

EMERGING TRENDS IN SECURITIES LAW

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By Harold S. Bloomenthal and Samuel Wolff

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Preface

Introduction

EMERGING TRENDS IN SECURITIES LAW for the 12th year chronicles securities developments for the year measured between July 1 of the preceding year through June 30 of the current year, the end of the Supreme Court's most recent term. Important developments post-June 30 and prior to publication also have been taken into account. There was no decision of the Supreme Court during its last term directly relating to securities regulation. Several Circuit Courts of Appeals, however, now have spoken to the PSLRA state of mind and other pleading provisions. The Securities and Exchange Commission has been active in a number of areas, as Chairman Levitt continues to build on his already impressive legacy. Those areas include adopting what is in substance Part II of the Aircraft Carrier Proposal, significantly revamping the regulatory scheme relating to business combinations, exchange and cash tender offers; adopting over the strong objections of the Securities Industry Association the Fair Disclosure Regulation (Regulation FD); adopting the International Disclosure Standards for foreign private issuers, and modernizing EDGAR. Congress achieved the elusive goal of partially repealing Glass-Steagall and adopting a more realistic approach to placing restraints on the combination of investment banking and other financial services.

Private Securities Litigation Reform Act (PSLRA) Scorecard

During the period covered by this edition, the Private Securities Litigation Reform Act (PSLRA) continued to live up to the prediction that in the short run at least it would foster more litigation than it would eliminate. The PSLRA is now almost five years old. Through August 31, 2000, 875 companies, an increase of 220 from August 31, 1999, had been named as defendants in cases subject to the

PSLRA brought in the federal courts. During the first eight months of 1999, 120 companies had been named as defendants in the federal courts in cases subject to the PSLRA. The same “entrepreneurial lawyers” that incurred the wrath of Congress that led to the adoption of the PSLRA are still bringing the same type of cases. The Act virtually assures that reaching the merits will come, if at all, only after a long drawn-out and expensive process in which courts at all levels serve as the gatekeeper to access to a jury trial. *See* § 1.01.

There has been a slackening of the bringing of class actions during 1999 and 2000. In 1999, there were 28 fewer companies named in securities fraud class actions than in 1998, a record year. During the first eight months of 2000, there were 34 fewer companies named as defendants in such action than during the comparable period of 1999. Since the adoption of the Private Securities Litigation Reform Act, several of the leading securities fraud class action lawyers have continued to file a steady stream of class actions (*see* § 1.01); in an effort to become lead counsel have fought among themselves to have their plaintiff named lead plaintiff; with discovery stayed endured extended hearings to determine whether motions to dismiss should be granted; received relatively little good news from the appellate courts with the possible exception of the Second Circuit interpreting the PSLRA pleading provisions (*see* § 1.02), and had relatively few good paydays. All of this undoubtedly involved a very substantial capital investment and stretched the financial resources of some of them. About the moment of time some were undoubtedly reconsidering their strategy, at least a few of them hit pay dirt. This change in fortunes in large part was thanks to some major accounting fiascoes by some major public companies, the most prominent of which involved Cendant.

The *Cendant* litigation produced two large settlements. The *Feline Prides* settlement took the form of the issuance of a security and the aggregate value of the settlement placed on it by the court was approximately \$340 million.¹ The court awarded counsel a fee

¹ In re Cendant Corp. Prides Litig., 51 F. Supp. 2d 537 (D.N.J. 1999).

in securities valued at \$19 million and \$2.3 million in reimbursable expenses. The fee amounted to less than six percent of the recovery. Under the other settlement, Cendant agreed to pay over \$2.85 billion and Ernst & Young \$335 million, a total of approximately \$3.2 billion to the class.² The court approved lead counsel's request for a fee representing 8.275 percent of the net class action settlement (after deducting allowable expenses of \$14,623,806) or approximately \$262 million.³ The City of New York, one of the three lead plaintiffs selected by the court, objected to the amount of the fee, arguing to no avail that it would result in an hourly rate of \$10,861, or 32.7 times the lawyers' average billing rates. *See* § 1.08.

The settlement of the securities fraud class action in *Ikon Solutions* was in the amount of \$111 million; the attorneys requested a fee of 30 percent of the amount recovered and the court approved both the settlement and a fee of 30 percent of the amount recovered after deducting reimbursable litigation expenses of counsel in excess of \$3.5 million. This was only a partial settlement as the case continued against the company's independent accountants and as part of the settlement the company agreed to cooperate with the plaintiffs in pursuing that claim. Probably more important than the amount of the fee from the perspective of plaintiff class bar was the liberal standards adopted by the court in determining an appropriate fee. *See* § 1.08.

The PSLRA Enhanced Pleading Provisions

The Act has “generated a flood of litigation and commentary regarding the proper interpretation of these [enhanced pleading] standards.”⁴ The proponents of the PSLRA put their faith primarily in

² In re Cendant Corp. Sec. Litig., 2000 WL 1146416 (D.N.J. Aug. 15, 2000).

³ In re Cendant Corp. Sec. Litig., 2000 WL 1161902 (D.N.J. Aug. 16, 2000).

⁴ In re Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 973 (9th Cir. 1999) (Sneed, J.).

the changes the PSLRA makes to the Federal Rules of Civil Procedure as applied to securities fraud actions arising under the Exchange Act. The effectiveness of the PSLRA in bringing an end to the rush to the courthouse depends in large part on how the circuit courts of appeal (and ultimately the Supreme Court) answer the question, “what must a plaintiff allege in order to satisfy the requirement that he state facts giving rise to a ‘strong inference’ of fraudulent intent?”⁵ The Circuit Courts of Appeals, as might be expected, have not spoken with one voice and several important circuits have not as yet had the opportunity to address issues arising under the PSLRA. During a span of approximately eight months in 1999, six circuit courts of appeal addressed the enhanced pleading standards of the PSLRA. A divided Ninth Circuit panel on July 2, 1999 rendered its long-awaited decision in *Silicon Graphics*.⁶ While the Ninth Circuit took its time “resolving” the matter, the Second⁷ and Third⁸ Circuit Courts of Appeal weighed in on the pleading issue, the Second Circuit in a case poorly designed to consider an issue of this complexity. Less than a week after the split decision in *Silicon Graphics*, the Sixth Circuit, without referring to the Ninth Circuit decision, added its view as to the PSLRA pleading standard.⁹ Shortly thereafter, the Eleventh Circuit reviewed the opinions of the four other circuits before adopting a position similar

⁵ *Id.*

⁶ In re *Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 973 (9th Cir. 1999), *petition for reconsideration and request for en banc review denied*, 195 F.3d 521 (9th Cir. 1999).

⁷ *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529 (2d Cir. 1999). See HAROLD S. BLOOMENTHAL AND SAMUEL WOLFF, SECURITIES AND FEDERAL CORPORATE LAW (hereinafter “SFCL”) § 16:13.

⁸ In re *Advanta Corp. Sec. Litig.*, 180 F.3d 525 (3d Cir. 1999). See SFCL § 16:12.4.

⁹ In re *Comshare Inc. Sec. Litig.*, 183 F.3d 542 (6th Cir. 1999). See SFCL § 16:13.2.2.

to that of the Sixth.¹⁰ In October of 1999, the First Circuit chimed in with a somewhat different approach from the others.¹¹

Of the six, in terms of verbal formulation, the Ninth Circuit is the most stringent. Recklessness is no longer the basis for alleging or proving scienter unless it constitutes “deliberate recklessness.” Motive and opportunity, at least standing alone, is not a sufficient basis for drawing a strong inference of scienter.¹² The Third and Second Circuits¹³ both viewed the PSLRA standard as the Second Circuit pre-PSLRA standard, although the Third Circuit has added its own nuance as to the particularity required in pleading state of mind.¹⁴ The Sixth¹⁵ and Eleventh Circuits¹⁶ agree with the Second and Third as to recklessness as an appropriate basis for alleging and proving scienter, but side with the Ninth Circuit as to motive and opportunity alone not being an appropriate basis for pleading scienter. The First Circuit disagreed with the Ninth Circuit as to “recklessness” and refused to commit itself to a specific approach, opting for the view that whatever the factual pattern, “inferences of scienter survive a motion to dismiss only if they are both reasonable and ‘strong’ inferences.”¹⁷ *See* § 1.01. Since that flurry of activity, it has been mainly the Second Circuit that has dealt with the pleading issues, to

¹⁰ *Bryant v. Avado Brands, Inc.*, 187 F.3d 1271 (11th Cir. 1999). *See* SFCL § 16:13:2.3.

¹¹ *Greebel v. FTP Software, Inc.*, 194 F.3d 185 (1st Cir. 1999). *See* SFCL § 16:2.8.

¹² *See* SFCL § 16:12.1–16:12.3.

¹³ *See* SFCL § 16:12.10.

¹⁴ *See* SFCL § 16:12.4.

¹⁵ *See* SFCL § 16:13.2.

¹⁶ *See* SFCL § 16:13.3.

¹⁷ *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195-96 (1st Cir. 1999). *See* SFCL § 16:13.8.

some degree reinforcing *Press*, but, more importantly, disagreeing with the Ninth Circuit’s view as to pleading information and belief. *See* §§ 1.02 and 1.03. Two circuit courts of appeal have dealt with the PSLRA safe harbor for forward-looking statements (*see* § 1.07[1]-[2]) and a third (*see* § 1.07[3]) applied *bespeaks* caution in a manner akin to the PSLRA safe harbor. It seems apparent the courts have only started down the safe harbor road.

The circuit courts that have spoken for the most part have talked at a high level of abstraction that does not translate into concrete guidance for district courts. The conceptual difference as to “recklessness,” for example, has not played a significant role in resolving cases based on the allegations. A difference in this regard as to the state of mind that has to be pled at best plays a marginal role if the plaintiffs are relying primarily on allegations of circumstantial evidence as a basis for drawing a strong inference of a culpable state of mind. Similarly, whether motive and opportunity (usually insider stock sales) is sufficient alone or requires more to create a strong inference of a culpable state of mind may be less important than what the court regards as significant in determining, for example, whether the stock sales create “suspicious” circumstances. The marginal role that the circuit court’s abstract verbal formulations of the standard may play is evidenced by the district court’s opinion in *Bryant* on remand from the Eleventh Circuit. When the case came back to Judge Fitzpatrick, he recounted what the Eleventh Circuit had to say about pleading scienter and particularly noted what it said with respect to motive and opportunity. He didn’t find much guidance, however, noting, “[u]nfortunately, although the court above said that pleading motive and opportunity to commit securities fraud would not be enough to state a claim for securities fraud, the court did not say what facts would suffice to meet the standard under the PSLRA, and it is that question that this Court must now confront.”¹⁸ *See* § 1.05.

¹⁸ *Bryant v. Avado Brands, Inc.*, 2000 WL 861844, at *6 (M.D. Ga. June 23, 2000).

Although the courts have not reached consensus on any major issue arising under the Act and may not do so for several more years, a framework of analysis is discernible that may provide a framework within which to resolve the motion to dismiss issues. First, the First Circuit has made sense out of one aspect of the formulation. Virtually all opinions dealing with a motion to dismiss start out with the rote recital that on a motion to dismiss the court “must accept as true all factual allegations in the complaint as true and draw all reasonable inferences in favor of plaintiff.” Having said that, the courts generally go in another direction without explanation. The First Circuit in *FTP Software* was the first to attempt to reconcile this rote learning with the realities of the PSLRA, stating: “Although all inferences if reasonable must be drawn in plaintiff’s favor under the traditional lore, under the PSLRA inferences of scienter survive a motion to dismiss only if they are both reasonable and ‘strong’ inferences.”¹⁹ District courts are beginning to pick up on this theme. *See* § 1.05[3].

Second, in applying the traditional lore content must be given to the information and belief proviso of the PSLRA, something that only two circuit courts have focused on to date. Allegations relating to state of mind and very often those relating to the reasons representations are false tend to be of the information and belief category. The weight to be given to such allegations and the degree of particularity required with respect to such allegations are critical to reach a consensus as to PSLRA pleading standards. If all reasonable inferences are to be drawn in favor of the plaintiff and allegations based on information and belief are taken into account and believed, it may not be too difficult to allege “facts” that establish the representations were false when made and arguably create a strong inference that defendants knew or were reckless in disregarding that the representations were false.²⁰ In that event, the prin-

¹⁹ *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 195–96 (1st Cir. 1999).

²⁰ This is what bothered Judge Fern Smith in *Silicon Graphics* on the District Court level about allegations as to the contents of a “flash report,” which, if believed, were incriminating. “Although plaintiffs have complied with the letter of the

cial check on plaintiffs' counsel is the Rule 11(b) provision for imposing sanctions requiring that counsel reasonably believed the allegations would have evidentiary support after discovery. The PSLRA, however, requires as to allegations based on information and belief that the complaint "state with particularity all facts on which that belief is formed."²¹

In June and July of 2000, the Second Circuit decided two PSLRA pleading cases that are important if for no other reason the Southern District of New York since 1998 has superseded the Northern District of California as the district court in which the largest number of companies are being sued under the PSLRA. *See* § 1.01. The opinion in *Novak* is of particular importance because it is one of the two Circuit Court opinions construing the information and belief proviso of the PSLRA, the other being the Ninth Circuit in *Silicon Graphics*. On the surface the two cases reached diametrically opposite results, but may not be that far apart. *See* § 1.03.

In *Novak*, the defendant AnnTaylor Stores allegedly engaged in a box and hold inventory scheme to cover its failure to write down a substantial amount of obsolete inventory. The facts in *Novak*²² in several respects are similar to the facts in *Silicon Graphics*.²³ The district court opinion in *Novak*²⁴ that the Second Circuit reversed followed *Silicon Graphics* in many respects. In both *Novak* and *Silicon Graphics*, there were alleged accounting irregularities. In *Silicon Graphics*, the defendant allegedly prematurely and improp-

standard . . . the allegations fail to conform to the spirit of the standard. If the Court allowed plaintiffs to go forward with such general allegations, the strengthened standard of the SRA would lose its meaning." *In re Silicon Graphics, Inc. Sec. Litig.*, 970 F. Supp. 746, 767 (N.D. Cal. 1997).

²¹ Exchange Act § 21D(b)(1), 15 U.S.C.A. § 78u-4(b)(1).

²² *Novak v. Kasaks*, 216 F.3d 300 (2d Cir. 2000).

²³ *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 973 (9th Cir. 1999).

²⁴ *Novak v. Kasaks*, 26 F. Supp. 2d 658 (S.D.N.Y. 1998).

erly recognized revenues; in *Novak*, the defendant AnnTaylor Stores allegedly failed to write down a substantial obsolete inventory. In both cases, ultimate bad news announcements resulted in a steep decline in the price of the defendant's stock. In both, the allegations of the complaint were full of details that, if believed, tended to show knowledge of the defendants of the inappropriate accounting practices. In both cases, the allegations were based on information and belief and the source of the detailed information was not disclosed in the complaint or otherwise. The failure to disclose the source was an important, if not critical, factor in *Silicon Graphics*; in *Novak* it was not. What really may be critical may be what the meaning of "all" is.

Judge Walker and the Second Circuit in *Novak* concluded that "all" in the "shall state with particularity *all* facts on which that belief is formed" clause of the information and belief proviso²⁵ does not mean "all." Judge Walker did so because of the "illogical results" if the word "all" is read literally, and Congress is presumed not to have intended the illogical. It would be sufficient to satisfy the proviso if "'all' the facts supporting the plaintiff's information and belief were pled, but those facts were patently insufficient to support that belief." On the other hand, if only some are named they would be insufficient even if the "facts [were] fully sufficient to support a convincing inference."²⁶ Judge Walker started part-way down what could be a significant road, although he did not put it in this precise way. When one pleads on the basis of information and belief, they are stating that there is reason to believe that information. What the proviso calls for with particularity are the facts giving credibility (support) for belief in that information. Pleading, for example, the information and belief allegation is based on the investigation of counsel, if that was all that is pled, may be all of the facts on which the belief is based, but is "patently insufficient to support that belief."

²⁵ See Exchange Act § 21D(b)(1), 15 U.S.C. § 78u-4(b)(1).

²⁶ *Novak v. Kasaks*, 216 F.3d 300, 314 n.1 (2d Cir. 2000).

On that basis, what the proviso is about is facts that go to the creditability of the allegation based on information and belief. That is what Judge Sneed seemed to be concerned about in *Silicon Graphics* in applying the information and belief proviso to allegations based on what was said at alleged meetings of the company officers and the content of alleged internal reports. As to the allegations of the complaint relating to a meeting of company officers, “Brody [plaintiff] does not plead facts to corroborate her allegations. Instead, she merely provides a list of sources from which she allegedly obtained her information.” The sources referenced being investigation of counsel, discussion with consultants, etc., referred to by the court as “[t]he boilerplate section of her complaint.” As to the reports, supported only by the same boilerplate allegation of sources, plaintiff “does not include adequate corroborating details. She does not mention, for instance, the sources of her information with respect to the reports, how she learned of the reports, who drafted them, or which officers received them.” So, although specific sources of the specific information is one respect in which the allegations were lacking, it was not the only one. Further, the complaint does not include “an adequate description of their contents *which we believe—if they did exist—would include countless specifics regarding ASIC chip shortages, volume shortages, negative financial projections, and so on.* We would expect that a proper complaint which purports to rely on the existence of internal reports would contain at least some specifics from those reports *as well as such facts as may indicate their reliability.*”²⁷

Judge Walker started with the allegation relating to the allegedly worthless inventory boxed and stored in the warehouses.²⁸ It was supported by the acknowledgement in the bad news announcement on May of 1995 that the company’s inventory was too large and the liquidation of the inventory would have an adverse impact on that

²⁷ *In re Silicon Graphics, Inc. Sec. Litig.*, 183 F.3d 970, 985 (9th Cir. 1999). Emphasis added.

²⁸ *Novak v. Kasaks*, 216 F.3d 300, 312-13 (2d Cir. 2000).

year's earnings. A weekly report six months later referenced inventory dating back to 1993 and 1994, "which supports the inference that inventory during the Class Period was similarly dated. Thus, the complaint identifies with particularity several documentary sources that support the plaintiffs' belief that serious inventory problems existed during the Class Period itself."²⁹ This predicate appears to be critical to the court's views in two respects — (1) the details required as to the basis for the information and belief allegations, and (2) the extent to which the source of such information had to be disclosed. "Accordingly," the court said, "where plaintiffs rely on confidential personal sources but also on other facts, they need not name their sources as long as the latter facts provide an adequate basis for believing that the defendants' statements were false."³⁰

All of this puts a different shape on matters. The purpose of Rule 9(b) and the PSLRA "can be served without requiring plaintiffs to name their confidential sources as long as they supply sufficient specific facts to support their allegations. Imposing a general requirement of disclosure of confidential sources serves no legitimate pleading purpose while it could deter informants from providing critical information to investigators in meritorious cases or invite retaliation against them."³¹ But this is not the end of it. The Second Circuit "express[ed] no view as to whether the plaintiffs' allegations in this case were sufficiently particularized. Instead, we remand to the district court with instructions to: (1) allow the plaintiffs to replead in light of our discussion above; and (2) reconsider the particularity of the plaintiffs' pleadings in light of the proper standards."³² But the court also saw "no reason to impose such a requirement [to name sources] under the circumstances of this

²⁹ Novak v. Kasaks, 216 F.3d 300, 313 (2d Cir. 2000).

³⁰ Novak v. Kasaks, 216 F.3d 300, 313-14 (2d Cir. 2000).

³¹ Novak v. Kasaks, 216 F.3d 300, 314 (2d Cir. 2000).

³² Novak v. Kasaks, 216 F.3d 300, 314 (2d Cir. 2000).

case.”³³ It remains to be seen what the district court will do in applying the standard outlined by the court in *Novak* and, for that matter, precisely what Judge Walker is looking for in the way of particularity, although he noted three times, in one instance quoting from Judge Scirica in *Advanta*, that the state with particularity requirement in the context of (b)(2) (pleading state of mind) goes beyond what the Second Circuit strong inference standard requires. *See* § 1.02[2].

The third factor revolves around the content to be given to the “state with particularity facts” language of (b)(2) (the state of mind pleading provision) and the “state with particularity all facts” language of (b)(1) (the information and belief proviso). The similarity in language with respect to “particularity” is no happenstance, but attributable to the behind the scene role Judge Scirica played on behalf of the Judicial Conference in the drafting of these provisions by the Conference Committee. The “state with particularity” language of (b)(1) was substituted for “specifically allege” language of the bill that the Senate sent to the Conference Committee and that was the basis for the mark-up that led to the Act reported by the Conference Committee and enacted by Congress. The “state with particularity” language of (b)(2) was substituted for “set forth all information” as part of the same mark-up. The changes were suggested by Judge Scirica to the Conference Committee to “conform with the existing language in Rule 9(b).” This became apparent in the course of the debate on overriding the President’s veto in the Senate when Senator Domenici made part of the record a letter from Judge Scirica, “speaking on behalf of the Judicial Conference,” in the words of Senator’s Domenici, to Senate Committee staff members.³⁴ In *Advanta*, Judge Scirica, without disclosing his

³³ *Id.*

³⁴ *See* letter of Anthony J. Scirica, dated October 31, 1995, to Laura Unger and Robert Giuffra, Senate Committee on Banking, Housing and Urban Affairs, at 141 Cong. Rec. S19045 (Dec. 21, 1995), and remarks of Senator Domenici, at 141 Cong. Rec. S19044-S19045 (Dec. 21, 1995).

role in the legislative process, referred to the “state with particularity” language in the context of (b)(2) and stated: This is the language of Rule 9(b), which “requires plaintiffs to plead ‘the who, what, when, where, and how: the first paragraph of any newspaper story.’”³⁵

Having determined the extent to which allegations based on information and belief are to be taken into account, if at all, the court on a motion to dismiss must make the ultimate determination. Taking into account the information and belief allegations that pass muster, as well as any other facts pled with appropriate particularity, do such allegations create a strong, as distinguished from merely reasonable, inference that defendant(s) had the culpable state of mind required by the appropriate provision(s) of the Exchange Act under which the private action is being asserted.

PSLRA Safe Harbor for Forward-Looking Statements

The safe harbor for forward-looking statements is an important ingredient of the PSLRA, designed to provide an environment in which corporate executives would feel free to talk about the future of their company. Limited to reporting companies, the company escapes liability under the Securities Act for forward-looking statement if any of the three prongs are applicable: (1) The statement “is identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the forward-looking statement.”³⁶ (2) The forward-looking state-

³⁵ *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525 (3d Cir. 1999), at 534, *quoting from* *DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990).

³⁶ Securities Act § 27A(c)(1)(A)(i), *as added by* § 102(a) of Pub. L. No. 104-67; Securities Exchange Act § 21E(c)(1)(A)(i), *as added by* § 102(a) of Pub. L. No. 104-67.

ment is “ immaterial.”³⁷ (3) The plaintiffs fail to prove that the forward-looking statement was made “with actual knowledge” that it was false or misleading.³⁸ Several courts, including three circuit courts of appeals, have spoken to the cautionary statement prong of the PSLRA, although one did so in the context of bespeaks caution.

The Eleventh Circuit in *IVAX*³⁹ concluded that even if the defendant company deliberately substantially understated the amount by which it was going to have to restate and reduce its income for a prior fiscal quarter, the statement was not actionable as it was forward-looking and accompanied by appropriate cautionary statements. Specifically the court cited the statement of the Conference Committee report that “[f]ailure to include the particular factor that ultimately causes the forward-looking statement not to come true will not mean that the statement is not protected by the safe harbor.”⁴⁰ The court construed this to mean “when an investor has been warned of risks of a significance similar to that actually realized, she is sufficiently on notice of the danger of the investment to make an intelligent decision about it according to her own preferences for risk and reward.”⁴¹ The court denied plaintiff’s request to amend the complaint to include allegations that certain documents would reveal that at the time of the statement the company knew that it would have to write off a large amount of goodwill. The court concluded that such an amendment would be futile even if true. “The statutory definition of ‘forward-looking statement’ does not refer at all to the defendants’ knowledge of the truth or falsity of the statement, however; such knowledge is relevant only to liability

³⁷ Securities Act § 27A(c)(1)(A)(ii), as added by § 102(a); Securities Exchange Act § 21E(c)(1)(A)(ii), as added by § 102(b) of Pub. L. No. 104-67.

³⁸ Securities Act § 27A(c)(1)(B)(i), as added by § 102(a); Securities Exchange Act § 21E(c)(1)(B)(i), as added by § 102(b) of Pub. L. No. 104-67.

³⁹ *Harris v. IVAX Corp.*, 182 F.3d 799 (11th Cir. 1999).

⁴⁰ *Harris v. IVAX Corp.*, 182 F.3d 799, 807 (11th Cir. 1999).

⁴¹ *Id.*

in the safe harbor, and even there only when there is inadequate cautionary language.”⁴² The SEC belatedly submitted an *amicus* brief in connection with a motion for reconsideration and for a hearing *en banc*. The Commission argued that cautionary statements cannot be “meaningful” if, to quote the court’s paraphrase, “the cautionary statement knowingly omits a fact that is such a market-driver that it dwarfs the listed ‘factors that could cause actual results to differ.’” The panel rejected the argument because it had not been submitted to the court previously and no member of the Eleventh Circuit requested that the court be polled whether to consider the case *en banc*.⁴³ See § 1.07[1].

The Third Circuit in *Semerenko* resolved the issue under the speaks caution doctrine, although the district court primarily relied upon and the case was largely argued on the basis of the PSLRA safe harbor for forward-looking statements. The confusion in this regard appears to have been a result of the belated realization that the alleged misrepresentations were made in connection with a tender offer and tender offers are excluded from the PSLRA safe harbor.⁴⁴ The statement in issue was an announcement by the defendant company that it was going to have to restate its financial statements, which announcement included an estimate of the amount by which revenues and earnings would be reduced that substantially underestimated the amount. In issue was the adequacy of a cautionary statement that warned that the amount of the actual restatement may differ.⁴⁵

The court “conclude[d] that the accompanying warnings were not sufficiently cautionary to warn against the danger of relying on

⁴² Harris v. IVAX Corp., 182 F.3d 799, 807 n.10 (11th Cir. 1999).

⁴³ See Harris v. IVAX Corp., 209 F.3d 1275 (11th Cir. 2000).

⁴⁴ Semerenko v. Cendant Corp., 2000 WL 1131928, at *14 n.12 (3d Cir. Aug. 10, 2000), *citing* 15 U.S.C. § 78u-5(i)(A)-(B).

⁴⁵ Semerenko v. Cendant Corp., 2000 WL 1131928, at *14 n.12 (3d Cir. Aug. 10, 2000), *citing* 15 U.S.C. § 78u-5(i)(A)-(B).

the specific numbers identified in the announcement.”⁴⁶ The court took as its guide what it had said earlier in *Trump* with respect to the bespeaks caution doctrine — “a vague or blanket (boilerplate) disclaimer which merely warns the reader that the investment has risks which will ordinarily be inadequate to prevent misinformation. To suffice, the cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions in the prospectus which the plaintiffs challenge.”⁴⁷ The cautionary statement failed that test.⁴⁸ See § 1.07[3].

Although based on bespeaks caution, the “meaningful cautionary statements” language of the PSLRA was derived from *Trump*.⁴⁹ The overlap of the two in this context explains in part the fact that the standard applied in *Semerenko* is similar in many respects to what the Conference Committee Report said regarding the adequacy of a cautionary statement:⁵⁰ “Under this first prong of the safe harbor, boilerplate warnings will not suffice as meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the statement. The cautionary statements must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement.”

Both *Ivax* and *Semerenko* involved forward-looking statements, which if forward-looking at all, were not in the mainstream of what

⁴⁶ *Semerenko v. Cendant Corp.*, 2000 WL 1131928, at *14 (3d Cir. Aug. 10, 2000).

⁴⁷ *Id.*, quoting *In re Trump Casino Sec. Litig.*, 7 F.3d 357, 371-72 (3d Cir. 1993). For a discussion of *Trump*, see SFCL § 15:28.

⁴⁸ *Semerenko v. Cendant Corp.*, 2000 WL 1131928, at *15 (3d Cir. Aug. 10, 2000).

⁴⁹ See SFCL § 16.04[4].

⁵⁰ Conference Report to accompany H.R. 1058, H.R. Rep. No. 369, 104th Cong., 1st Sess. (Nov. 28, 1995).

the PSLRA safe harbor is all about. *Ivax* involved a preliminary estimate of financial results for a quarter that had just ended. *Semerenco* involved an estimate made in connection with the announcement of a forthcoming restatement of the financial statements. In *Vencor*, on the other hand, plaintiffs attacked an earnings forecast because of the failure to take into account the possible impact of legislation (the Balanced Budget Act) before Congress.⁵¹ The majority opinion is not a model of exposition as it invokes the PSLRA safe harbor, but shortcuts the need to include cautionary statements if the “facts” that undermine the statement constitute “soft information.” Judge Kennedy speaking for the majority relied on pre-PSLRA law in the Sixth Circuit to the effect that there was no obligation to disclose “soft information” unless “virtually as certain as hard facts.”⁵² Because adoption of the Balanced Budget Act was uncertain, “defendants cannot be held responsible for not disclosing information about the possible effect that this legislation would have on Vencor’s business.”⁵³ *See* § 1.07[2].

Judge Merritt dissented because, among other things, in his view the company continued to make earnings forecasts without taking into account the impact of the legislation even after the Act in question had passed both houses of Congress. Judge Merritt acknowledged there was a “general warning” without specifically referencing the Balanced Budget Act about governmental legislation that could reduce expenditures for Medicare and Medicaid, “but unequivocally stated that it could not predict the impact of the legislation.”⁵⁴ An interesting sidelight is that Judge Merritt was on the

⁵¹ *Helwig v. Vencor, Inc.*, 210 F.3d 612, 617 (6th Cir. 2000).

⁵² *Helwig v. Vencor, Inc.*, 210 F.3d 612, 621 (6th Cir. 2000), *citing* *In re Sofamor Danek Group, Inc.*, 123 F.3d 394, 401 (6th Cir. 1997). *Sofamor* in turn quoted from *Starkman v. Marathon Oil Co.*, 772 F.2d 231, 241 (6th Cir. 1985), *cert. denied*, 475 U.S. 1015 (1986).

⁵³ *Helwig v. Vencor, Inc.*, 210 F.3d 612, 621-22 (6th Cir. 2000).

⁵⁴ *Id.*

Sixth Circuit panel and joined in the opinion in *Sofamor*, on which the majority opinion in *Vencor* placed so much reliance.

New Regime for Business Combinations and Exchange Offers

The Commission in November of 1998 launched the “Aircraft Carrier” proposals with a big splash. The Aircraft Carrier had two principal compartments — the securities offering proposal and the business acquisition/tender offer proposal. By the end of the comment period on June 30, 1999, it was apparent that heavy fire from the critics put the securities offering compartment of the aircraft carrier in dry dock for extended repairs.⁵⁵ That aspect of the Aircraft Carrier Proposal, now referred to by the Commission as the Securities Act Reform Proposal, as of this writing has not resurfaced, although it continues to be promised in a less ambitious form.

The business combination/exchange tender offer proposal escaped much of the criticism. The reason it found such favor is that it gave a lot in the way of freedom to communicate with shareholders before and after filing the appropriate documents, without demanding much in return that was not already required. On October 22, 1999, the Commission adopted that component of the Aircraft Carrier Proposal without reproposing it, but with some modification from the original proposal.⁵⁶ In doing so, the Commission had to take into account that Part 1 contemplated new Forms C and SB-3 for business combinations and exchange offers. The Commission avoided this issue by the simple expedient of disregarding that part of Part 1 and by making some modest changes to Form S4, the existing form for registering business combinations and exchange offers, and Form F-4, the counterpart form for foreign private issuers. *See* § 2.05. The new regime necessitated some modest revi-

⁵⁵ *See* SFCL § 9:129.

⁵⁶ Sec. Act Release No. 7760 (Oct. 22, 1999), 1999 WL 969596.

sions to the proxy rules (*see* § 2.04[1]), but entailed a complete re-vamping of the regulations covering all tender offers — cash and exchange tender offers by third parties and by issuers. *See* §§ 2.07-2.10. The Commission concurrently adopted a cross-border proposal that, among other things, facilitates compliance with U.S. securities laws in connection with business combinations and tender offers involving the acquisition of foreign private issuers that have a limited number of U.S. shareholders.⁵⁷ *See* § 2.13.

The adoption of the new business combination, exchange and cash tender offer regime is no small achievement and in many respects could show the way for a new Securities Act offering regime if anyone is listening. With respect to a business combination, exchange offer, or tender offer, there no longer are any absolute restrictions on communications before the filing of the documents required under the relevant Acts or outside of those documents once they are filed. *See* § 2.07. The written communications with prescribed legends must be filed with the Commission, but what is said (at least in writing) is out in the open and available to everyone. The Commission to accomplish this in the tender offer context had to redefine when a tender offer commences. *See* § 2.08. Beyond that, to level the playing field to some degree between exchange and cash tender offers, an exchange tender offer now may commence once a preliminary prospectus is available for delivery. *See* § 2.10[1].

When a foreign private issuer makes a rights offering to its shareholders or when any issuer, foreign or domestic, makes an exchange offer, or proposes to acquire with its shares by merger or otherwise a foreign private issuers with U.S. shareholders, consideration must be given to possible application of the federal securities laws governing the registration of securities. In the case of exchange offers and tender offers, the tender offer regulations and rules governing tender offers also must be taken into account. In many such transactions, foreign issuers and other market partici-

⁵⁷ *See* Sec. Act Release No. 7759 (Oct. 22, 1999), 1999 WL 969592.

pants concluded that the burdens of complying with the U.S. securities laws outweighed the benefits of including U.S. shareholders in the transaction. *See* § 2.13. The globalization of securities markets accentuated the situations in which U.S. shareholders in foreign private issuers were through various devices left out of such transactions. The new cross-border regime is designed to alleviate this situation. *See* §§ 2.15-2.19.

Selective Disclosure and Regulation FD

Chairman Levitt and members of the Commission for some time have expressed publicly concerns about conference and other telephone calls between the issuer and analysts and private meetings between companies and analysts that exclude the media and members of the public. Companies increasingly use a conference call to analysts and institutional investors as a means of distributing information about quarterly and annual results. Conference calls to analysts and institutional investors may be employed in lieu of periodic meetings that company executives often had and sometimes continue to have with a group of analysts that follow their company. Investment banking firms sponsor forums at which companies in particular industries are invited to make presentations. Major securities firms on occasion schedule retreats where the firm's analysts following the company meet in a resort atmosphere with the executive officers of companies that the firm represents in its investment banking capacity. *See* § 11.01[1].

If only information that is public is disclosed or the information is otherwise being disclosed concurrently to the public, there is nothing unlawful about such activities.⁵⁸ Even if disclosure is made to the analysts prior to public disclosure, *Dirks*⁵⁹ suggests that there is no violation of Rule 10b-5 if there is no pecuniary benefit to the com-

⁵⁸ *See* SFCL § 19:19.3.

⁵⁹ *Dirks v. SEC*, 463 U.S. 646 (1983). *See* SFCL § 19:18.

pany. This does not permit insiders to make a “gift” of such information to friends or family, but does permit considerable latitude as to what insiders, absent a quid pro quo, disclose to securities analysts.

The Commission addressed its concern over selective disclosure to analysts by proposing on December 20, 1999 and adopting on August 15, 2000 a Fair Disclosure Regulation (Regulation FD) applicable to all reporting companies. Rule 100(a), the operative part of Regulation FD, requires a company disclosing material non-public information to persons falling within enumerated categories as specified by Rule 100(b)(1) to simultaneously make public disclosure of the information. Public disclosure has to be made on a Form 8-K or in a press release or other means designed to provide broad public access to the information.⁶⁰ The rule as adopted differs significantly in a number of respects from the rule as proposed. The revisions to the proposed rule are designed to narrow the persons to whom disclosure of material non-public information triggers the public disclosure obligation and to narrow as well the persons deemed to be acting on behalf of the issuer. *See* § 11.01[2]. Of considerable significance as well, Regulation FD as proposed would have been applicable to selective disclosures made by a reporting company in connection with a road show relating to a public offering. A proposed companion Rule 181 under the Securities Act would have exempted from Section 5(b)(1) of the Securities Act any communication made to comply with Rule 100 if made after the filing of the Securities Act registration statement. The Fair Disclosure Regulation as adopted, however, specifically is not applicable to selective disclosures made in connection with substantially all offerings registered under the Securities Act.⁶¹ *See* § 11.01[5].

The Commission’s announcement of the Fair Disclosure proposal produced two diametrically opposite reactions. Individual in-

⁶⁰ Rule 101(e), 17 C.F.R. § 243.101(e).

⁶¹ Rule 100(b)(2)(iv), 17 C.F.R. § 243.100(b)(2)(iv).

vestors loved it and almost immediately directed their comments electronically to the Commission's web site. The SIA and investment banking firms were absent from the SEC "bulletin board" in the early stages, but let the financial press know what they thought about "fair disclosure" and, presumably, the Commission as well. In brief, they were very concerned that it will have a chilling effect on a company's relationships with analysts, investment bankers, and other securities professionals. The Adopting Release noted the receipt of nearly 6,000 letters, the vast majority of whom were individual investors urging the Commission "almost uniformly" to adopt proposed Regulation FD. *See* § 11.01[1]. It is apparent that FD struck a sensitive chord with the investing public, but that does not mean that it may not cast a big chill as feared by some on communications between public companies and what heretofore has been regarded as the investment community. The Commission's guidance on discussing earnings projections with analysts privately, in particular, is likely to undo what the Supreme Court in *Dirks* sought to protect. *See* § 11.01[3].

Regulation FD conceptually is a brilliant end-run around *Dirks*. The Commission did not rely on Section 10(b) of the Exchange Act as its authority for Regulation FD. Rather the Commission relied primarily on its authority under Section 13(a) (and Section 15(d) counterpart) to adopt rules requiring a company with a class of securities registered under the Exchange Act to file such reports with the Commission "as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security." This also ameliorated to a limit extent the concern of securities professionals and others as a violation of the rule does not give rise to a violation of Rule 10b-5 and the rule expressly provides that violations of the rule are not a basis for a private action. The enforcement of violations of the rule is solely the domain of the SEC. *See* § 11.01[4].

Bringing Communications While In-Registration into the Internet Age ¾ Delayed or Derailed?

The intricate and highly technical Aircraft Carrier proposal in contrast to Regulation FD drew a big yawn from individual investors. In large part, the Securities Act Reform Proposal aspect of the Aircraft Carrier proposal, at which the securities industry directed its criticism, to a significant degree was concerned with liberalizing communications by a registrant while in registration. That aspect of the proposal, much like the new regime adopted for business combinations and exchange tender offers, would have liberalized communications made by a company while in registration both before and after the filing of a registration statement.

On March 3, 2000, David Martin, Director of the Division of Corporation Finance, speaking with the usual disclaimers at the annual SEC Speaks Conference, stated that “the aircraft carrier proposal has been scrapped, but some pieces of it will be kept afloat.”⁶² Specifically, according to the *Wall Street Journal* reporter, “he referred to two smaller proposals — one tackling communication, and a second that deals with integrating public and private offerings.” The article continues: “The communication proposal, aimed at updating 1930s-era laws for the Internet age, is ‘probably in better shape,’ and is likely to be the first taken up by the SEC, Martin told reporters following his prepared remarks.” Mr. Martin, presumably, in referring to communications is referring to a reproposal of the Securities Act Reform Proposal. Two events implicating to some degree communications while in registration have taken place since, but as of this writing the reproposal of the Securities Act Reform Proposal has not taken place.

One of those actions relates to Regulation FD adopted on August 15, 2000, discussed above and at § 11.01[5]. Regulation FD as proposed would have made Regulation FD applicable under cer-

⁶² Judith Burns, *SEC Sinks ‘Aircraft Carrier,’ Will Float Smaller Plans*, WALL ST. J., Mar. 6, 2000 (Interactive ed.).

tain circumstances to selective disclosure made in the course of a road show. The proposal raised more questions than it answered. *See* § 4.10. When the Commission adopted Regulation FD on August 15, 2000, it elected to punt. Regulation FD as adopted does not include that part of the proposed regulation that related to selective disclosure while in registration. Regulation FD provides that it is not applicable to communications made in connection with substantially all offerings registered under the Securities Act. Accordingly, selective disclosure can be made orally in the course of a road show without violating Regulation FD, whether made by a reporting company or in connection with an IPO. If such disclosure is made, the registrant does not have the alternative of disclosing the information in a press release or other written communication without violating Section 5(b)(1). The Commission in the Regulation FD Adopting Release justified not going part way down this slippery slope because “[w]e are satisfied that the Securities Act already accomplishes at least some of the policy imperative of Regulation FD within the context of a registered offering.”⁶³ The Release does suggest further action in this area is forthcoming, stating: “To the extent selective disclosure concerns arise in connection with registered offerings of securities, we believe it would be more appropriate to consider that impact in the context of a broader Securities Act rulemaking.”⁶⁴ *See* § 11.01[5].

On April 28, 2000, the Commission issued its third Interpretative Release dealing with “Use of Electronic Media” Interpretative Release III in significant part relates to communications on a registrant’s web site while in registration. One of the objectives of Interpretative Release III is to clarify “general legal principles that govern permissible web site communications by issuers when in registration.”⁶⁵ The basis for this interpretation is a number of earlier

⁶³ *See* Sec. Act Release No. 7881 (Aug. 15, 2000), Pt. II.B.6.a, 2000 WL 1197687.

⁶⁴ *Id.*

⁶⁵ Sec. Act Release No. 7856 (Apr. 28, 2000), 2000 WL 502290, at *3.

guidance-type releases as to what does and does not constitute free writing while in registration, the most recent of which dates back to 1971. Interpretative Release III prefaces the new old guidance with the following statement: “An issuer that is in registration should maintain communications with the public as long as the subject matter of the communications is limited to ordinary-course business and financial information, which may include the following.” What follows is a bulleted rephrase of the 1971 Release 5180 guidelines as to what is permitted while in registration. *See* § 4.05[1].

Although the Release 5180 terminology is changed slightly suggesting a modest liberalization of the guidelines, it seems apparent that was not the intention of the staff. Interpretative Release III in large part is all about when information on a web site constitutes impermissible free writing and explicitly states: “[T]he web site content must be reviewed in its entirety to determine whether it contains impermissible free writing. The Commission staff will continue to raise questions about information on an issuer’s web site that . . . would constitute an “offer to sell,” “offer for sale” or “offer” under Section 2(a)(3) of the Securities Act.”⁶⁶ This appears to have been intended as a shot across the bow placing registrants on notice that the staff is looking at the web sites of registrants in registration. *See* § 4.05[4]. It is apparent that the staff in connection with its review of registration statements filed under the Securities Act in many instances is looking at the registrant’s web site and taking a very aggressive attitude as to the information on the web site that may be deemed inappropriate free writing. *See* § 4.05[4]. The bringing of the statutory scheme relating to offers while in registration and free writing into the Internet age appears to be dependent upon the adoption of a reproposal of the Securities Act Reform Proposal. When and whether that will take place is not predictable. The strict application of the limitation on communications while in registration to registrant’s web site suggests that there may

⁶⁶ Sec. Act Release No. 7856 (Apr. 28, 2000), 2000 WL 502290, at *6 (footnotes omitted).

be considerable disagreement among members of the staff whether there should be any liberalization. *See* § 4.10.

Corporate Finance

A large portion of this book examines the work of the Division of Corporation Finance at the SEC and the rules and regulations that it administers. The Division is now being led by David Martin, a well respected Washington, D.C. securities lawyer with extensive prior experience both in private practice and at the Commission. Commission actions affecting or relating to business combinations,⁶⁷ free writing,⁶⁸ the Internet,⁶⁹ road shows⁷⁰ and selective disclosure⁷¹ are discussed in various chapters of this book. Chapter 9 reviews the subject of shareholder proposals, which are also administered by the Division of Corporation Finance. Chapter 3, entitled “Corporate Finance,” examines several more routine but nonetheless important regulatory developments in the area of corporate disclosure, corporate finance and the distribution process.

In the fall of 1998, in a speech entitled “The ‘Numbers Game,’”⁷² SEC Chairman Arthur Levitt took registrants to task for the use of creative accounting to manage earnings and meet analysts’ expectations. The Numbers Game speech formally kicked off

⁶⁷ *See* Chapter 2.

⁶⁸ *See* Chapter 4.

⁶⁹ *See* Chapter 4.

⁷⁰ *See* Chapter 4.

⁷¹ *See* § 11.01.

⁷² *See* Arthur Levitt, *The Numbers Game*, speech delivered to the NYU Center for Law and Business, available at the Commission’s web site at <http://www.sec.gov/news/speeches/speech220.txt> (Sept. 28, 1998) (hereinafter “Levitt, The Numbers Game”).

an SEC action plan later be dubbed “the year of the accountant.”⁷³ The initiative on financial fraud and earnings management became a top enforcement priority for the Commission. As part of its accounting action plan, the SEC, among other things, encouraged the strengthening of independent audit committees for listed companies and closer cooperation between the outside auditor and the audit committee. In February 1999, a blue ribbon panel sponsored by the New York Stock Exchange and the National Association of Securities Dealers issued a report on audit committees presenting ten recommendations in three areas: (a) the independence of the audit committee; (b) making the committee more effective; and (c) improving mechanisms for accountability among the committee, the outside auditors and management.⁷⁴ The committee proposed guiding principles for audit committee best practices, emphasizing (i) the audit committee’s key role in monitoring the audit process; (ii) independent communication and flow of information between the audit committee and the internal auditor, and between the audit committee and the outside auditors; (iii) candid discussions with management, and internal and outside auditors regarding “issues implicating judgment and impacting quality”;⁷⁵ and (iv) diligence and financial expertise among the audit committee membership.⁷⁶

As discussed in Chapter 3, a number of the recommendations of the blue ribbon committee were implemented in the past year. For example, the Commission amended its rules effective December 15,

⁷³ Norman Johnson, *The Year of the Accountant*, speech delivered to the Practising Law Institute’s SEC’s Conference, available at www.sec.gov/news/speeches/spch256.htm (Feb. 26, 1999). See also C. Rogers, *The Year of the Accountant*, in BLOOMENTHAL AND WOLFF, *EMERGING TRENDS IN SECURITIES LAW 1999-2000* ed., at § 10.01.

⁷⁴ See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, 54 *BUS. LAWYER* 1067, 1072 (1999) (hereinafter “Millstein/Whitehead Report”), discussed *infra* § 3.02.

⁷⁵ *Id.* at 1091.

⁷⁶ *Id.* at 1093.

2000 to require that companies with audit committees include an expanded report of the audit committee in a proxy statement filed with the Commission.⁷⁷ The report does not have to be included in the proxy statement relating to the annual meeting of shareholders at which directors are elected, but that probably is where most companies will include it as that is the logical place and many companies only prepare one proxy statement per year. It can be expected that a flood of new audit committee reports will occur in the upcoming (2001) proxy season. The audit committee report must cover such matters as independence of the audit committee; for example, for listed companies, as to any member who is not independent, the issuer must disclose the reasons that keep him/her from being independent and why it was determined appropriate to name him/her to the audit committee. The audit committee report also must indicate whether the audit committee discussed with the independent auditors the matters required to be discussed by Statement on Auditing Standards (SAS) No. 61.⁷⁸

The Auditing Standards Board of the American Institute of Certified Public Accountants amended SAS 61 and SAS 71 in December 1999. The amendment to SAS 61 extends the matters to be discussed by the auditor with the audit committee to “the auditor’s judgments about the quality, not just the acceptability, of the entity’s accounting principles as applied in its financial reporting.”⁷⁹ The ASB amended SAS 71 for interim periods ending after March 15, 2000. SAS 71, as amended, requires auditors of public company clients to attempt to discuss with audit committees the matters described in SAS No. 61 prior to the filing of a Form 10-Q.⁸⁰ Specifically, in reviewing interim financial information, the auditor must consider whether any of the matters described in SAS 61 have been

⁷⁷ See § 3.04.

⁷⁸ See § 3.04.

⁷⁹ SAS 61, ¶ 11, as amended by SAS 90.

⁸⁰ SAS 90, ¶ 3.

identified.⁸¹ If such matters have been identified, the accountant should communicate them to the audit committee or be satisfied that such matters have been communicated to the audit committee by management.⁸² When the accountant has conducted a review prior to filing a Form 10-Q and has identified matters to be communicated to the audit committee, “he or she should attempt to make such communications with the audit committee, or at least its chairman, and a representative of financial management prior to such filing. If such communications cannot be made prior to the filing, they should be made as soon as practicable in the circumstances.”⁸³

The New York Stock Exchange and Nasdaq also amended their rules relating to the composition of the audit committee, generally imposing more stringent terms concerning the qualifications and independence of audit committee members.⁸⁴ The Commission also amended Regulation S-X to require that interim financial statements included in quarterly reports on Form 10-Q be reviewed by an independent public accountant.⁸⁵

Other rule amendments and proposals affect intermediaries involved in the distribution process. In October 1999, the NASD filed a proposal with the SEC to adopt a new rule, Rule 2790, concerning trading in hot equity offerings.⁸⁶ Rule 2790, if adopted, will replace the current Free-Riding and Withholding Interpretation, IM-2110-1. On August 17, 2000, the NASD Board of Governors voted to revise

⁸¹ SAS 71, ¶ 722.25.

⁸² SAS 71, ¶ 722.25.

⁸³ SAS 71, ¶ 722.27.

⁸⁴ See § 3.03.

⁸⁵ See § 3.05.

⁸⁶ See § 3.06.

the proposed “hot issue” rule.⁸⁷ The NASD’s Press Release states that, under the proposed revisions, the rule will be applied to all initial equity public offerings, not just “hot issues.” The revised rule proposal was not available as this book went to press. In April 2000, the SEC solicited comments on a proposal of the NASD to amend the “Corporate Financing Rule.”⁸⁸ If it is adopted, it will give issuers and underwriters greater clarity in determining whether their activities comply with the compensation guidelines. If amended as proposed, the Corporate Financing Rule will provide an objective test for determining underwriting compensation. During pendency of the rulemaking initiative, the NASD is following the proposed rule as if it had been adopted. Stephen Older, Ron Adee and Marc Gold, of Akin, Gump, Strauss, Hauer & Feld, L.L.P., discuss the proposed amendments to the Corporate Financing Rule in § 3.07.

The remaining sections of this Chapter primarily discuss issues arising under Section 5 of the Securities Act of 1933 and Rule 144 as they relate to start-up and shell corporations, and the SEC’s recent expression of concern over the creation of public markets in the stock of such companies without registration. In *Harmony Trading Corp.*,⁸⁹ the staff took the opportunity to express its concern over circumstances where, “after a company is formed without either substantial capital or the prompt commencement of business, but in proximity to the company’s efforts to have its securities traded in the public markets, its closely-held securities are transferred to significant numbers of persons.”⁹⁰ In NASD Regulation,

⁸⁷ See NASD Press Release, *NASD Board of Governors Votes to Improve Rule Proposal on Trading and Initial Public Offerings* (Aug. 17, 2000), www.nasdr.com/press_frame.htm.

⁸⁸ See § 3.07.

⁸⁹ See § 3.09.

⁹⁰ *Harmony Trading Corp.*, SEC No-Action Letter (Nov. 22, 1999), 1999 WL 1059812, at *7.

Inc.,⁹¹ the staff stated that “transactions in blank check company securities by their promoters or affiliates, especially where they control or controlled the ‘float’ of the ‘freely tradable’ securities, are not the kind of ordinary trading transactions between individual investors of securities already issued that Section 4(1) was designed to exempt.”⁹² Further, the merger of a non-reporting company with a reporting shell company will also be subject to strict scrutiny.⁹³ The staff is taking the position that the acquisition of a blank check company by a non-reporting operating company will not be effective in itself to acquire reporting company status; rather, the non-reporting company must file a registration statement under the Exchange Act, which is subject to review.⁹⁴ Alternatively, an 8-K may be filed within 15 days of the acquisition, but the staff may also review the Form 8-K. “[W]e will advise you,” the staff stated, “of those situations where a Form 8-K ‘back door’ registration has been selected for review, when we have issued comments on it and when those comments have been cleared by the staff.”⁹⁵

International Securities Law

The internationalization of securities markets and securities regulation continues inexorably. The trend in securities markets and securities law mirrors the growing independence among and integration of nations that has swept other areas of law, commerce and culture. Securities regulators around the world have been reacting in the past decade to the integration of world securities markets with in-

⁹¹ See § 3.10.

⁹² NASD Regulation, Inc. (Jan. 21, 2000), 2000 WL 64968, at *3.

⁹³ See § 3.12.

⁹⁴ Letter dated April 7, 2000 from Richard K. Wulff, SEC, to Lisa Roberts, Nasdaq, Re: “Back Door” Registration Under the Securities Exchange Act of 1934. See § 3.12.

⁹⁵ See § 3.12 and Chapter 3, App. 1.

creasingly harmonized securities regulations. Perhaps the most significant development during the past year in this area of securities law was the decision of the European Commission to pursue a proposal for all listed European Union companies to prepare their accounts in accordance with IASs.⁹⁶ The European Commission “proposes that all EU companies listed on a regulated market (estimated at around 6,700) should be required to prepare consolidated accounts in accordance with IASs.”⁹⁷ This position is a dramatic vote in favor of International Accounting Standards by a major legal institution and, if adopted, will be a significant catalyst for further erosion of national accounting standards. The U.S. SEC is in a direct collision course with the international momentum in favor of International Accounting Standards. The SEC’s Concept Release concerning the possible adoption of International Accounting Standards for foreign issuers accessing the U.S. markets⁹⁸ was met with near unanimous opposition from the U.S. corporate community and U.S.-based accounting regulatory institutions and accounting firms. In face of this overwhelming criticism, it is highly unlikely the Commission will move forward at the present time to adopt IASs into U.S. law for foreign issuers. On the other hand, if the Commission simply stands in steadfast support of the citadel of U.S. GAAP, over the long run the U.S. securities markets and securities industry may face some erosion of market share as securities transactions migrate to other markets with less burdensome accounting requirements. In the short run, the SEC probably will not publish specific proposals to adopt IASs for foreign issuers, but will continue to participate in the work of the International Accounting Standards Committee toward international convergence of accounting standards.

⁹⁶ See § 6.14.

⁹⁷ See § 6.14.

⁹⁸ See § 6.13.

In 1998, the International Organization of Securities Commissions (“IOSCO”) adopted International Disclosure Standards (“IDSs”) for cross-border offerings and listings in 1998.⁹⁹ Within a year the SEC had adopted these standards into U.S. law for foreign private issuers filing on Form 20-F.¹⁰⁰ Ironically, however, this move toward international comity on the part of the SEC actually *increases* the amount of disclosure required of foreign private issuers compared to their pre-existing disclosure obligations in the United States. It was for this reason that many of the major U.S. law firms which representing foreign clients filed comment letters opposing the SEC’s adoption of the IOSCO standards. Several other countries have adopted the IOSCO Standards, with some variation,¹⁰¹ and within a year it is likely this trend will become more pronounced. This trend may have the effect of raising non-financial statement disclosure requirements to some generally small degree in some countries outside the United States. Ultimately, harmonization of disclosure requirements and accounting standards is a worthwhile objective since it is in the interest of issuers to be able to raise capital worldwide on the basis of a single prospectus.

⁹⁹ See § 6.03.

¹⁰⁰ See § 6.04.

¹⁰¹ See § 6.06. Spain and the United Kingdom permit optional use of IDSs by foreign companies, and Mexico requires use of IDSs by both foreign and domestic companies. Italy has revised its listing rules in a manner that conforms to the IOSCO Standards, and the revised standards must be used by both Italian and foreign issuers. France changed its regulations to permit use of IDSs effective in 2000. Australia, Belgium, Germany, Hong Kong, Japan, Luxembourg, The Netherlands and Switzerland have indicated that they would permit foreign companies to use IDSs. Ontario and Quebec have indicated they plan to commence rulemaking activities to permit the use of IDSs by foreign companies. Australia, Belgium, Germany, Luxembourg, The Netherlands, Spain and Switzerland the United Kingdom have indicated they would permit domestic companies to use IDSs, although with some conditions in some cases. Argentina has announced that it has adopted IDSs. Singapore also accepts disclosure documents prepared in accordance with IDSs. See § 6.06.

Glass-Steagall Reform

Congress partially repealed the Glass-Steagall Act in November 1999.¹⁰² The new legislation, designated the Gramm-Leach-Bliley Act, eliminated Glass-Steagall restrictions on affiliations between commercial banks and investment banks.¹⁰³ Section 20 of the Glass-Steagall Act,¹⁰⁴ which prohibited member banks of the Federal Reserve System from affiliating with any company “engaged principally in the issue, floatation, underwriting, public sale or distribution”¹⁰⁵ of securities, was repealed.¹⁰⁶ Thus, among other things, securities affiliates of banks may engage in the general underwriting business without regard to the quantitative limitations on such activities previously set forth in Section 20 of the Banking Act. In lieu of the statutory separation of commercial banking and other financial services, the GLB Act authorized the establishment of new types of holding companies (principally, “financial holding companies”) that allow the affiliation of securities firms, depository institutions, insurance firms, and other financial institutions. The new financial firms, through these structures, are able to provide virtually all financial services, including, among other things, securities underwriting, brokerage, dealing, market-making, insurance underwriting and agency activities, merchant banking, and acting as a futures commission merchant — in addition to the business of banking. However, from the standpoint of securities activities that may be carried out directly by banks, the GLB Act did not significantly affect current banking law. Section 16 of the Glass-Steagall Act,¹⁰⁷ which defines the cor-

¹⁰² See Chapter 7.

¹⁰³ The Gramm-Leach-Bliley Act, P.L. 106-102, 113 Stat. 1338.

¹⁰⁴ 48 Stat. 162, 12 U.S.C.A. § 377.

¹⁰⁵ 12 U.S.C. § 377.

¹⁰⁶ GLB Act § 101(a). The GLB Act also repealed Section 32 of the Glass-Steagall Act, which prohibited depository institutions and securities firms from having interlocking officers, directors or employees.

¹⁰⁷ 12 U.S.C.A. § 24.

porate powers of national banks, was not repealed. However, by eliminating (subject to numerous exceptions) banks' exemption from the broker-dealer registration requirements of the Securities Exchange Act of 1934 ("Exchange Act"),¹⁰⁸ the GLB Act likely will have the effect of causing banks to "push out" certain securities activities to its broker-dealer affiliate.

As of August 11, 2000, over 350 institutions had filed elections, which had become effective, to become financial holding companies.¹⁰⁹ Included among these are Bank of America Corporation, Bank of New York, Canadian Imperial Bank of Commerce, the Chase Manhattan Corporation, Citigroup Inc., Credit Suisse Group, Deutsche Bank Aktiengesellschaft, Banco Santander Central Hispano, First Union Corporation, FleetBoston Financial Corporation, J.P. Morgan & Co., Mellon Financial Corporation, State Street Corporation, Wachovia Corporation, and Wells Fargo & Company.¹¹⁰ Most major securities firms, however, have not yet elected to become FHCs. The first major securities firm to take the plunge was the Charles Schwab Corporation. Schwab became a financial holding company by acquiring, U.S. Trust Corporation, a bank holding company the principal subsidiary of which is United States Trust Company of New York, a state banking institution. Through the acquisition, Schwab will be able to provide private banking and related services to its retail customers, although there is a price: by becoming a financial holding company, Schwab subjected itself and, to some extent, its non-depository subsidiaries, including the broker-dealer, to the jurisdiction of the Federal Reserve Board.

During the period following enactment of the Gramm-Leach-Bliley Act, the banking regulators (principally, the Federal Reserve Board, Comptroller of the Currency, and FDIC) promulgated a substantial number of implementing regulations, many on an interim

¹⁰⁸ See *infra* § 7.09.

¹⁰⁹ See www.federalreserve.gov/generalinfo/fhc.

¹¹⁰ *Id.*

basis. The Gramm-Leach-Bliley Act and such implementing regulations are analyzed in detail in Chapter 7.

Market Centers and Market Regulation

Even the casual observer has to be struck by the pace and nature of change in world securities markets. Who could have predicted ten years ago that nine “alternative trading systems” would account for 28 percent of all trades in Nasdaq equities?¹¹¹ Who could have predicted five years ago that the London Stock Exchange and the Deutsche Boerse would propose to merge?¹¹² Or that their proposed merger would be trumped by a hostile bid for the London Stock Exchange by OM Gruppen AB, operator of the Stockholm Stock Exchange?¹¹³

The securities markets in the United States are undergoing rapid change, driven by technology, globalization, and increases in volume. The past five years have witnessed the dramatic growth of alternative trading systems (“ATs”), accounting as indicated for a sizeable percent of all trades in Nasdaq equities.¹¹⁴ In May 2000 the Commission rescinded off-board trading restrictions¹¹⁵ at the New York Stock Exchange (and subsequently at other exchanges), paving the way among other things for ATs to make inroads in the

¹¹¹ See *infra* Chapter 8 N. 65.

¹¹² See § 8.11.

¹¹³ See *infra* Chapter 8 N. 268 and accompanying text. The outcome of this contest was not known at press time.

¹¹⁴ See § 8.05[2].

¹¹⁵ Rule 390 of the New York Stock Exchange restricted NYSE members from effecting transactions in NYSE-listed securities away from a national securities exchange. Rule 390 only applied to stocks listed on the NYSE as of 1979. Rule 390 also permitted members to trade as agent in the OTC market with another person, except where the member was also acting as agent for the other person. See § 8.03.

market for exchange-traded equities.¹¹⁶ NYSE Rule 390 directly restricted competition between exchange market centers and market centers other than exchange markets. In rescinding Rule 390, the Commission found that Rule 390 was overbroad, in part because it restricted the competitive opportunities of ECNs and ATSS.¹¹⁷

The Commission has also approved rule amendments giving ATSS access to the mechanisms of the national market system, so that ATSS now may post orders and execute trades through the consolidated systems for exchange-listed stocks.¹¹⁸ Archipelago, an ATS, recently availed itself of these revisions, setting the inside quote for 11 exchange-listed securities on its first day of trading on the national market system through the Nasdaq Intermarket, Nasdaq's new name for the "third market."¹¹⁹ There are now over 40 ATSS in operation, and more than one has applied for registration as a national securities exchange. In the past two years, the International Securities Exchange registered as an all-electronic securities exchange,¹²⁰ while Tradepoint, an electronic communications network based in the United Kingdom, was granted an exemption from registration with the Commission as an exchange.¹²¹

¹¹⁶ See *infra* § 8.03.

¹¹⁷ Exch. Act Release No. 42758 (May 5, 2000), 2000 WL 649013, at *5 ("the Rule effectively restricts NYSE members from participating in markets operated by ECNs or ATSS").

¹¹⁸ See *infra* § 8.07.

¹¹⁹ See *infra* § 8.07.

¹²⁰ Exch. Act Release No. 42,455 (Feb. 24, 2000), 2000 WL 217439 (fully electronic options market).

¹²¹ Tradepoint Financial Networks, Exch. Act Release No. 41,119 (Mar. 22, 1999), 1999 WL 152920, at *4 ("Tradepoint offers investors an excellent low-cost non-intermediated mechanism for trading U.K. stocks"). Tradepoint does not list securities, but rather offers trading in securities listed on other exchanges. *Id.* In J.P. Morgan & Co., Inc., and UBS AG, 86 Fed. Reg. Bull. 61 (2000), the Federal Reserve Board approved a proposal by J.P. Morgan & Co. and UBS AG to own indirect interests in Tradepoint Financial Networks, plc, which operated the Tra-

Tradepoint's exemption from U.S. exchange registration is only the tip of the cross-border iceberg. There is an almost unthinkable international consolidation of market-centers underway, culminating with OM Gruppen's hostile bid for the London Stock Exchange.¹²² The market for securities markets is discussed in Chapter 8 at § 8.11.

The principal "market structure" issues facing the Commission and the securities industry aside, from the proliferation of electronic communication networks, are market fragmentation generally,¹²³ including order routing¹²⁴ and execution practices;¹²⁵ demutualization of stock exchanges;¹²⁶ decimalization;¹²⁷ the possibility of establishing a central limit order book;¹²⁸ price transparency;¹²⁹ the develop-

depoint Stock Exchange. *See* Chapter 7 N. 108 (discussing permissible activities for financial holding companies under the Gramm-Leach-Bliley Act).

¹²² Erik Portanger, *Exchange in London Now in Play: Swedish Concern OM Launches Hostile Bid Valued at \$ 1.19 Billion*, WALL ST. J. A18 (Aug. 30, 2000).

¹²³ *See* § 8.02.

¹²⁴ *See* § 8.09[2].

¹²⁵ *See* § 8.09[1].

¹²⁶ Traditionally the stock exchanges in the United States have been in mutual form, owned by their members and with access to trading limited to members. Demutualization separates ownership rights from trading privileges. *See infra* § 8.10.

¹²⁷ The Commission ordered the exchanges and Nasdaq to submit a plan to phase in decimal pricing for listed stocks and certain options. The exchanges and Nasdaq are being required to phase-in decimal pricing over a period from September 2000 to April 2001. Decimals Implementation Plan for the Equities and Options Markets, Exchange Committee on Decimals (July 2000), <http://www.sec.gov/rules/other/decimalp.htm>.

¹²⁸ *See infra* § 8.04.

¹²⁹ *See infra* § 8.06.

ment of effective linkages among market centers;¹³⁰ and the practices of internalization and payment for order flow.¹³¹ The Commission has been very focused on order routing and execution practices, and in late July 2000 proposed two new disclosure rules relating to these subjects.¹³² Proposed Rule 11Ac1-5 requires market centers electronically to make available monthly reports concerning their order executions and to provide statistical information about the quality of executions.¹³³ Proposed Rule 11Ac1-6 requires broker-dealers that route orders as agent for customers to disclose their order routing practices.¹³⁴ A proposed rule relating to the options market may presage further rulemaking relating to order execution in the equities market.¹³⁵ In July 2000, the Commission proposed for public comment a rule that would require broker-dealers effecting transactions in listed options to disclose to the customer when the customer's order traded "at a worse price than the best quote published in the options quote reporting system."¹³⁶ The proposed options rule excepts orders routed to markets participating in a joint industry plan containing provisions reasonably designed to limit trade-throughs. In the July Release proposing new order handling and order execution provisions,¹³⁷ the Commission indicated that it was considering "whether a similar trade through disclosure

¹³⁰ See *infra* § 8.07.

¹³¹ See *infra* § 8.08.

¹³² Exch. Act Release No. 43,084 (July 28, 2000), 2000 WL 1092311. See *infra* § 8.09.

¹³³ Exch. Act Release No. 43,084 (July 28, 2000), 2000 WL 1092311, at *11.

¹³⁴ Exch. Act Release No. 43,084 (July 28, 2000), 2000 WL 1092311, at *20.

¹³⁵ See § 8.09[1].

¹³⁶ Exch. Act Release No. 43,085 (July 28, 2000).

¹³⁷ Exch. Act Release No. 43,084 (July 28, 2000), 2000 WL 1092311.

approach is workable in the equities markets, to strengthen the price priority provided to the best published quotes.”¹³⁸

The future structure of the U.S. securities markets raises consummately national issues and these issues have become significantly politicized. Although generally it is the Commission that is actually implementing market structure reform, members of Congress are certainly interested in monitoring the process and accordingly much of the significant discourse concerning these issues is occurring in the Congressional forum. The Commission has also revealed its approaches to various issues and may have tested the waters with respect to its ideas in speech-making by SEC officials, particularly Chairman Levitt. Because much of the important discourse regarding market structure issues has taken place before Congress and through speech-making by SEC officials, these sources are examined in considerable detail in Chapter 8, along with recent Commission rulemaking initiatives involving securities market reform.

Modernization of EDGAR ¾ Farewell (Almost) to ASCII; Hello to HTML and EDGARLink 7.0

When the Commission initiated the Electronic Data Gathering Analysis and Retrieval System (EDGAR) as a pilot program in 1984, it was on the cutting edge of available technology. On July 14, 1992, when EDGAR moved from a pilot program to the operational stage, it was married to an outmoded technology. Whatever the reason, EDGAR and filers were burdened with a DOS-based system that could accept only American Standard Code for Information Interchange (ASCII) files formatted in a standardized and limiting manner. On March 10, 1999, the Commission announced and on May 17, 1999 adopted the first concrete result of its effort to modernize EDGAR. The Commission built on its own experience in operating its generally excellent site on the Internet. ASCII is to be

¹³⁸ Exch. Act Release No. 43,084 (July 28, 2000), 2000 WL 1092311, at *32.

replaced by the Hypertext Markup Language (HTML), the language of the Internet. *See* § 5.01. Filers also optionally can file a second unofficial copy of the same document in Adobe Acrobat PDF format, which PDF version is available on the EDGAR Database for downloading. *See* § 5.02[7].

On April 24, 2000, the Commission further amended Regulation S-T and announced changes to EDGAR that it hails as EDGAR II.¹³⁹ A new Windows-oriented version of EDGARLink, modernized EDGARLink or EDGARLink 7.0, is central to modernized EDGAR II. Effective November 27, 2000, legacy EDGARLink (Versions 6.75a and below) no longer can be used to prepare and submit EDGAR filings.¹⁴⁰ A number of important steps are being taken to implement EDGAR II, but we are not quite there in terms of completing the transition to HTML. The Commission continues to caution that at some point substantially all documents will have to be filed in HTML format, but in the meantime issuers can continue to file ASCII documents.

The major features of EDGAR II that came into effect on May 30, 2000 include the following:

1. Filers can now attach graphic and image material in a document filed as an HTML filing so long as JPEG (jpg extension) or GIF files. *See* § 5.02[1].

2. The creation of an EDGAR filing web site (<https://www.edgarfiling.sec.gov>), which can be accessed through any internet service provider. EDGARLink 7.0 is available only by downloading from this site. Filings made using EDGARLink 7.0 can be made conveniently through the EDGAR filing web site. *See* § 5.02[2].

¹³⁹ *See* Rulemaking for EDGAR System, Sec. Act Release No. 7855 (Apr. 24, 2000) (hereinafter “Release No. 7855”), 2000 WL 433278.

¹⁴⁰ *See* SEC Press Release 2000-106, August 1, 2000, available on the Internet at <http://www.sec.gov/news/edgarfin.htm>.

3. Filers now can receive email and acceptance suspension notices at an email address of their designation. The email address can be any valid Internet mail address at an internet service provider or can be a mailbox maintained as a subscriber to the EDGAR Private Mail Service managed by TRW. *See* § 5.02[3].

4. Previously hypertext links could be used in HTML documents only to link materials within the same document; for example, the prospectus table of contents could be linked to the referenced section headings. EDGAR II allows hypertext links within HTML documents to other documents included in the same submission; for example, the exhibits. EDGAR II also allows linking within HTML documents to other documents officially filed and available in the EDGAR database on the Internet (<http://www.sec.gov>). A registrant cannot link to documents on its own web site or to any document not included as part of the submission or not available as official files on the Commission's EDGAR database. *See* § 5.02[4].

6. Filers using EDGARLink 7.0 can make filings directly to EDGAR or, alternatively, can make submissions via the Internet through an internet service provider of their choice by accessing the EDGAR filing web site (<https://www.edgarfiling.sec.gov>). The Commission provides security by a secure socket layer (*i.e.*, encryption) and filers optionally may provide additional security by providing their own certificates. *See* § 5.02[5].

The major changes embodied in EDGAR II are dependent upon a significantly different Windows-oriented up-to-date technology-wise version of EDGARLink denominated 7.0 or Modernized EDGARLink. The ABCs of preparing a submission file and transmitting it to the Commission using EDGARLink 7.0 are described at length at §§ 5.07-5.09.

Shareholder Proposals $\frac{3}{4}$ Securities Regulation's Step-Child

Shareholder proposals might be termed the step-child of securities regulation. The mainstream of securities practitioners tends to ignore the area of practice. The major corporations reluctantly toler-

ate them. The “law” governing shareholder proposals is found in Rule 14a-8, adopted by the Commission as part of the proxy rules under the Exchange Act. The Commission proposed amendments to Rule 14a-8 in November of 1997 and adopted a slimmed-down version of what it proposed on May 21, 1998. The primary substantive change, reversing its prior no-action position in *Cracker Barrel*, was adopted — not as a formal amendment but as a statement the Commission was doing so. The 1999-2000 edition of *Emerging Trends* discussed the first proxy season under the new regime. The sum and substance of the new direction as outlined in that edition was that other for the reversal of *Cracker Barrel* not much had changed. This edition examines the year 2000 proxy season and for the most part little has changed outside of the area directly related to *Cracker Barrel*. The areas in which the staff during 2000 changed directions have not in all instances necessarily been for the better. Those areas include (1) no longer taking a hands-off attitude toward proposed bylaw amendments to require shareholder approval of poison pill plans (*see* § 9.10[6]); (2) deeming an employee benefit plan as outside the ordinary business exclusion in the limited area of a conversion from a defined benefit plan to a cash balance plan (*see* § 9.03[2]); (3) taking inconsistent positions on the same day as to whether two identical shareholder proposals relating to predatory lending presented to two different companies could be excluded under the ordinary business exclusion (*see* § 9.08); and (4) going out of its way to announce that the staff would no longer *per se* exclude as ordinary business a proposal solely because it called for a report relating to a specific matter to be included in a Form 10-K or other filing with the Commission. *See* § 9.08.

The Interfaith Center on Corporate Responsibility (“ICCR”), in conjunction with SocialFunds.com, maintains a database of socially-oriented resolutions sponsored by organizations affiliated with it. The database is available on the ICCR Internet site and also on SocialFunds’ Internet site (<http://www.socialfunds.com/sa/index.cgi>). The latter Internet site includes a Resolution Status Report following the results of resolutions filed during the proxy season by ICCR-motivated sponsors. As of August 15, 2000, the Status Report reflected 197 socially-oriented shareholder proposals filed with 141

different companies during the 2000 proxy season. This does not include all shareholder proposals as a number are filed by others not affiliated with the ICCR and not included in the status report. Of the 197 resolutions filed, 50 were withdrawn. The status report notes that 39 resolutions were contested, of which 28 were won (*i.e.*, the company's request for a no-action letter was denied) and 11 were lost (*i.e.*, the company's request for a no-action letter was granted). *See* § 9.02.

Another player in the shareholder proposal arena is the Council of Institutional Investors (CII), the membership of which includes employee benefit plan, state or local agencies officially charged with the investment of plan assets, or non-profit endowment funds and non-profit foundations. The CII focuses primarily on issues of corporate governance and specifically states that “[t]he Council does not address social issues.” The Council maintains a web site (<http://www.cii.com>) that includes considerable information relating to corporate governance issues and shareholder proposals. The Council tracks corporate governance proposals that receive a majority vote and contacts the companies in an effort to persuade them to implement the proposals, all of which, presumably, are precatory. At August 19, 2000, the site noted that “48 companies reporting majority votes on 57 resolutions — up from 44 companies and 51 resolutions in 1999. Twenty-four of the 2000 majority-vote resolutions were sponsored by Council members or sustainers.” Thirty-four of those proposals related to eliminating classified boards (staggered election of directors); 15 related to poison pill plans, and five proposed eliminating supermajority voting. *See* § 9.02.

The shareholder proposal arena is governed by a unique application of the no-action letter process. Companies presented with shareholder proposals either include them or request a no-action letter from the staff on the basis of one of the 13 specific grounds for exclusion included in Rule 14a-8(i) or failure to comply with the rules relating to the submission of shareholder proposals. This process, notwithstanding the disclaimer included in every staff response to the request for a no-action letter, is a *de facto* adjudication administered by mid-level counsel within the Division of Corporation

Finance. *See* § 9.01. The lack of oversight by the Commission or any single commissioner is apparent. Consider the following:

After the reversal of *Cracker Barrel*, shareholder proposals pertaining to employment-related matters (as distinguished from executive compensation) are difficult to exclude if they raise important social policy issues. But the determination is to be made on a case-by-case basis. Proposals relating to producing goods outside the United States, sourcing the production of goods outside the United States, or buying from vendors who produce goods outside of the United States under “sweatshop” conditions as a general rule cannot be excluded. But the correct words have to be used, the inappropriate words have to be avoided, and where the words appear are critical. The key words to include, or a similar version thereof, in the Resolved part of the resolution are avoiding “human rights violations, such as forced labor, convict labor or illegal child labor or fail to satisfy other applicable laws and standards.” The words not to include are some variation of “wage adjustments, ensuring adequate purchasing power and a sustainable living wage.” Inclusion of the latter or something like it in the Resolved part of the resolution or in the supporting statement likely will result in the staff concurring that it can be excluded as an ordinary business matter. If it is included, however, in the Whereas clause the staff will not concur that it can be excluded. Why inclusion of reference to wages in an inappropriate place makes the proposal excludable is not clear; wages substandard by any measure are a critical feature of a “sweatshop,” but apparently not in the view of the staff. *See* §§ 9.04-9.05.

Shareholder proposals for the most part have to be precatory (*i.e.*, recommend or request, but not mandate) in form as it generally is only the board of directors that can initiate corporate action. Proposals that are not a proper subject for shareholder action can be excluded if mandatory in form under Rule 14a-8(i)(1). Similarly, those that would violate state law if adopted can be excluded under Rule 14a-8(i)(2). The one area, however, in which shareholders under state corporate law in many states, including Delaware, may reign supreme is the proposal to adopt, amend, or repeal corporate

bylaws. This does not necessarily mean, however, that a shareholder-approved amendment to the bylaws can without restriction limit the authority of the board of directors to act in specific areas. The scope of shareholders' authority in that regard is a very contentious issue. *See* § 9.10[1].

The SEC staff during the 1999 proxy took the unusual (*i.e.*, for it) position of refusing to express its view as to whether proposals to adopt, amend, or repeal bylaws so as to limit the power of the board to adopt poison pill plans without the approval of shareholders can be excluded under Rule 14a-8(i)(1) as improper for shareholder action under state law, absent controlling state law precedent in the applicable state. It followed this position consistently, as well in other areas in which the shareholder proposal was cast as an amendment to the bylaws. *See* § 9.10[2]-[5]. During the 2000 proxy season, the staff without explanation abandoned its position that absent controlling precedent it would not express a view as to whether a proposal to amend a bylaw in a state authorizing shareholders to propose amendments to the bylaws could be excluded as contrary to Rule 14a-8(i)(1) as “not a proper subject for action by shareholders under the laws of the jurisdiction of the company’s organization.” A proposal was presented to Novell, a Delaware corporation, in the form of an amendment to the bylaws that would preclude the board from adopting a rights plan (poison pill) without the approval of a majority of the outstanding shares, would require the board to redeem the rights outstanding under the plan previously adopted by the board, and would preclude the board from amending the proposed bylaw. The company’s request for a no-action letter included an opinion of Delaware counsel to the effect that the proposal was improper under Delaware law. Counsel presented an argument based on relevant but not controlling precedent that the Delaware Supreme Court might regard as persuasive, but it is a stretch to characterize it as “controlling.” From the material included with the no-action letter, it does not appear that the proponent made any submission to the staff on behalf of the proposal. The staff apparently had a memory lapse as to what it said less than a year before, as it concurred that there was a basis for excluding the proposal under Rule 14a-8(i)(1), noting “that in the opinion of your Delaware

counsel, Morris, Nichols, Arsat & Tunnell, implementation of the proposal would be an improper subject for shareholder action under Delaware law.”¹⁴¹ *See* § 9.10[6].

Shortly thereafter, a similar proposal to amend the bylaws of Emcor Group, Inc., a Delaware corporation, pitted the views of contending counsel as to Delaware law. Counsel for the proponent raised a good point — the staff didn’t have to choose between the contending views, but merely had to recognize that the law in Delaware is unsettled on this issue. Therefore, since under Rule 14a-8(g) the company has the burden of proof, the proposal is not excludable under Rule 14a-8(i)(1). The proponent attempted to distinguish Novell because no contrary opinion of counsel was presented in that matter. There was another issue, however. A similar proposal had been presented previously by another proponent, although presented as a recommendation to the board rather than a bylaw amendment. The company had agreed to include that proposal and argued that the bylaw proposal was duplicative and excludable under Rule 14a-8(i)(11). The staff took the bait and avoided the real issue as in the staff view the bylaw proposal was “substantially duplicative” of the proposal the company had agreed to include.¹⁴² This defies logic and at least 30 years of shareholder proposal history relating to the difference between a mandatory and a precatory proposal. *See* § 9.10[6].

The year 2000 proxy season continued to confirm the demise of the not significantly related to the company’s business exclusion of Rule 14a-8(i)(5) for proposals impacting less than five percent of the company’s business. The Release proposing the 1998 amendments to Rule 14a-8, referring to what now is Rule 14a-8(i)(5), noted that during “the period between September 30, 1996, and the date of this release, only two companies successfully invoked the

¹⁴¹ Novell, Inc., SEC No-Action Letter (Feb. 14, 2000), 2000 WL 223715.

¹⁴² Emcor Group, Inc., SEC No-Action Letter (May 16, 2000), 2000 WL 631012.

rule to exclude proposals.”¹⁴³ One of the two instances cited involved proposals relating to operations in Burma, which has since been reversed. The other proposal called on a pharmaceutical company to “prohibit the use of “any fetal tissue or human body parts obtained from any intentionally aborted unborn children.”¹⁴⁴ The staff took note “that the Company does not use fetal tissue or body parts from intentionally aborted fetuses.” *See* § 9.07[1].

If taking on the exclusion directly may pose problems, there is a way around it. In 1994, Merrill Lynch was allowed to exclude a proposal relating to the Hydro-Quebec James Bay power projects. The proposal requested that Merrill Lynch prepare a (i) “a summary of reasons why the Corporation has participated in the bond offering for such a financially and environmentally controversial project”; (ii) a summary of the Corporation’s policy on “future involvement with Hydro-Quebec”; (iii) a summary of the Corporation’s “history with the Hydro-Quebec/James Bay Project dating back to 1972, and plans for the future.” Merrill Lynch acknowledged from time to time it had acted as lead underwriter on the offering of bonds by Hydro-Quebec, but argued that the proceeds from the offerings were not earmarked for the James Bay project. The staff allowed the exclusion of the proposal noting that the amount of the underwriting were under the five percent threshold and “the proposal fails to establish a link between the Company’s business and the Hydro-Quebec/James Bay project.”

The same scenario was replayed in the year 2000 proxy season, but with a different dam (Three Gorges Dam), a different country (China), a slightly different approach, and a different result. The shareholder proposal included nine Whereas clauses, eight of which relate to the Three Gorges Dam, the environmental and human havoc resulting from the project, and Merrill Lynch’s involvement in

¹⁴³ Exch. Act Release No. 39093, 1997 WL 578696, at n.59.

¹⁴⁴ La Jolla Pharmaceutical Co., SEC No-Action Letter (Feb. 18, 1997), 1997 WL 74198.

financing the project. The RESOVED part of the proposal, however, read as follows: “[T]he shareholders request the Board to issue a report to shareholders by October 2000, reviewing the underwriting criteria of Merrill Lynch with the view to incorporating and fully disclosing criteria related to a transaction’s impact on the environment, human rights and risk to the company’s reputation.”¹⁴⁵

The company argued that the proposal was a proposal relating to the company’s role in financing the Three Gorges Dam disguised as a proposal relating to underwriting criteria. The company argued as such that it was excludable as not significantly relating to its business. As in Hydro-Quebec, it disclaimed any role in financing the dam. None of the above concerned the staff. The proposal simply was one to review underwriting criteria “with a view to incorporating criteria related to a transaction’s impact on the environment, human rights and risk to the company’s reputation.” It could not be excluded under either Rule 14a-8(i)(5) or Rule 14a-8(i)(7). As to the latter, “the proposal raises significant policy issues that are beyond the ordinary business operations of Merrill Lynch.” *See* § 9.07[2].

The message for registrants is that they will have to include most precatory proposals if prepared by knowledgeable proponents, of whom there are many. The best hope for excluding a proposal is on technical grounds — not received timely; not adequate “evidence” of stock ownership for required period of time, etc. The knowledgeable proponents, however, seldom make this kind of error. There are some buzz word exclusions that may work — sale or pricing of a specific product; (b) management of the company’s premises; (c) company’s legal compliance program; (d) litigation strategy; (e) employee retirement benefits. Inclusion of the shareholder proposal, of course, does not mean that the shareholders are going to approve the proposal. The proponents are limited to 500 words, and ordinarily are not in a position to go through the hoops necessary to solicit

¹⁴⁵ *See* Merrill Lynch & Co., SEC No-Action Letter (Feb. 25, 2000), 2000 WL 233124.

proxies. Management has no limit on the number of words it can include in opposition to the proposal and can solicit proxies to vote against it. The goal of management is to assure that the proposal does not meet the threshold vote the proposal needs to be eligible for resubmission. *See* § 9.12. A “Ten-Step Survival Kit for Registrants” is included as § 9.13.

Other U.S. Developments

The Commission at the same time it adopted Regulation FD adopted two other rules that are only tangentially related. Rule 10b5-1 was adopted to resolve the “causation” issue arising out of conflicting judicial views in determining if Rule 10b-5 was violated in the insider trading context. The conflicting views raised the issue of whether it is sufficient that the trader was in *possession* of material non-public information at the time of the transaction or whether the Commission (or the United States in the event of a criminal prosecution) must prove that the trader *used* the material non-public information. *See* § 11.02[1]. The rule makes the critical factor whether “the person making the purchase or sale was aware of the material non-public information when the person made the purchase or sale.”¹⁴⁶ Although the word “knowing” is not used in the rule, the Releases refer to Rule 10b5-1 as akin to a “knowing possession” standard. The Adopting Release, in response to comments that equating “on the basis of” with “awareness” eliminates the scienter requirement, states: “Scienter remains a necessary element for liability under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Rule 10b5-1 does not change this.” *See* § 11.02[2]. The rule also provides a safe harbor characterized as an affirmative defense for several specific situations and subject to the conditions of the rule, all predicated on the relevant action having taken place before the person became aware of the material non-public information in question. In some respects, this is the most important part of the

¹⁴⁶ Rule 10b5-1(b).

rule as for the first time insiders have some assurance that a pre-arranged plan for purchasing or selling securities will not constitute a violation of Rule 10b-5 if the specified conditions are complied with. *See* § 11.02[3].

The Commission adopted Rule 10b5-2 to identify situations in which family relationships and limited other specified situations give rise under Rule 10b-5 to a fiduciary duty in the context of trading by a misappropriator of non-public information. *See* § 11.03. The family relationships under the rule that give rise to a duty of confidentiality are husband and wife, parent and child, and siblings (brother and sister).¹⁴⁷ Under the rebuttable bright-line rule, a person who receives material non-public information from such a family member has a duty of trust and confidence vis-a-vis such information. The “offending” relative, however, has an affirmative defense if s/he can establish that “he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential, because the parties’ history, practice, or pattern of sharing and maintaining confidences, and because there was no agreement or understanding” to keep the information confidential.¹⁴⁸ The other two non-exclusive situations that may give rise to a duty are not bright-line rules, but are dependent on the specific facts and circumstances. Under one provision, the duty of maintaining a trust and confidence for this purpose arises when a person in writing or otherwise agrees to keep the information confidential.¹⁴⁹ The other situation covered by the rule is that in which the person who shared material non-public information with the alleged misappropriator has “a history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that

¹⁴⁷ Rule 10b5-2(b)(3), 17 C.F.R. § 240.10b5-2(b)(3).

¹⁴⁸ Rule 10b5-2(b)(3), 17 C.F.R. § 240.10b5-2(b)(3).

¹⁴⁹ Rule 10b5-2(b)(1).

the person communicating the material nonpublic information expects that the recipient will maintain its confidentiality.”¹⁵⁰

Jonathan Gottlieb and Diana de Brito have contributed a discussion of recent significant corporate developments. *See* § 11.05. The discussion surveys judicial developments in several states relating, among other areas, to slow hand, dead hand, and no hand poison pills, all designed to various degrees to keep a new board of directors from redeeming the rights issued under the poison pill plan. Recent important amendments to the Delaware corporate law, including those pertaining to electronic transmissions and conversion to alternative forms of business entities, also are surveyed.

Securities Law in the Russian Federation

In Chapter 10, the law firm of Akin, Gump, Strauss, Hauer & Feld, L.L.P., examines securities law developments in the Russian Federation following the 1998 financial crisis. As indicated in Chapter 10, in 1997, Russia had the best-performing stock market in the world and a number of Russian companies and the Russian federal government had successfully entered the international capital markets with securities offerings. By mid-1998, the securities of approximately 100 Russian companies were being traded outside of Russia and a number of Russian companies had established American Depositary Receipt or Global Depositary Receipt programs in the United States and Europe, while other Russian issuers were offering high-yield bonds and convertible bonds. The August 1998 financial crisis, and subsequent collapse of the Russian financial markets, effectively ended access to the international and Russian domestic capital markets for most Russian government and corporate issuers.

During the period since the 1998 crisis, securities reform and corporate governance issues have received renewed attention in

¹⁵⁰ Rule 10b5-2(b)(2), 17 C.F.R. §240.10b5-2(b)(2).

Russia. The Federal Commission on the Securities Market of the Russian Federation (the “FCSM”), among other things, has issued more comprehensive regulations and enhanced its enforcement functions. Chapter 10 addresses some of the principal legal developments since August 1998, particularly the new Investor Protection Law,¹⁵¹ new public disclosure requirements for certain Russian companies¹⁵² and new broker-dealer regulations.¹⁵³ A translation of the Investor Protection Law, by Akin, Gump, Strauss, Hauer & Feld, L.L.P., is included as Appendix 1 to Chapter 10.

The Investor Protection Law has the laudable goal of protecting the rights of shareholders, especially minority shareholders, from abuse by companies and other shareholders. However, in practice, certain provisions in this law, notably the possibility that an issue of securities will be declared invalid or void until the Placement Report is registered,¹⁵⁴ create uncertainty and may unduly impede legitimate efforts to raise capital by Russian companies.

The recently adopted disclosure rules represent an important step in guaranteeing investors’ rights to information on the companies in which they hold securities. The FCSM has also shown it is willing to take action against issuers who fail to disclose information on a timely basis. However, the quality and relevance of such information to investors still needs improvement. Especially with respect to financial information, Russian accounting standards need to converge towards greater conformity with international accounting

¹⁵¹ Federal Law No. 46-FZ, “On the Protection of the Rights and Legitimate Interests of Investors in the Securities Market” (Mar. 5, 1999).

¹⁵² Regulation on the Quarterly Report of Issuer of Emissive Securities (Aug. 11, 1998); Regulation on the Procedure for Disclosure of Information with Respect to Significant Facts (Events and Actions), Concerning Financial and Business Activities of an Issuer of Emissive Securities. *See* § 10.03.

¹⁵³ Rule on Conducting Brokers’ and Dealers’ Activity in the Securities Market of the Russian Federation (Oct. 1999). *See* § 10.04.

¹⁵⁴ *See* § 10.02[2].

standards¹⁵⁵ and generally accepted accounting principles. Interestingly, the FCSM recently announced that it intends to promote a corporate governance code for Russian enterprises which may enhance transparency and rights of minority shareholders.¹⁵⁶ Reportedly, the code will cover financial transparency by Russian companies, minority shareholders' rights, conflicts of interest, independent directors, management compensation, shareholders' meetings and elections to the board.¹⁵⁷ The code will be backed by legislation "to ensure that it is enforced."¹⁵⁸

New regulations for brokers and dealers are important to raising the standards of Russian market intermediaries.¹⁵⁹ However, these regulations will need to be backed up by effective oversight and enforcement by the FCSM and Russian courts, as well as self-regulatory organizations.

Despite the Russian government debt default in August 1998 that triggered a crisis in Russia's financial markets, just two years later the capital markets are showing signs of reviving for Russian government and corporate issuers. At least two Russian corporate issuers successfully tapped the international capital markets for fresh capital through major equity and convertible debt offerings in the summer of this year. As Akin, Gump, Strauss, Hauer & Feld, L.L.P. observes in Chapter 10, the regulation and development of the Russian securities markets are steadily improving.

¹⁵⁵ See § 6.11 concerning international accounting standards generally.

¹⁵⁶ "Russia Watchdog Plans to Launch Corporate Code," FINANCIAL TIMES (Sept. 4, 2000), at 5.

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ See § 10.04.

Securities Law in Singapore

Section 11.04 is a case study of the securities law of Singapore, an emerging market economy. Singapore has experienced rapid development of its securities markets and system of securities regulation in the past several years. It provides an interesting illustration of the development of a system of securities law in an emerging market country.

The legal system of Singapore, a former Crown colony and now a member of the Commonwealth, has its foundation in English common law. The Companies Act and the Securities Industry Act of 1986 are the principal statutes governing the securities market in Singapore.¹⁶⁰ The securities markets of Singapore are regulated primarily by the Monetary Authority of Singapore. The Monetary Authority also supervises Singapore's futures markets and the banking and insurance industries,¹⁶¹ and performs the functions associated with a central bank, except for the issuance of currency which is handled by the Board of Commissioners of Currency Singapore.¹⁶² Securities markets as well as market participants also are regulated by the Singapore Exchange.

Singapore Exchange Limited (SGX) calls itself "the first demutualised, integrated securities and derivatives exchange in Asia-Pacific."¹⁶³ Prior to demutualization, SES and SIMEX were owned

¹⁶⁰ See www.mas.gov.sg/aboutmas_overview-c.html.

¹⁶¹ BUTTERWORTH'S HANDBOOK OF SINGAPORE SECURITIES LAW 3 (Woon, W., ed. 1998) (hereinafter "Handbook"). The single-regulator concept has recently taken hold in the United Kingdom, where the status of the Financial Services Authority as super-regulator has been codified and augmented by the new Financial Services and Markets Act. Even prior to the passage of that Act by Parliament in the summer of 2000, the Bank of England Act had transferred most supervisory authority over banks in the U.K. from the Bank of England to the FSA.

¹⁶² See www.mas.gov.sg/aboutmas_overview-c.html.

¹⁶³ See www.ses.com.sg/.

by their members and access to the exchange was limited to members. Demutualization, which separates ownership rights from trading privileges, is an emerging trend discussed in the U.S. context elsewhere in this book.¹⁶⁴ SGX is a holding company for the stock exchange, Singapore Exchange Securities Trading Limited (SGX-ST), the derivatives exchange, the Securities Exchange Derivative Trading Limited (SGX-DT), and related businesses. SGX-ST includes the Main Board as well as the Stock Exchange of Singapore Dealing and Automated Quotation (SESDAQ).

As of January 2002, the Singapore Exchange hopes to have open access to trading privileges for all securities brokers.¹⁶⁵ After January 1, 2002, there will be no restriction on qualified participants who wish to trade in Singapore.¹⁶⁶ Singapore has also recently liberalized securities trading commissions. On May 12, 2000, the Singapore Exchange announced that brokerage rates will be fully negotiable for all transactions on SGX-ST with effect from October 1, 2000.¹⁶⁷

The views expressed herein are solely those of the authors, and do not necessarily reflect the views of the authors' respective law firms.

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¹⁶⁴ See § 8.10.

¹⁶⁵ See www.ses.com.sg/.

¹⁶⁶ www.ses.com.sg/.

¹⁶⁷ SGX to Liberalize All Commissions from October; Risk Control Measures Under Review (May 12, 2000), www.ses.com.sg/. See § 11.04.

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