submission of legal memorandum to Securities and Exchange Commission (SEC), with whom trader stood in adversarial position as subject of SEC investigation in connection with which memorandum was sought, waived protections of work product doctrine in subsequent class action); *In re John Doe Corp.*, 675 F.2d 482, 489 (2d Cir. 1982) (rejecting the limited waiver doctrine in a grand jury proceeding where previous disclosure was to a non-governmental agency) (noting that the attorney-client privilege "is an exception to the critically important duty of citizens to disclose relevant evidence in legal proceedings [and that it] does not shield communication which serve purposes other than those which led to judicial recognition of the privilege").

(n49)Footnote 49. *Osterneck v. E.T. Barwick Industries, Inc.*, 82 F.R.D. 81, 85-87 (N.D. Ga. 1979) : ("They were not retained... for their legal expertise. They were retained to conduct an investigation... as a result of a complaint being filed by the SEC") An agreement with the SEC that disclosure to the special counsel would "not be deemed... a waiver of any privilege which may have previously attached" was found beside the point essentially because the privilege had never attached.

(n50)Footnote 50. *SEC v. Canadian Javelin, Ltd.*, 451 F. Supp. 594, 596 (D.D.C.) , *vacated and remanded*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 96,742 (D.C. Cir. 1978).

(n51)Footnote 51. *In re LTV Securities Litigation*, 89 F.R.D. 595, 618 (N.D.Tex. 1981) . The court also observed that "allowing the type of discovery requested here may kill the goose that lays the golden egg--the Commission may be deprived of a useful enforcement option, while shareholders will hardly be benefited by inhibiting corporate self-investigation." *Id.* at 619 .

(n52)Footnote 52. *In re Leslie Faye Cos. Sec. Litig.*, 161 F.R.D. 274 (S.D.N.Y. 1995) ; *In re Kidder Peabody*, 168 F.R.D. 459

(n53)Footnote 53. The doctrine stems from *Hickman v. Taylor*, 329 U.S. 495, 34 Ohio Op. 395 (1947) . See also *Upjohn Co. v. United States*, 449 U.S. 383, 397-402 (1981) ; *United States v. Nobles*, 422 U.S. 225, 236-240 (1975) ; *U.S. v. Deloitte LLP.*, No. 09-5171, 610 F.3d 129 (D.C. Cir. June 29, 2010) .

(n54)Footnote 54. *In re International Systems & Controls Corp. Securities Litigation*, 91 F.R.D. 552, 557 (S.D. Tex. 1981) , vacated on other grounds, 693 F.2d 1235 (5th Cir. 1982) ; *In re LTV Securities Litigation*, 89 F.R.D. 595, 612 (N.D. Tex. 1981) ; *Panter v. Marshall Field & Co.*, 80 F.R.D. 718, 724 (N.D. Ill. 1978) . But see *In re Grand Jury Proceedings*, 73 F.R.D. 647, 653-54 (M.D. Fla. 1977) ("Where the work-product materials in question were prepared for a distinct and prior criminal litigation, long completed, the policies underlying the work-product privilege have already been achieved").

(n55)Footnote 55. *In re International Systems & Controls Corp. Securities Litigation*, n.40 *supra*, at 557 ; *In re LTV Securities Litigation*, n.40 *supra*, at 612 (anticipation of suit by federal agency protects material in later shareholder suit.).

(n56)Footnote 56. *In re Qwest Communications Int'l. Inc.*, 450 F.3d 1179 (10th Cir. 2006) (holding that corporation waived privilege when it disclosed documents to the SEC and a selective waiver was not applicable).

(n57)Footnote 57. See *United States v. Abrams*, 357 F.2d 539 (2d Cir.) , cert. denied, 384 U.S. 1001 (1966) (discussing grants of immunity under a now repealed provision of the Exchange Act).

(n58)Footnote 58. 18 U.S.C. §§ 6001-6005 *et. seq.*

(n59)Footnote 59. 18 U.S.C. § 6004.

(n60)Footnote 60. 18 U.S.C. § 6002.

(n61)Footnote 61. See *Kastigor v. United States*, 406 U.S. 441 (1972) .

(n62)Footnote 62. The Attorney General can delegate immunity power to subordinates. See *In re Application of President's Commission on Crime*, 763 F.2d 1191,1199-1200 (11th Cir. 1985) .

(n63)Footnote 63. *Dresser Industries, Inc. v. United States*, 596 F.2d 1231 (5th Cir. 1979) , cert. denied, 444 U.S. 1044 (1980) ("no statute authorized agents of the SEC to grant immunity from prosecution or to curtail the prosecutorial discretion of the Department of Justice and United States Attorneys"); accord, SEC, Division of Enforcement, "Enforcement Manual," § 6.2.5, Jan. 13, 2010.

(n64)Footnote 64. 18 U.S.C. § 1621;

(n65)Footnote 65. *Boehm v. United States*, 123 F.2d 791 (8th Cir. 1941) , cert. denied, 315 U.S. 800 (1942) .

(n66)Footnote 66. *Woolley v. United States*, 97 F.2d 258 (9th Cir.) , cert. denied, 305 U.S. 614 (1938) .

(n67)Footnote 67. 97 F.2d 258 .

(n68)Footnote 68. See *United States v. Tallant*, 547 F.2d 1291 (5th Cir.) , cert. denied, 434 U.S. 889 (1977) .

(n69)Footnote 69. See *United States v. Thayer*, 17 B.N.A. Sec. Reg. & L. Rep. 841 (D.D.C. 1985); *United States v. Alo*, 439 F.2d 751 (2d Cir.) , cert. denied, 404 U.S. 850 (1971) .

(n70)Footnote 70. *SEC v. Rind*, 991 F.2d 1486, 1492 (9th Cir. 1993) .

(n71)Footnote 71. *SEC v. Calvo*, 378 F.3d 1211 (11th Cir. 2004) .

(n72)Footnote 72. *3M Co. v. Browner*, 17 F.3d 1453 (D.C. Cir. 1994) .

(n73)Footnote 73. *Johnson v. SEC*, 87 F.3d 484 (D.C. Cir. 1996) .

(n74)Footnote 74. *SEC v. PacketPort.com*, No. 3:05-CV-1747 (JCH), 2006 U.S. Dist. LEXIS 73638 (D. Conn. Sept. 27, 2006) .

(n75)Footnote 75. *421 F. Supp 2d 781* (S.D.N.Y. 2006) .

(n76)Footnote 76. *15 U.S.C. § 78u-3(c)(3)*.

(n77)Footnote 77. *See SEC v. HealthSouth Corp.*, SEC Litig. Rel. No. 18044 (Mar. 20, 2003), *available at* www.sec.gov/litigation/litreleases/lr18044.htm.



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Federal Securities Exchange Act of 1934

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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.10

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§ 9.10 Administrative Proceedings

[1] Broker-Dealers

Under Section 15(b)(4) of the Exchange Act, the Commission can terminate a broker-dealer's registration, limit a broker-dealer's activities, or censure a broker-dealer if the Commission finds, on the record, after notice and an opportunity for a hearing that certain specified offenses have been committed and that such disciplinary action is in the public interest.

While Section 15(b)(4) applies only to firms, Section 15(b)(6) gives the Commission similar authority over "any person associated or seeking to become associated, with a broker or dealer." n1 In practice, however, the Commission does not use that section to proceed administratively against people who are neither associated nor seeking association with broker-dealers, but it may use it to proceed against people formerly associated with brokers or dealers if they committed violations while so associated. n2

These sections of the Exchange Act provide that the commission cannot "suspend [a broker-dealer's activities] for a period ... exceeding twelve months." n3 Despite this language, sanctions tantamount to suspensions for longer periods are commonplace. The commission achieves this result by barring the respondent from the industry with the express provision that he or she may apply for permission to return to it after two, three, or five years. n4

Though broad, the Commission's discretion with respect to disciplinary sanctions is not unlimited and is subject to judicial review. n5 Although the Commission has argued that harsh sanctions can be used to deter others, n6 severe sanctions require cogent explanations. n7

With respect to disciplinary actions taken by the securities industry's self-regulatory organizations, the Commission's jurisdiction is purely appellate. n8 This jurisdiction is normally invoked by an aggrieved respondent, but the Commission may review on its own motion. n9

The standard of review depends on the nature of the issue. If the contention is that there was no violation, the Commission must make its own de novo finding. n10 When the appropriateness of the sanction is at issue, the

Commission must affirm unless it finds the penalty "excessive or oppressive." n11

[2] Stop Orders

Stop orders suspend the effectiveness of registration statements under the Securities Act. n12 They must be supported by findings of material misstatements or omissions made after notice and opportunity for a hearing. n13 No showing of an intent to deceive is needed. The essential issue is the accuracy of the filing, not the good faith of those who prepared it. n14 This does not mean that mitigating factors are totally irrelevant. n15 They may lead the Commission to withhold a stop order on condition that its opinion be distributed to all security holders. n16

Regulation A and other exemptive regulations under the Securities Act provide for proceedings akin to stop orders. n17 They differ procedurally from stop orders in that the proceeding begins with an order temporarily suspending the claimed exemption. The suspension order will be vacated if shown after hearing to be erroneous or unwarranted. If the Commission finds the allegations in the temporary order well founded and if it is not persuaded that vacation would be appropriate, the suspension becomes permanent. n18

[3] National Securities Exchanges

Section 19 of the Exchange Act authorizes administrative proceedings against national securities exchanges. n19

[4] Suspension of Trading

Section 12(k) of the Exchange Act permits the SEC summarily to suspend trading in any security for a period not exceeding ten days, if, in its opinion, the public interest and the protection of investors so require. In *SEC v. Sloan*, n20 the Supreme Court held that "ten days" means ten days. The Court unanimously rejected the Commission's long standing position that the statute authorized a series of summary suspension orders based on a single set of circumstances. Prolonged trading suspensions are still possible, but notice, an opportunity for a hearing, and findings on the record are essential. n21 Summary suspensions of trading, which were frequent before *Sloan*, are now quite rare.

[5] Lawyers, Accountants and Other Professionals

Prior to the passage of the Sarbanes-Oxley Act, the SEC had no explicit authority to discipline professionals. It believed, however, that it had the inherent power to do so. The "peculiarly strategic and especially central role of the private [practitioner] n22 in the investment process and in the enforcement of the body of federal law aimed at keeping that process fair" requires that persons who practice before it be held "to appropriately rigorous standards of professional honor." n23

Any doubt as to the SEC's statutory authority was erased by the passage of the Sarbanes-Oxley Act. Section 602 added a new Section 4C to the Exchange Act n24 which, in effect, adopts the SEC's Rule 102(e). n25 Under Section 4C and Rule 102(e), the SEC may sanction, by way of censure or the denial of the privilege to practice before it, a professional whom it finds fails to possess the requisite qualifications to represent others, engages in improper professional conduct or willfully violates (or aids and abets a violation of) the Federal securities laws. With respect to accountants, the definition of "improper professional conduct" specifies the mental state required for a violation and states that the standard for professional conduct is evaluated based on applicable professional standards. n26 This definition is the same as that adopted by the SEC in 1998 in response to judicial criticism that the SEC had not promulgated intelligible standards for this term. n27

No court has ruled on whether former Rule 102(e), as modified in 1998, meets constitutional standards, and skeptics continued to wonder about the adequacy of Rule 102(e)'s legal basis. n28 Regardless, courts continue to uphold SEC orders penalizing professionals pursuant to Rule 102(e). n29 With respect to anything other than constitutional concerns, it would seem that the Sarbanes-Oxley Act resolved these doubts. Critics also raise policy questions about the

desirability of a practice under which an agency that they consider prosecutorially oriented determines who can and who cannot practice before it. They maintain that this can have a chilling effect on advocacy and on the vigorous assertion of legitimate positions with which the Commission or its staff happen to disagree.

Other objections go to the scope of such terms as "practice before the Commission," "lacking in character or integrity" and "the requisite qualifications to represent others." n30 The Commission's view that anybody who gives advice about any question relating to the federal securities laws is practicing before it n31 has been criticized as overbroad. n32 The other quoted phrases give the Commission similarly broad latitude. Vicarious responsibility for another's ethical infractions is another point of contention. A question arises as to whether an entire firm should be held accountable for the derelictions of one or two partners or associates. n33

Firms usually stand behind their partners. Fully litigated Rule 2(e) cases are very rare and the Commission assesses the extent of the firm's involvement when it imposes sanctions. Thus, for example, in *In the Matter of Ernst & Ernst*, the firm was censured while two of its partners were suspended for varying periods. Moreover, that opinion observed that the firm had not tried to disassociate itself from the partners involved so that "the question of whether there might be circumstances in which it would be inappropriate to attribute the unprofessional conduct of a partner in a... firm to that firm" was not raised. n34

The Commission answered by pointing to considerations similar to those stated at the outset of this section, to such institutional safeguards against abuse as prosecution by the presumably more detached General Counsel's Office rather than by the Division of Enforcement, to what it views as its historical record of fairness and to the availability of judicial review. n35 The Rule created a presumption in favor of the proceedings being public, although this was not always the case. n36 There were years of debate before the change was made; until the change, the proceedings were normally nonpublic. n37 There was also significant opposition from the bar. n38

Some Rule 102(e) proceedings are "derivative," *i.e.*, they are based on other cases. Criminal convictions, disbarments or other disciplinary actions, injunctions obtained by the Commission, or findings of willful violation of the federal securities laws by a court or by the Commission itself in an earlier administrative proceeding can lead to *ex parte* temporary suspensions from practice n39 before the Commission. n40 The suspended professional must then petition for an order lifting the suspension. That normally leads to a hearing on the question of whether the suspension should be made permanent. Since collateral attacks on the result in the predicate proceeding are prohibited and since the burden is on the petitioner to show cause why the Commission should not disbar him, there is little the petitioner can do at the hearing but plead for leniency. n41

Derivative Rule 102(e) proceedings are not automatic. Their institution is discretionary with the Commission. Accordingly, settlements in predicate proceedings against professionals sometimes provide that they will not be used for Rule 102(e) purposes. n42

[a] Attorney Reporting Requirements. On January 29, 2003, pursuant to its mandate under Section 307 of the Sarbanes-Oxley Act, the Commission promulgated a set of rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of issuers. n43 As mandated by Congress, the heart of these rules is a requirement that an attorney who "becomes aware of evidence of a material violation by the issuer" or any officer, director, employee or agent of the issuer must report such evidence "up the ladder"--to some combination of the chief legal officer, chief executive officer, or a committee of the board of directors. n44 Violations of these duties subject the attorney to potential civil penalties and other remedies available to the Commission in court proceedings for violating the securities laws, and may also subject the attorney to disciplinary proceedings under Rule 102(e). n45 Moreover, Section 307 represents another example of the extraterritorial reach of Sarbanes-Oxley, because the provision applies equally to foreign and domestic attorneys. n46 The most controversial proposal, one requiring "noisy withdrawal" by attorneys whose "up the ladder" reporting meets with an unsatisfactory response, received extensive criticism and commentary. n47 As a result, the SEC extended the comment period and

invited further discussion. The comment period for the "noisy withdrawal" proposal, however, expired on April 7, 2003 and the proposal has never been adopted.

The Commission has not aggressively sought enforcement actions against attorneys under Section 307 since then. In one case, *SEC v. Spiegel*, the court did reference Section 307 of the Sarbanes-Oxley Act.ⁿ⁴⁸ The reference however, was more of a warning than an application, because the conduct at issue occurred prior to the passage of Sarbanes-Oxley. In addition, it is clear that the SEC does not consider Section 307 to provide a private right of action against an attorney.ⁿ⁴⁹ The Commission has, by these rules, extended its reach into areas of attorney discipline previously reserved primarily to the states.ⁿ⁵⁰ The passage of Section 307 has not led to a dramatic increase in SEC enforcement actions and litigation against attorneys.ⁿ⁵¹

[b] Regulation of Accountants--The Public Company Accounting Oversight Board. Title I of the Sarbanes-Oxley Actⁿ⁵² created a new entity, the Public Company Accounting Oversight Board ("PCAOB" or "Board"), "to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors."ⁿ⁵³ The PCAOB is not a federal agency but is rather a private, not-for-profit corporation that for most purposes should be considered a self-regulatory organization ("SRO") similar to the exchanges.

While the Sarbanes-Oxley Act carefully states that the creation of the PCAOB in no way detracts from the Commission's authority to directly regulate auditors and auditing standards,ⁿ⁵⁴ the PCAOB has become a major source of regulations of accounting firms and accountants. For example, in the PCAOB's first year of operation alone, compliance with PCAOB regulations pursuant to the Sarbanes-Oxley Act cost U.S. firms more than \$35 billion.ⁿ⁵⁵

The PCAOB consists of five members appointed by the Commission in consultation with the Federal Reserve Chairman and the Secretary of the Treasury.ⁿ⁵⁶ Two of the five members must be or must have been certified public accountants.ⁿ⁵⁷ Each member serves for five years (in staggered terms), subject to removal for cause prior to expiration of his or her term by the Commission.ⁿ⁵⁸ As required by Section 101(d) of the Sarbanes-Oxley Act,ⁿ⁵⁹ on April 25, 2003, the PCAOB was certified by the Commission to be sufficiently organized to begin fulfilling its duties under the Act.ⁿ⁶⁰ In 2010, the Supreme Court addressed the constitutionality of the PCAOB and found it to be constitutional except for the removal procedures of PCAOB members.ⁿ⁶¹ Those procedures were changed and now allow for the removal of PCAOB members at will by the SEC.ⁿ⁶²

Effective October 22, 2003, all public accounting firms participating in the audit of any issuer must be registered with the PCAOB.ⁿ⁶³

The PCAOB's enforcement powers in many ways parallel those of the Commission, and consist of both regular inspectionsⁿ⁶⁴ of registered firms (and associated persons) and investigative and disciplinary powers.ⁿ⁶⁵ On October 7, 2003, the PCAOB issued its final rules with respect to both inspections and investigations;ⁿ⁶⁶ Pursuant to 15 U.S.C. § 7217(b)(2), these rules went into effect with the Commission's approval on June 18, 2004.ⁿ⁶⁷ The overall structure of inspections and investigations is largely laid out in the Sarbanes-Oxley Act itself.

With respect to inspections, the PCAOB must conduct regular inspections at a frequency dependent upon the number of audits performed by a registered firm; annual inspections are required for firms that regularly audit at least 100 issuers, while other firms must be inspected at least once every three years--subject to potential adjustment by PCAOB rulemaking and the ability of the PCAOB to conduct special inspections.ⁿ⁶⁸ Inspections must include inspection and review of selected audit engagements of each firm, evaluation of the firm's quality control and communication systems, and such other testing as the PCAOB determines to be necessary.ⁿ⁶⁹ Firms are given the opportunity to review and comment on inspection reports prior to their transmittal to the Commission.ⁿ⁷⁰ Critical comments by the Board about a firm's quality control systems will not be made available to the public, provided that the firm takes corrective action

within twelve months of the date of the report. n71

The PCAOB has the power to investigate any act, practice, or omission by a registered public accounting firm, or any associated person, that may violate the Sarbanes-Oxley Act, the rules of the Board, or the securities laws or rules or regulations issued thereunder insofar as they relate to audit reports. n72 The PCAOB has, like the Commission, provided for both informal and formal investigations, the latter initiated by an order of formal investigation issued by the Board. n73 While the Board has the power to compel testimony and production of documents by a registered firm or associated person, it must request the Commission to issue subpoenas to any other persons. n74 Failure of a registered firm or associated person to cooperate with an investigation may lead to disciplinary proceedings by the Board resulting in sanctions, including suspension and revocation of registration. n75

The Board may initiate disciplinary proceedings by a formal order notifying the registered firm or associated person of the specific charges. n76 The PCAOB has adopted a form of "Wells submission" procedure n77 by which targets of informal or formal investigations may submit a statement of position that will be forwarded to the Board along with any staff recommendation for initiation of disciplinary proceedings. n78 Hearings will normally be non-public, n79 and will typically be conducted before a hearing officer who will make a final recommendation as to disposition to the Board itself. n80

The Board may impose sanctions for intentional or reckless violations, or repeated negligent violations, including (1) temporary suspension or permanent revocation of registration; (2) temporary or permanent bar of a person from association with a registered firm; (3) temporary or permanent limitations on the activities of a firm or associated person; and (4) civil monetary penalties of up to \$750,000 for a natural person or \$15,000,000 for any other person. The Board may also impose the following sanctions for *any* violation: (1) a civil penalty of up to \$100,000 for a natural person or \$2,000,000 for other persons; (2) censure; (3) mandatory additional professional education or training; or (4) other sanctions provided for by rules of the Board. n81 Sanctions by the PCAOB are appealable to the Commission in the same manner as sanctions by other SRO's n82 and an appeal operates as an automatic stay of such sanctions until and unless the stay is lifted by the Commission. n83

[c] Regulation of Credit-Ratings Agencies. Credit-ratings agencies were widely criticized as contributing to the 2008-2009 Global Financial Crisis, because credit-ratings agencies were viewed as having failed to accurately identify the riskiness of complex financial products such as mortgage-backed securities. Indeed, in the post-crisis aftermath, many believe that the underlying assumptions and methodologies used by the credit-ratings agencies were overly optimistic. Further, some alleged that the ratings agencies' over-optimism was driven, in whole or in part, by conflicts of interest inherent in the relationship in which the ratings agencies are paid directly by the issuers they are rating.

As a result, the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* imposes sweeping reforms of the credit-ratings industry. The Dodd-Frank Act establishes an "Office of Credit Ratings" within the SEC and imposes enhanced regulatory standards and reporting requirements for ratings agencies. Ratings agencies will now be examined by the SEC annually, and the key findings of these examinations will be publicly available. n84 Additionally, credit-ratings agencies will have to disclose their methodologies and assumptions, n85 their use of third parties to conduct due diligence, n86 and their ratings track record. Furthermore, credit-ratings agencies must not permit certain employees from performing functions for an issuer that may create a conflict of interest--namely, persons engaged in sales and marketing efforts to issuers should be separated from those responsible for making the rating. n87 Finally, Dodd-Frank ends the practice of "ratings shopping" by issuers. Importantly, Dodd-Frank creates a private right of action for "expert liability" against any credit ratings agency for knowing or reckless failures to conduct a reasonable investigation of the underlying facts concerning the product being rated or to obtain analysis from independent sources. n88

Regarding corporate governance, credit-ratings agencies are now required to have a board of directors that is comprised of at least 50% independent directors. The board of directors will be charged with oversight of conflicts of interest,

compliance, compensation, and promotion. Further, each credit agency is required to have a compliance officer who is not permitted to perform credit ratings or engage in any sales or marketing efforts. n89 The compliance officer's compensation may not be tied to the overall performance of the ratings agency. n90 The compliance officer will be responsible not only for maintaining and implementing internal controls, such as the establishment of procedures to effectively investigate external complaints and protect internal whistleblowers, but also for the filing of annual reports with the SEC addressing the credit-ratings agency's internal controls and compliance with the securities laws. n91

Because many of the necessary rules and procedures implementing the regulation of credit-ratings agencies under the Dodd-Frank Wall Street Reform Act have not yet been developed, it is unclear the extent to which credit-ratings agencies will find themselves subject to SEC enforcement proceedings. However, it is clear that Congress intends to make credit-ratings agencies subject to, and liable for breaches of, the federal securities laws.

[6] Reports of Investigation

Section 21(a) of the Exchange Act authorizes the Commission to publish reports about violations of the statutes it administers. These reports, which are not adjudications, enable the Commission to publicize its concerns about practices it thinks objectionable. Section 21(a) supplies the Commission with a viable middle ground between total inaction and litigation before itself or in the courts. n92 Although the absence of any need to meet the standards of proof that govern adjudication creates a potential for abuse, n93 affected private persons generally prefer a report under Section 21(a) to litigation in which they risk findings of misconduct and administrative or judicial sanctions. n94 Moreover, Section 21(a) permits the private persons to tell their side of the story. n95

Section 21(a) reports were intended to deal with inquiries of great public concern. n96 The Commission used a Section 21(a) report in 1943 to articulate the concerns that had led it to adopt its then new *Rule 10b-5* under the Exchange Act and to make what appears to have been its first statement about insider trading. n97 Section 21(a), however, has never been confined to "great cases." It has been used in lesser matters where malpractices were cured and mitigating circumstances present. n98 An undertaking to distribute copies of the Commission's report to shareholders can be helpful in borderline situations of this character. n99

Suggestions that this procedure be followed can be made in negotiations with the staff and in Wells submissions to the Commission. n100 Counsel should consider Section 21(a) when confronted by a case in which it may be best to concede that "something" ought to be done but where counsel can also point to flaws in the Commission's litigating posture. The more doubtful the Commission's chance of success in the arena, the greater the likelihood that Section 21(a) will be found the remedy of choice. n101

[7] Rules of Practice Applicable to Administrative Proceedings

[a] Notice of Proceedings. Parties entitled to notice must be informed of the time and nature of the hearing and supplied with a short and simple statement of the matters of fact and law to be considered and determined. n102 The document in which this is done is known as the "Order for Proceedings." It is analogous to a complaint in a civil action. Though orders for proceedings are prepared by the Division of Enforcement and though they consist in the main of the Division's allegations, the staff has no authority to issue them. They are issued by the Commission itself. n103 They are called "orders" because they direct that a hearing be held to determine whether the allegations are true and what, if any, remedial action should be taken.

A pre-hearing motion to dismiss orders for proceedings for legal insufficiency can be made. n104 As a practical matter, the movant must show a want of administrative jurisdiction. n105 An order denying a motion to dismiss a proceeding before any evidence has been taken is not reviewable in the courts of appeals because it is not "final agency action." n106

Courts are loath to interfere at the pre-hearing stage. Like the decision to investigate, n107 the decision to go forward with an administrative adjudication is interlocutory, committed to agency discretion, and immune from judicial review. n108 However, the rule may be different when pre-hearing dismissal is sought solely on jurisdictional grounds and the only question presented is one of statutory interpretation. n109

[b] Failure to Appear. If any person against whom findings may be made or sanctions imposed fails to appear at a hearing, of which he or she has been duly notified, that person may be deemed in default and the proceedings may be determined against him. n110

[c] Answers. In any order for proceedings issued by the Commission, the Commission may direct that an answer be filed. Failure to file an answer shall be deemed a default and the proceeding may be determined against any such person. n111

[d] Settlements. Parties may propose offers of settlement in writing that shall be considered by the staff of the Commission where time, the nature of the proceedings and the public interest permit. If the staff recommends approval, the offer and the staff recommendation go to the Commission. n112

Offers that the staff recommends are generally viewed with favor by the Commission. But counsel must remember that only the Commission can accept an offer of settlement. n113 Once in a great while it concludes that the staff settled too cheaply. In that event, the offeror must choose between litigation on the merits and a revised offer acceptable to the Commission. n114

On the other hand, the staff's objection to an offer is not determinative. The offeror, although not permitted to approach the Commission directly, may insist that the staff present the offer to the Commission. n115 Strong showings with respect to the equities of the matter and forceful presentations of mitigating circumstances occasionally lead the Commission to accept settlements to which its staff objects. n116

Offers of settlement that the Commission rejects are deemed withdrawn and documents relating to them do not become part of the record. n117

[e] Evidence. All witnesses shall testify under oath. Every party has the "right to present its case or defense by oral or documentary evidence, to submit rebuttal evidence and to conduct such cross-examination as in the discretion of the Commission or the hearing officer may be required for a full and true disclosure of the facts." n118 The scope and form of evidence, rebuttal and cross examination are determined by the Commission or the hearing officer. n119

The rules of evidence that govern jury trials, however, are not controlling. The Commission's general policy with respect to admissibility is extremely liberal and favors the receipt of anything that "can conceivably throw any light upon the controversy." n120 Hence, objections based solely on the hearsay rule are unlikely to be sustained. n121 However, counsel should not hesitate to assert privileges and to object to the form of questions.

[f] Right to Counsel. A party to an SEC administrative proceeding has a right to be represented by counsel in the proceeding, n122 but indigents have no right to appointed counsel. n123

[g] Initial Decisions. An initial decision shall include factual findings and conclusions of law with the reasons or basis thereof, on all material issues. The initial decision becomes the final decision of the Commission unless a petition for review is filed. n124

Initial decisions can be waived with the consent of all parties and the hearing officer. Because the staff is a party, its consent is essential. Although the parties' wishes usually govern, the Commission can:

- order an initial decision, even if the parties chose to waive it; n125 or

- direct that the initial decision be omitted if it "finds on the record that due and timely execution of its functions imperatively and unavoidably so requires." n126

[h] Review by the Commission and by the Courts of Appeals. Parties dissatisfied with the initial decision must normally file petitions for review within 21 days after service of the initial decision. n127 These need not be elaborate and are invariably granted. n128 However, objections to the initial decision that are not stated in the petition for review may be disregarded. n129 Hence, care should be taken to articulate all points that seem worth raising.

After the petition has been granted, briefs are filed n130 and, although they are not favored, oral argument may be requested. n131 Commissioners who were not present at the argument can participate in the decision. n132 Appeals from the Commission's decisions can be taken to the Court of Appeals for the circuit in which the aggrieved person resides or has his principal place of business, or to the United States Court of Appeals for the District of Columbia Circuit. n133 As previously noted, the Commission is represented on appeal by the General Counsel and his or her staff. In addition, lawyers from the Division of Enforcement often participate and are free to act as advocates at any stage of the proceeding.

Of course, this freedom does not extend to adjudication. n134 The "decisional employees" who assist in the preparation of the SEC's opinions and orders n135 have no prior association of any sort with the controversies described in the opinions and orders they help to draft. n136 When it decides cases, the Commission adheres scrupulously to the Administrative Procedure Act's separation of functions mandate. n137

Some consider this a mere ritual since the Commission's contacts with its enforcement staff are daily and intimate and the Commissioners authorized the formal investigation and voted to institute the proceeding. n138 However, American administrative law assumes that agency members can and will put their prior contacts with a case to one side when they sit as adjudicators. n139 Administrative lawyers and students of the administrative process differ about the realism of this assumption. With respect to SEC enforcement jurisprudence, it is true that the staff's batting average before the Commission is very high. However, it must be remembered that the cases are on the whole well prepared and abundantly supported by the record. n140

[i] Standard of Proof and Scope of Judicial Review. The preponderance of the evidence test controls, even in fraud cases. n141 In the Court of Appeals, the Commission's findings of fact are conclusive, "if supported by 'substantial evidence.'" n142 Though that is on the whole a deferential standard, n143 courts do not hesitate to reverse SEC factual determinations they consider farfetched or dubious. n144

The Commission is sensitive to this. It does not like reversals and is genuinely concerned about the fairness of its proceedings. Hence, arguments before the Commission that persuasively emphasize factual weaknesses in the staff's case often succeed. n145

[8] Assessment of Monetary Penalties

[a] Imposition of a Penalty. In proceedings instituted pursuant to Sections 15(b)(4), 15(b)(6), 15B, 15C, or 17A of the Exchange Act, Section 9(b) of the Investment Company Act, and Section 203(e)-(f) of the Investment Advisers Act, the Commission (or the appropriate regulatory agency) is empowered to impose civil penalties if it finds, on the record after notice and an opportunity for a hearing, that the penalty is in the public interest, and the respondent willfully committed one of the following violations:

- violation of any provision of the Securities Act, the Investment Company Act, the Investment Advisers Act, or the Exchange Act, the rules or regulations there under, or the rules of the Municipal Securities Rulemaking Board;

2-9 Federal Securities Exchange Act of 1934 § 9.10

- aiding, abetting, counseling, commanding, inducing, or procuring such a violation by another person;
- making or causing to be made in any registration statement, application for registration or report required to be filed, or proceeding before the Commission with respect to registration, any statement which was (at the time and in light of circumstances under which it was made) false or misleading with respect to any material fact;
- omitting to state in any such registration, application, or report any material fact which is required to be stated therein; or
- failing to reasonably supervise (within the meaning of Section 15(b)(4)(E) of the Exchange Act or Section 203(e)(5) of the Investment Advisers Act, with a view to preventing violations of the provisions of such statutes rules and regulations) another person who commits such a violation, if such other person is subject to the respondent's supervision. n146

In considering whether a penalty is "in the public interest," the Commission (or appropriate regulatory agency) may consider the following factors: n147

- whether the act or omission involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; n148
- the harm to other persons resulting either directly or indirectly from the act or omission; n149
- the extent to which "any person" was unjustly enriched, taking into account any restitution made to injured persons; n150
- whether the respondent previously has been found by the Commission, another appropriate regulatory agency, or self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization; has been enjoined by a court of competent jurisdiction from violating such laws or rules; or has been convicted by a court of competent jurisdiction of violating such laws or of any felony or misdemeanor described in Section 15(b)(4)(B) of the Exchange Act or Section 203(e)(2) of the Investment Advisers Act; n151
- the need to deter the respondent and other persons from committing the acts or omissions n152; and
- such other matters as justice may require. n153

In considering whether a penalty is "in the public interest," the Commission or appropriate regulatory agency may, in its discretion, also consider evidence submitted by the respondent of such respondent's ability to pay the penalty. n154 Such evidence may relate to the respondent's ability to continue in business and the collectability of a penalty, taking into account any other claims of the United States or third parties upon the respondent's assets and the amount of the respondent's assets. n155 Additionally, the Commission may take into consideration whether or not the defendant cooperated with the investigation. n156 The Commission, however, is not permitted to impose a monetary penalty based solely upon the entry of an injunction or a criminal conviction. n157

[b] Maximum Amount of Penalty. The maximum penalty that may be imposed by the Commission depends upon whether the act or omission: n158

- involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;
- or

- directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to others or resulted in substantial pecuniary gain to the person who committed the act or omission. n159

If neither factor is present (a "first tier" penalty), the maximum amount of the penalty for each act or omission is \$6,500 for a natural person and \$65,000 for any other person. n160 If the first factor is present (a "second tier" penalty), the maximum amount of the penalty for each act or omission is \$65,000 for a natural person and \$325,000 for any other person. n161 If both factors are present (a "third tier" penalty), the maximum amount of the penalty for each act or omission is \$130,000 for a natural person and \$650,000 for any other person. n162 Under Section 308 of the Sarbanes-Oxley Act, these penalties may, under certain circumstances, be paid into a fund for restitution to defrauded investors. n163

[c] Accounting and Disgorgement. In any proceeding in which the Commission or appropriate regulatory agency may impose a penalty, the Commission or other agency may enter an order requiring accounting and disgorgement, including reasonable interest. n164 The purpose of disgorgement is to force the respondent to give up the amount by which he or she was unjustly enriched, rather than to compensate any victims for their loss. n165 Similarly, the Sarbanes-Oxley "fair funds" provisions enable the SEC to distribute, at its discretion, disgorgements (returns of wrongful profits) and penalties (fines) to defrauded investors. n166 The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, enacted on July 22, 2010, amended Section 308 of *Sarbanes-Oxley* to broaden the sources of funds available to the SEC for inclusion in compensation funds. It authorizes the SEC to, for the first time, allocate a portion of a civil penalty obtained as part of a settlement or judgment in any judicial or administrative action to a "disgorgement fund or other fund established for the benefit of the victims of [a securities] violation." n167

[9] Cease-and-Desist Proceedings

[a] Permanent Orders

[i] Authority to Enter. If the Commission finds, after notice and an opportunity for a hearing, that any person is violating, has violated, or is about to violate any provision of the securities laws (or any rule or regulation there under) the Commission may publish its findings and enter an order requiring a person to cease-and-desist from committing or causing such violation or a future violation of the same provision, rule, or regulation. n168 The cease-and-desist order may also require compliance (or steps to effect compliance) with the provision, rule, or regulation upon the conditions and within the time specified by the Commission. n169

The Commission's cease-and-desist authority allows the Commission to take remedial action in the form of injunctive relief without establishing the usual requirements for injunctive relief necessary in federal court. n170

The cease-and-desist order may issue against the violator or any other person who is, was, or would be a cause of the violation due to an act or omission such person knew or should have known would contribute to the violation. n171

The notice instituting the above must set a hearing date 30 to 60 days after service of the notice. n172 The Commission and the respondent may agree to an earlier or a later hearing date. n173

[ii] Accounting, Disgorgement and Civil Penalties. As with proceedings in which the Commission may impose a monetary penalty, n174 the Commission may enter an order requiring accounting and disgorgement, including reasonable interest, in any cease-and-desist proceeding. n175 Under the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, the SEC is now authorized to impose civil penalties against any person, not just SEC-regulated entities, in administrative cease-and-desist proceedings. n176

[iii] Officer and Director Bars. Pursuant to Section 1105 of the *Sarbanes-Oxley Act*, n177 the Commission may, in a cease-and-desist proceeding, prohibit any individual found in violation of the antifraud provisions of the securities

laws from acting as an officer or director of a registered issuer "if the conduct of that person demonstrates unfitness to serve" in that capacity. Prior to the Sarbanes-Oxley Act, this remedy was only available to the Commission in federal court (and then only for "*substantial* unfitness"). n178 The officer or director bar may be conditional or unconditional, and permanent or for such time as the Commission orders. The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* has expanded the scope of the collateral bar; previously, the SEC could only bar an individual from participating in the type of business the person was in when the violation occurred, now the SEC can bar a person from working in any aspect of the securities business. n179

[iv] Review of Permanent Orders. Review of permanent orders is governed by the procedure typically applicable to review of Commission proceedings. n180

[b] Temporary Orders

[i] Authority to Enter. The Commission also has the authority to enter temporary orders against certain respondents. n181 The Commission may enter a temporary order whenever it determines that the violation or threatened violation set forth in the notice instituting proceedings is likely to result any of the following prior to the completion of proceedings:

- significant dissipation or conversion of assets;
- significant harm to investors; or
- substantial harm to the public interest, including losses to the Securities Investor Protection Corporation. n182

The temporary order may require the respondent, pending the completion of proceedings on a permanent order, to cease-and-desist from the violation, and to take such action as the Commission deems appropriate to prevent the violation or threatened violation and to prevent the dissipation or conversion of assets, significant harm to investors, or substantial harm to the public interest. n183

The temporary order can be entered only after notice and an opportunity for a hearing unless the Commission (notwithstanding Section 40(a) of the Investment Company Act or Section 211(c) of the Investment Advisers Act) determines that notice and hearing prior to entry of the order would be impracticable or contrary to the public interest. n184 A temporary order issued *ex parte* is intended to be an extraordinary remedy, rather than a wholesale substitute for the other enforcement options available to the Commission. n185

Temporary orders are effective upon service. n186 Unless set aside or limited upon review, n187 the temporary order remains effective until the completion of the proceedings. n188

[ii] Review of Temporary Orders. A respondent who is served with a temporary order has two avenues of appeal--administrative and judicial--depending on when the appeal is sought and whether the respondent has had an opportunity for a hearing before the Commission.

If the respondent has not had a hearing prior to receiving a temporary cease-and-desist order, the respondent has 10 days from the date of service to request a hearing on an application to have the order set aside, limited, or suspended. n189 A hearing must then be held and a decision on such application must be rendered at the earliest possible time. n190

If the respondent has had a hearing prior to receiving a temporary cease-and-desist order, the respondent has 10 days n191 to apply to a United States district court for an order setting aside, limiting, or suspending the effectiveness or enforcement of the order. n192 The commencement of the judicial process does not stay the temporary order unless the court directs otherwise. n193 Venue for the application is proper in the district in which the respondent resides or has its

principal place of business, or in the District of Columbia. n194

A prerequisite to judicial review is a Commission hearing (whether held before or after the order is issued). n195 Therefore, if the respondent did not have a hearing prior to receiving a temporary order and failed to request a hearing within 10 days of service of the order, the respondent cannot judicially appeal the temporary order. n196 The respondent's only recourse would be an application to the Commission to have the order set aside, limited, or suspended, but without the possibility of either a hearing on the application or judicial review of the determination. n197

This procedure supplants Section 25 of the Exchange Act, Section 9(a) of the Securities Act, Section 43 of the Investment Company Act, and Section 213 of the Investment Advisers Act, and is the exclusive means by which a respondent can judicially appeal a temporary order. n198

[c] Enforcement of Cease-and-Desist Orders. A violation of a permanent and temporary cease-and-desist order is punishable by a court-imposed civil penalty and a mandatory injunction directing compliance with the Commission's order. n199 The consequences of failing to comply with a cease-and-desist order can be severe. Each day the respondent fails to comply with the cease-and-desist order constitutes a separate offense, punishable by up to \$500,000 per day (or higher, if the respondent's pecuniary gain from the violation is higher). n200

This ability to obtain such a civil penalty, plus the provision permitting the Commission to enter an order requiring accounting and disgorgement, n201 makes the cease-and-desist remedy more effective than a proceeding brought pursuant to Section 15(c)(4) of the Exchange Act. n202

FOOTNOTES:

(n1)Footnote 1. Similar proceedings may be conducted pursuant to Section 9(b) of the Investment Company Act and Sections 203(e) and (f) of the Investment Advisers Act of 1940. But the pertinent provision of the Investment Advisers Act, Section 203(f), is modeled on the Exchange Act and limits administrative proceedings there under to persons "associated or seeking to become associated" with investment advisers. *See In re Milton J. Wallace*, 45 SEC 694 (1975). The version of this section that was in effect from 1964 to 1975 was not limited to associated persons. It permitted administrative proceedings under the Exchange Act against "any person" and was sometimes used to publicize misconduct by people who had never been in the securities business. Proceedings of that character are still theoretically possible under the Investment Company Act because the older, unrestricted "any person" formulation survives in Section 9(b) of that statute.

(n2)Footnote 2. John Kilpatrick, Exch. Act Rel. No. 33-23251, 35 SEC Docket 914 (1986).

(n3)Footnote 3. Sections 15(b)(4) and 15(b)(6) of the Exchange Act and Sections 203(e) and 203(f) of the Investment Advisers Act.

(n4)Footnote 4. *See Arthur Lipper Corp. v. SEC*, 547 F.2d 171 (2d Cir.1976), cert. denied, 434 U.S. 1009 (1978), where the dissenting opinion to the order denying the rehearing referred approvingly to this practice.

(n5)Footnote 5. *Butz v. Glover Livestock Comm'n Co., Inc.*, 411 U.S. 182 (1973), suggests that this discretion is virtually unlimited. Hence the Commission cites *Butz* frequently, although it was not an SEC case. However, the specific disciplinary action there involved was a short suspension for what appears to have been a gross fraud. Even so, two justices dissented. *Id.* at 189-191.

(n6)Footnote 6. *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 184 (2d Cir. 1976), cert. denied, 434 U.S. 1009 (1978): "The purpose of... severe sanctions must be to demonstrate not only to petitioners but to others that the Commission will deal harshly with egregious cases." On the facts, however, the *Lipper* court found the severe sanction the Commission imposed an abuse of discretion. *Beck v. SEC*, 430 F.2d 673 (6th Cir. 1970), which held the

deterrence of others an illegitimate objective, has not been followed by other courts.

(n7)Footnote 7. *Steadman v. SEC*, 603 F.2d 1126, 1143 (5th Cir. 1979) , *aff'd on other grounds*, 450 U.S. 91 (1981) , remanding to the Commission for reconsideration of the sanction of exclusion and holding that "When the Commission imposes the most drastic sanctions at its disposal, it has a duty to articulate carefully the grounds for its decision, including an explanation of why lesser sanctions will not suffice."

(n8)Footnote 8. Section 19(d)(2) of the Exchange Act.

(n9)Footnote 9. Section 19(d)(1) of the Exchange Act and Rule 19d-1 there under require these bodies to report most of their final disciplinary actions to the Commission.

(n10)Footnote 10. Hence, the argument that self-regulation or cooperative regulation involves a constitutionally impermissible delegation of lawmaking power to private groups has been repeatedly rejected. *See Todd & Co. v. SEC*, 557 F.2d 1008 (3d Cir. 1977) ; *R.H. Johnson & Co. v. SEC*, 198 F.2d 690 (2d Cir.) , *cert. denied*, 344 U.S. 855 (1952) .

(n11)Footnote 11. Section 19(e)(2).

(n12)Footnote 12. Section 8(d) of the Securities Act. Section 8(b) provides for so-called "refusal orders with respect to filings deficient on their face." But the time constraints are so tight that this authority is not used in practice.

(n13)Footnote 13. Efforts to avoid the requisite findings by frustrating the inquiry are unavailing. The last sentence of Section 8(e) reads: "If the issuer or underwriter shall fail to cooperate or shall obstruct or refuse the making of an examination, such conduct shall be proper ground for the issuance of a stop order."

(n14)Footnote 14. *See In re Haddam Distillers Corporation*, 1 S.E.C. 37, 47(1934) ("stop order proceedings go only to the truth of the statements... made"); *In re Herman Hanson Oil Syndicate*, 2 SEC 743, 746 (1937) .

(n15)Footnote 15. *See, e.g., In re Franchard Corporation*, 42 S.E.C. 163, 174 (1964) : "We may, of course consider whether certain information could reasonably have been provided... But that issue is separate and distinct from the basic question of whether or not the absence of that information made the registration statement deficient under the statutory standards."

(n16)Footnote 16. *See In re Franchard Corporation*, n.17 *supra*, at 185 ; *see also, In re Miami Window Corporation*, 41 SEC 68 (1962) ; *In re The Londontown Manufacturing Company*, 41 S.E.C. 676 (1963) .

(n17)Footnote 17. *See 17 C.F.R. § 230.261*. For discussion of proceedings under Regulation A, which permits an issuer to make exempt public offerings of securities having an aggregate offering price not exceeding \$1.5 million (\$100,000 when the offering is on behalf of a person in a control relationship), *see Chapter 5 supra*.

(n18)Footnote 18. Failure to request a hearing also causes the suspension to become permanent.

(n19)Footnote 19. *See In re Philadelphia Stock Exchange*, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,475 at 82,996 (1980); *San Francisco Mining Exchange v. SEC*, 378 F.2d 162 (9th Cir. 1967) (exchange's registration revoked).

(n20)Footnote 20. 436 U.S. 103 (1978) .

(n21)Footnote 21. *See Section 12(j) of the Exchange Act. See also SEC v. Sloan*, 436 U.S. 103, 112-113 (1978) .

(n22)Footnote 22. The word "practitioner" has been substituted for the words "practicing lawyer" because the Commission also applies this approach to accountants.

(n23)Footnote 23. *In re Emanuel Fields*, 45 SEC 262 (1973) , *aff'd without opinion sub nom.*, *Fields v. SEC*, 495 F.2d 1075 (D.C. Cir. 1974) .

(n24)Footnote 24. 15 U.S.C. § 78d-3.

(n25)Footnote 25. 17 C.F.R. § 201.102(e)(1).

(n26)Footnote 26. Under Section 4C(b), "improper professional conduct" means: (A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or (B) Either of the following two types of negligent conduct: (1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances in which an accountant knows, or should know, that heightened scrutiny is warranted; or (2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards, that indicate a lack of competence to practice before the Commission.

(n27)Footnote 27. *Checkosky v. SEC*, 139 F.3d 221 (D.C. Cir. 1998) (attacking Rule 102(e) as unconstitutionally vague).

(n28)Footnote 28. One school of thought concedes the Commission's power to discipline accountants but denies the existence of any such power over lawyers on the ground that the Commission has neither the authority nor the expertise to set ethical standards for the bar. See the dissents of former Commissioner Karmel in, *In re Keating, Muething & Klekamp*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,124 at 81,993-81,996 (1079); *In re Bernard J. Coven*, Exch. Act Rel. No. 33-16648, 19 SEC Docket 12, 13 (1979) . It has also been suggested that Rule 102(e) involves a constitutionally impermissible assault on the client's right to vigorous representation by counsel of his own choice. See Freeman, *Recent Governmental Attacks on the Private Lawyer As an Infringement of the Constitutional Right to the Assistance of Counsel*, 36 Bus. Law. 1791 (1981).

(n29)Footnote 29. See, e.g., *Dearlove v. SEC*, 573 F.3d 801 (D.C. Cir. 2009) (accountant not denied due process); *McCurdy v. SEC*, 396 F.3d 1258 (D.C. Cir. 2005) (affirming SEC order suspending attorney from practicing before the Commission for one year because of a violation of SEC Rule 102(e)).

(n30)Footnote 30. Rule 102(e)'s first paragraph uses these locutions.

(n31)Footnote 31. See 17 C.F.R. § 201.102(f), which states that practicing before the Commission includes but is "not limited to" the transaction of business with the Commission and the preparation of papers filed with it. The Commission has prohibited lawyers from rendering advice. See Stephen Joel Sitomer, Sec. Exch. Act Rel. No. 33-12501 (1976); *In re Richard D. Hodgin*, [1979-80 Transfer Binder] Fed. Sec. L. Rep.(CCH) P 82,334 (1979); see also *SEC v. Ezrine*, [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,594 (S.D.N.Y. 1972) (suspended attorney enjoined from accepting or retaining legal fees for opinions about securities matters).

(n32)Footnote 32. See Marsh, *Rule 2(e) Proceedings*, 35 Bus. Law. 987, 994 (1980).

(n33)Footnote 33. The Commission has often done this. There have been many Rule102(e) proceedings in which national accounting firms have been named as respondents. See, e.g., *In re Ernst & Ernst*, 46 SEC 1234, 1270 (1978) : "[W]e have consistently held that where... a firm of public accountants permits a report or certificate to be executed in its name, it will be held responsible therefor." For example, the Commission censured the Arthur Andersen firm itself for the misconduct of certain partners in certifying materially false financial statements issued by Waste Management, Inc. between 1993 and 1996. Citing principles of "enterprise liability," the Commission concluded that the "circumstances of this case, including the positions within the firm of the partners who were consulted by the engagement team, the gravity and duration of the misconduct, and the nature and magnitude of the misstatements mandate that the firm be held responsible for the acts of its partners in causing the firm to issue false and misleading audit reports in the firm's name." *In the Matter of Arthur Andersen LLP*, Sec. Exch. Act. Rel. No. 44444, 2001 SEC LEXIS 1174 (June 19, 2001) . Although cases of this sort against law firms are much more rare, they are not wholly

unknown. Thus, for example, in *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682 (D.D.C. 1978) , the Commission brought an injunctive action against two prominent law firms on the basis of allegations that could reasonably be viewed as essentially ethical. And, in *In re Keating, Muething & Klekamp*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,124 (1979), Rule 2(e) sanctions were imposed on an entire law firm. *See also* J.M. Ferguson, Sec. Act Rel. No. 33-5523, 5 SEC Docket 3738 n.3 (1974) , where changes in a law firm's procedure were among the factors that led the Commission to accept an offer of settlement from one of its partners. But a footnote to the Second Circuit's decision in *Touche Ross & Co. v. SEC*, 609 F.2d 570, 582 n.21 (2d Cir. 1979) raises the question posed in the text. Moreover, the concurring opinion stated that "if sanctions are unjustifiably extensive in scope-- e.g., embracing every partner despite the isolated transgressions of a few--the corrective process of judicial review may be called into play." *Id.* at 583 .

(n34)Footnote 34. 46 SEC at 1271 n.68 . In *In the Matter of Arthur Andersen LLP*, the Commission's Rule 102(e) administrative proceeding against the firm was accompanied by similar administrative proceedings against individual firm partners and by an injunctive proceeding in federal court under the anti-fraud provisions of the 1934 Act. *See* SEC Litig. Rel. No. 1410 (June 19, 2001) (describing judicial and administrative proceedings). In settling the related administrative and judicial proceedings, the firm itself agreed to harsh sanctions, accepting not only the censure noted above but also an injunction against further violations of the 1934 Act, which included an express finding that the firm and its individual partners had committed violations of the statute, and a monetary penalty of \$ 7 million. *See* SEC v. Arthur Andersen LLP, et al., Civil Action No. 01 CV 01348 (D.D.C.) (consent judgment filed June 19, 2001). In its press release announcing the settlement, the Commission trumpeted the results as the then "largest-ever civil penalty" and the "first antifraud injunction in more than 20 years" against a "Big Five" accounting firm. SEC Press Release, S.E.C. 01-62 (June 19, 2001). The individual partners agreed to prohibitions against practicing before the Commission for periods ranging from one to five years. *See* SEC Litig. Rel. No. 1410 (June 19, 2001).

(n35)Footnote 35. *See* Ferrara, *Administrative Disciplinary Proceedings under Rule 2(e)*, 36 Bus. Law. 1807 (strong defense by the Commission's then General Counsel). *See also* *Touche Ross & Co. v. SEC*, 609 F.2d 570, 583 (2d Cir. 1979) concurring opinion: "Our opinion... affirms the ability of the SEC to ensure that the professionals who practice before it--on whose probity the viability of the regulatory process depends--meet the highest ethical standards... But in recognition that any power may be misused, dispassionate panels of Article III judges stand ready to correct the occasional excesses and errors that are an inevitable part of the administrative process."

(n36)Footnote 36. 17 C.F.R. § 201.2(e)(7): "All hearings... held under this paragraph (e) shall be public unless otherwise ordered by the Commission on its own motion or after considering the motion of a party."

(n37)Footnote 37. Sec. Act Rel. No. 33-6662, [1986-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,030 (1986). A 1974 proposal to the same effect was withdrawn. Sec. Act. Rel. No. 33-5477, [1973-74 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,738 (1974). Note, however, that the proceedings became public if the administrative law judge thought sanctions appropriate. *See* Sec. Act Rel. No. 5572 (1975). *See also* *In re William R. Carter and Charles J. Johnson, Jr.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,175 (1979) (administrative law judge's initial decision imposing sanctions on attorneys, published and proceedings widely commented on although the Commission ultimately reversed and found sanctions inappropriate).

(n38)Footnote 38. This is so even though Rule 2(e) proceedings with respect to lawyers had become rare. The Commission was silent about the area since *In re William R. Carter and Charles D. Johnson, Jr.* [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,847 (1981), where it dismissed the proceedings. In this regard, see [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,089 (1982), reproducing the full text of a speech by Edward F. Greene, Esq., the Commission's then General Counsel, which expressed views about Rule 2(e) and the legal profession narrower and more conservative than those said to have been held by the staff during the 1970's. However, administrative policy could change again. For example, the SEC brought a cease and desist action against an attorney for "aiding and abetting" securities laws violations as a result of incorrect legal advice the attorney administered to his client. The action was eventually settled. *In re Feldman*, Securities Exchange Act of 1934, Release No. 7014 (Sept. 20, 1993).

(n39)Footnote 39. *17 C.F.R. § 201.102(e)(3)*.

(n40)Footnote 40. Moreover, the professional is, in effect, required to turn himself in. *See 17 C.F.R. § 201.102(e)(4)*: "Any person appearing or practicing before the Commission who has been the subject of an order, judgment, decree, or finding as set forth in paragraph (e)(3) shall promptly file with the Secretary [of the Commission] a copy thereof (together with any related opinion or statement of the agency or tribunal involved)."

(n41)Footnote 41. *See 17 C.F.R. § 201.102(e)(3)*.

(n42)Footnote 42. Or, the settlement can call for Rule 102(e) sanctions in lieu of or in addition to an injunction. *See 15 U.S.C. § 7245*.

(n43)Footnote 43. *See 17 C.F.R. Part 205*.

(n44)Footnote 44. *See 17 C.F.R. § 205.3*.

(n45)Footnote 45. *See 17 C.F.R. § 205.6*.

(n46)Footnote 46. *17 C.F.R. § 205.2(a)*; J. Curtis Greene, New Regulations for Lawyers: The SEC's Final Rule for Professional Conduct in the Wake of Sarbanes-Oxley: Challenges for Foreign Attorneys, 14 IND. INT'L & COMP. L. REV. 807 (2004).

(n47)Footnote 47. *See 68 Fed. Reg. 6324 (Feb. 6, 2003)*.

(n48)Footnote 48. No. Civ.A. 03 C 1685, 2003 U.S. Dist. LEXIS 17933 (N.D. Ill. 2003).

(n49)Footnote 49. *17 C.F.R. § 205.7*

(n50)Footnote 50. *See, e.g., 17 C.F.R. 205.1*, which asserts that the SEC's rules preempt conflicting state attorney ethics standards, and the public comments thereto published at *68 Fed. Reg. 6296 (Feb. 6, 2003)*.

(n51)Footnote 51. For example, a survey conducted by one commentator located only twenty-five Rule 102(e) proceedings against attorneys since the passage of the Sarbanes Oxley Act. HAROLD S. B LOOMENTHAL, SARBANES-OXLEY ACT IN PERSPECTIVE § 7.6 (Dec. 2006). In contrast, as of 2006, at least 115 accountants and accounting firms had been named as respondents in 102(e) proceedings since the passage of Sarbanes-Oxley. *Id.*

(n52)Footnote 52. *15 U.S.C. § 7211 et seq.*

(n53)Footnote 53. *15 U.S.C. § 7211(a)*.

(n54)Footnote 54. *15 U.S.C. § 7202(c)*.

(n55)Footnote 55. *See Compliant filed in Free Enterprise Fund v. PCAOB, Case No. 1:06CV00217 (U.S. District Court for the District of Columbia, Feb. 7, 2006)*.

(n56)Footnote 56. *15 U.S.C. § 7211(e)(1), (4)*.

(n57)Footnote 57. *15 U.S.C. § 7211(e)(2)*.

(n58)Footnote 58. *15 U.S.C. § 7211(e)(5), (6)*.

(n59)Footnote 59. *15 U.S.C. § 7211(d)*.

(n60)Footnote 60. *See SEC Order Regarding Section 101(d) of the Sarbanes-Oxley Act (April 25, 2003) (available*

at <http://www.sec.gov/rules/other/33-8223.htm>).

(n61)Footnote 61. *Free Enter. Fund v. Public Co. Accounting Oversight Board*, No. 08-861, 561 U.S.____(2010) .

(n62)Footnote 62. *Id.*

(n63)Footnote 63. 15 U.S.C. § 7212(a); PCAOB Rel. No. 2003-07 (available at <http://www.pcaobus.org/rules/Release2003-007.pdf>).

(n64)Footnote 64. 15 U.S.C. § 7214.

(n65)Footnote 65. 15 U.S.C. § 7215.

(n66)Footnote 66. See PCAOB Rules on Investigations and Adjudications, PCAOB Rel. No. 2003-15 (Sept. 29, 2003) (available at <http://www.pcaobus.org/rules/Release2003-016.pdf>); Inspection of Registered Public Accounting Firms, PCAOB Rel. No. 2003-19 (Oct. 7, 2003) (available at <http://www.pcaobus.org/rules/Release2003-016.pdf>).

(n67)Footnote 67. PCAOB Rules 4000-4012, 5000-5501.

(n68)Footnote 68. 15 U.S.C. § 7214(b).

(n69)Footnote 69. 15 U.S.C. § 7214(d).

(n70)Footnote 70. 15 U.S.C. § 7214(f).

(n71)Footnote 71. 15 U.S.C. § 7124(g).

(n72)Footnote 72. 15 U.S.C. § 7215(b)(1).

(n73)Footnote 73. See PCAOB Rules 5100, 5101, available at http://www.pcaobus.org/Rules/Rules_of_the_Board/Section_5.pdf.

(n74)Footnote 74. 15 U.S.C. § 7215(b)(2).

(n75)Footnote 75. 15 U.S.C. § 7215(b)(3).

(n76)Footnote 76. 15 U.S.C. § 7215(c)(1).

(n77)Footnote 77. See § 9.07 *supra*.

(n78)Footnote 78. See PCAOB Rule 5109(d) available at http://www.pcaobus.org/Rules/Rules_of_the_Board/Section_5.pdf.

(n79)Footnote 79. 15 U.S.C. § 7215(c)(2).

(n80)Footnote 80. See PCAOB Rules 5200(b), 5204, available at http://www.pcaobus.org/Rules/Rules_of_the_Board/Section_5.pdf.

(n81)Footnote 81. 15 U.S.C. § 7215(c)(4), (5).

(n82)Footnote 82. 15 U.S.C. § 7217(c).

(n83)Footnote 83. 15 U.S.C. § 7215(e)(1).

(n84)Footnote 84. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 932 (a)(2)(B) (S.E.C.

to prescribe rules within one year requiring ratings agencies to submit annual internal audit reports to the Commission).

(n85)Footnote 85. *Id.* at § 932 (a)(8) (S.E.C. to create a form within one year for credit ratings agencies to use for the publication of the assumptions underlying a credit rating so that the users of the rating can understand it).

(n86)Footnote 86. *Id.* (Within one year, S.E.C. is to create regulations and to establish the form and content of due diligence provider certification).

(n87)Footnote 87. *Id.* at § 932 (a)(4) (S.E.C. to prescribe rules within one year to prevent the a credit rating agency's sales and marketing concerns from influencing the credit rating issued); § 939H (directing the S.E.C. to create rules within one year to prevent conflicts of interest arising where employees of credit ratings agencies are providing services to issuers other than the creation of credit ratings).

(n88)Footnote 88. *Id.* at §§ 932-33.

(n89)Footnote 89. *Id.* at § 932.

(n90)Footnote 90. *Id.*

(n91)Footnote 91. *Id.*

(n92)Footnote 92. An investigative report can be as effective as a formal opinion in alerting injured investors and the plaintiffs' financial bar to possible private rights of action. But since such reports are not adjudications, they have no collateral estoppel effect. This is often an important consideration.

(n93)Footnote 93. See Gellhorn, *Adverse Publicity by Administrative Agencies*, 86 *Harv. L. Rev.* 1380 (1973), cited in ex-Commissioner Karmel's separate statement with respect to the Commission's practice under Section 21(a), [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,014 at 81,558-81,559 (1979). This danger can generally be ameliorated by asking for a fair opportunity to review the draft and to suggest revisions. But reports can issue without the target's consent. See, e.g., Fidelity Financial Corporation and Fidelity Savings & Loan Association, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,239 (1982).

(n94)Footnote 94. From their standpoint, however, a general interpretive release that articulates the Commission's views about a problem area without naming names is, of course, far better than the gentlest Section 21(a) report. For examples of such releases, see Insider Trading by Law Firm Employees, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 81,116 (1977); SEC Warning to Investors on Get-Rich Quick Schemes, [1973-74 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,832 (1974).

(n95)Footnote 95. Section 21(a) provides in pertinent part that the Commission may "permit any person to file with it a statement in writing... as to all the facts and circumstances concerning the matter to be investigated." In State National Bank of Maryland, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,341 (1979) and in Statement Submitted to Commission in Connection with Non-Public Inquiry into Certain Transactions, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,015 (1979) (sometimes called the "Albert's Inc. release"), the reports consist entirely of statements by investigatees.

(n96)Footnote 96. Staff Report of the Securities and Exchange Commission on the Financial Collapse of the Penn Central Company (August 1972) and Staff Report on Transactions in Securities of the City of New York (August 1977) are noteworthy examples.

(n97)Footnote 97. *In re Ward La France Truck Corporation*, 13 SEC 373 (1943) . Forty-two years later the Commission again resorted to a Section 21(a) report to express its views about the disclosure duties that *Rule 10b-5* imposes on companies engaged in preliminary acquisition discussions. *In re Carnation Company*, [1984-85 Transfer

Binder] Fed. Sec. L. Rep. (CCH) P 83,801 (1985). In both cases the Commission preferred publication of its views about novel legal questions in the non-adversarial Section 21(a) context to litigation in which it might not have prevailed and that would in any event have been a drain on its resources.

(n98)Footnote 98. *See, e.g., In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,258 (1982); *In re Greater Washington Investors Inc.*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 82,032 (1979); *Allegheny Corporation*, 6 SEC 960 (1940) .

(n99)Footnote 99. *See, e.g., In re Seaboard Associates, Inc.*, Fed. Sec. L. Rep. (CCH) P 73,428 (1984).

(n100)Footnote 100. *See* § 9.07 *supra*.

(n101)Footnote 101. *See* n. 52 *supra*.

(n102)Footnote 102. 17 C.F.R. § 201.200 (a) and (b).

(n103)Footnote 103. The Commission sometimes deletes or modifies allegations the staff proposes to make.

(n104)Footnote 104. 17 C.F.R. § 201.250.

(n105)Footnote 105. *See In re Carl L. Shipley*, 45 SEC 589 (1974) (proceeding is missed because it was based entirely on statutory provisions that did not authorize administrative remedies).

(n106)Footnote 106. *See FTC. v. Standard Oil Co. of California*, 449 U.S. 232 (1980) .

(n107)Footnote 107. *See* § 9.05[1] *supra*.

(n108)Footnote 108. *See FTC. v. Standard Oil Co. of California*, n.61 *supra* ; *Wolf Corp. v. SEC*, 317 F.2d 139 (D.C. Cir. 1963) ; *R.A. Holman & Co. v. SEC*, 299 F.2d 127 (D.C. Cir.) , *cert. denied*, 370 U.S. 911 (1962) ; 4 K. Davis, *Administrative Law Treatise* 455 (2d ed. 1980) ("The broad theory is that courts review only final action, not interlocutory action."); *see also Heckler v. Chaney*, 470 U.S. 821, 105 S.Ct. 1659 (1985) (a regulatory agency's decision not to take action is presumptively immune from judicial review).

(n109)Footnote 109. Thus, for example, in *Touche Ross & Co. v. SEC*, 609 F.2d 570 (2d Cir. 1979) , the court dealt with the merits of the plaintiff's contention that the Commission had no jurisdiction to discipline accounting firms. *See also, Leedom v. Kyne*, 358 U.S.184, 188-189 (1958) .

(n110)Footnote 110. 17 C.F.R. §§ 201.310 and 201.155(a).

(n111)Footnote 111. 17 C.F.R. §§ 201.220(a) and (f) and 201.155(a).

(n112)Footnote 112. 17 C.F.R. § 201.240.

(n113)Footnote 113. 17 C.F.R. § 201.240. "Final acceptance by the Commission of any offer of settlement will be only its Findings and Opinion issued in the proceedings." This means that, as a matter of strict law, no SEC administration proceedings are ever settled until the Commission's order is issued. Practically, however, counsel who has been told by the staff that the Commission has decided to accept the offer can rest assured. The words of the rule reflect a long abandoned practice under which offers of settlement were routinely re-examined for adequacy after the Commission had given its tentative approval.

(n114)Footnote 114. When the Commission passes on offers of settlement it deems itself to be acting administratively rather than quasi judicially. Hence, its view is that its rejection of a settlement is not a prejudgment on the merits.

2-9 Federal Securities Exchange Act of 1934 § 9.10

(n115)Footnote 115. If the offeror fails to do this, the Commission will never see the offer. 17 C.F.R. § 201.240(c)(3).

(n116)Footnote 116. An opportunity for oral presentation can be sought. However, this is discretionary with the Commission and seldom granted. Much of what was discussed in § 9.07 *supra* about Wells submissions is also applicable to efforts to persuade the Commission to overrule its staff in the offer of settlement context.

(n117)Footnote 117. 17 C.F.R. § 201.240(c)(6).

(n118)Footnote 118. 17 C.F.R. § 201.326.

(n119)Footnote 119. 17 C.F.R. § 201.326.

(n120)Footnote 120. *Samuel H. Moss, Inc. v. FTC*, 148 F.2d 378, 380 (2d Cir.) , *cert. denied*, 326 U.S. 734 (1945) , *quoted and followed in* *Clinton Engines Corp.*, 41 SEC 408, 411-412 (1963) ; *accord*, *In the Matter of City of Anaheim, City of Irvine, Irvine Unified Sch. Dist., North Orange Co. Comm. Coll. Dist., and Orange Co. Bd. of Educ.*, 71 S.E.C. Docket 144 , (S.E.C. Release No. 34-42140 Nov. 16, 1999) ("The Federal Rules of Evidence are designed for juries and do not apply to administrative adjudications. Administrative agencies such as the Commission are more expert fact-finders, less prone to undue prejudice, and better able to weigh complex and potentially misleading evidence than are juries.").

(n121)Footnote 121. *See generally* *Richardson v. Perales*, 402 U.S. 389 (1971) ; *Yancey v. Apfel*, 145 F.3d 106 (2d Cir. 1998) (administrative law judge's reliance on physician reports containing hearsay in denying social security benefits did not constitute an abuse of discretion); 3 K. Davis, *Administrative Law Treatise* 233-255 (2d ed. 1980).

(n122)Footnote 122. 17 C.F.R. § 201.102(b).

(n123)Footnote 123. *Feeney v. SEC*, 564 F.2d 260 (8th Cir. 1977) , *cert. denied*, 435 U.S. 969 (1978) ; *Nees v. SEC* 414 F.2d 211 (9th Cir. 1969) ; *Boruski v. SEC*, 340 F.2d 991 (2d Cir.) , *cert. denied*, 381 U.S. 928 (1965) ; *accord*, *Elliott v. S.E.C.*, 36 F.3d 86 (11th Cir. 1994) (holding there is no there is no statutory or constitutional right to counsel in an administrative proceeding barring operator of financial services firm from associating with any securities broker or dealer).

(n124)Footnote 124. 17 C.F.R. § 201.16(a). Unlike appellate courts, the Commission can review initial decisions on its own initiative. 17 C.F.R. § 201.360(b). But it has not done so since *In re Investors Management Co., Inc.*, 44 SEC 633 (1971) (*sua sponte* review limited to doctrinal questions the Commission thought significant).

(n125)Footnote 125. 17 C.F.R. § 201.360(a).

(n126)Footnote 126. 5 U.S.C. § 557(b)(2).

(n127)Footnote 127. 17 C.F.R. §§ 201.410(b) and 201.360(b).

(n128)Footnote 128. The Commission seldom sees these petitions. They are granted by the Director of the agency's Office of Opinions and Review, the staff unit that assists the Commission on its decisional work. *See* 17 C.F.R. § 200.30-8(a)(v).

(n129)Footnote 129. 17 C.F.R. § 201.410(b).

(n130)Footnote 130. 17 C.F.R. § 201.450.

(n131)Footnote 131. 17 C.F.R. § 201.451. Oral argument can, of course, be waived.

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(n132)Footnote 132. 17 C.F.R. § 201.21. *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 182 n.8 (2d Cir. 1976) , cert. denied, 434 U.S. 1009 (1978) , sustained the validity of this practice where only one of the four Commissioners who decided the case heard the argument. See also, *Falcon Trading Group Ltd. v. S.E.C.*, 102 F.3d 579 (D.C. Cir. 1996) (holding that the SEC could by regulation designate two out of three members as valid quorum therefore affirmance by two members was valid); *Gearhart & Otis, Inc. v. SEC*, 348 F.2d 798 (D.C. Cir. 1965) .

(n133)Footnote 133. Section 9 of the Securities Act, Section 25(a)(1) of the Exchange Act, Section 43 of the Investment Company Act and Section 213 of the Investment Advisers Act.

(n134)Footnote 134. When the parties consent to the Division's participation in the decision, the Commission permits its lawyers to act as adjudicators in cases in which they were formerly advocates. For obvious reasons, waivers that permit members of the enforcement staff to pass on the merits of their own contentions are practically unheard of except in the settlement context where the offer of settlement almost always permits the Division to prepare or at least to participate in the preparation of the document that terminates the proceeding.

(n135)Footnote 135. The term "decisional employees" includes but is not limited to the Commission's administrative law judges, all members of the staff of the Office of Opinions and Review and the Commissioners' legal assistants. See 17 C.F.R. § 200.111(d)(3). Lawyers in the General Counsel's Office often advise the Commission at the decisional stage. See 17 C.F.R. § 200.21(a).

(n136)Footnote 136. This is not true of the Commissioners' legal assistants. They may have been involved at earlier stages. But they are viewed as extensions of the Commissioners for whom they work.

(n137)Footnote 137. See n. 91 *supra*.

(n138)Footnote 138. Injunctive proceedings and criminal references may also have been authorized.

(n139)Footnote 139. See *Withrow v. Larkin*, 421 U.S. 35 (1975) ; *Hortonville Joint School Dist. v. Hortonville Educational Ass'n*, 426 U.S. 482 (1976) ; accord, *Harline v. Drug Enforcement Agency*, 148 F.3d 1199 (10th Cir. 1998) (holding that an ALJ's employment with the DEA did not give rise to a colorable claim that physician's due process rights would be violated if the ALJ presided over a hearing concerning the DEA's revocation of a physician's registration to dispense controlled substances).

(n140)Footnote 140. Moreover, the Commission need not write at length when it rejects a staff contention. The staff cannot seek judicial review. So elaborate opinions are unnecessary. Hence decisions adverse to the staff are sometimes short and cryptic. See, e.g., *In re Alan Bennett Harp*, Sec. Exch. Act Rel. No. 33-22511, 34 SEC Docket 344 (1985) (case dismissed without discussion of the facts). Or the Commission may dismiss in the exercise of its administrative discretion without reaching the legal issues presented. See, e.g., *In re Lee Petillar*, 45 SEC 762 (1975) . However, full opinions rejecting the staff's position in toto can be found. See, e.g., *In re Wall Street West, Inc.*, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 83,477 (1984); *In re International Shareholders Services Corp.*, 46 SEC 378, 386, [1975 -76 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,493 n.19 (1976) (which rebuked the staff for misconduct); *Edgerton, Wyckoff & Co.*, 36 SEC 583 (1955) ; *In re Otis & Co.*, 35 SEC 650 (1954) .

(n141)Footnote 141. *Steadman v. SEC*, 450 U.S. 91 (1981) ; *S.E.C. v. Moran*, 922 F. Supp. 867 (S.D.N.Y. 1996) . *Whitney v. SEC*, 604 F.2d 676 (D.C. Cir. 1979) and *Collins Securities Corp. v. SEC*, 562 F.2d 820 (D.C. Cir. 1977) , which held the Commission limited by the "clear and convincing" standard where fraud was alleged and severe sanctions imposed, are no longer authoritative. Cf. *Herman & MacLean v. Huddleston*, 459 U.S. 375, 387-91 (1983) (preponderance standard governs in private actions for fraud and also noting that circumstantial evidence can be "more than sufficient" to establish scienter).

(n142)Footnote 142. Section 9(a) of the Securities Act, Section 25(a)(1) of the Exchange Act, Section 43(a) of the Investment Company Act and Section 213(a) of the Investment Advisers Act.

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(n143)Footnote 143. See 5 K. Davis, *Administrative Law Treatise* 435-460(2d ed. 1980).

(n144)Footnote 144. See *Kivitz v. SEC*, 475 F.2d 956 (D.C. Cir. 1973) (evidence against lawyer in Rule 2(e) proceeding insufficient); *Klopp v. SEC*, 427 F.2d 455 (6th Cir. 1970) (Commission's order based on investor testimony the court found unreliable vacated).

(n145)Footnote 145. The Commission's opinions customarily state that they are based on an "independent review of the record." That review is generally made by the Commission's Office of Opinions and Review, which prepares the initial drafts of the opinions and the orders that the Commission issues in contested cases.

(n146)Footnote 146. See Exch. Act § 21B(a); Inv. Co. Act § 9(d)(1); Inv. Adv. Act. § 203(i)(1). Sections 21B, 9(d), and 203(i) are codified at 15 U.S.C. §§ 78u-2, 80a-9(d), and 80b-3(i), respectively.

(n147)Footnote 147. Consideration of the factors is permissive and not mandatory because not all of the factors would apply in any given case. H.R. Rep. No. 616, 101st Cong., 2d Sess. 20, reprinted in 1990 U.S. Code Cong. & Admin. News 1379 (hereinafter cited as "1990 House Report" using citations to the original report pages). Furthermore, the factors that are applicable need not be accorded the same weight. *Id.*

(n148)Footnote 148. This factor takes into account the violator's culpability, including whether the violator acted with scienter. 1990 House Report, n.104 *supra*, at 20. An example of a violator who deliberately or recklessly disregards a regulatory requirement is an investment adviser who fails to maintain required books and records notwithstanding prior warnings. *Id.*

(n149)Footnote 149. This factor relates to the gravity of the violation and can be evaluated regardless of the violator's culpability. 1990 House Report, n.104 *supra*, at 20.

(n150)Footnote 150. The phrase "any person" is intended to take into account the situation where a group of persons act together to violate the federal securities laws. 1990 House Report, n.104 *supra*, at 20.

(n151)Footnote 151. This factor recognizes that the Commission may properly impose a higher penalty on repeat offenders. 1990 House Report, n.104 *supra*, at 21.

(n152)Footnote 152. This factor recognizes that the civil penalty should be higher if the economic gain to be derived from the violation is relatively higher or the violation is relatively more difficult to detect. 1990 House Report, n.104 *supra*, at 21.

(n153)Footnote 153. Exch. Act § 21B(c); Inv. Co. Act § 9(d)(3); Inv. Adv. Act. § 203(i)(3). The phrase "such other matters as justice may require" is taken from the Federal Trade Commission Act, 15 U.S.C. § 45(m)(C). 1990 House Report, n.104 *supra*, at 21. It is intended to give the Commission the latitude to take into account any equitable considerations that are unforeseeable, that are not readily susceptible to statutory delineation, or that do not fit directly into the factors that are enumerated. *Id.* For example, the Commission may consider the threat of harm (rather than the "actual harm" in factor 2), or any history of delinquency by the violator that did not result in an actual agency or court adjudication (factor 4). *Id.*

(n154)Footnote 154. Exch. Act § 21B(d); Inv. Co. Act § 9(d)(4); Inv. Adv. Act. § 203(i)(4). Without elaboration, the legislative history of these provision notes that the respondent's ability to pay is "an important consideration." See 1990 House Report, n.104 *supra*, at 21.

(n155)Footnote 155. Exch. Act § 21B(d); Inv. Co. Act § 9(d)(4); Inv. Adv. Act. § 203(i)(4).

(n156)Footnote 156. Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Securities Exchange Act

Release No. 44969 (Oct. 23, 2001) (available at: <http://www.sec.gov/litigation/investreport/34-44969.htm>).

(n157)Footnote 157. 1990 House Report, n.104 *supra*, at 19.

(n158)Footnote 158. *See* § 9.10[9][a] *supra*.

(n159)Footnote 159. *See* Exch. Act § 21B(b); Inv. Co. Act § 9(d)(2); Inv. Adv. Act. § 203(i)(2).

(n160)Footnote 160. Exch. Act § 21B(b)(1); Inv. Co. Act § 9(d)(2)(A); Inv. Adv. Act. § 203(i)(2)(A). The penalty amounts prescribed by these statutes are subject to adjustment for inflation under the Debt Collection Improvement Act of 1996, Pub. L. No. 104-134, Title III, § 310001, 110 Stat. 1321-358. *See* 17 C.F.R. § 201.1002.

(n161)Footnote 161. Exch. Act § 21B(b)(2); Inv. Co. Act § 9(d)(2)(B); Inv. Adv. Act. § 203(i)(2)(B).

(n162)Footnote 162. Exch. Act § 21B(b)(3); Inv. Co. Act § 9(d)(2)(C); Inv. Adv. Act. § 203(i)(2)(C). Commission orders imposing a monetary penalty, like other final orders in administrative proceedings, are subject to judicial review. 1990 House Report, n.104 *supra*, at 21-22. For a discussion of review of Commission orders, see § 9.10[8][h]-[i] *supra*.

(n163)Footnote 163. *See* § 9.11[2][d] *infra*.

(n164)Footnote 164. Exch. Act § 21B(e); Inv. Co. Act § 9(e); Inv. Adv. Act. § 203(j).

(n165)Footnote 165. 1990 House Report, n.104 *supra*, at 22, citing *SEC v. Blavin*, 760 F.2d 706, 713 (6th Cir. 1985); accord, *S.E.C. v. Haligiannis*, 470 F. Supp. 2d 373 (S.D.N.Y.) ("The primary purpose of disgorgement is not to compensate victims or punish the wrongdoer, but rather to prevent wrongdoers from unjustly enriching themselves through violations, and thereby deter subsequent fraud."); *S.E.C. v. Phoenix Telecom, L.L.C.*, 231 F. Supp. 2d 1223 (N.D. Ga. 2001) ("The purpose of disgorgement is not to compensate the victims of the fraud, but to deprive the wrongdoer of his ill-gotten gain. Because disgorgement is remedial and not punitive, the court's power to order disgorgement extends only to the amount with interest by which the defendant profited from his wrongdoing.").

(n166)Footnote 166. 15 U.S.C. § 7246(a); *see also* *Official Committee of Unsecured Creditors of WorldCom, Inc. v. S.E.C.*, 467 F.3d 73 (2nd Cir. 2006) (affirming the right of the S.E.C. to discriminate between classes of investors, in this instance allowing the S.E.C. to discriminate in favor of investors who recovered less in bankruptcy court, and against those who received more).

(n167)Footnote 167. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, § 929B.

(n168)Footnote 168. Exch. Act § 21C(a); Sec. Act § 8A(a); Inv. Co. Act § 9(f)(1); Inv. Adv. Act. § 203(k)(1). Sections 21C, 8A, 9(f), and 203(k) are codified at 15 U.S.C. §§ 78u-3, 77h-1, 80a-9(f), and 80b-3(k), respectively.

(n169)Footnote 169. Exch. Act § 21C(a); Sec. Act § 8A(a); Inv. Co. Act § 9(f)(1); Inv. Adv. Act. § 203(k)(1).

(n170)Footnote 170. H.R. Rep. No. 616, 101st Cong., 2d Sess. 23, reprinted in 1990 U.S.Code Cong. & Admin. News 1379 (hereinafter cited as "1990 House Report" using citations to the original report pages). At least one administrative law judge, however, has held that the Staff must show a likelihood of a future violation in order to obtain a cease and desist order. *In the Matter of Valicenti Advisory Servs., Inc.*, Admin. Proceeding File No. 3-8854, 64 SEC Docket (CCH) 2281 (July 2, 1997).

(n171)Footnote 171. Exch. Act § 21C(a); Sec. Act § 8A(a); Inv. Co. Act § 9(f)(1); Inv. Adv. Act. § 203(k)(1).

(n172)Footnote 172. Exch. Act § 21C(b); Sec. Act § 8A(b); Inv. Co. Act § 9(f)(2); Inv. Adv. Act. § 203(k)(2).

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(n173)Footnote 173. Exch. Act § 21C(b); Sec. Act § 8A(b); Inv. Co. Act § 9(f)(2); Inv. Adv. Act. § 203(k)(2).

(n174)Footnote 174. *See § 9.10[9][c] supra.*

(n175)Footnote 175. Exch. Act § 21C(e); Sec. Act § 8A(e); Inv. Co. Act § 9(f)(5); Inv. Adv. Act. § 203(k)(5).

(n176)Footnote 176. *See Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 929P(a).*

(n177)Footnote 177. 15 U.S.C. § 78u-3(f); 15 U.S.C. § 77h-1(f).

(n178)Footnote 178. *See § 9.11[3] infra.*

(n179)Footnote 179. *See Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 925.*

(n180)Footnote 180. 1990 House Report, n.123 *supra*, at 24-25. For a discussion of review of Commission proceedings, see § 9.10[8][h] *supra*.

(n181)Footnote 181. These respondents are those who (1) act, or acted at the time of the alleged misconduct, as brokers, dealers, investment advisers, investment companies, municipal securities dealers, government securities brokers or dealers, or transfer agents, or (2) are, or were at the time of the alleged misconduct, associated persons of or persons seeking to become associated with, any of the persons enumerated in (1) above. Exch. Act § 21C(c)(2); Sec. Act § 8A(c)(2); Inv. Co. Act § 9(f)(3)(B); Inv. Adv. Act. § 203(k)(3)(B). For purposes of Section 9(f) of the Investment Company Act, "investment adviser" includes a corporate or other trustee performing the functions of an investment adviser. Sec. Act § 9(g).

(n182)Footnote 182. Exch. Act § 21C(c)(1); Sec. Act § 8A(c)(1); Inv. Co. Act § 9(f)(3)(A); Inv. Adv. Act. § 203(k)(3)(A).

(n183)Footnote 183. Exch. Act § 21C(c)(1); Sec. Act § 8A(c)(1); Inv. Co. Act § 9(f)(3)(A); Inv. Adv. Act. § 203(k)(3)(A); *see also* 1990 House Report, n.123 *supra*, at 25.

(n184)Footnote 184. Exch. Act § 21C(c)(1); Sec. Act § 8A(c)(1); Inv. Co. Act § 9(f)(3)(A); Inv. Adv. Act. § 203(k)(3)(A).

(n185)Footnote 185. 1990 House Report, n.123 *supra*, at 25.

(n186)Footnote 186. Exch. Act § 21C(c)(1); Sec. Act § 8A(c)(1); Inv. Co. Act § 9(f)(3)(A); Inv. Adv. Act. § 203(k)(3)(A).

(n187)Footnote 187. *See § 9.10[10][b][ii] infra.*

(n188)Footnote 188. Exch. Act § 21C(c)(1); Sec. Act § 8A(c)(1); Inv. Co. Act § 9(f)(3)(A); Inv. Adv. Act. § 203(k)(3)(A).

(n189)Footnote 189. Exch. Act § 21C(d)(1); Sec. Act § 8A(d)(1); Inv. Co. Act § 9(f)(4)(A); Inv. Adv. Act. § 203(k)(4)(A).

(n190)Footnote 190. Exch. Act § 21C(d)(1); Sec. Act § 8A(d)(1); Inv. Co. Act § 9(f)(4)(A); Inv. Adv. Act. § 203(k)(4)(A).

(n191)Footnote 191. This 10-day period runs from (1) the date of service, if the respondent has had a hearing prior to the issuance of the temporary order, or (2) the date the Commission renders its decision on the respondent's application if the hearing is held pursuant to a request by the respondent after the issuance of the order. Exch. Act §

21C(d)(2); Sec. Act § 8A(d)(2); Inv. Co. Act § 9(f)(4)(B); Inv. Adv. Act. § 203(k)(4)(B).

(n192)Footnote 192. Exch. Act § 21C(d)(2); Sec. Act § 8A(d)(2); Inv. Co. Act § 9(f)(4)(B); Inv. Adv. Act. § 203(k)(4)(B).

(n193)Footnote 193. Exch. Act § 21C(d)(3); Sec. Act § 8A(d)(3); Inv. Co. Act § 9(f)(4)(C); Inv. Adv. Act. § 203(k)(4)(C). Of course, the Commission also has the authority to stay the temporary order pending appeal. 1990 House Report, n.123 *supra*, at 25.

(n194)Footnote 194. Exch. Act § 21C(d)(2); Sec. Act § 8A(d)(2); Inv. Co. Act § 9(f)(4)(B); Inv. Adv. Act. § 203(k)(4)(B).

(n195)Footnote 195. Exch. Act § 21C(d)(2); Sec. Act § 8A(d)(2); Inv. Co. Act § 9(f)(4)(B); Inv. Adv. Act. § 203(k)(4)(B).

(n196)Footnote 196. *See* Exch. Act § 21C(d); Sec. Act § 8A(d); Inv. Co. Act § 9(f)(4); Inv. Adv. Act. § 203(k)(4).

(n197)Footnote 197. *See* Exch. Act § 21C(d)(1) (providing that the respondent may apply to the Commission to have the temporary order set aside, limited, or suspended "[a]t any time"); Sec. Act § 8A(d)(1) (same); Inv. Co. Act § 9(f)(4)(A) (same); Inv. Adv. Act. § 203(k)(4)(A) (same).

(n198)Footnote 198. *See* Exch. Act § 21C(d)(4); Sec. Act § 8A(d)(4); Inv. Co. Act § 9(f)(4)(D); Inv. Adv. Act. § 203(k)(4)(D).

(n199)Footnote 199. 1990 House Report, n.123 *supra*, at 24, 26. For a discussion of injunctive actions to enforce compliance with a Commission order, *see* § 9.11[1] *infra*. For a discussion of court-imposed monetary penalties, *see* § 9.11[2] *infra*.

(n200)Footnote 200. *See* Exch. Act § 21(d)(3); Sec. Act § 20(d)(1); Inv. Co. Act § 42(e); Inv. Adv. Act. § 209(e).

(n201)Footnote 201. *See* § 9.10[10][a][ii] *supra*.

(n202)Footnote 202. 1990 House Report, n.123 *supra*, at 24. For a discussion of administrative proceedings brought pursuant to Section 15(c)(4) of the Exchange Act, *see* § 9.10[3] *supra*.



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.11

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§ 9.11 Judicial Enforcement

In addition to the administrative forum, the SEC may bring its enforcement proceeding in federal court. The preponderance of the evidence standard governs judicial enforcement actions brought by the SEC. n1

[1] Injunctive Actions

[a] Statutory Authority. Whenever it shall appear to the Commission that any person is engaged or about to engage in any act or practice that constitutes or will constitute a violation of the federal securities laws, the Commission may, in its discretion, bring an action in federal court to enjoin such acts and practices. n2

Section 20(c) of the Securities Act and Section 21(e) of the Exchange Act provide the Commission with authority to petition a federal district court to "issue a writ of mandamus commanding any person to comply with the provisions of this title or any order of the Commission made in pursuance thereof."

Although the Federal Rules of Civil Procedure abolished writs of mandamus, n3 these provisions are still important. They permit mandatory injunctions to enforce compliance with reporting requirements and with the Commission's orders. n4 The Investment Company and Investment Advisers Acts expressly authorize such actions. n5

Section 21(d) of the Exchange Act permits the Commission to seek injunctions restraining violations of rules promulgated by the exchanges, the NASD, the registered clearing agencies and the Municipal Securities Rulemaking Board. Section 21(e) of the Exchange Act permits the Commission to obtain an order commanding any national securities exchange or registered securities association to enforce compliance with its rules or the Exchange Act (or the rules, regulations, or orders thereunder), or commanding a registered clearing agency to enforce compliance with its rules. The Commission may not, however, bring an action under Sections 21(d) or 21(e) to require compliance with the rules of a self-regulatory organization unless it appears to the Commission that such organization is unable or unwilling to act, or such action is necessary or appropriate in the public interest or for the protection of investors. n6

[b] Standard for Granting Injunction. The statutory provisions cited above are written in mandatory terms. They state that injunctions "shall be granted without bond" whenever the Commission makes "a proper showing."

For many years, the Commission considered that these provisions required little more than proof of the violation itself, n7 and found support for this position from the Supreme Court. In *SEC v. Capital Gains Research Bureau*, n8 the Supreme Court stated that an SEC injunction was no more than a "mild prophylactic" and made it clear that the Commission was not required to establish "irreparable injury." n9 Injunctions merely direct defendants to obey the law, which they are supposed to do in any event. n10

Although a showing of "cognizable danger of recurrent violation" was always essential, n11 the Commission maintained that past misconduct was a sufficient basis for the requisite inference of probable future misconduct and that the public interest in effective enforcement outweighed the inconvenience to the defendant. Courts often agreed, n12 and injunctions issued freely.

In egregious cases, they still do. n13 However, the reasonable likelihood of future violation requirement has become more of a stumbling block for the Commission than it used to be. n14 The agency must "go beyond the mere facts of past violations and demonstrate a realistic likelihood of recurrence." n15 In determining the likelihood of recurrence, courts examine the totality of the circumstances surrounding the violation. n16 Some courts say that the Commission must offer "positive proof" that future violations are likely. n17

This can scarcely have been meant literally. "Positive proof" that a person is "likely" to do something in the future seems something of a contradiction in terms. However, the rigor of the formulation underscores the late Judge Friendly's statement in 1976 that "the current judicial attitude toward the issuance of injunctions on the basis of past violations at the SEC's request has become more circumspect. n18 The Supreme Court's decision in *Aaron v. SEC* n19 is of great import in this regard. n20

Since the Commission's fraud complaints always invoke Sections 17(a)(2) and 17(a)(3), these semantic distinctions are of little practical moment. Hence the Chief Justice's concurring opinion in *Aaron* commented that "this dispute, though pressed vigorously by both sides, may be much ado about nothing." n21

Thus, the real significance of *Aaron* as a precedent appears to lie in what it said about injunctions restraining future violations of statutory provisions that do not require scienter. Significantly, the Court stated: "This is not to say that scienter has no bearing at all on whether a district court should enjoin a person violating or about to violate Section § 17(a)(2) or § 17(a)(3)." n22 In addition, the Court observed that "the Commission must establish a sufficient evidentiary predicate to show that... future violation may occur" and that "[a]n important factor... is the degree of intentional wrongdoing evident in a defendant's past conduct." n23 Chief Justice Burger spelled this out in a concurring opinion that said: "[I]t will almost always be necessary for the Commission to demonstrate that the defendant's sins have been the result of more than negligence. Because the Commission must show some likelihood of a future violation, defendants whose past actions have been in good faith are not likely to be enjoined... That is as it should be. An injunction is a drastic remedy, not a mild prophylactic, and should not be obtained against one acting in good faith." n24

In addition to this degree of intentional wrongdoing or scienter with respect to defendant's past conduct, the courts have considered other factors in assessing the totality of the circumstances to determine whether there is a likelihood of future violations. These factors include the isolated or recurrent nature of the violation, defendant's recognition of the wrongful nature of the conduct, the sincerity of the defendant's assurances against future violations, the risk of future violations created by defendant's professional occupation, the egregiousness of the violation, and defendant's age and health. n25

In *SEC v. Unifund SAL*, n26 the Second Circuit added another stumbling block for the Commission in obtaining a preliminary injunction. Although the Court reaffirmed that the Commission must establish a likelihood of future violation, it held that the strength of the showing that must be made depends upon the nature of the injunctive relief sought. n27 When the Commission seeks preliminary relief that goes beyond preservation of the status quo, it must make a more substantial showing of likelihood of future violation (as well as a more substantial showing with respect to

a current violation). n28 The more significantly the status quo is altered, the more substantial the showing must be. n29

[c] Consequences of an SEC Injunction. SEC injunctions n30 are "drastic" because not only do they inflict reputational damage, n31 but they are also enforceable in contempt proceedings that can lead to imprisonment or substantial fines. n32 The magnitude of each varies greatly from case to case, but can be considerable. n33 Moreover, injunctions may also have significant collateral consequences under state and federal law.

Moreover, injunctions must be disclosed in various SEC filings. n34

Injunctions can have a devastating impact on those engaged in regulated activities and on those who seek to raise new capital. n35 This is so because injunctions are an express statutory ground for disciplinary action against broker-dealers, n36 investment advisers n37 and persons associated or seeking to become associated with them. n38 They also bar enjoined entities and persons from any meaningful association with registered investment companies. n39 SEC injunctions can also spawn disciplinary proceedings by states, by exchanges, and by the NASD. In addition, an injunction against an issuer or any of its officers, directors, controlling persons, or underwriters bars financing under the Securities Act's exemptive regulations. n40 Finally, adverse findings in an SEC injunctive action may have potent collateral estoppel effects in private litigation. n41 This is so, even when no injunction issues. n42 However, a defendant that consents to the injunction without admitting or denying the Commission's allegations will not be bound by collateral estoppel in subsequent litigation. The doctrine, therefore, provides a significant incentive for settlement. n43

[2] Monetary Penalties

[a] Authority of the Commission. In addition to an injunction (or lieu of an injunction or any other equitable relief), n44 the Commission is authorized to obtain civil penalties against defendants in federal court. Whenever it appears to the Commission that a person has violated the Exchange Act, the Securities Act, the Investment Company Act, the Investment Advisers Act, the rules or regulations thereunder, or a cease-and-desist order, n45 the Commission may bring an action in federal district court for a civil penalty against the violator. n46

[b] Amount of the Penalty. The amount of the penalty to be imposed "shall be determined by the court in light of the facts and circumstances." n47 The maximum penalty that may be imposed upon the defendant is the greater of:

- the gross amount of the pecuniary gain to the defendant as a result of the violation; or
- certain statutory amounts that vary with the defendant's culpability and the gravity of the harm that was or could have been caused by the violation. n48

These statutory amounts are divided into three "tiers." If the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement, and directly or indirectly resulted in substantial losses or created a significant risk of substantial losses to others (a "third tier" penalty), the maximum statutory amount is \$120,000 for a natural person and \$600,000 for any other person. n49 If the violation only involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement (a "second tier" penalty), the maximum statutory amount is \$60,000 for a natural person and \$300,000 for any other person. n50 If neither factor is present (a "first tier" penalty), the maximum statutory amount is \$6,500 for a natural person and \$60,000 for any other person. n51

A civil penalty may be imposed in addition to an order of disgorgement. n52 Therefore, the defendant could be required to pay up to twice the amount of that defendant's profits due to the violation--that is, disgorgement of the defendant's profits plus a monetary penalty equal to the gross amount of the defendant's pecuniary gain as a result of the violation. n53

A separate penalty, as set forth above, may be imposed for each violation. n54 In an action by the Commission to

enforce a cease-and-desist order, n55 each separate violation of such order is a separate offense. n56 In the case of a continuing failure to comply with a cease-and-desist order, each day the defendant fails to comply is a separate offense. n57 However, in its discretion the court can determine that despite numerous technical violations, a penalty based on one violation is appropriate. n58

[c] Collection of the Penalty. Except where directed by the Commission into a disgorgement fund, n59 the penalty imposed on the defendant is payable into the U.S. Treasury. n60 If the defendant fails to pay the penalty in a timely manner, the Commission may refer the matter to the Attorney General for collection. n61 Such action may be brought in addition to any other action the Commission or the Attorney General is entitled to bring. n62 For jurisdiction and venue purposes, a collection action is deemed to be an action to enforce a liability or a duty. n63

[d] Fair Funds Provision. Section 308 of the Sarbanes-Oxley Act, n64 known as the "Fair Funds" provision, provides that where the Commission obtains an order of disgorgement against any person for violation of the securities laws, either through judicial or administrative proceedings, and the Commission also obtains civil penalties, such penalties shall, at the direction of the Commission, be paid into the disgorgement fund instead of the U.S. Treasury. The effect of this provision is to make civil penalties available for compensating investors who were victims of the securities violations.

Former SEC Chairman Harvey Pitt described the Fair Funds provision as "one of the most important new tools we have received under Sarbanes-Oxley." n65 The Commission has announced its intent "to use the provision whenever reasonably possible, consistent with its mission to protect investors." n66 Some commentators have noted that the ability to use civil penalties for compensatory purposes has heightened the rationale for imposing them and that the Commission should be expected to become (and has become) more aggressive in seeking penalties, particularly against entities not otherwise directly regulated by the Commission (such as broker-dealers and audit firms). n67 A notable example of use of this provision was the settlement reached by the Commission in the WorldCom fraud; the penalty payment of \$750 million was to be paid into a disgorgement fund for benefit of defrauded shareholders. n68 The Commission similarly announced that the \$255 million in disgorgement and penalties obtained against J.P. Morgan Chase and Citigroup in connection with the Enron and Dynegy frauds would be completely paid into a fund for investors pursuant to Section 308. n69 More specifically, from 2003 to 2007, the SEC and courts ordered \$13.8 billion in disgorgement and civil penalties to be paid to the SEC. n70 The SEC has returned approximately \$6.6 billion in disgorgement and Fair Fund distributions to injured investors since the passage of the Sarbanes-Oxley Act--with \$2.1 billion distributed in 2009 alone. n71 As previously discussed, the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, enacted on July 22, 2010, amended Section 308 of *Sarbanes-Oxley* to authorize the S.E.C. to allocate a portion of a civil penalty obtained in a settlement or judgment in any judicial or administrative action to a "disgorgement fund or other fund established for the benefit of the victims of [a securities] violation." n72

[3] Ancillary Relief

The inherent equitable powers of the federal courts are proverbially broad and flexible. When the public interest is involved, "those equitable powers assume an even broader and more flexible character than when only a private controversy is at stake." n73 Hence, the Commission's complaints often pray for a variety of relief "ancillary" to the injunctions that it is expressly authorized to seek. n74 Indeed, any doubt as to the Commission's power to seek broad equitable relief was clarified by Section 305(b) of the Sarbanes-Oxley Act which states that "the Commission may seek, and any Federal court may grant, any equitable relief that may be appropriate or necessary for the benefit of investors." n75 Such ancillary relief is frequently obtained, n76 including:

- monetary relief, such as rescission, restitution, and disgorgement; n77
- orders directing the adoption of procedures designed to prevent the recurrence of the violations charged; n78

- receiverships; n79
- court-appointed directors; n80
- orders mandating special reports to the Commission enabling it to monitor the defendants' compliance with the injunction; n81
- freezes on assets: n82
- the appointment of special counsel; n83
- the appointment of a special master; n84 and
- the formation of a compliance review committee. n85

In addition to the above, the court is authorized by statute in injunction actions to prohibit any person from acting as an officer or a director of any issuer that has a class of securities registered pursuant to Section 12 or that is required to file reports pursuant to Section 15(d) if such person has violated Section 10(b) of the Exchange Act (or the rules and regulations thereunder) or Section 17(a)(1) of the Securities Act, and the person's conduct demonstrates unfitness to serve as an officer or a director of such issuer. n86 By specifically authorizing such ancillary relief by statute, Congress did not intend to limit the ancillary relief available to the Commission to officer and director bars. n87 Neither did it intend to limit officer and director bars to scienter-based fraud violations of the securities laws. n88 The legislative history of Section 21(d)(2) of the Exchange Act and Section 20(e) of the Securities Act suggests that a federal district court already possesses the equitable power to prohibit any person from acting as an officer or a director in any case when it "necessary or appropriate." n89

Prior to the adoption of Section 305 of the Sarbanes-Oxley Act, a court could prohibit an individual from serving as an officer or director if the individual's conduct demonstrated "substantial unfitness" to serve. Section 305 reduced the threshold articulated in Sections 21(d)(2) of the Exchange Act and 20(e) of the Securities Act from "substantial unfitness" to "unfitness." In practice, however, courts seem to employ a very similar test, both pre and post adoption of Section 305, in determining what an individual must demonstrate before he or she will be prohibited from serving as a director or officer. When making this determination, courts typically consider six factors: the egregiousness of the violation, whether the defendant was a repeat offender, the defendant's role in the violation, scienter, the defendant's economic stake in the violation and the likelihood that the misconduct will recur. n90

Cases of consensual ancillary relief are far more numerous than those in which such relief was obtained over the defendants' opposition. Defendants have found it advisable to consent to a variety of remedies.

Though the effects have generally been good and though the Division of Enforcement has shown admirable ingenuity and creativity in this area, ancillary relief has its problems.

Consider, for example, a case in which the appointment of a receiver accelerates debt maturities, entitles customers and suppliers to rescind contracts beneficial to the company, and "protects" investors into a total loss. n91

When a company's financial condition is very poor and when its securities-related infractions appear serious, some of the Commission's Regional Offices occasionally urge bankruptcy proceedings. Court-appointed special counsel may also be inappropriate. As noted earlier, the ambiguity of the relationship between such a counsel and his or her nominal corporate client can negate the attorney-client privilege. n92 The resulting confidentiality concerns may actually impede the investigation and make it less effective than it would have been had special counsel been selected in a different way.

Another negative factor has been stated as follows by a perceptive commentator:

Faced with an incomplete or ambiguous mandate, an ambitious special counsel might probe more aggressively than is warranted by the facts and inflict more disruption on corporate affairs than would the Commission's own enforcement personnel, who are accustomed to exercising investigative or quasi-prosecutorial discretion. As a result, the company would be saddled both with the special counsel's fees and with the resultant business uncertainty and burdens on management resources. n93

A searching, good faith self-investigation by a competent, wholly disinterested special counsel selected by the company or by its outside directors will often be both more effective and less detrimental than a judicially mandated special counselship. If such counsel is already in the picture, the Commission sometimes withholds enforcement action or defers it until counsel completes his or her own inquiry.

Because it can take so many forms and because the appropriateness of a particular remedy in a specific case is an intensely factual matter, SEC ancillary relief defies generalization. Each case calls for a careful analysis of "the needs to be served" n94 and for a judicious balancing of the equities. n95

FOOTNOTES:

(n1)Footnote 1. *SEC v. Moran*, 922 F. Supp. 867 (S.D.N.Y. 1996) .

(n2)Footnote 2. change fn to 2 and renumber accordingly Section 20(b) of the Securities Act, Section 21(d)(1) of the Exchange Act, Section 42(d) of the Investment Company Act, and Section 209(d) of the Investment Advisers Act. The Securities Act and Exchange Act use the words "is engaged or about to engage" reproduced in the text. But the Investment Company and Investment Advisers Acts authorize injunctive actions when the defendant "has engaged or is about to engage" in conduct in violation of those statutes. The Commission prefers the latter formulation because it expressly authorizes injunctions against violations that are not ongoing. Accordingly, it has tried, on a number of occasions, to persuade Congress to amend the earlier statutes. These efforts have been unsuccessful. *See SEC v. Commonwealth Chemical Securities, Inc.*, 574 F.2d 90, 99 n.7 (2d Cir. 1978) . However, this difference in terminology is of little substantive significance. *See* H. R. Rep. No. 229, 94th Cong., 1st Sess. 102 (1975) (Congressional conferees did not believe that existing law required clarification).

(n3)Footnote 3. F.R.C.P. 81(b). change to fn 3

(n4)Footnote 4. F.R.C.P. 81(b) provides that relief formerly available by mandamus "may be obtained under the practice prescribed in these rules."

(n5)Footnote 5. Section 42(e) of the Investment Company Act and Section 209(e) of the Investment Advisers Act.

(n6)Footnote 6. Exch. Act § 21(f).

(n7)Footnote 7. As in administrative proceedings, a preponderance of the evidence suffices to establish the violation. *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 355 (1943) ; *SEC v. Savoy Industries, Inc.*, 587 F.2d 1149, 1169 (D.C. Cir. 1978) , *cert. denied*, 440 U.S. 913 (1979) ; *SEC v. Commonwealth Chemical Securities, Inc.*, 574 F.2d 90, 102 (2d Cir. 1978) ; *accord*, *Aaron v. S.E.C.*, 446 U.S. 680, 689, 700-01, 100 S.Ct 1945 (1980) (holding that the S.E.C. has the authority under the Securities Exchange Act to bring an action in district court to enjoin individuals from engaging in acts or practices constituting a violation of any provision of the securities laws and that an injunction will be issued upon a "proper showing" which includes "at a minimum, proof that a person is engaging in or is about to engage in a substantive violation of either of the Acts or of the regulations promulgated thereunder"); *b'ut see SEC v. Unifund SAL*, 910 F.2d 1028, 1039-40 (2d Cir. 1990) (where the Commission seeks preliminary relief that goes beyond preservation of the status quo, it must make a more substantial showing of likelihood of success with respect to

a current violation).

(n8)Footnote 8. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 193 (1963) .

(n9)Footnote 9. *Id.* at 195 ; *see also SEC v. Unifund SAL*, 910 F.2d 1028, 1039-40 (2d Cir. 1990) (the Commission need not show irreparable injury or unavailability of a remedy at law); *but see SEC v. Cherif*, 933 F.2d 403, 407-08 (7th Cir.1991) (noting the standard set forth by the Second Circuit in *Unifund*, but applying the traditional injunction standard because of the parties' failure to argue that a different standard should be applied), *Dial Information Services Corp. v. Thornburgh*, 938 F. 2d. 1535 (2d. Cir. 1991) , *cert. denied*, 112 S. Ct. 966 (1992) . Furthermore, it has been held that the Commission may not (even if it wants to) obtain a preliminary injunction using an alternative test available to private litigants of irreparable injury plus both sufficiently serious questions going to the merits and a balance of hardships tipping decidedly to the party seeking the preliminary relief. *Unifund*, 910 F.2d at 1039-40 .

Another traditional principle vainly invoked by defendants in SEC injunctive actions is that equity will not enjoin a crime. *See SEC v. Carriba Air, Inc.*, 681 F.2d 1318, 1321(11th Cir. 1982) .

(n10)Footnote 10. *See SEC v. Thermodynamics, Inc.*, 464 F.2d 457, 461 (10th Cir. 1972) . *But see SEC v. Unifund SAL* 910 F.2d 1028, 1039-40 (2d Cir. 1990) (an injunction prohibiting future securities laws violations held to require a substantial showing of current violation and likelihood of future violation by the Commission, because it places the defendant at risk with respect to all future securities transactions).

(n11)Footnote 11. *S.E.C. v. Med. Comm. for Human Rights*, 404 U.S. 403, 406, 92 S.Ct 577 (1972) (case moot where "the allegedly wrongful behavior could not reasonably be expected to recur"); *United States v. W. T. Grant Co.*, 345 U.S. 629, 633 (1953) .

(n12)Footnote 12. *See, e.g., SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 808 (2d Cir. 1975) ("SEC appears... not as an ordinary litigant, but as a statutory guardian charged with safeguarding the public interest in enforcing the securities laws.").

(n13)Footnote 13. *See, e.g., SEC v. Carriba Air, Inc.*, 681 F.2d 1318 (11th Cir. 1982) .

(n14)Footnote 14. Injunctions have been denied because of a want of this element. *SEC v. Unifund SAL* 910 F.2d 1028, 1039-40 (2d Cir. 1990) (an injunction prohibiting future securities laws violations held to require a substantial showing of current violation and likelihood of future violation by the Commission, because it places the defendant at risk with respect to all future securities transactions); *SEC v. Caterinicchia*, 613 F.2d 102 (5th Cir. 1980) ("violation... resulted from a misguided attempt to protect investors by saving the company from bankruptcy and liquidation"); *SEC v. Monarch Fund*, 608 F.2d 938 (2d Cir. 1979) (court found no violation but also held that an injunction would be inappropriate even if there had been a violation, because the allegations were stale and because there was no evidence of prior or subsequent violations); *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8 (2d Cir. 1977) (isolated instance of misconduct unlikely to recur); *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682 (D.D.C. 1978) (no injunction against lawyer-defendants because the court was "confident that they will take appropriate steps to ensure that their professional conduct in the future comports with the law").

(n15)Footnote 15. *SEC v. Commonwealth Chemical Securities, Inc.*, 574 F.2d 90, 100 (2d Cir. 1978) .

SEC v. J.W. Korth & Co., 991 F. Supp. 1468 (S.D. Fl. 1998) ; *SEC v. Downe*, 969 F. Supp. 149 (S.D.N.Y. 1997) .

(n16)Footnote 16. *SEC v. Jakubowski*, 1997 U.S. Dist LEXIS 14575 , *aff'd* 150 F.3d 675 (7th Cir. 1998) ; *SEC v. Pinckney*, 1995 U.S. Dist LEXIS 17915 (E.D.N.C. Nov. 6, 1995) .

(n17)Footnote 17. *SEC v. Blatt*, 583 F.2d 1325, 1334 (5th Cir. 1978) ; *SEC v. Bausch & Lomb, Inc.*, 565 F.2d 8, 18 (2d Cir. 1977) ; *SEC v. J.N. Korth & Co.*, 991 F. Supp 1468 (S.D.Fl. 1998) ; *SEC v. Downe*, 969 F. Supp. 149

(S.D.N.Y. 1997) .

(n18)Footnote 18. *SEC v. Commonwealth Chemical Securities, Inc.*, 574 F.2d 90, 99 (2d Cir. 1978) ; see also, *SEC v. American Board of Trade, Inc.*, 751 F.2d 529 (2d Cir.1984) ("We begin by... emphasizing the gravity of an injunction against violation of the securities laws.").

(n19)Footnote 19. 446 U.S. 680 (1980) .

(n20)Footnote 20. The primary issue in the case was the need for a showing of deceptive intent or "scienter." The Court held such a showing essential under Section 10(b) of the Exchange Act and *Rule 10b-5* thereunder because it had previously found this mandated by Section 10(b)'s words. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) , a private action for money damages. The Commission's argument that those words meant one thing in private actions at law and another quite different thing in SEC suits for equitable relief was held untenable. Turning to Section 17(a) of the Securities Act, the Court held that "The language of § 17(a)(1), which makes it unlawful 'to employ any device, scheme or artifice to defraud' plainly evinces an intent on the part of Congress to proscribe only knowing or intentional misconduct." Hence, scienter was found required under Section 17(a)(1). Not so, however, under subdivisions (2) and (3) of Section 17(a). Subdivision (2) simply prohibits "any untrue statement of a material fact or any omission to state a material fact." The Court saw nothing in that "which smacks of scienter or intent to defraud." Subdivision 3, which makes it unlawful "to engage in any transaction, practice, or course of business which operates or would operate as a "fraud or deceit was read the same way. True, Section 17(a)(3) speaks of "fraud." But the Court concluded that the words "operate or would operate" focus on the "effect [emphasis by the Court] of particular conduct... rather than upon the culpability of the person responsible." 446 U.S. at 696-97 .

(n21)Footnote 21. 446 U.S. at 703, *Fed. Sec. L. Rep. (CCH)* at 97,686 .

(n22)Footnote 22. 446 U.S. at 701, *Fed. Sec. L. Rep. (CCH)* at 97,685 .

(n23)Footnote 23. 446 U.S. at 701 , citing *SEC v. Wills*, 472 F. Supp.1250, 1273-1275 (D.D.C. 1978) , where an injunction was refused because the violations were not "flagrant or outrageous" and because "the requisite proof of a threat of future wrongdoing" was lacking.

(n24)Footnote 24. 446 U.S. at 703 .

(n25)Footnote 25. See, e.g., *SEC v. Pros Int'l, Inc.*, 994 F.2d 767, 769 (10th Cir. 1993) ; *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1228 (D.C. Cir. 1989) ; *SEC v. Youmans*, 729 F.2d 413, 415 (6th Cir.) , cert. denied, 469 U.S. 1034 (1984) ; *SEC v. Holschuh*, 694 F.2d 130, 144 (7th Cir. 1982) ; *SEC v. Zale Corp.*, 650 F.2d 718, 720 (5th Cir.) , cert. denied, 454 U.S. 1124 (1981) ; *SEC v. Bonastia*, 614 F.2d 908, 912 (3d Cir. 1980) ; *SEC v. Murphy*, 626 F.2d 633, 655 (9th Cir. 1980) ; *SEC v. Universal Major Indus. Corp.*, 546 F.2d 1044, 1048 (2d Cir. 1976) , cert. denied, 434 U.S. 834 (1977) ; *SEC v. Pinckney*, 1995 U.S. Dist. LEXIS 17915 ; see also *SEC v. Schiffer*, 1998 U.S. Dist. LEXIS 8579 (S.D.N.Y. 1998) , *SEC v. Brethen*, 1992 U.S. Dist. LEXIS 20665 (S.D. Ohio Oct. 15, 1992) , *SEC v. Pros Int'l, Inc.*, 994 F.2d 767, 769 (10th Cir. 1993) .

(n26)Footnote 26. 910 F.2d 1028 (2d Cir. 1990) .

(n27)Footnote 27. 910 F.2d at 1039 .

(n28)Footnote 28. 910 F.2d at 1039-40 ; see also n.6 *supra*.

(n29)Footnote 29. See 910 F.2d at 1040 , 1042. The court held that a prohibition against future securities laws violations required a heightened showing by the Commission, because it places the defendant at risk with respect to all future securities transactions. See *id.* at 1040-41 . On the other hand, the requisite showing by the Commission for an order freezing the defendant's assets is less onerous. *Id.* at 1041 . Such an order "does not place [a defendant] at risk of

contempt in all future securities transactions... [i]t simply assures that any funds that may become due can be collected." *Id.*

(n30)Footnote 30. For comprehensive discussion, see Andre, *The Collateral Consequences of SEC Injunctive Relief: Mild Prophylactic or Perpetual Hazard*, 1981 U. Ill. L. J. 625.

(n31)Footnote 31. "The sting of the decree lies in the implication that the defendants are dishonest." *Timetrust, Inc. v. SEC*, 130 F.2d 214, 220 (9th Cir. 1942) .

(n32)Footnote 32. See *Frank v. United States*, 395 U.S. 147 (1969) (no right to jury trial if term of imprisonment does not exceed six months); *United States v. Custer Channel Wing Corp.*, 376 F.2d 675 (4th Cir.) , cert. denied, 389 U.S. 850 (1967) ; *A.V. By Versace, Inc. v. Gianni Versace, S.p.A.*, 279 F.Supp.2d 341 (S.D.N.Y. Mar. 31, 2004) (after repeated failure to comply with the court's orders, including contempt orders issuing coercive fines, court was left with "no recourse other than to enter this Order and severe sanction" imprisoning defendant until he complied with the order); *S.E.C. v. Credit Bancorp*, 2000 U.S. Dist. LEXIS 9755 (S.D.N.Y. July 3, 2000) ; *SEC v. Ormont Drug & Chemical Co., Inc.*, 739 F.2d 654 (D.C. Cir. 1984) ; *U.S. v. Kormel, Inc.*, 230 F. Supp. 275 (D. Nev. 1964) .

(n33)Footnote 33. See, e.g., *SEC v. Thermodynamics, Inc.*, 464 F.2d 457, 459 (10th Cir. 1972) , cert. denied, 410 U.S. 927 (1973) (difficulty in obtaining credit, injunction mentioned in Dun & Bradstreet report, and need to explain to business associates); *SEC v. Warren*, 583 F.2d 115 (3d Cir. 1978) (loss of corporate directorships and preclusion from several substantial business opportunities in addition to embarrassment and humiliation). Both cases involved applications to dissolve SEC injunctions that had been entered on consent. The application was granted in *Warren* but denied in *Thermodynamics*.

(n34)Footnote 34. See, e.g., 17 C.F.R. § 229.401(f), discussed in *Federal Securities Exchange Act of 1934*, A.A. Sommer, Jr., General Editor, § 4.03[5][a][vi] (Matthew Bender & Co., Inc. 2007); Item 11 of Form S-1, discussed in § 7.03[3][k] *supra*; Item 1 of Form 10, discussed in *Federal Securities Exchange Act of 1934*, A.A. Sommer, Jr., General Editor § 4.01[3][a] (Matthew Bender & Co., Inc. 2007); and Item 6(a) of Schedule 14A, discussed in *Federal Securities Exchange Act of 1934* A.A. Sommer, Jr., General Editor, § 7.04[2][a] (Matthew Bender & co., Inc. 2007). With respect to broker-dealers, see Item 10(a)(iii) of Form B-D, discussed in *Federal Securities Exchange Act of 1934*, A.A. Sommer, Jr., General Editor, § 3.03[2][a] (Matthew Bender & Co., Inc. 2007). With respect to investment advisers, see Item 10(c) of Form ADV.

(n35)Footnote 35. See § 9.10[6] *supra* for possible effects under Rule 2(e) of the Commission's Rule of Practice on professionals who practice before the Commission.

(n36)Footnote 36. Section 15(b)(4)(C) of the Exchange Act.

(n37)Footnote 37. Section 203(e)(3) of the Investment Advisers Act.

(n38)Footnote 38. Section 15(b)(6) of the Exchange Act and Section 203(f) of the Investment Advisers Act. Because of the potential hardships stemming from these provisions, courts sometimes refuse to enjoin. See, e.g., *SEC v. Geon Industries, Inc.* 531 F.2d 39, 54-56 (2d Cir. 1976) .

(n39)Footnote 39. Section 9(a)(2) of the Investment Company Act imposes an automatic bar, which the Commission can lift under Section 9(c) of that statute. See *In re E.F.Hutton & Co.*, [1986-87 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 84,024 (1986).

(n40)Footnote 40. See 17 C.F.R. §§ 230.252(c)-(f), 230.306(a)(2) and 230.505(b)(2)(iii). However, the Commission has discretionary authority to grant relief from this disqualification. 17 C.F.R. § 230.252(g).

(n41)Footnote 41. *Parklane Hosiery Co. v. Shore*, 439 U.S. 322 (1979) . In other contexts, however, there are

limitations on the use that private persons can make of the Commission's injunctive actions. Thus, for example, they cannot initiate contempt proceedings to enforce an SEC injunction. *SEC v. Vickers Christy Co.*, 1965 U.S. Dist. LEXIS 9838 (S.D.N.Y. 1965) ("The Securities and Exchange Commission alone acting in the public interest can seek enforcement of this court's injunction. In this instance, the... Commission requests no relief. Petitioners are seeking to use this court's contempt power to... collect a private debt."). Nor can they delay the Commission's case by causing it to be consolidated with their parallel actions. Such consolidation requires the Commission's consent. Section 21(g) of the Exchange Act.

(n42)Footnote 42. *Parklane*, 439 U.S. 322 was such a case. The Commission succeeded in establishing that the proxy statement involved there was false, but an injunction was found unwarranted. Nevertheless, the factual findings in the Commission's unsuccessful injunctive suit enabled private plaintiffs to obtain a partial summary judgment in their parallel action.

(n43)Footnote 43. See § 9.13 *infra*.

(n44)Footnote 44. 1 H.R. Rep. No. 616, 101st Cong., 2d Sess. 22, reprinted in 1990 U.S. Code Cong. & Admin. News 1379 (hereinafter cited as "1990 House Report" using citations to the original report pages).

(n45)Footnote 45. For a discussion of cease-and-desist orders, see § 9.10[10] *supra*.

(n46)Footnote 46. Exch. Act § 21(d)(3)(A); Sec. Act § 20(d)(1); Inv. Co. Act § 42(e)(1); Inv. Adv. Act. § 209(e)(1). Violations subject to a penalty pursuant to Section 21A, which concerns civil penalties for insider trading, are excluded from the operation of Section 21(d)(3) of the Exchange Act and Section 20(d) of the Securities Act. Exch. Act. § 21(d)(3)(A); Sec. Act § 20(d)(1). For a discussion of Section 21A, see § 9.12[2] *infra*. Sections 21(d)(3), 20(d), 42(e), and 209(e) are codified at 15 U.S.C. §§ 78u(d)(3), 77t(d), 80a-41(e), and 80b-9(e), respectively.

(n47)Footnote 47. Exch. Act § 21(d)(3)(B)(i); Sec. Act § 20(d)(2)(A); Inv. Co. Act § 42(e)(2)(A); Inv. Adv. Act. § 209(e)(2)(A). In this respect, the legislative history contemplates that the Commission would not seek a monetary penalty when a failure to comply with Commission requirements involves isolated or unintentional conduct. 1990 House Report, n.1 *supra*, at 18. On the other hand, when the defendant's conduct rises to the level of a criminal violation, a higher penalty may be appropriate. *Cf. id. at 18-19*.

(n48)Footnote 48. See Exch. Act § 21(d)(3)(B); Sec. Act § 20(d)(2); Inv. Co. Act § 42(e)(2); Inv. Adv. Act. § 209(e)(2).

(n49)Footnote 49. Exch. Act § 21(d)(3)(B)(iii); Sec. Act § 20(d)(2)(C); Inv. Co. Act § 42(e)(2)(C); Inv. Adv. Act. § 209(e)(2)(C). The penalty amounts prescribed by these statutes are subject to adjustment for inflation under the Debt Collection Improvement Act of 1996, Pub. L. No. 104-134, Title III, § 310001, 110 Stat. 1321-358. See 17 C.F.R. § 201.1002.

(n50)Footnote 50. Exch. Act § 21(d)(3)(B)(ii); Sec. Act § 20(d)(2)(B); Inv. Co. Act § 42(e)(2)(B); Inv. Adv. Act. § 209(e)(2)(B).

(n51)Footnote 51. Exch. Act § 21(d)(3)(B)(i); Sec. Act § 20(d)(2)(A); Inv. Co. Act § 42(e)(2)(A); Inv. Adv. Act. § 209(e)(2)(A).

(n52)Footnote 52. 1990 House Report, n.1 *supra*, at 22.

(n53)Footnote 53. 1990 House Report, n.1 *supra*, at 17.

(n54)Footnote 54. Exch. Act § 21(d)(3)(B)(i); Sec. Act § 20(d)(2)(A); Inv. Co. Act § 42(e)(2)(A); Inv. Adv. Act. § 209(e)(2)(A).

(n55)Footnote 55. *See* § 9.10[10] *supra*.

(n56)Footnote 56. Exch. Act § 21(d)(3)(D); Sec. Act § 20(d)(4); Inv. Co. Act § 42(e)(4); Inv. Adv. Act. § 209(e)(4).

(n57)Footnote 57. Exch. Act § 21(d)(3)(D); Sec. Act § 20(d)(4); Inv. Co. Act § 42(e)(4); Inv. Adv. Act. § 209(e)(4).

(n58)Footnote 58. *SEC v. J.W. Korth & Co.*, 991 F. Supp. 1468 (1998) , the court rejected the SEC's argument that defendant's failure to supply requested documents consisted of a new penalty each time the documents were requested.

(n59)Footnote 59. *See* § 9.11[2][d] *infra*.

(n60)Footnote 60. Fix footnotes. FRs jump from 48 to 58. Renumber, accordingly Exch. Act § 21(d)(3)(C)(i); Sec. Act § 20(d)(3)(A); Inv. Co. Act § 42(e)(3)(A); Inv. Adv. Act. § 209(e)(3)(A).

(n61)Footnote 61. Exch. Act § 21(d)(3)(C)(ii); Sec. Act § 20(d)(3)(B); Inv. Co. Act § 42(e)(3)(B); Inv. Adv. Act. § 209(e)(3)(B).

(n62)Footnote 62. Exch. Act § 21(d)(3)(C)(iii); Sec. Act § 20(d)(3)(C); Inv. Co. Act § 42(e)(3)(C); Inv. Adv. Act. § 209(e)(3)(C).

(n63)Footnote 63. Exch. Act § 21(d)(3)(C)(iv); Sec. Act § 20(d)(3)(D); Inv. Co. Act § 42(e)(3)(D); Inv. Adv. Act. § 209(e)(3)(D). For the appropriate jurisdiction and venue provisions, see Exch. Act § 27, Sec. Act § 22, Inv. Co. Act § 44, Inv. Adv. Act. § 214.

(n64)Footnote 64. 15 U.S.C. § 7246.

(n65)Footnote 65. Harvey L. Pitt, *Remarks before the U.S. Department of Justice Corporate Fraud Conference*, Sept. 26, 2002 (*available at* <http://www.sec.gov/news/speech/spch585.htm>).

(n66)Footnote 66. *See* Report Pursuant to Section 308(a) of the Sarbanes-Oxley Act, at 22 (*available at* <http://www.sec.gov/news/studies/sox308creport.pdf>). In this report, the Commission also recommended that Congress amend the Fair Funds provision to eliminate the requirement that disgorgement be obtained before penalties may be used for investor restitution. *Id.* at 33-34 .

(n67)Footnote 67. *See, e.g.*, William R. Baker III & Christopher E. Campbell, *Sarbanes-Oxley Enhancements to the SEC's Enforcement Authority*, Practising Law Institute Corporate Law and Practice Course Handbook Series, Securities Litigation & Enforcement Institute 2003 (PLI Order No. B0-01QX).

(n68)Footnote 68. *See SEC. v. WorldCom, Inc.*, 273 F. Supp. 2d 431 (S.D.N.Y. 2003) . Judge Rakoff's opinion also contains an interesting discussion of the degree to which Section 308 permissibly transforms the purpose of civil penalties from punishment or deterrence to compensation, stating that "to determine the size of the penalty primarily on the basis of how much shareholder loss will thereby be recompensed ... would run contrary to the primary purposes of S.E.C. fraud penalties themselves." This analysis is, to be fair, also reflective of the fact that WorldCom was in bankruptcy and Judge Rakoff's concern that an SEC penalty designed to compensate shareholders would place shareholders in a better position than otherwise permissible in bankruptcy proceedings.

(n69)Footnote 69. *See* SEC Press Release 2003-87 (July 28, 2003) (*available at* www.sec.gov/news/press/2003-87.htm).

(n70)Footnote 70. *See* U.S. Sec. & Exch. Comm'n, 2007 Performance and Accountability Report 2, at 26, *available at* <http://www.sec.gov/about/secpar/secpar2007.pdf>.

(n71)Footnote 71. U.S. Securities and Exchange Commission, "Management Discussion and Analysis," *Putting Investors First - 2009 Performance and Accountability Report*, p. 11 available at <http://www.sec.gov/about/secpar/secpar2009.pdf#mda>

(n72)Footnote 72. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, § 929B.

(n73)Footnote 73. *Porter v. Warner Holding Co.*, 328 U.S. 395, 398 (1946) ; see also *Hecht Co. v. Bowles*, 321 U.S. 321, 329 (1944) . Both cases involved wartime price control. Another important precedent on the broad permissible scope of ancillary remedies with no explicit statutory basis in public interest injunctive suits initiated by the government is *Mitchell v. Robert DeMario Jewelry, Inc.*, 361 U.S. 288 (1960) (injunction restraining violations of the Fair Labor Standards Act can order employer to reimburse employees for lost wages). *Deckert v. Independence Shares Corp.*, 311 U.S. 282, 287-290 (1940) , dealing with the broad scope of the equitable relief available to private plaintiffs suing under the Securities Act, has also been influential. *Northwest Env't Def. Center v. Bonneville Power Admin.*, 477 F.3d 668 (9th Cir. 2007) (environmental groups and others petitioned for judicial review of actions of power marketing agency that operated dams on river).

(n74)Footnote 74. The literature on the subject is voluminous. See, e.g., Comment, *Equitable Remedies in SEC Enforcement Actions*, 123 U. Pa. L. Rev. 1188 (1975); Farrand, *Ancillary Remedies in SEC Court Enforcement Suits*, 89 Harv. L. Rev. 1779 (1976); Matthews, *Recent Trends in SEC Requested Ancillary Relief in Civil Injunctive Action*, 31 Bus. Law. 1323 (1976); Sporkin, *SEC Developments in Litigation and Molding of Remedies*, 29 Bus. Law. 21 (1974); Treadway, *Enforcement Techniques: Expanding and Exotic Forms of Ancillary Relief*, 32 Wash. and Lee L. Rev. 37 (1975); Dent, *Ancillary Relief in Federal Securities Law, A Study in Federal Remedies*, 67 Minn. L. Rev. 865 (1983); Ellsworth, *Disgorgement in Securities Fraud Actions Brought by the SEC*, 1977 Duke L.J. 241.

(n75)Footnote 75. 15 U.S.C. § 78u(d)(5).

(n76)Footnote 76. See *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1308 (2d Cir.) , cert. denied, 404 U.S. 1005 (1971) (but only "so long as such relief is remedial relief and is not a penalty assessment").

(n77)Footnote 77. *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir.) , cert. denied, 404 U.S. 1005 (1971) ; *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082 (2d Cir. 1972) ; *SEC v. Golconda Mining Co.*, 327 F. Supp. 257 (S.D.N.Y. 1971) . Courts look at several factors to determine whether or not to award pre-judgment interest--the need to compensate the injured party, considerations of fairness, and the remedial purposes of the violated statute. See *SEC v. Jakubowski*, 1997 U.S. Dist LEXIS 14575 (N.D. Ill. Sept. 12, 1997) . In addition, courts have held that the violator bears the risk of any uncertainty in the amount of the disgorgement award. See *SEC v. Drexel Burnham Lambert*, 837 F. Supp. 587, 612 (S.D.N.Y. 1993) . Lastly, inability to pay is a basis for avoiding disgorgement. It is a valid defense on which the person asserting inability has the burden of proof. See *SEC v. Huffman*, 996 F.2d 800, 803 (5th Cir. 1993) .

(n78)Footnote 78. See *SEC v. Goldman Sachs & Co.*, [1973-74Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,556 (S.D.N.Y. 1974).

(n79)Footnote 79. *SEC v. S&P National Corp.*, 360 F.2d 741 (2d Cir. 1966) ; *SEC v. Keller Corp.*, 323 F.2d 397 (7th Cir. 1963) ; *SEC v. Bowler*, 427 F.2d 190 (4th Cir. 1970) ; *SEC v. Fifth Avenue Coach Lines, Inc.*, 289 F. Supp. 3 (S.D.N.Y. 1968) , *aff'd*, 435 F.2d 510 (2d Cir. 1970) . *SEC v. Wencke*, 622 F.2d 1363 (9th Cir. 1980) ; *SEC v. Bilzerian*, Civil Action No. 89-1854 (D.D.C.) (Mar. 1, 2001) (unpublished order appointing receiver). While this form of relief is usually sought to preserve the assets of a corporate entity, the Commission can seek a receivership for an individual as well, as was the case in *Bilzerian*.

(n80)Footnote 80. *International Controls Corp. v. Vesco*, 490 F.2d 1334 (2d Cir.) , cert. denied, 417 U.S. 932 (1974) . *SEC v. Lockheed Aircraft Corp.* (D.D.C. 1976). But see *SEC v. Falstaff Brewing Corp.*, (D.D.C. 1978), *aff'd on other grounds*, 629 F.2d 62 (D.C. Cir. 1980) , where the court refused the Commission's request for the appointment of independent directors and for the creation of an audit committee to be composed of such independent directors, even

though serious violations were found and an injunction granted.

(n81)Footnote 81. *SEC v. Radio Hill Mines Co.*, 479 F.2d 4 (2d Cir. 1973) (enjoined persons ordered to file quarterly reports of all their securities transactions and to supply initial inventories of their record and beneficial holdings).

(n82)Footnote 82. *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082 (2d Cir. 1972) ; *SEC v. Musella*, 578 F. Supp. 425 (S.D.N.Y. 1984) .

(n83)Footnote 83. *International Controls Corp. v. Vesco*, 490 F.2d 1334 (2d Cir.) , cert. denied, 417 U.S. 932 (1974) : *Handler v. SEC*, 430 F. Supp. 71 (C.D. Cal. 1977) , aff'd, 610 F.2d 656 (9th Cir. 1979) ; *SEC v. Canadian Javelin, Ltd.*, 451 F. Supp. 594 (D.D.C. 1978) ; *SEC v. Lincoln Thrift Association*, 577 F.2d 600 (9th Cir. 1978) .

(n84)Footnote 84. *SEC v. Universal Energy Corp.*, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,697 (D.D.C. 1984).

(n85)Footnote 85. *SEC v. Micro-Therapeutics, Inc.*, [1983-84 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 99,695 (S.D.N.Y. 1984).

(n86)Footnote 86. Exch. Act § 21(d)(2); Sec. Act § 20(e). The Commission was also given the power to impose such bars in administrative cease-and-desist proceedings. See § 9.10[10][a][iii] *supra*.

(n87)Footnote 87. H.R. Rep. No. 616, 101st Cong., 2d Sess. 28, reprinted in 1990 U.S.Code Cong. & Admin. News 1379 (hereinafter cited as "1990 House Report" using citations to the original report pages).

(n88)Footnote 88. 1990 House Report, n.14 *supra* at 27.

(n89)Footnote 89. 1990 House Report, n.14 *supra*, at 27; see also *SEC v. Materia*, 745 F.2d 197, 200 (2d Cir. 1984) , cert. denied, 471 U.S. 1053 (1985) ("once the equity jurisdiction of the district court properly has been invoked, the court has power to order all equitable relief necessary under the circumstances"). Indeed, long before Sections 21(d)(2) and 20(e) became law, one court prohibited a defendant from acting as an officer or a director as relief ancillary to an injunction. In *SEC v. Techni-Culture, Inc.*, [1973-74 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 94,501 (D. Ariz. 1974), the court enjoined the defendants from violating Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act. The court further ordered that one defendant be prohibited from assuming a position as or continuing to act as an officer or a director of any public company except upon a showing that measures have been taken to prevent repetition of the same or similar conduct.

(n90)Footnote 90. *SEC v. Patel*, 61 F.3d 137 (2d Cir. 1995) .

(n91)Footnote 91. Companies that face this prospect try to avoid it by consenting to other less drastic forms of ancillary relief. Even in contested cases where serious wrongdoing was involved, limited purpose trusteeships have been ordered in lieu of general receiverships. See, e.g., *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082 (2d Cir. 1972) .

(n92)Footnote 92. See § 9.09[3][c] *supra*. See also Gruenbaum and Oppenheimer, *Special Investigative Counsel; Conflicts and Roles*, 33 Rutgers L. Rev. 865 (1982).

(n93)Footnote 93. Farrand, *Ancillary Remedies in SEC Civil Enforcement Suits*, 89 Harv. L. Rev. 1779, 1811 n.164 (1976). The author goes on to point out that the other side of this coin is that "special counsel may choose to read his ambiguous mandate in a narrow or restrictive way and to conduct his investigation accordingly" and that "[s]hould this occur, neither the SEC nor the special counsel will unearth information that should come to light in a well-conducted enforcement proceeding."

(n94)Footnote 94. *General Stores Corp. v. Shlensky*, 350 U.S. 462, 466 (1956) (choice between different types of reorganization proceedings under the Bankruptcy Act of 1938).

(n95)Footnote 95. *See, e.g.*, SEC v. Falstaff Brewing Corp., n.9 *supra* , where court-appointed directors were found inappropriate, and *SEC v. Parklane Hosiery Co.*, 422 F. Supp. 477, 486 (S.D.N.Y. 1976) , *aff'd*, 558 F.2d 1083 (2d Cir. 1977) (Commission's request for the appointment of special counsel to determine the fair value of certain securities denied as "wholly unnecessary" because private litigation seeking that end had already been instituted).



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Federal Securities Exchange Act of 1934

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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.12

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§ 9.12 Specialized Treatment of Illicit Insider Trading

[1] Background

Concern about the prevalence and the evil effects of illicit insider trading has produced a specialized remedial scheme for that offense. Its keystone, a civil penalty, was introduced by the Insider Trading Sanctions Act of 1984. n1 That penalty was sharpened by, and the Insider Trading Sanctions Act strengthened by, the Insider Trading and Securities Fraud Enforcement Act of 1988. n2

These statutes do not define the offense with which they deal. Nor has the Commission done so. The substantive law of the subject is rooted in the Commission's *Rule 10b-5*, n3 a general proscription against fraud and deception that makes no express mention of insider trading. n4 However, courts have constructed a body of doctrine around the rule through case-by-case adjudication in traditional common law fashion. n5

The special insider-trading legislation first enacted in 1984 and materially strengthened at the end of 1988 deals solely with remedies for and deterrents to an undefined offense. That peculiar state of affairs reflects the following legislative judgments. First, the courts "have established clear guidelines for the vast majority of traditional insider trading cases." n6 Second, further refinements are best left to the judiciary because "a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law." n7 Finally, the truly serious problem with pre-1984 insider trading jurisprudence was that the remedies were ineffective and that there was no real deterrent. n8

[2] Civil Fines

Section 21A of the Exchange Act authorizes the Commission to seek, and the district courts to order, the payment to the United States Treasury of as much as three times the profit gained or the loss avoided as a result of the unlawful transaction. n9 Since the recovery goes to the United States and not to the victims of the wrong, n10 the penalty does not displace the disgorgement remedy that the Commission previously succeeded in establishing. n11 Rather, it supplements that remedy by adding what Congress hoped would be an effective deterrent. n12

This means that the SEC may be able to effect the collection of as much as four times the illicit gain n13 --disgorgement for the injured investors plus the trebled penalty for the United States. Trebling is not mandatory. n14 However, the

2-9 Federal Securities Exchange Act of 1934 § 9.12

Commission will be able to make a strong argument that it was intended to be the general rule at least when sophisticated professional traders are involved. n15

These substantial liabilities can be imposed on aiders and abettors who did not trade themselves. n16 In *Central Bank of Denver v. First Interstate Bank*, n17 the Supreme Court held that there is no civil liability for aiding and abetting under Section 10(b). This decision was later clarified by legislation that specified that SEC enforcement actions may be brought against persons who aid and abet violations of Section 10(b). n18 The Supreme Court in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*, however, made plain that only the SEC had the right to bring aiding and abetting claims, and that the private right of action permitted under § 10(b) and *Rule 10b-5* did "not extend to aiding and abetting." n19 Tipsters are as liable as tippees. n20 The tippee's payment of the penalty does not extinguish the tipster's liability. n21

The *Dodd-Frank Wall Street Reform and Consumer Protection Act* granted the SEC the express right to bring aiding-and-abetting claims under the federal securities laws including Section 10(b). Additionally, *Dodd-Frank* lowered the required mental state for aiding-and-abetting liability from "actual knowledge" to "recklessness" thereby abrogating the "knowing" standard for an aiding-and-abetting violation of the 34 Act under the Private Securities Litigation Reform Act of 1995. n22

Thus, a person who derived no pecuniary benefit from the unlawful trading may nevertheless be liable for very large amounts. Moreover, a tipster may be liable for profits realized by his tippees, even if the tippee is not held liable as an insider trader. n23

Tippees may be found liable even where it is shown that the tipster did not know that his or her breach of fiduciary obligation would lead the tippee to trade on the information. n24 To impose the Section 21A civil penalty, the Commission must establish that the defendant:

- had material nonpublic information;
- bought or sold securities while in possession of such information or conveyed that information to others who bought and sold; and
- the illicit transaction was "on or through the facilities of a national securities exchange or from or through a broker or dealer" and "not part of a public offering by an issuer of securities other than standardized options." n25

The exclusions reflect the purpose of the Act, the deterrence of informational abuses in the impersonal trading markets. n26 For face-to-face transactions and for public offerings by issuers, existing remedies were obviously deemed adequate. n27

There are several other noteworthy points about the civil fine. Profits gained or losses avoided are computed by comparing the price paid or received with the market price "a reasonable period after public dissemination of the nonpublic information." n28 In addition, there is a five-year statute of limitations, applicable only to actions under the Insider Trading Sanctions Act. n29 Finally, although the statute says nothing about jury trial, the *Seventh Amendment* entitles the defendant to a jury on the question of whether the law has been violated. This is so because "[a]ctions by the Government to recover civil penalties under statutory provisions... historically have been viewed as one type of action in debt requiring trial by jury." n30

The assessment of the penalty is another matter. That involves "highly discretionary calculations that take into account multiple factors." These are "traditionally performed by judges." Hence "the trial court and not the jury should determine the amount of penalty, if any." n31

[3] Vicarious Liability

The 1984 predecessor of present Section 21A reached only those who actually tipped or traded. No fines could be exacted from the people and the firms who "controlled" those tipplers and tippees. n32 Therefore, corporate entities and employers were immune from the penalty unless they had themselves tipped or traded. n33

The 1988 legislation changed this. It does not, however, take a mechanistic *respondeat superior* approach. Rather, it seeks to stimulate employers to supervise vigorously by penalizing "those broker-dealers, investment advisers and others who failed to take appropriate steps to prevent... violations from occurring." n34

The general rule is still that "[n]o controlling person shall be subject to a penalty." n35 Penalties, however, can be imposed when the Commission "establishes" that:

- the controlling person "knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred;" n36 or
- the controlling person "knowingly or recklessly failed" to establish, maintain, or enforce policies and procedures reasonably designed to prevent the misuse of material non-public information. n37

Note that the controlling person's fine may be much higher than that of the trader or tipper whom he or she controlled. That is so because the primary violator's fine can in no event "exceed three times the profit gained or loss avoided." n38 The controlling person's fine, on the other hand, may be that or it may be \$1 million, whichever is more. n39

However, there is a special rule when the controlled person is a non-trading tipper. In that situation, his or her employer n40 is not responsible for the gains of an "endless chain" of tippees. n41 The employer is responsible only for "the profit gained or loss avoided" by the person or persons to whom the controlled person directed such communication. n42 Even then, however, the million dollar ceiling, which is unrelated to the pecuniary aspects of the particular situation, could haunt the employer in an egregious case.

[4] Whistleblower Protections and Rewards

Previously, people who supplied information that led to the imposition of a penalty on a wrongdoer could receive a portion of the fine imposed. n43 The bounty-hunter's portion, however, could not exceed 10% of the amount recovered, n44 and there was no "right" to it because the questions of whether to pay, whom to pay, and how much to pay "shall be in the sole discretion of the Commission." n45 The Commission's determinations were "final and not subject to judicial review." n46 In 1989, the Commission promulgated rules that set forth the procedures regarding applications for bounty awards. n47 The rules provided that applications for bounty payments must be filed with the Commission within 180 days after the court enters the order requiring an insider trader to pay a penalty. n48 If the application was the communication in which the bounty hunter seeks to inform the Commission of insider trading activity, the application could have been anonymous. Should the bounty hunter have wished to collect the reward after the proceeding, he or she would have had to amend the bounty application, setting forth sufficient information to prove that he or she was the original informant. n49

The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* expanded whistleblower rewards and protections and thereby provided the SEC with another tool to facilitate investigations of securities violations. *Dodd-Frank* contains provisions that allow whistleblowers who report securities violations to recover a percentage of any settlement or sanction. Under the law, the SEC is required to give a whistleblower who provides original information leading to civil enforcement or criminal prosecution between 10 % and 30% of any sanction imposed, so long as the sanction collected exceeds \$1 million. n50 (Under the old law, whistleblower rewards were capped at 10%

of penalties enforced and limited to the insider-trading context.) The size of the reward will turn on the significance of the information and the level of cooperation provided by the individual. n51 Under the Act, other prosecuting agencies may be rewarded, including the DOJ or foreign regulators, based the usefulness of their original information. n52 The SEC has 270 days from enactment, until April 17, 2011, to prescribe rules implementing the new whistleblower protections and award program. n53 It is unclear how this additional bounty will affect the number of tips to the SEC or the number of enforcement actions ultimately brought.

Furthermore, the *Restoring American Financial Stability Act of 2010* provides enhanced whistleblower protections including an express private right of action for whistleblowers whose employers retaliate against them. n54 Additionally, the Act modifies whistleblower protections under *Sarbanes-Oxley* by extending the statute of limitations for whistleblower claims from 90 days to 180 days, forbidding the waiver of any rights or remedies provided to whistleblowers, and subjecting subsidiaries and affiliates that are consolidated with public companies for accounting purposes to whistleblower provisions. n55

[5] Employers' Supervisory Responsibilities

Section 15(f) of the Exchange Act and Section 204A of the Investment Advisers Act require registered broker-dealers and investment advisers to "establish, maintain, and enforce written policies and procedures reasonably designed... to prevent the misuse... of material nonpublic information." Both sections give the Commission broad rulemaking authority "to require specific policies or procedures." Although the Commission has not yet done so, these statutory provisions are still the "law" and must be complied with, whether or not the Commission elects to issue rules in this area. The legislative history states that Congress expects "that a firm's supervisory system would include, at a minimum, employment policies... requiring personnel to conduct their securities trading through in-house accounts or requiring that any trading in outside accounts be reported expeditiously to the employing firm." Reference was also made to the desirability of:

- restrictions on access to files likely to contain nonpublic information;
- continuing education programs concerning insider trading;
- restricting or monitoring trading in securities [about] which the firm's employees possess nonpublic information; and
- the need for vigorous monitoring and reviewing trading for the account of the firm or of individuals.

n56

[6] Private Rights of Action

The 1988 Act created an express private right of action against illicit inside traders. That right, under Section 20A of the Exchange Act, inures to the benefit of those who traded "contemporaneously" with the insider on the side opposite to him. At first blush, the need for this section seems obscure since contemporaneous traders have long had an implied right of action in these circumstances. n57

However, the courts have refused to permit contemporaneous traders to recover against those who acquired nonpublic information in a legitimate way and there after misappropriated it to enrich themselves. They have seen no breach of duty to the investing public in that situation. The leading case is *Moss v. Morgan Stanley*. n58 Congress disagrees with its holding, which it finds "inconsistent with the remedial purposes of the Exchange Act." n59 Accordingly, Section 20A is "specifically intended to overturn court cases which have precluded recovery... upon the misappropriation theory." n60

Contemporaneous traders who wish to bring a claim under Section 20A (or Section 10(b)) must adhere to the Fed. R. Civ. P. 9(b) requirement that fraud must be pled with particularity.

That no express right of action was given persons other than contemporaneous traders does not indicate hostility to such claims. On the contrary, the 1988 House Committee report expresses great sympathy for them. n61 However, Congress thought it best "to avoid creating an express private cause of action which might have the unintended effect of freezing the law or in any way restricting the potential rights of action which have been implied by the courts in this area." n62

Finally, claims under Section 20A cannot be predicated on *respondeat superior*. n63 In addition, damages cannot "exceed the profit gained or loss avoided in the transaction or transactions that are the subject of the violation." n64

FOOTNOTES:

(n1)Footnote 1. 98 Stat. 1264. That statute also made other enforcement-related changes. These amended Section 32 of the Exchange Act to increase the maximum criminal fine for a violation of the securities laws from \$10,000 to \$100,000, extended the Commission's power to require corrections under Section 15(c)(4) of the statute (see § 9.10[3] *supra*) to tender offers and proxy statements, and made violations of the Commodity Exchange Act an express ground for SEC disciplinary action against broker-dealers and their associated persons.

(n2)Footnote 2. Public Law 100-704, signed by the President on November 19, 1988. Like the 1984 statute, this statute is not limited to insider trading. Criminal penalties under Section 32 of the Exchange Act, which had been raised in 1984, were further increased. The maximum jail term for a violation of the securities laws is now 10 years, the maximum criminal fine for individuals has been raised from \$100,000 to \$1 million, and the maximum criminal fine for non-natural persons is now \$2.5 million, as against a previous limit of \$500,000. 15 U.S.C. § 78ff.

(n3)Footnote 3. 17 C.F.R. § 240.10b-5.

(n4)Footnote 4. Analogous provisions in Section 17(a) of the Securities Act, Section 14(e) of the Exchange Act which deals with tender offers, as well as Section 206 of the Investment Advisers Act are also invoked on occasion.

(n5)Footnote 5. The Supreme Court has set out two separate theories of liability under Section 10(b). Under the classical theory, an insider who buys or sells securities on the basis of non-public information violates *Rule 10b-5*. See *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980). Under the misappropriation theory, an individual who misappropriates material nonpublic information by breaching a duty arising out of a relationship of trust and confidence and uses that information in a securities transaction, regardless of whether he was an insider and owed any duties to the shareholders of the traded stock. *U.S. v. O'Hagan*, 521 U.S. 642 (1997).

(n6)Footnote 6. H. R. Rep. No. 910, 100th Cong., 2d Sess. (1988) (hereinafter cited as "1988 House Report") at 11. The Committee also observed that "the legal principles governing insider trading cases are well-established and widely-known."

(n7)Footnote 7. *Id.*

(n8)Footnote 8. On the patent ineffectiveness of mere disgorgement, see *SEC v. Randolph*, 564 F. Supp. 137 (N.D. Cal. 1983), *rev'd on other grounds*, 736 F.2d 525 (1984): "An insider can trade on nonpublic information secure in the knowledge that if he is caught he need only restore his illicitly acquired proceeds."

(n9)Footnote 9. Section 21A was added by the 1988 statute. It replaced the now-repealed Section 21(d)(2), enacted in 1984 which had initially introduced the civil fine. Section 21A is codified at 15 U.S.C. § 78u-1.

(n10)Footnote 10. As previously discussed, under the Fair Funds provisions of Sarbanes-Oxley, the S.E.C. may, at its discretion, distribute monies collected through disgorgement and fines to victims of the securities violation.

(n11)Footnote 11. See *SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir.) , cert. denied, 404 U.S. 1005 (1971) ; *SEC v. Shapiro*, 494 F.2d 1301 (2d Cir. 1974) ; *SEC v. MacDonald*, 699 F.2d 47 (1st Cir. 1983) (en banc).

MacDonald is an important authority on the measure of damages in disgorgement. It bases the damages on the price of the security "a reasonable time after public dissemination of the... information." 699 F.2d at 52 . The Commission's argument for a harsher rule seizing the insider's total profit was rejected.

Congress has also rejected it. Committee reports cite *MacDonald* with approval and state that the penalty is to be computed in accordance with its teaching. 1988 House Report at 20. In addition, Section 21A(f) expressly provides that the fine is to be "measured by the trading price of the security a reasonable period after public dissemination of the information."

In *United States v. Mooney*, 425 F.3d 1093 (8th Cir. 2005) , the Court of Appeals for the Eighth Circuit declined to extend MacDonald's market-absorption theory, based on the loss of the victim, in the criminal securities law context. *Mooney*, instead, held that the proper metric to determine punishment is the gain to the culprit. *Id.* at 1101 .

There is some disagreement concerning the issue of whether the expenses incurred in perpetrating securities fraud, such as brokers fees, should be deducted from the amount to be disgorged. Compare *SEC v. Thomas James Assocs., Inc.*, 738 F. Supp. 88, 94 (W.D.N.Y. 1990) (Court may consider sums paid to effect a fraudulent transaction) and *Litton Indus. Inc. v. Lehman Bros. Kuhn Loeb, Inc.*, 734 F. Supp. 1071, 1077 (S.D.N.Y. 1990) , rev'd on other grounds, 967 F.2d 742 (2d Cir. 1992) (permitting offset for expenses and costs), with *SEC v. Great Lakes Equities Co.*, 775 F. Supp. 211, 215 n. 22 (E.D. Mich. 1991) (offset for overhead and other expenses incurred in perpetrating fraud not warranted) and *SEC v. Dimensional Entertainment Corp.*, 493 F. Supp. 1270, 1283 (S.D.N.Y. 1980) (expenses incurred in perpetrating fraud not deducted from amount to be disgorged).

(n12)Footnote 12. See 1988 House Report at 14: "[T]he scandals of the last two years demand a legislative response." *Id.* at 11 : "Despite the stiffer penalties enacted by Congress in 1984, the last few years have seen a dramatic increase in insider trading cases, including cases against some of the most prominent officials in Wall Street investment banking firms."

(n13)Footnote 13. Criminal fines could add to this. Those could be as much as \$1 million for each wrongful transaction. For a non-natural person, that million dollar figure rises to \$2.5 million. Defendants may be required to disgorge the profits made through insider trading as well as pay a criminal fine, "to make sure that wrongdoers will not profit from their wrong doing." *SEC v. Shah*, 1993 U.S. Dist. LEXIS 10347 at 11 , quoting *SEC v. Tome*, 833 F.2d 1086, 1096 (2d Cir. 1987) .

(n14)Footnote 14. The statute says that "The amount of the penalty... shall be determined by the court in light of the facts and circumstances," without supplying any standards or criteria. Section 21A(a)(2).

(n15)Footnote 15. See H. R. Rep. No. 355, 98th Cong., 1st Sess. (1983): "In appropriate cases, the Commission might seek a penalty less than three times the amount of profit gained or loss avoided." (Emphasis added.) The quotation is from the Commission's memorandum in support of the bill that became the Insider Trading Sanctions Act.

(n16)Footnote 16. However, persons who aid and abet "in a manner other than by communicating material nonpublic information" are not subject to the penalty. Former Section 21(d)(2)(B) so provided. The deletion of that provision in 1988 did not change the rule. See 1988 House Report at 19 n.15.

(n17)Footnote 17. 511 U.S. 164 (1994) .

(n18)Footnote 18. 15 U.S.C. § 78t.

(n19)Footnote 19. 128 S. Ct. 761, 763 (2008) .

(n20)Footnote 20. *U.S. v. Libera*, 989 F.2d 596 (2d Cir. 1993) .

(n21)Footnote 21. See *SEC v. Gaffney*, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) § 92,002 (S.D.N.Y. 1985) (civil penalty imposed on tipper who did not trade and also on his tippees who did trade).

(n22)Footnote 22. See Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 § 929M.

(n23)Footnote 23. *SEC v. Clark*, 915 F.2d 439, 453 (9th Cir. 1990) (citing *Dirks*, 463 U.S. at 664).

(n24)Footnote 24. Section 21A(a)(1). Section 21A(c) gives the Commission rule-making authority to exempt other classes of persons or transactions.

(n25)Footnote 25. The 1984 and 1988 legislation was a response to the insider trading scandals of the mid- and late-1980s, all of which involved insider trading in markets.

(n26)Footnote 26. See Langevoort, *The Insider Trading Sanctions Act of 1984 and its Effect on Existing Law*, 37 *Vand. L. Rev.* 1273, 1279 n.31 (1984) (in face-to-face transactions defrauded people have a clear incentive to sue, and in public offerings "the strict disclosure requirements imposed under the Securities Act will presumably prevent most forms of abuse").

(n27)Footnote 27. Section 21A(f).

(n28)Footnote 28. Section 21A(d)(5). None of the other statutory provisions authorizing the Commission to seek civil relief provides for a limitation period. Hence it has been held that under Section 21A, lapse of time does not bar the Commission from seeking an injunction and that this is so even when the Commission asks for disgorgement. *SEC v. O'Hagan*, 793 F. Supp. 218, 220 (D. Minn. 1992) . However, the passage of time has led courts to deem injunctive relief inappropriate. See, e.g., *SEC v. Monarch Fund*, 608 F.2d 938, 943 (2d Cir. 1979) (dictum, since court found no violation); *SEC v. Parklane Hosiery Co.*, 422 F. Supp. 477, 486 (S.D.N.Y. 1976) , *aff'd*, 558 F.2d 1083 (2d Cir. 1977) ; *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682, 716 (D.D.C. 1978) . With respect to administrative proceedings, a laches contention failed in *Irish v. SEC*, 367 F.2d 637 (9th Cir. 1966) , *cert. denied*, 386 U.S. 911 (1967) (respondent not prejudiced by delay).

(n29)Footnote 29. 15 U.S.C. § 78u-1.

(n30)Footnote 30. *Tull v. United States*, 481 U.S. 412, 418-419 (1987) (unanimous holding in an action for civil penalties under the Clean Water Act). The Court divided on the question of who should fix the fine. Two justices thought the *Seventh Amendment* was applicable to the remedy as well as to the right. 481 U.S. at 427-428 .

(n31)Footnote 31. Former Section 21(d)(2)(B) provided that: "No person shall be subject to a sanction under... this paragraph solely because that person aided and abetted a transaction... in a manner other than by communicating material nonpublic information. Section 20(a) of this title [which imposes liability on those who control others] shall not apply to an action brought under this paragraph. No person shall be liable under this paragraph solely by reason of employing another person who is liable under this paragraph."

(n32)Footnote 32. See 1988 House Report at 17.

(n33)Footnote 33. *Id.*

(n34)Footnote 34. Section § 21A(b)(1); see also Section 21A(b)(2): "No person shall be subject to a penalty solely [emphasis added] by reason of employing another person who is subject to a penalty."

(n35)Footnote 35. Exch. Act § 21A(b)(1)(A).

(n36)Footnote 36. Exch. Act § 21A(b)(1)(B).

(n37)Footnote 37. Exch. Act § 21A(a)(2).

(n38)Footnote 38. Exch. Act § 21A(a)(3).

(n39)Footnote 39. The relationship between the controlling and the controlled person is generally that of employer and employee. However, "control" is a complex securities law concept that is not limited to the employment context. See the Commission's Rule 405 under the Securities Act of 1933, *17 C.F.R. § 230.405*. See also House Report at 17: "'Controlling person' may include... any person with power to influence or control... another... The Committee expects the Commission and the courts to continue to interpret the term 'controlling person' on a case-by-case basis according to the actual circumstances." (Citations omitted.)

(n40)Footnote 40. *Id.* at 19 .

(n41)Footnote 41. Exch. Act § 21A(a)(3), second sentence.

(n42)Footnote 42. Exch. Act § 21A(e), which provides that "no payment shall be made to any member, officer, or employee of any appropriate regulatory agency, the Department of Justice or a self-regulatory organization."

What about people in the securities business? Congress was ambivalent about them. The 1988 House Report says (at page 20): "[T]he Committee expects that bounty payments would not be made to supervisory and compliance officers of securities firms in situations in which a reward would undermine substantially the compliance programs within such firms. The Committee's adoption of an affirmative statutory obligation to supervise employees indicates the importance the Committee places on the internal compliance programs of these firms. See § 9.12[5] *infra*. The Committee is sympathetic to the concern that bounty payments, if indiscriminately awarded, would substantially undermine the authority of broker-dealer firms to carry out their supervisory duties to detect and prevent insider trading. On the other hand, there may be circumstances in which it would be appropriate to award a bounty to a broker-dealer employee. Thus, the bill gives the Commission discretion to award bounties to broker-dealer firms in appropriate cases."

(n43)Footnote 43. Exch. Act § 21A(e).

(n44)Footnote 44. Exch. Act § 21A(e).

(n45)Footnote 45. The 1988 Committee report explains (at page 22) that "The purpose of this provision is to assist the Commission and the Department of Justice in developing better information in their investigation and prosecution of insider trading cases."

(n46)Footnote 46. See *17 C.F.R. §§ 201.61-201.68*

(n47)Footnote 47. *17 C.F.R. § 201.63*

(n48)Footnote 48. *17 C.F.R. § 201.65*

(n49)Footnote 49. 1988 House Report at 22.

(n50)Footnote 50. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 tor Protections and Improvements to the Regulation of Securities § 922 (b).

(n51)Footnote 51. *Id.* at § 922 (c).

(n52)Footnote 52. *Id.* at § 922 (h)(2)(D).

(n53)Footnote 53. *Id.* at § 924 (a).

(n54)Footnote 54. *Id.* at § 922 (h).

(n55)Footnote 55. *Id.*

(n56)Footnote 56. 1988 House Report.

(n57)Footnote 57. *See e.g., Comtech Telecommunications Corp.*, 648 F.2d 88 (2d Cir. 1981) ; *Shapiro v. Merrill Lynch Pierce, Fenner and Smith, Inc.*; 495 F.2d 228 (2d Cir. 1974) ; *O'Connor & Associates v. Dean Witter Reynolds, Inc.*, 559 F. Supp. 800 (S.D.N.Y. 1983) , all of which are cited in n.22 to the 1988 House Report.

(n58)Footnote 58. 719 F.2d 5 (2d Cir. 1983) , *cert. denied*, 465 U.S. 1025 (1984) .

(n59)Footnote 59. 1988 House Report at 26.

(n60)Footnote 60. *In re Storage Tech. Corp. Sec. Litig.*, 804 F. Supp. 1368, 1372, 1374 (D. Colo. 1992) .

(n61)Footnote 61. It states at page 27 that "the Committee recognized that there clearly are injuries caused by insider trading to others beyond contemporaneous traders."

(n62)Footnote 62. *Id.*

(n63)Footnote 63. Exch. Act 20A(b)(3) states that no person shall be liable in a private action "solely by reason of employing another person who is liable." But the 1988 House Report states (at page 27 n.23) that "other theories of liability, such as aiding or abetting or the failure to supervise" should be available "in appropriate circumstances."

(n64)Footnote 64. Exch. Act 20A(b)(1).



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.13

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§ 9.13 Certification Requirements Under Sarbanes-Oxley Act

[1] Generally

In response to a wave of corporate scandals in 2001 and an increased demand for accountability in corporate governance, Congress enacted Sections 302 and 906 of the Sarbanes-Oxley Act of 2002. n1 Sections 302 and 906 require financial certifications by chief executive officers and impose civil and criminal penalties for false certifications. n2 Section 302 and 906 certifications are applicable to all types of issuers that file reports under Section 13(a) or 15(d) of the Exchange Act, including foreign private issuers, banks and savings associations, issuers of asset-backed securities, small business issuers, and registered investment companies.

[2] Applicability and Requirements

Section 302 requires an issuer's principal executive and financial officers to certify information addressing disclosure and internal controls procedures. n3 Section 302 requires the principal executive and financial officers to certify in each quarterly and annual report filed or submitted by the issuer to the SEC under section 13(a) or 15(d) of the 1934 Act that he or she has reviewed the report, and that based on his or her knowledge, the report and financial statements do not contain any material misstatements or omissions. n4 Additionally, with regards to disclosure and internal controls and procedures, the principal executive and financial officers must certify that they are responsible for establishing these controls and procedures and that they have designed them to ensure that financial statements prepared for external purposes are reliable and comply with Generally Accepted Accounting Principles ("GAAP"). Further, the principal executive and financial officers must certify that they have disclosed to the issuer's auditors all significant deficiencies in the design or operation of internal controls, including any fraud that may involve management or other employees who play a significant role in designing or implementing the issuer's internal controls. n5 The certification requirement of Section 302 applies to annual reports on Forms 10-K, 10-KSB, 20-F and 40-F, as well as quarterly reports on Forms 10-Q and 10-QSB. Forms 6-K and 8-K, as opposed to quarterly or annual reports, are not covered by the certification requirement.

Similarly, Section 906 of the Sarbanes-Oxley Act requires that the Chief Executive Officer and Chief Financial Officer of an issuer "certify that the periodic reporting containing the financial statements fully complies with the requirements of section 13(a) or section 15(d) of the Exchange Act" n6 and that the information contained in the periodic reports

fairly presents, in all material respects, the financial condition and results of operations of the issuer. n7

[3] Liability and Penalties for Violations

Prior to the adoption of Section 302, officers of an issuer could be liable as signatories for the issuer's disclosures under Exchange Act liability provisions. Providing a false certification under Section 302, however, may also expose CEOs and CFOs to personal liability, including SEC enforcement actions and/or private actions for violations of federal securities laws.

Violations of Section 906 may result in criminal liability. Pursuant to Section 906, a CEO or CFO that certifies a financial statement knowing that it does not comply with the requirements under this provision may be fined up to \$1 million, imprisoned for up to ten years, or both. n8 An officer who "willfully" certifies any statement knowing that the statement does not comport with all the requirements in the section shall be fined up to \$5 million and imprisoned for a period not to exceed twenty years. n9 Although courts have not meaningfully explained the difference between the standards for these two penalties, the court in *United States v. Scrushy*, explained that to "willfully" certify a financial report requires an act that is volitional, intentional and not merely accidental. n10 As a result, the act cannot be deemed criminal unless it satisfies strict scienter requirements. n11

In addition, Section 304, widely referred to as the "claw back" provision, provides that if an issuer files an accounting restatement as a result of "material noncompliance" with financial reporting requirements under the federal securities laws, the CEO and CFO must make certain reimbursements to the issuer. n12 Specifically, they must "reimburse the issuer for--(1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Commission (whichever first occurs) of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period." n13 Section 304 essentially prevents chief financial officers and chief executive officers from profiting by selling company stock, or receiving company bonuses, while misleading the public and regulators about the actual financial health of the company.

While the SEC has the authority to enforce the provisions of Section 304, n14 several federal courts have concluded that no private right of action exists under Section 304 and companies may not assert this right in an action to recoup losses against a former CEO or CFO. n15 In *Kogan v. Robinson* the court explicitly stated that "Congressional intent to grant such a remedy is not evident in the text and structure of the statute, particularly where Congress has explicitly created a private remedy in a neighboring provision but did not do so in Section 304." n16 The Ninth Circuit in *In re Digimarc* agreed. n17

In *In re Digimarc* a derivative plaintiff filed suit alleging that current and former officers and directors breached their fiduciary duties by issuing misleading financial statements and misrepresenting business prospects of the corporation in violation of Section 304. n18 After comparing Section 304 to other sections of the Sarbanes-Oxley Act that explicitly provide for a private right of action, the court ruled that Section 304 is devoid of any similar language relating to the availability of an action to enforce its mandate or a forum in which to do so. n19 The court determined that Section 304 does not provide an implied right of action because it could not "find in Congress' silence in section 304 an intent to create a private right of action where it was not silent in creating such a right to similar equitable remedies in other sections of the same Act." n20

FOOTNOTES:

(n1)Footnote 1. See Sarbanes-Oxley Act of 2002 §§ 302 and 906, 15 U.S.C. § 7241 and 18 U.S.C. § 1350 (2006).

(n2)Footnote 2. See *id.*

(n3)Footnote 3. See *id.* § 302, 15 U.S.C. § 7241 (2006).

(n4)Footnote 4. *See* Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (2006).

(n5)Footnote 5. *See id.*

(n6)Footnote 6. *See* Sarbanes-Oxley Act of 2002 § 906, 18 U.S.C. 1350 (2006).

(n7)Footnote 7. *See id.*

(n8)Footnote 8. *See id.*

(n9)Footnote 9. *See id.*

(n10)Footnote 10. *United States v. Scrushy*, 2004 U.S. Dist. LEXIS 23820 (N.D. Ala. Nov. 23, 2004) .

(n11)Footnote 11. *Id.* at *5 .

(n12)Footnote 12. *See* Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243 (2006).

(n13)Footnote 13. *Id.*

(n14)Footnote 14. *SEC v. McGuire*, SEC Litigation Release No. 20387 (December 6, 2007), *available at* <http://www.sec.gov/litigation/litreleases/2007/lr20387.htm>. (SEC procured a \$468 million settlement in an options backdating case against the former CEO of UnitedHealth Group Inc.).

(n15)Footnote 15. *See, e.g., In re iBasis, Inc. Derivative Litig.*, 532 F. Supp. 2d 214 (D. Mass. 2007) (citing cases where federal courts have rejected a private right of action under Section 304); *In re Goodyear Tire Rubber Co. Derivative Litig.*, 2007 U.S. Dist. LEXIS 1233 (N.D. Ohio Jan. 5, 2007) ; *In re Digimarc Corp. Derivative Litig.*, 2006 U.S. Dist. LEXIS 56134 (D. Or. Aug. 11, 2006) ; *Kogan v. Robinson*, 432 F. Supp. 2d 1075 (S.D. Cal. 2006) ; *In re Whitehall Jewelers, Inc., Derivative Litig.*, 2006 U.S. Dist. LEXIS 16635 (N.D. Ill. Feb. 27, 2006) .

(n16)Footnote 16. *Kogan*, 432 F. Supp. 2d at 1082 .

(n17)Footnote 17. *In re Digimarc, No. 06-35838*, 549 F.3d 1223 (9th Cir. Dec. 11, 2008) .

(n18)Footnote 18. *Id.* at *3 .

(n19)Footnote 19. *Id.* at *5 .

(n20)Footnote 20. *Id.* at *6-8 .



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.14

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§ 9.14 SEC Discovery Obligations in Enforcement Actions

[1] 30(b)(6) Depositions

Unlike in a civil litigation between private parties, in a SEC enforcement action, the defendant is typically unable to depose a SEC representative to obtain information relating to the SEC's investigation and factual basis for bringing the enforcement action. Courts have denied defendants' attempts to depose a SEC representative under Federal Rule of Civil Procedure 30(b)(6) on the basis that such a deposition is equivalent to deposing opposing counsel, and therefore the information sought is privileged. n1

In *SEC v. Buntrock* the SEC commenced an action against an officer of a corporation for violating federal securities laws by allegedly manipulating the corporation's stock price. n2 In response, the officer served the SEC with a Rule 30(b)(6) notice of deposition requiring the SEC to identify and produce an individual who could testify to the subject matters discussed in the notice. n3 The court quashed the notice of deposition, holding that the notice impermissibly "seeks to invade the SEC's attorney work product." n4 Similarly, in *SEC v. Rosenfeld* the court granted a protective order pursuant to Rule 26(c) to shield SEC attorney work product that a defendant was "impermissibly" seeking through a Rule 30(b)(6) notice of deposition. n5 The *Rosenfeld* court ruled that deposing an SEC official who maintained the requisite knowledge under Rule 30(b)(6) would inevitably lead to the disclosure of the SEC attorneys' "preliminary positions and legal theories concerning the suspected conduct of defendant." n6

[2] E-Discovery Obligations

In contrast to the SEC's position vis-a-vis depositions, it is obligated to behave like a typical civil litigant in connection with document discovery. For example, the United States District Court for the Southern District of New York in *SEC v. Collins & Aikman Corp.*, held that the government is obligated, just like any litigant, to abide by the Federal Rules of Civil Procedure during the course of discovery--"[i]t is not entitled to special consideration concerning the scope of discovery, especially when it voluntarily initiates an action." n7 The Court rejected the government's attempt to "dump" 1.7 million documents on defendants--most of which were collected during the SEC's investigation and maintained in thirty-six separate databases--in response to defendant's discovery requests. n8 In the course of maintaining the documents, the SEC segregated them into 175 file folders correlating to specific factual contentions, but despite document requests seeking specific documents supporting certain factual allegations, did not produce them in the

manner they had been maintained. n9 The defendant objected to the production and sought the subsets that the SEC had already organized the documents into. n10

The court examined three primary issues surrounding the government's production of documents including whether:

(1) The government identifying responsive documents that have been organized by the producing party invades the protection accorded to attorney work-product. (2) Whether a government agency may unilaterally restrict the scope of its search based on an assertion of an 'undue burden' on limited public resources ... (3) Whether a government agency may unilaterally exclude its own e-mail from document production on the ground that most--but not all--will be privileged. n11

First, the court held that the production of a compilation of documents organized and selected by the SEC to support factual allegations in the complaint is not "core" work product. n12 Rather, the court ruled that the compilation of legal documents would only implicate work product concerns if it were organized by legal theory or strategy. n13 Therefore, "[p]ermitting a party to shield production of a compilation simply because an attorney makes the decision to *continue* to hold the documents in the same manner would result in impermissible gamesmanship and an unwarranted expansion of the work product doctrine." n14

Second, the *Collins* court rejected the government's contention that the SEC may unilaterally restrict the scope of its search based on an assertion of "undue burden" on limited public resources. n15 While a court may consider a party's resources, here, the court held that the defendant's requests were reasonable. n16 The 175 file folders prepared by SEC attorneys were not protected by the work product doctrine because "[i]t is patently inequitable to require a party to search ten million pages to find documents already identified by its adversary as supporting the allegations of a complaint." n17

Lastly, the court flatly rejected the SEC's blanket refusal to produce any incoming or outgoing emails on the basis that nearly all of the documents and email generated or received by the Commission would purportedly be "privileged, protected, or non-substantive." n18 The court stated that the SEC could not reasonably contend that the examination of a party's email in civil litigation is beyond the scope of its capability. Therefore, the court directed the parties to negotiate a reasonable search protocol and to apply the protocol to a segment of the SEC's email to determine whether relevant (non-privileged) material might be identified and produced. n19

FOOTNOTES:

(n1)Footnote 1. See, e.g., *SEC v. Buntrock*, No. 02 C 2180, 2004 U.S. Dist. LEXIS 12036 (N.D. Ill. June 29, 2003) ; *SEC v. Rosenfeld*, No. 97 Civ. 1467, 1997 U.S. Dist. LEXIS 13996, *5 (S.D.N.Y. Sep. 16, 1997) ; *SEC v. Morelli*, 143 F.R.D. 42, 47 (S.D.N.Y. 1992) .

(n2)Footnote 2. 2004 U.S. Dist. LEXIS 12036, at *3 .

(n3)Footnote 3. *Id.*

(n4)Footnote 4. *Id.* at *10 .

(n5)Footnote 5. *Rosenfeld*, 1997 U.S. Dist. LEXIS 13996, at *9 .

(n6)Footnote 6. *Id.* at *8 .

(n7)Footnote 7. 2009 U.S. Dist. LEXIS 3367 (S.D.N.Y. Jan. 13, 2009) .

(n8)Footnote 8. *Id.* at *2 .

(n9)Footnote 9. *Id.* at *3 .

(n10)Footnote 10. *Id.*

(n11)Footnote 11. *Id.* at *2 .

(n12)Footnote 12. *Id.* at *4 .

(n13)Footnote 13. *Id.*

(n14)Footnote 14. *Id.* at *6 .

(n15)Footnote 15. *Id.* at *5 .

(n16)Footnote 16. *Id.* at *9 .

(n17)Footnote 17. *Id.*

(n18)Footnote 18. *Id.* at *11 .

(n19)Footnote 19. *Id.* at *5 .



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.15

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§ 9.15 Settlements and Consents

Though the Commission's enforcement program has contributed much to the annals of the law, a fully litigated SEC enforcement proceeding is the exception rather than the rule. The agency's administrative policies are reflected in the fact that most SEC cases are settled. Resources are allocated and budgets fashioned on the well-founded assumption that trial-type hearings will be relatively few. n1

High settlement rates enhance the effectiveness of the enforcement program by enabling the Commission to do more with less. Of course, those rates also show that defendants and respondents n2 generally find settlement advantageous. n3 Litigation against or before the Commission is expensive, time-consuming and often has adverse business effects. n4 It is also hazardous. Though the Commission and its staff are fallible and though some of the agency's cases are weaker than others, SEC enforcement proceedings in which complete vindication is totally certain are very rare. n5

To proceed without deviation on the premise that one's own case is among those rarities and to refuse to give an inch at any time is to pursue a high-risk strategy. People who contemplate that course should realize that even if they turn out to be right in the end, n6 they will have endured several blasts of adverse publicity on the road to ultimate triumph. n7 Moreover, that road can be quite long. A favorable decision in the district court or before one of the Commission's own administrative law judges is a good beginning, but the Commission and its staff are tenacious professional litigants. They appeal frequently, and their appeals are skillfully presented. n8

This propensity to appeal reflects considerations that transcend the particulars of the specific case. The Commission worries about "bad" precedent and does all it can to influence the direction of legal development. n9 Its adversaries seldom share these concerns. n10 Thus, they normally prefer livable settlements to long, expensive doctrinal battles. n11

Few insider trading cases would be treated in this fashion. However, accounting and financial disclosure questions about which it wishes to write freely with an eye to the future often lead the Commission to forego injunctive action in favor of an offer of settlement in an administrative proceeding under Section 15(c)(4) of the Exchange Act or, in some circumstances, an investigative report under Section 21(a) of that statute. n12 The Commission considers precedential the documents in which it writes at length about offers of settlement. It distinguishes such dispositions from

"nonadjudicative orders" that simply accept offers of settlement without discussion. n13

Settlement negotiations can begin at any time. n14 Many cases are settled by consenting to the institution of the proceeding and to its simultaneous disposition on agreed terms. The great advantage of this is that there is only one round of publicity instead of several. n15 It may also be possible to negotiate the language of the release in which the SEC describes the case. Another public-relations concern that can be addressed in a prefiling settlement is the venue of an injunctive action. Offerors occasionally ask the Commission to file its complaint in the District of Columbia or in the Southern District of New York rather than in their home districts where the effect will be more damaging.

Of course, these advantages are often outweighed by other factors that make hasty settlement inadvisable. n16 Whatever the stage at which they are reached, consent decrees in SEC injunctive actions n17 and consent orders in the agency's own administrative proceedings are as valid and as binding as those entered after trial. n18 Moreover, the Commission will not accept settlements in which the offeror insists on innocence. Its statement of policy about that reads:

The Commission has adopted the policy that in any civil lawsuit brought by it or in any administrative proceeding of an accusatory nature pending before it, it is important to avoid creating, or permitting to be created, an impression that a decree is being entered or a sanction imposed, when the conduct alleged did not, in fact, occur. Accordingly, it hereby announces its policy not to permit a defendant or respondent to consent to a judgment or order that imposes a sanction while denying the allegations in the complaint or order for proceedings. In this regard, the Commission believes that a refusal to admit the allegations is equivalent to a denial, unless the defendant or respondent states that he or she neither admits nor denies the allegations. n19

A related SEC policy not enshrined in the agency's rules but consistently followed insists that offers of settlement state that they are voluntary and have not been induced by threats or promises. Because of these policies, post-settlement second thoughts are generally unavailing.

By consenting to the court's judgment or the Commission's order without admitting or denying the agency's allegations and by stipulating that they do so "solely for purposes of this proceeding and any other proceeding brought by or on behalf of the Commission." n20

Of course, the Commission may insist on an administrative as well as an injunctive sanction. If so, every effort should be made to dispose of both proceedings at the same time, so that defendants and respondents avoid the collateral estoppel effects that findings made after trial can have in private litigation. n21 Moreover, SEC consent judgments have been held inadmissible in other proceedings because they involve neither admissions nor adjudications. n22

In administrative proceedings, settlements become final when the Commission accepts them. n23 However, the presentation of a consent judgment to the district court is a request for the exercise of judicial power. Hence, the court may require a showing in support of the settlement. n24 However, the only appellate decision on point holds the Commission's prosecutorial judgments entitled to great deference, n25 and such deference is uniformly given. n26

The settlement process relates only to civil proceedings that the Commission is empowered to institute. Hence, one cannot settle criminal matters with the Commission. n27 Authority and responsibility with respect to them "are vested in the Attorney General and representatives of the Department of Justice." n28

FOOTNOTES:

(n1)Footnote 1. In *SEC v. Clifton*, 700 F.2d 744, 748 (D.C. Cir. 1983), the Commission's counsel told the court at oral argument that over 90% of the agency's injunctive actions are settled. With respect to administrative proceedings in broker-dealer disciplinary cases, a study made in the 1970's found an 80% settlement rate. Thomforde, *Negotiating Administrative Settlements in SEC Broker-Dealer Disciplinary Proceedings*, 52 N.Y.U. L. Rev. 237 (1977) (1973-1975

data).

(n2)Footnote 2. Those against whom administrative proceedings are brought are called "respondents" rather than "defendants."

(n3)Footnote 3. *SEC v. Clifton*, 700 F.2d 744 (D.C. Cir. 1983) , discusses the factors involved.

(n4)Footnote 4. Its pendency may, for example, impede financing, trigger vexatious private litigation, and create difficulties with other government agencies.

(n5)Footnote 5. These tend to be winnowed out at the investigative stage. Internal staff review, persuasive presentations by counsel at an early point, Wells submissions (see § 9.07 *supra*), and the Commission's reactions to staff recommendations have a filtering effect.

(n6)Footnote 6. Litigation being what it is and the Commission's cases being what they are, it is seldom possible to be totally sanguine on this score.

(n7)Footnote 7. With the exception of those administrative proceedings that are initiated privately, the Commission invariably broadcasts the initiation of the case as well as each significant subsequent development therein in its Litigation Releases.

(n8)Footnote 8. See the description of the General Counsel's Office in § 9.01 *supra* . Although the General Counsel's office does not normally participate in appeals from administrative law judges' initial decisions in administrative proceedings, the Division of Enforcement sometimes asks for its assistance. Counsel should not underestimate the prowess of the Division's staff.

(n9)Footnote 9. Hence it often files *amicus curiae* briefs in private lawsuits that present questions it deems significant to its mission. Counsel involved in such litigation who think the Commission likely to sympathize with their cause generally try to obtain its support. Of course, this does not assure success. See *International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 566 n.20 (1979) , and cases cited therein: "On a number of occasions in recent years this Court has found it necessary to reject the SEC's interpretation of various provisions of the Securities Acts." However, the Commission's well-crafted, scholarly briefs command respect in the appellate forum. *Amicus* filings in trial courts are rare. But they have been made on occasion when requested by the court.

(n10)Footnote 10. Or, as one high-ranking staff member used to say, "[t]he Commission is interested in 'principle.' The other side is interested in 'principal.' "

(n11)Footnote 11. When novel questions are involved, respondents in administrative proceedings can sometimes settle on favorable terms if they give the Commission an opportunity to make an appeal-proof statement of its views and to warn that future cases of the same type will be viewed seriously. Much law has been made that way. See, e.g., *In re Cady, Roberts & Company*, 40 SEC 907 (1961) (seminal Commission opinion in a case of first impression about impersonal insider trading accepting an offer of settlement under which respondent agreed to a 20-day suspension from the New York Stock Exchange); see also *In re Certain Trading in the Common Stock of Faberge, Inc.*, 45 SEC 249, [1973Transfer Binder] Fed. Sec. L. Rep. (CCH) P 79,378 (1973), another early insider trading case in which the Commission accepted settlement offers that imposed no sanctions and conceded only that the offerors' conduct was "censurable" but in which it also took "this opportunity to emphasize the gravity with which we view... the misuse of material non-public information to the detriment of the investing public" and to write at length on that theme.

(n12)Footnote 12. See §§ 9.10[3] and 9.10[7] *supra* .

(n13)Footnote 13. *In re Carl L. Shipley*, 45 SEC 589, 591-592 n.6 (1974) .

(n14)Footnote 14. An internal Commission guideline reprinted in *SEC v. National Student Marketing Corp.*, 68 F.R.D. 157, 165-166 (D.D.C. 1975), *aff'd*, 538 F.2d 404 (1976), *cert. denied sub nom. White & Case v. SEC*, 429 U.S. 1073 (1977) directs the staff to refrain from negotiating settlements before the Commission authorizes the initiation of proceedings. However, the staff is free to ask the Commission for permission to negotiate at an early point in a particular case. And it is often well for counsel to suggest to the staff that it seeks such authority. Prospective defendants and respondents can also make unsolicited offers of settlement, which the staff transmits to the Commission together with its recommendations. Moreover, the Commission's authorization of the proceeding frees the staff to negotiate. True, the guideline states that "the complaint should be filed forthwith." But that directive is applied flexibly to permit pre-filing settlement discussions in appropriate cases.

(n15)Footnote 15. *See* n.9 *supra*.

(n16)Footnote 16. Like other litigants, the Division of Enforcement sometimes reappraises its initial assessment of a matter. On the other hand, the staff may raise its demands after it has made a substantial investment in a case.

(n17)Footnote 17. Trial judges sometimes have much to do with these. The judge's reaction at a settlement conference may induce the staff to reduce its demands by dropping some defendants or by accepting a self-dissolving injunction for a limited term. Counsel should also be aware of the fact that the Commission occasionally accepts so-called "final orders" in lieu of injunctions. These orders recite the defendant's undertakings, direct the defendant to comply with them, can be enforced in contempt proceedings and must be discussed. So the Commission attains its basic enforcement goal while the consenting defendant is not stigmatized by an injunction. Moreover an offer of settlement can preclude the initiation of parallel administrative proceedings.

(n18)Footnote 18. *SEC v. Dennett*, 429 F.2d 1303, 1304 (10th Cir. 1970) ("The decree is reviewable where it is claimed that there was in fact no consent, but if the record demonstrates that there was consent the decree is affirmed without consideration of the merits of the case."); *see also SEC v. Clifton*, 700 F.2d 744, 748 (D.C. Cir. 1983). In *SEC v. Bausch & Lomb, Inc.*, 82 F.R.D. 50 (S.D.N.Y. 1979), defendants who had consented to a judgment of permanent injunction moved for vacation after the non-settling defendants prevailed at trial. *See SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226 (S.D.N.Y. 1976), *aff'd*, 565 F.2d 8 (2d Cir. 1977). The application was denied. These cases involved consent injunctions. But their reasoning is also applicable to administrative orders entered on consent. *But see S.E.C. v. Pentagon Capital Mgmt.*, 2010 U.S. Dist. LEXIS 25092 (S.D.N.Y. Mar. 17, 2010) (admitting into evidence an Order of the S.E.C. making findings of facts discovered pursuant to its investigative authority and not part of the actual compromise negotiations where the Order is not being offered to establish liability).

(n19)Footnote 19. 17 C.F.R. § 202.5(e).

(n20)Footnote 20. This is the standard wording used by the SEC. Occasionally, however, the consent is limited to the particular proceeding. When an injunction is consented to on condition that no administrative proceedings will be based thereon, the narrower formulation is, of course, advisable. The judgment may state that it cannot serve as the predicate for an administrative proceeding, which makes this distinction moot.

(n21)Footnote 21. With respect to injunctions, *see Parklane Hosiery Co. v. Shore*, 439 U.S. 322 (1979), discussed in § 9.11[1] *supra*. Adverse determinations in administrative proceedings can also have preclusive effects. *See United States v. Utah Construction & Mining Co.*, 384 U.S. 394, 422 (1966). For comprehensive analysis, *see* Kerr and Stillman, *Collateral Estoppel Implications of SEC Adjudications*, 42 *Bus. Law.* 941 (1987).

(n22)Footnote 22. *See Lipsky v. Commonwealth United Corp.*, 551 F.2d 887, 893 (2d Cir. 1976) (Allegations about an SEC consent injunction stricken from a private plaintiff's pleading because "a consent judgment is not the result of an adjudication of any of the issues"); *United States v. Cook*, 557 F.2d 1149 (5th Cir. 1977), *cert. denied*, 434 U.S. 1020 (1978) (criminal conviction reversed because prosecutor was permitted to point to an SEC consent injunction as evidence of guilt).

(n23)Footnote 23. *See* § 9.10[8][d] *supra*. Save for the fact that there is no occasion for an SEC order, the Commission's internal decisional process with respect to offers of settlement in injunctive proceedings is the same as the one described in the earlier section with regard to administrative proceedings.

(n24)Footnote 24. Sometimes it does so because of concern about possible overreaching by the Commission. For example, in *SEC v. Nashwinter*, 559 F. Supp. 33 (E.D. Va. 1983) , the court refused to enter a consent injunction against a pro se settling defendant on the Commission's papers. It asked for an evidentiary showing of both the violation and the reasonable likelihood of future violation.

(n25)Footnote 25. *SEC v. Randolph*, 564 F. Supp. 137 (N.D. Cal. 1983) , *rev'd on other grounds*, 736 F.2d 525, 529 (9th Cir. 1984) ("The initial determination whether the consent decree is in the public interest is best left to the SEC and its decision deserves our deference"). *Randolph* was an insider trading case that arose prior to the enactment of the Insider Trading Sanctions Act so that the Commission's remedies were limited to injunctive relief plus simple disgorgement. Disturbed by the inadequacy of that relief and by the fact that the Commission had waived interest, the district court refused to enter the consent judgment. It saw no case or controversy and viewed the defendants' undertaking as a mere contract. *Id.* The Court of Appeals held this reasoning erroneous and reversed "with directions to enter the consent decree." The opinion pointed out that "The SEC's resources are limited, and that is why it often uses consent decrees as a means of enforcement."

(n26)Footnote 26. The broad social consequences that flow from consensual resolutions in such fields as antitrust and civil rights are lacking. Courts know this. Accordingly, SEC consent decrees are seldom subjected to strict judicial scrutiny. *See* Kronstein, *SEC Settlements--Is There a Need for a Judicial Rubber Stamp?*, 11 Sec. Reg. L. J. 284 (1983).

(n27)Footnote 27. *See* the discussion of immunity in § 9.09[4] *supra* .

(n28)Footnote 28. 17 C.F.R. § 202.5(f).



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.16

AUTHOR: Theodore Altman and Joshua S. Sohn

§ 9.16 Criminal References

[1] Statutory Authority

Any willful violation of the federal securities laws or of any rule or regulation thereunder or any willful false filing is a crime. n1 The federal securities laws authorize the SEC to transmit evidence to the Attorney General who may, in his or her discretion, institute the necessary proceedings. n2

[2] Formal Criminal References

Formal criminal references are written reports from the SEC to the Department of Justice. n3 Prepared by the SEC staff, they include a recital of facts and underlying evidence, a discussion of the theory of the case and the applicable law, a list of witnesses, and a list of persons recommended for indictment.

[3] Informal Criminal References

SEC staff members notify the office of the United States Attorney of investigations that may be of interest to the Department of Justice. These referrals have been held not to constitute a violation of due process. n4 The SEC is under no obligation to inform the subject of an investigation that the character of the investigation has changed from civil to criminal. n5 However, the SEC may not mislead a person respecting its intent to refer a matter for criminal prosecution. n6

FOOTNOTES:

(n1)Footnote 1. Section 24 of the Securities Act; Section 32(a) of the Exchange Act; Section 49 of the Investment Company Act; Sections 207 and 217 of the Investment Advisers Act.

(n2)Footnote 2. Section 20(b) of the Securities Act; Section 21(e) of the Exchange Act; Section 42(e) of the Investment Company Act; Section 209(e) of the Investment Advisers Act.

(n3)Footnote 3. The "close working relationship between the Justice Department and the SEC" is well known to Congress and to the courts. *See United States v. Fields*, 592 F.2d 638, 646 n.19 (2d Cir. 1978) , *cert. denied*, 442 U.S.

917 (1979) (*quoting* H. R. Rep. No. 95-650, 95th Cong., 1st Sess. 10 (1977)). But this does not mean that every criminal prosecution under the securities laws is SEC-inspired. The Justice Department sometimes develops its own securities cases. *See, e.g., United States v. Matthews*, 787 F.2d 38, 45 (2d Cir. 1986) . "[T]he United States Attorney's office proceeded on its own. In fact, both the then local SEC Administrator and a former SEC General Counsel publicly questioned the wisdom of trying Matthews on the securities count... The results of proceeding without the benefit of SEC expertise are evident... ." (citation and footnote omitted).

(n4)Footnote 4. *SEC v. Dresser Industries, Inc.*, 628 F.2d 1368 (D.C. Cir. 1980) , *cert. denied*, 449 U.S. 993 (1980) ; *United States v. Fields*, 592 F.2d 638 (2d Cir.1978) , *cert. denied*, 442 U.S. 917 (1979) .

(n5)Footnote 5. *United States v. Posada Carrilles*, 541 F.3d 344, 354 (5th Cir. 2008) (noting that it is a "well-settled rule that the government may conduct simultaneous civil and criminal proceedings without violating the due process clause or otherwise departing from proper standards in administering justice"); *United States v. Light*, 394 F.2d 908 (2d Cir. 1968) .

(n6)Footnote 6. *SEC v. ESM Gov't Sec., Inc.*, 645 F.2d 310, 311-12, 317 (5th Cir. Unit B 1981) (holding that government deception is grounds for denying an administrative subpoena where an SEC investigator failed to disclose the existence of an investigation and instead obtained access to the company's records under the guise of obtaining "education" for himself); *United States v. Fields*, 592 F.2d 638 (2d Cir. 1978) , *cert. denied*, 442 U.S. 917 (1979) ; *United States v. Rodman*, 519 F.2d 1058 (1st Cir. 1975) .



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.17

AUTHOR: Theodore Altman and Joshua S. Sohn

§ 9.17 Freedom of Information Act

[1] Purpose and Effect

Enacted in 1967 and amended in 1975 to broaden its coverage and narrow its exemptions, the Freedom of Information Act ("FOIA") n1 seeks to compel each federal agency to make available promptly to any person (rather than only to a party to a litigation) records that he or she has identified and requested in accordance with the agency's procedural rules. The FOIA requires an agency within 10 business days after a request for records has been received to make an initial decision whether to comply with that request. n2

The Commission's Public Information Officer, the director of a staff division, or an office head whose zone or responsibility relates to the requested records is given authority to determine whether a record is required to be made available. n3

If the decision has been made not to make a record available, an administrative appeal of that decision must be decided by the Commission within 20 days after receipt of the appeal. n4 If, on appeal, the Commission upholds the denial of a request for information, the Commission must so notify the person making the request and must advise him of the provisions of the FOIA n5 providing for judicial review of the Commission's determination. n6

[2] Exemptions

Exemptions from the FOIA n7 include:

- materials classified under an executive order for reasons of defense or foreign policy;
- materials related solely to the internal personnel rules and practices of an agency; n8
- materials specifically exempted from disclosure by statute; n9
- trade secrets; n10

- inter or intra agency memoranda; n11
- personnel and medical files;
- investigatory records compiled for law enforcement purposes, but only to the extent that the production of such records would: interfere with enforcement proceedings; deprive a person of a right to a fair trial or an impartial adjudication; constitute an unwarranted invasion of personal privacy; disclose the identity of a confidential source; disclose investigative techniques or procedures; or endanger the life or physical safety of law enforcement personnel; n12
- materials relating to financial institutions; n13 and
- geological and geophysical information.

Under the exemption for investigatory records from FOIA, the Commission will not publicly disclose investigatory records "if doing so would interfere with enforcement proceedings, deprive a person of a right to a fair trial or an impartial adjudication or disclose the identity of a confidential source." n14

"Investigatory records" include, but are not limited to, documents, records, transcripts, evidentiary materials, correspondence, related memoranda and work product concerning any examination or investigation (whether formal or informal) or any related litigation, which pertain to or may disclose any violation of the federal securities laws. Also included are all written communications from or to any person complaining of or furnishing information respecting such possible violations. n15 Records will remain non-public so long as a concrete prospect of enforcement action (to which the records would be relevant) continues to exist.

An individual may request confidential treatment of information disclosed during an SEC investigation. SEC Rule 83, adopted on September 12, 1980 provides the procedures by which a person may request confidential treatment of information that would otherwise be publicly available under FOIA. n16 The procedures have two components: notice and substantiation. n17 The notice phase consists of the person informing the Commission of the request for confidential treatment. n18 The substantiation process begins upon the SEC receiving a request for disclosure under FOIA. n19 If the SEC cannot find an independent basis for not disclosing the information, the SEC asks the person who requested confidentiality to substantiate their request. n20 If the substantiation is rejected by the SEC, the requesting person may appeal the decision to SEC's General Counsel. n21

Any person who has previously given testimony or supplied documentary evidence in a Commission investigation may write the Commission if he or she believes that a particular testimony or document would be exempt from disclosure.

Records may be made available with identifying details deleted, *e.g.*, apparently defamatory statements made about any person, information received by or given to the Commission in confidence, or any contents of personnel and medical and similar files. n22

In *SEC v. Republic National Life Insurance Co.*, n23 an accounting firm sought an order enjoining the SEC from withholding information the firm considered material to its examination of a client's financial statements. The SEC refused to release the information claiming it had been obtained pursuant to an investigation that was still in progress. The court held this decision within the scope of the discretion granted the Commission by Congress. Though somewhat dubious about the way in which the Commission had exercised that discretion, the court found itself constrained to dismiss for want of jurisdiction. n24

FOOTNOTES:

(n1)Footnote 1. 5 U.S.C. § 552.

(n2)Footnote 2. 5 U.S.C. § 552(a)(6)(A).

(n3)Footnote 3. 17 C.F.R. § 200.80(d)(5).

(n4)Footnote 4. 5 U.S.C. § 552(a)(6)(A).

(n5)Footnote 5. 5 U.S.C. § 522(a)(4).

(n6)Footnote 6. 17 C.F.R. § 200.80(d)(6)(vi).

(n7)Footnote 7. See 5 U.S.C. § 552(b).

(n8)Footnote 8. See *Department of Air Force v. Rose*, 425 U.S. 352 (1976) .

(N9)Footnote 9. See *Administrator, FAA v. Robertson*, 422 U.S. 255 (1975) ; *Chrysler Corp. v. Brown*, 441 U.S. 281 (1979) .

(n10)Footnote 10. See *Board of Trade v. CFTC*, 627 F.2d 392 (D.C. Cir.1980) ; *Brockway v. Department of the Air Force*, 518 F.2d 1184 (8th Cir. 1975) .

(n11)Footnote 11. See *Coastal States Gas Corp. v. Department of Energy*, 617 F.2d 854 (D.C. Cir. 1980) .

(n12)Footnote 12. See *Stern v. FBI*, 737 F.2d 84 (D.C. Cir. 1984) ; *Center for National Policy Review on Race & Urban Issues v. Weinberger*, 502 F.2d 370 (D.C. Cir.1974) .

(n13)Footnote 13. See *M.A. Schapiro & Co. v. SEC*, 339 F. Supp. 467 (D.D.C. 1972) . See also *Consumers Union of the United States v. Heimann* 589 F.2d 531 (D.C. Cir. 1978) .

(n14)Footnote 14. 17 C.F.R. § 200.80(b)(7); see also Sec. Act Rel.No. 33-5571, [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 80,114 (1975).

(n15)Footnote 15. 17 C.F.R. § 200.80(b)(7)(ii).

(n16)Footnote 16. Freedom of Information Act Release No. 61 (Sept. 12, 1980), *amended by* Exchange Act Release No. 43239 (Sept. 1, 2000).

(n17)Footnote 17. 17 C.F.R. § 200.83

(n18)Footnote 18. 17 C.F.R. § 200.83

(n19)Footnote 19. 17 C.F.R. § 200.83

(n20)Footnote 20. 17 C.F.R. § 200.83

(n21)Footnote 21. 17 C.F.R. § 200.83

(n22)Footnote 22. 17 C.F.R. § 200.80(a)(4).

(n23)Footnote 23. 383 F. Supp. 436 (S.D.N.Y. 1974) .

(n24)Footnote 24. 383 F. Supp. at 440 .



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.18

AUTHOR: Theodore Altman and Joshua S. Sohn

§ 9.18 Equal Access to Justice Act

The Equal Access to Justice Act ("EAJA") n1 helps victims of bureaucratic injustice by requiring government agencies to reimburse the litigation expenses of parties who prevail against them in civil litigation. The Act applies to administrative adjudications n2 as well as to judicial proceedings. n3

Although the securities laws expressly bar the assessment of costs against the Commission in judicial proceedings (Section 22 of the Securities Act, Section 27 of the Exchange Act, Section 44 of the Investment Company Act, and Section 214 of the Investment Advisers Act), the SEC does not resist EAJA liability on that ground.

Two factors limit the EAJA's scope in the SEC context. The first is that EAJA relief is available only to those who prevail in litigation. It does not extend to investigation. n4 An investigation that does not lead to the initiation of an adjudicatory proceeding creates no EAJA entitlement. n5 The second factor to bear in mind is that successful litigants have no right to reimbursement when "the position of the agency was substantially justified... or special circumstances make an award unjust." n6

These limitations are significant, because truly weak SEC cases tend to be winnowed out at the investigative stage. The Commission is not prone to concede that its litigation decisions lacked substantial justification. Moreover, it can often make a persuasive showing on that critical issue. n7

However, a few victors in SEC civil enforcement proceedings have recovered under the EAJA. n8 Since both the Commission and its staff are fallible, there will doubtless be other such recoveries in the future.

Procedure under the EAJA depends on whether the case was judicial or administrative. If judicial, the application is made to the district court. n9 If administrative, it is made to the administrative law judge who heard the case. n10

As its name indicates, the EAJA is intended to mitigate the disparities in litigation resources that handicap private persons in quest of justice from the Government. Hence, the Act is available only to parties whose resources do not exceed specified limits. These limits, however, are quite generous. Individuals are barred only if their net worth exceeds \$2 million. When they are sole proprietors, the more permissive enterprise test governs. That makes the Act available to

firms with a net worth of as much as \$7 million, provided that they have no more than 500 employees. Eligibility depends on net worth and on the number of employees when the civil action was filed or the administrative proceedings instituted. n11

Equal Access to Justice Act matters can be settled. n12 Time limits under this statute are very tight. The application must be filed "within thirty days of a final disposition in the adversary adjudication." n13

The "fees and other expenses" recoverable include "the reasonable expenses of expert witnesses, the reasonable cost of any study, analysis, engineering report, test or project... necessary for the preparation of the party's case, and reasonable attorney or agent fees." n14

Fees are "based upon prevailing market rates." n15 In a judicial proceeding the court has discretion to fix a higher fee on the basis of its assessment of the needs of the particular case. n16 Unfortunately, however, the Commission lacks this power. n17 Expert witnesses cannot be compensated at rates more generous than those the government pays its own experts. n18

FOOTNOTES:

(n1)Footnote 1. This statute has a complicated history. It was originally part of the Small Business Export Expansion Act of 1980, Pub. L. No. 96-481, tit. II, 94 Stat. 2321, 2325-2330 (1980). That was an experiment and expired pursuant to an automatic repealer on October 1, 1984. But the repealer was itself repealed and the statute revived by Pub. L. No. 99-80, 99 Stat. 183-186 (1985). Editorial notes to 5 U.S.C. § 504 in the United States Code Annotated summarize this history. For an excellent general discussion, see Note, *The Equal Access to Justice Act in the Federal Courts*, 84 *Colum. L. Rev.* 1089 (1984).

(n2)Footnote 2. 5 U.S.C. § 504.

(n3)Footnote 3. 28 U.S.C. § 2412(d).

(n4)Footnote 4. 5 U.S.C. § 504 begins with the words "An agency that conducts an adversary adjudication shall award... ." 28 U.S.C. § 2412(d)(1)(A) speaks of "any civil action (other than cases sounding in tort)."

(n5)Footnote 5. *Family Television, Inc. v. SEC*, 608 F. Supp. 882 (D.D.C. 1985) (allegations that investigation was "abusive and harassing," lasted for three years, and cost the investigatee \$385,000 in attorneys' fees did not convert the proceeding into an adversary adjudication); *In the Matter of Michael Flanagan, Ronald Kindschi, and Spectrum Administration, Inc.*, 81 S.E.C. Docket 2406, (S.E.C. Release No. ID-241 (Nov. 24, 2003) (holding, amongst other things, that staff investigations are not adversary adjudications under the EAJA).

(n6)Footnote 6. 5 U.S.C. § 504(a)(1); 28 U.S.C. § 2412(d)(1)(A). The "special circumstances" safety valve may immunize agencies from liability for the good faith assertion of novel but credible claims. See *S.E.C. v. Universal Exp., Inc.*, 2009 U.S. Dist. LEXIS 55064 (S.D.N.Y. June 25, 2008) ("The SEC's reading of the Florida secondhand dealer statute—which presented an issue of first impression—is precisely the sort of novel but credible interpretation that Congress determined should not form the basis of an EAJA award. Accordingly, it also substantially justified the SEC's decision to file the Motion."); *Midwest Research Institute v. United States*, 554 F. Supp. 1379, 1392 (W.D. Mo. 1983) (citing legislative history showing an intent "to insure that the Government is not deterred from [that course]"). Because the Commission and its staff are prone to experiment with novel approaches, the "special circumstances" exception to the general statutory rule could prove of considerable import in SEC equal access jurisprudence.

(n7)Footnote 7. See, e.g., *SEC v. Switzer*, 590 F. Supp. 756, 767-768 (W.D. Okla. 1984) (EAJA award denied because "the SEC presented strong circumstantial evidence in support of its [unsuccessful] theory" in an insider trading case predicated on an inadvertent revelation); but see *S.E.C. v. Zahares*, 374 F.3d 624 (8th Cir. 2004) (reversing denial of EAJA award where SEC's failure to appropriately and adequately investigate broker according to its own rules and

guidelines led SEC to bring action based on ungrounded and unsubstantiated legal theory, and without sufficient factual support).

(n8)Footnote 8. These are unreported. For a reported case of an EAJA recovery against the Commission in a non-enforcement context, see *United Church Board for World Ministries v. SEC*, 649 F. Supp. 492 (D.D.C. 1986) (Commission gave inadequate notice of a proposed rulemaking and its attempt to defend its position in subsequent litigation was "clearly unreasonable" and "not substantially justified").

(n9)Footnote 9. 28 U.S.C. § 2412(d)(1)(a).

(n10)Footnote 10. 5 U.S.C. § 504(a)(1) directs that the decision be made by "the adjudicative officer of the agency." The statute does not provide for an appeal from the adjudicative officer to the agency itself. But the Commission's rules do. 17 C.F.R. § 201.57. Some question the validity of this rule because they think it is contrary to the statute.

(n11)Footnote 11. See the definition of "party" in 5 U.S.C. § 504(b)(1)(B) and in 28 U.S.C. § 2412(d)(2)(B). The Commission revised its rules in 1989 to track the statute. See 17 C.F.R. § 201.34. EAJA applications to the Commission must be accompanied by a net worth exhibit. 17 C.F.R. § 201.42.

(n12)Footnote 12. 17 C.F.R. § 201.54; see also 17 C.F.R. § 201.52(b) (joint statement by the applicant and the Division of Enforcement of intent to negotiate a settlement extends the Division's time to answer). The unreported recoveries referred to in n.8 *supra* involved settlements.

(n13)Footnote 13. 5 U.S.C. § 504(a)(2). 17 C.F.R. § 201.44(a) is peremptory in this regard. The 30-day rule applicable to judicial proceedings appears in 28 U.S.C. § 2412(d)(1)(B).

(n14)Footnote 14. 5 U.S.C. § 504(b)(1)(A); 28 U.S.C. § 2412(d)(2)(A).

(n15)Footnote 15. *Id.*

(n16)Footnote 16. The court can determine that "an increase in the cost of living or a special factor such as the limited availability of qualified attorneys for the proceedings involved, justifies a higher fee." 28 U.S.C. § 2412(a)(2)(A).

(n17)Footnote 17. The Commission can provide for higher fees by regulation. 5 U.S.C. § 504(b)(1)(A)(ii). But it has not done so. Its rules state that "No award for the fee of an attorney or agent... may exceed \$75.00 per hour." 17 C.F.R. § 201.36(b). The regulation does allow for an award of reasonable expenses if the attorney, agent or witness ordinarily changes for such expense.

(n18)Footnote 18. 28 U.S.C. § 2412(d)(2)(A) ("highest rate of compensation for expert witnesses paid by the United States"); 5 U.S.C. § 504(b)(1)(A)(i) ("highest rate of compensation for expert witnesses paid by the agency involved").



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CHAPTER 9 SEC Enforcement--Legal Considerations

2-9 Federal Securities Exchange Act of 1934 § 9.19

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§ 9.19 SEC Enforcement Actions Against Hedge Funds

Hedge funds are typically structured in order to avoid the burdensome registration and regulatory requirements of the Investment Company Act of 1940. n1 Section 3(a)(1) of the Investment Company Act of 1940 generally defines an investment company as an issuer of securities engaged primarily in the business of investing in securities. n2 If a fund falls within this definition, then it must register as a fund, unless an exception applies. Registration under the Investment Company Act requires the fund to comply with statutory and regulatory requirements imposed on registered funds.

Hedge funds escape registration under the Investment Company Act by falling within the "private investment company" exceptions of Sections 3(c)(1) and 3(c)(7). n3 There are two requirements under the "private investment company" exception: first, the company must be "an issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons" and second, "which is not making and does not presently propose to make a public offering of its securities." n4

The first SEC investigation into hedge funds occurred in January 1969, and this early investigation was inhibited by a lack of information about the industry. n5 A new era of SEC investigation into hedge funds commenced with the issuance of the Heyman Memorandum. The Memorandum was written by then Director of the Division of Market Regulation and Investment Management, William H. Heyman, to then-SEC Chairman, Richard Breeden. n6 The Heyman Memorandum conveyed the SEC's position on hedge fund investigations, "[T]he regulatory issues potentially relevant to hedge funds, however, involve not so much the protection of the investors who invest in them--typically high net worth individuals or institutions--but the potential of these funds to affect the market due to their size and active market presence." n7

In 2005 the SEC took a substantial step towards regulation of hedge funds by amending the rule previously governing when hedge fund managers are required to register with the SEC. Prior to the 2005 rule change, hedge fund managers could avoid registration under the Investment Advisors Act of 1940 by treating a hedge fund as a single client. Thus, hedge fund managers fell within the exception of investment advisors with fourteen or fewer clients. n8 The SEC rule required hedge fund managers to count as clients all the individual investors of the fund. n9 In *Goldstein v. SEC*, however, the rule was invalidated as an arbitrary and unreasonable interpretation of the word 'client.' n10

The *Goldstein* reversal, however, has not ended the SEC's actions against hedge funds. The SEC also imposed a \$250 million fine against Bear, Sterns & Co. for helping favored hedge fund clients evade the rules designed to protect long-term mutual fund investors from the harm of market-timing and late trading. n11 Despite hedge funds being largely exempt from traditional SEC regulation, the SEC has instituted enforcement actions against a large number of hedge funds involving private investment in public equity (PIPE) transactions. n12 These cases often involve insider trading charges based on allegations that the hedge fund traded on material, non-public information about a PIPE that it had agreed to keep confidential.

As a result of modern financial scandals, including an alleged \$50 billion ponzi scheme perpetrated by Bernard Madoff, on January 29, 2009, the Senate introduced the Hedge Fund Transparency Act of 2009 (HFTA), which would bring hedge funds under the scrutiny of the SEC. n13 If passed, HFTA would have a significant impact on not only hedge funds but also private equity funds, venture capital funds, and structured finance vehicles. n14 The bill attempts to close what some senators view as a loophole in securities law that allows hedge funds to operate beyond the reach of the SEC. n15 HFTA attempts to amend current exceptions to the Investment Company Act of 1940, thereby requiring funds of \$50 million or more to register with the SEC, maintain books and records as mandated by the SEC, file annual disclosure statements that include both the identities of the funds' investors and the value of the fund assets, and cooperate with SEC requests for information or examination. n16 Additionally, the bill proposes requiring these funds to establish anti-money laundering compliance programs. n17

In 2009, the SEC launched a series of internal reforms designed to further regulate hedge funds in the aftermath of several high profile ponzi scheme frauds and the burst of the mortgage backed security bubble. First, the SEC is in the process of studying and developing new rules to regulate and limit "naked short selling" n18 through the use of price tests, circuit breaker rules, and pre-borrow and disclosure requirements. n19 Second, the SEC "created the Industry and Market Fellows Program in order to hire highly seasoned financial experts who will enhance the agency's expertise and perspectives on emerging issues and trends in the securities markets." n20 Third, in May 2009, the SEC proposed "a yearly 'surprise exam' of investment advisers performed by an independent public accountant to verify client assets." n21 Fourth, in September 2009, the SEC created a Division of Risk, Strategy, and Financial Innovation by combining the Office of Economic Analysis and the Office of Risk Assessment. This "new division will focus on strategic and long-term analysis, identifying new developments and trends in financial markets and systemic risk, and recommending ways to adjust Commission policies and practices to adapt to these new developments and trends." n22

The 2009 prosecutions of *Galleon* and *Cutillo* exemplify the increased SEC scrutiny of hedge funds. Both cases involved the use of wire-taps to amass evidence of complex insider trading rings involving hedge fund managers, Wall Street professionals, attorneys, and high-level corporate insiders. In the prosecution of Galleon Management LP and its billionaire hedge fund adviser, Raj Rajaratnam, the SEC filed charges against twenty-nine individuals who allegedly participated in an illegal scheme to generate \$53 million in profits. According to the SEC, the *Galleon* and *Cutillo* cases are important for two reasons: first, they include the use of traditional law enforcement surveillance techniques to prosecute illegal insider trading schemes; n23 and second, the cases evidence that insider trading may be a "business model" (rather than incidences of opportunistic conduct), which merits further investigation of hedge fund strategies going forward. n24 Accordingly, *Galleon* and *Cutillo* indicate that SEC oversight of hedge funds will be more vigorous in the near term.

Some commentators have referred to the Dodd-Frank legislation as the largest overhaul of the financial system since the 1930s. The "Volcker Rule" is one of the many reforms adopted as part of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. The Volcker Rule prohibits any "banking entity" from engaging in proprietary trading and sponsoring or investing in a hedge fund or private equity fund. n25 "Banking entities" are defined as any insured bank or thrift, any company that controls an insured bank or thrift, any company that is a bank holding company under the International Banking Act of 1978, and any affiliate of any such entity. Once the rule is in effect, n26 except for certain limited circumstances, banking entities will no longer be able to have an equity, partnership, or ownership interest in any hedge fund or private equity fund. At the time of publication, the SEC was still developing the final rules

implementing the Volcker Rule.

Additionally, the Dodd-Frank Wall Street Reform Act regulates advisors to hedge funds. Importantly, the Act eliminates the registration exemptions for private advisors and intrastate advisors who advise private companies. However, new exemptions are created for advisors to venture capital funds, investment advisors who exclusively work with private companies with less than \$150 million under management. n27 The Act raises the registration threshold for investment advisors to \$100 million in assets under management and subjects all registered advisors to more stringent record keeping rules.

Furthermore, the Dodd-Frank Wall Street Reform Act amends the definition of "accredited investor" and "qualified client" and thereby restricts who is eligible to participate in a hedge fund. The net-worth threshold for an "accredited investor" is raised to \$1 million, excluding the value of the investor's primary residence. n28 "Qualified client" is defined as an entity or person with \$750,000 assets under management and a net worth of \$1.5 million, adjusted annually for inflation for six years after the Act's enactment, through 2016. n29

Although it is unclear precisely how the new Dodd-Frank legislation and recent SEC initiatives will manifest themselves in the day-to-day regulation of hedge funds, it is clear that the SEC will continue its efforts to increasingly police hedge funds for the foreseeable future.

FOOTNOTES:

(n1)Footnote 1. Scott J. Lederman, Hedge Fund Regulation § 5:1 (2006).

(n2)Footnote 2. 15 U.S.C. § 80a-3(a)(1).

(n3)Footnote 3. 15 U.S.C. §§ 3(c)(1), (7).

(n4)Footnote 4. 15 U.S.C. § 80a-3(c)(1).

(n5)Footnote 5. Lederman, *supra* note 19 , at § 3:2.

(n6)Footnote 6. Memorandum to Richard Breeden, SEC Chairman from William H. Heyman, Director, Division of Market Regulation and Marianne K. Smythe, Director, division of Investment Management 4 (June 12, 1992).

(n7)Footnote 7. *Id.*

(n8)Footnote 8. 15 U.S.C. 80b-3(b)(3).

(n9)Footnote 9. 17 C.F.R. 275.203(b)(3)-2.

(n10)Footnote 10. 451 F.3d 873 (D.C. Cir. 2006) .

(n11)Footnote 11. *In re Bear, Stearns & Co.*, No. 3-12238 (Mar. 16, 2006).

(n12)Footnote 12. Nicolas Morgan et al., *SEC Rings in 2007 with Three-Pronged Assault on Hedge Funds and PIPES*, 11 Andrews Derivatives Litig. Rep. (Feb. 20, 2007).

(n13)Footnote 13. Hedge Fund Transparency Act of 2009, S. 334, 111th Cong. (2009).

(n14)Footnote 14. Hedge Fund Transparency Act of 2009, S. 334, 111th Cong. (2009).

(n15)Footnote 15. News Release, Office of Senator Carl Levin, *Grassley and Levin Introduce Hedge Fund Transparency Act*, at <http://levin.senate.gov/newsroom/release.cfm?id=307481> (Jan. 29, 2009).

(n16)Footnote 16. Hedge Fund Transparency Act of 2009, S. 334, 111th Cong. (2009).

(n17)Footnote 17. *Id.*

(n18)Footnote 18. The practice of short-selling a security without first obtaining or ensuring that the security can be obtained as is typically done in a short sale. Traders generally engage in naked short selling when they anticipate a price fall but exposes the trader to losses if the price should rise. Naked short selling is frowned upon as a method of driving down prices and damaging to companies trying to raise capital.

(n19)Footnote 19. U.S. Securities and Exchange Commission, "Management Discussion and Analysis," *Putting Investors First-2009 Performance and Accountability Report*, p. 9 available at <http://www.sec.gov/about/secpar/secpar2009.pdf#mda>.

(n20)Footnote 20. *Id.*

(n21)Footnote 21. *Id.* at 12 .

(n22)Footnote 22. *Id.* at 9 .

(n23)Footnote 23. The propriety of the government's use of these techniques to investigate insider trading is being litigated as part of the pretrial proceedings in the Galleon case.

(n24)Footnote 24. Khuzami, Robert, "Speech by SEC Staff: Remarks at AICPA National Conference on Current SEC and PCAOB Developments," Washington, D.C., Dec. 8, 2009.

(n25)Footnote 25. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Title VI Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions, Sec. 619.

(n26)Footnote 26. *Id.* (The Volcker Rule will not go into effect for two years at which point there will be a two-year transition period which may extended.)

(n27)Footnote 27. Katen, Munchin Rosenman LLP, "Financial Reform Bill Reshapes Investment Advisor Regulation," July 29, 2010, available at <http://www.kattenlaw.com/financial-reform-bill-reshapes-investment-adviser-regulation/>

(n28)Footnote 28. *Id.*

(n29)Footnote 29. Calfee, "Dodd-Frank Alters the Landscape for Private Funds," July 21, 2010, available at <http://www.calfee.com/ArticleView.aspx?ArticleID=885>.



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CHAPTER 10 Private RICO Litigation

2-10 Federal Securities Exchange Act of 1934 10.syn

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FOOTNOTES:

(n1)Footnote *. The authors are partners in the Washington, DC office of Fulbright & Jaworski L.L.P. Mr. Robinson has represented a wide array of corporate and individual clients in civil and criminal matters involving such issues as health care fraud, securities fraud, RICO, the federal False Claims Act, antitrust law, and the Foreign Corrupt Practices Act. Mr. Kirtland focuses his practice on white collar civil and criminal defense, international arbitration and complex civil litigation. They were assisted in preparing this chapter by summer associate Paul Simon.



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CHAPTER 10 Private RICO Litigation

2-10 Federal Securities Exchange Act of 1934

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SUMMARY OF THIS CHAPTER

The Racketeer Influenced and Corrupt Organizations Act ("RICO"), enacted in 1970 to provide the government with a weapon against the infiltration of organized crime into legitimate businesses, contains a private civil remedy. Broad and widely differing judicial interpretation of this provision of RICO has led to the rapid growth of private civil RICO litigation. RICO is the only basis for federal jurisdiction in many cases. *See § 10.01 infra.*

A civil RICO claim is built on three elements: pattern of racketeering activity; enterprise; and the injurious impact of the racketeering activity on the enterprise. Racketeering activity is defined by reference to a list of "predicate acts." The principal predicate acts for civil RICO claims traditionally were mail fraud, wire fraud, and securities fraud. However, the passage of the Private Securities Litigation Reform Act in late 1995 eliminated as predicate acts securities fraud and any conduct that would have been actionable as securities fraud. *See § 10.01 infra.*

The "pattern" element requires, at a minimum, two or more acts of related racketeering activity that pose a threat of continued criminal activity. *See § 10.02[1] infra.*

In order to satisfy RICO's civil standing requirement, the plaintiff must establish injury to plaintiff's business or property proximately caused by a RICO violation. The circuits are split on the issue of whether injuries caused solely by the predicate act, distinguished from injury caused by use or investment of the income derived from that act, is sufficient to support a RICO claim. A plaintiff does not have standing to sue for conspiracy to violate RICO if the injury is caused by a conspirator's acts that do not constitute one of the delineated predicate acts. Plaintiffs must plead and prove the causal nexus between the RICO activity and the injury. *See § 10.03 infra.*

If the plaintiff has established the elements of a private RICO claim, RICO requires that the plaintiff recover treble damages and attorneys' fees. *See § 10.04 infra.*

Jurisdiction over violations of RICO is conferred on the federal courts. However, state courts have concurrent jurisdiction with federal courts in private RICO cases. Venue in RICO civil cases exists in any district in which the

defendant resides, is found, has an agent, or transacts affairs, and where it is shown that the "ends of justice" require. A four-year statute of limitations applies to RICO civil actions. The circuits are split as to when the RICO claim is deemed to accrue. *See § 10.05[3] infra.*



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CHAPTER 10 Private RICO Litigation

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§ 10.01 Background

Enacted in 1970, but undiscovered by the private bar until 1980, the Racketeer Influenced and Corrupt Organizations Act ("RICO")ⁿ¹ has become a fixture of private civil litigation. Promulgated largely as an attempt to provide the government with a new weapon against the infiltration of organized crime into legitimate businesses, RICO has become a vehicle, in the view of many courts, for the federalization of common business disputes.

As originally proposed, enforcement of the Act was left solely to the government. However, a private civil remedy was suggested in hearings before a subcommittee of the House Judiciary Committee,ⁿ² and toward the end of the legislative process the full Committee approved an amendment including the private remedy provision in its present form.ⁿ³ It provides that "[a]ny person injured in his business or property by reason of a violation ... may sue therefor... and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee" ⁿ⁴ While the language is drawn directly from the antitrust laws,ⁿ⁵ Congress offered virtually no guidance as to how this provision was to be interpreted in the very different context of RICO.

Perhaps because of this absence of legislative direction, RICO's private civil section has been stretched to the limits of its language, with a concomitant growth of private civil RICO litigation. RICO is often the only basis for federal jurisdiction in many cases, which would otherwise be brought as common law fraud actions in the commercial parts of state courts.

Seeking to stem this imposition on their dockets, many federal courts initially responded by erecting various barriers to private RICO claims in the form of judicially-created requirements of "standing." A Second Circuit opinion was typical in its vehement opposition to the expansive use of RICO:

The uses to which private civil RICO has been put have been extraordinary, if not outrageous. Section 1964(c) has not proved particularly useful for generating treble damage actions against mobsters by victimized business people. It has, instead, led to claims against ... respected and legitimate "enterprises" ... labeled as "racketeers" in civil RICO claims. ⁿ⁶

However, in 1985, the Supreme Court made clear in *Sedima, S.P.R.L. v. Imrex Co., Inc.* that these judicially-crafted

limitations would not be tolerated. n7 In *Sedima*, the Court focused on the broad language of the RICO statute and refused to countenance any limitation that could not find some basis in such language. Recognizing that this rendered the scope of the statute broader than Congress may have intended, the Court nonetheless left it to Congress to correct this error if Congress found it to be an error. Since then, while there have been repeated legislative proposals to narrow the broad scope of the RICO statute, none has generated the necessary support.

In addition to the controversy engendered by the breadth of the statute, the vague language and peculiar phrasing of the statute have led to widely differing interpretations among the circuits. They also have led to repeated attempts to hold the statute unconstitutional, but virtually all such attempts have failed. n8 In some circuits, even the most common garden-variety fraud case may be expected to contain a RICO count. This expansion of RICO has led the Seventh Circuit to observe that "the murkiness of RICO's parameters coupled with its alluring remedies have led many plaintiffs to take garden variety business disputes and dress them up as elaborate racketeering schemes." n9 The explosion in the private use of RICO, combined with the wide variance of interpretation among the circuits, make it imperative for the practitioner to keep abreast of recent developments in this extensive body of law.

For the securities practitioner, the passage in December 1995 of the Private Securities Litigation Reform Act drastically limited the applicability of RICO to claims grounded in securities fraud. n10 Previously, securities fraud had been relied upon as a predicate act in many RICO claims. However, the Private Securities Litigation Reform Act amended Section 1964(c) to read: "No person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of Section 1962." As phrased, the Act provides that even claims based on mail or wire fraud may be dismissable if they could have been framed as securities fraud claims. Moreover, at least one court has held that plaintiffs may not rely on a party aiding and abetting securities fraud as a predicate RICO act. n11 However, it is likely that until the courts' interpretation and application of the Act becomes settled, practitioners will attempt to reframe their securities fraud claims as mail fraud, wire fraud, or some other still valid RICO predicate. n12

Since 1995, plaintiffs have attempted to bring RICO claims based on conduct occurring before the Private Securities Litigation Reform Act was passed. The Third, Seventh, Eighth and Ninth Circuits have dismissed such claims, holding that the Act's ban on RICO claims grounded in securities fraud applies to claims based upon a pattern of conduct that predates passage of the Act. The key date for viability of a RICO claim, according to these decisions, is the date the plaintiff filed the action. n13

The Ninth Circuit has held that the PSLRA's bar on securities actions claims extends to individual claims as well as to class actions. n14

FOOTNOTES:

(n1)Footnote 1. 18 U.S.C. §§ 1961-1968.

(n2)Footnote 2. Hearings on S.30, and related proposals, before Subcommittee No. 5 of the House Committee on the Judiciary, 91st Cong., 2d Sess. 520, 543-4, 548, 559.

(n3)Footnote 3. H.R. Rep. No. 1549, 91st Cong., 2d Sess. at 58 (1970), 1970 U.S.C.C.A.N. 4034.

(n4)Footnote 4. 18 U.S.C. § 1964(c).

(n5)Footnote 5. 15 U.S.C. § 15(a).

(n6)Footnote 6. *Sedima, S.P.R.L. v. Imrex Co.*, 741 F.2d 482, 487 (2d Cir. 1984) , rev'd, 473 U.S. 479 (1985) .

(n7)Footnote 7. 473 U.S. 479, 105 S. Ct. 3275, 87 L. Ed. 2d 346 (1985) .

(n8)Footnote 8. *Columbia Natural Resources v. Tatum*, 58 F.3d 1101, 1106 (6th Cir. 1995) (the phrase "pattern of racketeering activity" is not void for vagueness); *Bingham v. Zolt*, 66 F.3d 553, 566 (2d Cir. 1995) (the Second Circuit rejected the argument that RICO's pattern and enterprise requirements were unconstitutionally vague.)

(n9)Footnote 9. *Uniroyal Goodrich Tire Co. v. Mutual Trading Corp.*, 63 F.3d 516, 523 (7th Cir. 1995) . The Third Circuit also noted that: "we recognize that our ruling means that RICO may be applicable to many garden variety fraud cases... it is for Congress to decide whether to narrow the scope of RICO." *Tabas v. Tabas*, 47 F.3d 1280, 1296 (3d Cir. 1995) .

(n10)Footnote 10. Pub. L. No. 104-67, 109 Stat. 737 (1995).

(n11)Footnote 11. See *Fezzani v. Bear, Stearns & Co., Inc.*, No. 99 Civ. 0793, 2005 U.S. Dist. LEXIS 3266 at *17-19 (S.D.N.Y. March 2, 2005) ("[T]he RICO amendment does not require a particular plaintiff to have an actionable securities-fraud claim, but rather bars reliance on any conduct actionable as securities fraud" (citation omitted)); *but see OSRecovery, Inc. v. One Groupe Int'l., Inc.*, 354 F. Supp. 2d 357, 370 (S.D.N.Y. 2005) (holding that aiding and abetting securities fraud is not actionable under securities laws and may therefore be actionable under RICO).

(n12)Footnote 12. *But see Fezzani v. Bear, Stearns & Co., Inc.*, 2005 U.S. Dist. LEXIS 3266, *18 (S.D.N.Y. March 2, 2005) (refusing plaintiffs' request to add a RICO claim as an alternative to a securities fraud claim since plaintiffs relied on the same factual allegations for both.); *Gatz v. Ponsoldt*, 297 F. Supp. 2d 719, 731 (D. Del. 2003) (denying plaintiff's motion to amend its complaint to include RICO actions since the underlying factual allegations made a case for securities fraud); *Burton v. Ken-Krest Servs., Inc.*, 127 F. Supp. 2d 673, 676 (E.D. Pa. 2001) ("[T]he Third Circuit has rejected efforts to elude the amendment by pleading predicate acts that, while not securities fraud by name, are actionable as securities fraud and are 'undertaken in connection with the purchase and sale of securities.' orting meets with an unsatisfactory response, received extensive criticism and commentary" (quoting *Bald Eagle Area School Dist. v. Keystone Fin., Inc.*, 189 F.3d 321, 329-330 (3d Cir. 1999)).

(n13)Footnote 13. See *Popp Telecom, Inc. v. American Sharecom, Inc.*, 361 F.3d 482 (8th Cir. 2004) ; *Scott v. Boos*, 215 F.3d 940 (9th Cir. 2000) ; *Mathews v. Kidder, Peabody & Co.*, 161 F.3d 156 (3d Cir. 1998) ; *Fujisawa Pharmaceutical Co., Ltd. v. Kapoor*, 115 F.3d 1332 (7th Cir. 1997) . See also *Shaw v. Mancuso Inv. Corp.*, No. 03-C50515, 2004 U.S. Dist. LEXIS 6138 (N.D. Ill. Apr. 12, 2004) .

(n14)Footnote 14. *Powers v. Wells Fargo Bank, N.A.*, 439 F.3d 1043 (9th Cir.) , cert. denied, 127 S. Ct. 437 (2006) .



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CHAPTER 10 Private RICO Litigation

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§ 10.02 The Elements of a RICO Claim

Given its vague language, peculiar construction, and conflicting interpretations, RICO can be intimidating to the newcomer. RICO decisions often devote extensive discussion to the scope and meaning of critical terms included in the statute, and draw fine fact-specific distinctions that make it difficult to predict the outcome of future decisions.

However, while RICO is certainly not without complexity, in essence, it is built around three basic concepts: pattern of racketeering activity; enterprise; and the injurious impact of the pattern of activity on the enterprise. To appreciate the significance of these concepts, however, it is important to focus at the outset on the fact that RICO prohibits four particular kinds of activity, set forth in section 1962 of Title 18.

Specifically, Section 1962(a) makes it unlawful for "any person who has received any income derived, directly or indirectly, from a pattern of racketeering activity ... to use or invest... any part of such income ... in acquisition of any interest in, or the establishment or operation of, any enterprise"

Section 1962(b) makes it unlawful for any person "through a pattern of racketeering activity ... to acquire or maintain, directly or indirectly, any interest in or control of any enterprise"

Section 1962(c) makes it unlawful for "any person employed by or associated with any enterprise ... to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity"

Section 1962(d) makes it unlawful for any person to conspire with others to violate Sections (a), (b) or (c).

Given these prohibitions, the importance of understanding the scope and meaning of "pattern of racketeering enterprise" and the nature of its prohibited impact on a RICO "enterprise" becomes manifest.

[1] Pattern of Racketeering Activity

[a] Racketeering Activity

Racketeering activity is defined in section 1961(1) by reference to a long list of acts, known as "predicate acts," that are chargeable under state criminal law and punishable by imprisonment for more than one year, or indictable or punishable under various provisions of the federal criminal law. The principal predicates for private commercial litigation under RICO are mail fraud and wire fraud. If an act is not included on the list, it may not be relied upon as a predicate act. However, given the breadth of criminal activity captured by this list, a large variety of disputes can be transformed into alleged violations of RICO's predicates. n1

As the use of the terms "chargeable," "indictable," and "punishable" indicate, an act may qualify as a predicate act even if the defendant has never been convicted of the alleged crime. In *Sedima, S.P.R.L. v. Imrex Co., Inc.*, the Supreme Court reversed the Second Circuit's decision that a complaint must allege that the defendant had been criminally convicted of a predicate act, and noted that the RICO statute defined racketeering action to consist of "not facts for which the defendant has been convicted, but of acts for which he could be." n2 Any other interpretation, the Court noted, would be inconsistent with Congress's broad underlying policy concerns and severely handicap potential plaintiffs. n3

The mail fraud and wire fraud statutes, n4 among the broadest of any federal criminal statutes, respectively prohibit even incidental use of the mails or wires in connection with any kind of fraudulent scheme. The fraud language is identical in the two statutes, covering schemes to defraud or to obtain money or property by fraudulent devices, and each statute expressly applies both to a person who makes a communication and one who "causes" a communication to be made. The only practical difference between the two statutes is that the requisite mailing may be wholly intrastate, while the requisite wire transmittal must be made in interstate or foreign commerce. Courts consider these statutes to be *in pari materia* and have looked to mail fraud precedent in construing the wire fraud provision. n5

To establish a violation of the mail or wire fraud statutes, a plaintiff must show that there was a scheme to defraud, a specific intent by the defendant to defraud, and a use of the mails or wires to carry out the scheme. n6 The mailing itself need not cause injury, and it need not contain a misrepresentation. A mailing will suffice as long as it is part of the scheme to defraud, even if it is a minor, inconsequential part. As a result, almost any mailing or communication by wire by the defendant will suffice.

Fraudulently stating materially incomplete information is actionable, n7 as is representing without a factual basis or giving opinions not honestly held. n8 Where a fiduciary duty to disclose exists, omission of material information may be actionable. n9 In one case, the Seventh Circuit held that the omission of a material fact can constitute mail fraud even in the absence of a specific duty to disclose the information. n10 In some cases, no active misrepresentation or omission is necessary. n11 For example, a course of conduct that constitutes a scheme to defraud, such as check kiting, may be actionable upon use of the mails or wires even though no particular misstatements or omissions are made. n12

Although the defendant must have a specific intent to defraud, n13 this may be imputed from reckless indifference or disregard of the truth, or from a pattern of conduct. n14 While a good faith defense can negate the requisite intent, n15 honest belief in the ultimate success of the endeavor is not sufficient. n16

Contemplation of the use of mail or wire facilities need not be part of the scheme. n17 To "cause" use of the mails or wires, the defendant need only act in circumstances under which mailing or wire transmittal can reasonably be foreseen; actual intent to cause the communication is not required. n18

Each use of the mails or wires in furtherance of the scheme is a separate offense, even if each relates to the same scheme. Because there may be numerous mailings as part of a single scheme, courts evaluating whether a defendant engaged in a pattern of racketeering courts typically "look beyond the mailings and examine the underlying scheme or artifice." n19 Thus, although the mailing is the criminal act, the "deceit constituting the underlying fraudulent scheme" is more relevant to the continuity analysis. n20 As noted, such a communication is actionable even if it is wholly ineffective. n21

Until recently, there had been some uncertainty as to whether a plaintiff must establish reliance on the mailing in order to prove injury by reason of the mailing. Some circuits had concluded that the predicate-act element of a private RICO action grounded in mail and wire fraud could not be satisfied without proof of reliance on the fraudulent representation.
n22

The Fourth Circuit, in *Brandenburg v. Seidel*, n23 came to the same conclusion but analyzed the issue somewhat differently. After noting that Section 1964(c) limits private lawsuits to persons who are injured in their business or property "by reason of" the defendant's misconduct, the court held that proof of reliance was a required element of a private civil RICO action grounded in fraud, not because reliance was a required element of the predicate acts of mail and wire fraud, but because it was part of what was meant by causation under Section 1964(c). The court stated:

While, as we have noted, it is not necessary to establish detrimental reliance by the victim in order to make out of a violation of the federal mail fraud statute ... such reliance is necessary to establish injury to business or property "by reason of" a predicate act of mail fraud within the meaning of § 1964(c). n24

In comparison, other courts ignored the issue of reliance as an aspect of RICO causation and focused instead on the fact that reliance is not an element of the criminal offense of mail fraud or wire fraud. These courts held that no proof of reliance was required to satisfy the predicate-act element of RICO. n25 For example, the Third Circuit in an *en banc* decision held that completely innocent mailings could satisfy the mailings element and found that there was no requirement that the mailings be relied upon by the victim of the fraud. n26

The Court resolved this apparent conflict in *Bridge v. Phoenix Bond & Indemnity Co.*, when it held that a plaintiff asserting a RICO claim predicated on mail fraud does not need to plead or prove that it relied on the defendant's misrepresentations, either as an element of its claim or as a prerequisite to establishing proximate causation. n27 In *Bridge*, the RICO claim was brought against participants in Illinois tax lien auctions who allegedly filed false compliance attestations in order to obtain a disproportionate share of the auctioned liens. n28 The defendants argued that because the alleged fraudulent mailings were made to the county, not to the plaintiffs who were rival bidders, a RICO claim could not be brought by the plaintiffs. n29 In overruling the defendants' arguments, the Court held that reliance by the plaintiff (so-called "first-party reliance") on the alleged fraudulent statement was not a required element of a RICO offense:

If petitioners' proposed requirement of first-party reliance seems to come out of nowhere, there is a reason: Nothing on the face of the relevant statutory provisions imposes such a requirement. Using the mail to execute or attempt to execute a scheme to defraud is indictable as mail fraud, and hence a predicate act of racketeering under RICO, even if no one relied on any misrepresentation. n30

The Court further held that a showing of reliance on the alleged fraud *by the plaintiff* is not necessary to meet RICO's proximate cause requirement. However, the Court cautioned that this did not mean that it was not necessary to allege and prove that *someone* relied upon the alleged fraud in order to prove causation (so-called "third-party" reliance"). n31 The Court merely clarified that, " 'the fact that proof of reliance is often used to prove an element of the plaintiff's cause of action, such as the element of causation, does not transform reliance itself into an element of the cause of action.' " n32

Mention should also be made of the Hobbs Act, n33 which is capable of being broadly construed to cover a wide range of activity often ranging far beyond the type of activity traditionally viewed as "extortion." n34 For example, in *National Organization for Women v. Schneider*, n35 a RICO claim was brought against a coalition of anti-abortion groups that were charged with conspiring to use threatened or actual force to induce health care clinic employees and doctors to give up their jobs, and patients to forfeit their right to obtain medical services. While the court did not reach the issue of the Hobbs Act violation, it did note that plaintiffs had alleged injury resulting from defendant's conduct that

was sufficient for standing purposes at the pleading stage. The Court rejected the argument that the Hobbs Act required the defendant to profit economically from the extortion. n36 Moreover, prompted by concern about the scope of the activity alleged as a Hobbs Act violation, Justice Souter, in a concurring opinion, stressed that the conduct alleged as a Hobbs Act violation might be fully protected *First Amendment* activity, and urged courts to consider this issue carefully. On remand, the District Court found that the plaintiffs had adequately alleged violations of the Hobbs Act. n37 The Court noted that extortion under the Hobbs Act focuses on loss to the victim, which had been alleged and issued a nationwide injunction. n38 The Seventh Circuit affirmed. n39

Once again, however, the Supreme Court reversed and ruled that the claimed property taken from the plaintiff -- the right of a woman to seek medical services and the right of doctors to perform their jobs -- was outside the scope of the Hobbs Act's definition of property. n40 The defendant's acts could therefore not be considered extortion and the case was once again remanded to the lower courts. n41

On remand, the Seventh Circuit held that four separate acts of violence or threats of violence unrelated to extortion might constitute Hobbs Act violations. n42 For the third time, the Supreme Court reversed. n43 In an 8-0 decision, the Court ruled that in order for acts of violence or threats of violence to violate the Hobbs Act, it must be "in furtherance of a plan or purpose to engage in robbery or extortion." n44 "[F]reestanding physical violence" was not enough. n45

[b] The Pattern

Merely alleging commission of acts of racketeering activity is not in itself sufficient to make out a RICO "pattern." Something more is required, but the courts have labored with difficulty to determine exactly what. Section 1961(5) defines a RICO "pattern of racketeering activity" only by stating that it "requires at least two acts of racketeering activity, one of which occurred up to the effective date of this chapter [October 15, 1970] and the last of which occurred within ten years ... after the commission of a prior act of racketeering activity." n46

Prior to the 1985 Supreme Court decision in *Sedima, S.P.R.L. v. Imrex & Co.*, n47 several lower courts specifically equated two predicate acts with pattern. n48 Other courts were more demanding, requiring that the predicate acts be linked by some common plan, scheme, or motive for accomplishing the objective of the RICO violation. n49

In *Sedima*, the Court, in the course of rejecting judicially-crafted standing obstacles to private RICO claims, discussed the nature of the pattern requirement and noted that "two isolated acts of racketeering activity do not constitute a pattern." n50 The Court cited a Senate Report that stated that "[t]he infiltration of legitimate business normally requires more than one 'racketeering activity' and the threat of continuing activity to be effective. It is this factor of continuity plus relationship which combines to produce a pattern." n51 The Court also referred to the definition of "pattern" in the (since-repealed) repeat offender sentencing statute, n52 which provided that "criminal conduct forms a pattern if it embraces criminal acts that have the same or similar purposes, results, participants, actions, or methods of commission, or otherwise are interrelated by distinguishing characteristics and are not isolated events." n53 This language, the Court commented, "may be useful in interpreting other sections of the Act."

Following *Sedima*, the lower courts adopted a wide variety of often conflicting approaches to the definition of "pattern." One common approach focused on whether there were two or more schemes involved, n54 while another found a pattern if there were "at the least, acts relating to two or more episodes within a single scheme." n55 The only common thread among various interpretations was the tendency to find a pattern present in criminal RICO cases and absent in civil RICO cases, reflecting the prevailing view that the overextension of the statute was chiefly occurring in the civil context. n56

By 1989, the Supreme Court was forced to admit, in *H.J. Inc. v. Northwestern Bell Telephone Co.*, that developing a meaningful concept of "pattern" within the existing statutory framework was no easy task. n57 In *H.J. Inc.*, the Eighth Circuit had interpreted RICO's pattern concept to require proof of multiple illegal schemes. The Supreme Court rejected

this view, noting that, while Congress intended a more stringent requirement than proof simply of two predicate acts, it also envisioned a "concept of sufficient breadth that it might encompass multiple predicates within a single scheme that were related and that amounted to, or threatened the likelihood of continued criminal activity." n58 Harking back to the dictum in *Sedima*, the Court rejected any more definite test than that "the racketeering predicates are related, *and* that they amount to or pose a threat of continued criminal activity." n59

With respect to the "relatedness" requirement, the Court specifically adopted the definition from the repeat offender statute, n60 which states that acts are related if they "have the same or similar purposes, results, participants, victims or methods of commission, or otherwise are interrelated by distinguishing characteristics and are not isolated events." n61

As for the "continuity" requirement, the Court stated that continuity was "both a closed and open-ended concept, referring either to a closed period of repeated conduct, or to past conduct that by its nature projects into the future with a threat of repetition." n62 The Court further explained that predicate acts extending over only a few months without threatening future criminal conduct would be insufficient to establish a pattern. n63

As for open-ended continuity, the Court noted that if the related predicates involved a distinct threat of long-term racketeering activity, n64 or were part of an ongoing entity's regular way of doing business, the threat of continuity may be established.

Unable to provide additional guidance as to these concepts, the Court conceded that "the precise methods by which relatedness and continuity or its threat may be proved, cannot be fixed in advance with such clarity that it will always be apparent whether in a particular case a 'pattern of racketeering activity' exists. The development of these concepts must await future cases, absent a decision by Congress to revisit RICO to provide clearer guidance as to the Act's intended scope." n65

In a dissent joined by three other justices, Justice Scalia wrote that the majority opinion had done nothing to improve the prior guidance in *Sedima*, which had produced the "widest and most persistent Circuit split on an issue of federal law in recent memory." n66 To the contrary, the dissent contended that the majority opinion had actually increased the degree of vagueness in the definition of pattern. The dissent therefore openly invited a constitutional challenge to RICO on these grounds. Despite Justice Scalia's invitation, relatively few litigants have raised challenges to the constitutionality of RICO since *H.J. Inc.*, and virtually all of such challenges have failed. n67

While, in the wake of *H.J. Inc.*, the lower courts continue to employ a variety of approaches to assessing the existence of a "pattern," they have largely abandoned rigid conceptual formulas and have moved toward a more practical test that can be briefly defined as continuous criminal activity lasting (or threatening to last) more than at least a year.

[i] Relatedness

The requirement of relatedness is satisfied if acts have the same or similar purposes, results, participants, victims, or methods of commission, or are otherwise interrelated by distinguishing characteristics such that the acts cannot be considered isolated events. n68 While this is not a difficult test to meet, something more than a coincidental connection must be shown. n69

Moreover, the relationship must be between the acts themselves, and not simply a relationship to a common enterprise, unless the enterprise itself has a predominantly unlawful purpose. For example, in *Vild v. Visconsi*, n70 a mere allegation that the defendants used wire and mail fraud in two otherwise dissimilar schemes did not satisfy the relationship test. The court distinguished the relationship test in the civil context from the test applied in the criminal context:

In a criminal prosecution context, predicate acts committed by organized crime families are

necessarily related because they have the same purpose and relationship as the enterprise. The same does not hold true in civil cases in which businesses may have multiple legitimate purposes and the predicate acts are not related to the enterprise in the same way. n71

Nevertheless, because relatedness is not typically an obstacle to a RICO claim, the vast majority of cases dealing with the pattern requirement turn on the continuity prong of the test.

In *Heller Financial, Inc. v. Grammco Computer Sales, Inc.*, n72 the Fifth Circuit recognized that although the relatedness test was difficult to apply, the Court was required to attempt to give some meaning to the relationship prong of the pattern requirement. The Court concluded "we interpret the relationship prong of the pattern requirement to require more than an articulable factual nexus," and held that a plaintiff must prove a relationship between the criminal aspects of the predicate criminal acts, thereby supporting the conclusion that the criminal acts are ordered or arranged.

[ii] Continuity

Even courts that apply a multi-factor test have recognized that duration is the *sine qua non* of continuity. n73 In fact, in *Neely v. Campos*, the Ninth Circuit was unable to find a single case in which pattern had been satisfied by activity lasting less than a year. n74 The Second Circuit has observed that since *H.J., Inc.*, it had found closed-ended continuity only twice, and in those instances, the pattern had extended for an extensive period of time. The court noted that although giving such weight to the duration of criminal activities was somewhat mechanistic, it was "required to effectuate Congress' intent to target long-term criminal conduct."

While closed-end continuity appears to require acts of more than a year's duration, n75 shorter-term activity may suffice to establish open-ended continuity as long as there is a reasonable spectre that the activity will continue for more than a year. n76 The existence of open-ended continuity has been found even from a single scheme taking place over only six days, n77 and from a single scheme lasting a few weeks, n78 where there was a reasonable threat that the scheme would continue indefinitely. There are however, no clear guidelines as to when conduct may be deemed to raise the threat of continuing activity. The Second Circuit has observed that in cases where the acts of the defendant or the enterprise are inherently unlawful, such as murder or obstruction of justice, and are in pursuit of inherently unlawful goals, such as narcotics trafficking, the courts generally find continuity established by the nature of the activity even if its duration is brief. n79

[2] Enterprise

To constitute a RICO violation, the pattern of racketeering must impact on an "enterprise." n80 An enterprise, as defined in Section 1961(4), "includes any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact although not a legal entity." As the Supreme Court noted in *United States v. Turkette*, n81 the existence of an enterprise is a separate element to be proved by a plaintiff. Evidence of the commission of a number of acts of racketeering, constituting a pattern of racketeering action, does not establish the existence of an enterprise. To the contrary, even where, as in *Turkette*, the enterprise is an unlawful conspiracy that perpetuates numerous acts of misconduct, the enterprise is still theoretically "an entity separate and apart from the pattern of activity in which it engages." n82

In *Turkette*, the Supreme Court stated that enterprise "is proved by evidence of an ongoing organization, formal or informal, and by evidence that the various associates function as a continuing unit." n83 An enterprise need not be a legitimate entity; the Supreme Court has held that RICO is equally applicable to a criminal enterprise that has no legitimate aspect or has yet to acquire one. n84

An existing, ongoing formal organization of the type enunciated in the first part of Section 1961(4), i.e., a partnership, corporation, association, or other legal entity, generally will qualify as an enterprise under the standards set forth in

Turkette. n85 In fact, the Eighth Circuit has held that the participation of a corporation in a racketeering scheme is sufficient, in and of itself, to give the enterprise a structure separate from the racketeering activity. n86 A wide range of legitimate enterprises may be named as the vehicle through which racketeering acts are committed, including benevolent and nonprofit organizations, such as unions and benefit funds, governmental units, courts and judicial offices, police departments and motorcycle clubs. n87 However, the second part of the definition, referring to "any union or group of individuals associated in fact" has proven to be more difficult to apply and has led to conflicting views as to the circumstances in which such a group rises to the level of a RICO enterprise.

Since *Turkette*, the circuit courts have disagreed as to whether a RICO "association-in-fact" enterprise must have " 'ascertainable structure' *distinct from* that inherent in the conduct of a pattern of racketeering activity ... or [is established] even when the 'enterprise was, in effect, no more than the sum of the predicate racketeering acts.' " n88

The decision by the Third Circuit in *United States v. Console* n89 exemplifies the approach adopted by those courts that require proof that the enterprise have an ascertainable, independent structure. In *Console*, the government alleged that the RICO enterprise was an association in fact composed of a law firm and a medical practice. The government charged the defendants with a scheme to defraud insurance companies by submitting inflated medical bills on behalf of accident victims represented by the law firm.

The defendants contended that there was no proof that there was any kind of organizational structure for decision making, or that the enterprise existed separate and apart from the racketeering actions as alleged. Rather, the defendants contended that all that was shown was that the two offices combined to commit mail fraud on an *ad hoc* basis.

In rejecting the defendants' contention, the Third Circuit focused on each of the three elements enumerated by the Supreme Court in *Turkette*: proof of an ongoing organization; proof that the associates function as a continuing unit; and proof that the enterprise is an "entity separate and apart from the pattern of activity in which it engages." n90 The Third Circuit held that each of these elements "describes a separate aspect of the life of the enterprise" and requires different proof. n91

To satisfy the first test, the court held that the government was required to show that "some sort of structure exists within the group for the making of decisions, whether it be hierarchical or consensual. There must be some mechanism for controlling and directing the affairs of the group on an ongoing, rather than an *ad hoc*, basis." n92 Having found, however, that the individual defendants supervised the execution of their agreement and supervised the activities of their employees and clients in furtherance of their scheme, the court in *Console* found that the first test, the existence of an ongoing organization, was established.

The second test, according to the court, requires proof that each person "performed a role in the group consistent with the organizational structure established by the first element and which furthers the activities of the organization." n93 This requirement was satisfied by evidence that various employees of the defendants each performed roles within the structure that advanced the scheme devised and directed by the individual defendants.

The third element, according to the court, requires proof that the enterprise has an "existence beyond that which is necessary merely to commit each of the acts charged as predicate racketeering offenses." n94 Supervision and coordination of the commission of the predicate acts and of other activities on an on-going basis is sufficient to satisfy this requirement. In *Console*, this test was satisfied since the defendants continued to provide legitimate services at the same time as they were supervising the illegal scheme.

As *Console* illustrates, even a seemingly strict structural test of enterprise can frequently be satisfied. n95 Moreover, other courts, rejecting the "structure" requirement, have expressed the view that the existence of an association in fact is often more readily proven by what it does, rather than by an analysis of the structure, n96 and that proof of various racketeering acts may be relied on to establish the existence of the enterprise. To courts holding this view, even a

showing of an informal association of persons to conduct an illegal activity will usually suffice to establish an enterprise. n97 The Seventh Circuit, while noting that an enterprise must have a "structure and goals separate from the predicate acts themselves," also observed that RICO applies not only to formal enterprises, but to informal ones like criminal gangs. n98 The Court concluded that there need not be much structure to distinguish an enterprise from a conspiracy. On the other hand, the Seventh Circuit has required that group members have a common purpose, if they are to be considered an enterprise. n99

Despite the fact that the definition of enterprise in Section 1961(4) specifies only single formal entities and a "group of individuals associated in fact although not a legal entity," the Ninth and Second Circuits, and lower courts in the Third and Fourth Circuits, have held that a group or association of formal entities, such as an association solely of corporations, can only qualify as a rationalized RICO enterprise. n100 As the district court reasoned in *Chisholm v. Charlie Falk's Auto Wholesale Inc.*: n101

In enacting RICO, Congress recognized that organized crime in the United States had become a highly sophisticated, organized and widespread business ... Eliminating associations-in-fact of corporations from the reach of RICO would thus allow the most powerful, sophisticated and potentially dangerous criminals to escape punishment. This was certainly not the intent of Congress ... [A]n association in fact of corporations can be an enterprise for purposes of RICO.

However, an association-in-fact enterprise typically cannot consist solely of a corporation and its wholly-owned subsidiaries or divisions, or of an employer and its employees or outside agents, unless their alleged illegal activities go beyond the scope of their regular and intended course of business. n102 On the other hand, controlling shareholders may sometimes be found to be part of an enterprise with the corporations that they control. n103

Until recently, there was great uncertainty as to whether the enterprise, or the pattern of racketeering activity engaged in by the enterprise, had to be economically motivated. n104 However, in *National Organization for Women v. Scheidler*, n105 the Supreme Court resolved this issue by concluding that neither the enterprise nor the racketeering activity engaged in by the enterprise must be economically motivated.

In *Scheidler*, the Seventh Circuit had affirmed the dismissal of RICO claims brought against anti-abortion protesters on the grounds that "non-economic crimes committed in furtherance of non-economic motives are not within the ambit of RICO." n106 The Supreme Court reversed, finding that neither the definitional sections nor the other provisions of the statute provided any indication that an economic motive was required. The Court of Appeals had concluded that, since use of the term "enterprise" in Sections 1962(a) and (b) appears to be connected to economic motivation, the term should have the same meaning in Section 1962(c). The Supreme Court rejected this inference, noting the different roles played by the enterprise in the various subsections. The "enterprise" referred to in subsections (a) and (b) was defined as "something acquired through the use of illegal activities or by money obtained from illegal activities" (though, as the Court noted, even this did not mandate that such an enterprise be profit-seeking). In contrast, the Court found that the enterprise in Section 1962(c) generally was the vehicle through which the unlawful pattern of activity was committed, rather than the victim. The Court stated: "since the enterprise in subsection (c) is not being acquired, it need not have a property interest that can be acquired nor an economic motive for engaging in illegal activity; it need only be an association in fact that engages in a pattern of racketeering activity." n107

[3] Prohibited Activities

If a pattern of racketeering activity has been established, and an appropriate RICO enterprise identified, the next step is to determine whether the acts of the defendant affected the identified enterprise in one, or more, of the four ways prohibited by Section 1962:

(a) It shall be unlawful for any person who has received any income derived, directly or indirectly, from

a pattern of racketeering activity ... to use or invest, directly or indirectly, any part of such income, or the proceeds of such income, in acquisition of any interest in, or the establishment or operation of, any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce

(b) It shall be unlawful for any person through a pattern of racketeering activity ... to acquire or maintain, directly or indirectly, any interest in or control of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

(c) It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity

(d) It shall be unlawful for any person to conspire to violate any of the provisions of subsection (a), (b) or (c)

As the Supreme Court has noted, the three substantive subsections describe a progression from misconduct outside the enterprise through misconduct in gaining access to the enterprise to misconduct entirely from within the enterprise. n108

[a] § 1962(a): Use or Investment of Income or Proceeds of Racketeering Activity to Acquire Interest in or Establish an Operation or Enterprise

The Third Circuit has observed that Section 1962(a) is directed at "halting the investment of racketeering proceeds into legitimate business." n109 Under this section, a plaintiff must demonstrate: that the defendant has received money from a pattern of racketeering activity; that defendant invested that money in an enterprise; and that the enterprise affected interstate commerce. n110 The majority of courts also have held that the plaintiff's injury must be caused by the defendant's use or investment of income in the enterprise, and not by the predicate acts themselves. n111

"Mere investment of racketeering income is insufficient; the plaintiff's injury must stem from the investment of funds by the defendant." n112 As the Third Circuit has observed, if the mere reinvestment of racketeering income were to suffice, the use-or-investment injury requirement would be almost completely eviscerated when the alleged pattern of racketeering is committed on behalf of a corporation:

RICO's pattern requirement generally requires long-term continuing criminal conduct. Over the long term, corporations generally reinvest their profits regardless of the source. Consequently, almost every racketeering act by a corporation will have some connection to the proceeds of a previous act § 1962(c) is the proper avenue to redress injuries caused by the racketeering acts themselves. If plaintiff's reinvestment injury concept were accepted, almost every pattern of racketeering by a corporation would be actionable under 1962(a), and the distinction between 1962(a) and 1962(c) would become meaningless. n113

[b] § 1962(b): Acquisition or Maintenance of Interest in or Control of Enterprise Through Pattern of Racketeering Activity

As with Section 1962(a), the enterprise in Section 1962(b) is the victim of defendant's racketeering activity. To state a claim under section 1962(b), the plaintiff must allege two basic things: the defendant acquired or maintained an interest in an alleged enterprise through a pattern of racketeering activity; and the plaintiff suffered injury to business or property as a result of that acquisition or maintenance. n114 The interest referred to in Section 1962(b) relates to a proprietary interest, such as the acquisition of stock or ownership equity and the classic example of 1962(b) injury is injury to the owner of a legitimate business as a result of infiltration of the business by racketeering activity such as

loan-sharking or extortion. n115

An owner of an enterprise infiltrated by the defendant as a result of racketeering activities may bring suit if the owner is injured by the defendant's acquisition or control of his enterprise. n116 However, it is not enough to show that a person engaged in racketeering has an otherwise legitimate interest in the enterprise: "It must be established firmly that there is a nexus between the interest and the alleged racketeering activities." n117 In all circuits except the Eleventh, an allegation that a pattern of racketeering was used to acquire the interest or control is not sufficient. n118 Rather, a plaintiff must show a causal relationship between the violations and his or her damages. n119

[c] § 1962(c): Unlawful for a Person Employed by or Associated with an Enterprise to Conduct or Participate in Conduct of Enterprise's Affairs Through a Pattern of Racketeering Activity

Section 1962(c) is the section most commonly relied upon by civil RICO plaintiffs. Under Section 1962(c) it is unlawful "for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity." Section 1962(c) also proscribes the "collection of unlawful debt," although this provision is rarely invoked in civil RICO actions. n120 Caselaw concerning Section 1962(c) falls into two basic lines. One concerns the scope of activity included within Section 1962(c)'s requirement that the defendant "conduct or participate in the conduct" of an enterprise's activities. The other concerns whether the individual or entity alleged to be the liable person may also be the enterprise.

[i] Participation in the Conduct of an Enterprise.

In *Reves v. Ernst & Young*, n121 the Supreme Court held that to be subject to liability under Section 1962(c) "one must participate in the operation of management of the enterprise itself." n122

Prior to *Reves*, the circuits were split as to the level of participation required to show that a defendant had conducted or participated in the conduct of the affairs of an enterprise through a pattern of racketeering. The split was of considerable practical importance, since under some but not all of the circuits' tests, it was possible to hold outsiders, such as attorneys, accountants, and bankers, liable for Section 1962(c) violations.

In *Reves*, an action under Section 1962(c) was brought against Arthur Young, an independent accounting firm, that had provided audit services for a farmers' cooperative. Plaintiffs alleged that the accounting firm knowingly certified false financial records and otherwise assisted management in perpetrating a fraud on the cooperative's noteholders.

The district court, relying on Eighth Circuit precedent, granted summary judgment for Arthur Young on the RICO claim, holding:

Plaintiffs have failed to show anything more than that the accountants reviewed a series of completed transactions, and certified the Co-Op's records as fairly portraying its financial status as of a date three or four months preceding the meetings of the directors and the shareholders at which they presented their reports. We do not hesitate to declare that such activities fail to satisfy the degree of management [test] n123

The Court of Appeals affirmed, and the Supreme Court granted *certiorari*.

The Supreme Court began its analysis by focusing on the construction of the word "conduct." The Court concluded that, as defined, the term requires some element of direction. The Court then considered the scope of the word "participate," and found that "participate" meant "to take part in" the required direction. Based on these findings, the Court held that "In order 'to participate, directly or indirectly, in the conduct of such enterprise's affairs,' one must have some part in

directing those affairs," n124 *i.e.*, some part in directing the enterprise's "operation or management."

In explaining the scope of this test, the Supreme Court stressed that liability was not limited in application to the upper management of an enterprise. The Court stated:

An enterprise is "operated" not just by upper management but also by lower-rung participants in the enterprise who are under the direction of upper management. An enterprise also might be "operated" or "managed" by others "associated with" the enterprise who exert control over it as, for example, by bribery. n125

Rejecting assertions that the "operation or management" test would preclude the application of RICO to "outsiders," the Court noted that Section 1962(a) and (b) both address the infiltration of legitimate organizations by outsiders, and that outsiders could still be liable under Section 1962(c) if they are associated with the enterprise and participate in the operation or management of the enterprise itself, as in the bribery example. Nonetheless, applying its test to the facts of *Reves*, the Court concluded that Arthur Young's creation of financial statements for the co-op, based on information provided by management, did not constitute the requisite "participation." Accordingly, the Supreme Court affirmed the summary judgment for the defendant.

Taking directions and performing tasks that are necessary or helpful to the enterprise, without more, are insufficient to bring a defendant within the scope of Section 1962(c) because they do not exhibit management or operation of the enterprise's affairs. n126 Further, "[s]imple exertion of control over one aspect of an enterprise's activities does not evince control over the enterprise itself" and will not bring the defendant within the liability of § 1962(c). n127 The First Circuit, however, has rejected a claim that mere employees, by definition, cannot participate in the operation or management of an enterprise, n128 concluding "we think Congress intended to reach all who participate in the conduct of a loan sharking enterprise, whether they are general or foot soldiers."

The *Reves* decision has significantly limited the potential RICO liability of outside professionals, such as accountants and attorneys. Since *Reves*, almost every court to consider the issue has declined to find such advisers directly liable under Section 1962(c). n129 In one case, a bank that performed an essential function, which was the cornerstone of an enterprise, and that decided who among the investors in the enterprise would be paid, was held not to have participated in the operation or the management of the enterprise. n130 In that case, the Court found that it is not enough that the RICO enterprise might not have been able to function without the banking scheme in place. "Even the provision of services essential to the operation of the RICO enterprise itself, is not the same as participating in the conduct of the affairs of the enterprise." n131

A number of decisions however, have held that outside professionals may be liable under Section 1962(c) where they "aided and abetted" the RICO violation of another party who did meet the "operation or management" test. n132 Others have sought to incorporate the "operation or management" test into this realm as well, finding that only inside directors and certain top officers can be liable as aiders and abettors. n133 More broadly, however, the "aiding and abetting" theory may no longer be viable in light of the Supreme Court's decision in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.* n134 In *Central Bank*, the Court refused to allow "aiding and abetting" liability under Section 10(b) of the Securities Exchange Act of 1934 because the statute nowhere specifies such secondary liability. As the RICO statute similarly makes no reference to "aiding and abetting" liability (except with respect to the little used portion of Section 1962(a) concerning the collection of an unlawful debt), similar reasoning would seem to preclude aiding and abetting liability under RICO. n135

[iii] Separation of the Defendant and the Enterprise Under § 1962(c)

Section 1962(c) liability extends, by its terms, only to a person "employed by or associated with" the enterprise. The Circuit Courts have uniformly held that § 1962(c) requires some distinctness between the RICO defendant and the

RICO enterprise. n136 This "distinctness" principle was explored in the Supreme Court's decision in *Cedric Kushner Promotions, Ltd. v. King*, n137 in which the president and sole shareholder of a closely held corporation conducted the corporation's affairs in a RICO-forbidden way while acting within the scope of his authority as the corporation's employee. Because the owner/employee was distinct from the corporation itself by virtue of the incorporation, creating a legally different entity with different rights and responsibilities, the "separateness" or "distinctness" requirement of RICO was satisfied. n138 The Court specifically stated that it did not "quarrel with the basic principle that to establish liability under § 1962(c) one must allege and prove the existence of two distinct entities: (1) a 'person'; and (2) an 'enterprise' that is not simply the same 'person' referred to by a different name." n139 Further, the Court distinguished its decision in *Kushner* from prior case law based on different circumstances in which the "distinctness" requirement had not been met, such as: when a corporation is the "person" and the corporation together with all its employees and agents were the "enterprise" n140; or the corporate subsidiaries were "persons" and the subsidiaries taken together as the parent were the "enterprise" n141; or cases in which the same entity was alleged to be both the "person" and the "enterprise." n142 The Court concluded that the RICO statute requires "no more than the formal legal distinction between 'person' and 'enterprise' (namely, incorporation) ... [and therefore] the RICO provision ... applies when a corporate employee unlawfully conducts the affairs of the corporation of which he is the sole owner -- whether he conducts those affairs within the scope, or beyond the scope, of corporate authority." n143

[d] § 1962(d): Conspiracy

Under Section 1962(d) it is unlawful "for any person to conspire to violate any of the provisions of 1962(a), (b) or (c)." Liability under Section 1962 is thus based on the defendants' agreement to engage in activity prohibited by one of the other, substantive subsections of Section 1962. n144

There are two main issues under Section 1962(d) that have divided the courts. The first is whether the acts that allegedly injured the plaintiff can simply be overt acts in furtherance of the conspiracy or must be predicate acts under Section 1961(1). The second is whether a RICO defendant, in order to be held liable, must agree to commit personally at least two requisite acts himself or whether his agreement to be a member of the conspiracy will itself suffice.

The Supreme Court answered the first question in 2000 in *Beck v. Prupis*, n145 holding that "a person may not bring suit under § 1964(c) predicated on a violation of § 1962(d) for injuries caused by an overt act that is not an act of racketeering or otherwise unlawful under the statute." n146 In the *Beck* case, this meant that the former president, CEO, and director of an insurance company could not maintain a § 1962(d) civil RICO conspiracy claim against certain directors and officers of the company who had engaged in acts of racketeering and had orchestrated Beck's employment termination when he brought their wrongdoing to the attention of authorities. Beck's theory was that his injury was caused by the overt act of his employment termination which was done in furtherance of the defendants' conspiracy. The Court rejected this theory, however, and resolved a conflict among the Courts of Appeals, by referring to the well-established common law of civil conspiracy and holding that an "injury caused by an overt act that is not an act of racketeering or otherwise wrongful under RICO is not sufficient to give rise to a cause of action under § 1964(c) for a violation of § 1962(d)." n147

As for the second issue, the Third, Fourth, Sixth, Seventh, Eighth, Ninth and Eleventh Circuits all reject the requirement that a Section 1962(d) defendant participate personally in the commission of two predicate offenses. n148 Rather, "§§ 1962(d)'s target, like that of all provisions prohibiting conspiracies, is the *agreement* to violate RICO's substantive provisions, not the actual violations themselves. Accordingly, ... an individual can be charged under §§ 1962(d) even if he personally does not agree to commit two predicate acts of racketeering. 'The touchstone of liability under §§ 1962(d) is an agreement to participate in an endeavor which, if completed, would constitute a violation of the substantive statute.' Hence, in order to state a viable claim for conspiracy under §§ 1962(d), a plaintiff must allege that (1) the defendant agreed to maintain an interest in or control of an enterprise or to participate in the affairs of an enterprise through a pattern of racketeering activity, and (2) the defendant further agreed that someone would commit at least two predicate acts to accomplish those goals." n149 In these Circuits, a defendant may be liable if he or she simply agrees to

be a member of a conspiracy to violate Section 1962 in one of the ways specified in Section 1962(a), (b) or (c). Proof of an agreement is required and there must be knowledge of and voluntary participation in an agreement to do an illegal act. n150

By contrast, the First and Second Circuits both require that the defendant agree to personally commit at least two of the predicate acts forming the basis of the RICO claim. n151 In *United States v. Ruggiero*, n152 the Second Circuit rejected the government's assertion that a RICO conspiracy charge could be based on the defendants' entry into a conspiracy to engage in an enterprise through a pattern of racketeering acts committed by others. The court stated: "to convict on a RICO conspiracy [the government] must prove that defendant himself at least agreed to commit two or more predicate crimes." n153

Since liability under Section 1962(d) stems from the agreement to engage in actions prohibited under Section 1962(a), (b) or (c), it is not necessary to show that one actually violated those sections to be liable under Section 1962(d). For example, although the *Reves* decision mandates that there can be no violation of Section 1962(c) unless the defendant participates in the operation or management of the enterprise, a district court held that an outside attorney could be liable under Section 1962(d) if he *conspired* to participate in the operation or management of the enterprise. n154

The Seventh Circuit agreed, noting that "to hold that under 1962(d) [the agreement] must show that an alleged co-conspirator was capable of violating the substantive offense under 1962(d), that is, that he participated to the extent required by *Reves*, would add an element to RICO conspiracy that Congress did not direct." n155

FOOTNOTES:

(n1)Footnote 1. The following *state* offenses qualify as predicate acts under § 1961(1)(A):

[A]ny act or threat involving murder, kidnapping, gambling, arson, robbery, bribery, extortion, dealing in obscene matter, or dealing in a controlled substance or listed chemical (as defined in section 102 of the Controlled Substances Act), which is chargeable under State law and punishable by imprisonment for more than one year.

The following *federal* offenses qualify as predicate acts:

Under § 1961(1)(B):

-bribery (18 U.S.C. § 201);-sports bribery (18 U.S.C. 224);-counterfeiting (18 U.S.C. §§ 471-473);-theft from interstate shipment if felonious (18 U.S.C. § 659);-embezzlement from pension and welfare funds (18 U.S.C. § 664);-extortionate credit transactions (18 U.S.C. §§ 891-894);-fraud and related activity in connection with identification documents (18 U.S.C. § 1028);-fraud and related activity in connection with access devices (18 U.S.C. § 1029);-transmission of gambling information (18 U.S.C. § 1084);-mail fraud (18 U.S.C. § 1341);-wire fraud (18 U.S.C. § 1343);-financial institution fraud (18 U.S.C. § 1344);-procurement of citizenship or naturalization unlawfully (18 U.S.C. § 1425);-reproduction of naturalization or citizenship papers (18 U.S.C. § 1426);-sale of naturalization or citizenship papers (18 U.S.C. § 1427);-dealing in obscene matter (18 U.S.C. §§ 1461-1465);-obstruction of justice (18 U.S.C. § 1503);-obstruction of criminal investigations (18 U.S.C. § 1510);-obstruction of state or local law enforcement (18 U.S.C. § 1511);-tampering with a witness, victim, or an informant (18 U.S.C. § 1512);-retaliating against a witness, victim, or an informant (18 U.S.C. § 1513);-false statement in application and use of passport (18 U.S.C. § 1542);-forgery or false use of passport (18 U.S.C. § 1543);-misuse of passport (18 U.S.C. § 1544);-fraud and misuse of visas, permits, and other documents (18 U.S.C. § 1546);-peonage and slavery (18 U.S.C. §§ 1581-1588);-interference with commerce, robbery, or extortion (18 U.S.C. § 1951);-racketeering (18 U.S.C. § 1952);-interstate transportation of wagering paraphernalia (18 U.S.C. § 1953);-unlawful welfare fund payments (18 U.S.C. § 1954);-illegal

gambling businesses (*18 U.S.C. § 1955*);-laundering of monetary instruments (*18 U.S.C. § 1956*);-engaging in monetary transactions in property devised from specified unlawful activity (*18 U.S.C. § 1957*);-use of interstate commerce facilities in the commission of murder-for-hire (*18 U.S.C. § 1958*);-use of illegal money transmitters (*18 U.S.C. § 1960*);-sexual exploitation of children (*18 U.S.C. §§ 2251, 2251A, 2252, and 2260*);-interstate transportation of stolen motor vehicles (*18 U.S.C. §§ 2312-2313*);-interstate transportation of stolen property (*18 U.S.C. §§ 2314-2315*);-trafficking in counterfeit labels for phonorecords, computer programs, or computer program documentation or packaging and copies of motion pictures or other audiovisual works (*18 U.S.C. § 2318*);-criminal infringement of a copyright (*18 U.S.C. § 2319*);-unauthorized fixation of and trafficking in sound recordings and music videos of live musical performances (*18 U.S.C. § 2319A*);-trafficking in goods or services bearing counterfeit marks (*18 U.S.C. § 2320*);-trafficking in certain motor vehicles or motor vehicle parts (*18 U.S.C. § 2321*);-trafficking in contraband cigarettes (*18 U.S.C. §§ 2341-2346*);-white slave traffic (*18 U.S.C. §§ 2421-2424*);-violating prohibitions on biological weapons (*18 U.S.C. §§ 175-178*);-violating prohibitions on chemical weapons (*18 U.S.C. §§ 229-229F*);-violating prohibitions on nuclear weapons (*18 U.S.C. § 831*).

Under § 1961(1)(C):

-restrictions on payments and loans to labor organizations (*29 U.S.C. § 186*); or-embezzlement from union funds (*18 U.S.C. § 501(c)*).

Under § 1961(1)(D):

[A]ny offense involving fraud connected with a case under title 11 [Bankruptcy] (except a case under section 157 of this title), fraud in the sale of securities or the felonious manufacture, importation, receiving, concealment, buying, selling, or otherwise dealing in a controlled substance or listed chemical (as defined in section 102 of the Controlled Substances Act), punishable under any law of the United States.

Under § 1961(1)(E): Any act indictable under the Currency and Foreign Transactions Reporting Act, Pub. L. No. 91-508, 84 Stat. 1118, codified at *31 U.S.C. §§ 1051-1062, 1081-1083, 1101-1105, 1121, 1122* (1982).

Under § 1961(1)(F): Any act indictable under the following provisions of the Immigration and Nationality Act, if committed for purpose of financial gain:

-bringing in and harboring certain aliens (*8 U.S.C. § 1324*);-aiding or assisting certain aliens to enter the United States (*8 U.S.C. § 1327*); or,-importation of alien for immoral purpose (*8 U.S.C. § 1328*).

Under § 1961(1)(G): Any act indictable under any provision listed in *18 U.S.C. § 2332b(g)(5)(B)* regarding acts of terrorism transcending national boundaries.

The meaning of "involving" under Section 1961(1)(A) and (D) appears not yet to have been defined by the courts.

(n2)Footnote 2. *473 U.S. 479, 488, 105 S. Ct. 3275, 3281, 87 L. Ed. 2d 346, 354 (1985)* .

(n3)Footnote 3. *Id. at 493, 105 S. Ct. at 3283, 87 L. Ed. 2d at 357* .

(n4)Footnote 4. *18 U.S.C. §§ 1341, 1313*.

(n5)Footnote 5. *United States v. Lemire, 720 F.2d 1327, 1335 n.6 (D.C. Cir. 1983)* ; *United States v. Garner, 663*

F.2d 834, 838 (9th Cir. 1981) ; *United States v. Louderman*, 576 F.2d 1383, 1387 n.3 (9th Cir. 1978) .

(N6)Footnote 6. *McDonald v. Schencker*, 18 F.3d 491, 494 (7th Cir. 1994) ; *Morda v. Klein*, 865 F.2d 782, 785 (6th Cir. 1989) ; *United States v. Simon*, 839 F.2d 1461, 1465 (11th Cir. 1988) .

(n7)Footnote 7. *United States v. O'Boyle*, 680 F.2d 34, 36 (6th Cir. 1982) ; *United States v. Beecroft*, 608 F.2d 753, 757 (9th Cir. 1979) .

(n8)Footnote 8. *United States v. Amrep Corp.*, 560 F.2d 539, 543 (2d Cir. 1977) ; *Irwin v. United States*, 338 F.2d 770, 774 (9th Cir. 1964) .

(n9)Footnote 9. *United States v. Siegel*, 717 F.2d 9, 14 (2d Cir. 1983) (conversion of company assets by parent company chairman and company officer); *United States v. Newman*, 664 F.2d 12, 19-20 (2d Cir. 1981) (failure to make required reports of tainted stock purchases to employing investment banking firms); *United States v. Bronston*, 658 F.2d 920, 926-27 (2d Cir. 1981) , (attorney's nondisclosure of interest adverse to some of his firm's clients); *United States v. Von Barta*, 635 F.2d 999, 1005-07 (2d Cir. 1980) (government bond trader's concealment of adverse material trading account information from employer securities firm).

(n10)Footnote 10. *Emery v. American Gen. Fin.*, 71 F.3d 1343, 1346-47 (7th Cir. 1995) .

(n11)Footnote 11. *United States v. Frankel*, 721 F.2d 917, 920-21 (3d Cir. 1983) ; *McLendon v. Continental Group, Inc.*, 602 F. Supp. 1492, 1507 (D.N.J. 1985) .

(n12)Footnote 12. *Frankel*, 721 F.2d at 917 .

(n13)Footnote 13. *United States v. Condo*, 741 F.2d 238, 240 (9th Cir. 1984) ; *Dan River, Inc. v. Icahn*, 701 F.2d 278, 291 (4th Cir. 1983) .

(n14)Footnote 14. *United States v. Dick*, 744 F.2d 546, 551 (7th Cir. 1984) ; *Gusow v. United States*, 347 F.2d 755, 756 (10th Cir. 1965) .

(n15)Footnote 15. *E.g.*, *United States v. Fowler*, 735 F.2d 823, 828-29 (5th Cir. 1984) .

(n16)Footnote 16. *United States v. Beecroft*, 608 F.2d 753, 757 (9th Cir. 1979) ; *United States v. Amrep Corp.*, 560 F.2d 539, 547 (2d Cir. 1977) .

(n17)Footnote 17. *Pereira v. United States*, 347 U.S. 1, 8-9, 74 S. Ct. 358, 362-63, 98 L. Ed. 435, 444 (1954) .

(n18)Footnote 18. *Pereira*, 347 U.S. at 8-9 .

(n19)Footnote 19. *Kehr Packages v. Fidelcor, Inc.*, 926 F.2d 1406, 1414 (3d Cir. 1991) .

(n20)Footnote 20. *Kehr Packages*, 926 F.2d 1406 . *See also* *United States v. McDonald*, 576 F.2d 1350, 1359 n.15 (9th Cir. 1978) .

(n21)Footnote 21. *Durland v. United States*, 161 U.S. 306, 313 16 S. Ct. 508, 40 L. Ed. 709 (1896) . However, this may obviate damages and thus remove standing.

(n22)Footnote 22. *Chisolm v. Transouth Fin. Corp.*, 1998 U.S. App. LEXIS 24632 (4th Cir. Oct. 5, 1998) ; *Summit Props. Inc. v. Hoechst Celanese Corp.*, 214 F.3d 556, 562 (5th Cir. 2000) ; *VanDen Broeck v. Commonpoint Mortgage Co.*, 210 F.3d 696, 699 (6th Cir. 2000) ; *Sikes v. Teleline, Inc.*, 281 F.3d 1350, 1360-61 (11th Cir. 2002) , *cert. denied*, *Sikes v. AT&T Co.*, 537 U.S. 884, 123 S. Ct. 117, 154 L. Ed. 2d 143, 2002 U.S. LEXIS 6519, 71 U.S.L.W. 3240 ; *Shaw v. Rolex Watch, U.S.A.*, 726 F. Supp. 969, 972-973 (S.D.N.Y. 1989) .

(n23)Footnote 23. 859 F.2d 1179 (4th Cir. 1988) .

(n24)Footnote 24. *Brandenburg*, 859 F.2d at 1189, n.10 .

(n25)Footnote 25. *United States v. Philip Morris Inc.*, 273 F. Supp. 2d 3, 6 (D.C. Cir. 2002) ("Unlike common-law fraud, the mail and wire fraud statutes, whose violation constitute the predicate acts for the Government's RICO claim, do not require proof of reliance or damages or completion of the scheme to defraud.") *vacated and remanded on other grounds*, 347 F.3d 951 (2003) .

(n26)Footnote 26. *Tabas v. Tabas*, 47 F.3d 1280, 1295 n.18 (3d Cir. 1995) . *See also Rodriguez v. McKinney*, 878 F. Supp. 744, 748-49 (E.D. Pa. 1995) (victims of a RICO mail fraud need not demonstrate reliance on the predicate mailings to allege a viable claim).

(n27)Footnote 27. *Bridge v. Phoenix Bond & Indemnity Co.*, 128 S. Ct. 2131, 170 L. Ed. 1012 (2008) .

(n28)Footnote 28. *Id.* at 2138.

(n29)Footnote 29. *Id.*

(n30)Footnote 30. *Id.*

(n31)Footnote 31. *Id.* at 2144 ("Of course, none of this is to say that a RICO plaintiff who alleges injury 'by reason of' a pattern of mail fraud can prevail without showing that someone relied on the defendant's misrepresentations. ... In most cases, the plaintiff will not be able to establish even but-for causation if no one relied on the misrepresentation.") (internal citation omitted).

(n32)Footnote 32. *Id.*

(n33)Footnote 33. 18 U.S.C. § 1951.

(n34)Footnote 34. *See, e.g., Robbins v. Wilkie*, 433 F.3d 755, 768 (10th Cir.) , *cert. granted*, *Wilkie v. Robbins*, 549 U.S. 1075, 127 S. Ct. 722, 166 L. Ed. 2d 559, 2006 U.S. LEXIS 9196, 75 U.S.L.W. 3293 , *rev'd*, *Wilkie v. Robbins*, 127 S. Ct. 2588, 168 L. Ed. 2d 389, 2007 U.S. LEXIS 8513, 75 U.S.L.W. 4529, 20 Fla. L. Weekly Fed. S 443, 22 A.L.R. Fed. 2d 695 (even if defendant, a government agency, "engaged in lawful actions with an intent to extort a right-of-way from [plaintiff] rather than with an intent to merely carry out their regulatory duties," such actions violate the RICO statute) (emphasis added), *cert. granted*, 127 S. Ct. 722 (2006) .

(n35)Footnote 35. 510 U.S. 249, 114 S. Ct. 798, 127 L. Ed. 2d 99 (1994) .

(n36)Footnote 36. *National Organization for Women v. Scheidler*, 510 U.S. 249, 252 (1994) .

(n37)Footnote 37. 897 F. Supp. 1047 (N.D. Ill. 1995) .

(n38)Footnote 38. *National Organization for Women v. Scheidler*, 897 F. Supp. 1047, 1073 (N.D. Ill. 1995) (citations omitted).

(n39)Footnote 39. *Nat'l Org. for Women, Inc. v. Scheidler*, 267 F.3d 687 (7th Cir. 2001) , *cert. granted*, *Operation Rescue v. NOW, Inc.*, 545 U.S. 1151, 125 S. Ct. 2991, 162 L. Ed. 2d 909, 2005 U.S. LEXIS 5222, 73 U.S.L.W. 3755 .

(n40)Footnote 40. *Scheidler v. Nat'l Org. for Women, Inc.*, 537 U.S. 393, 397, 123 S. Ct. 1057, 154 L. Ed. 991 (2003) , *cert. granted*, *Scheidler v. NOW, Inc.*, 545 U.S. 1151, 125 S. Ct. 2991, 162 L. Ed. 2d 909, 2005 U.S. LEXIS 5221, 73 U.S.L.W. 3755 .

(n41)Footnote 41. *Id.*

(n42)Footnote 42. *Nat'l Org. for Women v. Scheidler*, 91 Fed. Appx. 510, 512 (7th Cir. 2004) .

(n43)Footnote 43. *Scheidler v. Natl Org. for Women*, 126 S. Ct. 1264, 1268, 164 L. Ed. 2d 10, 16 (2006) .

(n44)Footnote 44. *Scheidler v. Natl Org. for Women*, 126 S. Ct. 1264, 1273 (2006) , citing 18 U.S.C. § 1951(a).

(n45)Footnote 45. *Scheidler v. Natl Org. for Women*, 126 S. Ct. 1264, 1274 (2006) .

(n46)Footnote 46. *Snowden v. Lexmark Int'l, Inc.*, 237 F.3d 620, 625 (6th Cir. 2001) ("[t]o prevail on a RICO claim, a plaintiff must show two acts of racketeering activity as a 'minimum necessary condition' " -- second act of computer chip theft was "wholly unsubstantiated").

(n47)Footnote 47. 473 U.S. 479, 105 S. Ct. 3275, 87 L. Ed. 2d 346 (1985) .

(n48)Footnote 48. See, e.g., *Mazza v. Kozel*, 591 F. Supp. 432, 438 (N.D. Ohio 1984) ; *Beth Israel Medical Center v. Smith*, 576 F. Supp. 1061, 1066 (S.D.N.Y. 1983) .

There were some exceptions. See, e.g., *Exeter Towers Assocs. v. Bowditch*, 604 F. Supp. 1547, 1554-55 (D. Mass. 1985) (pattern not satisfied by two or more acts of mail fraud in negotiating a single mortgage); *Teleprompter of Erie, Inc. v. Erie*, 537 F. Supp. 6, 12-13 (W.D.Pa. 1981) (multiple bribes at single fund-raiser insufficient).

(n49)Footnote 49. See *United States v. Brooklier*, 685 F.2d 1208, 1222-23 (9th Cir. 1982) ; *United States v. Dean*, 647 F.2d 779, 788 (8th Cir. 1981) ; *United States v. Starnes*, 644 F.2d 673, 677-78 (7th Cir. 1981) .

Some courts requiring relationship required only that the predicate acts be related to the enterprise. See *United States v. Sinito*, 723 F.2d 1250, 1261 (6th Cir. 1983) ; *United States v. Bright*, 630 F.2d 804, 830 n.47 (5th Cir. 1980) ; *United States v. Weisman*, 624 F.2d 1118, 1121-23 (2d Cir. 1980) .

(n50)Footnote 50. 473 U.S. 479, 496, 105 S. Ct. 3275, 3285, 87 L. Ed. 2d 346, 358 .

(n51)Footnote 51. *Sedima*, 473 U.S. 479 (quoting S. Rep. No. 617, 91st Cong., 1st Sess. 158 (1969)).

(n52)Footnote 52. 18 U.S.C. § 3575.

(n53)Footnote 53. 18 U.S.C. § 3575(e).

(n54)Footnote 54. *Lipin Enterprises, Inc. v. Lee*, 625 F. Supp. 1098, 1100-01 (N.D. Ill. 1985) , *aff'd*, 803 F.2d 322 (7th Cir. 1986) ; *Superior Oil Co. v. Fulmer*, 785 F.2d 252, 257 (8th Cir. 1986) .

(n55)Footnote 55. *H.J. Inc. v. Northwestern Bell Tel. Co.*, 829 F.2d 648, 650 (8th Cir. 1987) , *rev'd*, 492 U.S. 229 (1989) ; *International Data Bank, Ltd. v. Zepkin*, 812 F.2d 149, 155 (4th Cir. 1987) .

(n56)Footnote 56. See *Torwest DBC, Inc. v. Dick*, 810 F.2d 925, 929 (10th Cir. 1987) (alleged scheme to recover secret profits by self-dealing of some of plaintiff's directors in sale of property to an enterprise; removal of defendants from the boards of the enterprises eliminated any threat of continuity); *Holmberg v. Morrisette*, 800 F.2d 205, 210 (8th Cir. 1986) , (one scheme to draw down three letters of credit securing a defendant's transactions with a third party absent any indication that defendants had engaged in like activities in the past or that they were engaged in other criminal activities); *Superior Oil Co. v. Fulmer*, 785 F.2d 252, 257 (8th Cir. 1986) (several related acts of mail and wire fraud in pursuit of gas conversion from plaintiff's pipeline were part of one isolated scheme; court noted that there was no indication that defendants had done these acts in the past nor that they were engaged in other criminal acts elsewhere); *Kredietbank, N.V. v. Joyce Morris, Inc.*, Civ. No. 84-1903, 1986 U.S. Dist. LEXIS 30653, at *9-11 (D.N.J.

Oct. 11, 1985) (two alleged mail frauds in submission of allegedly false affidavits in a prior lawsuit lacked ongoing nature); *Allington v. Carpenter*, 619 F. Supp. 474, 478 (C.D. Cal. 1985) (three alleged acts of wire fraud in inducement of a single loan took place in only one criminal episode); *Northern Trust Bank/O'Hare, N.A. v. Inryco, Inc.*, 615 F. Supp. 828, 831-33 (N.D. Ill. 1985) (alleged taking of four kickbacks on a single warehouse construction project, involving at least two and perhaps more uses of the mails, lacked the required "multiplicity of events").

But see *Bank of America Nat'l Trust & Sav. Ass'n v. Touche, Ross & Co.*, 782 F.2d 966, 970, 970-71 (11th Cir. 1986) (pattern requirement satisfied by allegations of nine distinct mail and wire fraud violations involving the same parties that were part of a single three-year scheme to prepare false financial statements and reports to induce plaintiff banks to lend money to the enterprise); *R.A.G.S. Couture, Inc. v. Hyatt*, 774 F.2d 1350, 1354-55 (5th Cir. 1985) (two acts of alleged mail fraud, five months apart, in a single scheme to collect on false invoices could constitute a pattern).

(n57)Footnote 57. *H.J. Inc. v. Northwestern Bell Tel. Co.*, 492 U.S. 229, 236, 109 S. Ct. 2893, 106 L. Ed. 2d 195 (1989) ("[D]eveloping a meaningful concept of 'pattern' within the existing statutory framework has proved to be no easy task.").

(n58)Footnote 58. *H.J. Inc.*, 492 U.S. at 237, 109 S. Ct. at 2899, 106 L. Ed. 2d at 206 .

(n59)Footnote 59. *H.J. Inc.*, 492 U.S. at 239, 109 S. Ct. at 2900, 106 L. Ed. 2d at 208 .

(n60)Footnote 60. 18 U.S.C. § 3575(e) (since repealed).

(n61)Footnote 61. *H.J. Inc.*, 492 U.S. at 240, 109 S. Ct. at 2901, 106 L. Ed. 2d at 208 .

(n62)Footnote 62. *H.J. Inc.*, 492 U.S. at 253, 109 S. Ct. at 2907, 106 L. Ed. 2d at 216 .

(n63)Footnote 63. *H.J. Inc.*, 492 U.S. at 242, 109 S. Ct. at 2902, 106 L. Ed. 2d at 209 .

(n64)Footnote 64. The example given by the court to illustrate this was the sale of "insurance" by a hoodlum to storekeepers to cover against the breakage of their windows provided they make monthly payments.

(n65)Footnote 65. *H.J. Inc.*, 492 U.S. at 243, 109 S. Ct. at 2893, 106 L. Ed. 2d at 210 .

(n66)Footnote 66. *H.J. Inc.*, 492 U.S. at 251, 109 S. Ct. at 2893, 106 L. Ed. 2d at 215 .

(n67)Footnote 67. *United States v. Blinder*, 10 F.3d 1468, 1475 (9th Cir. 1993) ; *United States v. Ashman*, 979 F.2d 469, 487 (7th Cir. 1992) ; *United States v. Glecier*, 923 F.2d 496, 498 (7th Cir. 1991) ; *United States v. Van Dorn*, 925 F.2d 1331, 1334 n.2 (11th Cir. 1991) ; *United States v. Coiro*, 922 F.2d 1008, 1017 (2d Cir. 1991) ; *United States v. Woods*, 915 F.2d 854, 862-64 (3d Cir. 1990) ; *United States v. Angiulo*, 897 F.2d 1169, 1178-80 (1st Cir. 1990) ; *Mohr v. A.O. Smith Corp.*, No. 88 CV-10043, 1993 U.S. Dist. LEXIS 19226, at *11-12 (Mar. 25, 1993 E.D. Mich) ; *In re Taxable Mun. Bond Sec. Litig.*, MDL 863 Section G, 1992 U.S. Dist. LEXIS 7298, at *3-6 (E.D. La May 20, 1992) ; *Schrag v. Dinges*, 788 F. Supp. 1543, 1552-55 (D.Kan. 1992) ; *Alter v. DBLKM, Inc.*, 840 F. Supp. 799, 810 (D. Colo. 1993) ; *In re Integrated Resources Real Estate Ltd. Partnerships Sec. Litig.*, 850 F. Supp. 1105, 1114-16 (S.D.N.Y. 1993) ; *Compacion Insular de Segeros v. Reyes Munoz*, 826 F. Supp. 599, 607-08 (D.P.R. 1993) ; *Bingham v. Zolt*, 66 F.3d 553, 566 (2d Cir. 1995) (the Second Circuit rejected the argument that RICO's pattern and enterprise requirements were unconstitutionally vague.)

But see *Firestone v. Galbreath*, 747 F. Supp. 1556 (S.D. Ohio 1990) , *aff'd*, 976 F.2d 279 (6th Cir. 1992) (finding "pattern" requirement unconstitutionally vague as applied to defendants).

(n68)Footnote 68. *Vemco v. Camardella*, 23 F.3d 129, 133 (6th Cir. 1994) .

(n69)Footnote 69. *Vicom v. Harbridge*, 20 F.3d 771, 779-82 (7th Cir. 1993) .

(n70)Footnote 70. 956 F.2d 560 (6th Cir. 1992) . See also *United States v. Indelicato*, 865 F.2d 1370, 1382-83 (2d Cir. 1989) , *aff'd*, *Furnari v. United States Parole Comm'n*, 531 F.3d 241, 2008 U.S. App. LEXIS 14512

(n71)Footnote 71. *Visconsi*, 956 F.2d at 568-69 .

(n72)Footnote 72. 71 F.3d 518, 525 (5th Cir. 1996) .

(n73)Footnote 73. *Vemco Inc. v. Camardella*, 23 F.3d 129, 135 (6th Cir. 1994) ; *Hindes v. Castle*, 937 F.2d 868, 872 (3d Cir. 1991) ; *Tabas v. Tabas*, 47 F.3d 1280, 1292 (3d Cir. 1995) .

(n74)Footnote 74. 1994 U.S. App. LEXIS 12704 (9th Cir. May 27, 1994) . See also *Feinstein v. Resolution Trust Corp.*, 942 F.2d 34 (1st Cir. 1991) ; *Kehr Packages Inc. v. Fidelcor Inc.*, 926 F.2d 1406, 1413 (3d Cir. 1991) ; *Eizonas Inc. v. Dollar Savings and Trust Co.*, 12 F.3d 212 (6th Cir. 1993) ; *Aldridge v. Lily Tulip*, 953 F.2d 587, 593 (11th Cir. 1992) ; *Primary Care Investors, Seven Inc. v. PHP Healthcare Corp.*, 986 F.2d 1208, 1215 (8th Cir. 1993) ; *420 East Ohio Limited Partnership v. Cocose*, 980 F.2d 1122, 1124-25 (7th Cir. 1992) .

(n75)Footnote 75. *Spool v. World Child Int'l Adoption Agency*, NO. 06-5698 (2d Cir. Mar. 18, 2008) (reiterating that two years is not a bright-line rule, but noting it would be rare for conduct persisting for a shorter period to establish closed-ended continuity); *GICC Capital Corp. v. Technology Finance Group, Inc.*, 67 F.3d 463 (2d Circuit 1995) ; *Hughes v. Consol-Pennsylvania Coal Co.*, 945 F.2d 594 (3d Cir. 1991) (finding 12 months is not a substantial enough period of time to constitute a pattern); *Moon v. Harrison Piping Supply* (465 F.3d 719 (6th Cir. 2006) (holding predicate acts over a 30-month period do not satisfy closed-ended continuity); *Midwest Grinding Co., Inc. v. Spitz*, 976 F.2d 1016 (7th Cir. 1992) (noting that a time frame of less than nine months does not satisfy the durational requirement); *Primary Care Investors, Seven, Inc. v. PHP Healthcare Corp.*, 986 F.2d 1208 (8th Cir. 1993) (holding 10 to 11 months insufficient to establish closed-ended continuity); *Rampersad v. Deutsche Bank Sec., No. 02 Civ. 7311*, 2003 U.S. Dist. LEXIS 7867 (S.D.N.Y. May 9, 2003) (dismissing claim for lack of closed-ended continuity when scheme lasted approximately one year).

(n76)Footnote 76. *National Credit Union Admin. Bd. v. Regine*, 749 F. Supp. 401, 406-08 (D.R.I. 1990) ; *Three Crown Ltd. Partnership v. Caxton*, 817 F. Supp. 1033, 1044 ; *United States v. Pelullo*, 964 F.2d 193, 208 (3d Cir. 1992) ; *Parcoil Corp. v. Nowsco Well Serv. Ltd.*, 887 F.2d 502, 503-04 (4th Cir. 1989) ; *Calcasieu Marine National Bank v. Grant*, 943 F.2d 1453, 1463 (5th Cir. 1991) ; *United States v. Busacca*, 936 F.2d 232, 237 (6th Cir. 1991) ; *Miller v. Gain Fin., Inc.*, 995 F.2d 706, 708-09 (7th Cir. 1993) ; *Thornton v. First State Bank*, 4 F.3d 650, 652 (8th Cir. 1993) ; *Neely v. Campos*, No. 92-56197, 1994 U.S. App. LEXIS 12704, at *8-10 (9th Cir. May 27, 1994) ; *Resolution Trust Corp. v. Stone*, 998 F.2d 1534, 1543-44 (10th Cir. 1993) ; *United States v. Link*, 921 F.2d 1523, 1527 (11th Cir. 1991) ; *Edmonson & Gallagher v. Alban Towers Tenants Ass'n*, 829 F. Supp. 420, 423-24 (D.D.C. 1993) (finding no pattern of racketeering activity where plaintiff alleged a single scheme, directed at a single victim, and resulting in a single injury); *Malone v. First Freedom Group, Inc.* 1996 U.S. Dist. LEXIS 1867, at *21 n.10 (E.D. Pa. Feb. 16, 1996) , *rev'd on other grounds*, 118 F.3d 1576 (3d Cir. 1997) (plaintiff failed to show a pattern of racketeering activity where the alleged conduct lasted only 8 months.).

(n77)Footnote 77. *Chase Manhattan Bank v. Malatesta*, 1990 U.S. Dist. LEXIS 9222 (S.D.N.Y. July 6, 1990) (involving six counterfeit check transactions that took place over the course of six days).

(n78)Footnote 78. See, e.g., *Shields Enters. v. First Chicago Corp.*, 975 F.2d 1290, 1295-97 (7th Cir. 1992) (finding sufficient continuity where defendant allegedly engaged in extortion three times over an eight-month period because defendant would have continued to use extortion if a sale had not gone through, even though defendant argued that the alleged racketeering activity would have naturally ended with the completion of the sale); *United States v. Busacca*, 936 F.2d 232, 237-38 (6th Cir. 1991) (involving predicate acts over a period of two and one half months and finding that plaintiff alleged sufficient evidence of continuity because there was nothing to stop defendant from

continuing to misappropriate money); *Morrow v. Black*, 742 F. Supp. 1199, 1207 (E.D.N.Y. 1990) ("[R]acketeering activity which in actuality extend over a few weeks only but at the time of the occurrence threatens any future criminal activity satisfied the continuity requirement."); *Norstar Bank v. Pepitone*, 742 F. Supp. 1209, 1211-12 (E.D.N.Y. 1990) (finding that the plaintiff alleged sufficient evidence of continuity where the predicate acts extended over a four-month period because the acts implicitly threatened future criminal activity at the time of their occurrence).

(n79)Footnote 79. *Morrow v. Black*, 742 F. Supp. 1199, 1207 (E.D.N.Y. 1990) ; *Norstar Bank v. Pepitone*, 742 F. Supp. 1209, 1211-12 (E.D.N.Y. 1990) .

(n80)Footnote 80. *United States v. Aulicino*, 44 F.3d 1102, 1110 (2d Cir. 1995) .

(n81)Footnote 81. 452 U.S. 576, 101 S Ct. 2524, 69 L. Ed. 2d 246 (1981) .

(n82)Footnote 82. *Turkette*, 452 U.S. at 583 .

(n83)Footnote 83. *Turkette*, 452 U.S. at 583 .

(n84)Footnote 84. *United States v. Turkette*, 452 U.S. 576, 591 (1981) .

(n85)Footnote 85. *United States v. Turkette*, 452 U.S. 576, 580 (1981) .

(n86)Footnote 86. See *Bennett v. Berg*, 685 F.2d 1053, 1060-61 (8th Cir. 1982) (stating that legal entities are garden variety enterprises that are ordinarily separate from the predicate acts).

(n87)Footnote 87. *United States v. Beasley*, 72 F.3d 1518, 1525 (11th Cir. 1996) (emphasis in original).

(n88)Footnote 88. *United States v. Blinder*, 10 F.3d 1468, 1473 (9th Cir. 1993) (citations omitted) (citing *United States v. Bledsoe*, 674 F.2d 647, 665 (8th Cir. 1982) and *United States v. Bagaric*, 706 F.2d 42, 55 (2d Cir. 1983)).

(n89)Footnote 89. 13 F.3d 641 (3d Cir. 1993) .

(n90)Footnote 90. *Console*, 13 F.3d at 650 .

(n91)Footnote 91. *United States v. Console*, 13 F.3d 641, 650-51 (3d Cir. 1993) . See also *United States v. Riccobene*, 709 F.2d 214, 223-24 (3d Cir. 1983) ; *United States v. Tillett*, 763 F.2d 628, 632 (4th Cir. 1985) ; *Manax v. McNamara*, 842 F.2d 808, 811 (5th Cir. 1988) ; *Jennings v. Emry*, 910 F.2d 1434, 1440 (7th Cir. 1990) .

For cases decided by the First Circuit, see, e.g., *Miranda-Rodriguez v. Ponce Federal Bank, F.S.B.*, 751 F. Supp. 18, 21 (D.P.R. 1990) , *aff'd*, 948 F.2d 41 (1st Cir. 1991) ("the term 'enterprise' must signify an association that is substantially different from the acts which form the 'pattern of racketeering activity.' ").

For cases decided by the Seventh Circuit see, e.g., *Segreti v. Lome*, 747 F. Supp. 484, 486 (N.D. Ill. 1990) ("enterprise must be an entity separate and apart from the pattern of racketeering activity in which it engages" and must be defined "by what it is, not what it does.") (internal quotations omitted). But see, *United States v. King*, 850 F. Supp. 750, 751, 753 (C.D. Ill. 1994) (court rejects jury instruction requiring Government to prove the existence of an enterprise separate and apart from the racketeering activity in which it engaged).

(n92)Footnote 92. *Console*, 13 F.3d at 651 (citing *United States v. Riccobene*, 709 F.2d 214, 222 (3d Cir. 1983)) .

(n93)Footnote 93. *Console*, 13 F.3d at 651 .

(n94)Footnote 94. *United States v. Console*, 13 F.3d 641, 651 (3d Cir. 1993) .

(n95)Footnote 95. *Console*, 13 F.3d at 652 . See also *Libertad v. Welch*, 854 F. Supp. 19, 25-28 (D.P.R. 1993) , *aff'd in part, rev'd in part, remanded*, 53 F.3d 428 (1st Cir. 1995) (alleged association-in-fact could not constitute a valid RICO enterprise where it had no structure or organization beyond that necessary to commit the underlying predicates).

In the Seventh Circuit, see *Chicago HMO v. Trans Pacific Life Ins. Co.*, 622 F. Supp. 489, 495 (N.D. Ill. 1985) (if the defendants "were involved in a fairly long term, continuing relationship that had some [distinct] identity ... it is conceivable that such an entity could constitute an 'enterprise.' ").

In the Ninth Circuit, see *Allington v. Carpenter*, 619 F. Supp. 474, 478-79 (C.D. Cal. 1985) . See also *United Energy Owners Comm., Inc. v. United States Energy Management Systems, Inc.*, 837 F.2d 356, 362 n.13 (9th Cir. 1988) (approving of the *Allington* opinion).

Cf. McCullough v. Suter, 757 F.2d 142, 144 (7th Cir. 1985) (sole proprietorship could be an enterprise because proprietor had several employees, all of whom together were more than "just a one-man band").

(n96)Footnote 96. *United States v. Coonan*, 938 F.2d 1553, 1559 (2d Cir. 1991) citing *United States v. Bagaric*, 706 F.2d 42,, 56 (2d Cir. 1983) ; *United States v. Darden*, 70 F.3d 1507, 1521 (8th Cir. 1995) .

(n97)Footnote 97. *United States v. Weinstein*, 762 F.2d 1522, 1537 (11th Cir. 1985) ("[T]he definitive factor in determining the existence of a RICO enterprise [is] an association of individuals, however loose or informal ..."). *United States v. Bagaric*, 706 F.2d 42 (2d Cir. 1983) . See also *United States v. Bagnariol*, 665 F.2d 877 (9th Cir. 1981) *vacated on other grounds sub nom*, *United States v. Walgren*, 885 F.2d 1417 (9th Cir. 1989) .

(n98)Footnote 98. *United States v. Korando*, 29 F.3d 1114, 1117-18 (7th Cir. 1994) .

(n99)Footnote 99. See *Baker, et al. v. IBP, Inc.*, 357 F.3d 685, 691 (7th Cir. 2004) (dismissing RICO claim for lack of common purpose, when some members of association-in-fact wanted to drive immigrant workers' wages down, while other members wanted to drive wages up).

(n100)Footnote 100. *United States v. Blinder*, 10 F.3d 1468, 1473 (9th Cir. 1993) ("if a corporation can form part of an 'associated in fact' enterprise, *a fortiori*, a group of corporations should be able to constitute the entire enterprise."). In the Second Circuit, see *United States v. Huber*, 603 F.2d 387, 393-94 (2d Cir. 1979) , *cert. denied*, 445 U.S. 927 (1980) .

In the Fifth Circuit, see *United States v. Thevis*, 665 F.2d 616, 625-626 (5th Cir.) , *cert. denied*, 459 U.S. 825 (1982) (upholding an enterprise as a "group of individuals associated in fact with various corporations").

In the Eighth Circuit, see *Atlas Pile Driving Co. v. DiCon Financial Co.*, 886 F.2d 986, 995 (8th Cir. 1989) .

In the First Circuit, see *United States v. London*, 66 F.3d 1227, 1243 (1st Cir. 1995) , (two or more legal entities can form or be part of an association in fact RICO enterprise.)

(n101)Footnote 101. 851 F. Supp. 739 (E.D. Va. 1994) , *vacated and remanded*, *Chisholm v. TranSouth Fin. Corp.*, 95 F.3d 331 (4th Cir. 1996) .

(n102)Footnote 102. *Miller Hydro Corp. v. Popovitch*, 793 F. Supp. 24, 27 (D. Me. 1992) ; *Glessner v. Kenny*, 952 F.2d 702, 711-12 (3d Cir. 1991) ; *Riverwoods Chappaqua, Corp. v. Marine Midland Bank, N.A.*, 30 F.3d 339, 344 (2d Cir. 1994) ; *Richmond v. Nationwide Cassel, L.P.*, 52 F.3d 640, 646-47 (7th Cir. 1995) .

(n103)Footnote 103. *United States v. Robinson*, 8 F.3d 398, 406-07 (7th Cir. 1993) .

(n104)Footnote 104. *United States v. Flynn*, 852 F.2d 1045, 1052 (8th Cir.) , cert. denied, 488 U.S. 974 (1988) , in which the court allowed RICO charge against members of an enterprise directed towards controlling St. Louis labor unions for their own economic gain, which met the requirement that "an enterprise must be directed toward an economic goal." See also *United States v. Anderson*, 626 F.2d 1358, 1372 (8th Cir. 1980) , cert. denied, 450 U.S. 912 (1981) (Congress intended enterprise "to encompass only an association having an ascertainable structure which exists for the purpose of maintaining operations directed toward an economic goal"); *Northeast Women's Center, Inc. v. McMonagle*, 868 F.2d 1342, 1349-50 (3d Cir.) , cert. denied, 493 U.S. 901 (1989) (women's health center brought a RICO action against anti-abortion demonstrators for intimidation and harassment of center's employees, court upheld RICO liability, and did not directly address the existence of a financial motive requirement, holding only that a civil RICO plaintiff need not prove economic motivation if the underlying RICO predicate act is a Hobbs Act offense).

(n105)Footnote 105. 510 U.S. 249, 114 S. Ct. 798, 127 L. Ed. 2d 99 (1994) .

(n106)Footnote 106. 968 F.2d 612, 629 (7th Cir. 1992) .

(n107)Footnote 107. 510 U.S. at 259, 114 S. Ct. at 804, 127 L. Ed. 2d at 109 .

(n108)Footnote 108. *Reves v. Ernst & Young*, 507 U.S. 170, 179-83 (1993) .

(n109)Footnote 109. *Brittingham v. Mobil Corp.*, 943 F.2d 297, 303 (3d Cir. 1991) .

(n110)Footnote 110. *Lightning Lube v. Witco, Corp.*, 4 F.3d 1153, 1188 (3d Cir. 1993) .

(n111)Footnote 111. See *Nolen v. Nucentrix Broadband Networks, Inc.*, 293 F.3d 926, 929-30 (5th Cir. 2002) (RICO plaintiff's alleged injury stemmed solely from cable provider's assessment and collection of late fees, not from their use of investment of those fees); *Nugget Hydroelectric, L.P. v. Pacific Gas & Elec. Co.*, 981 F.2d 429, 437 (9th Cir. 1992) , cert. denied, 113 S. Ct. 2336 (1993) ("a plaintiff seeking civil damages for a violation of section 1962(a) must allege facts tending to show that he or she was injured by the use or investment of racketeering income"); *Ouaknine v. MacFarlane*, 897 F.2d 75, 82-83 (2d Cir. 1990) ; *Craighead v. E.F. Hutton & Co.*, 899 F.2d 485, 494 (6th Cir. 1990) ; *Rose v. Bartle*, 871 F.2d 331, 357 (3d Cir. 1989) ; *Grider v. Texas Oil & Gas Corp.*, 868 F.2d 1147, 1149, 103 O.&G.R. 594 (10th Cir.) , cert. denied, 493 U.S. 820 (1989) .

See also *Danielsen v. Burnside-Ott Training Ctr.*, 941 F.2d 1220, 1229-30 (D.C. Cir. 1991) ; *Metcalf v. PaineWebber, Inc.*, 886 F. Supp. 503, 508-09 (W.D. Pa. 1995) (1962(a) claim failed because it did not allege injury resulting from use or investment of racketeering income); *Pinski v. Adelman*, 1995 U.S. Dist. LEXIS 16550 (N.D. Ill., Nov. 7 1995) (1962(a) requires that the plaintiff allege an injury caused by the investment of racketeering proceeds). *R.C.M. Executive Gallery Corp. v. Rols Capital Co.*, 901 F. Supp. 630, 642 (S.D.N.Y. 1995) (allegations that investment of income in an enterprise enabled the defendants to continue their fraudulent behavior deemed insufficient).

But see *Busby v. Crown Supply, Inc.*, 896 F.2d 833, 836-40 (4th Cir. 1990) (stating that no investment use injury need be alleged); *Mid-State Fertilizer v. Exchange Nat'l Bank*, 693 F. Supp. 666, 670-73 (N.D. Ill. 1988) , *aff'd on other grounds*, 877 F.2d 1333 (7th Cir. 1989) .

(n112)Footnote 112. *Lightning Lube v. Witco Corp.*, 4 F.3d 1153, 1188-89 (3d Cir. 1993) .

(n113)Footnote 113. *Brittingham*, 943 F.2d at 305 (citation omitted).

(n114)Footnote 114. *Wagh v. Metris Direct, Inc.*, 348 F.3d 1102, 1111 (9th Cir. 2003) .

(n115)Footnote 115. *Welch Foods, Inc. v. Packer*, No. 1:94-cv-814, 1996 U.S. Dist. LEXIS 951, at *5-7 (W.D. Mich. Jan. 8, 1996) .

(n116)Footnote 116. *Lightning Lube v. Witco, Corp.*, 4 F.3d 1153, 1190 (3d Cir. 1993) .

(n117)Footnote 117. *Id. See also Litton Indus. v. Lehman Bros.*, 709 F. Supp. 438, 452 (S.D.N.Y. 1989) , rev'd, 967 F.2d 742 (2d Cir. 1992) .

(n118)Footnote 118. *Avirgan v. Hull*, 691 F. Supp. 1357, 1362 (S.D. Fla. 1988) , aff'd on other grounds, 932 F.2d 1572 (11th Cir. 1991) .

(n119)Footnote 119. *Arnold v. Evergreen Valley Nurseries*, No. 94-0061, 1994 U.S. Dist. LEXIS 579, at *13-15 (E.D. Pa. Jan. 26, 1994) ; *Jiffy Lube Int'l v. Jiffy Lube*, 848 F. Supp. 569, 583 (E.D. Pa. 1994) ; *Dent Manufacturing, Inc. v. Zafir*, No. 94-2532, 1995 U.S. Dist. LEXIS 15045, at *19-21 (E.D. Pa. Oct. 12, 1995) (1962(b) claim rejected where plaintiff failed to argue that it was injured as a result of the defendant's acquisition or control of an alleged enterprise.).

(n120)Footnote 120. *Nolen v. Nucentrix Broadband Networks, Inc.*, 293 F.3d 926, 929 (5th Cir. 2002) (fixed late fees charged under a cable rental or service agreement by the cable service provider were not considered interest under Texas law and therefore RICO plaintiff failed to establish that cable provider collected an unlawful debt).

(n121)Footnote 121. 507 U.S. 170, 113 S. Ct. 1163, 122 L. Ed. 2d 525 (1993) .

(n122)Footnote 122. *Reves*, 507 U.S. at 189 .

(n123)Footnote 123. *Reves*, 507 U.S. at 176, 113 S. Ct. at 1169, 122 L. Ed. 2d at 534 .

(n124)Footnote 124. *Reves*, 507 U.S. at 179, 113 S. Ct. at 1170, 122 L. Ed. 2d at 536-37 . See, e.g., *Slaney v. Int'l Amateur Ath. Fed'n*, 244 F.3d 580, 598 (7th Cir. 2001) .

(n125)Footnote 125. *Reves*, 507 U.S. at 184, 113 S. Ct. at 1173, 122 L. Ed. 2d at 540 (footnote omitted).

(n126)Footnote 126. See, e.g., *United States v. Viola*, 35 F.3d 37, 41 (2d Cir. 1994) .

(n127)Footnote 127. *Slaney v. Int'l Amateur Ath. Fed'n*, 244 F.3d 580, 598 (7th Cir. 2001) .

(n128)Footnote 128. *United States v. Oreto*, 37 F.3d 739, 750 (1st Cir. 1994) .

(n129)Footnote 129. See *University of Maryland v. Peat, Marwick, Main & Co.*, 996 F.2d 1534, 1539-40 (3d Cir. 1993) ; *Nolte v. Pearson*, 994 F.2d 1311, 1317 (8th Cir. 1993) ; *Hannelore Baumer v. Pacht*, 8 F.3d 1341, 1346 (9th Cir. 1993) . See also *Azrielli v. Cohen Law Offices*, 21 F.3d 512, 521-22 (2d Cir. 1994) . But see *Clark v. Milam*, 847 F. Supp. 409, 415-17 (S.D. W. Va. 1994) . But see *Napoli v. United States*, 45 F.3d 680, 683 (2d Cir. 1995) (investigators who provided substantial assistance to lawyers who litigated and settled fraudulent lawsuits were involved in playing a part in the direction of the affairs of the enterprise.).

(n130)Footnote 130. *DeWit v. Firststar Corp.*, 879 F. Supp. 947, 966 (N.D. Iowa 1995) .

(n131)Footnote 131. *Dewitt*, 879 F. Supp. at 966 .

(n132)Footnote 132. *Independent Drug Wholesalers Group v. Denton*, 833 F. Supp. 1507, 1518 (D. Kan. Oct. 7, 1993) .

(n133)Footnote 133. *Rolo v. City Investing Co. Liquidating Trust*, 845 F. Supp. 182, 231-32 (D.N.J. 1994) , vacated, 66 F.3d 312 (3rd Cir. 1995) , *Clark v. Milam*, 847 F. Supp. 409 (S.D.W. Va. 1994) .

(n134)Footnote 134. 511 U.S. 164, 114 S. Ct. 1439, 128 L. Ed. 2d 119 (1994) , superseded in part by 15 U.S.C. §

78(t).

(n135)Footnote 135. See, e.g., *Rolo v. City Investing Co. Liquidating Trust*, 155 F.3d 644, 656-57 (3d Cir. 1998) ; *Pennsylvania Assn of Edwards Heirs v. Righenour*, 235 F.3d 839, 843 (3d Cir. 2000) , cert. denied, 122 S. Ct. 43, 151 L. Ed. 2d 15 (2001) ; *In re Mastercard Int'l Inc.*, 132 F. Supp. 2d 468, 494-95 (E.D. La. 2001) (aiding and abetting liability under §§ 1962(c) was eliminated by the Court's holding in *Central Bank*).

(n136)Footnote 136. See *St. Paul Mercury Ins. Co. v. Williamson*, 224 F.3d 425, 445 (5th Cir. 2000) ; *United States v. Golden Industries, Inc.*, 219 F.3d 1268, 1270 (11th Cir.) en banc, cert. denied, 531 U.S. 1102, 121 S. Ct. 838, 148 L. Ed. 2d 719 (2000) ; *Begala v. PNC Bank*, 214 F.3d 776, 781 (6th Cir. 2000) , cert. denied, 531 U.S. 1145 (2001) ; *Doyle v. Hasbro, Inc.*, 103 F.3d 186, 190 (1st Cir. 1996) ; *Richmond v. Nationwide Cassel L.P.*, 52 F3d 640, 646-47 (7th Cir. 1995) ; *Gasoline Sales, Inc. v. Aero Oil Co.*, 39 F.3d 70, 72-73 (3d Cir. 1994) ; *Confederate Memorial Ass'n v. Hines*, 995 F.2d 295, 299-300 (D.C. Cir. 1993) ; *Bd. of County Comm'rs, v. Liberty Group*, 965 F.2d 879, 885 (10th Cir.) , cert. denied, 506 U.S. 918, 113 S. Ct. 329, 121 L. Ed. 2d 247 (1992) ; *River City Markets, Inc. v. Fleming Foods West, Inc.*, 960 F.2d 1458, 1461 (9th Cir. 1992) ; *Busby v. Crown Supply, Inc.*, 896 F.2d 833, 840 (4th Cir. 1990) ; *Atlas Pile Driving Co. v. DiCon Financial Co.*, 886 F.2d 986, 995 (8th Cir. 1989) ; *Bennett v. United States Trust Co. of New York*, 770 F.2d 308, 315 n.2 (2d Cir. 1985) , cert. denied, 474 U.S. 1058, 106 S. Ct. 800, 88 L. Ed. 2d 776 (1986) ; *Semiconductor Energy Laboratory Co., Ltd. v. Samsung Electronics Co., Ltd.*, 204 F.3d 1368, 1383, n.7 (Fed. Cir. 2000) , cert. denied, 531 U.S. 1190, 121 S. Ct. 1187, 149 L. Ed. 2d 104 (2001) .

(n137)Footnote 137. 533 U.S. 158, 121 S. Ct. 2087, 150 L. Ed. 2d 198 (2001) .

(n138)Footnote 138. 533 U.S. 158, 163, 121 S. Ct. 2087, 2091, 150 L. Ed. 2d 198, 204 (2001) .

(n139)Footnote 139. 533 U.S. 158, 161, 121 S. Ct. 2087, 2090, 150 L. Ed. 2d 198, 203 (2001) .

(n140)Footnote 140. *Riverwoods Chappaqua Corp. v. Marine Midland Bank, N.A.*, 30 F.3d 339, 344 (2d Cir. 1994) .

(n141)Footnote 141. *Discon, Inc. v. NYNEX Corp.*, 93 F.3d 1055, 1064 (2d Cir. 1996) , vacated on other grounds, 525 U.S. 128 (1998) .

(n142)Footnote 142. *Anatian v. Coutts Bank (Switzerland) Ltd.*, 193 F.3d 85, 89 (2d Cir. 1999) , cert. denied, 528 U.S. 1188 (2000) ; *Bennett v. United States Trust Co. of New York*, 770 F.2d 308, 315, n.2 (2d Cir. 1985) , cert. denied, 474 U.S. 1058 (1986) .

(n143)Footnote 143. 533 U.S. 158, 165-66, 121 S. Ct. 2087, 2092, 150 L. Ed. 2d 198, 206 (2001) .

(n144)Footnote 144. *Nolen v. Nucentrix Broadband Networks, Inc.*, 293 F.3d 926, 930 (5th Cir. 2002) (failure to successfully plead the requisite elements of either a § 1962(a) or a § 1962(c) violation meant that the RICO plaintiff could not plead a conspiracy to violate either section under § 1962(d)).

(n145)Footnote 145. 529 U.S. 494, 120 S. Ct. 1608, 146 L. Ed. 2d 561 (2000) .

(n146)Footnote 146. 529 U.S. 494, 507, 120 S. Ct. 1608, 1617, 146 L. Ed. 2d 561, 572 (2000) .

(n147)Footnote 147. 529 U.S. 494, 505, 120 S. Ct. 1608, 1615-1616, 146 L. Ed. 2d 561, 571 (2000) (citation omitted). The Court specified, however, that it was not resolving the question of "whether a plaintiff suing under § 1964(c) for a RICO conspiracy must allege an actionable violation under §§ 1962(a)-(c), or whether it is sufficient for the plaintiff to allege an agreement to complete a substantive violation and the commission of at least one act of racketeering that caused him injury." *Id.* at 506 n.10 .

(n148)Footnote 148. *United States v. Adams*, 759 F.2d 1099, 1116 (3d Cir.) , cert. denied, 474 U.S. 971 (1985) ;

United States v. Pryba, 900 F.2d 748, 759-60 (4th Cir.) , cert. denied, 498 U.S. 924 (1990) ; *United States v. Joseph*, 781 F.2d 549, 554 (6th Cir. 1986) ; *Slaney v. Int'l Amateur Ath. Fed'n*, 244 F.3d 580, 600 (7th Cir. 2001) ; *United States v. Kragness*, 830, F.2d 842, 860 (8th Cir. 1987) ; *United States v. Tille*, 729 F.2d 615, 619 (9th Cir.) , cert. denied, 469 U.S. 845, 105 S. Ct. 156, 83 L. Ed. 2d 93 (1986) ; *United States v. Rosenthal*, 793 F.2d 1214, 1228 (11th Cir.) , cert. denied, 480 U.S. 919 (1987) .

(n149)Footnote 149. *Slaney v. Int'l Amateur Ath. Fed'n*, 244 F.3d 580, 600 (7th Cir. 2001) (citations omitted); *Blue Cross & Blue Shield of N.J., Inc. v. Philip Morris, Inc.*, 113 F. Supp. 2d 345, 367 (E.D.N.Y. 2000) .

(n150)Footnote 150. *United States v. Blinder*, 10 F.3d 1468, 1477 (9th Cir. 1994) . In *Cox v. Administrator United States*, 17 F.3d 1386 (11th Cir. 1994) , the Eleventh Circuit adopted the test set forth in *Feinstein v. RTC* that each defendant must have joined knowingly in the scheme and been involved, directly or indirectly, in the commission of at least two predicate offenses. It is unclear whether this was intended to mark a departure from prior Eleventh Circuit holdings on this issue. See *United States v. Rosenthal*, 793 F.2d 1214, 1228 (11th Cir. 1987) ("The government need only prove that each defendant conspired to commit the substantive RICO offense and was aware that others had done likewise.").

(n151)Footnote 151. *Feinstein v. RTC*, 942 F.2d 34, 41 (1st Cir. 1991) ; *United States v. Rastelli*, 870 F.2d 822, 828 (2d Cir.) , cert. denied, 493 U.S. 982, 110 S. Ct. 515, 107 L. Ed. 2d 516 (1989) .

(n152)Footnote 152. 726 F.2d 913 (2d Cir.) , cert. denied 469 U.S. 831, 105 S. Ct. 118, 83 L. Ed. 2d 60 (1984) .

(n153)Footnote 153. *Ruggiero*, 726 F.2d at 921 .

(n154)Footnote 154. See *Biofeedtrac, Inc. v. Kolinier Optical Enters. & Consultants*, 832 F. Supp. 585, 592 (E.D.N.Y. 1993) .

(n155)Footnote 155. *United States v. Quintanilla*, 2 F.3d 1469, 1485 (7th Cir. 1993) (internal quotations omitted).



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Federal Securities Exchange Act of 1934

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CHAPTER 10 Private RICO Litigation

2-10 Federal Securities Exchange Act of 1934 § 10.03

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§ 10.03 Injury, Causation, and Standing

[1] Standing

Section 1964(c) sets forth the standing requirements for a private civil RICO action:

Any person injured in his business or property by reason of a violation of § 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee, except that no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of section 1962. The exception contained in the preceding sentence does not apply to an action against any person that is criminally convicted in connection with the fraud, in which case the statute of limitations shall start to run on the date on which the conviction becomes final. n1

To satisfy RICO's private civil standing requirement, the courts have held that a plaintiff must establish, in addition to a violation of Section 1962, an injury to plaintiff's business or property proximately caused by a RICO violation. The first question thus presented is whether the injury must result from the underlying predicate acts or from the further "RICO" act (the impact on the enterprise) specified in Section 1962. n2

Prior to the Supreme Court's decision in *Sedima, S.P.R.L. v. Imrex Co.*, n3 several courts had held that injury resulting from the predicate acts of racketeering alleged was insufficient even in an action brought under Section 1962(c). Instead, these courts held that the plaintiff must prove some distinct racketeering or competitive injury that was either "different in kind from that occurring as a result of the predicate acts themselves, or not simply caused by the predicate acts, but also caused by an activity which RICO was designed to deter. n4 This analysis mirrored the standing test applied in the antitrust context, which required special antitrust injury. n5

In *Sedima*, the Supreme Court rejected the notion that RICO required any distinct "racketeering injury" requirement under Section 1962(c). The Court reasoned that:

[t]he compensable injury necessarily is the harm caused by predicate acts sufficiently related to constitute a pattern, for the essence of the violation is the commission of those acts in connection with

the conduct of an enterprise Any recoverable damages ... will flow from the commission of the predicate acts. n6

Sedima, however, did not resolve the issue of whether an injury flowing only from the predicate acts was sufficient under Section 1962(a) and (b).

Section 1962(a) makes it unlawful for a person who has received income from a "pattern of racketeering activity" to "use or invest" the income so obtained in an enterprise engaged in commerce. Despite *Sedima*, a number of courts have held that injuries caused solely by the predicate racketeering activity, as distinguished from injury caused by the "use or investment" of the income derived from that racketeering, are insufficient to support a claim under 1962(a). n7

In *Ouaknine v. MacFarlane*, n8 for example, the Court reasoned that, "under the plain terms of the statute," a violation of Section 1962(a) is created not by mere participation in predicate acts of racketeering but by the investment or use of income derived from that racketeering to acquire an interest in, establish or operate an enterprise. n9 Similarly, in *Brittingham v. Mobil Corp.*, n10 the Third Circuit concluded that a Section 1962(a) injury allegedly resulting from the mere reinvestment of racketeering income in an enterprise, that still allowed the enterprise to continue its operations, was insufficient. n11

The contrary view, now a distinct minority view, was expressed by the Fourth Circuit, *en banc*, in *Busby v. Crown Supply Inc.* n12 In *Busby*, the court examined the language of the statute and found that nothing in the "by reason of" language of Section 1964(c) limits the compensable racketeering injuries to those sustained *after* the investment and/or use of the income. The Fourth Circuit noted that plaintiffs may sustain injury from a Section 1962(a) violation "in the process of the [defendant] corporation's receipt and use of the illegally obtained income" and that recovery for such injury is proper even if the defendants use of the proceeds did not contribute to or cause the injury. n13 Referring to the fact that RICO is to be liberally interpreted, the Fourth Circuit concluded that if the investment use rule were applied:

[c]orporate liability under RICO will be eviscerated. Given that the named "person" and the named "enterprise" must be separate for 1962(c) purposes ... plaintiffs injured by corporate racketeering have only § 1962(a) to turn to for relief Invoking the "investment use" rule would close this avenue off, as it is virtually impossible to prove that the invested income caused the alleged injury. n14

Although the case law is much less developed under Section 1962(b), there appears to be a similar split. n15

The circuits have also split on the issue of whether a person has standing to sue for conspiracy to violate RICO if he or she is injured by a conspirator's overt acts that do not constitute specifically delineated predicate acts of racketeering. This is similar to the split over the requirements for a RICO conspiracy violation, *see* § 10.02[3][d], *supra*, which was resolved in *Beck v. Prupis*, n16 in which the Supreme Court held that "a person may not bring suit under § 1964(c) predicated on a violation of § 1962(d) for injuries caused by an overt act that is not an act of racketeering or otherwise unlawful under the statute." n17

By contrast, the First, Second, Sixth, Eighth, and Ninth Circuits, as well as a district court in the D.C. Circuit all have held that injury in a Section 1962(d) conspiracy claim must result from a predicate act committed in furtherance of a conspiracy to violate RICO. n18 The Eighth Circuit, expressing the majority view, concluded:

Imposing the predicate act requirement on civil claims based on violations of § 1962(d) narrows the focus of those suits to the specified racketeering activity that lies at the heart of the RICO statute. While this might appear to collapse a civil RICO suit based on a § 1962(d) conspiracy into those suits based on substantive RICO violations as delineated in 1962(a)-(c), any other result would render this decision merely a guide to an artful pleader. n19

[2] Injury

Under any of these approaches to any of RICO's violations, the only compensable injury is injury to business or property, as specified in section 1964(c). In construing this requirement, the courts have repeatedly held that neither personal injury nor emotional distress can provide the basis for injury under RICO. n20 As the Third Circuit explained:

Congress' apparent unwillingness to allow recovery for personal injuries under RICO appears to be consistent with enacting RICO and its specific intention to thwart the organized criminal invasion and acquisition of legitimate business enterprises and property. Ample law already existed to provide recovery for wrongfully inflicted personal injuries ... We discern no injustice in limiting a RICO plaintiff's recovery for his personal injuries to ordinary non-RICO legal measures. n21

However, while the Ninth Circuit has held that injury requires proof of concrete financial loss, perhaps even requiring proof that the plaintiff actually paid out money as a result of racketeering activity, n22 other courts have held that intangible economic injuries can constitute RICO "injury." n23

[3] Causation

Finally, plaintiffs must plead and prove the requisite causal nexus between the RICO activity and the plaintiffs' injuries. Section 1964(c) defines this nexus with the words "by reason of." Considering this language in *Holmes v. SIPC*, the Supreme Court held that to prove that an injury resulted "by reason of" the actions of the defendant, the plaintiff must show that the defendant's violations were a "proximate" cause of the plaintiff's injury *i.e.*, more than simple factual causality is required. n24 In reaching this conclusion, the Court noted that Congress, in promulgating Section 1964(c), modeled it on the civil action provision of the federal antitrust laws, section 4 of the Clayton Act, and, in so doing, intended that proximate cause, which is required under the Clayton Act, also would be required under RICO. n25 Under the Clayton Act, "proximate cause" is defined as some close or "direct relation between the injury asserted and the injurious conduct alleged." n26

In *Holmes*, The Supreme Court found several virtues in the "direct relation" requirement:

First, the less direct an injury is, the more difficult it becomes to ascertain the amount of a plaintiff's damages attributable to the violation, as distinct from other, independent factors Second, quite apart from problems of proving factual causation, recognizing claims of the indirectly injured would force courts to adopt complicated rules apportioning damages among plaintiffs removed at different levels of injury from the violative acts, to obviate the risk of multiple recoveries ... And, finally, the need to grapple with these problems is simply unjustified by the general interest in deterring injurious conduct, since directly injured victims can generally be counted on to vindicate the law as private attorneys general, without any of the problems attendant upon suits by plaintiffs injured more remotely. n27

As applied, the proximate cause requirement has led to the dismissal of numerous claims. For example, in *Anza v. Ideal Steel Supply Corp.*, plaintiff, a steel supply company, alleged one of its competitors committed wire and mail fraud by failing to charge its cash-paying customers sales tax and then investing the illegally obtained income in competing offices. n28 The plaintiff claimed these actions directly caused him to lose a significant share of his business due to his competitor's unfair market advantage. n29 Relying on the analysis in *Holmes*, the Court ruled that the "direct victim" of defendant's conduct was the State of New York, not the plaintiff, since plaintiff's harms stemmed from "a set of actions (offering lower prices) entirely distinct from the alleged RICO violation (defrauding the State)." n30 The fact that plaintiff's lost sales could have resulted from any number of causes "implicates fundamental concerns expressed in *Holmes*." n31 The Court therefore declined to find proximate causation for a violation of § 1962(c) and remanded the case to the Second Circuit to determine whether defendant's alleged violation proximately caused plaintiff's injuries under § 1962(a). n32

In the majority of circuit cases where the courts have ruled on the issue of causation, they have held that the alleged pattern of racketeering was not the proximate cause of the plaintiff's injury. n33 In a sizable minority, however, proximate cause was found. n34 When factors other than the defendant's fraud are an intervening direct cause of plaintiff's injury, plaintiff's claim will be rejected as his injury cannot be said to have occurred by reason of the defendant's actions. n35

However, a business that loses contracts to a competitor who hires and underpays undocumented aliens (a RICO predicate offense) has standing to bring a civil RICO action since there is a direct proximate relationship between the business's injury of losing contracts and the competitor's pattern of racketeering. n36 Further, the Seventh Circuit held that the *Holmes* decision did not preclude all possibility of recovery for injury that was transmitted indirectly, and held that a RICO suit could be brought by a business derivatively injured by acts aimed at its potential customers. n37

In the context of mail and wire fraud -- two of the more commonly alleged predicate acts -- the circuits are split on the question of whether a plaintiff must rely on the defendants' misrepresentation to establish proximate cause. n38 The Second, Sixth, Eighth, and Eleventh Circuits have adopted the position that an act of mail or wire fraud may only serve as a predicate act if the plaintiff has actually relied on defendant's fraudulent misrepresentations. n39 In contrast, the First and Fifth Circuits have rejected the idea that detrimental reliance by the plaintiff is required. n40

FOOTNOTES:

(n1)Footnote 1. 18 U.S.C. § 1964(c), as amended eff. Dec. 22, 1995.

(n2)Footnote 2. *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 769 (2d Cir. 1994) .

(n3)Footnote 3. *Sedima, S.P.R.L. v. Imrex Co.*, 741 F.2d 482, 496 (2d Cir. 1984) , rev'd, 473 U.S. 479 (1985) .

(n4)Footnote 4. *Wilcox Development Co. v. First Interstate Bank,N.A.*, 590 F. Supp. 445, 451 (D. Or. 1984) , aff'd, remanded, 815 F.2d 522 (9th Cir. 1987) ; *Johnsen v. Rogers*, 551 F. Supp. 281, 284-85, 75 O.&G.R. 20 (C.D. Cal. 1982) .

(n5)Footnote 5. *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 489, 97 S. Ct. 690, 50 L. Ed. 2d 701 (1977) ; *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574, 586, 106 S. Ct. 1348, 89 L. Ed. 2d 538 (1986) .

(n6)Footnote 6. *Sedima*, 473 U.S. 479, 497, 105 S. Ct. 3275, 3285, 87 L. Ed. 2d 346, 359 (1985) .

(n7)Footnote 7. *St. Paul Mercury Ins. Co. v. Williamson*, 224 F.3d 425, 443 (5th Cir. 2000) ; *Rose v. Bartle*, 871 F.2d 331, 357 (3d Cir. 1989) ; *Grider v. Texas Oil & Gas Corp.*, 868 F.2d 1147, 1149, 103 O.&G.R. 594 (10th Cir.) , cert. denied, 493 U.S. 820 (1989) ; *Lightning Lube Inc. v. Witco Corp.*, 4 F.3d 1153, 1190 (3d Cir. 1993) ; *Nugget Hydroelectric L.P. v. Pacific Gas & Electric Co.*, 981 F.2d 429, 437 (9th Cir. 1992) , cert. denied, 113 S. Ct. 2336 (1993) ; *Danielson v. Burnside Oil Aviation Training*, 941 F.2d 1220, 1229 (D.C. Cir. 1991) ; *Ouaknine v. MacFarlane*, 897 F.2d 75, 83 (2d. Cir. 1990) ; *Craighead v. E. F. Hutton & Co.*, 899 F.2d 485, 494 (6th Cir. 1990) ; *Metcalfe v. PaineWebber, Inc.*, 886 F. Supp. 503, 507-09 (W.D. Pa. 1995) (1962(a) claim failed because it did not allege injury resulting from use or investment of racketeering income); *Pinski v. Adelman*, No. 94 C 5783, 1995 U.S. Dist. LEXIS 16550, at *28-29 (N.D. Ill., Nov. 7 1995) (1962(a) requires that the plaintiff allege an injury caused by the investment of racketeering proceeds). See also *R.C.M. Executive Gallery Corp. v. Rols Capital Co.*, 901 F. Supp. 630, 642 (S.D.N.Y. 1995) (allegations that investment of income in an enterprise enabled the defendants to continue their fraudulent behavior deemed insufficient).

See also *Dent Manufacturing, Inc. v. Zafir*, No. 94-2532, 1995 U.S. Dist. LEXIS 15045, at *21 (E.D. Pa., Oct. 12, 1995) .

(n8)Footnote 8. 897 F.2d 75 (2d Cir. 1990) .

(n9)Footnote 9. *Ouaknine*, 897 F.2d at 82-83 .

(n10)Footnote 10. 943 F.2d 297 (3d Cir. 1991) .

(n11)Footnote 11. See also *Lightning Lube, Inc. v. Witco Corp.*, 4 F.3d 1153 (3d Cir. 1993) ; *R.E. Davis Chemical Corp v. Nalco Chemical Co.*, No. 89C 1182, 1188, 1991 U.S. Dist. LEXIS 14199, at *17 (N.D. Ill. Oct. 7, 1991) (injury occurred through act of misappropriation, not use of the information by the corporation, 1962(a) claim dismissed).

(n12)Footnote 12. 896 F.2d 833 (4th Cir. 1990) .

(n13)Footnote 13. *Busby*, 896 F.2d at 838 .

(n14)Footnote 14. *Busby*, 896 F.2d at 839 (citations omitted).

(n15)Footnote 15. *Lightning Lube Inc. v. Witco Corp.*, 4 F.3d 1153, 1190 (3d Cir. 1993) ; *Old Time Enters. v. Int'l Coffee Corp.*, 862 F.2d 1213, 1219 (5th Cir. 1989) ; *Davidson v. Bunside-Ott Aviation Training Ctr. Inc.*, 941 F.2d 1220 (D.C. Cir. 1991) ; *Avirgan v. Hull*, 691 F. Supp. 1357, 1362 (S.D. Fla. 1988) , *aff'd on other grounds*, 932 F.2d 1572 (11th Cir. 1991) ; *Dent Manufacturing, Inc. v. Zafir*, No. 94-2532, 1995 U.S. Dist. LEXIS 15045, at *19-20 (E.D. Pa., Oct. 12 1995) . (1962(b) claim rejected where plaintiff failed to argue that it was injured as a result of the defendant's acquisition or control of an alleged enterprise.).

(n16)Footnote 16. 529 U.S. 494, 120 S. Ct. 1608, 146 L. Ed. 2d 561 (2000) .

(n17)Footnote 17. 529 U.S. 494, 507, 120 S. Ct. 1608, 1617, 146 L. Ed. 2d 561, 572 (2000) .

(n18)Footnote 18. *Miranda v. Ponce Federal Bank*, 948 F.2d 41, 48 (1st Cir. 1991) ; *Hecht v. Commerce Clearing House*, 897 F.2d 21 (2d Cir. 1990) ; *Sanders Confectionery Prods. v. Heller Fin., Inc.*, 973 F.2d 474, 487 (6th Cir. 1992) , *cert. denied*, 113 S. Ct. 1046 (1993) ; *Bowman v. Western Auto Supply Co.*, 985 F.2d 383, 388 (8th Cir. 1993) , *cert. denied*, 113 S. Ct. 2459 (1993) ; *Reddy v. Litton Industries, Inc.*, 912 F.2d 291, 294-95 (9th Cir. 1990) , *cert. denied*, 112 S. Ct. 332 (1991) ; *Dooley v. United Technologies Corp.*, No. 91-2499 1992 U.S. Dist. LEXIS 8653, at *18-20 (D.D.C. June 17, 1992) .

(n19)Footnote 19. *Bowman*, 985 F.2d at 388 .

(n20)Footnote 20. *Evans v. Chicago*, 434 F.3d 916, 930-31 (7th Cir. 2006) (holding that personal injuries, including any pecuniary losses due to false imprisonment, do not establish standing for RICO); *Hughes v. The Tobacco Institute, Inc.*, 278 F.3d 417, 422 (5th Cir. 2000) (smokers' allegations of assault and injury to a child, elderly, or disabled individual by tobacco manufacturers and trade associations could not support a civil RICO claim); *Genty v. Resolution Trust Corp.*, 937 F.2d 899, 918 (3d Cir. 1991) (plaintiffs could not recover medical expenses and emotional distress resulting from their exposure to toxic waste); *Berg v. First State Ins. Co.*, 915 F.2d 460, 464 (9th Cir. 1990) (holding that even pecuniary losses from emotional distress are not compensable under RICO); *Avirgan v. Hull*, 932 F.2d 1572, 1577 (11th Cir.) , *cert. denied*, 112 S. Ct. 913 (1992) ; *Fleischhauer v. Feltner*, 879 F.2d 1290, 1300 (6th Cir. 1989) , *amended*, 879 F.2d 1290 (6th Cir. 1989) , *cert. denied*, 493 U.S. 1074 (1990) ; *Rylewicz v. Beaton Services Ltd.*, 888 F.2d 1175, 1180 (7th Cir.) *reh'g denied*, 1990 U.S. App. LEXIS 1535 (7th Cir. Feb. 2, 1989) (harassment and intimidation of litigants in an attempt to get them to settle lawsuit could not support RICO claim); *Pappas v. Passias*, 887 F. Supp. 465, 470-71 (E.D.N.Y. 1995) (claim of emotional distress not cognizable under RICO); *Reynolds v. Condon*, 908 F. Supp. 1494, 1518-19 (N.D. Iowa 1995) (mere injuries to employment or income from employment were not RICO injuries, personal injuries, including emotional distress, were not sufficient to meet RICO's statutory requirement of injury to business or property.).

See also *Reiter v. Sonotone Corp.*, 442 U.S. 330, 339, 99 S. Ct. 2326, 60 L. Ed. 2d 931, 1979-1 Trade Cas. (CCH) P62688 (1979) (dictum).

(n21)Footnote 21. *Genty v. Resolution Trust Corp.*, 937 F.2d 899, 918 (3d Cir. 1991) .

(n22)Footnote 22. See, e.g., *Ove v. Gwinn*, 264 F.3d 817, 825 (9th Cir. 2001) (deprivation of "honest services" of the city attorney, sheriff, and police department did not constitute concrete financial loss); *Oscar v. University Students Co-op. Ass'n*, 965 F.2d 783, 786 (9th Cir. 1992) , cert. denied, 113 S. Ct. 655 (1992) ("finding no RICO injury where plaintiff did not allege any out-of-pocket expenses as a direct or indirect result of the racketeering activity"); *Sheperd v. American Honda Motor Co.*, 822 F. Supp. 625, 628-29 (N. Cal. 1993) .

But see *Guerrero v. Gates*, 442 F.3d 697, 707 (9th Cir. 2006) (a plaintiff has standing to bring RICO claims for tortious interference with business relations stemming from alleged wrongful incarceration) (citing *Diaz v. Gates*, 420 F.3d 897, 900 (9th Cir. 2005) , cert. denied, 126 S. Ct. 1069 (2005))) overruling *Guerrero v. Gates*, 357 F.3d 911, 920 (9th Cir.2004) and *Diaz v. Gates*, 354 F.3d 1169 (9th Cir. 2004) .

(n23)Footnote 23. *Media General, Inc. v. Tanner*, 625 F. Supp. 237, 243-44 (W.D. Tenn. 1985) (harm to business reputation is injury to business); *Alexander Grant & Co. v. Tiffany Indus.*, 742 F.2d 408, 411 (8th Cir. 1984) , vacated, remanded, 473 U.S. 922 , (plaintiff's injury cognizable and included loss of business reputation, lost fees for services rendered to defendant and cost of representation during any SEC investigation; remanded for reconsideration in light of *Sedima and Haroco*).

(n24)Footnote 24. *Holmes v. Securities Investor Protection Corp.*, 503 U.S. 258, 279, 112 S. Ct. 1311, 117 L. Ed. 2d 532 (1992) ; *Standardbred Owners Ass'n v. Roosevelt Raceway Assocs., L.P.*, 985 F.2d 102, 104 (2d Cir. 1993) .

(n25)Footnote 25. *Holmes*, 503 U.S. 258, 112 S. Ct. 1311, 117 L. Ed. 2d 532 . See also *First Nationwide Bank v. Gelt Funding Corp.*, 27 F.3d 763, 769-70 (2d Cir. 1994) .

(n26)Footnote 26. *Holmes*, 503 U.S. at 268, 112 S. Ct. at 1313, 117 L. Ed. 2d at 544 .

(n27)Footnote 27. *Holmes*, 503 U.S. at 269, 112 S. Ct. at 1318, 117 L. Ed. 2d at 545 (citations omitted).

(n28)Footnote 28. *Anza v. Ideal Steel Supply Corp.*, 126 S. Ct. 1991, 1995, 164 L. Ed. 720, 727 (2006)

(n29)Footnote 29. *Anza v. Ideal Steel Supply Corp.*, 126 S. Ct. 1991, 1995 (2006) .

(n30)Footnote 30. *Anza v. Ideal Steel Supply Corp.*, 126 S. Ct. 1991, 1997 (2006) .

(n31)Footnote 31. *Anza v. Ideal Steel Supply Corp.*, 126 S. Ct. 1991, 1997 (2006)

(n32)Footnote 32. *Anza v. Ideal Steel Supply Corp.*, 126 S. Ct. 1991, 1999 (2006) .

(n33)Footnote 33. *Association of Washington Public Hospital Districts v. Philip Morris Inc.*, 241 F.3d 696, 703 (9th Cir. 2001) , cert. denied, 122 S. Ct. 207, 151 L. Ed. 2d 147 (2001) (public hospital districts did not have a civil RICO claim against tobacco companies to recover their unreimbursed costs for treating tobacco-related illnesses); *Kaufman v. BDO Seidman*, 984 F.2d 182, 184-85 (6th Cir. 1993) ("jury found that" financial losses "were" due to market forces and tax law "not the defendant's conduct"); *Hidden Cove Marina Inc. v. Newell*, No. 91-2899, 1993 U.S. App. LEXIS 3243, at *12-15 (7th Cir. Feb. 25, 1993) (competitor's bribery of mayor did not cause police chief to stop making referrals to plaintiff); *Scivally v. Graney*, No. 92-11688 1993 U.S. Dist. LEXIS 7826, at *8 n.3 (D.C. Mass June 7, 1993) , aff'd, 1994 U.S. App. LEXIS 7834 (1st Cir. Apr. 15, 1994) (alleged pattern of bribery did not cause plaintiff to lose her position on employee committee); *First Nationwide Bank v. Gelt Funding Inc.*, No. 92-0790, 1992 U.S. Dist.

LEXIS 18278, at *15-29 (S.D.N.Y. Nov. 30, 1992) (bank's injury resulted from downturn in real estate market not alleged misrepresentations).

(n34)Footnote 34. See, e.g., *Commercial Cleaning Servs. v. Colin Serv. Sys., Inc.*, 271 F.3d 374, 381-83 (2d Cir. 2001) (allegation that underbidding cleaning business kept its costs low by hiring illegal aliens and underpaying them satisfied the proximate cause requirement for civil RICO); *Standardbred Owners Ass'n v. Roosevelt Raceway Ass'n, L.P.*, 985 F.2d 102, 104 (2d Cir. 1993) (scheme to sell racetrack caused direct injury to horse owners, trainers and others); *Cox v. Administrator, United States Steel & Carnegie*, 17 F.3d 1386, 1399 (11th Cir. 1994) (Union negotiators' request for pension benefits from company could have been proximate cause of union's concessions on bargaining issues, causing injury to union members).

(n35)Footnote 35. *Powers v. British Vita, PLC*, 57 F.3d 176, 189 (2d Cir. 1995) (finding that a decline in the market value of stock was an intervening cause).

(n36)Footnote 36. *Commercial Cleaning Servs. v. Colin Serv. Sys., Inc.*, 271 F.3d 374, 383 (2d Cir. 2001) (if the business can prove that but for the lower wage costs related to the illegal hiring scheme, it would have won the contract in question and earned a profit on it, "it will have shown a proximately caused injury, compensable under RICO").

(n37)Footnote 37. *Israel Travel Advisory Service, Inc. v. Israel Identity Tours*, 61 F.3d 1250, 1257-58 (7th Cir. 1995) (plaintiff could not base its claim on predicate acts of mail fraud, however, since the mail fraud statute protected customers only, and not those who were potential vendors to customers).

(n38)Footnote 38. Recently, in *Anza*, the Supreme Court did not reach whether reliance is necessary to plead mail or wire fraud because the plaintiff had otherwise failed to adequately plead proximate cause. In a lengthy dissent, Justice Thomas disagreed with the majority's proximate cause analysis and moreover found that a plaintiff did not have to plead reliance. *Anza*, 126 S. Ct. at 2007. He stated that while reliance may be one method to establish causation, it was not the only one, since the defendant's fraudulent actions could harm the plaintiff in other ways than where the plaintiff relied on defendant's fraudulent misrepresentations. *Id.* at 2008.

(n39)Footnote 39. See *Central Distributors of Beer Inc. v. Conn.*, 5 F.3d 181 (6th Cir. 1993); *Pelletier v. Zweifel*, 921 F.2d 1465 (11th Cir. 1991) (requiring plaintiff to have relied on misrepresentations to his detriment); *County of Suffolk v. Long Island Lighting Co.*, 907 F.2d 1295 (2d Cir. 1990) (finding that phrase "by reason of" requires plaintiff to allege reliance on misrepresentation); *Flowers v. Cont'l Grain Co.*, 775 F.2d 1051 (8th Cir. 1985).

(n40)Footnote 40. See *System Management Inc. v. Loiselle*, 303 F.3d 100, 104 (1st Cir. 2002) (finding that "criminal fraud under the federal [RICO] statute does not require 'reliance' by anyone: it is enough that the defendant sought to deceive, whether or not he succeeded."); *Proctor & Gamble Co. v. Amway Corp.*, 280 F.3d 519, 61 U.S.P.Q.2d 1385 (5th Cir. 2002) (reliance not required so long as other elements of proximate causation are met).



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CHAPTER 10 Private RICO Litigation

2-10 Federal Securities Exchange Act of 1934 § 10.04

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§ 10.04 Damages and Other Relief

Once the elements of a private civil RICO claim have been established, Section 1964(c) requires that a plaintiff recover treble damages and attorneys' fees. n1 A few examples of these kinds of damages are as follows:

- When a pattern of predicate acts in violation of RICO forces competitors out of business, RICO recovery is available to the injured competitors for lost profits, and to the monopolist's purchasers for excess costs; n2
- when a pattern of predicate acts in violation of RICO requires protection money, purchase of certain goods, or hiring of certain employees, RICO recovery is available for added costs accruing from these payments; and
- when a pattern of predicate acts in violation of RICO enables the perpetrator to gain control of a business, RICO recovery is available to displaced owners for the loss of control, to competitors due to any enhanced position the enterprise achieved from the predicate acts or from continuing predicate acts, and to customers upon whom the enterprise may force added costs.

However, damages for indirect injuries were held insufficient in a case in which county taxpayers sought recovery for higher assessments of their property. The assessments were allegedly attributable to defendant's alleged bribery scheme securing lower tax assessments for his clients. n3 The court analogized to the antitrust *Illinois Brick* doctrine n4 under which only the direct purchaser may recover from an overcharging antitrust violator.

Other cases have held that a stockholders' derivative action for injury to the corporation and concomitant decrease in the value of stockholdings does not lie. These cases have stated that stockholders lacked standing to sue for their indirect loss that merely reflected the decrease in the value of the corporation, and that their rights must be asserted through the corporation. n5

The Second Circuit has held that shareholders lack standing to bring a derivative action on behalf of the corporation where the alleged wrongful activity was intended to benefit the corporation and any injury to the corporation occurred,

not as a result of that activity, but rather as a result of the public exposure thereof. Since the injury to the corporation was neither the preconceived purpose nor the intended consequence of the defendant's acts, the Court held that plaintiffs lacked standing to assert a shareholder derivative action. n6

A case of apparent first impression decided that there is no right to contribution on a third-party complaint under RICO, at least as to third-party defendants who did not participate in the underlying allegedly fraudulent acts. n7 Meanwhile, the D.C. Circuit ruled that disgorgement of profits is not an available remedy under § 1964(a). n8 The language of the RICO statute indicated that the jurisdiction of § 1964(a) is limited to forward looking remedies designed to "prevent and restrain" RICO violations. Disgorgement, meanwhile, is a primarily backward-looking remedy meant to deal with past conduct. n9 The court therefore concluded that "[t]he order of disgorgement is not within the terms of that statutory grant, nor any necessary implication of the language of the statute." n10

In pleading damages, a plaintiff may also claim "racketeering injury" damages flowing from the RICO violation itself rather than directly from the predicate acts, which, even though not required under Section 1962(c), are allowable.

The question of whether private injunctive or other equitable relief is available under RICO is still an open one. n11 Some district courts have denied request for this kind of relief on the ground that it is not provided for by the statute. n12 Circuit courts have expressed serious doubt that these remedies are available in a private action. n13 Moreover, Congress has twice rejected amendments that would have expressly conferred a right to equitable relief on private RICO plaintiffs. n14 However, some district courts have granted injunctions or other equitable relief, n15 or denied a motion to dismiss the claim, n16 while others have tacitly assumed the existence of equitable remedies either by denying the relief on other grounds without questioning the propriety of the claim n17 or by recognizing the allowability of the remedy in dicta. n18

The Seventh Circuit in *NOW v. Scheidler*, n19 held that the RICO statute authorized private parties to seek injunctive relief. The court affirmed the district court's issuance of a permanent nationwide injunction prohibiting the defendants from physically blocking access to abortion clinics after the jury found RICO violations and awarded treble damages.

FOOTNOTES:

(n1)Footnote 1. *18 U.S.C. § 1964(c)*. The costs of suit are also to be awarded. *Id.*

(n2)Footnote 2. *See Commercial Cleaning Servs. v. Colin Serv. Sys., Inc.*, 271 F.3d 374, 384 (2d Cir. 2001) (competitor of cleaning business that hired lower wage illegal aliens and beat out competitor for contracts, if successful in RICO claim, would have claim damages of lost profits).

(n3)Footnote 3. *Carter v. Berger*, 777 F.2d 1173, 1174 (7th Cir. 1985) . Under this decision, the county itself could sue under private RICO to recover the whole loss trebled, but the taxpayers would have to look to the county for relief.

(n4)Footnote 4. *Illinois Brick v. Illinois*, 431 U.S. 720, 97 S. Ct. 2061, 52 L. Ed. 2d 707 (1977) , *reh'g denied*, *Illinois Brick Co. v. Illinois*, 434 U.S. 881, 98 S. Ct. 243, 54 L. Ed. 2d 16 .

(n5)Footnote 5. *Rand v. Anaconda-Ericsson, Inc.*, 794 F.2d 843, 849, 1986-1 Trade Cas. (CCH) P67183 (2d Cir. 1986) ; *Warren v. Manufacturers National Bank of Detroit*, 759 F.2d 542, 544 (6th Cir. 1985) ; *Carr v. Equistar Offshore Limited*, 1995 U.S. Dist. LEXIS 13703, *30 (S.D.N.Y. Sep. 21, 1995) (RICO action against an investment company deemed not to be derivative where the plaintiff was injured in his capacity as a securities purchaser, not as a shareholder, and where defendants had allegedly breached duties they owed to the plaintiff as a securities purchaser.).

See also Kubecka, Inc. v. Avellino, 898 F. Supp. 963, 968 (E.D.N.Y. 1995) ; *North South Finance Corp. v. Al-Turki*, No. 93 Civ. 2133 (MGC), 1996 U.S. Dist. LEXIS 1303, at *23-24 (S.D.N.Y. Feb. 8, 1996) ; *Schrag v. Dinges*, 1995 U.S. App. LEXIS 31949, at *11 (10th Cir. Nov. 14, 1995) .

(n6)Footnote 6. *In re American Express Co. Shareholder Litigation*, 39 F.3d 395, 400 (2d Cir. 1994) .

(n7)Footnote 7. *Delta Holdings, Inc. v. National Distillers and Chem. Corp.*, No. 85 Civ. 3439 (JFK), 1986 U.S. Dist. LEXIS 20818, at *12-13 (S.D.N.Y. Sept. 4, 1986) rev'd on other grounds, 945 F.2d 1226 (2d. Cir. 1991) .

(n8)Footnote 8. *United States v. Phillip Morris USA, Inc.*, 396 F.3d 1190, 1198 (D.C. Cir.) , cert. denied, *United States v. Philip Morris USA Inc.*, 546 U.S. 960, 126 S. Ct. 478, 163 L. Ed. 2d 363, 2005 U.S. LEXIS 7664, 74 U.S.L.W. 3246 , cert denied, 546 U.S. 960, 126 S. Ct. 478, 163 L. Ed. 2d 363 (2005) .

(n9)Footnote 9. *Id.* at 1198 .

(n10)Footnote 10. *Id.*

(n11)Footnote 11. See *NOW v. Scheidler*, 267 F.3d 687, 698 (7th Cir. 2001) , rev'd on other grounds, 537 U.S. 393 (2003) (issuance of nationwide injunction affirmed as relief available under RICO).

(n12)Footnote 12. *Miller v. Affiliated Fin. Corp.*, 600 F. Supp. 987, 994 (N.D. Ill. 1984) ; *De Ment v. Abbott Capital Corp.*, 589 F. Supp. 1378, 1382-84 (N.D. Ill. 1984) ; *Kaushal v. State Bank*, 556 F. Supp. 576, 581-85 (N.D. Ill. 1983) .

(n13)Footnote 13. In the only circuit case to squarely meet the issue, it was held that private litigants may not have injunctive relief under RICO. *Religious Technology Ctr. v. Wollersheim*, 796 F.2d 1076, 1088 (9th Cir. 1986) .

See also *Sedima, S.P.R.L. v. Imrex Co.*, 741 F.2d 482, 489 n.20 (2d Cir. 1984) , rev'd on other grounds, 105 S. Ct. 3275 (1985) ("seems altogether likely" that relief not allowable); *Trane Co. v. O'Connor Securities*, 718 F.2d 26, 28-29 (2d Cir. 1983) ("serious doubt"); *Bennett v. Berg*, 685 F.2d 1053, 1064 (8th Cir. 1982) , ("difficult question"); *Dan River, Inc. v. Icahn*, 701 F.2d 278, 290 (4th Cir. 1983) ("substantial doubt").

(n14)Footnote 14. See S. 16, 92d Cong., 1st Sess. (1971); H.R. 19215, 91st Cong., 2d Sess. (1970).

(n15)Footnote 15. *Aetna Casualty and Surety Co. v. Liebowitz*, 570 F. Supp. 908, 910 (E.D.N.Y. 1983) , aff'd on other grounds, 730 F.2d 905 (2d Cir. 1984) ; *County of Cook v. Lynch*, 560 F. Supp. 136, 140-41 (N.D. Ill. 1982) .

(n16)Footnote 16. *Chambers Dev. Co. v. Browning-Ferris Indus.*, 590 F. Supp. 1528, 1540-41 (W.D. Pa. 1984) .

(n17)Footnote 17. *University Bank and Trust Co. v. Gladstone*, 574 F. Supp. 1006, 1011-12 (D. Mass. 1983) ; *Marshall Field & Co. v. Icahn*, 537 F. Supp., 413, 420 (S.D.N.Y. 1982) ; *Vietnamese Fishermen's Ass'n v. Knights of the Ku Klux Klan*, 518 F. Supp. 993, 1014 (S.D. Tex. 1981) .

(n18)Footnote 18. *United States v. Barber*, 476 F. Supp. 182, 189 (S.D.N.Y. 1979) ; *United States v. Mandel*, 415 F. Supp. 997, 1021 (D. Md. 1976) .

(n19)Footnote 19. 267 F.3d 687, 695 (7th Cir. 2001) , rev'd, 537 U.S. 393 (2003) .



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Federal Securities Exchange Act of 1934

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CHAPTER 10 Private RICO Litigation

2-10 Federal Securities Exchange Act of 1934 § 10.05

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§ 10.05 Miscellaneous Matters

[1] Commerce

In *United States v. Robertson*,ⁿ¹ the Supreme Court concluded that a corporation is "generally engaged in commerce when it is itself directly engaged in the production, distribution or acquisition of goods and services in interstate commerce," and found that when equipment and supplies for a gold mine were purchased out of state and when workers were solicited and hired from out of state and the mine's output taken out of state, the activities of the gold mine brought it well within the "engaged in" interstate commerce language of Section 1962(a). The Court found it unnecessary to address the issue of whether the gold mine's activities had affected interstate commerce because it found that such a test was relevant only when assessing whether certain intrastate activity had substantial interstate affects.

[2] Jurisdiction and Venue

Jurisdiction over violations of RICO is conferred on the federal district courts by Section 1964(a), and section 1964(c) grants the private right of action. Additional bases of federal jurisdiction are 28 U.S.C. § 1331 (action arising from federal law) and, in appropriate cases, 28 U.S.C. § 1332 (diversity of citizenship). Since RICO does not contain a provision governing personal jurisdiction, obtaining personal jurisdiction depends on the law of the state in which the action is brought. Ordinary principles of pendent jurisdiction apply for collateral jurisdiction over related state claims.
n2

In early 1990, a unanimous Supreme Court held in *Taflin v. Levitt*ⁿ³ that state courts have concurrent jurisdiction with federal courts in private RICO cases.

As for venue, RICO has both an ordinary and an extraordinary venue provision. Under RICO's ordinary provision, venue exists in any district in which the defendant resides, is found, has an agentⁿ⁴ or transacts affairs.ⁿ⁵ While this provision does not by its terms include venue where the claim arose, as does the general federal provision,ⁿ⁶ courts have viewed RICO's provision as non-exclusive and have found venue where the claim arose by reference to the general federal statute.ⁿ⁷

RICO's extraordinary venue provision, contained in Section 1965(b), allows suit to proceed in any district where it is

shown that the "ends of justice" so require. Section 1965(b) was employed in a case arising from the liquidation of two broker-dealer firms to exercise venue over numerous out-of-district defendants and enable trial of all claims in the same forum. n8

[3] RICO Case Statements

In order to clarify allegations, avoid unsubstantiated claims, and allow courts to determine the validity of RICO claims, many federal district courts now require that plaintiffs alleging RICO violations file a RICO Case Statement. Oftentimes exacting, RICO Case Statements ordinarily require plaintiffs to respond to specific questions patterned after the specific elements of their RICO claim. Some courts have standing orders requiring that a RICO Case Statement automatically be filed along with the complaint, while others may order the filing of a case statement upon request by the defendant, in response to a Fed. R. Civ. P. 12(b)(6) motion to dismiss for failure to state a claim, Fed. R. Civ. P. 12(e) motion for more definite statement, or in later stages of litigation. n9

Courts have noted that the statements help to implement Federal Rule of Civil Procedure 9(b)'s requirement that plaintiffs plead fraud with particularity. n10 Plaintiffs who are unable to provide the required information may have their RICO claims dismissed. RICO Case Statements are subject to the mandates of Federal Rule of Civil Procedure 11. n11

[4] RICO and State Law Conflicts

The Supreme Court had occasion to determine whether RICO impaired a state law which proscribed the same conduct but which provided different remedies in *Humana, Inc. v. Forsyth*. n12 Beneficiaries of group health insurance plans issued by the defendant insurance company brought a RICO suit alleging a pattern of racketeering activity. The defendants moved for summary judgment citing the McCarran-Ferguson Act, n13 which precludes application of a federal statute if it "invalidates, impairs, or supersedes" any state law enacted to regulate insurance unless the federal law specifically relates to the business of insurance. The Court held that because RICO "advances the State's interest in combating insurance fraud, and does not frustrate any articulated Nevada policy, ... the McCarran-Ferguson Act [did] not block the respondent beneficiaries' recourse to RICO." n14

[5] Limitation Periods

[a] Four Year Statute of Limitations

In *Agency Holding Corp. v. Malley-Duff & Associates, Inc.*, n15 the United States Supreme Court recognized the need for a uniform federal statute of limitations in civil RICO cases and held that the four-year statute of limitations applicable to Clayton Act civil enforcement actions n16 applies to RICO civil enforcement actions.

The cause of action in *Malley-Duff* arose in February, 1978 when petitioner, Crown Life Insurance Company, terminated its relationship with its agent, respondent Malley-Duff, for failure to meet a production quota. In March 1981, Malley-Duff brought suit under RICO alleging, *inter alia*, that the petitioner's true reason for the termination was to acquire Malley-Duff's lucrative territory. n17 The federal district court granted the petitioner's motion for summary judgment on all counts and dismissed Malley-Duff's RICO claims on the ground that they were barred by Pennsylvania's two-year statute of limitations period for fraud. n18 The District Court concluded that this was the best state law analogy for Malley-Duff's claims. The Court of Appeals for the Third Circuit reversed, n19 holding that under *Wilson v. Garcia*, n20 Pennsylvania's "catchall" six-year residual statute of limitations n21 was the appropriate statute of limitations for all RICO claims arising in the state. n22

The Supreme Court concluded in *Malley-Duff* that a better approach for the federal courts would be a uniform federal statute of limitations. n23 Part of the Court's reasoning was that predicate acts that may establish a civil RICO violation are far ranging and cannot be reduced to a single generic classification. Also, important RICO concepts such as a RICO

"enterprise" and "pattern of racketeering activity" were unknown to common law. For these reasons, the Court concluded that a uniform federal statute of limitations was required to avoid intolerable uncertainty and time-consuming litigation. n24

Another reason for having a uniform federal statute of limitations cited by the Court was the multistate nature of RICO. The possibility of multiple state statutes of limitations plainly presents the dangers of forum shopping and of complex, expensive, and unnecessary litigation. n25 Moreover, application of a uniform federal limitations period avoids the possibility of the application of unduly short state statutes of limitations that would defeat the legislative purpose of creating an effective remedy. n26

After comparing the language of both statutes, the Court concluded that RICO's private enforcement provision was patterned after Section 4 of the Clayton Act. n27 Therefore, the Court reasoned, the Clayton Act provides a far closer analogy to RICO than any state statute. Both acts seek to remedy economic injury. Both encourage attorneys general with a treble damage remedy, and each requires a plaintiff to demonstrate injury to business or property by reason of a violation. n28 Moreover, aside from the similarities in purpose and structure between RICO and the Clayton Act, the Court concluded that there was clear legislative intent to pattern RICO's civil enforcement provision on the Clayton Act. n29

Finally, the Court stated that there was no Congressional intent opposing a uniform federal statute of limitations. n30 Therefore, the federal policies that lay behind RICO and the practicalities of RICO litigation made the selection of the four-year statute of limitations for Clayton Act actions the most appropriate limitations period for civil RICO actions. n31 As a result, it is clear that the four-year period applies to all RICO claims regardless of the limitations period applicable to the underlying predicate act.

[b] Accrual of RICO Claim

Prior to 1997 there were three distinct approaches for determining when the statute of limitations period in a RICO action had begun:

- (1) the "last predicate act" rule, in which the statute of limitations began to run as soon as the plaintiff knew or should have known of the injury and the pattern of racketeering but that could begin to run anew with each predicate act that formed part of the same pattern; n32
- (2) the "injury and pattern discovery" rule in which the RICO claim accrued only when the claimant discovered, or should have discovered, an injury and a pattern of RICO activity; n33 and
- (3) the "injury discovery" rule in which the statute of limitations began to run when the plaintiff knew or should have known of the injury. n34

The Supreme Court's 1997 decision *Klehr v. A.O. Smith Corp.*, n35 eliminated the "last predicate act" rule and the Court's 2000 decision in *Rotella v. Wood*, n36 eliminated the "injury and pattern discovery" rule for purposes of the accrual of a RICO claim. The "last predicate act" rule was rejected because it created a limitations period that was longer than Congress could have contemplated -- with each predicate act separated by as many as ten years, the limitations period could go on for decades. n37 In addition, the "last predicate act" rule was inconsistent with the ordinary rule of the Clayton Act, upon which the civil RICO statute was patterned. n38 The "injury and pattern discovery" rule was rejected by the Supreme Court for similar reasons:

We start with the realization that under the provision recognizing the possibility of finding a pattern of racketeering in predicate acts 10 years apart, even an injury occurrence rule unsoftened by a discovery feature could in theory open the door to proof of predicate acts occurring 10 years before injury and 14

before commencement of litigation. A pattern discovery rule would allow proof of a defendant's acts even more remote from time of trial and, hence, litigation even more at odds with the basic policies of all limitations provisions: repose, elimination of stale claims, and certainty about a plaintiff's opportunity for recovery and a defendant's potential liabilities. n39

Any accrual rule that includes a pattern discovery feature ties the start of the limitations period to a plaintiff's "reasonable discovery of a pattern" instead of to the point of injury or its reasonable discovery. The pattern discovery feature extends the potential limitations period for most civil RICO cases well beyond the time when the cause of action is complete. n40 In *Rotella* the Court specifically declined to decide whether "civil RICO allows for a cause of action when a second predicate act follows the injury, or what limitations accrual rule might apply in such a case." n41

Having struck down both the "last predicate act" and the "injury and pattern discovery" rules, the Court acknowledged that this left the "injury discovery" rule, but the Court declined to "settle on a final rule" noting that in addition to the various forms of the injury discovery rule in the Courts of Appeals, there is the possibility of a straight injury *occurrence* rule, under which discovery would be irrelevant. n42

[c] Tolling the Statute of Limitations; Fraudulent Concealment

Courts generally have incorporated the concept of equitable tolling into RICO, and have thereby delayed the running of the limitation period while a victim diligently investigates the possible existence and extent of a pattern of racketeering. n43

Fraudulent concealment is another equitable doctrine that is read into RICO. Because the RICO limitations period is derived from the Clayton Act, courts have adopted federal fraudulent concealment doctrine for civil RICO claims. n44 Fraudulent concealment will serve to toll a statute only if: (1) the plaintiff lacked actual knowledge of the defendant's unlawful activities, (2) the defendant took "affirmative steps" to conceal its actions, and (3) the plaintiff exercised "reasonable diligence" in trying to discover the cause of action. n45

The Supreme Court reaffirmed the importance of the plaintiff's "due diligence" in the civil RICO context in *Klehr v. A.O. Smith Corp.*, n46 holding that "a plaintiff who is not reasonably diligent may not assert 'fraudulent concealment.'" The Court rejected the holdings of some circuits that when the plaintiff does not know of a defendant's unlawful activity and the defendant had affirmatively concealed the activity, the statute of limitations is tolled regardless of whether the plaintiff "should have known" of the defendant's unlawful activity. The Court again drew the parallel between RICO and antitrust in holding that the fraudulent concealment requirement can only be satisfied if the plaintiff shows that he did not know nor, in the exercise of due diligence, could have known of the offense. Further, the Court stated that in both antitrust and civil RICO, "private civil actions seek not only to compensate victims but also to encourage those victims themselves [to] diligently investigate and thereby to uncover unlawful activity." n47

[6] Vicarious Liability

In the absence of Supreme Court direction on the issue of vicarious liability, wide discrepancies among the lower courts have arisen concerning the application of vicarious liability in RICO cases. Most courts have adopted "middle" positions, requiring as a necessary condition of vicarious liability that the defendant company be more than a mere "victim" of the racketeering activity, n48 that the company be the "direct beneficiary" of the pattern of racketeering activity, n49 that the company be a "central figure" or "aggressor" rather than a "conduit," n50 or that there be some unspecified "more" than simply applying the respondeat superior doctrine. n51

The language of the RICO statute does not expressly address the issue of vicarious liability. However, since civil RICO is a form of statutory tort, some courts have reasoned that "general agency principles" should apply as fully as to other torts. n52 Certainly, in civil RICO claims finding liability under §§ 1962(a) or (b), when the principal has derived some

benefit from the agent's wrongful acts, there is no barrier to vicarious liability. n53

Most courts of appeals, however, have held that Section 1962(c)'s limitation of liability to employees and associates of an enterprise who conduct the enterprise's affairs through a pattern of racketeering activity would be rendered effectively meaningless if the enterprise itself could be held liable on a respondeat superior theory. n54 For example, the Fifth Circuit noted:

It would be incongruous here to find that while [defendant,] as the enterprise, cannot be a RICO person, it can be held vicariously liable for the acts of [one of its agents]. If this were the rule, all legal enterprises could be found liable under RICO if their employees or agents were involved in perpetrating predicate acts through or against them. This is contrary to the rule Congress meant to impose as evidenced by the language of the statute. n55

In the Eleventh Circuit, which has rejected the limitation on liability under 1962(c) applied by the other circuits, the Court of Appeals has held that vicarious liability applies without exception to all RICO claims and that "liability for the act's of one's agents is simply a reality to be faced by corporate entities." n56 The Eleventh Circuit also suggested that the RICO exception to vicarious liability applied by other circuits "is a narrow one [that] ... protects only those employees who are also the RICO enterprise for purposes of 1962(c)." n57

However, the Eleventh Circuit's interpretation is questionable in light of the broad language used by the other circuits in rejecting vicarious liability claims. Thus, the Seventh Circuit has stated: "we follow the First and Eighth Circuits in rejecting the doctrine of respondeat superior in civil RICO cases." n58 Similarly, the Eighth Circuit has held that "corporations will not be liable under RICO based solely on the respondeat superior doctrine." n59

As the Supreme Court noted in *Reves v. Ernst & Young*, RICO's liability provisions are primarily focused on "the infiltration of organized crime and racketeering into legitimate organizations." n60 In light of this focus, one district court observed: "the notion that a corporation should be vicariously responsible under RICO for the independent fraudulent acts of its employees is a rather startling one ... Indeed, the initial intent of the statute was to protect corporations from criminal infiltration, not to make them the responsible parties." n61

In an attempt to apply principles of vicarious liability in a manner consistent with the overriding intent of the statute, one district court limited vicarious liability under RICO to situations in which the putatively liable company is more of an "aggressor" than a "passive instrumentality" of the violation. n62 The court suggested that factors such as whether high-level employees were involved in the unlawful activity, whether they knew of the unlawful activity, and acquiesced in it, and whether the company directly and substantially benefited from the racketeering activity all should be taken into consideration. n63 This approach has been adopted by numerous district courts in the Second Circuit and appears to be finding favor in other jurisdictions as well. n64

Vicarious liability also has been applied in the partnership context. A district court held that as neither the language nor the legislative history of RICO spoke to the issue of vicarious or partnership liability, there was no basis for concluding that the statutory scheme would be disrupted by the application of partnership liability in a civil RICO context. n65 In one case, a court refused to find a union vicariously liable for the racketeering acts of its president where there was no allegation that the union had retained any benefits from the alleged violations. The court concluded that the union could not be liable merely for acquiescing in the fraudulent scheme, and concluded that vicarious liability should be reserved for aggressor entities which serve as central figures in an unlawful scheme rather than mere conduit organizations. The court stated "Although agency law does recognize that failure to repudiate can act as an affirmation of an unauthorized transaction... we do not think that this doctrine should be used to undermine the federal policy of punishing only culpable RICO parties." n66

[7] In Pari Delicto

At least two circuits have held *in pari delicto* to be a valid defense in RICO cases, blocking recovery of damages. n67 *In pari delicto* depends upon a plaintiff's active participation in the violation and the policy goals of the federal statute. n68 In distinguishing RICO cases from antitrust cases where the Supreme Court found that *in pari delicto* did not apply, the 11th Circuit stated that "[i]n contrast with antitrust violations, a federal RICO violation requires affirmative and deliberate participation." n69 Regarding the policy goals of RICO, the 11th Circuit further stated:

It would be anomalous, to say the least, for the RICO statute to make racketeering unlawful in one provision, yet award the violator with treble damages in another provision of the same statute. "Congress intended RICO's civil remedies to help eradicate 'organized crime from the social fabric' by divesting 'the association of the fruits of ill-gotten gains.' " n70

More recently, the 5th Circuit adopted the 11th Circuit's reasoning, noting that "a wealth transfer among similarly situated conspirators" would not further RICO's deterrence goals. n71

[8] Territorial Limitations

The RICO Act applies only to organized crime occurring within the United States or directed at the United States. n72 In *Castellanos v. Pfizer, Inc.*, the court dismissed the claim, arising out of a dispute over distribution rights in Ecuador. n73 The court held that because the underlying alleged organized crime did not occur within or against the United States, dismissal was appropriate for failure to state a claim upon which relief could be granted. n74

FOOTNOTES:

(n1)Footnote 1. 514 U.S. 669, 115 S. Ct. 1732, 131 L. Ed. 2d 714 (1995) .

(n2)Footnote 2. See, e.g., *Windsor Associates, Inc. v. Greenfeld*, 564 F. Supp. 273, 281 (D. Md. 1983) ; *D'Iorio v. Adonizio*, 554 F. Supp. 222, 233 (M.D. Pa. 1982) .

The leading Supreme Court case on the general doctrine of pendent jurisdiction is *United Mine Workers v. Gibbs*, 383 U.S. 715, 726, 86 S. Ct. 1130, 16 L. Ed. 2d 218 (1966) .

(n3)Footnote 3. *Tafflin v. Levitt*, 493 U.S. 455, 461 .

(n4)Footnote 4. However, the designation of a state Corporations Commissioner as statutory agent for service of process in connection with actions arising from defendant's sale of securities in the state was not deemed the appointment of an agent within this provision where no securities were actually sold as part of the subject transaction although such a sale had initially been contemplated. *King v. Vesco*, 342 F. Supp. 120, 123 (N.D. Cal. 1972) .

(n5)Footnote 5. 18 U.S.C. § 1965(a). Venue over nonresident defendants was sustained on the basis of their regular telephone contact with resident plaintiffs, coupled with resident plaintiffs, coupled with defendants' active solicitation of customers in the district and frequent visits there to execute business relationships. *Haber v. Kobrin*, No. 82 Civ. 3715, 1983 U.S. Dist. LEXIS 16491, at *15-18 (S.D.N.Y. June 3, 1983) . See *King v. Vesco*, 342 F. Supp. 120, 122 (N.D. Cal. 1972) , applying precedent under Sections 4 and 12 of the Clayton Act in construing RICO's ordinary venue provision.

(n6)Footnote 6. The general federal venue provision is codified at 28 U.S.C. § 1391.

(n7)Footnote 7. See *Eacho v. N.D. Resources, Inc.*, No. 83-2903, 1984 U.S. Dist. LEXIS 19816, *7 (D.D.C. Feb. 2, 1984) ; *Farmers Bank of Delaware v. Bell Mortgage Co.*, 452 F. Supp. 1278, 1280-81 (D. Del. 1978) .

RICO's ordinary venue provision states that venue "may" be laid in districts with the designated contacts, but does not contain the restrictive qualifying term "only" in those districts as is the case with the general federal venue provision.

(n8)Footnote 8. *Securities Investor Protection Corp. v. Vigman*, No. CV 83-4242 AWT, 1984 U.S. Dist. LEXIS 16267, at *7-8 (C.D. Cal. May 30, 1984) .

(n9)Footnote 9. *See, e.g.,* www.nysd.uscourts.gov/Individual_Practices/rico.pdf (Standing Order by U.S. Dist. Ct. Judge Casey (S.D.N.Y.) containing instructions for filing RICO Case Statement).

(n10)Footnote 10. *See Old Time Enters., Inc. v. Int'l Coffee Corp.*, 862 F.2d 1213 (5th Cir. 1989) .

(n11)Footnote 11. *See Marriott Bros. v. Gage*, 911 F.2d 1105, 1109 (5th Cir. 1990) .

(n12)Footnote 12. 525 U.S. 299, 303, 119 S. Ct. 710, 142 L. Ed. 2d 753 (1999) .

(n13)Footnote 13. 15 U.S.C. § 1011 et seq.

(n14)Footnote 14. 525 U.S. 299, 314, 119 S. Ct. 710, 719, 142 L. Ed. 2d 753, 765 (1999) .

(n15)Footnote 15. 483 U.S. 143, 107 S. Ct. 2759, 97 L. Ed. 2d 121 (1987) .

(n16)Footnote 16. 15 U.S.C. § 15b.

(n17)Footnote 17. *See* 483 U.S. at 145, 104 S. Ct. at 2761, 97 L. Ed. 2d at 126-27 .

(n18)Footnote 18. 42 Pa. Cons. Stat. § 5524(7) (1982).

(n19)Footnote 19. 792 F.2d 341 (1986) .

(n20)Footnote 20. 471 U.S. 261, 105 S. Ct. 1938 . 85 L. Ed. 2d 254 (1985) .

(n21)Footnote 21. 42 Pa. Cons. Stat. § 5527 (1981).

(n22)Footnote 22. Prior to *Malley-Duff*, the federal courts' approach to the problem of selecting the most appropriate statute of limitations for civil RICO claims was confusing and inconsistent. Some courts simply used the state limitations period most similar to the predicate offenses alleged in the particular RICO claim. Others, such as the Court of Appeals in this case, chose a uniform statute of limitations applicable to all civil RICO actions brought within a given state. The courts, however, had uniformly looked to state statutes of limitations rather than a uniform federal statute of limitations.

(n23)Footnote 23. *Malley-Duff*, 483 U.S. at 149, 104 S. Ct. at 2763, 97 L. Ed. 2d at 129 .

(n24)Footnote 24. *See Malley-Duff*, 483 U.S. at 150, 104 S. Ct. at 2764, 97 L. Ed. 2d at 129 .

(n25)Footnote 25. *Malley-Duff*, 483 U.S. at 154, 104 S. Ct. at 2766, 97 L. Ed. 2d at 132 .

(n26)Footnote 26. *Malley-Duff*, 483 U.S. at 154 .

(n27)Footnote 27. *Malley-Duff*, 483 U.S. at 151, 104 S. Ct. at 2764, 97 L. Ed. 2d at 130 .

(n28)Footnote 28. *Malley-Duff*, 483 U.S. at 151, 104 S. Ct. at 2764, 97 L. Ed. 2d at 130 .

(n29)Footnote 29. *Malley-Duff*, 483 U.S. at 152, 104 S. Ct. at 2765, 97 L. Ed. 2d at 131 .

(n30)Footnote 30. *Malley-Duff*, 483 U.S. at 155, 104 S. Ct. at 2767, 97 L. Ed. 2d at 133 .

(n31)Footnote 31. *Malley-Duff*, 483 U.S. at 156, 104 S. Ct. at 2767, 97 L. Ed. 2d at 133-34 .

(n32)Footnote 32. See *Keystone Ins. Co. v. Houghton*, 863 F.2d 1125, 1130 (3d Cir. 1988) .

(n33)Footnote 33. See, e.g., *Caproni v. Prudential Securities, Inc.*, 15 F.3d 614, 619-620 (6th Cir. 1994) ; *Granite Falls Bank v. Henrikson*, 924 F.2d 150, 154 (8th Cir. 1991) ; *Bath v. Bushkin, Gaims, Gaines & Jonas*, 913 F.2d 817, 820-821 (10th Cir. 1990) ; *Bivens Gardens Office Building, Inc. v. Barnett Bank*, 906 F.2d 1546, 1554-1555 (11th Cir. 1990) .

(n34)Footnote 34. See, e.g., *Grimmett v. Brown*, 75 F.3d 506, 511 (9th Cir. 1996) ; *McCool v. Strata Oil Co.*, 972 F.2d 1452, 1464-1465 (7th Cir. 1992) ; *Rodriguez v. Banco Central Corp.*, 917 F.2d 664, 665-666 (1st Cir. 1990) ; *Bankers Trust Co. v. Rhoades*, 859 F.2d 1096, 1102 (2d Cir. 1988) ; *Pocahontas Supreme Coal Co. v. Bethlehem Steel Corp.*, 828 F.2d 211, 220 (4th Cir. 1987) .

(n35)Footnote 35. 521 U.S. 179, 117 S. Ct. 1984, 138 L. Ed. 2d 373 (1997) .

(n36)Footnote 36. 528 U.S. 549, 120 S. Ct. 1075, 145 L. Ed. 2d 1047 (2000) .

(n37)Footnote 37. *Klehr v. A.O. Smith Corp.*, 521 U.S. 179, 187, 117 S. Ct. 1984, 1989, 138 L. Ed. 2d 373, 381 (1997) . See also *Rotella v. Wood*, 528 U.S. 549, 554, 120 S. Ct. 1075, 1080, 145 L. Ed. 2d 1047, 1054 (2000) .

(n38)Footnote 38. 521 U.S. 179, 188, 117 S. Ct. 1984, 1990, 138 L. Ed. 2d 373, 382 (1997) .

(n39)Footnote 39. 528 U.S. 549, 555, 120 S. Ct. 1075, 1080-1081, 145 L. Ed. 2d 1047, 1055 (2000) . The Court also assailed the "clash" of the "injury and pattern discovery" rule with the limitations imposed in Clayton Act suits, as it had in *Klehr*.

(n40)Footnote 40. 528 U.S. 549, 558, 120 S. Ct. 1075, 1082, 145 L. Ed. 2d 1047, 1057 (2000) . The Court noted that the "injury and pattern discovery" rule is applied "out of fear that when the injury precedes a second predicate act, the limitations period might otherwise expire before the pattern is created." This was not an issue in *Rotella*, however, since the plaintiff's injury in 1986 completed the elements of his cause of action.

(n41)Footnote 41. 528 U.S. 549, 559, 120 S. Ct. 1075, 1083, 145 L. Ed. 2d 1047, 1058 (2000) . See, e.g., *Poling v. K. Hovnanian Enters.*, 99 F. Supp. 2d 502, 510-511 (D.N.J. 1997) (plaintiffs' civil RICO cause of action accrued when all of the elements of the action existed, whether or not discovered, and plaintiffs knew of the existence and source of their injury or should, with the exercise of reasonable diligence, have known of their injury).

(n42)Footnote 42. 528 U.S. 549, 554 n.2, 120 S. Ct. 1075, 1080, 145 L. Ed. 2d 1047, 1055 (2000) . See also, *Mathews v. Kidder, Peabody & Co.*, 260 F.3d 239, 244-46 (3d Cir. 2001) .

(n43)Footnote 43. *Bontkowski v. First Nat. Bank of Cicero*, 998 F.2d 459, 462 (7th Cir.) cert. denied, 510 U.S. 1012 (1993) . See also *Bankers Trust Co. v. Rhoades*, 859 F.2d 1096, 1105 (2d Cir. 1988) , cert. denied, 490 U.S. 1007 (1989) .

(n44)Footnote 44. See, e.g., *Klehr v. A.O. Smith Corp.*, 521 U.S. 179, 194-195, 117 S. Ct. 1984, 1993, 138 L. Ed. 2d 373, 386 (1997) ; *Davis v. Grusemeyer*, 996 F.2d 617, 624 (3d Cir. 1993) .

(n45)Footnote 45. *Klehr v. A.O. Smith Corp.*, 521 U.S. 179, 194, 117 S. Ct. 1984, 1993, 138 L. Ed. 2d 373, 385-386 (1997) . See, e.g., *Mathews v. Kidder, Peabody & Co.*, 260 F.3d 239, 255-257 (3d Cir. 2001) ; *Grimmett v. Brown*, 75 F.3d 506, 514-515 (9th Cir. 1996) , cert. dismissed, 519 U.S. 233 (1997) (plaintiff failed to show active concealment on defendant's part); *Davis v. Grusemeyer*, 996 F.2d 617, 624 n.13 (3d Cir. 1993) .

(n46)Footnote 46. 521 U.S. 179, 194-195, 117 S. Ct. 1984, 1993, 138 L. Ed. 2d 373, 386 (1997) .

(n47)Footnote 47. 521 U.S. 179, 195, 117 S. Ct. 1984, 1993, 138 L. Ed. 2d 373, 386 (1997) . See also *Whitehall Tenants Corp. v. Whitehall Realty Co.*, No. 97-7423, 1997 U.S. App. LEXIS 30264, *5-*7 (2d Cir. October 31, 1997) (the question of whether plaintiff exercised "Reasonable diligence," while highly fact-based, can be decided on summary judgment).

(n48)Footnote 48. *Petro-Tech, Inc. v. Western Co. of North America*, 824 F.2d 1349, 1360 (3d Cir. 1987) .

(n49)Footnote 49. *Garbade v. Great Divide Mining and Milling Corp.*, 831 F.2d 212, 213 (10th Cir. 1987) ; *Crowe v. Henry*, 43 F.3d 198, 206 (5th Cir. 1995) .

(n50)Footnote 50. See, e.g., *Chubb & Son, Inc. v. Kelleher*, 1998 U.S. Dist. LEXIS 22542, at *58-59 (E.D.N.Y. February 27, 1998) (unpublished) ("employers may be held vicariously liable under RICO for the malfeasance of their employees under certain circumstances ... [which] may be identified through the application of the "central figure" test); *Gruber v. Prudential Bache Securities Inc.*, 679 F. Supp. 165, 180-82 (D. Conn. 1987) .

(n51)Footnote 51. *Luthi v. Tonka Corp.*, 815 F.2d 1229 (8th Cir. 1987) .

(n52)Footnote 52. *Quick v. Peoples Bank*, 993 F.2d 793, 797 (11th Cir. 1993) .

(n53)Footnote 53. *Crowe v. Henry*, 43 F.3d 198, 206 (5th Cir. 1995) .

(n54)Footnote 54. See *Schofield v. First Commodity Corp. of Boston*, 793 F.2d 28, 32-33 (1st Cir. 1986) ; *Petro-Tech, Inc. v. Western Co.*, 824 F.2d 1349, 1359 (3d Cir. 1987) ; *Landry v. Airline Pilots Ass'n Int'l*, 901 F.2d 404, 425 (5th Cir.) , cert. denied, 498 U.S. 895 (1990) ; *Davis v. Mutual Life Insurance Co.*, 6 F.3d 367, 378-80 (6th Cir. 1993) ; *D&S Auto Parts v. Schwartz*, 838 F.2d 964, 967-68 (7th Cir.) , cert. denied, 486 U.S. 1061 (1988) ; *Luthi v. Tonka Corp.*, 815 F.2d 1229, 1230 (8th Cir. 1987) ; *Brady v. Dairy Fresh Products Co.*, 974 F.2d 1149, 1154 (9th Cir. 1992) .

(n55)Footnote 55. *Landry v. Air Line Pilots Ass'n*, 901 F.2d 404, 425 (5th Cir. 1990) .

(n56)Footnote 56. *Cox v. Administrator*, 17 F.3d 1386, 1406 (11th Cir. 1994) (internal quotations omitted).

(n57)Footnote 57. *Cox*, 17 F.3d at 1406 .

(n58)Footnote 58. *D&S Auto Parts Inc. v. Schwartz*, 838 F.2d 964, 968 (7th Cir. 1988) .

(n59)Footnote 59. *Luthi v. Tonka Corp.*, 815 F.2d 1229, 1230 (8th Cir. 1987) .

(n60)Footnote 60. *Reves v. Ernst & Young*, 507 U.S. 170, 185, 113 S. Ct. 1163, 122 L. Ed. 2d 525 (1993) (internal quotations omitted).

(n61)Footnote 61. *Banque Worms v. Luis A. Duque Pena E. Hijos Ltda.*, 652 F. Supp. 770, 772 (S.D.N.Y. 1986) .

(n62)Footnote 62. *Gruber v. Prudential-Bache Securities Inc.*, 679 F. Supp. 165, 180-81 (D. Conn. 1987) .

(n63)Footnote 63. *Gruber*, 679 F. Supp. at 181 .

(n64)Footnote 64. See *Metro Furniture Rental Inc. v. Alessi*, 770 F. Supp. 198, 201-02 (S.D.N.Y. 1991) ; *Kahn v. Chase Manhattan Bank, N.A.*, 760 F. Supp. 369, 372-73 (S.D.N.Y. 1991) ; *Philan Insurance Limited v. Frank B. Hall & Co.*, 748 F. Supp. 190, 198 (S.D.N.Y. 1990) . See also Local 56, United Food & Commercial Workers Int'l Union v. Suzannah Farms 92-2930, (S.N.J. August 17, 1993) and cases cited therein.

(n65)Footnote 65. *131 Main St. Associates v. Manko*, 897 F. Supp. 1507, 1533-34 (S.D.N.Y. 1995) .

(n66)Footnote 66. *Volmar Distributors, Inc. v. The New York Post Co.*, 899 F. Supp. 1187, 1194 (S.D.N.Y. 1995) (citation omitted).

(n67)Footnote 67. See *Rogers v. McDorman*, NO. 05-41347 (5th Cir. Mar. 18, 2008); *Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145 (11th Cir. 2006) .

(n68)Footnote 68. See *Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d at 1154 .

(n69)Footnote 69. *Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d at 1156 .

(n70)Footnote 70. *Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d at 1155 .

(n71)Footnote 71. *Rogers v. McDorman*, NO. 05-41347 (5th Cir. Mar. 18, 2008).

(n72)Footnote 72. See *Castellanos v. Pfizer, Inc.*, NO. 07-60646-CIV-Zloch (S.D. Fla. May 29, 2008); *United States v. Noriega*, 746 F. Supp. 1506 (S.D. Fla. 1990) .

(n73)Footnote 73. *Castellanos v. Pfizer, Inc.*, NO. 07-60646-CIV-Zloch (S.D. Fla. May 29, 2008).

(n74)Footnote 74. *Castellanos v. Pfizer, Inc.*, NO. 07-60646-CIV-Zloch (S.D. Fla. May 29, 2008).