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Editor's Message

First, I would like to thank all of the authors who submitted articles for this issue, and for their patience in working with me. I hope you will concur with my view that we have a remarkably timely and informative group of articles in this issue. The authors deserve our thanks for taking the time from their busy schedules to share their considerable expertise with fellow members of the Business Law Section of the New York State Bar.

As always, we strongly encourage you to consider submitting to us an article for consideration for a future issue. The range of interests of the Section and its members is broad, and we think that many of you have valuable information that could usefully be shared with other members, perhaps already lurking in your files in the form of a memorandum to a client or colleague.

We begin this issue with a report on the activities of the Consumer Financial Services Committee during 2001-2002, including assistance to those affected by the 9/11 tragedy, presentations made to the Committee and preparation of a Commentary to Part 41 of the Banking Department's Regulations on High Cost Home Loans.

Next, we have a detailed and thought-provoking position paper, from the Committee on Securities Regulation, on private offering exemptions and exclusions under the New York State Martin Act and section 18 of the Securities Act of 1933. The paper offers suggestions for clarification of the state law provisions.

The first article, by David Glass, Counsel with Clifford Chance US LLP, discusses an issue of enormous concern to law firms, the applicability of the privacy provisions of the Gramm-Leach-Bliley Act to the practice of law. The article argues strongly that these provisions should not apply, and discusses the lawsuit filed by the New York State Bar Association seeking exemption from the law on both administrative law and constitutional grounds. The importance of this issue is demonstrated by the fact that this is only the second lawsuit filed by NYSBA, on behalf of its members, against the federal government, the first (successful) suit having been to block the infamous "Granny's Lawyer Goes to Jail" provision under the Medicaid asset transfer rules.

The recent and unsettling corporate accounting and corporate governance brouhahas led to the enactment of the Sarbanes-Oxley Act, which was signed by President Bush in July 2002. Our next article, by Guy Lander of Davies, Ward, Phillips & Vineberg LLP, is a timely summary of the major provisions of the Act. The appendix to the article includes a helpful discussion of the new CEO and CFO certification requirements under the Act, and suggested procedures for addressing them.

The third article, also by Guy Lander, discusses a statement published by the SEC in January 2002, the Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), and summarizes disclosure requirements under this new statement.

Howard Meyers of Meyers & Heim LLP is the author of our next article, which discusses finder's fee agreements under New York law. The article summarizes the relevant case law and describes pitfalls to be avoided when drafting such an agreement.

Our fifth article, by Thomas J. Dougherty and Wystan M. Ackerman of Skadden, Arps, Slate, Meagher & Flom LLP, discusses the circumstances under which fraud claims are barred by the parol evidence rule under New York law, with extensive discussion of and citations to the relevant case law. The article serves as a reminder, particularly perhaps for those of us who graduated from law school longer ago than we care to remember, that boilerplate language in a contract will *not* always protect a client against a claim based on parol evidence, so we should not always rely unthinkingly on Samuel Goldwyn's famous dictum.

Our final article, also by David Glass, discusses whether, in the wake of the Enron debacle, the Federal Reserve Board can strike an appropriate regulatory balance.

Finally, Michelle Almeida, Ned Glenn and Steven Masur of Masur & Associates, LLC, have contributed a note on the decision of the D.C. Circuit in *Fox Television Stations, Inc. v F.C.C.*, a case with significant implications for the ownership and operation of television stations and other broadcast media.

I anticipate that we will continue to have numerous important developments to discuss in our next issue, particularly as regulatory guidance becomes available under the Sarbanes-Oxley Act and the new accounting oversight board begins its work. We welcome submissions from our readers. In our next issue, we will also report the results of our first student writing competition, and will publish at least one of the winning papers.

I would be remiss if I did not acknowledge the ongoing assistance I have received from my colleague, Nancy Ota, and from Stuart Newman, the Chair of the *Journal*'s Advisory Board, who is unfailingly helpful, patient and enthusiastic. Finally, on a personal note, congratulations to my son Nick, who recently aced the LSATs and aspires to be (what else) a business lawyer.

David Pratt
Professor of Law
Albany Law School

Save the Date!

Business Law Section

2003
Annual Meeting

Wednesday, January 22, 2003

New York Marriott Marquis

Committee Report

Committee on Consumer Financial Services

The Consumer Financial Services Committee of the Business Law Section had an active year during 2001-2002. The Committee actively contributed to the efforts of the New York State Bar Association to provide assistance to those affected by the tragedies of September 11th. These contributions included efforts by Committee member David Kotkin, who provided guidance to servicemen and servicewomen about their rights under the Soldiers and Sailors Relief Act through the Bar Association's Web site.

During the Committee's regular meetings, Committee members heard from Curtis Johnson of the Federal Reserve Bank of New York regarding the perspective of Bank examiners during privacy compliance examinations. Lloyd Harris, Vice President and Assistant General Counsel of J.P. Morgan Chase, explored the future of check truncation with the Committee members, emphasizing the implications of pending federal legislation and the views of competing interest groups. In addition, Committee members presented to the Committee new developments in the members' areas of interest. This included Geoff Rogers of McNamee, Lochner, et al. on Truth-in-Lending; Peter Cubita and Seth Berman of Weil, Gotshal & Manges LLP discussing automobile finance; Stephen Ambrose, General Counsel, and Alfred Rosa, Litigation Counsel of GE Card Services, presenting new methods to efficiently manage legal risk in an in-house environment; and Barbara Kent, Director of Consumer Affairs and Financial Products of the New York State Banking Department, on the ongoing initiatives from the Banking Department.

Of all the activities undertaken by the Committee, the effort that stands out for recognition is that of the group of Committee members headed by Grace Sterrett of Hudson Cook and past Committee Chair. The group (Tim Meredith, Geoff Rogers and Helen Sontag), working with Barbara Kent and others within the Banking Department, prepared an unofficial commentary to Part 41 of the Banking Department's regulations on High Cost Home Loans. This effort took past guidance from the Banking Department, combined it with how industry and attorneys were interpreting Part 41, added the working group's own insight, and created a section-by-section examination of the provisions of Part 41. This unofficial commentary is now available to attorneys and the public at the Web site for the Banking Department (www.banking.state.ny.us).

The Committee Chair is grateful to the Committee members and speakers who contributed so much of their time so that colleagues could be enlightened and the public served.

Vincent N. Amato
Chair

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Click on "Sections/Committees/ Business Law Section/ Member Materials/ *NY Business Law Journal*."

For your convenience there is also a searchable index. To search, click on the Index then "Edit/ Find on this page."

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Private Offering Exemptions and Exclusions Under the New York State Martin Act and Section 18 of the Securities Act of 1933

By the Committee on Securities Regulation of the New York State Bar Association

This position paper was originally prepared for, and submitted to, the Office of the New York State Attorney General. The Committee on Securities Regulation of the Business Law Section of the New York State Bar Association ("Committee") is composed of members of the New York Bar, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice and in corporation law departments. A draft of this position paper was circulated for comment among members of the Committee, and the views expressed in this position paper are generally consistent with those of the majority of the members who reviewed the position paper in draft form. The views set forth in this position paper, however, are those of the Committee, and do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association, or its Business Law Section.

Introduction

New York State's securities statute, Article 23-A of the General Business Law ("GBL"), known as the Martin Act, is unique among state securities laws in two important respects. First, the Martin Act does not require the registration of securities, other than securities sold in real estate offerings, theatrical syndications or intra-state offerings.[1] Instead, it requires some issuers to register as dealers in their own securities.

Second, the laws of every other state and the federal Securities Act of 1933 ("Securities Act") require the registration of all securities offerings, and then provide an exemption for non-public offerings if certain conditions are met. In contrast, the Martin Act requires registration (whether of brokers, dealers or special categories of offerings) only for offers and sales to, and purchases and offers to purchase from, the public. The Martin Act is silent with respect to private or non-public offerings, thus requiring no dealer registration filings, and no filing exemptions, for private offerings (other than intrastate offerings). The differences between the Martin Act and other state securities laws, particularly the first, have resulted in the use of registration and exemption forms and procedures that are unique among the states. Concerns about lack of uniformity are not academic. The capital markets in this country depend upon raising money in private placements, and New York is at the center of this market. Yet the manner in which the Office of the New York State Attorney General ("OAG") regulates private offerings exempt from registration under (a) § 4(2) of the Securities Act, the "classic" private placement exemption, and (b) Rule 506 of Regulation D under the Securities Act, the safe harbor exemption adopted by the Securities and Exchange Commission ("SEC") under § 4(2), is in conflict with the federal law and the laws of other states.

This paper addresses the regulation by the OAG of those offerings exempt from registration under either § 4(2) or Rule 506, and the application of the relevant provisions of the Martin Act and of § 18 of the Securities Act to those offerings. In the course of the following discussion, the Committee states several conclusions, which are summarized as follows:

(a) All offerings exempt under § 4(2) of the Securities Act, and all offerings exempt under Rule 506 ("Rule 506 offerings"), are excluded from the registration requirements of the Martin Act.

(b) An issuer that sells its own securities in New York exclusively to, from or through a bank, dealer or broker, whether on a firm commitment or "best efforts" basis, is excluded from the requirement to register as a dealer for that transaction.

(c) Section 18 of the Securities Act pre-empts New York State from requiring any filing with respect to securities offered under Rule 506, other than Form D (or a substantially similar form), a consent to service of process and a fee.

(d) Section 15(h) of the federal Securities Exchange Act of 1934 ("Exchange Act") pre-empts New York State from requiring federally-registered brokers to file the Further State Notice form (described in GBL § 359-e(8)) for securities offerings.

The Non-Public Offering Exclusion

GBL § 352-e requires the registration of certain real estate syndication offerings. Section 352-e provides that it is illegal "to make or take part in a public offering or sale in or from the state of New York" of real estate securities as defined in that section without filing a written offering statement or prospectus with the OAG (unless an exemption is available). Securities covered by § 352-e include interests in limited partnerships owning real estate or mortgages, shares in real estate invest-

ment trusts, cooperative apartment shares, condominium units and resort timeshare units.

GBL § 359-e requires the registration of dealers and brokers in securities. Section 359-e(1)(a) defines a dealer as including a person "engaged in the business of buying and selling securities from or to the public," and also a person "selling or offering for sale from or to the public within or from this state securities issued by it." Sections 359-e(2), (3) and (8) then require brokers or dealers to make certain filings (State Notice, broker or dealer registration statement and Further State Notice) if selling securities or offering securities for sale *to the public* within or from the State.

When the provisions of GBL § 359-e were substantially rewritten in 1959, the securities industry was concerned that New York State might interpret the term "to the public" differently than it was interpreted under federal law, which would result in a lack of uniformity and the risk of prosecution by the State for failure to register as a dealer or broker for offerings considered to be private offerings under the Securities Act. In response, the memorandum of Governor Nelson Rockefeller, dated April 22, 1959, approving L. 1959, c. 692, stated, in pertinent part:

> The bill will make appropriate exemption for situations not requiring regulation, including providing for exemptions for securities registered on a national securities exchange and for private placements of securities. In this latter connection it has been observed that there may be some ambiguity in the bill with respect to the scope of the exemption and the need for specific approval of the Attorney General in the case of limited offerings. I am confident that the underlying spirit of the Act will compel a determination that the bill is restricted in its application to situations tantamount to public offerings and will be administered in accordance with a philosophy comparable to that underlying the Federal Securities Act of 1933 which over the years has proven to be entirely workable. 1959 N.Y. Sess. Laws 1767 at 1768.

The cases in New York State courts interpreting the concept of public offering have consistently looked to federal case law interpreting the phrase "not involving a public offering" under § 4(2) of the Securities Act. *People v. Landes*, 84 N.Y.2d 655 (1994); *People v. Glenn Realty Corp.*, 106 Misc. 2d 46 (Sup. Ct. Spec. Term, N.Y. County 1980); *Puro v. Zimmerman*, N.Y.L.J. at 14, col. 3, April 18, 1977 (Sup. Ct.), *aff'd*, 61 A.D.2d 772 (1st Dep't 1978). The OAG itself has looked to federal law and rules in interpreting its statute; *see*, *e.g.*, Interpretive Opinion, 2A *Blue Sky L. Rep.* (CCH) *¶42,584* (December 6, 1994) (advising that issuers are not "dealers" if selling "'*private placements' as that term is understood under federal securities law*, solely to institutional investors described in the last sentence of New York General Business Law § 359-e(1)(a)" [emphasis supplied].

Rule 506 creates a safe harbor for non-public offerings under § 4(2) of the Securities Act. As the SEC makes clear in Preliminary Note 3 to Regulation D, while an offering satisfying Rule 506 will be deemed to be a non-public offering under § 4(2), Rule 506 is not the exclusive means for establishing a § 4(2) exemption. The Rule 506 exemption is not an exemption created by the SEC in the exercise of the authority given to the SEC to create exemptions under § 3(b) of the Securities Act, as are the exemptions under Rules 504 and 505. Rather, it is a determination by the SEC that offerings meeting the conditions of Rule 506 are not public offerings.

This determination by the SEC has been subsequently ratified by Congress in § 18(b)(4)(D) of the Securities Act, which preempts state registration requirements for securities sold in a transaction exempt from registration pursuant to "Commission rules or regulations issued under section 4(2)." At the time § 18 was amended by the National Securities Markets Improvement Act of 1996 ("NSMIA"), and at all times since, the only rule of the SEC describing an offering exemption and issued under § 4(2) has been Rule 506.

In *People v. Landes*, the Court of Appeals discussed the factors to be considered in determining whether an offering is public, looking for guidance to the decision of the Supreme Court in *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). The decisive factor identified by the Supreme Court in *Ralston Purina* is whether investors have such access to material information about the offering and the issuer and its principals that they do not require a prospectus registered with the SEC. Rule 506 has built into it conditions designed to ensure that investors will have access to all material information about the offering. Rule 502, incorporated into Rule 506, requires that a disclosure document, meeting the requirements of specified SEC registration forms, be provided to all non-accredited investors. Accredited investors, a category that includes institutional investors and high net-worth and high income individuals, have the financial leverage to obtain the information they consider necessary to make the investment. Thus, the most important factor in *People v. Landes* is satisfied in all Rule 506 offerings. The other factors in *People v. Landes* are designed to test whether an offering is being made as part of a public distribution, but the conditions to Rule 506 ensure that these factors are sat-

isfied as well. A Rule 506 offering may not be made using general advertising or general solicitation, and the resale of securities purchased in a Rule 506 offering is restricted.

Given: (a) that the cases in New York State interpreting the concept of public offering have looked to federal case law under § 4(2) of the Securities Act, (b) that the requirements of *People v. Landes* are satisfied by compliance with Rule 506, (c) the clear statement of legislative intent reflected in Governor Rockefeller's memorandum that the term "public offering" under the New York law should be interpreted consistently with the federal securities law, and (d) the clear statement of intent by Congress that Rule 506 should apply to state securities laws uniformly, we believe that all § 4(2) offerings and all Rule 506 offerings are non-public offerings under GBL §§ 352-e and 359-e. We further believe that the Attorney General should state publicly his agreement with that conclusion.

Because § 4(2) and Rule 506 offerings are non-public offerings under GBL §§ 352-e and 359-e, issuers are not required to file any form of notice or fee with the OAG. If New York State wishes to receive a notice and fee for § 4(2) and Rule 506 offerings, it must amend the Martin Act to require (or to permit the Attorney General to require) notice filings in non-public offerings.

The Exclusion for Offerings "to, from or through" a Bank, Dealer or Broker

GBL § 359-e(1)(a) excludes certain persons from the definition of dealer, stating, in part, that "[n]o person shall be deemed to be a 'dealer,' as defined in this subdivision, or a broker, as defined in subdivision (b), solely by reason of the fact that he is engaged in the business of (i) selling, offering for sale, purchasing or offering to purchase any security or securities to, from or through any bank, dealer or broker. . . ." The meaning of this provision is clear on its face. An issuer selling securities *to* an underwriter or underwriting syndicate in a firm commitment offering is excluded from the definition of dealer, and an issuer selling securities *through* a broker or group of brokers in a best efforts offering is likewise excluded from the definition of dealer. Although the OAG has recognized the exclusion for issuers selling in firm commitment offerings, to date it has not publicly recognized the equally valid exclusion for issuers selling through brokers in best efforts offerings. *See, e.g.*, "Broker-Dealer and Securities Registration Information Sheet, Part I(C), *CCH Blue Sky L. Rep. ¶42,573* (revised May 1993).

The intent of the New York State legislature to exclude issuers in both kinds of offerings is highlighted by the 1959 amendment to GBL § 359-e. Prior to that amendment, § 359-e, in relevant part, (a) encompassed only "dealers," not "brokers," (b) defined "dealer" as a person "who engages directly or through an agent in the business of trading in securities in such manner that as part of such business any of such securities are sold or offered for sale to the public in this state," (c) did not explicitly include issuers as a type of "dealer," and (d) contained exclusions for (i) "any sale or offer of sale to any person engaged in the business of acquiring securities for the purpose of resale to the public," and (ii) "any sale or offer of sale to a banker, to a dealer or to a corporation or to any syndicate or group formed for the specific purpose of acquiring such securities for resale to the public directly or through other syndicates or groups, or any sale or offer of sale upon the floor of any exchange to a broker in securities." GBL § 359-e (McKinney 1957, as amended by 1958 N.Y. Laws ch. 750, §§ 4-6).

Thus, the prior version of the statute excluded only sales *to* the designated persons, acting for their own account, and the 1959 addition of an exclusion for sales or offers *through* banks or brokers was a significant change. In particular, by excluding sales through brokers, who, by definition in GBL § 359-e(1)(b), are "engaged in the business of effecting transactions in securities for the account of others," the current exclusion must, by definition, apply to "best efforts" offerings, since a broker may only act in an agency capacity, not as a principal; *i.e.*, one cannot sell securities "to" a broker, but only "through" a broker. The rationale for the Legislature's amendment to expand the exclusion to also exclude sales through a bank or broker is that as long as a bank or registered broker is interjected between an issuer and public investors, there is no basis for also requiring the issuer to register as a dealer.

We realize there is a possibility that, in a best efforts offering, an issuer may sell some securities directly to the public and may, therefore, be a dealer. However, in best efforts offerings in which the issuer sells to the public *exclusively through a broker* (even if it sells directly to persons who are not banks, dealers or brokers in non-public offerings), the issuer is entitled to claim the exclusion from the definition of dealer. We also note the use of the disjunctive "or" introducing the clause following the "to, from or through" exclusion, rather than the conjunctive "and."[2] Thus it is clear that the issuer does not *also* have to be selling to a syndicate, corporation or group formed for the specific purpose of acquiring such securities for resale to the public in order to be entitled to the exclusion. A contrary interpretation would mean, among other things, that the 1959 amendment to the statute adding the word "through" would have served no purpose.

We believe that the Attorney General should publish advice confirming that issuers selling through

brokers in best efforts offerings are excluded from the definition of dealer, as clearly provided by GBL § 359-e(1)(a). In the absence of such clarification, many issuers assume the unnecessary burden and expense of filing a Form M-11 issuer-dealer registration statement or a Form 99 issuer-dealer registration statement for covered securities offerings, compromising the privacy rights of the principals of issuers by doing so.[3]

Section 18 Preemption for Rule 506 Offerings

Section 18(a)(1) of the Securities Act, as amended by NSMIA in 1996, provides that no law, rule, regulation or order, or other administrative action of any State "requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a security that (A) is a covered security or (B) will be a covered security upon completion of the transaction." Section 18(b)(4)(D) provides that a security is a covered security in a transaction that is exempt from registration under the Securities Act under "Commission rules or regulations issued under Securities Act § 4(2), except that this subparagraph does not prohibit a State from imposing notice filing requirements that are substantially similar to those required by rule or regulation under § 4(2) that are in effect on September 1, 1996."

As discussed above, the only rule or regulation issued by the SEC under § 4(2) is Rule 506. The notice filing requirements in effect on September 1, 1996, were to file the first five pages (Parts A-D) of Form D within 15 days after the first sale of securities in the Rule 506 offering. *See* Rule 503 (Filing of Notice of Sales) and instructions to Form D.

It is clear that § 18 preempts the registration requirements under GBL § 352-e for real estate offerings made pursuant to Rule 506 (leaving aside the fact that under New York statutory provisions, such offerings are private offerings outside of the purview of § 352-e in any event). Section 18(a)(1) provides that no such registration requirement, whether of securities or of *securities transactions* shall apply, *directly or indirectly*, to a covered security. Thus, because of §18 preemption, New York State may not require the registration of issuers as dealers as a way of indirectly requiring registration of transactions in covered securities. All New York State could do (if it were permitted to do so under its statutory provisions) would be to impose notice filing requirements substantially similar to those required by Rule 503 and Form D.[4]

If the Martin Act permitted New York State to receive anything at all under GBL §§ 352-e or 359-e, it could receive only a fee, a consent to service of process and the first five pages (Parts A-D) of Form D together with the "State Signature" portion of page 6 of Form D, within 15 days after the first sale. In particular, New York may not require a notice filing before the first offer, nor may it require responses to questions 1-4 of Part E of Form D as regards information about disqualification under the provisions of Rule 262 of SEC Regulation A, undertakings to make other state filings, undertakings to provide offering materials and representations about familiarity with the Uniform Limited Offering Exemption provisions, as they are not part of the notice filing requirements of the SEC under Rule 506.

We note that information about disqualification under Rule 262 of SEC Regulation A, referenced in Part E on page 6 of Form D, was included in Part E of Form D purely for purposes of the state Uniform Limited Offering Exemption, which is no longer applicable to Rule 506 offerings. The Senate, House and Conference reports on NSMIA make clear that Congress did not intend to permit the states to use the enforcement powers reserved to them to "reconstruct in a different form the regulatory regime for covered securities that Section 18 has preempted." (See excerpts from reports attached as Appendix hereto.)

Section 15(h) Preemption of Further State Notice Filing

GBL § 359-e(8) provides that no dealer may sell or offer to sell securities to the public within New York State as principal or agent unless the dealer has filed a form known as the Further State Notice. The Further State Notice requirement is thus an operational reporting requirement for brokers or dealers.[5] For reasons discussed above, no Further State Notice should be required in any § 4(2) or Rule 506 offering, because such offerings do not involve the sale of securities to the public. To the extent that § 359-e(8) requires filing of a Further State Notice by broker-dealers registered under § 15 of the Exchange Act, that requirement is preempted in any case by § 15(h) of the Exchange Act. Section 15(h)(1) provides, in pertinent part, that

> [n]o law, rule, regulation, or order, or other administrative action of any State or political subdivision thereof shall establish capital, custody, margin, financial responsibility, making and keeping records, bonding, or financial or operational reporting requirements for brokers, dealers, municipal securities dealers, government securities brokers, or government securities dealers that differ from, or are in addition to, the requirements in those areas established under this title.

There is no equivalent to the Further State Notice under the Exchange Act. Since the requirement to file a Further State Notice is an operational reporting requirement for brokers or dealers that differs from, or is in addition to, the requirements established by the SEC and self-regulatory organizations like the NASD under the Exchange Act, §15(h) preempts the Further State Notice requirement, and registered brokers and dealers may not be compelled to file them.

We support the current efforts of the Attorney General to update and streamline its regulation of private offerings. The U.S. Congress has made it clear, through its amendment of Securities Act § 18 by NSMIA, that there is a national interest in reducing the regulatory burden on small business capital formation in connection with Rule 506 offerings. We believe that the Attorney General should take this opportunity to review its interpretation of the Martin Act, and to revise its filing requirements to comply with the provisions of NSMIA. We hope that this position paper assists in that process, and we would be pleased to make ourselves available for additional dialogue on the subjects discussed here.

Drafting Committee
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Endnotes

1. Section 23.03 of the New York State Art and Cultural Affairs Law requires registration of certain theatrical syndications, and GBL § 359-ff requires registration of intra-state offerings. Those registration requirements are not discussed in this paper, but we note that provisions of federal law preempting registration of real estate syndications apply equally to registration of theatrical syndications.
2. The full exclusion, contained in § 359-e(1)(a)(i), provides:

   > No person shall be deemed to be a "dealer," as defined in this subdivision, or a broker, as defined in subdivision (b), solely by reason of the fact that he is engaged in the business of (i) selling, offering for sale, purchasing or offering to purchase any security or securities to, from or through any bank, dealer or broker, or to or from any syndicate, corporation or group formed for the specific purpose of acquiring such securities for resale to the public directly or through other syndicates or groups.

3. Principals of issuers registering on Form M-11 are required to disclose their social security numbers and residence addresses, among other facts. Officers and directors of foreign companies, in particular, have long objected to disclosing their residence addresses for fear of kidnapping and assassination.
4. The power of Congress to preempt state laws in matters of interstate commerce, even where the state asserts its police powers, has been decisively settled. As the Supreme Court stated in *Hodel v. Virginia Surface Mining & Reclamation Assoc., Inc.*, 452 U.S. 264, 290-291 (1981), "A wealth of precedent attests to congressional authority to displace or pre-empt state laws regulating private activity affecting interstate commerce when these laws conflict with federal law. [Citations omitted.] Moreover, it is clear that the Commerce Clause empowers Congress to prohibit all—and not just inconsistent—state regulation of such activities. . . . This conclusion applies regardless of whether the federal legislation displaces laws enacted under the States' 'police powers.' The Court long ago rejected the suggestion that Congress invades areas reserved to the States by the Tenth Amendment simply because it exercises its authority under the Commerce Clause in a manner that displaces the States' exercise of their police powers."
5. If the Further State Notice were a transactional reporting requirement, it would be preempted by Securities Act § 18(b)(4)(D).

Appendix

Excerpts from Committee Reports on NSMIA Relating to Preemption of State Registration of Covered Securities

From Conference Report H. Rept. No. 104-684. September 28, 1996

With respect to securities offerings, the Managers have allocated regulatory responsibility between the Federal and state governments based on the nature of the securities offering. Some securities offerings, such as those made by investment companies, and certain private placements are inherently national in nature, and are therefore subject to only federal regulation. Smaller, regional, and intrastate securities offerings remain subject to state regulation. The Managers have preserved the authority of the states to protect investors through application of state antifraud laws. This preservation of authority is intended to permit state securities regulators to continue to exercise their police power to prevent fraud and broker-dealer sales practice abuses, such as churning accounts or misleading customers. It does not preserve the authority of state securities regulators to regulate the securities registration and offering process through commenting on and/or imposing requirements on the contents of prospectuses or other offering documents, whether prior to their use in a state or after such use.

From United States Senate Report No. 104-293. June 26, 1996

In both cases, the bill preserves state fraud authority. This preservation of authority makes clear that states would continue their role in regulating broker-dealer conduct whether or not the offering is subject to state

review. The Committee believes that allowing the states to oversee broker-dealer conduct in connection with preempted offerings will ensure continued investor protection. As long as states continue to police fraud in these offerings, compliance at the federal level will adequately protect investors. In preserving this authority, however, the Committee expects the states only to police conduct—not to use this authority as justification to continue reviewing exempted registration statements or prospectuses. The Committee clearly does not intend for the "policing" authority to provide states with a means to undo the state registration preemptions. States will continue to receive notice filings and fees as specified to facilitate their antifraud efforts.

From House Report No. 104-622. June 17, 1996

Section 18(a) prohibits State governments from requiring the registration of, or otherwise imposing conditions on, offerings of "covered securities" as defined in Section 18(b), subject to Section 18(d), which preserves State authority to investigate and bring enforcement actions with respect to fraud or deceit (including broker-dealer sales practices) in connection with securities or securities transactions. Section 18(d) also preserves the authority of States to require notice filings and fees with respect to certain offerings, and to suspend the offer or sale of securities within a State as a result of the failure to submit a filing or fee. Section 18(a) also limits State governments from requiring the regulation or otherwise imposing conditions on offerings of "conditionally covered securities" as defined in Section 18(c). Section 18(a) specifically provides that States may not conduct merit reviews of these offerings. In addition, Section 18(a) prohibits States from placing limits or imposing conditions upon (including outright prohibition of) the use of offering documents with respect to such "covered securities" offerings, including advertising or sales literature used in connection with such offerings. It further preempts State regulation or other disclosure documents such as proxy statements and annual reports. In each case, the prohibition applies both to direct and indirect State action, thus precluding States from exercising indirect authority to regulate the matters preempted by Section 18(a). Also, in each case, the prohibitions are subject to the provisions of subsection (d). By extending the prohibition to indirect State action, the Committee specifically intends to prevent State regulators from circumventing the provisions of Section 18(a) that expressly prohibit them from requiring the registration of, or otherwise imposing conditions or limitations upon, offerings of covered securities. The Committee does not intend, however, that the extension of the prohibition to indirect actions by State regulators restrict or limit their ability to investigate, bring actions, or enforce orders, injunctions, judgments or remedies based on alleged violations of State laws that prohibit fraud and deceit or that govern broker-dealer sales practices in connection with securities or securities transactions.

* * *

Paragraph 18(d)(1) preserves specified State authority, pursuant to state law, consistent with Section 18. The relationship between Section 18(d) and Section 18(a) is especially important. The Committee intends to preserve the ability of the States to investigate and bring enforcement actions under the laws of their own State with respect to fraud and deceit (including broker-dealer sales practices) in connection with any securities or any securities transactions, whether or not such securities or transactions are otherwise preempted from state regulation by Section 18. It is the Committee's intent that the limitations on State law established by Section 18 apply to State law registration and regulation of securities offerings, and do not affect existing State laws governing broker-dealers, including broker-dealer sales practices. In preserving State laws against fraud and deceit, (including broker-dealer sale practice abuse), however, the Committee intends to prevent the States from indirectly doing what they have been prohibited from doing directly. The Committee intends that the authority that States retain over broker-dealers to allow the States to impose conditions on, or otherwise to regulate, offerings of securities. [sic] The legislation preempts authority that would allow the States to employ the regulatory authority they retain to reconstruct in a different form the regulatory regime for covered securities that Section 18 has preempted.

Thus, for example, Section 18 precludes State regulators from, among other things, citing a State law against fraud or deceit or regarding broker-dealer sales practices as its justification for prohibiting the circulation of a prospectus or other offering document or advertisement for a covered security that does not include a legend or disclosure that the State believes is necessary or that includes information that a State regulator criticizes based on the format or content thereof. The Committee intends to eliminate States' authority to require or otherwise impose conditions on the disclosure of any information for covered securities.

Are You a Dolphin? Or a Financial Institution?

By David L. Glass

> It is the policy of the Congress that each financial institution has an affirmative and continuing obligation to respect the privacy of its customers and to protect the security and confidentiality of those customers' nonpublic personal information.[1]

> [Lawyers are like] happy dolphins swimming along in the ocean and getting caught in a tuna net.[2]

For only the second time in its 125-year history, the New York State Bar Association (NYSBA) has filed a lawsuit on behalf of its members.[3] In late September 2002, as this article was going to press, the Government filed a motion to dismiss NYSBA's Complaint. And the American Bar Association (ABA), which has been working behind the scenes on a legislative fix, has now taken up the litigation cudgel as well.[4]

At issue in both actions is the refusal of the Federal Trade Commission (FTC) to acknowledge the seemingly obvious: that an attorney engaged in the practice of law is not a "financial institution" under the financial reform legislation enacted in 1999, known as the Gramm-Leach-Bliley Act ("GLB Act").[5] Among other things, the GLB Act requires all "financial institutions" to take certain measures to protect the privacy of consumers with whom they deal. No one—not the Congress, not the consumer advocates, not the lawyers who assisted in drafting the legislation, and apparently not the FTC itself[6]—ever intended or contemplated that lawyers would be caught in this particular tuna net. But the FTC has elected to cast its net wide and far, and many of the one million practitioners in the United States are going to be not-so-happy dolphins.

At a minimum, the FTC's interpretation imposes a substantial paperwork burden on the profession. The GLB Act mandates that all financial institutions dealing with consumers provide a notice to their customers, upon establishing the relationship and annually thereafter. It is doubtful that most individual practitioners or smaller firms have the systems capability to readily identify all of the clients to which the requirement applies.[7] This burden falls especially heavily on legal aid lawyers and others representing poor clients, who typically have large caseloads and limited resources.[8] And it is unclear how the law applies to someone who is a client for a one-time transaction, such as a real estate closing.

But the potential consequences are far more troublesome than additional paperwork. As noted in NYSBA's Complaint, applying the GLB Act to lawyers raises the specter that the privacy requirements imposed by the Act could be deemed to preempt the more stringent confidentiality and privilege rules to which the profession is subject under state law.[9] And the notices are sure to alarm clients, who may well perceive them as a *reduction* in the confidentiality they take for granted in their relationships with their attorneys.[10]

This assumes that a client bothers to read the notice in the first instance. Shortly after the enactment of the GLB Act, the author participated in a panel discussion on the privacy provisions with a representative of the American Civil Liberties Union (ACLU). While arguing for still more stringent privacy legislation, the ACLU representative complained that the required notices were already so lengthy and confusing that consumers "couldn't be bothered" to read them.[11] Of course, a notice identifying one's attorney as a "financial institution" is just what is needed to clear up the confusion (and help fill up the recycling bin).

As stated by NYSBA in its Complaint, the FTC's interpretation " . . . is the paradigm of a regulatory pronouncement that is arbitrary, capricious, contrary to law, and an offense to common sense."[12] Viewed in a broader context, it is the *reductio ad absurdum* of the "one size fits all" model of regulation, as so persuasively described by attorney Philip Howard in his best-seller "The Death of Common Sense,"[13] whereby those charged with administering the law see themselves as constrained from the exercise of judgment and common sense, and are reduced to the wooden application of the literal language of a rule. Indeed, it seems clear that the FTC itself—or at least its staff—sees its role in exactly this way.

Thus, an FTC staff attorney has been quoted as acknowledging that "[n]o one realized at the time that [the GLB Act] might apply to lawyers. . . . We agree that it doesn't make sense."[14] But the same staff attorney—even while conceding that lawyers are covered by state disciplinary rules that are far more protective of clients' confidential information than is the GLB Act—also said that "all folks who are technically covered by the [FTC] rules need to comply."[15] Thus, having determined that attorneys are "technically covered," the FTC relieves itself of the need to exercise judgment, discretion or common sense.

The remainder of this article discusses the background of the FTC's action, reviews NYSBA's complaint and its prospects for success, and considers the prospects for reconsideration by the FTC or new legislation as a way out of the morass.

The FTC Rule

The FTC promulgated its rule pursuant to the mandate of the GLB Act, which assigned the responsibility to write privacy rules to seven federal agencies and, with respect to insurance companies that are historically regulated by the states, some 50 state agencies. The FTC's authority is residual; it essentially covers all entities that meet the definition of "financial institution," but are not under the jurisdiction of the SEC or one of the federal banking or state insurance regulators. As required by the GLB Act, the FTC published its proposed privacy regulations for comment in 2000.[16] The proposed rule made no reference to lawyers as such, but stated that it applied to entities engaged in "any activity that the [Federal Reserve] Board has determined to be a financial activity." The FTC received some 640 comments on the proposed rule from members of the public, not one of them regarding its possible applicability to lawyers.[17]

In accordance with the mandate of Congress, as promulgated the FTC's regulations require every "financial institution" to provide its customers, at the outset of the relationship and on an annual basis thereafter, with a notice setting forth the institution's policy regarding whether and under what circumstances it will share the customer's nonpublic information in its possession with others, and giving the customer an opportunity to "opt out" of such sharing.[18] For this purpose, the FTC rule states that "financial institutions . . . include, but are not limited to . . . credit counselors and other financial advisors, tax preparation firms . . . and investment advisors that are not required to register with the Securities and Exchange Commission."[19]

Among the examples given of financial activities to which the law would apply were "real estate settlement services; providing financial or investment advisory activities including tax planning, tax preparation, and instruction on individual financial management."[20] These are all activities that lawyers may engage in from time to time. Arguably, therefore, the FTC definition is broad enough to include lawyers, at least to the extent that they provide financial advice to individual clients—for example, in connection with tax or estate planning, real estate transactions, or trust fund management.[21] Nonetheless, the bar did not recognize the danger until the spring of 2001, with the rule due to take effect on July 2 of that year.

The Bar's Response

On June 22, 2001, NYSBA filed a letter with the FTC, calling upon the agency to declare for the record that attorneys were exempt from the GLB Act privacy provisions.[22] The following week the ABA also filed a letter with the FTC, requesting an extension of time to comply. On July 10, 2001, the ABA sent a letter to the chairman of the FTC, formally requesting an exemption.[23] While noting that "common sense" dictated otherwise, the ABA letter conceded that a lawyer or law firm "significantly engaged" in one or more of the covered financial activities "potentially would be subject to the [GLB] Act's privacy requirements."[24] Thereafter representatives of the bar associations met with FTC staff.[25] The FTC participants initially appeared to be receptive to the concept of exempting attorneys, but indicated that they did not yet "fully understand" the scope of the agency's authority to issue exemptions.[26] On August 22, 2001, the ABA again wrote to the FTC, enclosing a memorandum discussing state regulation of the legal profession, in response to questions raised by FTC staff.[27]

Nonetheless, in a letter dated April 8, 2002 (the "Beales Letter"), the FTC declined to grant relief. While stating that the FTC "recognized" the concerns raised by applying the privacy rules to attorneys, it noted "significant questions as to the legal authority of the [FTC] to grant the exemption you request." The letter went on to assert that the FTC's authority to grant exemptions was limited to section 502 of the GLB Act, which prohibits disclosure by a financial institution of a consumer's nonpublic personal information to third parties unless the consumer has been given a chance to "opt out" of such disclosure. Therefore, in the FTC's view, the GLB Act did not confer authority to grant exemptions from the Act's other provisions, such as the annual notice requirement.[28]

The NYSBA Complaint

Just three weeks after the Beales Letter, NYSBA responded by filing its Complaint. The Complaint sought relief on essentially two grounds: first, that the FTC's failure to grant an exemption was arbitrary, capricious and contrary to the law and the Congress' intent; and second, to the extent that the law was read to apply to attorneys, it would violate the Tenth Amendment of the Constitution, since it "infringes on an area of lawmaking and regulation historically committed and reserved solely to the States—the regulation of the confidential nature of the relationship between clients and practicing lawyers subject to State licensure."[29]

The Tenth Amendment issue received comparatively short shrift in the Complaint, although it was developed in much greater depth in NYSBA's Memorandum opposing the Government's motion to dismiss, filed on September 16, 2002 (discussed below). The crux of the Complaint lies in the area of administrative law—namely, whether the agency's action—or, in this case, inaction—was arbitrary, capricious or not in accordance with law.[30] Under the Supreme Court's *Chevron* standard, the court is instructed to first determine whether "the intent of Congress is clear [as to] "the precise question at issue."[31] If so, "that is the end of the matter . . . [but] if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute . . . if the administrator's reading . . . defines a term in a way that is reasonable in light of the legislature's revealed design, we give the administrator's judgment controlling weight."[32]

Thus, the *Chevron* standard requires the court to give "controlling weight" to the FTC's judgment only if 1) the intent of Congress is not clear, 2) the construction of the statute adopted by the FTC is a permissible one, and 3) "a term [i.e., "financial institution"] is defined in a way that is reasonable in light of the legislature's revealed design." In the NYSBA case, there appear to be grounds for optimism on all three points.

Is the Intent of Congress Clear?

While the statute is silent on its face as to whether lawyers are included, the legislative intent of Congress seems quite clear that they were *not* intended to be included. The GLB Act was crafted over a period of years, by the House Financial Services Committee (formerly the Banking Committee), the House Energy & Commerce Committee, and their Senate counterparts. Numerous trade groups, representing banks, securities dealers, insurance underwriters and agents, and other financial services providers, participated actively in its drafting, along with a variety of consumer advocates. The stated objective of the GLB Act was to repeal or overhaul those provisions of the Glass-Steagall Act and the Bank Holding Company Act that prohibited the affiliation of banks with securities firms and insurance companies, and more generally to modernize the structure for the delivery of financial services.[33] The privacy issue played no part in the early deliberations. Indeed, a precursor to the GLB Act passed the House in 1998 without any privacy provision at all.

The privacy title first appeared in early 1999, during the final deliberations that led to the bill that ultimately was enacted.[34] It was included primarily to secure the support of consumer advocates for the legislation, which was perceived in some quarters as not being in the interests of consumers. Under these circumstances, there is no indication whatever that Congress ever intended to cover lawyers under the GLB Act's privacy title. To the contrary, there is every indication that such coverage was not intended.[35] As the Complaint notes, had Congress intended the GLB Act to cover lawyers, as a matter of normal practice—not to mention procedural fairness—it would have been referred to the House and Senate Judiciary Committees, which have jurisdiction over legislation that impacts on the practice of law. In fact, however, it was never referred to either of these committees.[36]

Is the FTC's Construction a Permissible One?

The second inquiry under *Chevron* is whether the agency's construction of the enabling statute is a permissible one. Given the unique structure of the GLB Act privacy provisions, it appears that the FTC's interpretation fails this test.

A key aspect of the GLB privacy provisions is that they explicitly preserve the authority of the states to adopt privacy laws that afford greater protection to consumers. Indeed, several states have actively considered legislation along these lines. Consistent with this objective, the GLB Act preserves state law that is "not inconsistent," and expressly provides that a state law affording *greater* protection to consumers than the GLB Act is "not inconsistent" and, therefore, is not preempted.[37] As the Complaint argues, the federal law, if construed to apply to lawyers, could effectively preempt the far greater protections afforded under state regulation of the practice of law. For example, the GLB Act specifically allows financial institutions to share nonpublic personal information with third parties, unless the consumer expressly "opts out" of such sharing. But attorneys clearly would be violating well-settled principles of privilege and confidentiality if they were to share client information without the client's consent.[38]

Thus, the FTC's construction is directly contrary to the structure and intent of the GLB Act. Clearly, state disciplinary rules would prohibit an attorney from selling her client list, containing personal information, to third-party marketers. But in principle, at least, an attorney could argue that the FTC regulations authorize her to do exactly that, as long as she has given the client an opportunity to "opt out."

Is the FTC's Definition Reasonable?

The FTC has adopted a definition of "financial institution" that it construes to include attorneys. As such, the definition is unreasonable, because it flies in the face of the "legislature's revealed design." As argued by NYSBA in its Complaint,[39] and again in its brief oppos-

ing the government's motion to dismiss,[40] there is nothing in the language or the legislative history of the GLB Act to suggest that Congress intended to include lawyers in the definition of "financial institution." To the contrary, there is every indication to the contrary.

As discussed above, the GLB Act was the product of many years of negotiation among financial institutions, the agencies that regulate them, the Congress and the executive branch, all aimed at streamlining the financial system and enabling American financial companies to compete with their foreign competitors. Thus, the legislative history states the Act's purpose to be "to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies and other financial services providers."[41] Lawyers manifestly do not "compete" with financial conglomerates; nor are financial firms permitted to practice law.

As noted, the privacy title was the caboose that was added to the train as it was about to leave the station—primarily to address the concern of consumer groups and elected officials that customer privacy be preserved in the brave new world of financial conglomerates. To adopt a definition that does not distinguish the practice of law from the services offered by these conglomerates manifestly does violence to the intent of Congress. Indeed, as NYSBA notes in its brief, the regulators of financial conglomerates supervise their activities to make certain that, in offering services such as tax planning, they do not inadvertently lap over into the unauthorized practice of law.[42]

The Tenth Amendment Argument

It is axiomatic that courts will avoid reaching a constitutional issue if the case presents narrower grounds for decision. Nonetheless, NYSBA sets forth a persuasive case to overturn the FTC's reading of the GLB Act on Tenth Amendment grounds.

The Tenth Amendment reserves to the states all powers not expressly granted to the federal government. When a federal statute appears to intrude into an area traditionally reserved to state regulation, therefore, Congress is presumed not to have intended "to precipitate a constitutional confrontation" unless its intent to do so is clear.[43] In *Gregory v. Ashcroft*, a group of Missouri state judges argued that the federal Age Discrimination in Employment Act (ADEA), which protects "employees" from age discrimination, preempted the Missouri state constitution, which mandated retirement for judges at age 70. ADEA specifically exempts "appointees on the policymaking level" from its protections.[44] The respondents in *Gregory* argued that appointed state judges fall within this exemption because, inter alia, state courts have supervisory power over the state bar.

In upholding Missouri's right to establish mandatory retirement age for appointed judges, the Supreme Court said that Congress' power to impose its will on the states is one that " . . . we must assume Congress does not exercise lightly." Accordingly, there must be a clear and unmistakable intent by Congress, in a "plain statement," to override state sovereignty before it will be inferred that that is the result. Applying this "plain statement" rule, the Court held that because the ADEA did not have clear, unambiguous language that appointed state judges were intended to be covered, it is presumed that they are not covered.[45]

Thus, it is not sufficient to infer, as the FTC did, that lawyers were intended to be included in the GLB Act privacy protections simply because they were not expressly excluded (applying, or misapplying, the hoary maxim of statutory construction that *expressio unius est exclusio alterius*). Given that regulation of lawyers, as officers of the court, is a long-standing state prerogative, the inclusion of lawyers is not to be inferred unless it is clearly stated.

FTC Administrative Precedent

The FTC is on record as asserting that it lacks the jurisdiction to reverse its interpretation, absent a formal rule-making or a legislative fix. Not the least ironic aspect of the situation is that an agency that sometimes has been aggressive, if not high-handed, in upsetting settled expectations in the past is suddenly so deferential regarding its own jurisdiction. Just two years ago, for example, in an informal staff opinion, the FTC abruptly reversed what the lending industry had long thought was its settled interpretation under the Fair Credit Reporting Act (FCRA). FCRA generally requires certain protections in connection with a "consumer report." The agency's long-standing interpretation was that a consumer report obtained in connection with a business, rather than personal, transaction—for example, a report on a sole proprietor in connection with a transaction for his business—was not covered by the protections of FCRA.

This interpretation, which appears in the agency's own FCRA regulations,[46] was abruptly overturned by an "informal" staff interpretation—which did not even bother to reference the apparently contrary language in the regulation, even as it baldly asserted that it was consistent with that regulation. The opinion stated that it was an informal staff opinion, and as such was "not binding" on the FTC.[47] While technically correct as a

matter of administrative law, this statement is more than a bit disingenuous; it cannot be reasonably supposed that such an opinion would be issued by a staff attorney without at least implicit approval from the agency, or that the agency would disregard it once it has been issued. Certainly the lending and leasing industry took it quite seriously; the letter generated a firestorm of protest, leading to the intercession of the general counsel of all four federal banking agencies in asking the FTC staff to reconsider. In response, a subsequent staff letter beat a hasty retreat from the worst aspects of the initial, ill-considered, position.[48]

The FTC's Commentary on FCRA, included as an appendix to its regulation, states that "Staff will continue to respond to requests for *informal* staff interpretations" [emphasis supplied], but goes on to provide a separate procedure for seeking "*formal* Commission interpretations of the FCRA . . ."[49] The FTC does not appear to make a similar distinction in the case of the GLB Act regulations, and it is not clear whether the agency regards the Beales Letter, which was signed by the Director of its Bureau of Consumer Protection, as a formal or informal interpretation. The NYSBA Complaint asserts that it is a final agency action, which as a matter of administrative law would be a prerequisite to suing the agency.

In any event, if it were so inclined, the FTC could reverse its interpretation and end the controversy without the need for legislation or a court determination. There is no need for a new rule-making, because it is not the FTC's rule that is at issue. The rule itself, as noted, makes no mention of attorneys; it is the FTC's interpretation of the rule that has created the problem. And the agency has the clear authority under the GLB Act to create exemptions; it has already exempted colleges and universities that comply with the Federal Educational Rights and Privacy Act.[50]

Corrective Legislation

Finally, the problem could be corrected by legislation amending the GLB Act to expressly exempt lawyers from the definition of "financial institution." As this article went to press, Reps. Judy Biggert (R-Illinois) and Carolyn Maloney (D-New York) were introducing legislation to this effect.[51] The American Bar Association's legislative office previously had indicated that it has the support of members from both parties for "narrowly crafted legislation to exempt lawyers" from the GLB Act privacy provisions,[52] and has established a working group to seek a legislative fix.[53]

Whether the legislation makes any headway is something else again, however. Congressman John LaFalce (D-New York), ranking member of the House Financial Services Committee, told the author in June that he regarded the FTC's interpretation as clearly violating the intent of the Congress, and intended to support a legislative fix. But Rep. LaFalce since has decided not to seek reelection. And with the public mood not favorable to professions such as law and accounting in the wake of Enron and other scandals, there is no great incentive for Congress to move this issue at this time. As one attorney active in the legislative effort noted, the response she got from members of Congress was, "Why would we tell the world we were trying to exempt lawyers from a privacy statute?"[54]

In the end, the attempt at a legislative fix may prove counterproductive. In the absence of a favorable court decision on the NYSBA (or ABA) action, the FTC can continue to take the position that it need not act to reconsider its position on the application of the GLB Act to lawyers, since legislation is pending. Indeed, that is precisely the position the agency has taken in commenting on the Biggert-Maloney initiative.[55]

Conclusion

The FTC's refusal to exempt attorneys from the GLB Act privacy rules is a classic example of the law of unanticipated consequences—as well as the mischief that can result when an administrative body interprets its mandate as the mechanistic application of a rule, rather than the exercise of judgment and common sense to achieve a legislative objective. If it is not reversed, its consequences will range from added cost and administrative burden, to potential disruption of the ethical governance of legal practice at the state level.

In *New York State Bar Ass'n v. Reno*, NYSBA's only prior venture into court, it succeeded in enjoining enforcement of a provision in the "Granny's Lawyer Goes to Jail" Act, which sought to impose criminal penalties on lawyers and others who counsel individuals to dispose of assets in order to qualify for Medicaid benefits.[56] The court agreed with NYSBA that the provision was patently unconstitutional; and besides, the Justice Department had made clear that it had no intention of enforcing it anyway.

In this case, by comparison, NYSBA is seeking not to enjoin, but to compel, a federal agency to issue a ruling in an area where it has declared it has no jurisdiction to act. The NYSBA's and ABA's efforts to judicially compel the agency to reverse its course present novel questions of administrative law. Under normal circumstances, an interpretation by an agency of a statute entrusted to its jurisdiction carries every presumption of validity, and will not be overturned unless arbitrary

and capricious, which is a heavy burden for the complainant to meet. In this case, however, the particular structure of the underlying legislation—which specifically empowers the agency to make exemptions in accordance with the legislative intent, and in effect not to preempt state laws that afford greater protection to consumers—offers some hope of a favorable decision.

While courts normally are loath to reach constitutional issues if they can be avoided, the Tenth Amendment issue here may be the ace in the hole. The FTC determined that lawyers were included in the rule simply because they were not expressly excluded and, arguably, some of their activities appear to fit the definition of financial institution. But as the NYSBA memo persuasively argues, under *Gregory v. Ashcroft* that is not sufficient—rather, given the historical and long-settled state regulation of the practice of law, the intent of Congress to cover attorneys would have to be explicit before it can be assumed that they are covered.

Absent a sudden reversal by the FTC—which, as noted, the FTC could do if it were so inclined—attorneys whose practice falls into one of the covered areas are best advised, as a matter of prudence, to comply with the FTC rule's notice requirements, at least pending the outcome of the NYSBA suit or a legislative fix. The good news is that it appears that attorneys who attempt to comply in good faith, by furnishing at least a minimal notice to their covered clients, will not be subject to enforcement action. And at the least, we attorneys can take some comfort from thinking of ourselves as happy dolphins for a change, rather than those other "dorsal finned denizens of the deep"[57] with which we are more often compared.

Endnotes

1. Gramm-Leach-Bliley Financial Modernization Act of 1999, P.L. 106–102 tit. V, § 501(a) (hereinafter "GLB Act").
2. Loomis, *With July 1 Deadline, State Bar Challenges FTC's Position*, 227 N.Y.L.J. No. 99 at 5 (May 23, 2002) (quoting outgoing NYSBA President Steven C. Krane) (hereinafter "Loomis").
3. *New York State Bar Ass'n v. Federal Trade Commission*, No. 1:02CV00810, complaint filed (D.D.C., Apr. 29, 2002); *see NYSBA sues FTC over privacy notice requirement for lawyers*, 44 State Bar News No. 3 (May/June 2002). *See also N.Y. Bar Association Seeks Exemption From Privacy Requirements*, 8 Andrews Sec. Litig. & Reg. Rep. No. 1 at 15 (June 19, 2002). NYSBA is the largest voluntary state bar association in the United States, with some 70,000 members.
4. *ABA Sues Over Privacy Statute*, A.B.A.J. eReport (Sept. 27, 2002), available online at http://www.abanet.org/journal/ereport/s27glb.html.
5. GLB Act tit. V, codified at 15 U.S.C. §§ 6801 *et seq*.
6. *See* Loomis, *supra* note 2 (quoting a consumer advocate to the effect that application of the GLB Act privacy provisions to lawyers is "silly").
7. *See Firms Face Deadline for Mailing Privacy Notices*, 225 N.Y.L.J. No. 124 at 5 (June 28, 2001).
8. Loomis, *supra* note 2 (quoting former NYSBA president Steven Krane).
9. *New York State Bar Ass'n v. The Federal Trade Commission*, Case No. 1:02CV00810, Complaint for Declaratory Relief filed April 29, 2002 (hereinafter "Complaint").
10. Loomis, *supra*.
11. *See* David L. Glass, remarks at Symposium of N.Y.L. Sch. J. Hum. Rts., Apr. 28, 2000, reprinted in 17 N.Y.L. Sch. J. Hum. Rts. 53, 61.
12. Complaint ¶ 52.
13. Philip K. Howard, The Death of Common Sense (Random House, New York 1994).
14. *Lawyers Try to Make Sense of Rule Requiring Privacy Notice to Clients*, 165 New Jersey L.J. No. 1 at 7 (July 2, 2001).
15. *Law Firms Scramble to Meet FTC Rule*, 24 Legal Times No. 27, July 2, 2001, at 20.
16. 65 Fed. Reg. 11,174 (Mar. 1, 2000).
17. *Law Firms Scramble to Meet FTC Rule*, *supra*.
18. 16 C.F.R. § 313.1(a).
19. 16 C.F.R. § 313.1(b).
20. *Id*.
21. *N.Y. Bar Seeks Exemption from Privacy Regulations*, 3 Andrews E-Business L. Bull. No. 10 (July 2002).
22. Complaint ¶ 39.
23. Letter from Martha Barnett, president of the ABA, to Hon. Timothy J. Muris, Chairman, FTC (July 10, 2001) (the "ABA Letter").
24. *Id.* at 4.
25. *See* Complaint ¶¶ 37–63.
26. *Law Firms Scramble to Meet FTC Rule*, *supra*.
27. Letter from Robert D. Evans, Director, Governmental Affairs Office, to J. Howard Beales, Director, Bureau of Consumer Protection (Aug. 22, 2001).
28. Letter from J. Howard Beales, Director, Bureau of Consumer Protection, to Robert E. Hirshon, President, and Robert D. Evans, Director, Governmental Affairs (Apr. 8, 2002) (the "Beales Letter").
29. Complaint ¶ 6.
30. The Complaint itself gives comparatively short shrift to the Tenth Amendment argument, which is developed at much greater length in the NYSBA's brief opposing summary judgment.
31. *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842 (1984).
32. *NationsBank v. VALIC*, 513 U.S. 251 (1995) (paraphrasing *Chevron*).
33. *See generally* Glass, *The Gramm-Leach-Bliley Act: Overview of the Key Provisions*, 17 Part One N.Y. Law Sch. J. of Hum. Rts. 1 (2000).
34. *Id.* at 26 *et seq*.
35. *See* Complaint ¶¶ 76-79.
36. Complaint ¶ 81.
37. 15 U.S.C. § 6807(a) and (b).

38. *See* Complaint ¶¶ 64-67.

39. Complaint ¶¶ 80-82.

40. *New York State Bar Ass'n v. The Federal Trade Commission*, Case No. 1:02CV00810, Memorandum of the New York State Bar Association in Opposition to the FTC's Motion to Dismiss the Complaint, Sept. 16, 2002 ("NYSBA Memo").

41. H.R. Rep. No. 106-434 at 1.

42. Federal Reserve Bank Holding Co. Supervision Manual § 3130.6 (1998).

43. NYSBA Memo at 23.

44. 29 U.S.C. § 630(f).

45. NYSBA Memo at 24.

46. Statement of General Policy or Interpretation, 55 Fed. Reg. 18804 (codified at 16 C.F.R. pt. 600) app. "Commentary on the Fair Credit Reporting Act" at 18811 ("[a] report on a consumer for credit or insurance in connection with a business operated by the consumer is not a 'consumer report,' and [FCRA] does not apply to it.").

47. *In re* Applicability of FCRA to Commercial Credit Reports, [Bank-Issue 98–99 FBLR Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 92–419 (Charles Tatelbaum, FTC Advisory Op. July 26, 2000); *available at* http://www.ftc.gov/os/statutes/fcra/tatelbaum.htm.

48. *See* Glass, *The Business Use Purpose under FCRA Is Alive and Well (Or Is It?)*, 20 Banking & Financial Services Policy Report No. 10 (Oct. 2001) at 1.

49. Commentary ¶ 4 (emphasis supplied).

50. *N.Y. Bar Association Seeks Exemption from Privacy Requirements*, 8 Andrews Sec. Litig. & Reg. Rep. No. 1 at 15.

51. A.B.A.J. eReport, Sept. 27, 2002 (http://www.abanet.org/journal/ereport/s27glb.html).

52. *ABA Talks with Congress About Gramm-Leach-Bliley Exemption*, 29 Florida Bar News No. 16, Aug. 15, 2002, at 5.

53. *Taking it to Congress*, 88-JUN A.B.A.J. 70 (June 2002).

54. *Lawyers Still Lax About Reach of Gramm-Leach*, 169 New Jersey L.J. No. 93 at 1 (July 8, 2002).

55. *See* A.B.A.J. eReport, Sept. 27, 2002, *supra*.

56. *New York State Bar Ass'n v. Reno*, 999 F. Supp. 710 (N.D.N.Y. 1998).

57. Loomis, *supra*.

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The Sarbanes-Oxley Act of 2002

By Guy P. Lander

The President has signed legislation, the Sarbanes-Oxley Act of 2002 (the "Act"), that amends U.S. securities and other laws in significant ways. The law changes corporate governance, including the responsibilities of directors and officers; the regulation of accounting firms that audit public companies; corporate reporting; and enforcement. Many of the Act's provisions will be enhanced by SEC rulemaking and, probably, by stock market listing standards as well.

Generally, the Act applies to U.S. and non-U.S. public companies that have registered securities (debt or equity) with the SEC under the Securities Exchange Act of 1934.

The Act is lengthy. The implications of the Act will not be fully known until the SEC adopts implementing rules and, thereafter, as interpretations develop, whether by the SEC or in litigation. This memorandum is a summary and not a complete description of the Act. It does not constitute legal advice for any particular situation.

"The implications of the Act will not be fully known until the SEC adopts implementing rules and, thereafter, as interpretations develop, whether by the SEC or in litigation."

Executive Summary

The Act establishes new law or changes existing law in the following areas:

1. Corporate Responsibility

Corporate governance and the responsibilities of directors and officers have been changed, including:

a. Enhanced audit committee responsibility and auditor oversight, including pre-approval of non-audit services by the auditor and disclosure of all non-audit services of the auditor approved by the committee.

b. CEOs and CFOs must certify that the company's annual and quarterly reports are accurate and not misleading, and that their responsibility for evaluating internal controls has been met.

c. Immediate ban on personal loans by companies to their directors or executives other than certain regular consumer loans. Existing loans may continue provided they are not revised or extended.

2. Auditor Independence and Regulation of Auditors

New standards for determining auditor independence have been established and a new oversight board for the regulation of auditors will be created. New audit standards include a prohibition against independent auditors providing many non-audit services (other than tax services) and mandatory audit partner rotation.

3. Enhanced Disclosure

The quality and timeliness of company information has been enhanced, including:

a. management and auditors must annually assess their company's internal controls and related disclosures;

b. additional disclosure of off-balance sheet financing and financial contingencies;

c. additional regulation of the presentation of *pro forma* information;

d. accelerated disclosure under section 16 of the Exchange Act (within two business days) of insider stock transactions; and

e. "real time" disclosure of certain information.

4. Other Provisions

Other provisions provide:

a. Protections for the independence of security analysts and enhanced disclosure of their potential conflicts of interest.

b. Expanded SEC review of company reports, enhanced SEC enforcement powers and increased penalties for securities law violations.

A more detailed description of the Act's principal provisions follows.

I. Corporate Responsibility

A. Audit Committees

1. Oversight and Independence

The audit committee of an issuer will appoint, compensate and oversee the work of the issuer's auditor.

Any issuer that does not meet the audit committee requirements will be delisted from NASDAQ and the national securities exchanges.

Each member of the audit committee must be "independent," in that each member must be unaffiliated with the issuer and is prohibited from accepting any consulting, advisory, or other compensatory fees from the issuer other than fees for services as a member of the board of directors and the audit committee.

2. Audit Committee Financial Expert

The SEC must issue rules requiring each public company to disclose, in its periodic reports, whether the board's audit committee has at least one member who is a "financial expert" (and if not, why not). Subject to SEC rules to be adopted, a financial expert is someone who, through education and experience as a public accountant or auditor or a principal financial officer, comptroller or principal accounting officer of an issuer, has an understanding of U.S. GAAP and financial statements and experience in preparing or auditing financial statements of comparable issuers, in the application of GAAP for accounting for estimates, accruals, and reserves, experience in internal accounting controls, and in the functioning of audit committees.

3. Complaints

Each audit committee must establish procedures for receiving, retaining and handling complaints received by the issuer concerning accounting, internal accounting controls, or auditing matters. The procedures must also enable the issuer's employees to confidentially submit their concerns about questionable accounting or auditing practices.

4. Advisers and Funding

The audit committee may engage independent counsel and other advisers necessary to carry out its duties. And, the issuer must provide adequate funding, as the audit committee may determine, for compensating the issuer's auditor and any of the committee's advisers.

B. Senior Officers

1. Certification of Periodic Reports

The CEO and CFO of the issuer must certify in each annual or quarterly report (e.g., Forms 10-Q, 10-K and 20-F) that:

(a) each officer has reviewed the report;

(b) based on each officer's knowledge, the report does not contain any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;

(c) based on each officer's knowledge, the financial statements, and other information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report;

(d) together the CEO and CFO:

(i) are responsible for establishing and maintaining internal controls;

(ii) have designed the internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;

(iii) have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days before the report; and

(iv) have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date.

(e) together, the CEO and CFO have disclosed to the issuer's auditor and the audit committee :

(i) all significant deficiencies in the design or operation of the issuer's internal controls that could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the auditor any material weaknesses in internal controls; and

(ii) any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

(f) the CEO and CFO have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls after the date of their evaluation, including any corrective actions for significant deficiencies and material weaknesses.

This certification requirement is effective upon adoption by the SEC of implementing rules, which shall not be later than 30 days after enactment. There is another similar certification requirement discussed below under "Penalties" which is effective immediately and applies to all upcoming periodic reports. The knowing and willful violation of the certification requirement described below is subject to criminal penalties.

2. Code of Ethics for Senior Financial Officers

The SEC must adopt rules requiring public companies to disclose in periodic reports whether they have adopted a "code of ethics" for senior financial officers and if not, the reason why not. Additionally, the SEC rules must require the immediate public disclosure of any change in, or waiver of, the code of ethics of the public company. A "code of ethics" must include standards to promote (a) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and company relationships; (b) full, fair, accurate, timely and understandable disclosure in the periodic reports filed with the SEC by the public company; and (c) compliance with applicable governmental rules and regulations.

3. Ban on Loans to Management

Issuers (both U.S. and foreign companies, and their subsidiaries) are prohibited from directly, or indirectly, extending personal loans to their executive officers and directors. The primary exceptions to this prohibition are: (a) existing loans that are not modified or renewed; (b) certain consumer credit arrangements such as home improvement and credit card loans, provided in each case that the loans are (i) made in the ordinary course of business, (ii) of a type generally made available by the issuer to the public, and (iii) made on market terms or terms no more favorable than those offered to the general public, and for issuers that are broker-dealers, margin loans to their employees, unless used to carry stock of the issuer. This ban is effective immediately.

4. Forfeiture by CEO or CFO of Certain Bonuses and Profits

If, as a result of misconduct, an issuer must restate its financials due to its material non-compliance with any financial reporting requirement, the CEO and CFO must reimburse the issuer for: (1) any bonus or other incentive- or equity-based compensation received during the 12-month period following the first public issuance or filing of the non-complying document with the SEC (whichever occurs first); or (2) any profits realized from the sale of the issuer's securities during that 12-month period. This provision is effective immediately.

5. Improper Influence on the Conduct of Audits

Officers and directors, or any persons acting under their direction, are prohibited from fraudulently influencing, coercing, manipulating or misleading any auditor of the issuer's financial statements for the purpose of rendering the audited financial statements materially misleading. This provision is effective upon adoption by the SEC of implementing rules within 270 days of enactment.

6. Insider Trades During Pension Fund Blackout Periods

Executive officers and directors are prohibited from buying or selling their equity securities of the issuer during pension fund "blackout periods" if those directors or executive officers acquired the securities in connection with their service or employment in those capacities. Any profit realized by a director or executive officer from such prohibited trading will be recoverable by the issuer, irrespective of the intention of the director or executive officer in entering into the transaction. This remedy may be pursued by a shareholder if the issuer does not commence an action to recover the profit within 60 days of a request by the shareholder or if the issuer fails to diligently pursue the action. This provision is effective 180 days after enactment.

"Blackout periods" are periods of more than three business days during which trading in the security by 50 percent or more of the beneficiaries or participants in a company retirement plan is suspended. ERISA will be amended to require that the administrator of a section 401(k) or other individual account retirement plan provide 30 days advance notice of a blackout period to affected participants and beneficiaries.

7. Officer and Director Bars and Penalties

At the request of the SEC, an individual may be barred by court order from serving as an officer or director of a company if he has violated the general anti-fraud provisions of the securities laws (section 10(b) of the Exchange Act, section 17(a) of the Securities Act, and the related SEC rules) and his activities are found by the court to show that he is "unfit" to serve as an officer or director of a public company. Previously, this standard by which courts may bar an officer or director from serving a public company was "substantial unfitness." This provision is effective immediately.

II. Auditor Independence, Regulation of Audits and Auditors

A. Services Prohibited to Auditors

To preserve its independence, a registered public accounting firm (generally described here as "auditor") and its associated persons, will be prohibited from providing to an issuer, contemporaneously with an audit, the following non-audit services:

1. bookkeeping or other services related to the accounting records or financial statements;
2. financial information systems design and implementation;
3. appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
4. actuarial services;
5. internal audit outsourcing services;
6. management functions or human resources;
7. broker or dealer, investment adviser, or investment banking services;
8. legal services and expert services unrelated to the audit; and
9. any other service that the Public Company Accounting Oversight Board determines to be impermissible.

Auditors may provide all other non-audit services, including tax services, provided the services are approved in advance by the issuer's audit committee.[1] Additionally, all audit services provided to an issuer must be pre-approved by its audit committee.[2] Pre-approvals for services may be made when approving the audit engagement.

The pre-approval requirement will be waived for non-audit services if the aggregate amount of all such non-audit services provided to the issuer is *de minimus* (i.e., they constitute less than five percent (5%) of the total amount of revenues paid by the issuer to its auditor during the fiscal year in which the non-audit services are provided); the services were not recognized by the issuer at the time of the engagement to be non-audit services; and the services are promptly brought to the attention of the audit committee of the issuer and approved before the completion of the audit by the audit committee (or its designated members).

All approvals by an audit committee of non-audit services of the auditor must be disclosed in the issuer's Exchange Act periodic reports. Providing comfort letters for a securities offering is considered an audit service.

B. Audit Partner Rotation

The lead (or coordinating) audit partner and the lead review partner will have to be rotated off the audit engagement after five years.

C. Auditor Reports to Audit Committee

Each auditor will be required to timely report to the audit committee of its public company clients:

1. all critical accounting policies and practices to be used;
2. all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management of the issuer, the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditor; and
3. other material written communications between the auditor and management of the issuer, such as any management letter or schedule of unadjusted differences.

D. Prohibition Where CEO or CFO Previously Employed by Auditor

An auditor will be prohibited from providing audit services to an issuer if the CEO, controller, CFO, or chief accounting officer, was employed by the auditor and participated in any capacity in the audit of that issuer within one year before initiation of the audit.

III. Public Company Accounting Oversight Board

A. Creation

The Act creates a new Public Company Accounting Oversight Board ("Board"), to oversee the audit of public companies subject to the securities laws and related matters. The Board will consist of five full-time members, two members of which must be or must have been certified public accountants. Members will be approved by the SEC. The SEC will have oversight and enforcement authority over the Board and no rule of the Board will become effective without prior approval of the SEC. Funding for the Board's operations will be provided by assessing auditors and issuers.

B. Duties

The Board will:

1. register public accounting firms that prepare audit reports for issuers;

2. establish auditing, quality control, ethics, independence and other standards for the preparation of audit reports for issuers;
3. inspect registered public accounting firms (annually for larger firms);
4. investigate and conduct disciplinary proceedings and sanction registered public accounting firms and their associated persons;
5. perform such other duties or functions as the Board or the SEC determines to be necessary or appropriate to promote high professional standards and improve the quality of audit services offered by registered public accounting firms;
6. enforce compliance with the Act, the rules of the Board, professional standards, and the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants; and
7. set the budget and manage the operations of the Board and its staff.

C. Registration

The Board is expected to be functioning within 270 days of enactment. Beginning 180 days thereafter, only auditors that are registered with the Board will be permitted to prepare audit reports for any issuer. In registering, auditors must consent to comply with any request of the Board or the SEC for testimony or production of documents.

D. Foreign Public Accounting Firms

Any foreign public accounting firm that prepares an audit report for any issuer will be subject to the Act and the rules of the Board and the SEC issued under the Act, to the same extent as a U.S. auditor. Registration under the Act does not by itself create a basis for subjecting a foreign public accounting firm to the jurisdiction of the federal or state courts, other than for controversies between the foreign firm and the Board.

Additionally, the Board may determine that a foreign public accounting firm that does not issue audit reports, but nonetheless plays a substantial role in preparing and furnishing such reports for particular issuers should be treated as a public accounting firm for purposes of registration under the Act.

E. SEC Authority Over U.S. GAAP

The Act gives the SEC enhanced authority to determine what constitutes U.S. GAAP on its own for SEC reporting purposes or based on activities of private standard setting bodies, over which it is also given additional oversight powers.

IV. Enhanced Disclosures

The provisions of the Act described below relating to disclosure obligations are intended to enhance the quality and timeliness of information made publicly available by issuers and their insiders. The Act does not exclude foreign companies that file periodic reports with the SEC from the disclosure requirements. Consequently, at least for now, both U.S. and non-U.S. issuers will be subject to all of the disclosure requirements, except for those disclosures of insider trading (under section 16 of the Exchange Act), which currently do not apply to foreign issuers.

A. Correcting Adjustments by Auditors

Section 13 of the Exchange Act has been amended. It now requires reporting companies to disclose in their periodic reports any material correcting adjustments to any "financial report" filed with the SEC that contains financial statements required to be prepared under, or reconciled to, U.S. GAAP, that have been identified by the issuers' auditors in accordance with GAAP or SEC rules. This provision may be effective immediately, but it requires that the material correcting adjustment be identified by "a registered public accounting firm" and registration will not be required for some time.

B. Off-Balance Sheet Transactions

The SEC must issue rules requiring each annual and quarterly financial report filed with the SEC to disclose all material "off-balance sheet" transactions, arrangements, obligations, and other relationships with unconsolidated entities or other persons that may have a material current or future impact on the issuer's financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses. This provision will be effective within 180 days of enactment when the SEC adopts implementing rules.

C. *Pro Forma* Financial Information

The SEC is to adopt more stringent rules for *pro forma* financial information disclosed by public companies. *Pro forma* financial disclosures must be presented in a manner that does not contain any untrue statement or omission of a material fact necessary to make the financial information not misleading, and *pro forma* financial data must be reconciled with the corresponding financial condition and results of operations under GAAP.

D. Accelerated Filing of Changes in Beneficial Ownership by Insiders

Section 16 of the Exchange Act is amended to require directors, officers and over-10 percent shareholders of U.S. reporting issuers, to disclose changes in

beneficial ownership of their issuer's equity securities by the end of the second business day after the transaction. Insiders must also report purchases or sales of "securities-based swap agreements" within the same two business days. The SEC may modify the rule. This provision is effective 30 days after enactment.

Additionally, within one year of enactment, insiders must file their section 16 reports electronically, and the SEC must post them on its EDGAR Web site within one day of filing. Issuers with Web sites must also post on their Web sites their insiders' statements within one day of SEC filing.

E. Mandated Disclosures Regarding Fitness of Management and Adequate Internal Controls

The SEC must adopt rules requiring issuers' annual reports to contain an "internal control report" prepared by management. The internal control report must (a) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and (b) assess, as of the end of the last fiscal year, the effectiveness of the internal control structure and procedures for financial reporting. Management's assessment of the internal control report must be attested to by the issuer's auditor. This attestation would be deemed part of the audit engagement. This provision would be effective upon adoption of SEC implementing rules (with no deadline).

F. Real-Time Disclosures

Each issuer is required to disclose, in plain English and on a "rapid and current" basis, such information concerning material changes in financial condition or operations as the SEC may require. The disclosure of trend and qualitative information and graphic presentations may be required. This provision is effective upon adoption of SEC implementing rules (with no deadline).

Currently, the SEC has two projects underway to increase and accelerate current reporting requirements under Form 8-K. Further use by the SEC of its new authority under the Act could subject issuers to so-called "evergreen" disclosure requirements, where existing disclosure is required to be updated as material events occur. Any such change might render unnecessary the need for the SEC's Regulation FD, which was intended to prevent selective disclosure of material inside information. Upon adoption, that regulation was criticized as unnecessarily restricting or complicating corporate communications. Under current SEC interpretations and judicial decisions, absent an obligation under Regulation FD, public companies are at times permitted to defer disclosures of material events if no "duty to update" exists at that time.

G. Enhanced Scrutiny

The SEC must now review disclosures made by issuers, including their financial statements, on a regular and systematic basis, which shall be no less frequently than once every three years. The SEC must base its scheduling of reviews on specific factors, which include: companies that have issued material restatements of financial results; companies that experience significant volatility in their stock price; companies with the largest market capitalization; emerging companies with disparities in price to earnings ratios; companies whose operations significantly affect a material sector of the economy; and any other factors that the SEC may deem relevant.

V. Other Provisions

A. Analyst Conflicts of Interest

The Act adds a new section 15D to the Exchange Act. Under this new provision, the SEC or, at its direction, a national securities exchange or the NASD must adopt rules to address conflicts of interests for securities analysts. These provisions are similar to those recently adopted by the NYSE and NASD. The Act's new provisions:

1. restrict the prepublication clearance of research reports by investment bankers (or persons not directly responsible for investment research);
2. limit the supervision and compensation review of securities analysts to non-investment bankers;
3. prohibit retaliation against securities analysts for publishing negative research reports that may adversely affect a present or prospective investment banking relationship of the broker-dealer;
4. define blackout periods during which underwriters or dealers that have participated in a public offering of securities may not publish research reports relating to those securities or to the issuer;
5. require effective "Chinese Walls" within broker-dealers to separate securities analysts from the review, pressure or oversight of investment bankers;
6. require disclosure of analyst conflicts of interest in public appearances and research reports, including:
   (i) any investments of the analyst in the issuer;
   (ii) any compensation received by the analyst or broker-dealer from the issuer;

(iii) whether the issuer is, or within 12 months preceding the research report has been, a client of the broker-dealer and, if so, the types of services provided to the issuer; and

(iv) whether the analyst received compensation for a research report, based upon (among other factors) the investment banking revenues of the broker-dealer.

B. Rules of Professional Responsibility for Attorneys

The SEC is required to establish minimum standards of professional conduct for attorneys representing issuers before the SEC. Attorneys appearing before the SEC on behalf of issuers will have to report evidence of material violations of securities' laws, breaches of fiduciary duty or similar violations by the company or its agents to its chief legal counsel or CEO. If the counsel or CEO does not respond appropriately, the attorney must report the evidence to the audit committee, to another committee composed entirely of outside directors, or to the board of directors as a whole.

C. Whistle-Blower Protection

The Act protects employees of public companies from retaliation for providing evidence of fraud. No public company may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee because the employee lawfully provides information or otherwise assists in an investigation of conduct of the public company that the employee reasonably believes violates the securities laws or otherwise assists a securities or fraud-related investigation of the public company. Any employee who is retaliated against for such whistle-blowing activities may sue the company within 90 days of discharge or other retaliatory action by the employer. An employee that prevails under this provision is entitled to receive compensatory damages and attorneys' fees.

D. Debts Nondischargeable in Bankruptcy

The Act amends Federal bankruptcy laws to provide that a debtor may no longer discharge in bankruptcy any order or claim for a violation of any federal or state securities law, or for common law fraud, deceit or manipulation in connection with the purchase or sale of any security.

E. Temporary Freeze Authority for SEC

The SEC may, during an investigation into securities law violations by a public company or a director, officer, partner, controlling person, agent or employee of a public company, seek a temporary order from a federal district court requiring the company to escrow extraordinary payments (whether compensation or otherwise) to any such person for 45 days. The 45-day freeze period may be extended once for another 45 days. It may also be extended until the proceeding expires.

F. SEC Censure

The SEC may censure or bar any person from appearing before the SEC, if it finds that such person (i) is not qualified to represent others, (ii) lacks the requisite character or integrity or has engaged in unethical conduct, or (iii) has wilfully violated, or wilfully aided or abetted the violation of, any provision of the securities laws, rules or regulations.

VI. Criminalization of Misconduct, Penalties and Statutes of Limitations

A. Criminalization of Misconduct

The Act makes criminal the following misconduct, effective immediately:

1. CEO and CFO Officer Certification Requirement

All periodic reports containing financial statements filed with the SEC must be accompanied by a written statement by the CEO and CFO of the issuer (or equivalent), certifying that: (1) the periodic report fully complies with the rules of the Exchange Act governing periodic reports; and (2) the information contained therein fairly presents, in all material respects, the financial condition and results of operations of the issuer. Knowingly certifying a statement that does not comport with all these requirements will be an offense punishable by a fine of up to $1 million and imprisonment for up to ten (10) years. Wilfully giving the certification knowing that it is false will be an offense punishable by a fine of up to $5 million and imprisonment for up to twenty (20) years.

This certification requirement applies to all public companies (in addition to the 947 of the largest U.S. companies already required to submit a separate sworn statement under the SEC June 27 order). This requirement is effective immediately, for all future periodic reports (probably Forms 10-Q, 10-K and 20-F only, not Forms 8-K and 6-K) filed on or after July 30.

The form of the certification has yet to be determined by the SEC. However, because the Act specifies a statement "accompanying" the report, it should probably be submitted separately from the filing itself.

Finally, this certification requirement, required under section 906 of the Act, differs significantly from

the one under section 302 described earlier, specifically in terms of standards for certification and the consequences of same. The SEC will have to clarify how this will be resolved.

2. Destruction of Corporate Audit Records

The knowing and wilful destruction of any audit work papers or other documents related to an audit will be subject to a maximum 10 years in prison. Auditors of a public company must maintain all audit or review work papers for five years.

3. Destruction, Alteration or Falsification of Records

Destruction, alteration, or falsification of records in federal investigations and bankruptcy proceedings with the intent to impede or influence such investigations or proceedings is subject to a maximum 20 years imprisonment.

4. Criminal Penalties for Defrauding Shareholders of Public Companies

The Act increases the penalties under the federal mail fraud statute by subjecting anyone convicted of securities fraud or attempted securities fraud to a fine or imprisonment for up to 25 years or both.

B. Increased Penalties and Other Remedies

1. Attempts and Conspiracies to Commit Criminal Fraud Offenses

The Act amends the federal criminal fraud statute and provides that any person who attempts or conspires to commit any offense under the federal criminal fraud statute (mail, wire, bank or securities fraud) will be subject to the same penalties as those prescribed for the underlying offense.

2. Criminal Penalties for Mail and Wire Fraud

The penalty for mail and wire fraud will be increased from five (5) to twenty (20) years in prison.

3. Criminal Penalties for ERISA Violations

The Act amends the maximum fine for violations of ERISA by a natural person from $5,000 to $100,000 and increases the maximum jail term from one (1) year to ten (10) years. Penalties for violations committed by companies will also increase from $100,000 to $500,000.

The foregoing penalties are effective immediately.

4. Increased Criminal Penalties Under Securities Exchange Act

The Act amends the Exchange Act to provide that a person who wilfully violates any provision of the Exchange Act, or any rule or regulation thereunder, or who wilfully and knowingly makes a statement in an application, report or document required to be filed under the Exchange Act, which is false or misleading with respect to any material fact, will be subject to a fine of $5 million (increased from $1 million) or imprisonment for up to twenty (20) years (increased from ten (10) years), if such person is a natural person; and an increase in the fine from $2.5 million to $25 million for a person other than a natural person.

5. Retaliation Against Informants

Knowing and intentional retaliation against informants providing truthful information relating to the commission or possible commission of a federal offense will be punishable by a fine and imprisonment for up to twenty (20) years.

C. Statute of Limitations for Securities Fraud Lengthened

The Act lengthens the statute of limitations for securities fraud. A private right of action that involves a claim of fraud, deceit, manipulation or contrivance in violation of a regulatory requirement concerning the securities laws may now be brought not later than the earlier of (i) two years after the discovery of the facts constituting the violation, or (ii) five years after the violation. This provision is effective immediately.

VII. Studies and Reports

The Act requires that a number of studies and reports be conducted:

A. Mandatory Rotation of Auditors

The Comptroller General of the United States is directed to conduct a study and review of the potential effects of requiring the mandatory rotation of registered public accounting firms.

B. Accounting Standards

The SEC is directed to conduct a study on the adoption by the U.S. financial reporting system of a principles-based accounting system.

C. Consolidation of Public Accounting Firms

The Comptroller General is directed to conduct a study of the factors that led to consolidation among public accounting firms, the effects of the consolidation, resulting problems, possible solutions and related issues.

D. Credit Rating Agencies

The SEC is directed to conduct a study of the role and function of credit rating agencies in the operation of the securities market.

E. Violators and Violations

The SEC is directed to conduct a study to determine, based on the period from January 1, 1998, to December 31, 2001, the number of securities professionals practicing before the SEC who have engaged in violations of the federal securities laws.

F. Enforcement Actions

The SEC is directed to review and analyze all its enforcement actions involving violations of reporting requirements imposed under the securities laws, and restatement of financial statements, over the past five years. The SEC is directed to identify areas of reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management and provide recommendations for regulatory or legislative action to address the concerns of the study.

G. Investment Banks

The Comptroller General is directed to conduct a study on whether investment banks and financial advisers assisted public companies in manipulating their earnings and obfuscating their true financial condition.

VIII. SEC Rulemaking

Although the requirements of the Act are clear in broad measure, in many cases the details and effects of the Act will not be known until implementing regulations are issued over the course of the next year. The Act requires the SEC to issue rules on the following timetable:

SEC Rules	Dates Required
A. CEOs and CFOs to certify annual and quarterly reports.	Effective by August 29, 2002.
B. Companies to disclose whether at least one audit committee member qualifies as a "financial expert."	Proposed rules by October 28, 2002; final rules by January 26, 2003.
C. Prevention of directors and officers fraudulently influencing or misleading a company's auditors.	Proposed rules by October 28, 2002; final rules by April 26, 2003.
D. Disclosure of whether a company has adopted a code of ethics.	Proposed rules by October 28, 2002; final rules by January 26, 2003.
E. Disclosure of material off-balance sheet transactions and accurate disclosure of *pro forma* information.	Final rules by January 26, 2003.
F. Minimum standards of professional conduct for attorneys who practice before the Commission.	Final rules by January 26, 2003.
G. Recognizing Public Company Accounting Oversight Board.	By April 26, 2003.
H. Securities exchanges and associations required to prohibit listing of a company whose audit committee is not composed entirely of independent board members.	SEC rules to be effective by April 26, 2003.
I. Analyst independence.	Final rules by July 30, 2003.

Endnotes

1. The term "audit committee" means a committee or equivalent body established by and amongst the Board of Directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer, and if no such committee exists with respect to an issuer, the entire Board of Directors of the issuer.
2. The audit committee may delegate the authority to grant pre-approvals to one or more designated members of the audit committee who are independent directors. However, the decisions of any member to whom pre-approval authority is delegated must be presented to the full audit committee at each of its scheduled meetings.

ADDENDUM I

New CEO and CFO Certification Requirements and Suggested Procedures

The SEC has adopted new rules that require an issuer's principal executive officer and principal financial officer to certify the contents of the issuer's quarterly and annual reports. These rules (Rules 13a-14 and 15d-14 under the Exchange Act) implement section 302 of the Sarbanes-Oxley Act (the "Act"). These rules are in addition to the certification requirements of section 906 of the Act.

1. Two Separate Certification Requirements

Currently, there are two separate certification requirements, one backed by criminal penalties under section 906 of the Act and one under section 302 of the Act, which are not sufficiently harmonized under the Act. The section 906 certification requirement was effective immediately upon enactment of the Act without the need for SEC implementing rules. The SEC has now adopted new implementing rules under section 302 for the "civil certification."

2. Section 906: The Criminal Certification

a. **Application:** A section 906 certification must accompany all periodic reports filed with the SEC (i.e., reports on Forms 10-K, 10-Q, 20-F and 40-F (for MJDS issuers)). Absent further guidance, we believe that the section 906 certification is not required for reports furnished to the SEC in Form 6-K or 8-K.

b. **The Certification**: For each periodic report containing financial statements, both the CEO and CFO (or their functional equivalents) must certify that "the periodic report . . . fully complies with the requirements of section 13(a) or 15(d) of the [Exchange Act] and the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer." This certification is not limited to the financial statements in the reports.

The section 906 certification must "accompany" the periodic report. Depending on the circumstances, practice varies as to whether to file the section 906 certification as an exhibit to the report or supplementally so that it is neither an exhibit nor in the body of the report.

3. Section 302: The Civil Certification

a. **Application:** The new SEC rules apply to all issuers filing periodic reports with the SEC under section 13(a) or 15(d) of the Exchange Act. Consequently, the rules apply to all non-U.S. companies with securities listed on a U.S. exchange or NASDAQ or otherwise required to file an annual report. The new rules require the certification for annual reports on Forms 10-K, 10-KSB, 20-F and 40-F (for MJDS issuers), quarterly reports on Forms 10-Q and 10-QSB, and any amendments, and transition reports, to any of those reports. The rules do not apply to reports on Forms 6-K or 8-K, even if the Form 6-K contains interim financial information. The rules also do not apply to non-U.S. companies furnishing information to the SEC under the Rule 12g3-2(b) information-supplying exemption.

b. **The Certification:** For each quarterly and annual report filed by the issuer, both the CEO and CFO (or their functional equivalents) must certify that:

1. he or she has reviewed the report;
2. based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;
3. based on his or her knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report;
4. he or she and the other certifying officers:
   a. are responsible for establishing and maintaining "disclosure controls and procedures" (a newly defined term for the controls and procedures for non-financial disclosure) for the issuer;
   b. have designed such disclosure controls and procedures to ensure that material information is made known to them, particularly during the period in which the periodic report is being prepared;
   c. have evaluated the effectiveness of the issuer's disclosure controls and proce-

dures as of a date within 90 days prior to the filing date of the report; and

d. have presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on the required evaluation as of that date;

5. he or she and the other certifying officers have disclosed to the issuer's auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function):

a. all significant deficiencies in the design or operation of internal controls (relating to internal controls for financial reporting) which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and

b. any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and

6. he or she and the other certifying officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

4. Certification Discussion

The certification will be on the applicable SEC form after the signature section and may not be changed in any way. The certification covers three areas. First, it covers the material accuracy and completeness of the filed report. Second, it covers fair presentation of financial statements (including footnotes), selected financial data, MD&A, and other financial information. Here, "fair presentation" is not limited to "presented in accordance with GAAP," but rather means that the financial information, viewed as a whole, is materially accurate and complete. This part of the certification encompasses the selection of appropriate accounting policies, proper application of those policies, disclosure of financial information that is informative and reflective of the underlying transactions and events and any other disclosure needed to provide investors with a materially accurate and complete picture of the issuer's financial condition and results of operations.

Last, the certification covers "disclosure controls and procedures" and "internal controls." Disclosure controls and procedures is a new term defined as the controls and other procedures of an issuer that are designed to address the quality and timeliness of non-financial disclosure. These disclosure procedures must ensure that information required to be disclosed in SEC reports is gathered, analyzed, communicated to senior management and disclosed to the public within the required time periods.

The reference in the certification to "internal controls" is intended to cover existing standards for an issuer's internal controls and procedures for financial reporting and asset control. See section 13(b) of the Securities Exchange Act and AICPA Professional Standards AU § 319.06.

5. Disclosure Controls and Procedures

First, companies must ensure that their disclosure controls and procedures gather important information in a timely way. The information to be gathered is that (a) required under the relevant form and related rules, (b) needed to assess whether to disclose developments and risks to the issuer's business, and (c) such further material information that may be necessary to make the required statements not misleading. The controls and procedures must enable the CEO and CFO to supervise and review the information gathered and report the results to the public.

Second, the issuer, under the supervision of the CEO and CFO, must evaluate the effectiveness of the design and operation of its disclosure controls and procedures within 90 days of the filing date of the report.

Last, disclosure controls and procedures are required to be designed, maintained and evaluated to ensure full and timely disclosure in current reports, proxy materials and information statements, even though there is no specific certification requirement for those reports.

6. Effective Date

Generally, the first three items of the certification, which relate to the accuracy and completeness of the report, apply to quarterly and annual (including transition) reports filed after August 29, 2002. The second three items of the certification, which relate to the disclosure controls and internal controls, apply to quarterly and annual (including transition) reports filed for periods ending after August 29, 2002.

7. Proposed Steps to Support the Certification

No one set of procedures will be right for each company. Each company should re-examine its procedures for gathering, evaluating and disclosing financial and non-financial information for its periodic reports, then consider whether it would be appropriate to revise or

enhance these procedures in light of current requirements.

The following are a list of considerations that may offer guidance. The procedures actually selected should be designed for each company based on its particular circumstances, management, and controls and financial reporting systems already in place.

a. Procedures for Gathering Information

1. The CFO should review with senior finance staff members and auditors the company's record keeping and systems and internal controls to ensure that the CEO's and CFO's reliance on the financial information produced is justifiable.

2. The CEO and CFO should consider establishing a formal or informal disclosure committee that reports to them. While the SEC refrained from suggesting any particular disclosure controls and procedures, the one recommendation it did make was for such a committee to consider the materiality of information and ensure public disclosure on a timely basis. This committee could ensure that the company's systems gather the information necessary to meet its public disclosure requirements as well as monitor the integrity of the information received. The committee might include a senior counsel with principal responsibility for disclosure matters, the principal accounting officer or controller, principal risk management officer, chief investor relations officer and other officers or employees (such as a representative from each business unit and other department) that are most in the flow of information.

3. The committee should evaluate the process by which non-financial information is gathered and, if necessary, develop additional controls to ensure that the required information is provided to the committee or other persons preparing the report in a timely manner.

4. The committee should verify that the report was distributed to, and information updated by, a representative of each business unit and other department so that information is gathered covering each section of the required report, the company's financial performance, controls and financial reporting structures. The committee could include having the chief financial person of each business unit present preliminary results to the committee and respond to questions.

5. The committee members should review prior SEC reports, at least going back to the last annual report, to address any disclosure issues raised by earlier filings (including adjustments in trends). Issues identified when the prior filing was made should be re-examined. Any subsequent developments that affect the prior reported information or that affect any advice or expertise relied upon in preparing the prior reports should be examined.

6. The committee should review the periodic report being prepared to ensure its accuracy and completeness. The committee should also verify that a careful check of the report was conducted by in-house or outside counsel to confirm that it fully complies with the requirements of the applicable SEC form.

7. In reviewing financial information, the committee should carefully review the critical accounting policies of the company. These may include revenue recognition policies, off-balance sheet commitments, special purpose vehicles, capitalization of expenses, adequacy of reserves, exposure to customers and suppliers with financial difficulties and other issues.

8. If any committee member or other officer of the company has any concern that remains unresolved about the thoroughness of the review or accuracy of the report or any part of it, that concern should be raised with the CEO and CFO and that section should be reviewed closely with those who prepared it.

9. If any company filing is subject to an SEC comment letter, this should be disclosed to the CEO and CFO, and all efforts should be made to resolve any SEC comments on material matters.

10. Once the committee is satisfied with the report, it should be forwarded to the CEO, CFO and general counsel for their review.

b. CEO and CFO Inquiries

1. The CEO and CFO should each read the periodic report carefully and ask the other members of senior management not on the committee and officers of operating units to do

the same. Special attention should be given to sections covering "risk factors" and business trends affecting the company. Sufficient time should be allowed to permit this review to be done with care. Reference materials for the relevant period used by the committee, such as press releases and research reports, should be included.

2. The CEO and CFO should consult with committee members, the internal and external auditors, chief legal and risk management officers and other relevant members of senior management or the legal or finance staff, and make all appropriate inquiries into:

   (a) The current state of the company's controls and reporting systems as they may affect the financial reports to be filed and the appropriate disclosure of trends and risk factors;

   (b) The procedures that were undertaken by the committee for the report, confirming that all agreed-upon procedures had been taken, addressing any issues that arose and how they might affect this report and future reports; and

   (c) Any other inquiries that may be appropriate based on their review.

3. The CEO and CFO should review with other members of senior management and the auditors:

   a. all significant developments and trends in the business for the period covered by the report.

   b. the important accounting principles that affect the company, the rationale for selecting the key principles used from among the alternatives and the effect on the financial statements if alternate methods had been followed.

4. The CEO and CFO should confirm with the principal engagement partner of the company's auditors that the audit team is not aware of any untrue statements in the report or any material omissions and that the presentation of the company's financial information, including the MD&A section, are acceptable to the audit team.

5. After reviewing the report, the CEO, CFO and senior management should make suggestions to the committee for any areas where disclosure could be improved or clarified or where trends or risks facing the company or key assumptions and assessments in accounting policies could be further explained.

6. If necessary, the CEO and CFO should meet with the auditors and audit committee to disclose any significant deficiencies in the design or operation of internal controls or any fraud involving management or significant employees, as described in the certification.

7. Proper approval by the audit committee should be obtained for any service performed by the auditors for the certification process.

8. Throughout the process, the CEO and CFO must be alert to any "red flags" and pursue them.

8. Backup

The procedures taken should be documented to support the certification. The committee should keep a record of the procedures followed in preparing each report. Last, care should be taken that the controls and procedures are updated as needed.

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SEC Statement on MD&A

By Guy P. Lander

On January 22, 2002, the SEC published a statement, *Commission Statement about Management's Discussion and Analysis of Financial Condition and Results of Operations*, Release No. 33.8056, discussing disclosures that public companies should consider in preparing Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"). The statement was made in reference to a petition for guidance from the major (i.e., Big Five) accounting firms and the American Institute of Certified Public Accountants that was prepared in the wake of the Enron scandal. The statement applies to every public company's next filing with the SEC, which will generally be on its Form 10-K or Form 20-F for 2001. The following is a summary of the statement.

The petition identified three areas of concern regarding disclosure in MD&A:

- liquidity and capital resources, including off-balance sheet arrangements;
- certain trading activities involving non-exchange traded contracts accounted for at fair value; and
- relationships and transactions with persons or entities that derive benefits from their non-independent relationship with the issuer or the issuer's related parties.

A. Disclosures Concerning Liquidity and Capital Resources, Including "Off-Balance Sheet" Arrangements

Paragraphs (a)(1) and (a)(2)(ii) of Item 303 of Regulation S-K set forth certain requirements for disclosures about "Liquidity" and "Capital Resources."

(1) Liquidity. Identify any known trends or any known demands, commitments, events or uncertainties that will result in or that are reasonably likely to result in the issuer's liquidity increasing or decreasing in any material way.

(2)(ii) Capital Resources. Describe any known material trends, favorable or unfavorable, in the issuer's capital resources. Indicate any expected material changes in the mix and relative cost of such resources. The discussion shall consider changes between equity, debt and any off-balance sheet financing arrangements.

1. Liquidity Disclosures

The SEC statement stated that MD&A disclosures should be specific. Rather than general statements that short-term funding is sufficient, issuers should describe the sources of short-term funding and the circumstances that are reasonably likely to affect those sources of liquidity. For example, if an issuer's liquidity depends on its operating cash flows, technology or maintaining a particular credit rating or financial ratios, that fact should be disclosed, with disclosure concerning how changes in that item might affect liquidity.

If the issuer's liquidity depends on its use of off-balance sheet financing arrangements, such as securitizing receivables or obtaining access to assets through special purpose entities, the issuer should consider disclosing the factors that are reasonably likely to affect its ability to continue using those off-balance sheet financing arrangements. Disclosure should be made of the matters that could affect the funds required for management's short- and long-term plans. For example, many issuers fund their trade receivables by selling them daily, through an off-balance sheet arrangement. If the issuer no longer qualifies for those daily sales, it might lose an important source of liquidity.

The threshold for disclosing circumstances that might materially affect liquidity is whether they are "reasonably likely" to occur. This disclosure threshold is lower than "more likely than not." Consequently, issuers should consider disclosing market price changes, economic downturns, defaults on guarantees, or contractions of operations that could have material consequences for the issuer's financial position or operating results.[1]

2. Off-Balance Sheet Arrangements

Issuers should consider providing in MD&A disclosures about arrangements with unconsolidated entities or other persons that are not disclosed in the financial statements. Disclosure may be necessary for relationships with unconsolidated entities that facilitate the issuer's transfer of or access to assets (e.g., receivables facilities or similar asset-backed financing vehicles).

The extent of the issuer's reliance on off-balance sheet arrangements should be described where those arrangements provide financing, liquidity, or market or credit risk support for the issuer; engage in leasing, hedging, research and development services with the issuer; or expose the issuer to liability that is not reflected on the face of the financial statements. Where contingencies inherent in the arrangements are reasonably

likely to affect the continued availability of a material historical source of liquidity and finance, issuers must disclose those uncertainties and their effects.

Issuers should consider the need to include information about the off-balance sheet arrangements such as: their business purposes and activities; their economic substance; the key terms and conditions of any commitments; the initial and ongoing relationships with the issuer and its affiliates; and the issuer's potential risk exposures resulting from its contractual or other commitments involving the off-balance sheet arrangements.

For example, an issuer may be economically or legally required or reasonably likely to fund losses of an unconsolidated, limited-purpose entity, provide it with additional funding, issue securities under a call option held by that entity, purchase the entity's capital stock or assets, or the issuer may otherwise be financially affected by the performance or non-performance of an entity or counterparty to a transaction or arrangement. Then, the issuer may need to include information about the arrangements and resulting exposures. Other possible disclosures that issuers include:

- Total amount of assets and obligations of the off-balance sheet entity, with a description of the nature of its assets and obligations, and identification of the class and amount of any debt or equity securities issued to the entity by the issuer;
- The effects of the entity's termination if it has a finite life or it is reasonably likely that the issuer's arrangements with the entity may be discontinued in the foreseeable future;
- Amounts receivable or payable, and revenues, expenses and cash flows resulting from the arrangements;
- Extended payment terms of receivables, loans, and debt securities resulting from the arrangements, and any uncertainties as to realization, including repayment that is contingent upon the future operations or performance of any party;
- The amounts and key terms and conditions of purchase and sale agreements between the issuer and the counterparties in any such arrangements; and
- The amounts of any guarantees, lines of credit, standby letters of credit or commitments or take or pay contracts, throughput contracts or other similar types of arrangements, including tolling, capacity, or leasing arrangements, that could require the issuer to provide funding of any obligations under the arrangements, including guarantees of repayment of obligors of parties to the arrangements, make-whole agreements, or value guarantees.

Where there are many similar arrangements, they can be aggregated. However, important distinctions in terms and effects should be disclosed.

3. Disclosures About Contractual Obligations and Commercial Commitments

Disclosure about an issuer's obligations and commitments to make future payments under contracts, such as debt and lease agreements, and under contingent commitments, such as debt guarantees, should be provided in a single location so that a total picture of obligations would be readily available. One aid to presenting this information may be schedules of the issuer's contractual obligations and commercial commitments as of the latest balance sheet date. Examples that could be adapted to the issuer's particular facts are presented in Table I below.

Table I

Other Commercial Commitments	Total Amounts Committed	Amount of Commitment Expiration Per Period			
		Less than 1 year	1-3 years	4-5 years	Over 5 years
Long-Term Debt					
Capital Lease Obligations					
Operating Leases					
Unconditional Purchase Obligations					
Other Long-Term Obligations					
Total Contractual Cash Obligations					

The preceding Table I could be accompanied by footnotes to describe provisions that create, increase or accelerate liabilities, or other pertinent data. Issuers could also use the footnotes to disclose assumptions in making forward-looking calculations.

B. Disclosures About Certain Trading Activities that Include Non-Exchange Traded Contracts Accounted for at Fair Value

The Commission is concerned about the disclosure of trading activities involving commodity contracts that are accounted for at fair value but for which a lack of market price quotations necessitates the use of fair value estimation techniques. Issuers engaged to a material extent in trading involving energy, weather, or non-exchange traded commodities marked to fair value (e.g., non-derivative trading contracts in bandwidth) should consider providing disclosures in MD&A that supplement those required in the financial statements (e.g., additional statistical and other information about these business activities and transactions). That information should include any contracts that are derivatives involving the same commodities that are part of those trading activities (for example, energy derivatives that are part of energy trading activities).

Issuers should consider disclosing in MD&A information about trading activities, contracts and modeling methodologies, assumptions, variables and inputs, along with explanations of the different outcomes reasonably likely under different circumstances or measurement methods. Disclosure should include how the activities affect reported results for the latest annual period and subsequent interim period and how financial position is affected as of the latest balance sheet date. Issuers should also disclose the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions. This may include:

- disaggregating realized and unrealized changes in fair value;
- identifying changes in fair value attributable to changes in valuation techniques;
- disaggregating estimated fair values at the latest balance sheet date based on whether fair values are determined directly from quoted market prices or are estimated; and
- indicating the maturities of contracts at the latest balance sheet date (e.g., within one year, within years one through three, within years four and five, and after five years).

An example of this disclosure in the form of a schedule as follows:

Fair value of contracts outstanding at the beginning of the period	xxxxxx
Contracts realized or otherwise settled during the period	xxxxxx
Fair value of new contracts when entered into during the period	xxxxxx
Changes in fair values attributable to changes in valuation techniques and assumptions	xxxxxx
Other changes in fair values	xxxxxx
Fair value of contracts outstanding at the end of the period	xxxxxx

Table II

Source of Fair Value	Fair Value of Contracts at Period-End				
	Maturity less than 1 year	Maturity 1-3 years	Maturity 4-5 years	Maturity in excess of 5 years	Total fair value
Prices actively quoted					
Prices provided by other external sources					
Prices based on models and other valuation methods					

Issuers should consider the need to disclose the fair value of net claims against counterparties that are reported as assets at the most recent balance sheet date, based on the credit quality of the contract counterparty (e.g., investment grade; noninvestment grade; and no external ratings).

Additionally, issuers should consider disclosing risk management for trading activities, e.g., the management of risks related to changes in credit quality or market fluctuations of underlying, linked or indexed assets or liabilities, especially where such assets are illiquid or susceptible to material uncertainties in valuation.

C. Disclosures about Effects of Transactions with Related and Certain Other Parties

Statement of Financial Accounting Standards No. 57 (FAS 57), *Related Party Disclosures*, sets forth the requirements under GAAP concerning transactions with related parties. Where related party transactions are material, MD&A should include discussion of those transactions to the extent necessary for an understanding of the company's current and prospective financial position and operating results. In addition, Item 404 of Regulation S-K and Item 404 of Regulation S-B require disclosure of certain relationships and transactions with related parties:

- the business purpose of the arrangement;
- identifying the related parties;
- how transaction prices were determined by the parties;
- if disclosures represent that transactions have been evaluated for fairness, a description of how the evaluation was made; and
- any ongoing contractual or other commitments as a result of the arrangement.

Issuers should also consider the need for disclosing parties that are not "related parties," but with whom the issuer or its related parties have a relationship that enables the parties to negotiate terms of material transactions that may not be available from other, more clearly independent, parties on an arm's-length basis. For example, an entity may be established and operated by individuals that were former senior management of, or have some other current or former relationship with, an issuer.

Endnote

1. To identify trends, demands, commitments, events and uncertainties that require disclosure, management should consider the following:
    - arrangements that could trigger an early payment, additional collateral support, changes in terms, acceleration of maturity, or the creation of an additional financial obligation, e.g., adverse changes in the issuer's credit rating, financial ratios, earnings, cash flows, or stock price, or changes in the value of underlying, linked or indexed assets;
    - circumstances that could impair the issuer's ability to continue to engage in transactions that have been financially or operationally essential, e.g., the inability to maintain a specified investment grade credit rating, level of earnings, financial ratios, or collateral;
    - factors that the issuer expects to affect its ability to raise short-term and long-term financing;
    - guarantees of debt or other commitments to third parties; and
    - written options on non-financial assets (for example, real estate puts).

    To identify trends, demands, commitments, events and uncertainties that require disclosure, management should consider the following:
    - provisions in financial guarantees or commitments, debt or lease agreements or other arrangements that could trigger a requirement for an early payment, additional collateral support, changes in terms, acceleration of maturity, or the creation of an additional financial obligation, such as adverse changes in the issuer's credit rating, financial ratios, earnings, cash flows, or stock price, or changes in the value of underlying, linked or indexed assets;
    - circumstances that could impair the issuer's ability to continue to engage in transactions that have been integral to historical operations or are financially or operationally essential, or that could render that activity commercially impracticable, such as the inability to maintain a specified investment grade credit rating, level of earnings, earnings per share, financial ratios, or collateral;
    - factors specific to the issuer and its markets that the issuer expects to be given significant weight in the determination of the issuer's credit rating or will otherwise affect the issuer's ability to raise short-term and long-term financing;
    - guarantees of debt or other commitments to third parties; and
    - written options on non-financial assets (for example, real estate puts).

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Finder's Fee Agreements: Potential Pitfalls and Considerations

By Howard Meyers

The rush toward capital formation and strategic alliances often leads companies to engage the services of a "finder" to assist them in locating investors and raising capital. However, unsuspecting finders may become unnecessarily subject to regulation under the federal securities laws. This article examines how finder's fee agreements are treated under New York law generally and what potential pitfalls the drafter of finder's fee agreements should avoid.

I. Background

New York law recognizes a finder as "someone who finds, interests, introduces and brings parties together for a business transaction that the parties themselves negotiate and consummate."[1] Unlike a broker, a finder has no duty to bring the parties to an agreement, but instead acts as an intermediary or middleman.[2] As one court has explained, "[f]inders find potential buyers or sellers, stimulate interest and bring parties together. Brokers bring the parties to an agreement on particular terms."[3] In the corporate financing context, a finder's compensation is generally based on a percentage of the amount invested by one party or, in circumstances involving mergers and acquisitions, a percentage of the transaction value.

II. Causation Requirement

For a finder to recover under the typical finder's agreement, there must be a causal relation between the introduction of the parties and the ultimate conclusion of the transaction.[4] Moreover, courts have consistently required that the finder show more than that his service was a necessary "but-for" condition.[5] Rather, the finder must show that the final deal flowed directly from the introduction.[6] Accordingly, the finder typically must establish a continuing connection between the finder's service and the ultimate transaction.[7]

One commentator has observed that this continuing connection is not dependent upon the finder's participation in negotiations, and a finder's fee may be payable even though a third person brings the party to agreement. Thus, if a finder introduces a prospective investor who enters into negotiations that are abandoned and later resumed, the causation requirement is probably satisfied if the renewed negotiations stem from the original introduction.[8]

For example, in *Simon v. Electrospace Corp.*,[9] a finder introduced the defendant, Electrospace Corp. ("Electrospace"), to Louis Taxin ("Taxin"), for the purpose of arranging a merger with one of Taxin's companies. The finder had entered into an agreement which provided that "in the event you can effect the sale of the stock of this corporation . . . by introduction to a party or parties with whom a transaction will be thereafter consummated, then 5% of the gross value of the transaction will be paid as a commission to you at the time of closing."

> *"[I]f a finder introduces a prospective investor who enters into negotiations that are abandoned and later resumed, the causation requirement is probably satisfied if the renewed negotiations stem from the original introduction."*

Although nothing came of the initial meetings, Electrospace and Taxin resumed their negotiations eighteen months later. The Court of Appeals, in affirming the Appellate Court's decision that the finder was entitled to a finder's fee, held that the evidence was sufficient to establish a continuing connection between the finder's initial efforts and the merger that came about.[10]

III. Chain of Introductions Concept

Some courts have directed the payment of a finder's fee even in situations where the consummation of the transaction at issue culminated not directly from the finder's initial introduction but indirectly from a chain of introductions initiated by the finder's introduction. For example, *Defren v. Russell*[11] involved a finder's fee dispute in connection with a series of introductions that allegedly culminated in the acquisition of Bio-Dynamics, Inc. ("Bio-Dynamics") by IMS International, Inc. ("IMS"). The plaintiff and Thomas Russell ("Russell"), Bio-Dynamic's president, had entered into a finder's agreement that stated that plaintiff would receive $75,000 for the consummation of the acquisition of all of the stock of Bio-Dynamics "with or through" Loeb, Rhoades & Co. ("Loeb, Rhoades")and/or one of its affiliates.[12] After execution of the finder's agreement, plaintiff introduced Russell to Peter Dixon ("Dixon"), a representative of Loeb, Rhoades who, along with plain-

tiff, was going to assist Russell in his efforts to sell the Bio-Dynamics stock. However, approximately 10 months later, Russell told the plaintiff that he was going to sell the Bio-Dynamics stock on his own.[13] In fact, unknown to plaintiff, Russell continued to work closely with Dixon for the next two years in an attempt to sell the Bio-Dynamics stock. After plaintiff made the initial introduction of Russell to Dixon, there was a long series of introductions which eventually culminated in the acquisition of Bio-Dynamics by IMS.[14]

"Both the Defren *and* Seckendorff *cases illustrate that drafters of finder's fee agreements should be cognizant of the 'chain of introductions' concept."*

In addressing whether plaintiff was entitled to a finder's fee pursuant to the finder's agreement, the court recognized that the more narrow question presented was whether plaintiff was entitled to recover on the basis of Loeb, Rhoades' efforts on Russell's behalf.[15] Preliminarily, the court noted that the finder's agreement provided that the consummation of the acquisition "with" or "through" Loeb, Rhoades would fulfill the terms of the agreement with respect to the plaintiff's performance thereunder.[16] The court then recognized that there was not the slightest indication that Russell even would have become aware of the existence of IMS except "through" the diligent services performed by Dixon.[17] Thus, the court held that in view of the fact that the Bio-Dynamics stock was sold to IMS *through* the efforts of Loeb, Rhoades, the plaintiff was entitled to recover a finder's fee of $75,000.[18]

Similarly, in *Seckendorff v. Halsey, Stuart & Co.*,[19] a plaintiff approached the investment banking firm of Rogers Caldwell & Co. ("Rogers Caldwell") to determine if it was interested in arranging bond financing for certain properties located in Washington, D.C. After the plaintiff described the properties, Rogers Caldwell entered into an agreement which provided that the plaintiff would receive a one percent commission on the par value of any securities distributed to the public and two percent of any securities that Rogers Caldwell may receive as a bonus for handling the transaction.[20] After signing the agreement, Rogers Caldwell approached the investment firm of Halsey, Stuart & Co. ("Halsey") to inquire whether Halsey would be interested in heading the bond syndicate.[21] At this time, the plaintiff's agreement was brought to the attention of Halsey. However, Halsey indicated that it was not interested in participating in the bond financing.[22] Nevertheless, one year later, Halsey and Rogers Caldwell developed a different deal structure and ultimately financed the Washington D.C. properties without the plaintiff's knowledge.

In holding that the plaintiff was entitled to his commission under the agreement, the court recognized that Rogers Caldwell and Halsey were "in reality, partners or, at least, joint adventurers, and that Rogers Caldwell could legally bind its associates Halsey . . ."[23] Furthermore, the court found that without the plaintiff's introduction, there never would have been any bond issue because plaintiff himself was alone responsible for finding this business and bringing it to the defendants' attention.[24] Accordingly, the court held that the one-year lapse in negotiations and different deal structure did not preclude the jury's finding that the transaction "flowed directly from" the plaintiff's original introduction.[25]

Both the *Defren* and *Seckendorff* cases illustrate that drafters of finder's fee agreements should be cognizant of the "chain of introductions" concept. Accordingly, when drafting finder's fee agreements, the drafter may wish to include a provision entitling the finder to a fee if a transaction is ultimately consummated with any party that resulted from the finder's original introduction. Such a provision may, at the very least, clarify the scope of the finder's relationship and may avoid protracted litigation should a transaction be ultimately consummated with a third party that was not directly introduced by the finder himself.

IV. Finder's Fee Agreements and the Federal Securities Laws

The federal securities laws generally govern whether a finder must register as a broker-dealer, or conduct its activities through a registered broker-dealer. Section 3(a)(4) of the Exchange Act defines "broker" as "any person engaged in the business of effecting transactions in securities for the account of others." Section 3(a)(5) of the Exchange Act defines "dealer" as "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise." Section 15(a)(1) of the Securities Exchange Act of 1934 (the "Exchange Act") provides that it is unlawful for any broker or dealer to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security unless such broker or dealer is registered with the Securities & Exchange Commission.

As one commentator has noted, although a pure finder may "induce the purchase or sale of" a security within the meaning of section 15(a)(1), he or she is not normally a "broker" because he or she effects no transactions.[26] In addition, the staff of the Securities and

Exchange Commission has issued certain no-action letters further interpreting these provisions. For example, in a no-action letter the staff explained:

> [A]n intermediary who did nothing more than bring merger or acquisition-minded people or entities together and did not participate in negotiations or settlements between them probably would not be a broker in securities and not subject to the registration requirements of Section 15 of the Exchange Act; on the other hand, an intermediary who plays an integral role in negotiating and effecting mergers or acquisitions that involve transactions in securities generally would be deemed to be a broker and required to register with the Commission. *See* Henry C. Coppelt d/b/a/ May Pac Management Co., 1973-1974 Fed. Sec. L. Rep. (CCH), para. 79,814.

In light of the SEC's no-action letter, potential finders should be wary of performing anything more than an intermediary role in bringing parties together for the purposes of consummating business transactions involving the purchase or sale of securities; otherwise they run the risk of being deemed unregistered brokers pursuant to the federal securities laws. In particular, finders should avoid offering investment advice in connection with their services. Accordingly, finders, and drafters of finder's fee agreements, should preliminarily determine what the finder's role will be in connection with any potential finder's arrangement. Furthermore, finders and drafters of finder's fee agreements, should explore whether the finder's role will be restricted to merely bringing two parties together for a business transaction or whether the finder will assume a more active role in negotiating and structuring the ultimate financing arrangement. Only by examining the finder's duties can the practitioner determine whether the finder must register as a broker pursuant to the federal securities laws.

V. Conclusion

While the use of finder's fee agreements has become commonplace, finders and practitioners alike must be wary of potential pitfalls that may arise from such agreements. Before drafting any finder's agreement, the practitioner should first determine the extent of the finder's role in consummating the transaction at issue. In addition, the practitioner should evaluate whether the finder may be subject to regulation under the federal securities law. Finally, after the practitioner has addressed these considerations, the practitioner may want to include a provision in the finder's fee agreement to ensure that the finder will be compensated from transactions that culminated from a chain of introductions initiated by the finder.

Endnotes

1. *See Moore v. Sutton Resources, Ltd.*, 1998 WL 67664, *4 (S.D.N.Y. 1998) (citing *Northeast General Corp. v. Wellington Advertising, Inc.*, 82 N.Y.2d 158, 163, 604 N.Y.S.2d 1 (1993)).
2. *See id.*
3. *See Train v. Ardshiel Assoc., Inc.*, 635 F. Supp. 274, 279 (S.D.N.Y. 1986), *aff'd without opinion*, 805 F.2d 391 (2d Cir. 1986).
4. *See Moore v. Sutton Resources, Ltd.*, 1998 WL 67664, *4; *see also Simon v. Electrospace Corp.*, 28 N.Y.2d 136, 142, 320 N.Y.S.2d 225, 229 (1971); *Edward Gottlieb, Inc. v. City & Commercial Communications PLC*, 200 A.D.2d 395, 606 N.Y.S.2d 148, 150 (1st Dep't 1994); *Karelitz v. Damson Oil Corp.*, 820 F.2d 529, 531 (1st Cir. 1987) (Breyer, J.) (applying New York law).
5. *See Moore v. Sutton Resources, Ltd.*, 1998 WL 67664, *4; *see also Karelitz v. Damson Oil Corp.*, 820 F.2d at 531.
6. *See Moore v. Sutton Resources, Ltd.*, 1998 WL 67664, *4.
7. *See id.*
8. *See* B. Fox & E. Fox, Corporate Acquisitions and Mergers, at 30.04(3) (1986).
9. 32 A.D.2d 62, 299 N.Y.S.2d 712 (1st Dep't 1969), *rev'd as to damages*, 28 N.Y.2d 136, 142, 320 N.Y.S.2d 225, 229 (1971).
10. *See Simon v. Electrospace Corp.*, 28 N.Y.2d 136, 142.
11. 71 A.D.2d 416, 422 N.Y.S.2d 433 (1st Dep't 1979).
12. *Defren*, 422 N.Y.S.2d at 435–36.
13. *Id.* at 436.
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.*
19. 234 A.D. 61, 254 N.Y.S. 250, 260 (1st Dep't 1931), *rev'd on other grounds*, 259 N.Y. 353 (1932)
20. *Seckendorff*, 254 N.Y.S. at 254.
21. *Id.* at 255.
22. *Id.* at 256.
23. *Id.* at 255.
24. *Id.* at 260.
25. *Id.* at 261.
26. *See* Louis Loss, Securities Regulation, vol. VI, p. 3004 (1990).

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When Fraud Claims Are Barred by the Parol Evidence Rule Under New York Law

By Thomas J. Dougherty and Wystan M. Ackerman

The parol evidence rule generally bars evidence which contradicts the clear and unambiguous terms of a contract.[1] However, if the plaintiff claims that he was fraudulently induced to sign the contract, under what circumstances is the fraud claim barred because it is based on parol evidence?

On one hand, if every plaintiff were able to avoid the parol evidence rule simply by alleging a fraudulent inducement claim, the rule would be ineffectual. On the other hand, justice would not be served if every fraud claim asserted by a party in privity with another were barred.

> *"There are several different lines of cases . . . [that] have generated some confusion. At first glance some of the cases appear to conflict, but in fact they do not."*

New York courts have developed a principled way to apply the parol evidence rule to fraud claims, but we are aware of no simple summary of those rulings that sets out the New York rule. There are several different lines of cases, and, at times, these cases have generated some confusion.[2] At first glance some of the cases appear to conflict, but in fact they do not. This article explains the "New York rule" that a fraudulent inducement claim is barred by the parol evidence rule where the claim alleges: (1) an oral promise which is not "collateral or extraneous" to the contract; or (2) a promise as to "future expectations"; or (3) an oral promise which is within the Statute of Frauds.

I. Claims Alleging Promises Which Are Not "Collateral or Extraneous" to the Contract Are Barred

The source of some confusion in this area is *Sabo v. Delman*,[3] decided by the New York Court of Appeals in 1957. The plaintiff Sabo was an employee of the defendant Delman, a manufacturer of women's shoes. Sabo invented a machine to make shoes and obtained a patent. Sabo and Delman made several written contracts: a 1940 assignment by Sabo of Sabo's patent rights to Delman and mid-1940s contracts to share profits. Sabo later brought a fraudulent inducement claim seeking rescission of the contracts. He alleged a promise that was wholly collateral or extraneous to the patent rights and profit sharing agreements. Namely, Sabo alleged that prior to either and to induce both, Delman had promised Sabo to finance the manufacture of machines to be patented by Sabo and had failed to do so.[4] Those representations were not included in the agreements, each of which contained the same general merger clause, stating that: "No verbal understanding or conditions, not herein specified, shall be binding on either party."[5]

Judge Fuld emphasized that "the complaint before us neither asserts a breach of contract nor attempts to enforce any promise made by defendants."[6] What he meant was that the alleged promise was *collateral or extraneous* to the contracts—Delman did not contractually agree to finance the manufacture of the machines and promote the sale or lease of them.[7] The Court focused on the nature of the inducing promise.

Since the purported promise was collateral to, not within the scope of, the contracts, the Court held that the fraud claim was not barred by the parol evidence rule, regardless of the presence of a merger clause. Judge Fuld wrote that, on the facts of *Sabo*, the general merger clause

> merely furnishes another reason for applying the parol evidence rule, and, just as that rule is ineffectual to exclude evidence of fraudulent representations, so this provision may not be invoked to keep out such proof. Indeed, if it were otherwise, a defendant would have it in his power to perpetrate a fraud with immunity, depriving the victim of all redress, if he simply has the foresight to include a merger clause in the agreement.[8]

Fuld also wrote that "the parol evidence rule has no application in a suit brought to rescind a contract on the ground of fraud."[9] The Court held that the complaint stated a cause of action, reversing the Special Term's decision which granted Delman's motion for judgment on the pleadings.[10]

Unfortunately Judge Fuld did not confine his unnecessary discussion of the merger clause,[11] which has generated confusion, to the facts of *Sabo*. Judge Fuld clearly meant that "the parol evidence rule has no application" to fraud claims where the alleged inducing promise is *collateral* to the contract. He clearly could not have intended for his reasoning to apply in every case where fraud is alleged because *every* complaint alleging a pre-contractual oral promise is also going to allege fraud. If the parol evidence rule had "no application" in fraud cases, the rule would only convert contract claims into fraud claims, not protect the integrity of a final written agreement.[12] The important part of *Sabo*, indeed the only question the Court of Appeals needed to answer, was that the inducing promise was collateral to the contracts.

> *"The key difference between* Briefstein *and* Sabo *is that the allegedly fraudulent promise in* Briefstein *was* not *collateral to the contract—the promise was to perform the contract."*

In *Danann Realty Corp. v. Harris*,[13] often cited along with *Sabo*, the defendant sold a building lease to the plaintiff. The plaintiff brought a fraudulent inducement claim alleging that the defendant had falsely represented the amount of operating expenses and profits which the plaintiff could expect. This promise was, at first glance, collateral to the contract of sale, which made no representations regarding the expenses or profits.[14]

However, here the contract contained a merger clause stating that "Seller has not made and does not make any representations as to the . . . expenses, operation or any other matter or thing affecting or related to the aforesaid premises. . . ."[15] Because of the specific disclaimer in the merger clause, the alleged promise was *not* collateral to the contract. Rather, "the provisions of the written contract . . . directly contradict[ed] the allegations of oral representations."[16] The Court reinstated dismissal of the fraud claim, arguing that "[t]o hold otherwise would be to say that it is impossible for two businessmen dealing at arm's length to agree that the buyer is not buying in reliance on any representations of the seller as to a particular fact."[17] The Court repeated the overinclusive dicta "that a general merger clause is ineffective to exclude parol evidence to show fraud in inducing the contract."[18] As *Danann Realty itself* holds, that rule is applicable only where the inducing promise is collateral to the contract, not where the contract directly contradicts the promise.

As in *Sabo*, the Court in *Danann Realty* did not use the term "collateral" or "extraneous," but the Court clearly analyzed whether or not the inducing promise was collateral to the contract.[19]

Shortly after *Sabo* and *Danann Realty* were decided,[20] the First Department clarified matters in *Briefstein v. P.J. Rotondo Construction Co., Inc*.[21] In *Briefstein*, the plaintiff brought a fraud claim alleging that the defendant did not intend to perform an employment contract at the time it was made. The court dismissed the claim, stating that the defendant's proper claim was for breach of contract, not fraud:

> To say that a contracting party intends when he enters into an agreement not to be bound by it is not to state 'fraud' in an actionable area, but to state a willingness to risk paying damages for breach of contract. . . . The policy which runs through the fabric of the law of contracts is to bind a party by what he agrees to do whether or not he intends to do what he agrees.[22]

The key difference between *Briefstein* and *Sabo* is that the allegedly fraudulent promise in *Briefstein* was *not* collateral to the contract—the promise was to perform the contract.

Numerous Appellate Division decisions followed the rule in *Briefstein*[23] and the Court of Appeals has also done so, but without specifically addressing *Sabo*. In *Deerfield Communications Corp. v. Cheseborough-Ponds, Inc.*[24] the defendant brought a counterclaim for fraudulent inducement, alleging that the plaintiff did not intend to abide by an oral agreement placing geographical restrictions on the resale of merchandise which the defendant sold to the plaintiff. In a brief opinion, the Court held that the claim was "collateral to . . . the contract," "not barred by the general merger clause" in the sale agreement, and "not a mere promissory statement as to what will be done in the future."[25]

The Court of Appeals applied the "collateral or extraneous" rule again in *New York University v. Continental Insurance Co.*[26] NYU alleged that Continental had fraudulently induced the university to buy an insurance policy by representing that claims would be evaluated in good faith, when in fact Continental had a practice of denying claims and then terminating policies. The Court noted that "where a party engages in conduct outside the contract but intended to defeat the contract, its *extraneous* conduct may support an independent tort claim."[27] However, the claim was barred since NYU alleged "nothing more than a breach of the contract"—it did not allege any collateral representations or omissions.[28]

Federal courts interpreting New York law have now identified "a rule, widely adopted by the state and federal courts, pursuant to which a false promise can support a claim of fraud only where that promise was 'collateral or extraneous' to the terms [of] an enforceable agreement in place between the parties."[29] As Judge Sotomayor, now of the Second Circuit, wrote in *International Cabletel, Inc. v. Le Groupe Videotron Ltee*, this rule "reflects sound policy" by ensuring the predictability of contracting, particularly where sophisticated parties are involved.[30] For example, where the fraud claim is not collateral to the contract, the appropriate claim is for breach of contract and the remedy is limited to the liquidated damages stipulated in the contract.[31] As the Second Circuit explained in *Telecom Int'l Am., Ltd. v. AT&T Corp.*,[32]

> [S]imply dressing up a breach of contract claim by further alleging that the promisor had no intention, at the time of the contract's making, to perform its obligations thereunder, is insufficient to state an independent tort claim. [The plaintiff's] fraudulent inducement claim therefore also fails because it is simply a breach of contract claim in the tort clothing of (factually unsupported) allegations of an intent to breach.[33]

In so holding, the court also found, separately, that the alleged misrepresentations were not "collateral to the contract."[34]

Most of these cases do not explicitly apply the parol evidence rule. They hold that the plaintiff has not "stated a claim" for fraud—the proper claim is for breach of contract since the claim alleges a broken promise, not a false promise.[35] However, the courts' reasoning is by its nature an application of the parol evidence rule.[36] Courts analyze whether or not the promise is collateral to the contract because the parol evidence rule only applies to promises which are *not* collateral or extraneous. When the courts write that the complaint does not "state a claim" for fraud, they mean that the claim is barred by the parol evidence rule, not that the elements have not been properly alleged.[37]

One case that has recently recognized how the parol evidence rule should be applied to fraudulent inducement claims, implicitly (but not explicitly) applying the "collateral or extraneous" doctrine, is *Bibeault v. Advanced Health Corp.*[38] In that case, Judge Pauley of the Southern District of New York held that "[c]ourts should bar parol evidence of fraudulent inducement whenever an express contractual provision *contradicts* a claimed oral statement in a meaningful fashion."[39]

II. Claims Alleging Promises as to Future Expectations Are Barred

A fraud claim based on a collateral or extraneous promise will still be dismissed if it alleges "mere expressions of future expectation."[40] For example, in *Landes v. Sullivan*[41] the plaintiff sued to enforce a promissory note for a condominium mortgage after the defendants failed to make payments. The defendants counterclaimed, asserting that the plaintiff had fraudulently represented that the condominium was in good repair. The defendants also alleged that the plaintiff represented that the defendants would be able to resell the unit for profit in the future and, if not, the plaintiff would reduce the amount of the loan.[42]

"A fraud claim based on a collateral or extraneous promise will still be dismissed if it alleges 'mere expressions of future expectation.'"

The Appellate Division upheld summary judgment for the plaintiff on these counterclaims. With respect to the condition of the condominium, the court found persuasive the specific disclaimer in the contract that the unit was sold "as is." With regard to the alleged representation about future profits, the court said that was merely an opinion about future expectations, which is not a basis for a fraud claim.[43]

There is nothing controversial or confusing about this part of the New York rule.[44] However, it is important that this element be included when analyzing whether or not a claim for fraudulent inducement is barred.

III. Claims Alleging Promises Within the Statute of Frauds Are Barred

A fraudulent inducement claim will also be barred if it is based on a purported promise which is within the Statute of Frauds. The most commonly applicable provision of the Statute of Frauds is the one-year provision, which provides: "Every agreement, promise or undertaking is void, unless it or some note or memorandum thereof be in writing, and subscribed by the party to be charged therewith, . . . if such agreement . . . [b]y its terms is not to be performed within one year . . ."[45]

For example, in *Otiniano v. Magier* the plaintiff claimed that "he was fraudulently induced to purchase the store and agree to an assignment of the lease by the representations of [the] defendants . . . that the lease

agreement would be extended for five years."[46] The defendants refused to extend the lease. The First Department held that the fraud claim was barred by the Statute of Frauds, which requires that such an agreement be in writing.[47]

As with the "future expectations" rule, there is nothing unusual about applying the Statute of Frauds to purported promises which are alleged in fraudulent inducement claims. It is simply a matter of including the Statute of Frauds in the analysis.

IV. Conclusion

In contract disputes a party will often claim that there was a prior oral promise outside of or in addition to the written agreement. Courts usually dismiss these claims under the parol evidence rule. However, by characterizing the contract claim as a fraud claim, a party can potentially circumvent the rule. In some cases the fraud claim is legitimate, while in other cases it is merely a means to avoid the proper application of the parol evidence rule.

New York's appellate courts have held that a fraud claim is barred by the parol evidence rule under three circumstances. As this article has illustrated, a fraud claim will be dismissed under New York law where it alleges: (1) an oral promise which is not "collateral or extraneous" to the contract; or (2) a promise as to "future expectations"; or (3) an oral promise which is within the Statute of Frauds.

Endnotes

1. The parol evidence rule only applies to "integrated" agreements—the contract must appear to be the final expression of the agreement between the parties, although it need not be in writing. Almost every contract is integrated. *See, e.g., Intershoe, Inc. v. Bankers Trust Co.*, 77 N.Y.2d 517, 520, 571 N.E.2d 641, 643 (1991) (confirmation slip stating that "We have bought from you ITL 537,7500,000" and "We have sold to you $250,000" for delivery in October 1985 constituted an integrated agreement). If the contract appears to be the final and complete agreement between the parties, it is "completely integrated" and may not be contradicted or supplemented by parol evidence. Otherwise the contract is only "partially integrated" and may be supplemented, but not contradicted, by parol evidence. *See* 2 E. Allan Farnsworth, Contracts § 7.3, at 215B16 (2d ed. 1998). Most formal written contracts have a merger clause stating that the contract contains the complete agreement between the parties, thereby fully invoking the parol evidence rule.
2. *See, e.g., Sudul v. Computer Outsourcing Serv.*, 868 F. Supp. 59, 61–62 (S.D.N.Y. 1994) (discussing two different lines of cases); *Dornberger v. Metropolitan Life Ins. Co.*, 961 F. Supp. 506, 541–42 (S.D.N.Y. 1997) (same).
3. 3 N.Y.2d 155, 164 N.Y.S.2d 714 (1957).
4. *See id.* at 158–59.
5. *Id.* at 160.
6. *Id.* at 159.
7. Judge Fuld did not use the terms "collateral" or "extraneous" in *Sabo*. Those terms were coined by later courts. *See, e.g., Spellman v. Columbia Manicure Mfg. Co.*, 111 A.D.2d 320, 323, 489 N.Y.S.2d 304 (2d Dep't 1985) ("The holdings in Sabo and Channel Master Corp. were apparently tied to misrepresentations which were collateral or extraneous to the agreements entered into by the parties.").
8. *Sabo*, 3 N.Y.2d at 161.
9. *Id.*
10. It is also significant that Sabo sought rescission of the contracts, not enforcement of Delman's alleged promise to promote the manufacture of the machines. The Court might not have enforced the promise. *See id.* at 159; *Lipsit v. Leonard*, 315 A.2d 25, 29 (N.J. 1974) (interpreting New York law and citing *Sabo* for the proposition that "New York allows such [a fraud] action to be maintained and parol evidence to be introduced where the relief sought is rescission or restitution, [not] affirmation and enforcement" of the contract).
11. The merger clause is relevant only insofar as it defines the scope of the contract, enabling the court to ascertain what is "collateral" to the contract and what is "integral" to it. A subject matter which would otherwise clearly be "collateral" to the contract will instead be considered "within" the contract if it is specifically mentioned in the merger clause. *See Danann Realty Corp. v. Harris* and *Citibank v. Plapinger*, discussed below.
12. For example, in *Congress Financial Corp. v. John Morrell & Co.*, 790 F. Supp. 459, 468 (S.D.N.Y. 1992), Morell alleged that Congress Financial had orally agreed to continue financing Dinner Bell after Morell's acquisition of Dinner Bell. Morell also alleged that, at the time the oral agreement was made, Congress Financial fraudulently failed to inform Morell about a discrepancy in Dinner Bell's loan collateral report. *See id*. at 468. Morell and Congress Financial later signed an agreement regarding Congress's security interests in Dinner Bell's assets. The court distinguished *Sabo* and held that the fraud claim was barred by the parol evidence rule, reasoning that "If Morell were permitted to offer evidence of the oral agreement, the parol evidence rule would be rendered void. Any defendant in a claim for breach of contract could avoid summary judgment merely by alleging fraud in connection with an oral agreement." *Id*.
13. 5 N.Y.2d 317, 184 N.Y.S.2d 599 (1959).
14. *See id.* at 319–20.
15. *Id.* at 320.
16. *Id.* at 319.
17. *Id.* at 323; *see also Citibank v. Plapinger*, 66 N.Y.2d 90, 94–95, 495 N.Y.S.2d 309 (1985) (corporation's directors and officers alleged that Citibank fraudulently induced them to sign unconditional personal guarantees for a corporate loan by promising an additional line of credit; the fraud claim was dismissed because it was not collateral—there was a specific disclaimer of "any other agreement" in the "absolute and unconditional" guarantee).
18. *Danann Realty*, 5 N.Y.2d at 320.
19. Some courts have attempted to explain *Sabo* and *Danann* by articulating a rule that "[a]lthough a general merger clause cannot serve to exclude parol evidence of fraud in the inducement, a specific disclaimer is sufficient to destroy a plaintiff's allegation that the agreement at issue was executed in reliance upon contrary oral representations." *Marine Midland Bank, N.A. v. Walsh*, 260 A.D.2d 990, 990, 689 N.Y.S.2d 288, 289 (3d Dep't 1999) (holding that loan guaranty provision stating that it was "absolute and unconditional and shall not be changed or affected by any representation, oral agreement, act or thing whatsoever, except as herein provided" barred a fraudulent inducement

claim) (citations omitted); *see also Dyncorp v. GTE Corp.*, 215 F. Supp. 2d 308, 319 (S.D.N.Y. 2002) (stating that "[a] party to a contract cannot allege that it reasonably relied on a parol representation when, in the same contract, it 'specifically disclaims reliance upon [that] particular representation'"). However, these courts, in focusing on whether or not the merger clause specifically disclaims oral representations, have failed to recognize that the "collateral or extraneous" doctrine should be applied.

20. *Channel Master Corp. v. Aluminum Ltd. Sales, Inc.*, 4 N.Y.2d 403, 176 N.Y.S.2d 259 (1958) is often cited along with *Sabo* and *Danann*, although its facts are quite different. In *Channel Master* the plaintiff claimed that the defendant fraudulently misrepresented that it could sell 400,000 pounds per month of aluminum ingot when the defendant had already committed its resources to other customers. *See id.* at 405–06. However, in *Channel Master* there was no agreement between the parties—it was purely a tort case, not a contract case. The Court held that the complaint stated a claim for fraud. *See id.* at 408.
21. 8 A.D.2d 349, 187 N.Y.S.2d 866 (1st Dep't 1959).
22. *Id.* at 351.
23. *See, e.g., McKernin v. Fanny Farmer Candy Shops, Inc.*, 176 A.D.2d 233, 234, 574 N.Y.S.2d 58, 59 (2d Dep't 1991) (stating that it is "well settled" that a fraud claim is barred where it "is premised upon an alleged breach of contractual duties and the supporting allegations do not concern representations which are collateral or extraneous to the terms of the parties' agreement") (collecting cases). *See also PI, Inc. v. Quality Products, Inc.*, 907 F. Supp. 752, 761 (S.D.N.Y. 1995) (collecting cases).
24. 68 N.Y.2d 954, 502 N.E.2d 1003 (1986).
25. *Id*. at 956.
26. 87 N.Y.2d 308, 662 N.E.2d 763 (1995).
27. *Id*. at 316 (emphasis added).
28. *Id*. at 318.
29. *International Cabletel, Inc. v. Le Groupe Videotron Ltee*, 978 F. Supp. 483, 487 (S.D.N.Y. 1997) (Sotomayor, J.) (citing *Deerfield*). *See also Bridgestone/Firestone, Inc. v. Recovery Credit Serv., Inc.*, 98 F.3d 13, 20 (2d Cir. 1996) (vacating a finding of fraud based on the defendant's submission of checks drawn on insufficient funds; holding that the plaintiff had not "demonstrate[d] a fraudulent misrepresentation collateral or extraneous to the contract"); *Bell Sports, Inc. v. System Software Assoc., Inc.*, 45 F. Supp. 2d 220, 228 (E.D.N.Y. 1999) (plaintiff claimed it was fraudulently induced to enter into a contract for computer software by defendant's false representations about the software's capabilities; held that the "complaint does not allege a claim of fraud that is sufficiently distinct, collateral, or extraneous from its breach of contract claim").
30. 978 F. Supp. at 489 (emphasis added).
31. *See id.* at 489–90.
32. 280 F.3d 175 (2d Cir. 2001).
33. *Id.* at 196 (citations omitted).
34. *Id.*
35. *See Briefstein v. P.J. Rotondo Construction Co., Inc.*, 8 A.D.2d 349, 351, 187 N.Y.S.2d 866 (1st Dep't 1959); *New York University v. Continental Insurance Co.*, 87 N.Y.2d 308, 318, 662 N.E.2d 763 (N.Y. 1995); *International Cabletel, Inc. v. Le Groupe Videotron Ltee*, 978 F. Supp. 483, 487–88 (S.D.N.Y. 1997); *Bridgestone/Firestone, Inc. v. Recovery Credit Serv., Inc.*, 98 F.3d 13, 19–20 (2d Cir. 1996); *Bell Sports, Inc. v. System Software Assoc., Inc.*, 45 F. Supp. 2d 220, 227–28 (E.D.N.Y. 1999). *But see Deerfield Communications Corp. v. Cheseborough-Ponds, Inc.*, 68 N.Y.2d 954, 502 N.E.2d 1003 (1986) (explicitly holding that the claim was "not barred by the general merger clause").
36. A recent decision of the Western District of New York attempted to reconcile the line of cases cited herein in analyzing a fraudulent inducement claim, but failed to recognize the applicability of the parol evidence rule. *See Frontier-Kemper Constructors, Inc. v. American Rock Salt Co.*, No. 01-CV-6217(CJS), 2002 U.S. Dist. LEXIS 16894, at *6-15 (W.D.N.Y. Sept. 9, 2002) (holding that, under the "collateral or extraneous" doctrine, "[a] plaintiff may . . . pursue a claim [of] fraudulent inducement of a contract, based upon a misrepresentation of present fact, or upon a false promise to do something besides what is required by the contract").
37. The elements of a fraud claim are: a material misrepresentation, intent, reliance, and injury. *See Bridgestone/Firestone*, 98 F.3d at 19. Whether or not a purported promise is collateral to a contract has nothing to do with any of these elements.
38. No. 97 Civ. 6026 (WHP), 2002 U.S. Dist. LEXIS 225 (S.D.N.Y. Jan. 8, 2002).
39. *Id.* at *10 (dismissing fraudulent inducement claim alleging misrepresentation of company's share value based upon specific disclaimer in subscription agreement) (citation omitted).
40. *Bango v. Naughton*, 184 A.D.2d 961, 963, 584 N.Y.S.2d 942, 944 (3d Dep't 1992) (dismissing fraudulent inducement claim alleging that the defendant had falsely represented her ability to supply the plaintiff with hand-painted clothing).
41. 235 A.D.2d 657, 651 N.Y.S.2d 731 (3d Dep't 1997).
42. *See id*. at 659.
43. *See id.*
44. Undoubtedly there are cases which raise a close factual question as to whether a party has promised that it will do something in the future or merely asserted an "expression of future expectations." That is beyond the scope of this article.
45. N.Y. Gen. Oblig. Law § 5-701(a)(1).
46. 181 A.D.2d 438, 439, 580 N.Y.S.2d 759, 760 (1st Dep't 1992).
47. *See also Megaris Furs, Inc. v. Gimbel Bros. Inc.*, 172 A.D.2d 209, 213, 568 N.Y.S.2d 581, 583B84 (1st Dep't 1991) (alleged promise by Gimbel's to operate its department store for 10 years, inducing operator of fur and health food areas to purchase a license, held barred by the Statute of Frauds); *Breed v. Insurance Co. of N. Am.*, 81 A.D.2d 675, 676, 437 N.Y.S.2d 799 (3d Dep't 1981) (alleged oral promise to renew insurance contract with additional coverage barred by the Statute of Frauds).

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Can the Fed Strike a Post-Enron Regulatory Balance?

by David L. Glass

Introduction

Last year the Federal Reserve ("Fed") published for comment a proposed new Regulation W ("Reg. W") governing transactions and relationships between all FDIC-insured banks ("banks") and their affiliates,[1] and an interim final rule, which remains subject to comment and revision, governing banks' derivatives transactions with their affiliates (the "Derivatives Rule").[2] The Fed had indicated that final action on these proposals would take place in the second quarter of this year; however, it now appears that adoption of a final rule will be delayed at least until the end of the third quarter.

While many or most provisions of Reg. W simply codify existing law—sections 23A and 23B of the Federal Reserve Act (respectively; "23A" and "23B")[3]—and interpretations of those sections, the Fed left open several issues that go to the heart of how financial innovation is taking place in the markets today. And at first blush some of the transactions implicated by these provisions bear an uncomfortable resemblance to the types of transactions that have been blamed for the spectacular collapse of Enron Corp. In particular, Enron's abuse of special purpose entities (SPEs) to give the appearance of removing liabilities from its balance sheet, while in fact retaining the associated risk in disguised form, has cast a pall over the securitization market and led to calls for tighter regulation.[4] The direct fallout of the Enron debacle thus far has included a proposed tightening of the accounting rules for SPEs by the Financial Accounting Standards Board (FASB)[5] and a concerted effort by a group of law professors and others to remove from the pending bankruptcy reform legislation a provision that would facilitate the use of SPEs.[6] But the proposed Reg. W was published before Enron's fall, and it remains unclear whether, or how, the Fed's resolution of the open issues will be influenced by that event.

Of the many safeguards built into the U.S. bank regulatory system to protect the safety and soundness of banks, among the most important are the restrictions on affiliate relationships and transactions found in sections 23A and 23B. These two provisions together act to minimize the potential that a bank affiliate could abuse its relationship with the bank—for example, by inducing the bank to make it a large unsecured loan, or to contract with it on terms unduly favorable to the affiliate. By permitting well-capitalized and well-managed banks to affiliate with a much broader range of financial companies, the financial reform legislation of 1999, known as the Gramm-Leach-Bliley Act ("GLB Act")[7] has heightened the importance of these two sections.[8]

This article briefly reviews the background and purpose of sections 23A and 23B, and focuses on how certain of the Fed's proposals for inclusion in Reg. W might affect bank derivative transactions with affiliates and securitization programs using SPEs.

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Section 23A—Quantitative Limits

Originally enacted as part of the Glass-Steagall Act of 1933, section 23A has as its purpose to " . . . prevent the misuse of commercial bank resources stemming from non-arm's length financial transactions with affiliated companies."[9] Section 23A applies to all "covered transactions" between a bank and an "affiliate." Covered transactions generally include all loans or extensions of credit to or on behalf of the affiliate (such as a letter of credit securing the affiliate's obligation to a third party) or purchases of assets from the affiliate. The section limits the aggregate amount of all covered transactions with any one affiliate to 10 percent, and the aggregate amount of all covered transactions with all affiliates to 20 percent, of the bank's capital stock and surplus, and requires that each such transaction be secured by collateral. The collateral requirement varies from 100 percent of the amount of the credit if the collateral is composed of U.S. government securities up to 130 percent if other types of collateral are used. Moreover, all covered transactions must be ". . . on terms and conditions that are consistent with safe and sound banking practices."

An "affiliate" generally is defined as a company that controls or is under common control with the bank.

A direct subsidiary of the bank generally is not treated as an "affiliate," except for "financial subsidiaries" organized under the GLB Act to engage in non-bank activities. The Banking Affiliates Act of 1982 liberalized section 23A by making it inapplicable to affiliated banks, thereby enabling funds to flow more freely between banks under common ownership in a holding company system.[10] However, the revision also expanded the definition of "affiliate" to include, aside from any company with which the bank has an actual control relationship, any company "sponsored and advised on a contractual basis" by a bank or bank affiliate.[11] That change was made in response to the well-publicized failure of a real estate investment trust (REIT) sponsored by a bank. The bank did not control the REIT, so it would not have been an "affiliate" under prior law. However, the concern was that, since the market identified the REIT with the sponsoring bank, the bank could be induced to extend excessive amounts of credit to prop up the REIT.[12]

In this regard, it is significant that the definition requires that the company be both "sponsored *and* advised" before it will be deemed to be an affiliate. While there are few published interpretations of this term, the statement of these two factors in the conjunctive should be construed to express an intention that an otherwise unaffiliated company is not presumed to be an affiliate, unless a potential for abuse comparable to that recognized in the REIT situation is present. This distinction may be important in the context of bank sponsorship of SPEs—assuming the Fed does not simply define all SPEs to be affiliates.

Section 23B—Market Terms and Conditions

Section 23B, enacted as part of the Competitive Equality Banking Act of 1987,[13] generally provides that specified transactions between a bank and its affiliates must be conducted on terms and conditions (including credit standards) that 1) are substantially the same, or at least as favorable to the bank, as terms and conditions prevailing for comparable transactions with unaffiliated parties, or 2) in the absence of comparable transactions, that the bank in good faith would be willing to offer to unaffiliated parties.[14] For the purposes of 23B, the 23A definition of "affiliate" is applied, except that affiliated banks are excluded from the definition.[15] Section 23B applies to all "covered transactions," as defined for purposes of 23A.[16] In addition, however, it applies to, among other things, the sale of assets to an affiliate, or the provision of services to an affiliate on a contractual basis.[17]

Thus, while 23A applies only if the bank purchases assets from an affiliate, 23B also applies to a situation where a bank sells loans and other assets to the affiliate—for example, to enable the affiliate to package and sell them as part of a financing, liquidity or asset reduction program.

The problem is that as a practical matter, if there is no ready market for the assets being transferred, it may be difficult to determine whether the bank has received full value. Section 23B deals with this problem by permitting the insured bank to enter into the transaction, as long as it makes a good-faith determination that it would be willing to offer the transaction to a nonaffiliated company on the same terms and conditions. Thus, as a prudential matter, a bank might obtain an independent appraisal of the value of assets transferred, and generally should maintain a record of how the valuation was done.

Securitizations

In a typical bank securitization, a bank sells a portfolio of its assets—such as mortgages, commercial loans, or securities—to a bankruptcy-remote SPE. If the sale is made without recourse to the bank, it will qualify as a "true sale," thereby insulating the transferred assets from claims by creditors of the bank. The SPE is thus able to sell securities to the public backed by the assets it holds. Securitization thereby can benefit a bank in two ways: first, by providing a comparatively low-cost way of financing assets; second, by reducing the total size of its balance sheet, and thereby improving its capital position (i.e., its equity capital as a percentage of assets). In turn, a higher capital ratio keeps regulators happy, as well as lowering the bank's financing cost and facilitating its ability to take on new commitments.

In its Reg. W proposal, the Fed specifically requested comment as to whether SPEs should be treated as "affiliates" for purposes of 23A. In the wake of Enron, the case for doing so may seem more compelling. However, the author believes that such treatment generally would be undesirable, in that it would undermine the ability of banks to engage in otherwise sound and legitimate securitization transactions. They also do not generally implicate the policy concerns underlying 23A, since the establishment of an SPE is designed to benefit the bank, not an affiliate.[18] Indeed, the proper use of SPEs by banks benefits economic activity generally, by redistributing the credit risk of the underlying assets to a broader range of investors and freeing up bank funds to generate new loans. Viewed in this light, the creation of SPEs as securitization vehicles goes to the essence of commercial banking—the evaluation and intermediation of credit risk.

Moreover, assets sold into an SPE typically comprise readily marketable debt instruments. By contrast,

REITs invested in real estate and related assets, which are inherently less liquid and pose a heightened risk of loss in the event of adverse circumstances. Finally, it should be noted that SPEs are passive vehicles that do no more than hold bank-eligible assets and issue securities to finance them, and they lack the power to enter into other lines of business that could compromise safety and soundness. Therefore, depending upon the facts and circumstances, under the existing definition it may be argued that, unlike REITs, SPEs are not sponsored *and* advised by the bank.

Credit Derivatives

The use of swaps and other credit derivative products by banks is a relatively recent development. It is generally viewed as part of a more general approach of "unbundling" the risks involved in banking transactions, just as interest rate and currency derivatives are designed to transfer the risks of interest rate changes and currency fluctuations, respectively.[19] As the regulatory authorities became aware of the growing use of swaps and credit derivatives by banks in the mid-1990s, they issued supervisory guidance for banks engaging in these transactions.[20]

In these releases, the regulatory authorities have made clear that they consider the use of credit derivatives to be legitimate and appropriate banking transactions that entail substantial benefits for banks and the credit markets generally, provided they are conducted in accordance with sound and prudent banking practices. The proper use of swaps and other credit derivatives is viewed as assisting a bank in managing its internal credit limits and diversifying its credit risks.

In the past, some Fed officials have hinted that certain credit derivative transactions among affiliates "may be subject to the restrictions of sections 23A and 23B and raise important supervisory concerns, such as whether the transactions are effective guarantees of affiliate obligations."[21] Nonetheless, to date the Fed generally has refrained from treating swaps and other derivative transactions with affiliates as covered transactions.

Under the GLB Act, the Fed was required to adopt, not later than 18 months after the date of enactment of the GLB Act (i.e., by May 12, 2001) final regulations "to address as covered transactions credit exposure arising out of derivative transactions between [banks] and their affiliates . . ."[22] The Fed may, however, postpone the effective date of any such regulation as it deems necessary to enable banks to comply "without undue hardship."[23] Thus, the Derivatives Rule, although promulgated in fulfillment of this statutory mandate, remains an interim measure pending final promulgation of Reg. W.

For risk-spreading as well as other reasons, it may be advantageous for a derivative transaction with a customer to be booked in an affiliate, rather than the bank itself, or for the bank to transfer the risk to an affiliate through a "back-to-back" swap.[24] Thus, an interpretation that treated derivative transactions with affiliates as "covered transactions" would seriously undermine the legitimate objectives of these transactions and the regulatory interest in encouraging their use. Moreover, derivatives transactions used by banks to hedge customer transactions clearly do not involve the provision of funding to an affiliate, the fundamental concern underlying 23A. Recognizing this, the Fed thus far has refrained from applying 23A to derivative transactions—and indeed, has acknowledged that it is far from clear how 23A could be applied to various types of derivatives.[25]

On the other hand, derivative transactions with affiliates generally are subject to the "market terms" requirement under 23B. By requiring that derivative transactions with affiliates be conducted on terms and conditions no less favorable to the bank than similar transactions with unaffiliated third parties, the application of 23B brings into play the well-developed risk management techniques—including collateralization, where appropriate—that banks already apply to similar transactions with third parties. This is essentially the approach adopted by the Derivatives Rule. Of course, that rule was promulgated before the fall of Enron, and by its terms remains subject to revision in the final Reg. W.

Conclusion

In his 1994 best-seller, *The Death of Common Sense*,[26] attorney Philip Howard argues persuasively that the trend in American law toward "one size fits all" regulation, at the expense of the exercise of judgment and common sense, has undermined the attainment of legitimate regulatory objectives and sometimes led to absurd outcomes. By contrast, Howard cites the bank regulatory system as a particularly effective example of a regulatory structure that has remained effective precisely because it retains the ability to exercise judgment, through an emphasis on after-the-fact examination focused on broad objectives such as safety and soundness, rather than before-the-fact rule-making: "[bank examiners] look at each situation in context, and are considered highly effective."[27]

The Fed has thus far declined to treat bank SPEs as "affiliates," unless they are actually controlled by the

bank or otherwise meet the definition of affiliate in 23A. Similarly, the Fed has thus far taken a measured approach to derivative transactions with affiliates, relying on the "market terms" requirement of 23B rather than the more rigid strictures of 23A. It is to be hoped that, in completing its work on Reg. W, it will not allow itself to be unduly swayed by Enron fallout.

Endnotes

1. Board of Governors of the Federal Reserve System, Notice of proposed rulemaking, "Transactions between Banks and their Affiliates," Docket No. R-1103, May 4, 2001, 66 Fed. Reg. 24186 ("Reg. W Release"). Foreign banks with branches or agencies in the United States, which historically have not been subject to sections 23A and 23B, also would be subject to proposed Reg. W, but only with respect to certain activities, such as securities and insurance underwriting.
2. Board of Governors of the Federal Reserve System, Docket No. R-1104, May 3, 2001, 66 Fed. Reg. 24229, codified at 12 C.F.R. § 250.247. The same release also addressed intraday extensions of credit to affiliates.
3. Codified at 12 U.S.C. § 371c and 12 U.S.C. § 371c-1.
4. *See, e.g.*, Davis, *The Enron Factor*, 88 A.B.A.J. 40 (Apr. 2002).
5. *See, e.g.*, Osterland, *Reining in SPEs*, CFO Magazine, May 2002, at 95.
6. *See Controversy Over Asset Securitization Provisions in Proposed Bankruptcy Legislation*, Bankr. L. Letter, Mar. 1, 2002.
7. Pub. L. No. 106–102, 113 Stat. 1338 (1999).
8. *See* Reg. W Release
9. S. Rep. No. 97-536, 97th Cong. 2d Sess. 30, reprinted in 1982 U.S. Code Cong. & Ad. News at 3085 (the "Senate Report"). *See also* "Background and Summary of Federal Reserve Act Section 23A," I Federal Reserve Regulatory Service (FRRS) ¶ 3-1117. Both 23A and 23B by their terms apply only to Federal Reserve member banks; however, subsequent amendments apply them to all FDIC-insured banks and savings associations.
10. Enacted as part of the Garn-St. Germain Depository Institutions Act of 1982, P.L. 97-320.
11. Senate Report at 3085.
12. Thus, the Senate Report notes that "in view of the difficulties which many bank-advised [REITs] encountered in the mid-1970s, the [amendment] includes as an affiliate any organization that is sponsored and advised on a contractual basis by a banking organization . . ." Senate Report at 3085.
13. 101 Stat. 564 (1987), codified at 12 U.S.C. § 371c-1.
14. Section 23B(a)(1), 12 U.S.C. § 371c-1.
15. Section 23B(d)(1).
16. Sections 23B(a)(2)(A), 23B(d)(2).
17. Section 23B(a)(2)(B and C).
18. *See* Letter from Jeffrey R. Neubert, President, New York Clearing House, to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, at 19 (Aug. 15, 2001) ("NYCH Comment Letter").
19. *See* Office of the Comptroller of the Currency (OCC) Bulletin 96-43, "Credit Derivatives" (Aug. 12, 1996) ("OCC Bulletin").
20. *See* Federal Reserve Board, Supervision and Regulation (SR) Letter 96-17 (Aug. 12, 1996) ("SR 96-17"); OCC Bulletin; FDIC Financial Institutions Letter (FIL) 62-96, Aug. 19, 1996.
21. Joyce M. Hansen, Elizabeth Davy & Nikki M. Poulos, *Swaps and Other Derivatives in 1997: Bank Regulatory Developments*, 1017 PLI/Corp. 481, 484. Ms. Hansen is Deputy General Counsel, and Mss. Davy and Poulos are staff attorneys, with the Federal Reserve Bank of New York. However, their article disclaims that it represents an official statement by the Federal Reserve.
22. Codified at section 23A(f)(3)(A).
23. Section 23A(f)(3)(B). This provision apparently was included in the GLB Act at the request of the Fed. It is not clear why the Fed wanted this provision, since it undoubtedly has the authority to make rules interpreting and applying sections 23A and 23B in any event.
24. *See* NYCH Comment Letter at 24.
25. 66 Fed. Reg. at 24195.
26. Philip K. Howard, The Death of Common Sense: How Law Is Suffocating America (Random House, 1994).
27. *Id.* at 29.

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CASE NOTE

By Michelle Almeida, Ned Glenn and Steven Masur

Fox Television Stations, Inc. v. Federal Communications Commission and The United States of America, National Association of Broadcasters, et al., 280 F.3d 1031 (D.C. Cir.), *modified by rehearing*, 293 F.3d 537 (D.C. Cir. 2002).

Recent Case May Open Door to Media Mega-Giants

A tsunami of corporate takeovers and mergers may be poised to surge across the media industry. Under a recent decision of the D.C. Circuit of the U.S. Court of Appeals in Washington, D.C., huge companies such as AOL Time Warner may be able to merge with broadcast networks that own local TV stations. In addition, broadcast networks like Viacom's CBS may be able to continue buying TV stations without any regulatory limit as to the percentage of national households their stations may reach.

The case is *Fox Television Stations, Inc. v. Federal Communications Commission and The United States of America, National Association of Broadcasters, et al.*, ("*Fox*"),[1] decided February 19, 2002, and modified by rehearing on June 21, 2002. It involved five consolidated petitions asking the court to review the Federal Communications Commission's (FCC) 1998 decision not to repeal or modify the National Television Station Ownership Rule (NTSO) and the Cable/Broadcast Cross-Ownership Rule (CBCO). The NTSO, originally adopted in the 1940s, prohibits any one business entity from controlling TV stations having a combined audience reach exceeding 35 percent of television households in the United States. The CBCO prohibits common ownership of a broadcast station and a cable television system in the same local market. The court ruled that the FCC had to reassess the NTSO and struck down the CBCO completely, stating that it was contrary to the Administrative Procedure Act because it was "arbitrary and capricious."

The FCC argued that the NTSO and the CBCO were adopted to promote diversity in programming and prevent broadcasters from having "undue market power." The argument was based on the underlying theory that the public interest is served by preventing a single broadcaster from controlling access to the choice of news stories and/or slant on the news that people in particular broadcast markets have. The court was not persuaded by these arguments, noting that these rules were decades old and did not reflect the modern media marketplace. The three-judge panel, composed of Chief Judge Douglas H. Ginsburg, Judge Harry T. Edwards and Judge David B. Sentelle, also rejected arguments by the networks and AOL Time Warner that the regulations violated their First Amendment rights. They noted in their ruling that the FCC had not argued or presented evidence to justify the rules' necessity and that the FCC had violated the Administrative Procedure Act, which requires that a federal agency provide a reasoned analysis for its decisions.

The *Fox* decision has and will continue to intensify the debate as to whether broadcast and cable TV consolidations will negatively affect local mass media markets. It is clear that if cable giants like AOL Time Warner can buy broadcast stations in markets where they already own cable TV systems, they will have a larger and, therefore, more powerful presence in each market area. Supporters of the FCC's position, smaller companies and owners who seek to protect their own media interests, argue that if media giants control the local broadcast marketplaces, the result will be decreased diversity in programming, decreased access to alternative viewpoints, and the ability of a single entity to dictate what the audience in a particular market sees and hears. In addition, these FCC supporters argue, it will be more difficult for smaller broadcast companies to survive in the same local broadcast market as the media giants, especially in smaller markets and/or those markets struggling to be profitable.

Companies in favor of being able to purchase more than one broadcast property in each market argue that there is no longer a need to protect the public interest through these rules because new technologies give TV audiences a wide range of programming choices and

thus access to potentially diverse viewpoints. They argue that cable television, satellite television and other direct broadcasting services, TiVo and other recording and time-shifting devices, and the Internet have dramatically broadened consumers' choices in accessing specific and varied programming, creating a media industry strikingly different from that of the 1940s. Therefore, they argue, the NTSO and CBCO need to be modified and adapted to complement the media industry of today.

The supporters of the FCC argued in the rehearing that the court erred when it failed to defer to the decision of Congress' instruction to the FCC that it immediately "increase the national audience reach limitation for television stations to 35 percent." The court found it

> indicates that the Congress wanted the Commission later to review the NTSO Rule under a more deferential standard than any other broadcast ownership rule subject to biennial reconsideration. Had the Congress wished to insulate the NTSO Rule from review under § 202(h) [of the Telecommunications Act of 1996], it need only have enshrined the 35% cap in the statute itself.[2]

The February 19, 2002, ruling may be a landmark decision that will foster opportunity and advances in the industry. It is difficult to predict whether striking down the CBCO and allowing common ownership of broadcast and cable television stations in the same market will prove to be beneficial or detrimental to the industry. As for the NTSO, we will have to wait and see if the FCC decides to provide a more reasoned analysis under the Administrative Procedure Act to support it, or abandons the rule altogether.

The NTSO appears to have a valid purpose in promoting diverse ownership. It may, however, need modification. In a 1984 report, the FCC considered the NTSO irrelevant to promoting diversity on a local level, and suggested that the limitations be dropped. Congress disagreed and moved to block the implementation of the report's guidelines and itself established a guideline of 35 percent in 1996. But as noted previously, that guideline was to be subject to review, not to be a standard set in stone. Apparently Congress was concerned that one company could gain the capacity to reach more than 50 percent of all households nationwide or else there may be the possibility that a broadcast conglomerate will be dictating the news and viewpoints to which half of all Americans will have access. As television is the source of choice for news in America, the risks of a mega media conglomerate reaching greater than 50 percent of all television households in America and shaping the public perception through slanted reporting becomes harder to counteract. By not having a single dominant conglomerate, the majority of the public is, and would be, receiving its programming from more than one company. But as political influence and corporate realities change, the FCC and Congress may again act to establish some market cap. The merged Viacom-CBS company is projected to reach 41 percent of all households nationwide. Therefore, the FCC needs to decide soon where it wants to draw the line on broadcast ownership, and must be able to back up its rules with sound reasoning, as required by the Administrative Procedure Act.

Endnotes

1. 280 F.3d 1031 (D.C. Cir.), *modified by rehearing*, 293 F.3d 537 (D.C. Cir. 2002).
2. 293 F.3d at 540.

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Manuscripts intended for publication in the fall and spring issues must be received by the preceding June 15 and December 15, respectively. Manuscripts are to be submitted to: *NY Business Law Journal*, c/o Professor David Pratt, Editor-in-Chief, Albany Law School, 80 New Scotland Avenue, Albany, N.Y. 12208, telephone (518) 472-5839, fax (518) 445-2315.

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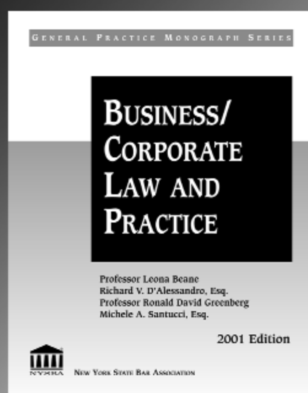

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