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COMMENTS

PUBLIC TRUST AND THE ROLE OF *QUI TAM* RELATORS IN THE REGULATORY FRAMEWORK

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INTRODUCTION

Americans now look to the government for myriad services and increased protection in all spheres of modern life. As the government struggles to meet these new and complex demands, it increasingly looks to partner with the private sector.[1] Private contractors[2] have begun to perform functions that, until very recently, were thought of as inherently governmental.

As contractors perform more and more characteristically governmental functions they are required to meet obligations beyond those of parties doing business solely in the private sector. The obligations of contractors have expanded along with their duties because the government is ultimately in "the trust business."[3] In other words, like banks and insurance companies, the government can function only if the public trusts the integrity of its operations.[4] Banks and insurance companies, however, have only their assets to lose—for the government, the stakes are much higher.

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1 Some writers to consider the subject have adopted the view that the increased use of contractors is a result of an ideological downsizing of government. More or less without exception, those writers have declared the perceived "contractor experiment" to be a failure. Most of those writers posit a simple solution—an increase in the size of government. While somewhat beyond the purview of this article, the author believes that the government's increased reliance on contractors is the result of a complex interplay of factors with no simple solution. For an excellent synopsis of this debate, see Richard J. Pierce, Jr., *Outsourcing is Not Our Only Problem*, 76 GEO. WASH. L. REV. 1216 (2008) (reviewing PAUL VERKUIL, OUTSOURCING SOVEREIGNTY: WHY PRIVATIZATION OF GOVERNMENT FUNCTIONS THREATENS DEMOCRACY AND WHAT WE CAN DO ABOUT IT (2007)).

2 Throughout this article, the use of the terms "government contractors" and "government contracting" are intended to cover all parties who regularly request or receive funds from the government. In this article, these terms go beyond the types of entities normally thought of as government contractors and include non-profit entities like universities and hospitals, as well as for-profit entities such as healthcare intermediaries, and so forth.

3 *See* R. Preston McAfee, *The Real Lesson of Enron's Implosion: Market Makers Are In the Trust Business*, 1 THE ECONOMISTS' VOICE, no. 2, 2004 at 1.

4 *Id.* at 2.

Since government contractors are increasingly intertwined with and inseparable from the government, Congress, on three recent occasions, sharpened the federal government's primary tool for combating fraud on the public fisc. This tool is the False Claims Act (FCA).[5] Congress amended the FCA on May 20, 2009, with the much publicized Fraud Enforcement and Recovery Act (FERA);[6] the second amendment on March 23, 2010, was a part of the Patient Protection and Affordable Care Act (PPACA).[7] Finally, the third amendment became law on July 21, 2010, in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) became law.[8] In addition to correcting the anti-retaliation provisions of the FCA, Dodd-Frank established a uniform statute of limitations for the anti-retaliation provisions of the FCA.[9] These changes follow on the heels of a significant regulatory development from December 2008, when administrators of the Federal Acquisition Regulations (FAR) added self-reporting and ethical requirements for government contractors[10] at the urging of Congress[11] and the Department of Justice.

It is no secret that individual and corporate legal compliance—regardless of whether the regulations restrict minor offenses like parking violations, or serious crimes like murder—are governed by the same basic considerations.[12] In no specific order, the general requirements are as follows: (1) the likelihood that transgressions of the law will be detected; (2) the likelihood that observed transgressions will be prosecuted; (3) the substance of the behavior the law forbids; (4) the nature and quality of the evidence required to prove a violation; and (5) the severity of the potential sanctions.[13] While the government has been very capable of addressing the latter three factors, it has proved somewhat less capable with addressing the

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5 False Claims Act, ch. 67, 12 Stat. 696 (1863) (codified as amended at 31 U.S.C. §§ 3729-3733 (2009)).

6 Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 386, 123 Stat. 1617 (2009). Prior to 2009, the FCA provisions were numbered §§ 3729(a)(1)-(7). Starting from 2009 the provisions became §§ 3729(a)(1)(A)-(G).

7 Patient Protection and Affordable Care Act, Pub. L. 111-148, 124 Stat. 119 (2010).

8 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (codified at 12 U.S.C. §5301 (2010)).

9 Dodd-Frank Wall Street Reform and Consumer Protection Act §1079A, 124 Stat. at 2076 (codified as amended at 18 U.S.C. §3301) (extending statute of limitations for securities fraud violations).

10 Post-9/11 Veterans Educational Assistance Act of 2008, Pub. L. No. 110-252, 122 Stat. 2323, 2353 (2008).

11 *Id.*

12 William E. Kovavic, General Counsel, Fed. Trade Comm'n, Third Annual Conference on International and Comparative Competition Law: The Transatlantic Antitrust Dialogue: Private Participation in the Enforcement of Public Competition Law (May 15, 2003), *available at* http://www.ftc.gov/speeches/other/030514biicl.shtm#N_1_.

13 *Id.*

first two factors. To better address the first two factors, Congress sharpened the FCA's *qui tam* provisions.

The *qui tam* provisions of the FCA empower any "person" with first-hand knowledge of fraud on the government to bring a lawsuit in their own name, as well as in the name of the government, against the fraudfeasor; thus, the *qui tam* provisions of the FCA change "the world of regulation from a two-party dynamic between a regulator and a targeted business to a three-party dynamic between [a] regulator, targeted business, and a private party."[14] To government contractors—who prefer to keep their regulators where they can see them—this third-party dynamic is most unwelcome.

While secondary objectives such as returning ill-gotten funds to the United States Treasury are important, protecting public trust in the government's integrity is the FCA's most important feature. The amendments discussed in this article are absolutely critical to the overarching goal of the FCA, and they are required for the private sector and the government to succeed in the trust business.

Part I of this article provides a brief history of *qui tam* litigation in general, and the FCA in particular, and discusses these regulatory tools in the context of the shifting roles of government over time. Part II discusses the three recent amendments to the FCA and the historical context of the recent changes. Part III reviews and discusses the recent amendments to FAR and how those changes fit into the larger picture. Part IV concludes with a discussion of the importance of public trust in the workings of government, and the manner in which *qui tam* relators[15] contribute to that trust.

I. A BRIEF HISTORY OF THE FEDERAL FALSE CLAIMS ACT

To appreciate the developing role of the *qui tam* relator as a party to the regulatory function, it is necessary to review the major chapters in the history of the FCA. While the history of the FCA begins in 1863, the history of *qui tam* claims is somewhat older.

A. Qui Tam *Claims and the FCA Before 1986*

The FCA was originally passed in 1863.[16] In the 147 years of its existence, the FCA has become the main tool for combating fraud on the public. Its success in this regard is not open to debate. Between 1986 and 2008, the

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14 Pamela H. Bucy, *Games and Stories: Game Theory and The Civil False Claims Act*, 31 FLA. ST. U. L. REV. 603, 607 (2004).

15 In the parlance of the FCA, "relators" are those who bring an FCA claim.

16 False Claims Act, ch. 67, 12 Stat. 696 (1863) (codified as amended at 31 U.S.C. §§ 3729-3733 (2009)).

government recovered more than $21 billion dollars through FCA claims.[17] In recent years, FCA prosecutions have picked up speed: between January 2009 and March 2010, the government recovered more than $3 billion.[18] The FCA's profitability has made it the model for the 26 states that have passed false claims legislation.

The efficacy of the FCA's *qui tam* provisions is also unquestionable. While the government can and does pursue its own FCA cases without a relator, the difference between FCA recoveries involving a *qui tam* relator and non-*qui tam* FCA recoveries is staggering. In recent years, the government's recoveries from *qui tam* FCA cases have been three to four times greater than recoveries in non-*qui tam* cases.[19]

In the most basic terms, the FCA creates liability for seven broad categories of misconduct in relation to government funds. It provides for treble damages and civil penalties between $5,500 and $11,000 for each false claim submitted to the government.[20] The *qui tam* provisions of the statute give the power of enforcement to the Attorney General of the United States as well as to any "person" with first-hand knowledge of wrongdoing within the scope of the statute.[21]

While the FCA dates to 1863, the idea of privatizing law enforcement by means of a *qui tam* provision dates back centuries. The term *qui tam* comes from the Latin expression *qui tam pro domino rege quam pro se ipso in hac parte sequitur*, meaning "he who brings the action for the king as well as for himself."[22] Thus, a *qui tam* action is an action brought under a statute that establishes a penalty for the commission or omission of a certain act that harms the state. Further, a *qui tam* action provides that part of the penalty is payable to the person bringing forth the information; the other part is payable to the state.[23]

Although the concept of a *qui tam* action has deep roots in English common law, the American colonies made use of this device to a degree previously unheard of in the English-speaking world. This explosion in the use of *qui tam* jurisprudence was largely the result of necessity: colonial law enforcement authorities found it difficult to police the vast territory and

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17 Press Release, Dep't of Justice, More Than $1 Billion Recovered by Justice Department in Fraud and False Claims in Fiscal Year 2008, More than $21 Billion Recovered Since 1986 (Nov. 10, 2008), *available at* http://www.justice.gov/opa/pr/2008/November/08-civ-992.html.

18 Press Release, Dep't of Justice, Houston Independent School District Agrees to Settle False Claims Allegations Involving the E-rate Program (Mar. 8, 2010), *available at* http://www.justice.gov/opa/pr/2010/March/10-civ-236.html.

19 U.S. DEP'T OF JUSTICE, CIVIL DIVISION, FRAUD STATISTICS OVERVIEW OCT. 1, 1987–SEPT. 30, 2009, http://www.taf.org/FCAstats2009.pdf (last visited Nov. 4, 2010).

20 False Claims Act, 31 U.S.C. § 3729(a)(1)(G) (2009).

21 False Claims Act, 31 U.S.C. § 3730(b)(1) (2009).

22 3 WILLIAM BLACKSTONE, COMMENTARIES, *144, *160.

23 S. Express Co. v. Commonwealth *ex rel.* Walker, 22 S.E. 809, 810 (1895).

widely dispersed populations of the New World.[24] As a result, most American colonies established statutes proscribing certain actions and allowing enforcement via a *qui tam* clause. Virginia has several regulatory statutes allowing for *qui tam* enforcement, some dating from as early as 1730.[25]

For these reasons, the FCA incorporates fundamental American values such as self-reliance; individual responsibility for the community's well-being and accountable government; and a good, healthy profit motive. Before going through a major overhaul in 1986, the FCA had only been revised once, in 1943, since its enactment during the Civil War. The details of the 1943 revision, while historically interesting, are beyond the scope of this article.[26]

B. *The 1986 Amendments to the FCA*

The modern FCA was born in 1986 when President Ronald Reagan led a broad bipartisan coalition that dusted off and modernized the slumbering statute. The original six wrongful acts from the 1863 version were included in renumbered subsections.[27] The coalition added a seventh category of prohibited actions such as concealing government funds, or avoiding obligations to remit money to the government.[28]

Most importantly, the 1986 amendments empowered *qui tam* relators with significant new rights. For the first time, the 1986 amendments made the size of a relator's reward directly contingent upon the scope of the relator's contribution to the recovery. In cases where the government intervened in an action, the relator would receive between 15% and 25% of the government's total recovery. In cases where the government did not intervene, the relator would receive a minimum of 25% and a maximum of 30%. Equally important, the amendments provided relators a way to contest the results if the relator and the government disagreed about the relator's contribution.

Additionally, because the government recognized that employees of a government contractor were the sort of insiders needed to make the FCA's *qui tam* provision work, the government added provisions granting protected status to any employee who acted in furtherance of a *qui tam* action.[29]

24 LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 165-66 (3d ed. 2005).

25 *See* Churchill v. Blackburn, 1 Va. Colonial Dec. R26 1, 1 (Gen. Ct. Va. 1730).

26 *See generally* CLAIRE M. SYLVIA, THE FALSE CLAIMS ACT: FRAUD AGAINST THE GOVERNMENT (2d ed. 2010) (guide to the FCA, including an excellent, succinct treatment of the statute's full history).

27 False Claims Act Amendments, Pub. L. 99-562, § 2, 100 Stat. 3153 (1986) (codified as amended at 31 U.S.C. §§ 3729(a)(1)(A)-(G) (2009)).

28 *Id.* (codified as amended at 31 U.S.C. §3729(a)(1)(G)).

29 False Claims Act Amendments §§ 3-4, 100 Stat. at 3157.

The remedy also provides for an award of all damages necessary to make such persons whole and an equal amount as liquidated damages.[30]

The importance of public trust applies to *all* private actors acting in tandem with the government, including *qui tam* relators and their counsel. As a result, the right of a relator to prosecute a *qui tam* claim is subject to important governmental checks on the relator's power. For example, the FCA requires that the relator disclose all material information and evidence to the government prior to filing an FCA lawsuit.[31]

The plaintiff must then file the initial complaint under seal in court and serve it on the government, but not on the defendant.[32] The government has sixty days from the filing date to investigate and may receive additional time if it shows good cause.[33] Eventually, the government must decide whether to intervene in the case. If the government intervenes, it takes primary responsibility for prosecuting whatever portions of the case it chooses and may also add new claims.[34] If the government does not intervene, the relator takes primary responsibility for prosecuting the case but may not settle or dismiss any claims without the government's approval.[35]

The results of the 1986 changes were dramatic. It is not going too far to say that the recent changes to the FCA framework were necessitated by the increased complexity of the government (and the contractors that have become almost synonymous with government) and experience with litigation under the statute rather than by drafting errors in the 1986 revisions.

C. *Congress Invites the States to Pass FCA Legislation*

The current phenomenon of the "population funnel" or the "gray tsunami" occasioned the next major event in the history of FCA legislation.[36] The population funnel problem consists of three interrelated challenges. First, the working-age population of the United States is rapidly decreasing

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30 *Id.*

31 It is important to note that the language of 31 U.S.C. § 3729(b)(2) (2009) only requires that a written disclosure be served on the government, and says nothing about the timing of the written disclosure. The language of § 3730(e)(4)(A) (2009) provides that only a relator who has made written disclosure to the government prior to filing the case under seal is eligible to qualify as an "original source" of the information.

32 False Claims Act Amendments, Pub. L. 99-562, § 2, 100 Stat. 3153 (1986) (codified as amended at 31 U.S.C. § 3730(b)(2) (2009)).

33 *Id.* (codified as amended at 31 U.S.C. § 3730(b)(3)-(4).

34 *Id.* (codified as amended at 31 U.S.C. § 3730(b)(4)).

35 *Id.*

36 *See* Press Release, AARP, AARP Endorses Bipartisan Legislation to Prevent Medicare Fraud (July 27, 2010), http://www.aarp.org/about-aarp/press-center/info-07-2010/AARPEndorsesBipartisanLegislationtoPreventMedicareFraud.html.

as the baby-boomers retire.[37] Second, the expected life span of the average retiree is longer than ever.[38] Third, healthcare costs have increased across the board, and the future cost of entitlement programs for retirees is mounting.[39]

These problems will likely cause crippling tax burdens on a dwindling working-age population and inter-generational strife. At a minimum, the population funnel threatens the United States' position as an economic superpower. In the worst case, the population funnel threatens the United States' political stability.

Early efforts to counter this looming crisis resulted in the enactment of the Deficit Reduction Act of 2005 (DRA).[40] As enacted by § 6031 of the DRA, § 1909 of the Social Security Act provides a financial incentive for states to enact false claims acts that establish liability for submitting false or fraudulent claims to the states' Medicaid program.[41]

However large the United States' defense budget might have been during the Cold War, federal defense spending today is only a fraction of the money spent on Medicare and Medicaid. The increase in healthcare spending, as reflected in the amount of FCA cases pertaining to healthcare, is startling. In 1987, healthcare cases constituted 12% of FCA cases filed. In 1998, healthcare cases made up 61% of FCA filings.[42]

II. CORRECTIONS AND UPDATES TO BRING THE FCA INTO THE MODERN ERA

The recent changes to the FCA's statutory and regulatory framework were necessary because the modern contracting environment is inherently more sophisticated and complex than it was in 1986. As a result, the 1986 language of the FCA became inadequate. For example, no one in 1986 could have foreseen prime contractors' increased reliance on subcontractors. It would also have been impossible to foresee the problems created when some courts interpreted § 3729(a)(1) to require that a claim be "presented" directly to the government in order to be actionable.[43] It was also

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37 WAN HE, ET AL., U.S. CENSUS BUREAU, 65+ IN THE UNITED STATES: 2005 25 (Dec. 2005), http://www.census.gov/prod/2006pubs/p23-209.pdf.

38 *Id.* at 35.

39 CONG. BUDGET OFFICE, ECONOMIC AND BUDGET ISSUE BRIEF: LONG-TERM ECONOMIC EFFECTS OF CHRONICALLY LARGE FEDERAL DEFICITS (2005), *available at* http://www.cbo.gov/ftpdocs/67xx/doc6744/10-13-Long-TermEffects_Brief.pdf.

40 Contrary to its title, Congress actually passed DRA in 2006. Deficit Reduction Act of 2005, Pub. L. No. 109-171, 120 Stat. 73 (2006) (codified in scattered sections throughout the U.S.C.).

41 *See id.* (codified at 42 U.S.C. § 1396h(b) (2007)).

42 Pamela H. Bucy, *Growing Pains: Using the False Claims Act to Combat Healthcare Fraud*, 51 ALA. L. REV. 57, 58 (1999).

43 *See* discussion *infra* Part II.B.1.

unforeseeable that some courts would read a materiality requirement into the FCA.[44] It is clear that the common motivating factor behind the amendments was a rethinking of the contractor's obligations to the government.

A. *The FERA Amendments and Recovering Government Overpayments*

Perhaps the most important corrections to the FCA were those pertaining to the recovery of government overpayments and increased liability for intentionally making false claims in order to receive overpayments or to avoid repayment of government money. The amended FCA creates liability for any person who:

> [K]nowingly makes, uses, or causes to be made or used, a false record or statement material to an obligation to pay or transmit money or property to the Government, or knowingly conceals or knowingly and improperly avoids or decreases an obligation to pay or transmit money or property to the Government.[45]

The revised FCA also makes it unlawful for any person who "has possession, custody, or control of property or money used, or to be used, by the Government and knowingly delivers . . . less than all of that money or property . . . ."[46]

The 1986 changes to the FCA made it unlawful to make or use "a false record or statement to conceal, avoid, or decrease an obligation to pay or transmit money or property to the Government."[47] Including the word "obligation" in the 1986 amendments was a giant leap forward, as it expanded the FCA's reach to include false or fraudulent statements made in order to avoid paying money *to* the government. However, the next twenty-four years would show that failing to define "obligation" was a serious flaw in the FCA.

As incredible as it may seem to the uninitiated, government overpayments are commonplace in the healthcare and defense procurement contexts. As healthcare and defense together make up the majority of government expenses, government overpayments are commonplace in most federal spending.

In the defense sector, government overpayments often occur in the context of cost-plus contracts. In these contracts, the federal government agrees to reimburse the contractor for a certain percentage of the contractor's total overhead costs plus the contractor's fee. The contractor is re-

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44 *See* discussion *infra* Part II.C.

45 False Claims Act, 31 U.S.C. § 3729(a)(1)(G) (2009).

46 31 U.S.C. § 3729(a)(1)(D).

47 31 U.S.C. § 3729(a)(1)(G).

quired to formulate a provisional indirect rate, which is an estimated overhead rate for future billings that the contractor uses to bill each cost-plus contract until the contractor knows the actual overhead costs.[48] This estimated rate must be based on historical data at the end of the accounting period.[49]

The process is somewhat similar in the healthcare context, for example, the government will pay the percentage of a hospital's overhead associated with the hospital's historical treatment of Medicare patients. Like the overhead costs of a defense contractor, the percentage of the hospital's overhead associated with future Medicare patients can only be estimated based on historical data.

In both of the contexts described above, many different types of potential overpayments would be caught as part of the contract reconciliation process. However, the hypothetical below illustrates a scenario that most government contractors have experienced in one form or another. Indeed, the random overpayments from the Department of Defense is a long recognized phenomenon by the United States[50] and has been the subject of regular reporting from the U.S. Government Accountability Office (GAO).[51] The hypothetical situation below will illustrate just one of the many forms such overpayments can take.

1. Hypothetical Overpayment Scenario

Executive agencies of the federal government are required to use electronic commerce to the maximum extent practicable.[52] As a result, government contractors of all sizes are likely to have a number of electronic fund transfers (EFTs) coming in from the U.S. Treasury. EFTs are normally identifiable by various means, but mistakes occur that make payments from the Treasury difficult to match to a corresponding invoice or contract number.

So what happens when a contractor receives a random, unidentified and unexpected EFT in the amount of $1 million? The money was not transferred in error simply because the contractor did not expect it, and it is possible that the company mistakenly believes that the money was incor-

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48 *See* FAR 42.701 (2010).

49 *Id.*

50 *See* U.S. GEN. ACCOUNTING OFFICE, NO. 94-245, DOD PROCUREMENT: OVERPAYMENTS AND UNDERPAYMENTS AT SELECTED CONTRACTORS SHOW MAJOR PROBLEMS 1 (1994). This GAO report was ordered after DOD contractors returned $751 million for a single six-month period ending in April 1993. *Id.* The GAO study examined nine contractor locations and discovered further discrepancies in the amount of $118 million. *Id.*

51 *See, e.g.*, U.S. GEN. ACCOUNTING OFFICE, NO. 02-635, DOD CONTRACT MANAGEMENT: OVERPAYMENTS CONTINUE AND MANAGEMENT AND ACCOUNTING ISSUES REMAIN (2002).

52 41 U.S.C. § 426(a) (2006); *see also* 31 U.S.C. § 3332 (2006).

rectly transferred. It is also possible that the contractor mistakenly under-billed the government at some point and that the government has in fact paid the correct amount. One can certainly forgive the contractor for holding on to the money for a short period of time in order to make absolutely sure that the government's payment was incorrect.

But what happens when all invoices are cleared, all subcontractors are paid, the company has met payroll, and there is still a bulge of extra money on the balance sheet? The contractor must admit at some point that it has received money to which it is not entitled, but when does that become clear? In theory, in both the healthcare and procurement contexts, the government and the contractor go through a collaborative reconciliation process to ensure that the contractor was not under or overpaid. In our hypothetical, however, the contractor is clueless, through no fault of his own, as to which contract received the extra $1 million. Therefore, there is no specific contractual reconciliation in which the overpayment should be disclosed. The experienced contractor will also be aware that the overworked auditors and accountants that supervise this process on the government's behalf are only able to check the most salient aspects of the reconciliation and can catch only the most obvious wrongdoing. The government will be more likely to notice the error when larger amounts of money are at issue. But even the most inexperienced contractor knows that agencies like the Defense Contract Audit Association (DCAA) find it very difficult to track amounts of money under $50 million within the massive machinery of the federal government.

Our hypothetical contractor will also be keenly aware of the powerful psychological factors at work in government employment: the person or group whose mistake resulted in the overpayment will want to pretend the whole thing never happened. Even if we assume the most optimistic scenario, which posits a government audit conducted by hard-working, patriotic, conscientious government employees, it would be asking too much to expect a person to bring their own grievous error to the attention of their superiors.[53] Moreover, while the contractor will take on real risks by openly defying a government inquiry into this overpayment, open defiance is not his only option. The contractor can instead resist the inquiry and make the government consume precious time and resources. Taking this cost into account, the government will investigate only the most egregious potential overpayments. As the Inspector General of the National Reconnaissance

[53] Needless to say, the reality is far from this ideal scenario. In one GAO audit of the DCAA, a DCAA employee candidly informed the GAO investigator that he had not performed all elements of the required audit because "the contractor would not appreciate it." U.S. GEN. ACCOUNTING OFFICE, NO. 09-468, DCAA AUDITS: WIDESPREAD PROBLEMS WITH AUDIT QUALITY REQUIRE SIGNIFICANT REFORM (2009). As part of that same audit, GAO learned that DCAA employees had spent 530 hours auditing a billing system that did not exist and reported that the system had adequate system controls. *Id.*

Office reported, it took more time and involved "more lawyers than acquisition people—to get the information and the cooperation we needed in matters involving our contractors."[54]

2. The Pre-FERA Struggle to Define a Contractor's Obligations to Return Money

Does the contractor have any obligation to return this money to the government? Prior to the May 2009 FERA amendments to the FCA, there were several statutes and rules concerning the obligations of a contractor who has been overpaid, including making the failure to return overpayments unlawful.[55] However, on the facts of this hypothetical, the contractor would not have made the factual misrepresentation necessary for FCA liability.[56]

Because the old FCA provided no definition of the word "obligation" it would have been impossible to prosecute a case under these facts with the FCA. In the absence of a congressional definition, courts struggled to define the obligations that contractors owed the United States. In *United States ex rel. S. Prawer & Co. v. Verril & Dana*, the district court defined a contractor's obligation to the government as referring to "something more than potential liability or moral or social duty . . . ."[57]

In *American Textile Manufacturers Institute, Inc. v. Limited, Inc.*, the Sixth Circuit held that a party had an obligation only where there was a specific, legal duty to pay money to the United States.[58] Moreover, the court held that the duty must exist at the time the false statement was made. In other words, one can legally make a false statement or claim in order to avoid incurring or creating an obligation.[59] Some courts interpreted the term, "obligation" under the old FCA to mean only amounts that were "fixed sums immediately due."[60] New FAR provisions now require any party with knowledge of a significant overpayment to self-report the violation within a minimum time frame.[61]

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54 Alan S. Larsen & Eric R. Feldman, *Convincing Contractors to Report Their Own Procurement Fraud to the Inspector General*, J. PUB. INQUIRY, Spring/Summer 2006, at 17.

55 31 U.S.C. §§ 3561-3567 (2006).

56 In other words, because of the EFT payment, there is no "claim" whatsoever to the United States with regard to this money. Historically, this was not the case, because FCA liability attached to any person depositing a government check to which they were not entitled—the act of endorsing and depositing such a check into the person's bank account constituted the knowing submission of a false claim to the government. *See* United States v. Fowler, 282 F. Supp. 1 (E.D.N.Y. 1968).

57 United States *ex rel.* S. Prawer & Co. v. Verril & Dana, 946 F. Supp. 87, 95 (D. Me. 1996).

58 Am. Textile Mfrs. Inst., Inc. v. Ltd., Inc., 190 F.3d 729, 735-36 (6th Cir. 1999).

59 *Id.*, at 736-38.

60 *See* U.S. *ex rel.* Marcy v. Rowan Cos., Inc., 520 F.3d 384, 390 (5th Cir. 2008).

61 *See infra* Part III.

3. The FERA Amendments and Obligations

The FERA amendments define the word "obligation" and make clear that an obligation under the FCA includes the retention of an overpayment. An obligation to repay money under the FCA now extends to an overpayment regardless of whether the overpayment is fixed in all particulars.[62] This is important because, as the hypothetical demonstrates, there will never come a time when the $1 million overpayment will be "fixed in all particulars." Another addition to the FCA makes it unlawful for any person "hav[ing] possession, custody, or control of property or money used, or to be used, by the Government," to "knowingly deliver or cause to be delivered less than all of the money or property."[63]

4. Analyzing the Alternative to Recovering Government Overpayment

The judicial interpretations of the term "obligations" are understandable in some situations, especially where there are allegations that a party made false statements and records in order to avoid civil or criminal penalties.[64] However, in other scenarios these interpretations would result in outcomes that could destroy public trust in the government and its contractors. The concept of returning money to which one is not entitled is elementary. Nevertheless, the government contracting community, its lawyers, and the accountants that work in their interests demand further explanation.[65]

B. *Eliminating the Requirement That a Claim be Presented Directly to the United States to be Actionable*

In §§ 3729(a)(1)(A)–(B), the revamped FCA removes the presentment requirement, which required that an actionable false claim must have been submitted directly to an officer or employee of the United States government. This quirk rendered the FCA inapplicable to a wide variety of cases, including many that are now common in modern government.

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62 False Claims Act, 31 U.S.C. § 3729(b)(2)(B)(3) (2009).

63 31 U.S.C. § 3729(a)(1)(D).

64 *See* U.S. *ex rel.* Marcy v. Rowan Cos., 520 F.3d 384 (5th Cir. 2008) (affirming dismissal of a relator's complaint which alleged defendants had made false statements in order to avoid paying fines for allegedly dumping oil in the Gulf of Mexico).

65 Robert J. Kenney et al., *New False Claims Act Amendments May Change the Way Research Institutions Respond to Discovery of Overpayments on Their Federal Grants and Contracts*, FED. RES. UPDATE (Hogan Lovells, Washington, D.C.), May 21, 2009, at 3.

For example, Medicare reimburses healthcare providers for the reasonable cost of the services provided to Medicare beneficiaries.[66] In order to facilitate this process, the government contracts with private insurance companies, known as fiscal intermediaries.[67] It is the fiscal intermediaries, and not the government itself, that receive invoices from hospitals and nursing homes. It is also the fiscal intermediaries that determine whether the costs submitted are reasonable and disburse government money to pay the invoices.[68]

This practice is not unique to the healthcare industry. As a result of the increased complexity of the business of government, the United States contracts with a variety of third parties to disburse government funds. For example, the federal government contracts with state and local governments to disburse federal block grants and emergency funds for disaster relief.[69] Federal block grants are also commonplace in the academic world for research purposes.[70] Likewise, it is not uncommon for a defense contractor to bill another defense contractor, who in turn bills yet another contractor for the services of the first company.

1. Courts Struggle to Define the Presentment Requirement

In the 1986 amendments, § 3729(a)(1) made it unlawful to "knowingly present, or cause to be presented, to an officer or employee of the United States Government or a member of the armed forces of the United States a false or fraudulent claim for payment or approval . . . ." Similarly, § 3729(a)(2) made it unlawful for any person to "knowingly make, use, or cause to be made or used, a false record or statement to get a false claim paid or approved by the government . . . ."[71]

Several cases held that for a claim to be actionable under § 3729(a)(1), the claim had to be submitted directly to an officer of the United States; submission to a prime contractor or other recipient of federal funds would not suffice. This was a controversial requirement; for example, the D.C. Circuit faced the question of whether submission of a false claim to Amtrak (which was funded entirely with government money) was actionable under the old FCA.[72]

Once the Supreme Court provided a definitive answer in *Allison Engine v. United States ex rel. Sanders*, it became clear that the 1986 language

66 42 C.F.R. § 413.1(a)-(h) (2007).

67 42 U.S.C. § 1395u (2006).

68 42 U.S.C. § 1395h (2006).

69 Joseph E.B. White, *Fraud Enforcement and Recovery Act of 2009: A Giant First Leap Forward for False Claims Act Enforcement*, 53 FALSE CLAIMS ACT & QUI TAM Q. REV. 227 (2009).

70 *Id.*

71 *Id.*

72 United States *ex rel.* Totten v. Bombardier Corp., 286 F.3d 542, 544 (D.C. Cir. 2004).

would no longer work. In *Allison Engine*, the Supreme Court unanimously held that to prove a violation of § 3729(a)(1), it was necessary to prove that the claim was submitted to the government.[73] While there was no such presentment requirement in order to bring a claim under § 3729(a)(2), the Court ruled that it was necessary to prove that a subcontractor submitted its false claim to a prime contractor with the intent that the prime contractor rely on the false claim when submitting its invoice to the government.[74]

2. Examining the Presentment Requirement

It was inconsistent with the realities of modern government for *Allison Engine* to prevent relators from prosecuting FCA cases successfully where a subcontractor submitted invoices to a third-party intermediary or to a prime contractor.

To require that a claim be submitted directly to the United States to be actionable under the FCA would also undermine public confidence in the government and in the contractors that perform so many of its vital functions. Contractors could simply form numerous holding companies and move the payments between them in order to insulate themselves from liability for false claims. Prosecuting contractors for such activities would be difficult even in the best case scenario.

United States v. Science Applications International Corp. exemplifies the problem of the requirement that a claim be submitted directly to the United States in order to be actionable. The government prosecuted several civil claims against Science Applications International Corporation (SAIC) for failing to disclose organizational conflicts of interest among various subdivisions of the company.[75] Prosecuting the case took more than five years, resulted in a nine-week jury trial, and cost the government enormous resources. Although the prosecution was ultimately successful, limited resources do not allow the government to prosecute many of these cases. Simply stated, frequent prosecutions of this type would be necessary because so much of the average contractor's work for the government is performed in tandem with a rival company or a subsidiary. This increase in prosecutions would consume the government's resources to the point that prosecuting wrongdoing in such cases would be unworkable. Finally, allowing contractors to obfuscate their liability in this way would be in direct opposition to government's primary role of engendering its citizens' trust.

73 Allison Engine Co. v. United States *ex rel.* Sanders, 553 U.S. 662, 666 (2008).

74 *Id.* at 671-72.

75 United States v. Sci. Applications Int'l Corp., 653 F. Supp. 2d 87, 93, 96 (D.D.C. 2009).

C. *Defining the Word "Material"*

Prior to the 2009 FERA amendments, there was a circuit split over whether a false claim had to be material in order to be actionable under the FCA. The text of the statute itself did not contain a materiality requirement. Nevertheless, the First,[76] Fourth,[77] Fifth[78] and Eighth[79] Circuits read this additional requirement into the FCA. While these courts agreed that a materiality requirement should be read into the FCA, they disagreed over how they should measure materiality.

The Fourth, Sixth and Ninth Circuits adopted a "natural tendency" test, which focused on the potential effects of the false statement at the time it was made, rather than on the false statement's actual effect after it was discovered.[80] The Eighth Circuit's test was more restrictive and focused on the ultimate outcome—it required a showing that the defendant's actions either had the purpose and effect of causing the United States to pay out money it was not obligated to pay, or that the defendant's actions intentionally deprived the United States of money that it was lawfully due.[81]

The FERA amendments solved the materiality problems that developed under the old statute. The amendments included a materiality requirement[82] and adopted the "natural tendency" definition of materiality.[83] Similarly, the revamped FCA included a definition of the terms "knowing" and "knowingly" and clarified that the statute does not require the specific intent to defraud.

D. *Conspiring to Violate the FCA*

Despite the broad reach of the statute after the 1986 amendments, the conspiracy provisions in § 3729(a)(3) applied only to conspiracies to get a false claim "paid or approved." In other words, it was not unlawful to conspire to violate any subsection of the FCA other than § 3729(a)(1). A conspiracy to avoid an overpayment, for example, would not have been unlawful. Furthermore, the conspiracy requirement could only be met where the government actually paid the claim. In other words, an unsuccessful conspiracy still did not violate the law.

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76 United States v. Data Translation, Inc., 984 F.2d 1256, 1267 (1st Cir. 1992).

77 Harrison v. Westinghouse Savannah River Co., 176 F.3d 776, 785 (4th Cir. 1999).

78 United States *ex rel.* Stebner v. Stewart & Stephenson Servs., Inc., 144 F. App'x 389, 393-94 (5th Cir. 2005).

79 United States *ex rel.* Rabuska v. Crane Co., 122 F.3d 559, 563, 565 (8th Cir. 1997).

80 United States v. Borseau, 531 F.3d 1159, 1171 (9th Cir. 2008).

81 Costner v. URS Consultants, Inc., 153 F.3d 667, 677 (8th Cir. 1998).

82 False Claims Act, 31 U.S.C. § 3729(b)(1) (2009).

83 31 U.S.C. § 3729(b)(1)(B).

Under § 3729(a)(1)(C), it is now unlawful to conspire to violate any substantive provision of the FCA. As the common law has long recognized, an unlawful conspiracy is itself damaging to the public, even if the conspiracy ultimately fails. Thus, it is also unlawful to unsuccessfully conspire to violate the FCA.[84] This concept is present in most criminal codes where the conspiracy to commit a criminal act or accomplish a lawful goal by criminal means is treated as a separate offense. By changing the focus of the conspiracy section of the FCA, the government has made it clear that any conspiracy that would erode the public's trust is actionable, even if it is unsuccessful.

E. *The Patient Protection and Affordable Care Act (PPACA)*

Widely known simply as "the healthcare law," the PPACA was signed into law on March 30, 2010, and represented a major victory for the Obama Administration and for the 111th Congress. One of the overall aims of the bill is to reduce the number of Americans lacking some form of health insurance. Given the future costs inherent in the government's new role, perhaps it is not surprising that Congress also chose this vehicle to make important changes to the FCA that increased the right of *qui tam* relators to file cases.

1. The Public Disclosure Bar and the Original Source Exception

Since 1986, the public disclosure bar has precluded relators from bringing cases based on information that was publicly available prior to the relator's filing.[85] The only exception to this blanket prohibition is if the relator can show that he or she was an "original source" of the information.[86] The logic underlying the public disclosure bar is easy to understand given the monetary incentive for people to claim fraud even when the information already is widely known. By precluding publicly available information, the government encourages real insiders to come forward and at the same time discourages profiteers from filing parasitic suits. Examples of parasitic suits could be *qui tam* actions based on information found in a newspaper article or a criminal indictment.

The public disclosure bar in § 3730(e) therefore exists only to further important government interests. Primarily, § 3730(e) prevents the govern-

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84 *See* 31 U.S.C. § 3729(a)(1)(C).

85 Pub. L. No. 99-562, §§ 3, 4, 100 Stat. 3154, 3157 (codified as amended at 31 U.S.C. § 3730(e)(2) (2009)).

86 Joel D. Hesch, *Understanding The Public Disclosure Bar in Light of the Supreme Court's Recent Decision in Rockwell*, 7 DEPAUL BUS. & COM. L.J. 1, 2 (2008).

ment from having to share its monetary rewards with relators who added nothing to the government's investigation. The legislative history of the 1986 amendments makes it clear that Congress intended the public disclosure bar to apply only to claims by relators which were truly parasitic, such as when a relator adds nothing to the government's investigation, performs little work on the case, and risks nothing.[87]

However, the public disclosure bar was jurisdictional prior to the PPACA amendments. As a result of the public disclosure bar and the original source exception, courts could not hear the merits of a claim unless the relator could first prove that he or she was the original source of the information. Predictably, defendants asserted this defense in nearly every FCA case and sought to obtain limited discovery on this jurisdictional matter before doing discovery on the underlying merits of the case. As a result, defendants were able to unnecessarily delay discovery on the merits in almost every case. Moreover, the government had no say in the matter despite the fact that the public disclosure bar's purpose is to protect the government's interests.

In 2007, the Supreme Court ruled on *Rockwell International Corp. v. United States*, and the opinion from that case is the only Supreme Court opinion on the 1986 public disclosure bar. In *Rockwell*, the Supreme Court upheld a district court decision dismissing the relator, Mr. Stone, from a lawsuit after the district court entered judgment against the defendant.[88] The defendant did not dispute its liability or wrongdoing.[89] The sole issue was whether Stone was the original source of the publicly disclosed information and thus entitled to share in the Government's recovery.[90]

The facts of *Rockwell* make the decision egregious. Rockwell International Corporation contracted with the Department of Energy to operate a nuclear weapons facility in Colorado.[91] In the early 1980s it became necessary for Rockwell to find a way to dispose of toxic sludge.[92] Stone was asked to work on a solution as part of his employment with Rockwell.[93]

Rockwell proposed a solution which involved sealing the toxic waste in concrete blocks and then disposing of the blocks.[94] Rockwell labeled these toxic waste blocks "pondcrete."[95] As one of the project's engineers, Stone felt strongly that the project would fail and that the pondcrete blocks would leak as a result of an engineering defect.[96] Soon thereafter, Stone left

87 *See* 132 CONG. REC. H9382-03 (daily ed. Oct. 7, 1986) (statement of Rep. Berman).

88 Rockwell Int'l Corp. v. United States, 549 U.S. 457, 479 (2007).

89 *Id.* at 466.

90 *Id.*

91 *Id.* at 460.

92 *Id.*

93 *Id.* at 461.

94 *Rockwell Int'l Corp.*, 549 U.S. at 461 (2007).

95 *Id.*

96 *Id.*

his employment with Rockwell and made a report to the FBI.[97] In 1989, Stone filed a *qui tam* case alleging that Rockwell had submitted false claims to the government in association with the integrity of the pondcrete blocks.[98] Specifically, Stone alleged that, the pondcrete blocks would leak as a result of what he believed to be an inadequate piping system.[99]

Despite his early interest in pondcrete, Stone did not file his *qui tam* case until after a local news report aired concerning problems with insolid pondcrete at the facility, and the payment by Rockwell of $18.5 million in fines related to the insolidity of the pondcrete.[100] The government declined to intervene in Stone's *qui tam* case initially. Stone and his private attorneys then devoted considerable effort and expense to litigating the case on their own for nearly ten years. The efforts of Stone and his private counsel paid off. After considerable discovery in the case, there was enough evidence to catch the government's attention, and the Government filed a complaint in intervention.

The matter was tried before a jury.[101] The jury determined that Rockwell had indeed submitted false claims to the United States in association with the pondcrete blocks.[102] However, the jury's verdict placed the date for the pondcrete failure *after* Stone left his employment at Rockwell; moreover, the pondcrete blocks leaked for a different reason than the one Stone predicted.[103] As a result, Stone was dismissed from the case on a post-trial motion.

Nevertheless, without the resources that Stone and his lawyers poured into the case, the case would not have caught the government's eye, and the defendants would have gotten away with considerable fraud. The Department of Justice felt strongly that Stone should be given a share in the Government's recovery and went so far as to file a strongly worded *amicus curiae* brief in support of his argument.[104] That was all that the Government could do to assist him because the Government had no say in the matter. The Court found that Stone did not qualify as an original source.[105] Despite his efforts and the Government's objections, the Court did not allow Mr. Stone to share in the Government's recovery.

The judicial opinions that followed *Rockwell* were even worse. Mere days after *Rockwell* was announced, the district court in *United States ex*

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97 *Id.* at 461-62.

98 *Id.* at 463.

99 *Id.* at 457.

100 *Rockwell Int'l Corp.*, 549 U.S. at 463 (2007).

101 *Id.* at 465.

102 *Id.* at 466.

103 *Id.*

104 Brief for the United States of America et al. as Amici Curiae Opposing Petitioner, Rockwell Int'l Corp. v. United States, 549 U.S. 457 (2007) (No. 05-1272), *available at* http://www.justice.gov/osg/briefs/2006/0responses/2005-1272.resp.pdf.

105 *Rockwell Int'l Corp.*, 549 U.S. at 476-77.

rel. Maxwell v. Kerr-McGee Oil & Gas Corp. granted a post-verdict motion to dismiss the relator from the case on public disclosure grounds, and reversing a jury award of more than $7.5 million.[106] Further, because the government had not intervened in the case, the relator's dismissal meant that the entire case had to be dismissed.[107] The court denied the Government's motion to intervene in the case post-judgment, despite the perverse result that a defendant who broke the law and committed a considerable fraud would avoid liability on a technicality.[108]

The PPACA solved this problem in two ways. First, the public disclosure bar is no longer jurisdictional.[109] Second, the language of the new public disclosure bar provides that "the Court shall dismiss an action or claim under this section, *unless opposed by the Government*, if substantially the same allegations or transactions alleged in the action or claim were publicly disclosed."[110] Finally, the government receives a say in the matter.[111]

2. Examining the Alternatives to the New Public Disclosure Bar

Given that the public disclosure bar's primary objective is to protect the government, it made little sense to allow a defendant to escape liability for any claim based on a public disclosure without allowing the government to play a role in the decision. Unlike other provisions of the FCA that serve to protect important rights of defendants, the public disclosure bar does nothing to protect a defendant's legal rights. As cases like *Rockwell* and *Maxwell* demonstrate, prior to the PPACA amendments, the public disclosure bar was a technicality that allowed parties who cheated the government to escape liability.

Because the relator in a successful *qui tam* case receives his or her reward from the government's recovery, one might fairly ask why defendants would care what the government does with the recovery it receives in cases like *Rockwell*. The reasons for the defendants' views in this regard are cynical and purely self-serving—they seek to discourage as many individuals from coming forward as they can. Defendants have switched their focus to discouraging *qui tam* relators from coming forward because the defendants can no longer assail the concept of the FCA. As one defense-side analysis stated bluntly, "[T]ogether these PPACA provisions . . . expand the class of private individuals empowered to bring an action on the government's be-

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106 United States *ex rel.* Maxwell v. Kerr-McGee Oil & Gas Corp., 486 F. Supp. 2d 1233, 1234-35 (D. Colo. 2007).

107 *Id.*

108 *Id.* at 1234.

109 29 U.S.C. § 3730(e)(4)(A) (2009).

110 *Maxwell*, 486 F. Supp. 2d at 1234 (emphasis added).

111 *Id.*

half. The likely result is an increase in both the number and types of FCA claims."[112] They said this as if it were a *bad* thing.

Americans dislike any system of rules that allow a wrongdoer to go unpunished because of a technicality. In some contexts, such as the constitutional rights of a criminal defendant, this distaste is the cost of our constitutional liberties. However, any system of laws or government is doomed to fail if it allows defendants to evade liability too often for technicalities that serve no important purpose.

III. REVAMPING FAR

The preamble to the new FAR regulations did not mince words—it unabashedly labeled the changes introduced as a "sea change."[113] There are several salient features of the new rules. For example, the new FAR provisions put into place a mandatory disclosure provision that must be incorporated into each contract.[114] The mandatory disclosure provision requires contractors to disclose "credible evidence" of a violation of the FCA.[115] Such requirements flow down to subcontractors from the prime contractor, meaning that the prime contractor does have some responsibility to supervise the subcontractor's billing.

Equally important is the requirement that each contractor maintain an ethics awareness and compliance program.[116] Indeed, the word "ethics" appears again and again throughout the new FAR provisions.[117] Generally speaking, ethics is the study of the obligations and responsibilities owed by a party to other parties, together with a marked acknowledgment that no set of rules can ever completely govern any worthwhile human activity. Despite the abundance of rules that govern contractors, the word "ethics" and all its implications still makes them uncomfortable.

The new ethics provisions in FAR require not only that contractors have in place an internal code of ethics, but also that they communicate this ethics code to employees[118] and train them on the proper course of action if they encounter an ethical issue. Perhaps most importantly, employers must instruct employees how to proceed if it appears that the organization is not

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[112] *U.S. Health Care Reform Legislation Significantly Expands the False Claims Act*, GIBSON DUNN (Apr. 2, 2010), http://www.gibsondunn.com/publications/Pages/HealthCareReformLegislatiónExpandstheFalseClaimsAct.aspx.

[113] FAR Case 2007-006, Contractor Business Ethics Compliance Program and Disclosure Requirements, 73 Fed. Reg. 67,064, 67,070 (Nov. 12, 2008).

[114] Solicitation Provisions and Contract Clauses, 73 Fed. Reg. 67,901 (Nov. 12, 2008).

[115] *Id.*

[116] Contractor Code of Business Ethics and Conduct, 48 C.F.R. 52.203-13 (2009).

[117] *See* 73 Fed. Reg. at 67,064.

[118] FAR pt. 3.1002.

complying with the code and if the employee's internal efforts to fix the problem yield inadequate results.[119]

The ethics rules also require contractors to display hotline posters that inform employees of what to do if they find that a contractor is not adequately addressing an ethics concern.[120] The requirement that contractors display a poster informing employees of their rights and available remedies is an old device, long used in other remedial statutes, such as the Fair Labor Standards Act.[121] The end result of all of these requirements is to empower *qui tam* relators to bring new and more sophisticated claims.

Although the FAR Councils and contractors both regarded the tone and scope of the new regulations as revolutionary,[122] the content of the regulations was not something a layperson would find unusual. Take, for example, the requirement that contractors report potential overpayments by the government. This scenario does not require advanced legal or accounting training to understand: most people understand that if they receive money that they are not entitled to, they have to give it back. One would be hard-pressed to find a similar windfall in any other context. For example, any bank customer who received an undeserved windfall as a result of a banking error would learn very quickly indeed that they are not allowed to keep the money.

The problem of government overpayments has long been a source of concern in government circles.[123] It seems likely that a public outcry would follow widespread knowledge of the frequency and size of government overpayments to contractors.

Furthermore, when considering how an overpayment investigation normally unfolds, one sees the importance of requiring contractors to self-report all suspected overpayments within a certain period of time.[124] Typically, investigators from the Office of the Inspector General (OIG) approach a contractor to ask for information about a suspected overpayment. The contractor either gives vague promises to cooperate in the investigation and then delays or tells the OIG staff that he does not have to cooperate. Of course, this refusal to cooperate generally also comes after a delay.[125]

The OIG counsel then writes a letter to the company citing the relevant regulatory, statutory, and contract language and asks again for compliance. At this point, a letter from the contractor's counsel arrives, stating that the

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119 *Id.*

120 FAR 52.203-13.

121 Fair Labor Standards Act of 1938, 29 U.S.C. §§ 201-219 (2007).

122 *See* Rockwell Int'l Corp. v. United States, 549 U.S. 457 (2007).

123 *See* 48 C.F.R. §§ 42.701.

124 False Claims Act, 31 U.S.C. § 3729(a)(1)(G) (2009). In fact, contractor self-reporting and cooperation requirements very similar (if not identical) to those of the new FAR provisions were first developed and tested by the National Reconnaissance Office as described by Larsen & Feldman, *supra* note 54.

125 Larsen & Feldman, *supra* note 54, at 17.

contractor wants to see a subpoena before the contractor produces any information. The OIG then brings the matter to a senior agency official's attention. The senior agency official calls one of the contractor's senior officials and asks if this is really the way the contractor intends to do business.[126]

It should not be surprising that the recent changes to the FCA framework deal with issues of this type. Any system that allowed for this sort of windfall to government contractors would be so far removed from common sense that the revelation of such practices would discredit any government that tolerated its existence.

IV. THE ROLE OF THE *QUI TAM* RELATOR IN THE REGULATORY FRAMEWORK

Sunlight is the best disinfectant for corruption.[127] In light of the increased role of government, it should come as no surprise that lawmakers have strengthened the FCA's *qui tam* provisions. Taken together with the FAR amendments discussed in this article, the government's belief that *qui tam* relators play an important role in illuminating the operations of contractors is apparent.

One can draw an imperfect analogy between FCA civil prosecutions' reliance on *qui tam* whistle blowers and the use of inside informers in criminal prosecutions. Indeed, *qui tam* relators are important to the FCA's civil enforcement for many of the same reasons that criminal informants are important to criminal prosecutions—namely, without an insider's cooperation, it can be very difficult for an outsider to understand secretive and insular criminal organizations that have their own unique and complex cultures, value systems, and means of maintaining internal controls. One can say the same thing for the world of government contracting, which is also secretive and insular with a unique and complex culture.

However, important differences exist between criminal informants and *qui tam* relators. Perhaps the most important difference is that the average criminal has a limited worldview, limited education, and limited contacts in high places. In short, he or she has a marked lack of understanding about the functioning of the real world and limited contacts with society's power structure. Therefore, most criminal enterprises lack the resources and connections to cause large-scale damage to our way of life.

By contrast, in the world of government business, law enforcement confronts the exact opposite of the criminal underworld. There, law en-

126 *Id.* at 18.

127 *See Building Public Integrity Through Positive Incentives: MCC's Role in the Fight Against Corruption* (unpublished paper), *available at* http://www.mcc.gov/documents/reports/mcc-workingpaper-corruption.pdf.

forcement confronts a world filled with Nobel Prize winning scientists, doctors performing research to cure disease and affliction, and charismatic military leaders with connections at the highest levels. Most, if not all, have performed decades of service to their country, and have the kinds of contacts and wisdom that go along with brilliant careers and pedigrees. They have the resources to employ hordes of the best lawyers and accountants to figure out how to bend the rules to just shy of the breaking point, and to represent them when they are caught. These contractors also employ large numbers of ex-senators and congressmen to do their bidding in the halls of Congress and state legislatures.

Our American system is unique in its openness and its ability to allow one relatively powerless person to challenge and change the elites of our society. The ability of a *qui tam* relator to police government and challenge the powers that be is a unique right of American culture, and it is even older than the Republic itself. Simply put, those that wish to do away with the three-party regulatory system created by the *qui tam* mechanism would prefer a country dominated by the wealthy and powerful, a world where dissenting individuals would be ground under the heel of the elite.

CONCLUSION

The recent changes to the FCA discussed in this article are timely and needed. It is important that all parties who do business with and receive money from the federal government understand that the nature of the game has changed: now they will be held accountable to a set of commonsense standards. These *qui tam* provisions are necessary because any attempt to regulate sophisticated contractors and other recipients of government funds by written rules alone is destined to fail. The same is true of any system of laws or government that comes to be viewed as nothing more than a source of economic gain for the powerful and well-connected.

APOLOGIA FOR THE SECOND CIRCUIT'S OPINION IN *SEC V. DOROZHKO*

*Michael D. Wheatley**

INTRODUCTION

The Second Circuit's decision in *SEC v. Dorozhko* addresses a potential gap in insider trading jurisprudence[1] that has some academics and practitioners scratching their heads. The issue the court faced was whether a person, who trades on inside information obtained through hacking, can be liable for insider trading in the absence of a fiduciary or similar relationship.[2] The Second Circuit held that hacking could be deceptive conduct and remanded that question to the district court for determination.[3] More controversial, however, was the Second Circuit's holding that a fiduciary or similar duty was not required for the perpetrator to be liable for insider trading under the securities laws.[4] Despite the controversy, many view the case as a victory for the United States Securities and Exchange Commission (SEC) in its efforts to enforce the anti-fraud provisions of the securities laws.[5]

Criticism of the Second Circuit's opinion in *Dorozhko* centers on two primary points: (1) the court's holding that no fiduciary or similar duty is necessary for a violation of Rule 10b-5 to occur, which according to critics, contradicts Supreme Court precedent on the topic; and (2) the court's holding that hacking may be deceptive conduct in violation of Rule 10b-5.[6] In

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* B.A., 2006, Brigham Young University; J.D. 2009, George Mason University School of Law.

1 SEC v. Dorozhko, 606 F. Supp. 2d 321, 323 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2nd Cir. 2009).

2 SEC v. Dorozhko, 574 F.3d 42, 43-44 (2nd Cir. 2009).

3 *Id.* at 49.

4 *Id.* For a discussion of the controversy surrounding the decision, *see* Alison Frankel, *Bloggers Fuel Debate Over Circuit's Hacker Ruling*, 242 N.Y. L.J. 23, Aug. 3, 2009, at 1; *see also* Alison Frankel, *With Blogosphere in Uproar over Second Circuit Ruling on Computer Hacking and Insider Trading, Dorozhko Lawyer Weighs Appeal*, AM. L. LITIG. DAILY (July 31, 2009), http://www.law.com/jsp/tal/digestTAL.jsp?id=1202432652749&With_Blogosphere_in_an_Uproar_over_SecondCircuit_Ruling_on_Computer_Hacking_and_Insider_Trading_Dorozkho_Lawyer_Weighs_Appeal.

5 *See* Alison Frankel, *Bloggers Fuel Debate Over Circuit's Hacker Ruling*, 242 N.Y. L.J. 23, Aug. 3, 2009, at 1.

6 Another criticism has been that *Dorozhko* does not satisfy the "in connection with" requirement. This argument is likely not viable in light of the Supreme Court's decision in *SEC v. Zandford*. 535 U.S. 813, 822 (2002) (holding that "in connection with" means "to coincide"). Indeed, the district court acknowledged that *Dorozhko*'s scheme was "in connection with" the purchase or sale of securities

Part I, this article explores the Second Circuit's holding that a breach of fiduciary duty is not a prerequisite for holding the defendant liable under the securities laws. In Part II, this article examines whether hacking contains the deceptive elements necessary to satisfy the requirements of the securities laws. In Part III, this article examines the plausibility of abandoning the fiduciary duty analysis in favor of a more workable "property rights" paradigm for insider trading liability.

I. *SEC v. Dorozhko* and an Introduction to Insider Trading

Part I discusses the SEC's case against Oleksandr Dorozhko and provides a general background of insider trading jurisprudence. Part I then discusses manipulative and deceptive devices prohibited by Section 10(b) and Rule 10b-5 and how insider trading fits within that regulatory rubric. Shifting to a more focused analysis, Part I concludes by discussing computer intrusion cases and how the SEC has prosecuted those cases.

A. *The SEC's Case Against Oleksandr Dorozhko*

The SEC's case against Oleksandr Dorozhko arose as a result of an electronic intrusion into Thomson Financial's internal secure server.[7] Thomson Financial is an investor relations services vendor.[8] In October 2007, Thompson Financial hosted IMS Health Care's investor relations website and provided support to IMS Health Care for public release of its earnings information.[9] IMS Health had publicly announced that they would disseminate their third-quarter earnings on October 17, 2007, at around 5:00 p.m.[10] That day, a hacker probed the Thomson Financial website six times before finally gaining access to IMS Health's quarterly results before they were published.[11]

Shortly after the hacker probed the network, Oleksandr Dorozhko, a Ukrainian national and resident, began using a newly opened account at Interactive Brokers to purchase 630 put options, including many options

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"because the close temporal proximity of the hacking to the trading (everything occurred in less than twenty-four hours) and the cohesiveness of the scheme (establishing the trading account, stealing the confidential information within minutes of its availability, and trading on it within minutes of the next day's opening bell) suggest that hacking into the Thomson computers was part of a single scheme to commit securities fraud." *Dorozhko*, 606 F. Supp. 2d at 328-29 (explanation added).

7 *Dorozhko*, 606 F. Supp. 2d at 325.

8 *Id.*

9 *Id.*

10 *Id.*

11 *Id.* at 325-26.

that were "out of the money."[12] When IMS Health released its financial results to the public at around 4:30 p.m. on October 17, the market reacted unfavorably to the news. The company reported earnings 28% below analyst estimates and 15% below the previous year's third-quarter earnings.[13] By 9:41a.m. the next morning, Dorozhko had sold all 630 of his put options for a $286,456.59 profit.[14] Although the identity of the hacker was not known with 100% certainty, the district court concluded that Dorozhko was likely the hacker based on the following circumstantial evidence: "(1) [T]he fact of the hack, and (2) the proximity to the hack of the trades by Dorozhko who was the only individual to trade heavily in IMS Health put options subsequent to the hack."[15] Very few details about the hacking technique Dorozhko allegedly employed were established at the trial level. The district court simply described the hacking technique used to access Thompson Financial's internal servers as "probing."[16]

In support of its motion for a preliminary injunction, the SEC presented two arguments: (1) that Dorozhko violated § 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 by trading in material, nonpublic information; and (2) that the hacking was a deceptive device.[17] The district court denied the SEC's motion for a preliminary injunction to freeze the proceeds of Dorozhko's transactions, finding that the SEC did not shown that it would likely succeed on the merits of alleging a violation of § 10(b) of the Exchange Act.[18] The district court stated that Dorozhko could not be held civilly liable for violating § 10(b) and Rule 10b-5 because he owed no fiduciary or similar duty, either to the source of his information, or to those he transacted with in the market.[19] Despite denying the SEC's request for a preliminary injunction, the court stayed its order, leaving the temporary restraining order in place, to allow the SEC to seek a stay pending appeal from the Second Circuit.[20]

On appeal, the SEC argued that Dorozhko committed an affirmative misrepresentation when he obtained unauthorized access to a computer

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12 *Id.* at 326. "Out-of-the-money" put options are options whose strike prices are below the current price of the issuer's stock. Because a put option is a bet that the price of the stock will decrease, the purchase of a put option that is below the current price of the stock will only be profitable if the value of the stock declines dramatically. *See Basic Option Concepts: Put Options*, YAHOO, http://biz.yahoo.com/opt/basics4.html (last visited Nov. 13, 2010).

13 *Dorozhko*, 606 F. Supp. 2d at 326.

14 *Id.* at 326-27.

15 *Id.* at 323.

16 *Id.* at 325.

17 *Id.* at 329.

18 *Id.* at 343.

19 *Dorozhko*, 606 F. Supp. 2d. at 324.

20 *Id.* at 343.

system that contained nonpublic information.[21] The SEC contended that "someone who deceptively obtains access to confidential information stored in a computer has engaged in fraud or deceit."[22] The SEC argued further that as a result of that affirmative misrepresentation, Dorozhko violated the securities laws regardless of whether he owed a fiduciary duty to any party involved.[23] The Second Circuit agreed, ruling that an affirmative misrepresentation in connection with the purchase or sale of a security violated the securities laws, regardless of the existence of a duty.[24] On the question of whether hacking constituted an affirmative misrepresentation, the court said, "misrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive' within the ordinary meaning of the word."[25]

Because the district court denied the injunction based on the lack of fiduciary duty, it did not address whether hacking was indeed deceptive conduct. Thus, the issue before the Second Circuit on appeal was simply whether hacking *could* be deceptive, but not whether hacking was in fact necessarily deceptive;[26] the Second Circuit remanded the latter question to the district court.[27] On remand, the district court granted the SEC's unopposed motion for summary judgment.[28]

B. *Development of Insider Trading Jurisprudence*

Two major policy goals drive the prohibition on insider trading: market integrity and investor protection.[29] Curiously, there is no statute that

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21 *See* Opening Brief of Appellant at 54, SEC v. Dorozhko, 606 F. Supp. 2d 321 (S.D.N.Y. 2008) (No. 08-0201-CV) [hereinafter Opening Brief].

22 *Id.* at 28-29.

23 *See id.* at 40.

24 *Dorozhko*, 574 F.3d at 49.

25 *Id.* at 51.

26 *Id.* at 46, 51.

27 *Id.* at 51.

28 SEC v. Dorozhko, No. 07 Civ. 9606 (S.D.N.Y. filed Mar. 24, 2010), *available at* http://law.du.edu/documents/corporate-governance/sec-and-governance/dorozhko/SEC-v-Dorozhko.pdf. Dorozhko's counsel, Charles A. Ross, told the court that he was unable to contact his client and therefore did not oppose the motion. In granting the motion for summary judgment, the district court directed Dorozhko to disgorge illegal gains of $286,456.59 and $6,903.94 in prejudgment interest. The court also directed Dorozhko to pay a penalty of $286,456.59, and barred him from future violations of federal securities laws. Yin Wilczek, *Court Grants SEC Summary Judgment In Ukrainian Hacker Insider Trading Case*, 42 Sec. Reg. & L. Rep. (BNA) 584 (Mar. 29, 2010).

29 Bud W. Jerke, *Cashing in on Capitol Hill: Insider Trading and the Use of Political Intelligence for Profit*, 158 U. PA. L. REV. 1451, 1509 (2010) ("[I]nsider trading poses a threat to the integrity of our financial markets. This, of course, is the fundamental aim of our securities laws. Insider trading is harmful because it reduces confidence in the markets. Consequently, the federal securities laws restore this confidence by requiring corporations to make public disclosures.") (citations omitted); Jonathan

defines insider trading or specifically prohibits it.[30] Rather, the prohibition of insider trading is based on judicial interpretations of the anti-fraud provisions of § 10(b) of the Exchange Act and the SEC's Rule 10b-5.[31] Accordingly, all theories of insider trading are judicially-created doctrines springing from the anti-fraud language in the Exchange Act and the SEC's rules.[32] In fact, theories for insider trading liability exist precisely because there are no express statutory prohibitions against it.[33] Congress came painfully close to creating a statutory definition of insider trading when it passed the Insider Trading Sanctions Act of 1984,[34] although the final legislation did not retain the definition that had been discussed in the Senate.[35] Congress did, however, codify *sanctions* for insider trading in the Insider Trading Sanctions Act of 1984 and the Securities Fraud Enforcement Act of 1988.[36] A portion of the latter, as amended, states:

> Whenever it shall appear to the Commission that any person has violated any provision of this chapter or the rules or regulations thereunder by purchasing or selling a security ... while in possession of material, nonpublic information in, or has violated any such provision by communicating such information in connection with, a transaction on or through the facilities of a national securities exchange or from or through a broker or dealer, and which is not

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Macey, *Getting the Word Out About Fraud: A Theoretical Analysis of Whistleblowing and Insider Trading*, 105 MICH. L. REV. 1899, 1922 (2007) ("The rules against insider trading are meant to protect... investors...."); *see* William L. Cary, *Corporate Standards and Legal Rules*, 50 CAL. L. REV. 408, 415 (1962) (arguing that insider trading "infects the integrity of the market"); *see also* Manuel F. Cohen, *Disclosure—The SEC and the Press*, 24 FIN. ANALYSTS J. 21, 22 (1968) (maintaining that "the problem of 'inside information' is one that has a tremendous impact on public confidence in the fairness of the securities markets").

30 Richard A. Booth, *The Missing Link Between Insider Trading and Securities Fraud*, 2 J. BUS. & TECH. L. 185, 195-96 (2007) ("[N]either Congress nor the SEC has been able to settle on a definition. Thus, it has been up to the courts to define insider trading as a matter of case law. In general, the courts have defined insider trading as using material nonpublic information in violation of a duty to the source of the information, not to use the information for personal gain.").

31 United States v. Teicher, 987 F.2d 112, 119 (2d Cir. 1993).

32 *See* General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.16b (2010).

33 Randall W. Quinn, *The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of United States v. O'Hagan*, 8 FORDHAM J. CORP. & FIN. L. 865, 868 (2003) (noting that while there are no express statutory prohibitions against insider trading, some reference can be found within the limited context of section 16(b) of the Securities Exchange Act of 1934).

34 *See* Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, § 2, 98 Stat. 1264 (1984) (codified as amended in scattered sections of 15 U.S.C.).

35 *See* Thomas L. Hazen, *Identifying the Duty Prohibiting Outsider Trading on Material Nonpublic Information*, 61 HASTINGS L.J. 881, 889 n.40 (2010).

36 *See* Insider Trading Sanctions Act of 1984 § 2; Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, § 3, 102 Stat. 4677 (1988) (codified as amended in scattered sections of 15 U.S.C).

> part of a public offering by an issuer of securities other than standardized options or security futures products . . . [37]

Despite these efforts to sanction inside traders by statute, a coherent definition of what constitutes insider trading has not emerged and the definition contained in the Securities Fraud Enforcement Act of 1988 is not a complete representation of the Supreme Court's view of insider trading. For example, the Securities Fraud Enforcement Act authorizes penalties for trading while in possession of material, nonpublic information, but that act alone is insufficient to seek punishment under the current Supreme Court case law. Insider trading case law has not adopted this "property rights" approach. Under this theory, law enforcement could punish an individual who happened to come across a folder on the sidewalk that contains material, nonpublic information and proceeds to trade on that information to his benefit. The "property rights" doctrine generally only allows punishment when a person violates a duty of candor or trust, engages in a market manipulation, or engages in an affirmative misrepresentation. However, the plain language of the definition contained in the Securities Fraud Enforcement Act authorizes a penalty for that person even in the absence of this nefarious conduct.[38]

In the absence of language that articulates a definition for insider trading, the SEC charges alleged insider trading offenders in the federal courts under § 10(b) of the Exchange Act and Rule 10b-5 promulgated under that act. As a result, the evolution of insider trading jurisprudence has developed from the opinions of federal judges. In 1975, then-Associate Justice Rehnquist described private actions under Rule 10b-5 as "a judicial oak which has grown from little more than a legislative acorn."[39] The SEC's haphazard enforcement of Rule 10b-5 has figuratively extended this metaphor. The SEC tried to expand this rule by advocating new theories on how the rule should be enforced, allowing the courts to add and lop off limbs of the oak, as these new theories have been introduced and ratified or struck down, respectively. Section 10(b) of the Exchange Act prohibits the use of manipulative or deceptive devices in connection with the purchase or sale of a security and grants the SEC power to enforce the section by rule.[40] The Supreme Court stated that the antifraud provisions of the Exchange Act are

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37 Insider Trading and Securities Fraud Enforcement Act of 1988, 15 U.S.C. § 78u-1 (2002).

38 15 U.S.C. § 78c(a)(9) (2010) ("The term 'person' means a natural person, company, government, or political subdivision, agency, or instrumentality of a government.").

39 *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975) (holding that in order to bring a private action under § 10(b) and Rule 10b-5 the plaintiff must have been an actual purchaser or seller of the stock).

40 Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1934) (states, in relevant part, that it shall be unlawful "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . .").

to be "construed not technically and restrictively, but flexibly to effectuate [the Exchange Act's] remedial purposes."[41] Pursuant to § 10(b), the SEC promulgated Rule 10b-5, which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[42]

According to Congress, one of the intentions of Rule 10b-5 was "to assure that dealing in securities is fair and without undue preferences or advantages among investors . . . ."[43] Based on this congressional intent, courts have construed Rule 10b-5 broadly. Indeed, the Supreme Court has even described Rule 10b-5 as a "catch-all antifraud provision."[44]

Even with the intended breadth of interpretation, liability under Rule 10b-5 cannot extend beyond the conduct prohibited by the language of § 10(b) of the Exchange Act.[45] The Supreme Court has explained that, "the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act."[46] Further, to violate § 10(b), an alleged device or contrivance must be either "manipulative" or "deceptive" within the meaning of the statute.[47] Notably, Rule 10b-5 does not contain

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[41] SEC v. Capital Gains Research Bureau, 375 U.S. 180, 195 (1963) (holding that an investment adviser must give full and frank disclosure of personal trading on recommended stocks).

[42] 17 C.F.R. § 240.10b-5 (2010).

[43] H.R. REP. NO. 94-229, at 91 (1975), *reprinted in* 1975 U.S.C.C.A.N. 321, 323.

[44] *See e.g.*, Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972) (stating that the proscriptions of § 10(b) and Rule 10b-5 "by statute and rule, are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive."); *see* Herman & MacLean v. Huddleston, 459 U.S. 375, 382 (1983) (holding that remedies available under § 11 of the Securities Act of 1933 do not preclude victims from also bringing an action under § 10(b) of the 1934 Securities Act). *But cf.* Chiarella v. United States, 445 U.S. 222, 234-35 (1980) ("Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.").

[45] *See e.g.*, United States v. O'Hagan, 521 U.S. 642, 651 (1997) (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 214 (1976)).

[46] Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 177 (1994).

[47] *See* Santa Fe Indus. v. Green, 430 U.S. 462, 473 (1977) ("The language of § 10(b) gives no indication that Congress meant to prohibit any conduct not involving manipulation or deception."); *see*

the word "manipulate."[48] Nevertheless, the Supreme Court has held that market manipulations violate Rule 10b-5.[49]

Generally, courts have held that the SEC can satisfy the manipulative or deceptive device requirement of § 10(b) and Rule 10b-5 in three different ways. The SEC can show: (1) that the defendant committed a market manipulation;[50] (2) that the defendant committed an affirmative misrepresentation; or (3) that the defendant omitted material information in violation of a duty to disclose. As this article will show, courts have held that no duty is required to establish a violation in the first or second type of case. However, in the third type of case courts have held that the SEC is required to show that there was a violation of a duty to disclose. The following section explores the differences between the three cases and the purpose each case serves under § 10(b) and Rule 10b-5. The section then focuses on fitting the *Dorozhko* facts into this three-case framework.

C. *Manipulative Devices: No Fiduciary Duty Required for a Violation of Rule 10b-5*

The Supreme Court assigned a specific meaning to the word "manipulate" in the securities fraud context, and courts have rejected attempts to recharacterize claims of misrepresentations or omissions as "manipulative".[51] Accordingly, in the securities fraud context, the word manipulative has a narrow meaning, and is "virtually a term of art when used in connection

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also Cent. Bank of Denver, 511 U.S. at 177-78 ("We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute.").

48 The rule is not restricted to affirmative misrepresentations or material omissions. Manipulative devices can fall within the ambit of the rule. As the Supreme Court has said: "[T]he second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted." *Affiliated Ute Citizens*, 406 U.S. at 152-53.

49 ATSI Commc'ns, Inc. v. Shaar Fund, Ltd., 493 F.3d 87, 99-100 (2d Cir. 2007).

50 It should be noted that § 9 of the Exchange Act explicitly prohibits market manipulations. 15 U.S.C. § 78i (1998). However, the conduct prohibited by § 9 is narrower than that prohibited by § 10(b). For example, § 9 is aimed specifically at manipulative activity on national securities exchanges. In contrast, § 10(b) is not limited to activity on national exchanges but rather addresses manipulations perpetrated by any person through any activity in connection with the purchase or sale of a security. *See* Lewis D. Lowenfels, *Sections 9(a)(1) and 9(a)(2) of The Securities Exchange Act of 1934: An Analysis of Two Important Anti-Manipulative Provisions Under the Federal Securities Laws*, 85 NW. U. L. REV. 698, 698 (1991).

51 *See e.g.*, Lentell v. Merrill Lynch & Co., 396 F.3d 161, 177-78 (2d Cir. 2005) (holding that mere misrepresentations or omissions do not fall under Rule 10b-5(a) and (c) and therefore plaintiffs who bring suits forward still have heightened pleading standards (citing Schnell v. Conseco, Inc., 43 F. Supp. 2d 438, 447-48 (S.D.N.Y. 1999) and stating that the Schnell court "refus[ed] to characterize allegations as market manipulation claims where alleged 'schemes to defraud' consisted largely of an aggregation of material misrepresentations to inflate stock, such as research reports containing misrepresentations of the underlying facts and use of false names to solicit investors").

with securities markets[;]"[52] it "refers generally to practices such as wash sales, matched orders, or rigged prices . . . ."[53] Manipulative devices connote "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[54] Market manipulations are deceitful and therefore violate Rule 10b-5 because they induce investors to buy or sell securities based on false information that has been incorporated into the price of the security.[55] When confronted with a market manipulation, the SEC need not identify any additional elements of deceit; rather, the manipulation itself is satisfactory.

Market manipulations are important for the present discussion because courts have held that the existence of a fiduciary or similar duty is not required to show a violation of § 10(b) or Rule 10b-5 where the defendant is accused of market manipulation. In *ATSI Communications, Inc. v. Shaar Fund, Ltd.*, the Second Circuit stated that a "market manipulation is forbidden regardless of whether there is a fiduciary relationship between the transaction participants."[56] In *United States v. Regan*, the Second Circuit stated that "[the] argument that a fiduciary relationship must exist before liability [under Rule 10b-5] can be found is without merit" in the market manipulation context.[57]

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52 *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 n.21 (stating that "'manipulate' [means] 'to manage or treat artfully or fraudulently; as to Manipulate accounts . . . . 4. Exchanges. To force (prices) up or down, as by matched orders, wash sales, fictitious reports . . . ; to rig.'") (quoting WEBSTER'S INTERNATIONAL DICTIONARY (2d ed. 1934)).

53 *Green*, 430 U.S. at 476-77 (stating that "manipulate" is to be broadly construed and that in enacting section 10(b), "Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices.").

54 *Ernst & Ernst*, 425 U.S. at 199; *see also ATSI Commc'ns, Inc.*, 493 F.3d at 99-100 (stating that market manipulations are deceitful because "investors are misled to believe 'that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators.'" (quoting Gurary v. Winehouse, 190 F.3d 37, 45 (2d Cir. 1999))); United States v. Charnay, 537 F.2d 341, 351 (9th Cir. 1976) (stating that failure to disclose manipulative activity "operates as a deceit on the market place and is an omission of a material fact.").

55 *See Ernst & Ernst*, 425 U.S. at 204-05 (citing S. REP. NO. 792, 73rd Cong., 2d Sess., 6 (1934), for the proposition that wash sales and matched orders are per se "manipulative and deceptive practices"); Edward J. Mawood & Co. v. SEC, 591 F.2d 588, 595 (10th Cir. 1979); *In re* Michael Batterman, 46 SEC Docket 304 (Mar. 29, 1976) (stating that wash sales and matched orders executed in connection with the purchase or sale of any security operate as a "fraud or deceit" and are prohibited by Section 10(b) and Rule 10b-5). *See also, ATSI Commn'cs. Inc.*, 493 F.3d at 99-100; *Charnay*, 537 F.2d 341; United States v. Cannistraro, 800 F. Supp. 30 (D.N.J. 1992).

56 *ATSI Commn'cs., Inc.*, 493 F.3d at 101.

57 United States v. Regan, 937 F.2d 823, 829 (2d Cir. 1991). In *United States v. Skelly*, the Second Circuit held that a pump-and-dump scheme violates Section 10(b) and Rule 10b-5 even though defendants did not act in breach of a fiduciary duty. 442 F.3d 94 (2d Cir. 2006). In that case, the defendants challenged a verdict against them on the grounds that the jury had been improperly instructed regarding fiduciary duty. *Id.* at 97. The Second Circuit affirmed the verdict on the ground that defendants' affirmative fraudulent conduct was clearly proven even assuming that the fiduciary duty theory

Some courts have adopted a slightly different rationale and stated that a market manipulation actually violates a duty of disclosure to the marketplace at large.[58] Under this minority view, all manipulators assume a duty to disclose to investors the material fact that the manipulator is engaged in creating artificial market activity.[59] Regardless of whether manipulations are viewed as violations of Rule 10b-5 because they artificially affect market activity, or because they violate a general duty to disclose the manipulative activity, the result is the same: market manipulations satisfy the deceptive element of Rule 10b-5.

Despite the deceit that some argue lurks in the background of a market manipulation, courts have generally analyzed market manipulations separately from other deceptive devices and have rejected attempts to extend the definition of "manipulation" to include deceptive conduct not involving the use of manipulative securities trades.[60] Accordingly, in the absence of a market manipulation, deceptive conduct is subject to a somewhat different Rule 10b-5 analysis.[61]

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was not properly presented to the jury. *Id.* at 99; *see also* Brief of the Securities and Exchange Commission, Appellant at 51, United States v. Skelly, 574 F.3d 42 (2d Cir. 2009).

58 *Charnay*, 537 F.2d at 349-50 ("As noted in *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 858-62 (2d Cir. 1968), *cert. denied sub nom.* Coates v. SEC, 394 U.S. 976 (1969), the duty to disclose material information is based upon a potential manipulator's duty to the investing public as a whole as well as to particular shareholders. Moreover, it should be noted that clauses (a) and (c) of Rule 10b-5 are not aimed at failures to disclose. Rather they are flat prohibitions of deceitful practices and market manipulations."). For a discussion of cases that have viewed market manipulations as affirmative misrepresentations or material omissions, see Judith R. Starr & David Herman, *The Same Old Wine in a Brand New Bottle: Applying Traditional Market Manipulation Principles to Internet Stock Scams*, 29 SEC. REG. L.J. 236, 249-53 (2001).

59 TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1988) (stating that to fulfill the materiality requirement "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."); *see also*, Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988).

60 United States v. Russo, 74 F.3d 1383, 1391-92 (2d Cir. 1996) (distinguishing between manipulation cases and cases requiring a misrepresentation or duty to disclose); *see also* Daniel McLaughlin, *Liability Under Rules 10b-5(a) & (c)*, 31 DEL. J. CORP. L. 631, 640 (2006).

61 An important issue not treated in this article is whether the deceit must be directly linked to the purchase or sale of a security rather than perpetuated to obtain information on which to trade. The SEC's Opening Brief in *Dorozhko* contains a detailed discussion of this issue and, citing Professor Donald C. Langevoort (*Deception without Breach of Fiduciary Duty, in* 18 INSIDER TRADING: REGULATION, ENFORCEMENT & PREVENTION ch. 6, at § 6:14, (2008)), argues that 10b-5 liability can be premised on deceitfully obtaining information as well as deceitfully purchasing or selling securities. Opening Brief, *supra* note 21, at 24. In addition, the "in connection with" element is likely met in this case because the misappropriated information is thereafter used in a securities transaction. *See* United States v. Bryan, 58 F. 3d 933, 944-45 (4th Cir. 1995).

D. *Deceptive Devices: Affirmative Misrepresentations and Material Omissions*

Deceptive devices fall into two general categories: (1) affirmative misrepresentations; and (2) material omissions in violation of a duty to speak, such as a fiduciary duty.[62] Nothing in the language of § 10(b) or Rule 10b-5 requires the existence of a duty when the wrongdoer defrauds through affirmative acts of deception rather than remaining silent.[63] In other words, no fiduciary relationship or other duty of candid disclosure is required to establish Rule 10b-5 liability where the violator has made an affirmative misrepresentation.[64] Moreover, a deceptive device need not be an oral or written statement. Rather, "conduct itself can be deceptive."[65] The Supreme Court has explained that "silence in connection with the purchase or sale of securities may operate as a fraud actionable under § 10(b)" where there is a "duty to disclose arising from a relationship of trust and confidence between parties to a transaction."[66] Unlike a market manipulation or affirmative misrepresentation, a material omission is not fraudulent unless it violates a duty to disclose; thus, without a duty to disclose, there can be no liability for a material omission.[67]

E. *Insider Trading in the Rubric of Manipulative or Deceptive Device*

As previously stated, insider trading jurisprudence has grown out of the anti-fraud provisions of § 10(b) of the Exchange Act and Rule 10b-5. Current insider–trading law is typically divided into two theories: classical

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62 *See In re* Charter Commc'ns, Inc., Sec. Litig., 443 F.3d 987, 990 (8th Cir. 2006) (defining "deception" as proscribed in Section 10(b) as the making of a material misrepresentation *or* the non-disclosure of material information in violation of a duty to disclose); *see also Green*, 430 U.S. at 474-75 n.15 (1977); *Affiliated Ute*, 406 U.S. at 153-54; *accord O'Hagan*, 521 U.S. at 653-55.

63 *See* SEC v. Monarch Funding Corp., 192 F.3d 295, 308 (2d Cir. 1999) (stating "a material misrepresentation *or* a material omission as to which he had a duty to speak" is required to satisfy the deception element under Section 10(b) and Rule 10b-5) (emphasis added); *see also* SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1467 (2d Cir. 1996) ("In order to establish primary liability under § 10(b) and Rule 10b-5, a plaintiff is required to prove that in connection with the purchase or sale of a security the defendant, acting with scienter, made a material misrepresentation (or a material omission if the defendant had a duty to speak) or used a fraudulent device."); *Dorozhko*, 574 F.3d at 49-50 (rejecting the notion that a fiduciary duty is necessary when there has been an affirmative misrepresentation).

64 *See* Arnold S. Jacobs, 5C DISCLOSURE AND REMEDIES UNDER THE SECURITIES § 12:113 (2008) ("While some duty must be owed by the defendant to the plaintiff in complete silence cases, under the duty theory, liability for misrepresentations flows absent a fiduciary or other duty between the plaintiff and the defendant.").

65 Stoneridge Inv. Partners, LLC. v. Scientific-Atlanta, Inc., 552 U.S. 148, 158 (2008).

66 *Chiarella*, 445 U.S. at 230.

67 *Id.* at 235 ("When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak.").

theory and misappropriation theory. The classical theory of insider trading is straightforward and intuitive. Under the classical theory, a violation of § 10(b) and Rule 10b-5 occurs when a corporate insider trades in his corporation's securities on the basis of material, confidential information he has obtained by reason of his position of confidence within the company.[68] According to the Supreme Court, the insider who trades on material, nonpublic information commits fraud by breaching his or her fiduciary duty of trust to shareholders.[69]

The misappropriation theory on the other hand is less intuitive. Under the misappropriation theory of insider trading, articulated in *United States v. O'Hagan*, "a person commits fraud 'in connection with' a securities transaction, and thereby violates [§] 10(b) [of the Securities Exchange Act of 1934] and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[70]

A brief description of *O'Hagan* is helpful to understand this more difficult doctrine. In *O'Hagan*, the defendant was a partner in a law firm who traded in securities based on material, nonpublic information obtained from one of the firm's clients.[71] The government alleged that the defendant committed fraud through silence because he had an affirmative duty to disclose to the source of the information (i.e., the firm's client) that he was trading on the basis of the confidential information disclosed to the firm.[72] The government's argument departed from the classical theory, which seeks to preserve the integrity of the relationship between a corporation's shareholders and its insiders. Instead, the government argued that because O'Hagan had obtained the information due to his position of trust as a partner in the law firm, O'Hagan had a duty to disclose to the *source* (as opposed to shareholders) his intention to trade on the material, nonpublic information of the firm's client. In holding for the government, the Supreme Court stated:

> [T]he misappropriation theory outlaws trading on the basis of nonpublic information by a corporate 'outsider' in breach of a duty owed not to a trading party, but to the source of the information. The misappropriation theory is thus designed to protect the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect the corporation's security price when revealed.[73]

With slight variations, the federal courts have employed the classical theory and the misappropriation theory consistently since their inception.

68 United States v. O'Hagan, 521 U.S. 642, 651-52 (1997).

69 *Id.*

70 *Id.* at 652.

71 *Id.* at 653.

72 *Id.*

73 *Id.* at 652-53.

The Second Circuit's opinion in *Dorozhko* is the largest departure from what had previously been a period of extended obedience to the Supreme Court. The *Dorozhko* opinion raises concerns about how to apply existing case law to novel and technologically-based fact patterns. An examination of one of the SEC's enforcement groups specializing in technology based securities fraud is instructive to understand the SEC's approach to these emerging fact patterns.

F. *The SEC's Office of Internet Enforcement and the Prosecution of Intrusion Cases*

Increasingly, criminals and fraudsters use the Internet as a tool to perpetuate their mischief.[74] The SEC's suit against Oleksandr Dorozhko was a continuation of the Division of Enforcement's ongoing battle against online securities fraud. As technology advances, so does the possibility for fraudsters to carry out their schemes in new and innovative ways.[75] The case against Dorozhko points to a particularly unique and sometimes complicated method of fraud involving computer hacking. These hacking cases are sometimes referred to as "intrusions."[76]

In general, an intrusion involves obtaining unauthorized access to electronic information or an electronic account, such as a brokerage account. To gain unauthorized access, intruders may falsely identify themselves as authorized users or exploit weaknesses in the electronic code within a computer program "to cause the program to malfunction in a way that grants the user greater privileges."[77]

The SEC's emphasis on intrusion cases is largely in response to the increased potential for securities fraudsters to use the Internet to perpetrate their schemes. In 1998, the SEC formed the Office of Internet Enforcement at the recommendation of two enterprising SEC Enforcement staff mem-

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74 Neal Kumar Katyal, *Criminal Law in Cyberspace*, 149 PENN. L. REV. 1003, 1013-14 (2001) (cybercrime is becoming an increasingly common form of criminal activity); Robert Steinbuch, *Mere Thieves*, 67 MD. L. REV. 570, 570 (2008) ("Today, criminals are capable of stealing financial secrets from multinational corporations. These hackers can adversely affect stock markets by trading on stolen confidential information.").

75 Bruce Carton, *SEC Office of Internet Enforcement Still Going Strong*, COMPLIANCE WEEK (Nov. 11, 2008), http://www.complianceweek.com/article/5138/sec-office-of-Internet-enforcement-still-going-strong.

76 *See e.g.*, Press Release, Sec. & Exch. Comm'n, SEC Obtains Order Freezing $3 Million in Proceeds of Suspected Foreign-Based Account Intrusion Scheme (Mar. 7, 2007) *available at*, http://www.sec.gov/news/press/2007/2007-33.htm.

77 Orin S. Kerr, *Cybercrime Scope: Interpreting "Access" and "Authorization" in Computer Misuse Statutes*, 78 N.Y.U. L. REV. 1596, 1644-45 (2003).

bers, John Reed Stark and Dave Gionfriddo.[78] Stark, who was serving as Special Counsel for Internet Projects, was appointed as the first Chief of the Office of Internet Enforcement.[79] Initially, the office focused largely on prosecuting spammers who promoted stocks in violation of the securities laws.[80] Increasingly, the Office of Internet Enforcement's attention focused on detecting and enforcing relatively more sophisticated intrusion cases. As the SEC Enforcement staff brought intrusion cases, the SEC and the courts have grappled over how pre-Internet securities case law should be applied to cases involving novel Internet fraud fact patterns.

SEC Commissioner Troy Paredes addressed this concern in a 2008 speech. As part of its ten-year anniversary commemoration, the Office of Internet Enforcement hosted a symposium entitled "CyberSecurities Fraud."[81] Commissioner Troy Paredes provided the keynote address.[82] While praising the cooperation of the enforcement staff and the criminal authorities in prosecuting a recent intrusion case,[83] Commissioner Paredes made the following statement regarding the application of the existing securities laws to new and technologically advanced fact patterns:

> [W]hile new schemes to defraud arise using the Internet, our existing body of statutes, rules, and case law may continue to be adequate tools in our arsenal. It is important not to rush to develop new and creative theories of liability, especially when the tried-and-true ones may work just fine.[84]

Compare Commissioner Paredes's statement with that of Associate Justice (and one-time SEC Chairman) William O. Douglas, who stated:

> We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type varie-

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78 Carton, *supra* note 75. The Office of Internet Enforcement was dissolved in January 2010 when Director of Enforcement Robert Khuzami restructured the Division of Enforcement. *See also* Press Release, Sec. & Exch. Comm'n, SEC Names New Specialized Unit Chiefs and Head of Office of Mkt. Intelligence (Jan. 13, 2010) *available at* http://www.sec.gov/news/press/2010/2010-5.htm.

79 See Press Release, Sec. & Exch. Comm'n, SEC Creates Office of Internet Enforcement to Battle Online Sec. Fraud (July 28, 1998), *available at* http://www.sec.gov.news/pressarchive/1998/98-69.txt.

80 *Id.*

81 Troy A. Paredes, SEC Comm'r, Remarks Before the CyberSecurities Fraud Forum, Washington, D.C. (Sept. 23, 2008), *available at* http://www.sec.gov/news/speech/2008/spch092308tar.htm.

82 *Id.*

83 *See* Litigation Release No. 180401, SEC, SEC Charges Hacker With Breaking Into Investor's Online Account, Placing Unauthorized Buy Order (Dec. 17 2009), *available at* http://www.sec.gov/litigation/litreleases/lr18401.htm (discussing SEC v. Van Dinh, No. 03-CV-11964RWZ (D. Mass. filed Oct. 9, 2003).

84 Paredes, *supra* note 81.

ty fraud, or present a novel form of deception. Novel or atypical methods should not provide immunity from the securities laws.[85]

These statements can be reconciled. Commissioner Paredes's statement demonstrated a reluctance to develop novel theories of liability when faced with a shift in technology. Justice Douglas was determined to not let fraudsters escape liability simply because they employ novel fraudulent means. Accordingly, so long as the established anti-fraud rules are applied in accordance with the law, they can and should be adapted to enforce the securities laws even in the face of a novel fact pattern.

Accepting that Commissioner Paredes and Justice Douglas are both right, an important question emerges: does an intrusion like that presented in *Dorozhko* fit within the existing body of securities law, or does the Second Circuit's opinion represent a disfavored "novel theory of liability"?

G. *Intrusions*

In the securities context, it is helpful to divide intrusions into two general types: (1) manipulative intrusions (sometimes known as "hacking and trading" cases); and (2) non-manipulative intrusions. A manipulative intrusion occurs when an individual or entity obtains unauthorized access to an electronic system or online brokerage account to conduct activity that courts proscribe as manipulative. In a manipulative intrusion, the proscribed conduct frequently involves artificial market activity, such as a wash sale,[86] matched order,[87] or pump-and-dump,[88] from which the intruder

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[85] *See* Superintendent of Ins. v. Bankers Life and Cas. Co., 404 U.S. 6, 10 n.7 (1971). More recently, SEC Enforcement Director Linda Chatman Thomsen stated: "Our Enforcement program is, by necessity, dynamic—we constantly strive to respond to market, as well as legal and technological, developments. Our priorities and resource allocations must change to meet trends in the market and developing forms of fraud." *Illegal Insider Trading: How Widespread is the Problem and is There Adequate Criminal Enforcement? Hearing Before the S. Comm. on the Judiciary*, 109th Cong. 138 (2006) (statement of Linda C. Thomsen, Director, Division of Enforcement, Sec. & Exch. Comm'n).

[86] *See* Lowenfels, *supra* note 50, at 699 ("A 'wash sale' is a securities transaction in which, by the intent of the parties, there is no change in the beneficial ownership.").

[87] *See id.* ("'Matched orders' are orders entered for the purchase of a security with the knowledge that an order or orders of substantially the same size at substantially the same price have been or will be entered at substantially the same time for the sale of such security and vice versa with respect to sale and purchase.").

[88] *See* U.S. SEC. & EXCHANGE COMMISSION, *Fast Answers: Pump and Dump* (last modified March 12, 2001), http://www.sec.gov/answers/pumpdump.htm. ("Pump and dump" schemes "involve the touting of a company's stock (typically microcap companies) through false and misleading statements in the marketplace. After pumping the stock, fraudsters make huge profits by selling their cheap stock into the market.") *See also*, THOMAS LEE HAZEN, LAW OF SECURITIES REGULATION, §§ 2.2 n.80, 14.18 (5th ed. 2005).

can benefit.[89] In comparison, a non-manipulative intrusion does not involve purposefully manipulative conduct. Rather, a non-manipulative intrusion occurs when an individual or entity obtains unauthorized access to electronically stored nonpublic information for the purposes of trading on the basis of that information. A non-manipulative intrusion also occurs when an individual or entity obtains unauthorized access to an online brokerage account to execute non-manipulative yet unauthorized trades.

H. *Classifying Previous SEC Intrusion Cases*

The discussion below analyzes how manipulative and non-manipulative intrusions fit into the Rule 10b-5 framework of market manipulation, affirmative misrepresentation, and material omission in violation of a duty to disclose. In a market manipulation intrusion, part of the perpetrator's manipulative device involves unauthorized access to electronically stored information or to electronic accounts. A common scenario involves an intruder gaining unauthorized access to an online brokerage account and then using the account to manipulate the market for a thinly traded security. Frequently this involves using the account to execute trades to create the appearance of legitimate trading activity.[90] As discussed above, market manipulations are always forbidden, regardless of whether they involve an intrusion.

In a non-manipulative intrusion, an intruder usually gains unauthorized access to material, nonpublic information contained on an electronic system or an online brokerage account. If the intruder accesses nonpublic information, the intruder may then trade on this information to his or her benefit. To date, the SEC has brought four cases involving non-manipulative intrusions. One of these cases involved stealing a password that was then used to access and trade on electronic information about a pending transaction at a private equity firm.[91] The other three cases involved hacking or otherwise

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89 *See Ernst & Ernst*, 425 U.S. at 199.

90 *See e.g.*, Litigation Release No. 21341, U.S. SEC. & EXCH. COMM'N., Default Judgment of Permanent Injunction and Other Relief Entered Against Defendants Pointer Worldwide, Ltd. and Tatiana Badmaeva (Dec. 17 2009), *available at* http://www.sec.gov/litigation/litreleases/2009/lr21341.htm (discussing SEC v. Pointer Worldwide Ltd., Civil Action No. 09-CIV-6162, (S.D.N.Y 2009)); Litigation Release No. 19949, U.S. SEC. & EXCH. COMM'N., SEC Files Emergency Action Against Foreign Traders to Stop an Online Account Intrusion Scheme (Dec. 19, 2006), *available at* http://www.sec.gov/litigation/litreleases/2006/lr19949.htm (discussing SEC v. Grand Logistic, S.A., Civil Action No. 06-15274 (S.D.N.Y. Dec. 22, 2006)); SEC v. Kamardin, No.8:07-cv-159-T-24-MAP, 2007 U.S. Dist. Lexis 44260 (M.D. Fla. 2007).

91 Litigation Release No. 20529, U.S. SEC. & EXCH. COMM'N., SEC Files Settled Illegal Trading Charges Against Day Trader Who Traded on Information He Fraudulently Obtained From His Brother-in-Law (Apr. 17, 2008), *available at* http://www.sec.gov/litigation/litreleases/2008/lr20529.htm (discussing SEC v. Stummer, Civil Action No. 08-CIV-3671 (S.D.N.Y. 2008)).

exploiting weaknesses in computer security to access nonpublic information on which to trade.[92]

In each of the three cases, the defendant's conduct is arguably an affirmative misrepresentation. The defendant must either affirmatively represent that he is someone else when accessing a password protected brokerage account, or trick the computer system into granting him greater privileges to information than otherwise permitted.

The final avenue for Rule 10b-5 liability for a non-manipulative intrusion, is a material omission in violation of a duty to speak.[93] From the SEC's enforcement perspective, the trouble with this theory in the intrusion context is the requirement of a duty of candid disclosure. Because intruders frequently do not have preexisting relationships to the electronic systems they are accessing or the people with whom they are trading, this duty is elusive. The SEC has never brought an intrusion case on the theory that the intrusion constituted a material omission in violation of a duty to disclose.[94]

II. A NOVEL CASE OR A NOVEL THEORY OF LIABILITY? THE SECOND CIRCUIT'S CONTROVERSIAL DECISION

A. *Squaring the Second Circuit's Decision with Existing Insider Trading Jurisprudence*

The Second Circuit's opinion in *Dorozhko* is arguably consistent with the congressional purpose that Rule 10b-5 is a catch-all provision for the prevention of securities fraud. After the Second Circuit issued the decision in *Dorozhko*, two criticisms quickly emerged: (1) that the *Dorozhko* court was wrong to conclude that violation of a fiduciary duty was not a prerequisite for insider trading liability;[95] and (2) that hacking could satisfy the "de-

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92 *See Dorozhko*, 574 F.3d 42 (2d Cir. 2009); Litigation Release No. 19450, U.S. SEC. & EXCH. COMM'N., SEC Files Emergency Action Against Estonian Traders to Stop Ongoing Fraudulent Hacking Scheme (Nov. 1, 2005), *available at* http://www.sec.gov/litigation/litreleases/lr19450.htm (discussing SEC v. Lohmus Haavel & Viisemann, No. 05-CV-9259 (S.D.N.Y. May 30, 2007)); Litigation Release No. 20018, U.S. SEC. & EXCH. COMM'N., Court Orders Temporary Restraining Order and Asset Freeze in SEC Emergency Fraud Action Involving Trading in Advance of Press Releases of 12 U.S. Companies (Feb. 26, 2007), *available at* http://www.sec.gov/litigation/litreleases/2007/lr20018.htm (discussing SEC v. Blue Bottle Ltd., Civil Action No. 07-CV-1380 (S.D.N.Y. 2007)).

93 SEC v. First Jersey Sec., Inc., 101 F.3d 1450, 1467 (2d Cir. 1996) (holding that a person is liable under Rule 10b-5 if they acted with scienter and made a material omission when they had a duty to speak).

94 A search of the SEC's online litigation database yields 14 distinct cases involving intrusions. Four of these intrusions were affirmative misrepresentation intrusions, and the other ten were market manipulation intrusions. Search results on file with the author.

95 Steven M. Bainbridge, *The Second Circuit's Egregious Decision in* SEC v. Dorozhko, PROFESSORBAINBRIDGE.COM (July 29, 2009),

ceptive device" requirement of Rule 10b-5.[96] Setting aside "manipulative devices" for current analytical purposes, if an intrusion like that in *Dorozhko* is to fit within the traditional Rule 10b-5 analysis, it must either be an affirmative misrepresentation or a violation of a duty to disclose.

The first criticism in the Second Circuit's decision in *Dorozhko* is the holding that a fiduciary duty is not necessary in insider trading cases.[97] This holding is consistent with the notion that insider trading cases are just a species of securities fraud cases to which Rule 10b-5 should be applied without special consideration. However, it is inconsistent with both the Classical and Misappropriation theories of insider trading which require fiduciary duties.[98] In *Dorozhko*, the district court found that trades of put options of a company's stock based on inside information allegedly obtained by hacking into a computer network did not violate antifraud provisions of federal securities law.[99] In vacating the district court, the Second Circuit held that "nothing in the Supreme Court's jurisprudence or prior decisions of our Court expressly imposes a fiduciary duty requirement on the ordinary meaning of 'deceptive' where the alleged fraud is an affirmative misrepresentation rather than a non-disclosure."[100]

Having held that affirmative misrepresentations need not involve a fiduciary duty of disclosure to be deceptive under Rule 10b-5, the question became whether an intrusion, or "hacking," constitutes a deceitful affirmative misrepresentation.[101] The Second Circuit, relying on the SEC's Open-

http://www.professorbainbridge.com/professorbainbridgecom/2009/07/the-second-circuits-recent-decision-in-sec-v-dorozhko-available-here-dealt-with-one-of-the-questions-left-open-by-the.html ("[T]his case was an attempt by the SEC to end run the fiduciary duty requirement applicable to nondisclosure cases. It's an end run around the basics of insider trading law. The Second Circuit aided and abetted it. . . . If a law student had written the *Dorozhko* [sic] [opinion], I'd give him a D (and only because I never ever fail anybody). It is not an interpretation of O'Hagan [sic]. It is the creation of an entirely new version of misappropriation liability, carved out of whole cloth and without any regard for precedent. It may be right on policy, but isn't that for the Supreme Court to decide [sic].").

96 *Id.* ("Calling computer hacking a lie is a rather considerable stretch. At most, the hacker 'lies' to a computer network, not a person. Hacking is theft; not fraud.").

97 *Dorozhko*, 574 F.3d at 49 ("[N]one of the Supreme Court opinions considered by the District Court *require* a fiduciary relationship as an element of an actionable securities claim under Section 10(b).").

98 *O'Hagan*, 521 U.S. at 651-52 (explaining that a violation occurs under the classical theory of insider trading when an insider trades on the basis of knowledge about the company and the misappropriation theory expands insider trading to those in the company who misappropriate confidential information in breach of a duty owed to the source of the information).

99 *See Dorozhko*, 606 F. Supp. 2d at 330 *vacated*, 574 F.3d 42 (2d Cir. 2009).

100 *Dorozhko*, 574 F.3d at 49.

101 It was because of this question that the Second Circuit remanded *Dorozhko* back to the district court. The Second Circuit in *Dorozhko* stated, "It is unclear, however, that exploiting a weakness in an electronic code to gain unauthorized access is 'deceptive,' rather than being mere theft. Accordingly, depending on how the hacker gained access, it seems to us entirely possible that computer hacking could be, by definition, a 'deceptive device or contrivance' that is prohibited by [section] 10(b) and Rule 10b-5." *Id.* at 51.

ing Brief,[102] separated hacking into two types: (1) engaging in "'false identification and masquerade[ing] as another user['] . . . ; or (2) 'exploit[ing] a weakness in [an electronic] code within a program to cause the program to malfunction in a way that grants the user greater privileges.'"[103] In the Second Circuit's view, "misrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive' within the ordinary meaning of the word."[104] Therefore, the court believed it was "entirely possible that computer hacking could be, by definition, a 'deceptive device or contrivance' that is prohibited by [§] 10(b) and Rule 10b-5."[105] The court then remanded to the district court the question of whether hacking constituted deceit.[106]

The resulting criticism was that hacking is theft, not fraud, and mere theft of information could not rise to the level of securities fraud.[107] However, there is some support for the argument that mere theft of information can qualify for § 10(b) and Rule 10b-5 fraud. For example, theft of material nonpublic information imposes a duty on the thief to disclose that he or she is in possession of and is trading on that information. This duty is analogous to the duty owed by a market manipulator, to the marketplace as a whole, to disclose that he or she is manipulating the price of a security.[108] Professor Langevoort posits that:

> A person who misappropriates the property of another holds the proceeds of the misappropriation in a constructive trust for the benefit of the innocent owner. The misappropriator is deemed a "trustee ex maleficio," which may be fiduciary status enough to fit within both the misappropriation and abstain or disclose rules even as currently formulated.[109]

Moreover, even if Dorozkho's actions were characterized as "mere theft," an argument can be made that stealing the information satisfied Rule 10b-5. Justice Blackmun, in his dissent in *Chiarella*, explained:

> [I]n my view, it is unnecessary to rest petitioner's conviction on a "misappropriation" theory. The fact that petitioner Chiarella purloined, or, to use THE CHIEF JUSTICE'S word, . . . "stole," information concerning pending tender offers certainly is the most dramatic evidence

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102 Opening Brief, *supra* note 21, at 22-23.

103 *Dorozhko*, 574 F.3d at 50-51 (quoting, Kerr, *supra* note 77, at 1644-45 (second and third alteration in original).

104 *Id.* at 51.

105 *Id.*

106 *Id.*

107 Bainbridge, *supra* note 95 ("Calling computer hacking a lie is a rather considerable stretch. At most, the hacker 'lies' to a computer network, not a person. Hacking is theft; not fraud.").

108 *See supra* text accompanying note 54.

109 Langevoort, *supra* note 61, at § 6:14 n.5 (citing Cox v. Schnerr, 156 P. 509 (Cal. 1916); RESTATEMENT (FIRST) OF TORTS § 757 cmt. b (1939)).

> that petitioner was guilty of fraud. . . . I do not agree that a failure to disclose violates the Rule only when the responsibilities of a relationship of that kind have been breached.[110]

By analogy, the law of evidence has addressed whether "thievery" is deceptive. For example, for purposes of impeaching a witness through introduction of past acts of deceit or dishonesty under Federal Rule of Evidence 609(a)(2),[111] the Ninth Circuit held in *United States v. Brackeen*[112] that a bank robbery was not considered dishonest or deceitful conduct in the narrow sense of the word because it is a violent taking.[113] The court also explained that:

> In the dictionary, and in everyday use, "dishonesty" has two meanings, one of which includes, and one of which excludes, crimes such as bank robbery. In its broader meaning, "dishonesty" is defined as a breach of trust, a "lack of . . . probity or integrity in principle," "lack of fairness," or a "disposition to . . . betray." *Webster's Third New International Dictionary* 650 (1986 unabridged ed.). This dictionary states, under the heading "synonyms," that "dishonest may apply to any breach of honesty or trust, as lying, deceiving, cheating, stealing, or defrauding." *Id.* Bank robbery fits within this definition of "dishonesty" because it is a betrayal of principles of fairness and probity, a breach of community trust, like stealing.[114]

The Ninth Circuit ultimately rejected the broader meaning in favor of the narrow meaning because the legislative history of Rule 609(a)(2) showed that for witness impeachment purposes, bank robbery was not considered "dishonest."[115]

The *Brackeen* court adopted an admittedly narrow view of dishonesty.[116] In contrast, the Supreme Court has explained that the securities laws are to be broadly construed to effectuate their remedial purposes.[117] Consequently, *Brackeen*'s holding does not appear to present an obstacle to finding that theft of information, or "hacking," is deceitful, in satisfaction of the requirements of § 10(b) and Rule 10b-5.

B. *Hacking as Deceptive Conduct*

The Second Circuit's opinion in *Dorozhko* does not adequately explain why hacking is deceptive conduct. Even though federal courts have not always required a fiduciary duty to show a violation of § 10(b) and

110 *Chiarella*, 445 U.S. at 245, 247 (Blackmum, J., dissenting) (internal citations omitted).

111 FED. R. EVID. 609(a)(2).

112 United States v. Brackeen, 969 F.2d 827, 829 (9th Cir. 1992).

113 *Id.*

114 *Id.*

115 *Id.*

116 *See id.* at 830-31.

117 *See Capital Gains Research Bureau*, 375 U.S. at 195.

Rule 10b-5, the SEC still must adduce evidence that the defendant engaged in a "deceptive or manipulative device" to prevail. In *Dorozhko*, the Second Circuit remanded to the district court the question of whether hacking satisfied this requirement.[118]

One of Congress's objectives in passing the Exchange Act was "to insure honest securities markets and thereby promote investor confidence" after the market crash of 1929.[119] Failing to enforce the securities laws in the intrusion context is contrary to this congressional intent because it ignores the conduct of corrupt hackers whose actions undermine the integrity of the markets. An important question arises: is hacking deceptive conduct for purposes of § 10(b) and Rule 10b-5? The Second Circuit certainly thought it could be, especially in the misrepresentation sense and grappled briefly with this question before leaving its ultimate resolution to the district court on remand. Furthermore, the language of § 10(b) and Rule 10b-5 should be read expansively to include hacking as an action that constitutes an affirmative misrepresentation, which in turn satisfies the requisite element of deceit.[120]

This question is important because, as the SEC indicated in its Opening Brief in *Dorozhko*, "companies increasingly use computers to perform tasks that once would have been carried out by human beings, such as granting and denying access to confidential information."[121] In the current commercial world, deceit of a machine should not disqualify an action for liability under Rule 10b-5.

The Seventh Circuit case, *SEC v. Cherif*, recognized this point.[122] The bank terminated defendant Cherif's employment, yet Cherif retained and continued to use his magnetic key card to pass an electronic security system intended to restrict building access to current employees. After using the key card to gain physical entry to the bank, Cherif obtained confidential information about upcoming corporate transactions. In the Commission's suit against Cherif for violations of Rule 10b-5, the Seventh Circuit ob-

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118 *Dorozhko*, 574 F.3d at 51 ("Having established that the SEC need not demonstrate a breach of fiduciary duty, we now remand to the district court to consider, in the first instance, whether the computer hacking in this case involved a fraudulent misrepresentation that was 'deceptive' within the ordinary meaning of Section 10(b).").

119 SEC v. Zandford, 535 U.S. 813, 819 (2002) (quoting United States v. O'Hagan, 521 U.S. 642, 658 (1997)).

120 *See* Part I.B, *supra*.

121 Opening Brief, *supra* note 21, at 24.

122 It is important to note that the court viewed Cherif's former employment at the bank as relevant and stated that Cherif owed a continuing common law duty to the bank to maintain the confidentiality of information. SEC v. Cherif, 933 F.2d 403, 411-12 (7th Cir. 1991). That the court found a duty does not diminish the point being made here which is simply this: deceiving an electronic system is fraudulent conduct constituting an affirmative misrepresentation for purposes of Rule 10b-5. The notion that an affirmative misrepresentation satisfies Rule 10b-5 deceit even absent a duty is established earlier in this section.

served that Cherif's actions were "fraudulent in the common understanding of the word because they deprived some person of something of value by trick, deceit, chicane or overreaching."[123] In a parallel case brought by the United States against Cherif for violation of the mail and wire fraud statutes, the Seventh Circuit stated that "every time he used the keycard [to gain unauthorized access] Cherif, in effect, falsely represented that he was a bank employee entitled to be in the bank."[124]

If courts or the Commission decide that misrepresentation to a machine cannot satisfy Rule 10b-5's deception element, then prosecution of certain types of securities violations will continue to lag far behind the scammers who perpetrate them. This is because electronic security is a competitive game of cat and mouse between would-be hackers and security professionals.[125] In this competitive enterprise, security aims to ferret out and repel hackers while hackers seek to develop increasingly more clever devices for avoiding detection and circumventing security to penetrate systems and access protected information.

"Hacking" is broadly defined as obtaining unauthorized access to electronic information such as files, data, materials, or other information.[126] It comes in two forms: physical access and electronic access.[127] The physical access might be as simple as breaking into an office to steal files. In contrast, unauthorized electronic access may employ more sophisticated means. A user may gain electronic access by stealing passwords, using random password generators, or using "trap doors."[128] The Second Circuit's opinion in *Dorozhko* asserts that, depending on the method employed, hacking may be a deceptive device in satisfaction of Rule 10b-5.[129] Because the facts of *Dorozhko* do not indicate what method of hacking Dorozhko used when he accessed information hosted by Thomson Financial's website, the Second Circuit remanded for an analysis of the hacking to determine whether it was deceitful.[130] This portion of the article aims to provide the Second Circuit

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123 *Cherif*, 933 F.2d at 412.

124 *Id.* at 696.

125 *See generally* Symposium, *Proceedings of the 2006 IEEE Symposium on Privacy and Security*, UNIV. OF MICH. DEP'T OF ELEC. ENG'G AND COMPUTER SCI. 314 (July 9, 2010), *available at* http://www.eecs.umich.edu/virtual/papers/king06.pdf [hereinafter *IEEE Symposium*] (describing an attackers' goal to control the system and thereby remain "invisible by lying to or disabling intrusion detection software.").

126 *See generally*, Computer Fraud and Abuse Act, 18 U.S.C. § 1030 (2001).

127 Katyal, *supra* note 74, at 1021.

128 *Id.*

129 *Dorozhko*, 574 F.3d at 51 ("[D]epending on how the hacker gained access, it seems to us entirely possible that computer hacking could be, by definition, a 'deceptive device or contrivance' that is prohibited by Section 10(b) and Rule 10b-5. However, we are hesitant to move from this general principle to a particular application without the benefit of the District Court's views as to whether the computer hacking in this case—as opposed to computer hacking in general—was 'deceptive.'").

130 *Id.*

with some guidance by analyzing some common forms of hacking to determine whether they contain elements of deceit that satisfy Rule 10b-5.

As the Seventh Circuit's decision in *SEC v. Cherif*[131] and the Second Circuit's decision in *Dorozhko* indicate, when an intruder obtains unauthorized access to material, nonpublic information by bypassing an electronic security system, the intruder falsely represents that he or she is authorized to access the information or the account. The main distinction between mere theft and misappropriation of information through hacking is the opportunity for hackers to employ deceptive devices. In this regard, the oft-proposed analogy between the hacker who accesses the CEO's computer to obtain material, nonpublic information and the thief who breaks into the CEO's office and obtains material, nonpublic information tends to break down.[132] There are several important distinctions, and the following discussion of various popular hacking methods points to some of these relevant issues.

Perhaps the least sophisticated form of hacking is called "social engineering." To execute a social engineering hack, the hacker sends an email to a target asking for certain information that is usually confidential. In the case of "shoulder surfing," the hacker simply peers at a user's computer when sensitive information is displayed on the screen. The hacker seeks to obtain information that may be useful in gaining unauthorized access to the target's personal financial accounts, email accounts or other databases. Armed with this information, the hacker can execute unauthorized financial transactions or obtain unauthorized access to information, some of which may be material, nonpublic information related to a publicly traded company. This type of hacking is deceptive. When a hacker enters the target's credentials, the hacker affirmatively misrepresents that he or she is authorized to access the information behind the password protection. Because affirmative misrepresentations are considered deceptive under Rule 10b-5, this type of hacking would satisfy that element.

A dictionary attack is a slightly more technical variation of social engineering. It is arguably more sophisticated because it involves a computer program designed to access password protected material by generating password guesses until the program is successful. Thus, the hacker need not send inquiring emails or peer over a user's shoulder to obtain the target's credentials and to ultimately gain access to the target's information.

Some security conscious network administrators have implemented mechanisms to prevent dictionary attacks. These mechanisms attempt to confirm that access credentials are being entered by a human as opposed to an automated program. But even these have proved vulnerable to sophisticated hacking programs that employ optical devices intended to defeat the

131 *Cherif*, 933 F.2d at 411-12.

132 Bainbridge, *supra* note 95 ("Hacking is theft; not fraud.").

additional security mechanism.[133] By programming machines to deceive other machines in order to obtain unauthorized access, hackers engage in conduct that is deceptive and satisfies the requirements of § 10(b) and Rule 10b-5.

Another type of hack is the "trap door" (sometimes called a "backdoor"). A paper first published by the RAND Corporation for the Secretary of Defense, defined a trap door as "[a]ny opportunity to penetrate, subvert, mislead, or by-pass security controls through an idiosyncrasy of the software, software-hardware, hardware, procedural controls, etc."[134] A specific form of backdoors is a rootkit, which hides the presence of malicious activity. It may also generate false information about disk and memory usage. A backdoor hack is deceptive because the hacker intentionally seeks to remain undetected and actively seeks to hide the malicious activity.

Another form of hack is the colorfully named Trojan horse. The name itself implies deception by reference to the Greeks clever deception of the Trojans during the Trojan War. A Trojan horse, once installed on a computer's system, perhaps through a trap door, is capable of lying "about which processes are running,"[135] thereby concealing malicious activity such as remote access to confidential information.

Another method through which hackers may obtain access to passwords and ultimately to password protected information is through a keylogging program.[136] Similar to the social engineering methods, a keylogging program, once installed on a target's computer, can provide the hacker with the information necessary to access protected information. Armed with the information obtained from the keylogging program, the hacker will likely be able to access password-protected information or obtain sensitive information simply as a result of the program.

Hackers may also gain access to password information or material, nonpublic information through a variation of the dictionary attack known as a "predictable resource location" (PRL). When conducting a PRL hack, the hacker attempts to guess the network locations of hidden files not intended

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133 Peter Whoriskey, *Digital Deception*, WASH. POST (May 1, 2008), http://www.washingtonpost.com/wp-dyn/content/article/2008/04/30/AR2008043003704.html.

134 Willis H. Ware, *Security Controls for Computer Systems: Report of Defense Science Board Task Force on Computer Security*, RAND.ORG (Oct. 10 1979), *available at* http://www.rand.org/pubs/reports/R609-1/index2.html.

135 *See IEEE Symposium*, *supra* note 125.

136 *See* Litigation Release No. 180401, SEC, SEC Charges Hacker With Breaking Into Investor's Online Account, Placing Unauthorized Buy Order (Dec. 17 2009), *available at* http://www.sec.gov/litigation/litreleases/lr18401.htm (discussing SEC v. Van Dinh, No. 03-CV-11964RWZ (D. Mass. filed Oct. 9, 2003) ("The e-mail invitation from Dinh directed the recipients to a website featuring a downloadable version of the purported stock-charting tool. In reality, the program was a disguised version of "The Beast," a keystroke-logging program that allowed Dinh to remotely monitor the computer activity of those who downloaded it.").

for public viewing.[137] Obtaining and utilizing password information obtained through a PRL would be akin to the affirmative misrepresentations already discussed in this section. Obtaining material, nonpublic information in this fashion and subsequently trading on the information is more akin to the scenario in the *Dorozhko* case and more closely approximates theft.

Intrusion detection systems are designed to detect network attacks in progress and assist in post-attack forensics. Intrusion detection is "the process of monitoring the events occurring in a computer system or network and analyzing them for signs of *intrusions,* defined as attempts to compromise the confidentiality, integrity, availability, or to bypass the security mechanisms of a computer or network."[138] The existence of commercially available intrusion detection systems provides further support for the notion that computer security is a competitive enterprise. The efforts of information security professionals to keep these hackers out, and the efforts of hackers to penetrate and control systems while remaining undetected by active security systems, are evidence of the deceptive nature of computer hacking.

It bears mentioning that a hack can deploy many of the above hacks in tandem. For example, a trap door hack can be exploited to install a keylogging program or collect and transmit sensitive information. It seems apparent that, at least in some contexts, intentionally obtaining unauthorized access is likely an affirmative misrepresentation or other deception that satisfies the deceit element of Rule 10b–5.

III. MOVING FORWARD FROM *DOROZHKO*

A. *The Problematic Focus on a Duty*

As discussed above, the existence of a duty is not always required to satisfy Rule 10b-5's manipulative or deceptive device requirement. Consequently, as the Second Circuit pointed out in *Dorozhko*, it is incorrect to state that a fiduciary or similar duty is always required for a violation of

137 *See Predictable Resource Location*, THE WEB APPLICATION SEC. CONSORTIUM, http://projects.webappsec.org/Predictable-Resource-Location (last visited Nov. 13, 2010) ("By making educated guesses via brute forcing an attacker can guess file and directory names not intended for public viewing. Brute forcing filenames is easy because files/paths often have common naming convention and reside in standard locations. These can include temporary files, backup files, logs, administrative site sections, configuration files, demo applications, and sample files. These files may disclose sensitive information about the website, web application internals, database information, passwords, machine names, file paths to other sensitive areas, etc.").

138 Rebecca Mace & Peter Mell, *Intrusion Detection Systems*, NAT'L INST. OF STANDARDS & TECH. (Apr. 20, 2010), *available at* http://www.tricare.mil/TMIS_new/Policy%5CFederal%5Csp800-31.pdf.

Rule 10b-5 to occur.[139] Despite the lack of a duty requirement in Rule 10b–5, many courts still consider such a requirement to be the essential hallmark of insider-trading jurisprudence.[140] The *Dorozhko* case points to a general shortcoming in this analysis.

At the outset, it should be noted that in cases where a duty is required, it is unclear exactly what type of duty it must be. At one point the Supreme Court stated that the requisite duty for Rule 10b-5 liability was one of "candid disclosure," but it did not go so far as to require a fiduciary duty.[141] While a duty of candid disclosure is certainly descriptive of a fiduciary duty, the Supreme Court has not explicitly stated that a fiduciary duty is a prerequisite to Rule 10b–5 liability.[142] Indeed, for all the criticism leveled at the Second Circuit that its opinion in *Dorozhko* failed to adhere to current insider-trading jurisprudence, it should be noted that the misappropriation theory developed by Justice Ginsburg in *O'Hagan* was created out of "whole cloth"[143] and dramatically changed the way that fiduciary duties were analyzed in the insider trading context. Under the classical theory, which predated the misappropriation theory, corporate insiders owed the duty to the firm's shareholders. This proved problematic and over-simplistic when the Court was confronted with *O'Hagan*. With the fiduciary duty as a keystone, the courts, with prodding from the SEC, adopted the legal fiction that an "insider"[144] who wishes to sell securities on the market on the basis of material, nonpublic information, also owes a duty to a potential buyer. The duty is fictional because there is no pre-existing relationship between the insider and the buyer. Courts adopted this fictional duty even though the buyer may not own any shares of the corporation's stock prior to the transaction, in which case the insider would not have a fiduciary rela-

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139 *Dorozhko*, 574 F.3d at 48 ("In our view, none of the Supreme Court opinions relied upon by the District Court—much less the sum of all three opinions—establishes a fiduciary duty requirement as an element of every violation of Section 10(b).").

140 *See e.g.*, Leoni v. Rogers, 719 F. Supp. 555, 566 (E.D. Mich. 1989).

141 *Compare* Regents of the Univ. of Cal. v. Credit Suisse First Bos. (USA), Inc., 482 F.3d 372, 389 (5th Cir. 2007) (stating "the [Supreme] Court, in its other cases interpreting Section 10(b), has established that a device, such as a scheme, is not 'deceptive' unless it involves breach of some duty of candid disclosure.") *with* SEC v. Dorozhko, 574 F.3d 42, 49 (2d Cir. 2009) ("We are aware of no precedent of the Supreme Court or our Court that forecloses or prohibits the SEC's straightforward theory of fraud. Absent a controlling precedent that 'deceptive' has a more limited meaning than its ordinary meaning, we see no reason to complicate the enforcement of Section 10(b) by divining new requirements.").

142 *See Stoneridge Inv. Partners*, 552 U.S. at 159 (the Supreme Court's most recent decision when addressing reliance in the context of Rule 10b-5 stated that reliance can be presumed "if there is an omission of a material fact by one with a duty to disclose").

143 *O'Hagan*, 521 U.S. at 687 ("Having rejected the Government's description of its theory, the majority then engages in the 'imaginative' exercise of constructing its own misappropriation theory from whole cloth.") (Thomas, J., concurring in part and dissenting in part).

144 The "insider" in *O'Hagan* was actually an outsider—an attorney at the firm that was handling a large corporate transaction and thereby obtained inside information. *Id.* at 647.

tionship with the buyer.[145] This is in stark contrast to prevailing state corporate law where corporate directors and officers owe duties only to the corporation and its shareholders.[146]

Because O'Hagan was an "outsider" to the corporation in whose stock he transacted, the Supreme Court, hampered by the seeming necessity to find a fiduciary duty, decided that the outsider owed a duty to the company in whose shares he traded. As Professor Fisch has explained: the "[m]isappropriation theory creates a legal fiction that the evil connected with insider trading is the harm it inflicts on the source of the information. Many observers, however, condemn insider trading for damaging market integrity or cheating investors."[147]

Arguably, the fictions above can be justified because accepting them allows the SEC and the courts to satisfy the dual goals of protecting investors and preserving market integrity. But if a measure can be justified based simply on its ability to satisfy these dual goals, then it is difficult to see why prohibiting the conduct at issue in *Dorozhko* should be so controversial. The continued emphasis on a duty-based approach makes this kind of cognitive dissonance necessary.

Further, focusing solely on conduct that breaches a fiduciary duty can have anomalous results. *Dorozhko* highlights this anomaly. Had Dorozhko lawfully obtained the earnings information (as the chief financial officer at the company, for instance), then, according to the traditional duty-centered analysis of insider trading, he would have been liable for insider trading because he would have had a duty to the company not to trade on the information. However, because Dorozhko had unlawfully obtained the information through theft rather than fraud he effectively shielded himself from liability to the SEC.[148]

While this may make sense as a matter of logical consistency, it is poor policy. Punishing only lawful possessors of inside information does not serve either of the dual goals at the heart of the prohibition against insider trading, namely protecting investors and ensuring market integrity. Certainly the aggrieved party in the transaction is no better off because the misappropriator obtained the information by hacking as opposed to abuse of

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145 United States v. Chestman, 947 F.2d 551, 565-66 (2d Cir. 1991).

146 *See, e.g.*, N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007).

147 *See* Jill E. Fisch, Letter to the Editor, *The Muddle of Insider Trading Regulation*, N.Y. TIMES, Nov. 24, 1991, at F11.

148 *See* Carolyn Silane, *Electronic Data Theft: A Legal Loophole For Illegally-Obtained Information–A Comparative Analysis of U.S. and E.U. Insider Trading Law*, 5 SETON HALL CIR. REV. 363, 364 (2009) ("The fact remains that those who obtain material, nonpublic information in a lawful manner may be held liable for a subsequent trade on such information, while those who actively and criminally steal such information and perform the same trade are entirely free from insider trading liability, is a contradiction which will continue to be exploited.").

his position of trust and confidence.[149] Neither is the integrity of the markets preserved by exempting thieves and hackers from the reach of the securities laws. Rather, "hackers can adversely affect stock markets by trading on stolen confidential information."[150]

Importantly, a fiduciary duty is not an intrinsic necessity of insider-trading law—that is to say, a body of securities laws that prohibits insider trading need not require a fiduciary duty in order to function. For example, the European Union's approach focuses on whether an individual is in possession of inside information when engaging in a securities transaction. While the European rule may have administrative and doctrinal defects of its own, its prohibitions would close up the loopholes left behind by the *O'Hagan* decision.[151] Specifically, the European Union Directive prohibits those in possession of inside information from:

> (1) Using that information, by acquiring or disposing of (or attempting to acquire or dispose of) any financial instrument to which the information relates, either directly or indirectly, and either for his own account or on account of a third party ("insider dealing");
>
> (2) Disclosing that information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties ("disclosing insider information"); or
>
> (3) Recommending or inducing another person, on the basis of such information, to acquire or dispose of financial instruments to which that information relates ("tipping").[152]

B. *Moving to a Property Rights Approach*

A coherent property-rights approach would be an improvement, as it would accomplish the twin objectives of insider-trading prohibitions while moving away from the fictions and anomalous results created by the unnecessary emphasis on a duty. In *O'Hagan*, the Supreme Court identified two arguments for prohibiting insider trading. First, the Court stated that prohibiting insider trading is "well tuned to an animating purpose of the Exchange Act: to [ensure] honest securities markets and thereby promote in-

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149 Hazen, *supra* note 35, at 902 (stating that "the *Dorozhko* court's rationale leads to uneven results" and comparing an ordinary thief who wouldn't be liable under *Dorozhko* to a thief who falsely identifies himself and would be liable).

150 Steinbuch, *supra* note 74, at 570.

151 The two loopholes arguably left open by *O'Hagan* are: (1) according to the duty-based analysis, an individual who unlawfully obtains inside information and trades on the information would not be liable for insider trading absent a relationship of trust and confidence; and (2) even if an individual owes a duty to the source of the information, if that individual discloses to the source of the information his intention to trade, then the misappropriation theory would not apply because the element of deceit would be defeated when the misappropriator discloses his intent to trade.

152 Council Directive 2003/6/EC, art. 10(a), 2003 O.J. (L 96) 23.

vestor confidence."[153] The second reason that the Court articulated was rooted in a company's property rights in its nonpublic information:

> A company's confidential information . . . qualifies as property to which the company has a right of exclusive use. The undisclosed misappropriation of such information, in violation of a fiduciary duty, . . . constitutes fraud akin to embezzlement—the fraudulent appropriation to one's own use of the money or goods entrusted to one's care by another.[154]

Perhaps motivated by a desire to preserve an allegiance to a duty-based analysis, the Court's opinion can be read as putting forth a narrow view of property rights. The Court, citing *Carpenter v. United States*,[155] stated that "the undisclosed misappropriation of [company] information, in violation of a fiduciary duty constitutes fraud akin to embezzlement."[156] But, if the Court were truly concerned about the company's property rights, a stronger dedication to protecting property rights may be in order. The Court's construction of property rights in *O'Hagan* is arguably too narrow, largely ignoring what the Court has previously considered the most fundamental of all property interests: the right to exclude all others—not just fiduciaries—from using the owner's property.[157] It is certainly hard to imagine a cogent theory of property rights where embezzlement (as the Supreme Court characterized O'Hagan's behavior)[158] is prohibited, but theft is not. For this reason, a theory of insider trading focused on protecting a company's property interest in confidential information should prohibit not only embezzlement of information but also theft. In light of the trouble caused by the misappropriation theory adopted in *O'Hagan*, a new approach is in order.

The Supreme Court should adopt a more traditional view of property rights and apply it universally to the insider trading context. Commissioner Paredes suggested that courts should look to past jurisprudence to solve cases that involve novel problems. As the SEC and the courts grapple with applying old rules to novel situations, the SEC should promulgate a new rule that reverts back to first principles of insider-trading law. A slight modification of an element of insider trading, enunciated in the 1963 SEC proceeding *In the Matter of Cady, Roberts & Co.*, could provide a refreshingly clear and workable rule.[159] With respect to those who do not owe a

153 *O'Hagan*, 521 U.S. at 658.

154 *Id.* at 654 (internal quotations omitted).

155 Carpenter v. United States, 484 U.S. 19, 27 (1987).

156 *O'Hagan*, 521 U.S. at 654.

157 *See* Lingle v. Chevron, 544 U.S. 528, 539 (2005) (citing Dolan v. City of Tigard, 512 U.S. 374, 384 (1994); Nollan v. California Coastal Comm'n, 483 U.S. 825, 831-32 (1987); Loretto v. Teleprompter Manhattan CATV Corp., 458 U.S. 419 (1982); Kaiser Aetna v. United States, 444 U.S. 164, 176 (1979)).

158 *O'Hagan*, 521 U.S. at 654.

159 *See In re* Cady, Roberts & Co., 40 S.E.C. 907, 1961 WL 60638 (1961).

fiduciary duty to the shareholders of a company (e.g., the Dorozhko types), that rule might be the following: a person who has unlawfully obtained access to a company's material, nonpublic information, either directly or indirectly, where such information is the property of that company and is intended to be available only for a corporate purpose and not for the personal benefit of anyone, must abstain from trading on such information.[160] This approach would dispose of the need for the courts to engage in the legal gymnastics described above in order to shoehorn a novel fact-pattern into a duty-based framework. Additionally, it would stop short of requiring parity of information in securities transactions, which otherwise would have made the rule unworkable and impractical.

This proposed rule would make O'Hagan's conduct illegal because the information on which he traded was intended to be used only for a corporate purpose. It would also close the notorious *O'Hagan* loophole by preventing a would-be trader from utilizing the information with impunity after simply disclosing his intent to trade to the informational source. The proposed rule would also broaden the overly-narrow property-rights approach espoused in *O'Hagan*. This rule would also make Dorozhko's conduct illegal because the information obtained through theft would constitute unlawful direct access to information, whose use was intended for a corporate purpose. Lastly, this rule would eliminate the incongruent and inadequate rules that govern the Classical and Misappropriation theories which have made a duty the touchstone of insider-trading law.

Nevertheless, even the property-rights approach is susceptible to at least one criticism: over-enforcement. This criticism involves the notion that eliminating the requirement of a fiduciary duty would sweep too much conduct into the rubric of insider trading and securities fraud. The feared result would be that even those who had not engaged in fraudulent or deceptive conduct would be liable for securities fraud. The district court in *Dorozhko* had hoped to avoid a showdown between the SEC's ability to bring cases outside of the normal fiduciary context and the SEC's mandate to maintain market integrity. The district court recommended that the matter be referred to the Department of Justice for criminal prosecution.[161] The

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160 The original language of the SEC proceeding stated:

> Analytically, the obligation [of corporate insiders to refrain from trading on inside information] rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing.

Id. at *4.

161 *Dorozhko*, 606 F. Supp. 2d at 324 ("Indeed, we would not have to address the tension between the fiduciary requirement and the goal of preserving fair and open markets had the SEC acted on this Court's suggestion at the November 28, 2007 preliminary injunction hearing that a way to avoid a decision that would result in the release of the restrained trading proceeds was to refer this matter to the United States Attorney's Office for criminal investigation.").

Department of Justice indeed has a Computer Crimes & Intellectual Property Section which handles such cases.[162]

Additionally, Congress has passed the Computer Abuse and Fraud Act. The statute provides that whoever "knowingly and with intent to defraud, accesses a protected computer without authorization, or exceeds authorized access, and by means of such conduct furthers the intended fraud and obtains anything of value" is liable under the Act.[163] Although the Act is a criminal statute, it provides a civil right of action to any person who suffers a loss caused by violation of the statute. A protected computer is one that is used in interstate commerce.[164] Subsection 1030(g) authorizes a private right of action to bring a civil suit for a violation of the statute. As litigated, the threshold for "intent to defraud" is quite low.[165]

The fact that a private right of action exists and that the threshold for proving one of its key elements is so low seems to provide a strong argument for letting businesses handle the situation on their own—without SEC involvement—by bringing private causes of action for breaches of their security. However, companies are reluctant to come forward with their breaches of security. The fear of negative publicity, its effect on reputation

162 *See About CCIPS*, DEP'T. OF JUST. COMPUTER CRIME & INTELL. PROP. SEC., http://www.cybercrime.gov/ccips.html (last visited Nov. 13, 2010) ("The Computer Crime and Intellectual Property Section (CCIPS) is responsible for implementing the Department's national strategies in combating computer and intellectual property crimes worldwide. The Computer Crime Initiative is a comprehensive program designed to combat electronic penetrations, data thefts, and cyber attacks on critical information systems. CCIPS prevents, investigates, and prosecutes computer crimes by working with other government agencies, the private sector, academic institutions, and foreign counterparts.").

163 18 U.S.C. § 1030(a)(4) (2008).

164 18 U.S.C. § 1030(e)(2) (2008); *See also* COMPUTER CRIME & INTELL. PROP. SEC., DEPARTMENT OF JUSTICE, PROSECUTING COMPUTER CRIMES 3 (Scott Eltringham ed., Office of Legal Education 2007), http://www.justice.gov/criminal/cybercrime/ccmanual/ccmanual.pdf.

165 *See* United States v. Willis, 476 F.3d 1121 (10th Cir. 2007) (The crime of accessing a protected computer without authorization only requires proof that defendant intentionally accessed information from a protected computer, it does not require proof of intent to defraud nor proof that the defendant knew the value of the information obtained); United States v. Sablan, 92 F.3d 865 (9th Cir. 1996) (Computer fraud statute only required government to prove that defendant intentionally accessed computer without authorization); NCMIC Fin. Corp. v. Artino, 638 F. Supp. 2d 1042 (S.D. Iowa 2009) (Company vice president acted with intent to defraud company under the Computer Fraud and Abuse Act when he violated employer's property rights by accessing company's customer spreadsheet, e-mailing it from his work e-mail account to his personal e-mail account without authorization, and using the customer spreadsheet for his own personal gain and against company's financial interests); Res. Ctr. for Indep. Living, Inc. v. Ability Res's., Inc., 534 F. Supp. 2d 1204 (D. Kan. 2008) (Allegations that former employees intentionally accessed their former employer's protected computer, without authorization, and as a result of such conduct caused damage to employer by, among other things, obtaining its confidential and proprietary information for the benefit of employees' competing enterprise were sufficient to state claim for violation of the Computer Fraud and Abuse Act); eBay Inc. v. Digital Point Solutions, Inc., 608 F. Supp. 2d 1156 (N.D. Cal. 2009) (Fraud under the Computer Fraud and Abuse Act (CFAA) only requires a showing of unlawful access; there is no need to plead the elements of common law fraud to state a claim under the Act).

and stock price, coupled with the possible use of the information to a competitor's advantage and law enforcers' lack of interest and resources to pursue computer intrusion cases, all serve to dissuade companies from coming forward, particularly when the matter does not involve significant losses.[166]

As the district court in *Dorozhko* correctly noted, when hackers such as Dorozhko gain unauthorized access to information, they arguably violate several statutes even before they trade on the information acquired.[167] Still, it was the SEC and not the DOJ or the aggrieved party that pursued the case. Despite the district court's recommendation and its attempt to avoid the issue altogether, SEC enforcement actions against such behavior might not be such a bad thing, especially in light of the SEC's stated goals to maintain fair, orderly, and efficient markets.[168] As Professor Langevoort explains, "profiting from stolen information is hardly an enterprise to be encouraged, and plainly threatens market integrity."[169] Further, "the Justice Department usually investigates high-profile cases of securities fraud, but the threshold for criminal prosecution is significantly higher than that of civil cases. The SEC files only civil cases."[170]

By recommending that the SEC refer the matter to the DOJ and by pointing out other statutes under which the DOJ might successfully prosecute Dorozhko, the district court hoped to prevent the defendant from being civilly liable for insider trading in addition to being criminally liable for the statutory violations. Such a process would serve to deter the type of behavior involved without subjecting a party to excess liability.

The strongest rebuttal to this argument is admittedly conditional: if hacking constitutes fraud and if no duty is required, then the SEC should not abstain from enforcement simply because the DOJ has parallel enforcement capabilities. The DOJ and the SEC have a long history of cooperation in parallel criminal and civil proceedings, and there is no reason to believe that parallel proceedings in a hacking and trading case would not proceed cooperatively.

Another rebuttal is that the thief with inside information enters into the securities markets with "unclean hands" and his subsequent trades on the basis of the ill-gotten information constitute additional bad acts for which he should be further punished. The district court in *Dorozhko* stated that

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166 *See* Ruperto P. Majuca & Jay P. Kesan, *Hacking Back: Optimal Use of Self-Defense in Cyberspace* (Ill. Pub. Law and Legal Theory Paper Series, Paper No. 08-20, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1363932.

167 *See Dorozhko*, 606 F. Supp. 2d at 323.

168 SEC. & EXCH. COMM'N, *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, SEC. & EXCHANGE COMMISSION, http://www.sec.gov/about/whatwedo.shtml (last modified Oct. 20, 2010).

169 *See* Langevoort, *supra* note 61.

170 *See* Zachary A. Goldfarb, *Goldman May Face Justice Department Review*, WASH. POST (Apr. 30, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/04/29/AR2010042904458.html?hpid=topnews.

"'hacking and trading'—while illegal under any number of federal and/or [sic] state criminal statutes—does not amount to a violation of § 10(b) of the Exchange Act under existing case law."[171] But the court seems to have ignored that the defendant did not simply obtain unauthorized access to confidential information. The defendant also engaged in a securities transaction while in possession and on the basis of the information.[172] The district court refers to statutes that focus only on the manner in which something of value is obtained through hacking or mail fraud. The statutes do not focus on how the information is utilized after it is obtained. At least in the context of securities law, it seems natural that securities liability would attach to the illicit use of material, nonpublic information in a securities transaction.

Although it is not publicly known why the DOJ did not bring the case against Dorozhko, from a practical standpoint, there may be several reasons: (1) perhaps the DOJ did not view it as a high priority; (2) perhaps the DOJ recognized the futility of trying to extradite Dorozhko from Ukraine[173] for prosecution; (3) perhaps the DOJ assumed that, given its track record of intrusion cases, the SEC would enforce any potential violation and that such enforcement would be sufficient. Obviously, without knowing for sure, these explanations are speculative; however, they point to reasons why the SEC should not simply abdicate its enforcement authority.

Additionally, in the interest of deterrence, cybercrime or cybertort may need to be treated differently from analogous violations that do not involve the Internet. This idea stems from the notion that if two crimes or offenses have the same payout for the offender, but one costs much less to perpetrate, from a deterrence perspective, the law should increase the costs of that offense by imposing greater penalties.[174] Prior to the advent of computers and the Internet, would-be inside traders had to rely on tips from others in order to obtain the sensitive inside information needed to profit from trades.[175]

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171 *Dorozhko*, 606 F. Supp. 2d at 323.

172 *Id.* n.2 (the court refers to the computer fraud statute, 18 U.S.C § 1030(a)(4) (2008), and the mail and wire fraud statutes, 18 U.S.C. § 1341 (2008). By way of example, pursuant to 18 U.S.C § 1030(a)(4), a person is liable for computer fraud when he or she "knowingly and with intent to defraud, accesses a protected computer without authorization, or exceeds authorized access, and by means of such conduct furthers the intended fraud and obtains anything of value, unless the object of the fraud and the thing obtained consists only of the use of the computer and the value of such use is not more than $5,000 in any 1-year period" but does not prohibit the subsequent use of that information.).

173 It is important to note, however, that the Department of Justice had the actual authority to seize Dorozhko's trading proceeds under 18 U.S.C. § 981(b) (2006).

174 *See* Katyal, *supra* note 74, at 1012-13.

175 For a discussion of "tipper" and "tippee" liability, see Dirks v. SEC, 463 U.S. 646, 663-64 (1983).

The unfolding case against Raj Rajaratnam is a prime example.[176] Rajaratnam's hedge fund allegedly depended on obtaining information from loyal relationships that had been carefully cultivated for several decades and likely at a cost of many thousands of dollars.[177] In the matter of cybercrimes and cybertorts, however, the Internet allows a defendant to carry out elaborate schemes with one person and a laptop. Armed with a computer and an Internet connection, an individual can gain remote, unauthorized access by himself, bypassing the "tipper" and the costs associated with obtaining the illicit information.[178] An effective hacker would not face any of the costs or legal risks associated with developing that contact and thus may even pose more of a threat than Rajaratnam's alleged information-seeking model. In a cybercrime or cybertort the hacker can bypass the middleman and simply obtain unauthorized direct access to the information on which to trade.

A stark contrast exists between Rajaratnam and Dorozhko. Rajaratnam allegedly spent decades cultivating a reliable relationship that would provide him with earnings numbers before they were released.[179] Dorozhko, however, accessed earnings information before it was released in a matter of minutes. Thus, cybercrimes and cybertorts, which can be committed relatively quickly, may need to be treated with greater penalties to provide for greater deterrence.

C. *Moving Forward: A Caution to the SEC*

Randall Quinn, an Assistant General Counsel at the SEC, summarized the criticisms of *O'Hagan* in the following manner:

> Critics have argued that the decision suffers from numerous flaws, including: misconstruing the relevant statute; misreading the Supreme Court's own precedents; lacking a coherent doctrinal basis for prohibiting insider trading; leaving too many unanswered questions; creating

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176 For a diagram and background on Rajaratnam's informational network, see Robert A. Guth & Justin Scheck, *The Man Who Wired Silicon Valley*, WALL ST. J. (Dec. 30, 2009), http://online.wsj.com/article/SB126204917965408363.html.

177 *Id.*

178 These costs would include the time and effort needed to foster the valuable relationship that would produce sensitive information as well as conferring a benefit on the tipper, as required by modern insider trading law. *See* Dirks v. SEC, 463 U.S. 646, 663 (1983) ("[T]o determine whether the disclosure itself 'deceive[s], manipulate[s], or defraud[s]' shareholders, the initial inquiry is whether there has been a breach of duty by the insider. This requires courts to focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or reputation benefit that will translate into future earnings.").

179 Guth & Scheck, *supra* note 176.

illogical loopholes in the regulatory scheme; and extending the reach of federal securities laws too far.[180]

Since 1997, the SEC has relied upon the misappropriation theory to enforce Rule 10b–5 in the insider trading context. In light of the many criticisms of *O'Hagan*, the several loopholes it has left, and the circuit split created by *Dorozhko*,[181] the SEC may face a Hobson's choice: either retreat somewhat from its aggressive enforcement or risk *O'Hagan* being overturned by the Supreme Court if a defendant (e.g., Oleksander Dorozhko) asserts that the SEC has exceeded the limits of enforcing anti-fraud liability. The risk of aggressive enforcement is that the Supreme Court, complete with new justices opposed to expansive securities law liability,[182] may take a view different from the majority opinion in *O'Hagan* if presented with a case like *Dorozhko*.

In its *Dorozhko* opinion, the Second Circuit noted that its decision likely conflicted with a decision in its sister circuit.[183] This circuit split, coupled with a perceived expansion of § 10(b) liability, increased exposure to the flaws in *O'Hagan*, and the changed composition of the court, could mean that *Dorozhko* may draw the Supreme Court's attention.

CONCLUSION

The Second Circuit's decision to swim upstream against a flood of insider trading cases relying exclusively on a fiduciary duty could be the first step in a paradigm shift away from the duty-based analysis that has been the source of much confusion.

While the Second Circuit may have rightly rejected a duty-based approach and while hacking can likely satisfy the requirements of Rule 10b–5, it is doubtful that the *Dorozhko* opinion has settled this area of law. As a result, confusion will continue to abound throughout the circuits unless more decisive action is taken. Should the *Dorozhko* opinion draw the attention of the Supreme Court, some additional clarification may be forthcoming; however, it would be unsurprising to see the Court take a conservative

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180 Quinn, *supra* note 33 at 867-68.

181 *See Dorozhko*, 574 F.3d at 48 (quoting Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372, 389 (2007) for the proposition that "the [Supreme] Court . . . has established that a device, such as a scheme, is not 'deceptive' unless it involves breach of some duty of candid disclosure.").

182 *See Stoneridge Inv. Partners*, 552 U.S. at 167 (narrowly construing a private right of action for aiding and abetting liability and stating that "[c]oncerns with the judicial creation of a private cause of action caution against its expansion. The decision to extend the cause of action is for Congress, not for us. Though it remains the law, the § 10(b) private right should not be extended beyond its present boundaries.").

183 *See Dorozhko*, 606 F. Supp. 2d at 323.

approach to changing the policy. Instead, the real change will likely have to come from the legislature or the regulatory rulemaking body within the SEC.

A move to a property rights centered paradigm appears able to cure the current ills of federal insider-trading jurisprudence. Investors would benefit from increased stability and integrity in the securities markets. Corporations would benefit from the deterrent effect of additional penalties to those that seek to unlawfully obtain and use the corporation's proprietary information. From a due process perspective, defendants and prospective defendants would benefit from increased simplicity that would allow both for the avoidance of the prohibited conduct as well as more effective defenses against charges of prohibited conduct.

A methodical way to proceed would be to follow the recommendation of former SEC Commissioner Paul Atkins and Bradley Bondi, who advocated the appointment of an independent advisory committee to conduct a detailed review and evaluation of the policies and procedures of the SEC's enforcement program.[184] Such a committee could, among other things, investigate whether the Division of Enforcement remains well equipped to bring cases involving hacking and trading, and whether from an enforcement perspective, the current approach to insider trading is consistent enough to execute the Division's goals while at all times preserving the due process rights of defendants. Finally, based on its findings, the proposed advisory committee could make recommendations to the Commission regarding the need for an alternative rule to regulate insider trading.

However, the best solution, and the one advocated by leading securities law experts, would be a statutory definition of prohibited insider and outsider trading.[185] A straightforward, property-rights based definition of insider trading could preen the judicial oak allowing insiders and outsiders—both the casual and aggressive type—to know the rules of the game and structure their behavior accordingly. Furthermore, the SEC would not have to fuss with the increasingly technical details of whether a hack perpetrated in any given case is mere theft or affirmative misrepresentation. A clear congressional prohibition would conserve valuable judicial, agency, and private sector resources.

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184 Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC's Enforcement Program*, 13 FORDHAM J. CORP. & FIN. L. 367, 369-70 (2008).

185 *See, e.g.*, Hazen, *supra* note 35, at 887.

TURNED INSIDE-OUT: THE DEVELOPMENT OF "OUTSIDER TRADING" AND HOW *DOROZHKO* MAY EXPAND THE SCOPE OF INSIDER TRADING LIABILITY

*Matthew T.M. Feeks**

INTRODUCTION

In the 1990s, technology companies began making huge strides in disseminating information to the public. As technology increased the speed at which information could be conveyed, the market more quickly assimilated information into valuation. While companies generally benefited from this trend, advancements in technology also created a substantial need to find new and better ways to secure information. This need arose because companies that fail to adequately safeguard confidential information risk inadvertent disclosures to the market.

In addition to inadvertent disclosures, companies must also protect against computer hacking. Computer hackers have responded to improved safeguards by finding new ways of breaking into secured databases. Recognizing the value of using nonpublic business information to guide securities trading, hackers have attempted to breach the computer systems of financial institutions. Such actions set the stage for a hotly debated issue in securities law: whether a fiduciary relationship is required for a violation of the insider trading laws.

In July 2009, the Second Circuit held in *SEC v. Dorozhko* that a breach of a fiduciary duty was not required for § 10(b) liability where a computer hacker misrepresents himself in order to access a database, steals material, nonpublic information from that database, and then trades on that information.[1] The Second Circuit distinguished *Dorozhko* from other insider trading cases by characterizing the deceptive act as an affirmative misrepresentation rather than the "fraud *qua* silence" in *Chiarella v. United States* and its progeny.[2]

This article traces the history of insider trading from its inception in *Chiarella* to the most recent case of *Dorozhko*. In *Chiarella*, the Court held "[w]hen an allegation of fraud is based on nondisclosure, there can be no fraud absent a duty to speak."[3] Thus, "a duty to disclose under § 10(b) [of

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* J.D. 2010, George Mason University School of Law. I would like to thank Professor Bradley Bondi for his significant comments and insights on this article.

[1] SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009).

[2] *Id.* at 49-50.

[3] Chiarella v. United States, 445 U.S. 222, 235 (1980).

the 1934 Securities Exchange Act] does not arise from the mere possession of nonpublic market information."[4] In *Dorozhko*, the court held that the fraud of affirmative misrepresentation does not require a breach of a fiduciary duty in order to be "deceptive" under § 10(b) of the Exchange Act.[5]

Part I of this article examines the legislative history of the Exchange Act and early cases that developed the current insider trading laws. Part I also discusses some criticisms of current insider trading laws, specifically the misappropriation theory. Part II discusses the facts, procedural history, and holdings of the district and appellate courts in the *Dorozhko* case. Part III analyzes the Second Circuit's holding in *Dorozhko* and evaluates the need to distinguish affirmative misrepresentations from fraudulent silence. Finally, this note concludes that the Second Circuit held incorrectly in *Dorozhko* that a fiduciary duty need not exist when the fraud is premised upon an affirmative misrepresentation rather than an omission.

I. THE EXCHANGE ACT AND THE MISAPPROPRIATION THEORY

Prior to the introduction of federal securities regulation, state law regulated the purchase and sale of securities. At common law, mere silence could not by itself constitute fraud.[6] Early courts and legal scholars generally accepted that a fiduciary must disclose nonpublic information to the beneficiary under the "fiduciary trading rule."[7] However, the common law lacked clarity in cases where, for example, corporations owed no fiduciary duty to one of the transacting parties.[8] This ambiguity in the common law and "the inadequacy of the common law remedies for the task of protecting investors from fraud . . . prompted Congress to enact the 1933 and 1934 Acts."[9]

Congress passed the Securities Exchange Act of 1934 (Exchange Act) to "insure the maintenance of fair and honest markets in [securities] transactions."[10] By reducing fraud and increasing transparency in the securities markets, Congress intended to make the market more efficient while also

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4 *Id.*

5 *Dorozhko*, 574 F.3d at 51.

6 Paula J. Dalley, *From Horse Trading to Insider Trading: The Historical Antecedents of the Insider Trading Debate*, 39 WM. & MARY L. REV. 1289, 1296 (1998).

7 *Id.* at 1297.

8 *Id.* at 1296-1306 (discussing both the majority view that corporate insiders did not owe a duty to their shareholders and the minority view that they did owe a duty to their shareholders).

9 Robert A. Prentice, *Stoneridge, Securities Fraud Litigation, and the Supreme Court*, 45 AM. BUS. L.J. 611, 623-24 (2008).

10 15 U.S.C.A. § 78b (West 2010).

protecting investors.[11] The Exchange Act was, thus, crafted with an eye to curtail market manipulation and provide a remedy for investors victimized by fraudulent securities transactions.[12] The Exchange Act also created the Securities and Exchange Commission (SEC), whose mission is "to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation."[13]

When drafting the Exchange Act, Congress was motivated by "the need for an independent administrative body to enforce the federal securities laws, regulate stock market practices, and curb the evils in the stock exchanges themselves."[14] While drafting the Exchange Act, Congress considered insider trading as "among the most vicious practices unearthed." [15] To Congress, insider trading was "the flagrant betrayal of . . . [the] fiduciary duties [of] directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities."[16] Congressman Lea remarked during the congressional hearings on the Exchange Act, "We have had the ugly picture of corporation officials juggling with the stocks of their own companies, preying on their own stockholders through inside information they obtained as trustees of the trust they violated."[17]

Though insider trading provided one of the impetuses for the Exchange Act, nowhere in the Exchange Act is the term "insider trading" used or defined. As one measure to combat insider trading, Congress included § 16 of the Exchange Act which prohibits the short sale of securities by corporate insiders and beneficial owners of stock.[18] Section 10(b) of the

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11 *See generally* Elisabeth Keller & Gregory A. Gehlmann, *Introductory Comment: A Historical Introduction to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 49 OHIO ST. L.J. 329 (1988).

12 *Id.* at 348-49.

13 *See* Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 FORDHAM J. CORP. & FIN. L. 367, 368 (2008) (citing 2006 SEC PERFORMANCE & ACCOUNTABILITY REP. 5, *available at* http://www.sec.gov/about/secpar/secpar2006.pdf).

14 Keller & Gehlmann, *supra* note 11, at 347.

15 *Id.* at 350 (citing S. REP. NO. 1455, at 55 (1934), *reprinted in* 5 J. S. ELLENBERGER & ELLEN P. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 55 (1973)).

16 *Id.*

17 *Id.* at 351 (citing 78 CONG. REC. 7861, 7862 (1934) (statement of Rep. Clarence F. Lea)).

18 *See id.*; *see also* 15 U.S.C.A. § 78(b) (West 2010), which states, in pertinent part:

> For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involving any such equity security within any period of less than six months, unless such security or security-based swap agreement was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security

Exchange Act partly addresses market manipulation,[19] and "[t]he Commission adopted Rule 10b-5 in 1942 to close a gap in the antifraud provisions of the securities laws."[20] Thomas G. Corcoran, a spokesman for the drafters of the provision that would become § 10(b) of the Exchange Act, remarked that § 10(b) was designed to be a "catch-all clause to prevent manipulative devices."[21]

The SEC and the courts, in order to effect Congress's intent in curtailing insider trading, have relied upon § 10(b) of the Exchange Act and Rule 10b-5 as the source of authority to regulate insider trading.[22] The SEC established the foundation for insider trading in *In re Cady, Roberts Co.*, holding that before a corporate insider may trade, he must disclose the material, nonpublic information he gained as a result of his insider status in the company.[23] As this article will discuss further, the "in connection with" language of § 10(b) began, in *Chiarella v. United States*, with "those persons owing a pre-existing fiduciary duty to the corporation's shareholders."[24] The Court has since expanded this § 10(b) language: in *Dirks v.*

> or security-based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months.

15 U.S.C.A. § 78(b) (West 2010).

19 *See* Keller & Gehlmann, *supra* note 11, at 349.

20 Gary M. Brown, *Fraud and Related Issues Under Rule 10b-5 and the Sarbanes-Oxley Act*, 1757 PRACTICING L. INST. § 12.1 (2009).

21 Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202 (1976) (citing *Stock Exchange Regulations: Hearings on H.R. 7852 and H.R. 8720 Before the H, Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934) (statement of Thomas G. Corcoran)).

22 Section 10 of the Exchange Act addresses manipulative and deceptive devices used in connection with the purchase or sale of a security, stating:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . .
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> . . . .
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> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or of the protection of investors.

15 U.S.C. § 78j (2000).

Rule 10b-5 states, in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1951).

23 Cady, Roberts & Co., Exchange Act Release No. 6668, 1961 WL 60638 (Nov. 8, 1961), at 10.

24 RALPH C. FERRARA ET AL., FERRARA ON INSIDER TRADING AND THE WALL § 2.02 (2009).

SEC, the Court held that persons who receive a tip from a corporate insider owe this pre-existing fiduciary duty.[25] In *Dorozhko*, the Court held that there is no fiduciary duty requirement when the alleged fraud is an affirmative misrepresentation.[26] This article discusses the evolution of insider trading law, from the classic theory, to tipper–tippee liability, to the misappropriation theory, in the following sections, respectively.

A. *Classic Insider Trading*

The classic theory of insider trading states that "trading the securities of a corporation while in possession of material, nonpublic information constitutes 'deception' within the meaning of [§] 10(b) and [Rule] 10b-5 when the person trading owes a pre-existing fiduciary duty to the corporation's shareholders."[27] *Chiarella v. United States* established the classic theory of insider trading by recognizing the duty to either disclose or abstain from trading.[28] In *Chiarella*, a printer deduced who the target companies were in a corporate takeover bid, then purchased stock in the target companies without disclosing this material, nonpublic information.[29] The Supreme Court held that the petitioner did not violate § 10(b) in his trading activity because he was not a corporate insider and he did not owe a fiduciary duty to the target company.[30] The Court specifically stated, "When an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak. We hold that a duty to disclose under § 10(b) does not arise from the mere possession of nonpublic material information."[31] Rather, insider trading liability under the classic theory "is premised upon a duty to disclose arising from a relationship of trust and confidence between the parties to a transaction."[32]

In so holding, the Court rejected the "parity of information" theory, which states that anyone who uses material, nonpublic information is liable for insider trading.[33] Rather, a fiduciary relationship must exist between the parties for the duty to disclose to apply.[34] To hold otherwise, the Court maintained, would "depar[t] radically from the established doctrine that

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25 Dirks v. SEC, 463 U.S. 646, 660 (1983).

26 SEC v. Dorozhko, 574 F.3d 42, 50 (2d Cir. 2009).

27 FERRARA ET AL., *supra* note 24, at § 2.02.

28 *See* Chiarella v. United States, 445 U.S. 222, 232 (1980).

29 *Id.* at 224.

30 *Id.* at 231.

31 *Id.* at 235.

32 *Id.* at 230.

33 *Id.* at 232. This rule is premised on the notion that the purpose of the securities laws is to protect both buyers and sellers and to ensure equal access to information in their securities transactions. *Id.*

34 *Chiarella*, 445 U.S. at 231.

duty arises from a specific relationship between two parties."[35] Thus, for the *Chiarella* Court, there was no deceptive act in connection with Chiarella's purchase of securities because a fiduciary duty did not exist between the parties.

Though *Chiarella* resolved the issue concerning liability for insider trading when one of the parties owed a fiduciary duty to the other, opportunistic corporate insiders could evade this requirement by tipping a friend or relative about material, nonpublic information and having this friend or relative then conduct the trade. The Court addressed this issue of tipper–tippee liability in *Dirks v. SEC.*

B. *Tipper–Tippee Liability*

In *Dirks v. SEC*, a corporate insider tipped off Dirks, an officer at a New York broker–dealer firm, about fraud occurring at Equity Funding of America.[36] The corporate insider informed Dirks about the fraud in an effort to publicize Equity Funding's fraudulent corporate practices after several regulatory agencies failed to take any action.[37] Though neither Dirks, nor anyone in his firm, traded in any of Equity Funding's securities, Dirks informed his clients of the fraud—some of whom then sold their interests in Equity Funding.[38] The SEC argued that Dirks was liable for insider trading because a "tippee breaches the fiduciary duty which he assumes from the insider when the tippee knowingly transmits the information to someone who will probably trade on the basis thereof."[39]

The Court asserted that the antifraud provisions of the Exchange Act do not require equal information among all traders.[40] They rejected the SEC's argument, holding that:

> [A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.[41]

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35 *Id.* at 233.

36 Dirks v. SEC, 463 U.S. 646, 648-49 (1983).

37 *Id.* at 649.

38 *Id.*

39 *Id.* at 656 (citing 21 SEC Docket 1401, 1410 n.42 (1981)).

40 *Id.* at 657.

41 *Id.* at 660. The Court noted that "[t]he SEC itself has recognized that tippee liability properly is imposed only in circumstances where the tippee knows, or has reason to know, that the insider has disclosed improperly inside corporate information." *Id.* at 660 n.19.

Thus, a "tippee's duty to disclose or abstain is derivative from that of the insider's duty."[42]

The Court recognized that "[w]hether disclosure is a breach of duty . . . depends in large part on the purpose of the disclosure."[43] The Court stated that "the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach."[44] Thus, corporate insiders cannot give material, nonpublic information to outsiders for the purpose of gaining an informational advantage in securities transactions.[45] Similarly, any outsider who trades on material, nonpublic information would also be liable for insider trading based on the corporate insider's breach of a fiduciary duty to the shareholders.[46] Since the corporate insider tipped off Dirks to shed light on corporate fraud, rather than for personal gain, the Court did not hold Dirks liable for insider trading.[47]

C. *Misappropriation Theory*

The misappropriation theory of liability for insider trading "holds that a person commits fraud 'in connection with' a securities transaction . . . when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."[48] The Court endorsed the misappropriation theory in *United States v. O'Hagan*, in which a lawyer for a firm representing one corporation used his access to material, nonpublic information concerning the corporation's confidential tender offer plan and purchased put options and stock in the target company.[49] O'Hagan, who did not owe a fiduciary duty to the target

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42 *Dirks*, 463 U.S. at 659.

43 *Id.* at 662.

44 *Id.*

45 *Id.* at 659.

46 *Id.*

47 *Id.* at 655, n.14. The Court further stated that liability was not strictly limited to corporate insiders, as certain individuals may inherit a temporary insider status because of their relationship to the corporation. *Id.* Accountants, underwriters, consultants and lawyers working for the corporation may become temporary insiders because "they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes." *Id.*

48 United States v. O'Hagan, 521 U.S. 642, 652 (1997). The Court was presented with the issue of liability for insider trading under the misappropriation theory in two cases before *O'Hagan*. In *Chiarella*, the Court did not rule on the validity of the misappropriation theory of liability because the issue had not been presented to the jury. *O'Hagan*, 521 U.S. at 650, n.4. In 1987, seven years after the *Chiarella* case, the Court was evenly divided on the validity of the misappropriation theory in *Carpenter v. United States*, 484 U.S. 19, 24 (1987).

49 *O'Hagan*, 521 U.S. at 647-48.

company or its shareholders, still violated the federal insider trading laws.[50] The Court held that "[i]n lieu of premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."[51] The Court maintained that the fraud in this case was predicated on the fact that a "fiduciary who '[pretends] loyalty to the principal while secretly converting the principal's information for personal gain' . . . defrauds the principal."[52]

Thus, the source of the deception is the fiduciary's failure to disclose to the source of the information that he plans to trade on the material, nonpublic information.[53] The Court stated, "Full disclosure forecloses liability under the misappropriation theory . . . if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no 'deceptive device' and thus no § 10(b) violation."[54]

The Court further held that deception occurs when the fiduciary-turned-trader trades on the confidential information without informing the source of the information.[55] The Court stated, "A misappropriator who trades on the basis of material, nonpublic information, in short, gains his advantageous market position through deception; he deceives the source of the information and simultaneously harms members of the investing public."[56] The securities transaction and the deception "coincide," thus satisfying the "in connection with" prong of § 10(b) and Rule 10b-5 liability.[57]

The Court acknowledged the distinction between the embezzlement of money and the embezzlement of information when both are used in a securities transaction.[58] The Court accepted the Government's distinction that "the proceeds [of embezzled money] would have value to the malefactor apart from their use in a securities transaction, and the fraud would be complete as soon as the money was obtained."[59] In this situation, the money retains an immediate value to the embezzler once embezzled and can be used in myriad ways other than the purchase or sale of securities.[60] Thus, the fraud in this scenario would be complete prior to the purchase or sale of

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50 *Id.* at 652.

51 *Id.*

52 *Id.* at 653-54 (quoting Brief for the United States at 17, United States v. O'Hagan, 521 U.S. 642 (1997) (No. 96-842)).

53 *Id.* at 654.

54 *Id.* at 655. However the Court held that a "fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty." *Id.*

55 *O'Hagan*, 521 U.S. at 656.

56 *Id.*

57 *Id.*

58 *Id.*

59 *Id.*

60 *Id.*

securities, and the requisite connection between the fraud and the purchase or sale of securities would be too attenuated to satisfy the "in connection with" prong.[61]

Embezzled information, on the other hand, does not have any inherent value to the embezzler until he uses that information in the purchase or sale of securities; therefore, the fraud would not be complete until that information is used in a securities transaction.[62] In other words, an embezzler of information does not commit fraud until he uses that information in a securities transaction without prior disclosure.[63] Simply embezzling information and not acting upon it does not constitute fraud because fraud only occurs when an insider uses the information without authorization from, or disclosure to, the source of the information.[64]

The Court went to great pains in *O'Hagan* to premise liability on the breach of a fiduciary duty. There were other means by which the Court could have found O'Hagan liable for securities law violations without expanding the "in connection with" element of § 10(b). For example, the Court could have relied on the "fraud on the market" theory,[65] or the "parity of information" theory put forth in *Chiarella* to support a finding of insider trading.[66] Rather, the Court adhered to the established precedent that insider trading liability must be premised on a breach of a fiduciary duty.[67] The Court then premised liability on the breach of duty that O'Hagan owed to the *source* of the information.[68] The Court reasoned that "it makes scant

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61 *O'Hagan*, 521 U.S. at 657. *See also infra* Part I.C., concerning the discussion of *SEC v. Zandford*, 535 U.S. 813 (2002).

62 *O'Hagan*, 521 U.S. at 656.

63 *Id.* The Supreme Court stated:

> The misappropriation theory targets information of a sort that misappropriators ordinarily capitalize upon to gain no-risk profits through the purchase or sale of securities. Should a misappropriator put such information to other use, the statute's prohibition would not be implicated. The theory does not catch all conceivable forms of fraud involving confidential information; rather, it catches fraudulent means of capitalizing on such information through securities transactions.

O'Hagan, 521 U.S. at 656.

64 This distinction is critical in the *Dorozhko* case and will be discussed in more detail in Part III.A.

65 The "fraud on the market" theory is:

> [B]ased on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business . . . . Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements . . . . The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.

Basic, Inc. v. Levinson, 485 U.S. 224, 241-42 (1988) (citing Peil v. Speiser, 806 F.2d 1154, 1160-61 (3rd Cir. 1986)).

66 Under the "parity of information" theory, the mere use of nonpublic information in a securities transaction can give rise to insider trading liability under § 10(b) and Rule 10b-5 thereunder. *See* Chiarella v. United States, 445 U.S. 222, 232-33 (1980).

67 *O'Hagan*, 521 U.S. at 656.

68 *Id.* at 652.

sense to hold a lawyer like O'Hagan a § 10(b) violator if he works for a law firm representing the target of a tender offer, but not if he works for a law firm representing the bidder."[69]

The Court rationalized its decision supporting the misappropriation theory by parsing the language of § 10(b) and looking at the Exchange Act's purpose "to insure honest securities markets and thereby promote investor confidence."[70] When analyzing § 10(b), the Court stated that the language of § 10(b) does not require "deception of an identifiable purchaser or seller."[71] Instead, the deception must be "in connection with the purchase or sale of any security."[72]

The Court significantly expanded the "in connection with" element of § 10(b) and Rule 10b-5 liability in *SEC v. Zandford.*[73] In *Zandford*, a securities broker convinced his client to open an investment account in which the client gave the broker discretionary authority to conduct securities transactions on the client's behalf.[74] Approximately four years later at the time of the client's death, Zandford sold all the client's securities in the account and kept the proceeds for himself.[75] The *Zandford* case presented a question of whether the fraud that Zandford committed was sufficiently "in connection with" the sale of securities to establish § 10(b) liability.[76] The Court held that it was sufficient, stating "each sale was made to further [the broker's] fraudulent scheme; each was deceptive because it was neither authorized by, nor disclosed to, the [client]."[77] Accordingly, the Court held that the fraudulent scheme to steal the client's money was in connection with the sale of the client's securities.[78]

This case is distinguishable from the hypothetical embezzler that the *O'Hagan* Court considered. In *Zandford*, the broker did not withdraw money from the victim's account and use the money to purchase securities like the embezzler contemplated in *O'Hagan*. Rather, the broker in *Zandford* sold his client's securities in the client's investment account for his own personal benefit, disregarding the client's stated investment objec-

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69 *Id.* at 659.

70 *Id.* at 658 (citing 45 Fed. Reg. 60,412 (Sept. 12, 1980) (codified at 17 C.F.R. pt. 240) (stating that trading on misappropriated information "undermines the integrity of, and investor confidence in, the securities markets")).

71 *O'Hagan*, 521 U.S. at 658.

72 *Id.*

73 *See* SEC v. Zandford, 535 U.S. 813 (2002).

74 *Id.* at 815. The elderly investor entrusted Zandford with over $400,000 in assets. *Id.* The SEC's complaint alleged that the "stated investment objectives for the account were 'safety of principal and income.'" *Id.*

75 *Id.*

76 *Id.*

77 *Id.* at 820-21.

78 *Id.* at 825.

tive.[79] However, similar to *O'Hagan*, the securities transaction coincided with the deception, which occurred the moment the broker conducted the securities transactions against the victim's stated investment objective.

The impact of the *O'Hagan* Court's decision set a new and expansive course for determining insider trading liability. By using the breach of fiduciary duty to determine insider trading liability,[80] the Court expanded the scope of liability further than advocates of the classic or tipper–tippee theories reasonably anticipated. This expansion of liability under the misappropriation theory was not without its detractors: the *O'Hagan* decision drew heated criticisms for its numerous perceived faults.

D. *Criticisms of the Misappropriation Theory*

After the Court decided *O'Hagan*, legal scholars accused the Court of several mistakes. Specifically, these scholars criticized the Court for "misconstruing the relevant statute; misreading [its] own precedents; lacking a coherent doctrinal basis for prohibiting insider trading; leaving too many unanswered questions; creating illogical loopholes in the regulatory scheme; and extending the reach of federal securities laws too far."[81]

Additionally, negating liability under the misappropriation theory by requiring disclosure to the source of the information is problematic because this disclosure "does not alleviate the resultant harm to market participants when a trader purchases securities with material[,] nonpublic information."[82] Under the misappropriation theory, the Court incorrectly focused on the liable party's deception of the source of the information rather than focusing on the individual investors who are harmed by the use of the inside information.[83] Permitting a trader to disclose to the source and trade on that information, even over the source's objection, seems inherently flawed when contrasted with the Exchange Act's driving force of protecting investors.[84]

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79 *Zandford*, 535 U.S. at 815.

80 United States v. O'Hagan, 521 U.S. 642, 656 (1997).

81 Randall A. Quinn, *The Misappropriation Theory of Insider Trading in the Supreme Court: A (Brief) Response to the (Many) Critics of* United States v. O'Hagan, 8 FORDHAM J. CORP. & FIN. L. 865, 867 (2003) (citing Mark Dallas, Note, United States v. O'Hagan*: A Failed Attempt to Protect Public Policies Underlying the Securities Laws*, 32 U.C. DAVIS L. REV. 1107 (1999); Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589 (1999); Amy E. Fahey, Note, United States v. O'Hagan: *The Supreme Court Abandons Textualism to Adopt the Misappropriation Theory*, 25 FORDHAM URB. L.J. 507 (1998); Michael H. Dessent, *Joe Six-Pack,* United States v. O'Hagan, *and Private Securities Litigation Reform: A Line Must Be Drawn*, 40 ARIZ. L. REV. 1137 (1998)).

82 Dallas, *supra* note 81, at 1122.

83 *Id.*

84 *See id.*

Professor Stephen M. Bainbridge of University of California at Los Angeles Law School has argued that insider trading, in general, is better characterized as a "means of protecting property rights in information, rather than as a means of preventing securities fraud."[85] He states that the requisite fiduciary duty must exist outside of Rule 10b-5 to prevent circular reasoning,[86] and that the proper source for the existence of a fiduciary duty is property rights.[87] He then questions whether O'Hagan owed any fiduciary duties at all to his firm's client, the source of his information.[88] The Court, according to Professor Bainbridge, "assumed that lawyers are fiduciaries, all fiduciaries are subject to a duty to refrain from self-dealing in confidential information, and, accordingly, the misappropriation theory applies to lawyers and all other fiduciaries."[89]

Another critic of *O'Hagan* argues that the misappropriation theory is inconsistent with Supreme Court precedent regarding statutory interpretation and the language of § 10(b).[90] The criticism is that the Court has traditionally employed a textualist approach to interpreting § 10(b) but abandoned that approach in *O'Hagan* in favor of purposivism, another approach of statutory interpretation.[91] Purposivism asserts that, when the spirit of the law conflicts with the law's literal text, judges should enforce the spirit, or purpose, of the law.[92] Thus, purposivism, unlike textualism, uses extrinsic evidence, such as legislative history and congressional reports, to interpret ambiguous laws.[93] As it is not strictly bound to the text of a statute, "[p]urposivism allows a statute to evolve to address new issues, while maintaining a connection with the original legislative expectations."[94] Purposivism can lead to an expansion of the statute's scope, since it endeavors to apply the spirit of the law, rather than its literal textual meaning.

According to this criticism of the misappropriation theory, using purposivism is an incorrect method for interpreting § 10(b) because it greatly enhances the risk of undue expansion of § 10(b) liability.[95] "[B]y using a purposivist approach to interpret § 10(b), the Court can remedy any problems by advancing the underlying purpose of the securities laws, which is to promote ethical standards in the securities market and to protect investors

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85 Bainbridge, *supra* note 81, at 1591.

86 *Id.* at 1621.

87 *Id.*

88 *Id.* at 1634.

89 *Id.*

90 Fahey, *supra* note 81, at 508.

91 *Id.* at 524, 530.

92 John F. Manning, *What Divides Textualists from Purposivists?*, 106 COLUM. L. REV. 70, 71, 90 (2006).

93 Jeffrey L. Roether, Note, *Interpreting Congressional Silence: CAFA's Jurisdictional Burden of Proof in Post-Removal Remand Proceedings*, 75 FORDHAM L. REV. 2745, 2766 (2007).

94 Fahey, *supra* note 81, at 523.

95 *Id.* at 532.

from fraud."[96] Using a textualist approach to interpret § 10(b) is better than a purposivist approach because the textualist approach ensures that the already broad scope of § 10(b) does not expand uncontrollably.[97]

Other critics have argued that the misappropriation theory does not go far enough. Professor Donna M. Nagy of Indiana University Maurer School of Law argued that the misappropriation theory should be extended to a "fraud on the investors" theory of liability.[98] This theory contends "that investors in the marketplace are also deceived and defrauded when a person purchases or sells securities based on material, nonpublic information that has been misappropriated from the information's source."[99]

Professor Nagy argues that although the Court reached the right result in *O'Hagan*, its underlying rationale is faulty.[100] First, she challenges the *O'Hagan* Court's narrow reading of the misappropriation theory as potentially limiting the Government in future misappropriation cases that involve complex factual predicates.[101] Next, she questions the Court's rationale for the misappropriation theory as being "vulnerable to the charge that the misappropriation theory is only a pretext for enforcing the parity of information theory that was rejected in *Chiarella* and *Dirks*."[102] Finally, she claims that the Court's holding that the source of the information is the victimized party in the transaction is difficult to square with the Court's holdings concerning § 10(b) and Rule 10b-5 standing for private parties.[103]

This history of insider trading liability and the criticisms of the *O'Hagan* decision set the stage for the *Dorozhko* case, in which the Second Circuit endorsed a new theory of insider trading liability.

II. *SEC v. DOROZHKO*

A. *The Facts*

After the close of the market on October 17, 2007, IMS Health (IMS) planned to announce its yearly earnings, which were significantly below the

96 *Id.* at 533.

97 *Id.* at 532, 534.

98 Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-*O'Hagan *Suggestion*, 59 OHIO ST. L.J. 1223, 1223 (1998).

99 *Id.*

100 *Id.* at 1249.

101 *Id.* at 1251.

102 *Id.*

103 *Id.* Professor Nagy asserts that "[i]n cases involving insider trading premised on the misappropriation theory, neither of these provisions [Rule 10b-5 and § 20A of the Exchange Act] typically permit the source of the misappropriated information to recover damages from the person who used that information in connection with a securities transaction." *Id.* at 1281.

market's predictions.[104] As they had for several years, IMS planned to use Thomson Financial, Inc. (Thomson Financial) to provide the webcasting and delivery services for the release of their earnings.[105] Beginning on the morning of October 17, 2007, a computer hacker attempted numerous times throughout the day to hack into Thomson Financial's database to gain access to IMS's nonpublic earnings report.[106] At approximately 2:15 p.m., the hacker successfully downloaded IMS's earnings that Thomson had stored on its secured database.[107]

Approximately thirty minutes later, Oleksander Dorozhko, who opened an online trading account with Interactive Brokers, LLC (Interactive Brokers) on October 4, 2007, and deposited $42,500 into the account,[108] purchased 630 "out-of-the-money" put options (worth $41,670.90).[109] A few hours after Dorozhko purchased the put options, IMS announced that its third-quarter earnings did not reach analysts' projections and that earnings were only $0.29 per share.[110] When the market opened the following morning on October 18, 2007, IMS's stock price dropped from $29.56 to $21.20.[111]

By the close of the market on October 18, 2007, Dorozhko had sold all 630 put options in IMS, netting a profit of $286,456.59 in one day of trading.[112] Interactive Brokers noticed the irregular trading activity, froze Dorozhko's account, and notified the SEC.[113] The SEC filed a complaint in the Southern District of New York, alleging Dorozhko was the hacker based on "two undisputed events: (1) the fact of the hack, and (2) the proximity to the hack of the trades by [defendant,] who was the only individual

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104 SEC v. Dorozhko, 606 F. Supp. 2d 321, 325 (S.D.N.Y. 2008), *vacated*, 574 F.3d 42 (2d Cir. 2009). IMS had publicly disclosed its plans as early as October 9, 2007. *Id.*

105 *Id.*

106 *Id.* The hacker's IP address was registered in the Netherlands. *Id.* at 325, n.3. The hacker tried to gain access to Thomson Financial's info on IMS at approximately 8:06 a.m., 12:10 p.m., 12:51 p.m., and 1:52 p.m. *Id.* at 325.

107 *Dorozhko*, 606 F. Supp. 2d at 326.

108 *Id.* at 324-25 (citing Second Decl. of Paul A. Gumagay, Counsel to the SEC, in Supp. of a Prelim. Inj. ¶¶ 3-5). In his application for the account, Dorozhko stated his annual income to be $45,000 to $50,000, roughly the same amount as he wired into the account. *Id.* at 325.

109 *Id.* at 326. 300 of the put options had a strike date of October 25, and 330 put options had a strike date of October 30, 2007. *Id.* In order for Dorozhko to realize any profit and not incur a substantial loss, the price of IMS stock must decline prior to the strike dates. Thus, Dorozhko's purchases indicate that he strongly believed that IMS stock was going to decline in price shortly after IMS's public release of its earnings.

110 *Id.*

111 *Dorozhko*, 606 F. Supp. 2d at 326. IMS stock traded $29.56 at the close of the market on October 17, 2007 prior to IMS's announcement of its yearly earnings. The price drop at the opening of the market the next morning was 28%, which is approximately the same percentage as IMS's earnings report came under analysts' predictions. *Id.*

112 *Id.* at 326-27.

113 *Id.* at 327.

to trade heavily in IMS put options subsequent to the hack."[114] The district court issued a temporary restraining order freezing Dorozhko's account while it considered the merits of the complaint.[115]

B. *The District Court's Ruling*

The district court began its analysis by setting forth the elements for Rule 10b-5 liability: "(1) a 'device or contrivance'; (2) which is 'manipulative or deceptive'; and (3) used 'in connection with' the purchase or sale of securities."[116] The court held that the facts supported a finding that the alleged hacking and trading satisfied the "device or contrivance" element.[117] Relying on the Supreme Court's decision in *Ernst & Ernst v. Hochfelder* which stated that the definition of a device includes "a scheme to deceive; . . . an artifice[,]"[118] the district court stated that Dorozhko's alleged hacking was certainly a scheme or artifice that presented the requisite intent to defraud.

The district court further stated that Dorozhko's actions satisfied the "in connection with" requirement.[119] The court cited *Zandford* as the leading case for determining the "in connection with" element; which required a showing that the alleged fraudulent scheme and the securities transactions "coincide."[120] In *Dorozhko*, the time between the alleged hacks and the purchase of the 630 put options was approximately thirty minutes.[121] The district court concluded that these two acts coincided together as part of a single fraudulent scheme,[122] and that the information Dorozhko stole from Thomson Financial's database retained no value apart from the securities transaction.[123] Thus, the stolen information's contingent value and the closeness in time between the hack and the subsequent securities transac-

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114 *Id.* at 323.

115 SEC v. Dorozhko, 574 F.3d 42, 44-45 (2d Cir. 2009).

116 *Dorozhko*, 606 F. Supp. 2d at 328.

117 *Id.*

118 *Id.* at 328 (citing Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976)).

119 *Id.* at 328.

120 *Id.* at 328-29; *see also* SEC v. Zandford, 535 U.S. 813, 822 (2002) ("It is enough that the scheme to defraud and the sale of securities coincide.").

121 *Dorozhko*, 606 F. Supp. 2d at 326, 329.

122 *Id.* at 329; *see also Zandford*, 535 U.S. at 824-25 (finding that a sale of securities and a deceptive device coincided, and therefore met the "in connection with" requirement in part because the embezzled securities "did not have value . . . apart from their use in a securities transaction and the fraud was not complete before the sale of securities occurred.").

123 *Dorozhko*, 606 F. Supp. 2d at 329. This comports with the analogy the Court drew in *O'Hagan* about the distinction between an embezzler of money versus an embezzler of information. *See supra* text accompanying note 63.

tions led the district court to find that Dorozhko's hacking was "part of a scheme that was 'in connection with' the purchase or sale of securities."[124]

However, the district court stated that Dorozhko's actions did not satisfy the "manipulative or deceptive" element.[125] The SEC conceded that Dorozhko's scheme was not "manipulative," relying solely on the theory that Dorozhko's hacking was "deceptive."[126] Citing *Zandford*, the SEC argued "that any fraudulent scheme that contains the requisite nexus to a securities transaction constitutes securities fraud . . . . [I]t is not Dorozhko's alleged trades themselves that work a deception, but rather Dorozhko's scheme taken as a whole."[127]

The district court rejected this argument, stating that *Zandford* "reaffirms both the [classic] and misappropriation theories of insider trading insofar as they require a breach of fiduciary duty of disclosure as the basis for liability under § 10(b)."[128] The district court relied upon *Zandford*, which held that it was Zandford's breach of his fiduciary duty to his client, and not the theft, that constituted the "deceptive" element giving rise to § 10(b) liability.[129] The district court analogized Justice Stevens' hypothetical, footnoted at the end of the *Zandford* opinion, to Dorozhko's situation.[130] The hypothetical stated that had Zandford disclosed his theft to the client, the disclosure would preclude § 10(b) liability.[131] As a result, the district court stated that "there can be no 'deception' . . . absent the existence and breach of a fiduciary duty."[132]

On January 8, 2008, the district court denied the SEC's motion for a preliminary injunction, stating that the SEC was not likely to succeed on the merits of its claim of a § 10(b) violation against Dorozhko.[133] The SEC subsequently appealed.

C. *The Second Circuit's Ruling*

The question presented on appeal was "whether . . . computer hacking may be 'deceptive' where the hacker did not breach a fiduciary duty in fraudulently obtaining material, nonpublic information used in connection with the purchase or sale of securities."[134] The district court held that "a

124 *Dorozhko*, 606 F. Supp. 2d at 329.
125 *Id.* at 343.
126 *Id.* at 329.
127 *Id.* at 336.
128 *Id.* at 337.
129 *Id.* at 338.
130 *Dorozhko*, 606 F. Supp. 2d at 338.
131 *Id.*
132 *Id.*
133 *Id.* at 343.
134 SEC v. Dorozhko, 574 F.3d 42, 43-44 (2d Cir. 2009).

breach of a fiduciary duty of disclosure is a required element of any 'deceptive' device under § 10(b)."[135] The SEC argued that the computer hacking, which involved numerous misrepresentations, established the requisite deceptive act for the case.[136]

The Second Circuit began its analysis by discussing the proper way to interpret ambiguous language in a statute.[137] First, the court must examine if there is any existing precedent, from either the Supreme Court or from the Second Circuit's prior holdings, "which provide definitive interpretations of otherwise ambiguous language."[138] If there is no binding precedent, a court should next look to the "'language itself, the specific context in which that language is used, and the broader context of the statute as a whole.'"[139] If the language itself offers no definitive interpretation, then the court must utilize the tenets of statutory construction, and finally legislative history.[140]

The district court, relying upon *Chiarella*, *O'Hagan*, and *Zandford*, stated, "as this review of case law makes clear, whether the [SEC] is relying on the traditional or misappropriation theories of insider trading, or a separate scheme theory as pursued in *Zandford*, it cannot establish a violation of § 10(b) absent a breach of a fiduciary duty to disclose or abstain."[141] The Second Circuit, however, interpreted these cases differently and distinguished them by stating that the fraud in these cases "was silence or nondisclosure, not an affirmative misrepresentation."[142] The Second Circuit distinguished between fraud based either, on an affirmative misrepresentation or on an omission, stating "[w]hile *Chiarella*, *O'Hagan*, and *Zandford* all dealt with fraud *qua* silence, an affirmative misrepresentation is a distinct species of fraud. Even if a person does not have a fiduciary duty to 'disclose or abstain from trading,' there is nonetheless an affirmative obligation in commercial dealings not to mislead."[143]

The Second Circuit acknowledged the distinction the SEC drew that Dorozhko "affirmatively misrepresented himself in order to gain access to material, nonpublic information, which he then used to trade[;]"[144] rather than "fraudulent[ly] remain[ing] silent in the face of a 'duty to disclose or abstain' from trading."[145] The Second Circuit then accepted the SEC's interpretation of *Chiarella*, *O'Hagan*, and *Zandford*, stating that "misrepre-

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135 *Id.* at 45 (quoting *Dorozhko*, 606 F. Supp. 2d at 330).

136 *Id.*

137 *See id.* at 46.

138 *Id.* at 46.

139 *Id.* (quoting United States v. Magassouba, 544 F.3d 387, 404 (2d Cir. 2008)).

140 *Dorozhko*, 574 F.3d at 46.

141 SEC v. Dorozhko, 606 F. Supp. 2d 321, 338 (S.D.N.Y. 2008).

142 *Dorozhko*, 574 F.3d at 48.

143 *Id.* at 49 (citing Basic Inc. v. Levinson, 485 U.S. 224, 240 n.18 (1988)).

144 *Id.*

145 *Id.*

sentations are [always] fraudulent, but . . . silence is fraudulent only if there is a duty to disclose."[146]

By designating the issue in *Dorozhko* as one that deals with an affirmative misrepresentation rather than "fraud *qua* silence," the Second Circuit rejected the established precedent in *Chiarella* and its progeny that a fiduciary relationship was required for § 10(b) liability.[147] As such, the Second Circuit looked at the language of § 10(b) and Rule 10b-5 and found that the definition of "deceptive" meant "tending to deceive[;]" and that "deceive" means "to cause to believe the false, or to disbelieve the true."[148] The Second Circuit then stated, "[i]n light of this ordinary meaning, it is not at all surprising that Rule 10b-5 equates 'deceit' with 'fraud.'"[149]

Next, the Second Circuit acknowledged that the SEC altered its argument on appeal, advocating that "[computer h]ackers either (1) 'engage in false identification and masquerade as another user['] . . . or (2) 'exploit a weakness in [an electronic] code within a program to cause the program to malfunction in a way that grants the user greater privileges.'"[150] The Second Circuit stated that the first theory, misrepresenting one's identity to gain access, is clearly deceptive.[151] As for the exploitation of a weakness in a computer code, the Second Circuit refrained from determining whether that is deceptive per se, as it may only constitute "mere theft."[152] Because the district court had not determined how Dorozhko gained access to Thomson Financial's database, the Second Circuit remanded the case back to the district court to determine that issue and whether Dorozhko's computer hacking in this case was "deceptive," consistent with the Second Circuit's holding.[153]

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146 *Id.* at 50 (quoting Opening Brief of the Securities and Exchange Commission at 44 SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009) (No. 08-0201-CV)).

147 *Id.* at 49.

148 *Dorozhko*, 574 F.3d at 50 (quoting WEBSTER'S INTERNATIONAL DICTIONARY 679 (2d ed. 1934)). The U.S. Supreme Court also cited WEBSTER'S INTERNATIONAL DICTIONARY for the term "deceptive" in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 199 (1976). *See supra* text accompanying note 103.

149 *Dorozhko*, 574 F.3d at 50 (citing 17 C.F.R. § 240.10b-5) (prohibiting "any untrue statement of a material fact . . . or . . . *any act, practice, or course of business* which operates or would operate as a *fraud or deceit* upon any person, in connection with the purchase or sale of any security" (emphasis added)).

150 *Id.* at 50-51 (quoting Opening Brief of the Securities and Exchange Commission at 22-23 SEC v. Dorozhko, 574 F.3d 42 (2d Cir. 2009) (No. 08-0201-CV)).

151 *Id.* at 51.

152 *Id.*

153 *Id.*

III. ANALYSIS OF THE SECOND CIRCUIT'S OPINION IN *SEC V. DOROZHKO*

The Second Circuit based its decision in *Dorozhko* on the distinction it drew in the Supreme Court's and its own decisions dealing with insider trading. The Second Circuit distinguished cases in which the trader fraudulently remained silent versus a case where the trader affirmatively misrepresented himself.[154] This distinction, according to the Second Circuit, is critical because there is no current precedent holding that an affirmative misrepresentation also requires a breach of a fiduciary duty in order to establish insider trading liability.[155] This reasoning begs the question, whether there is an analytical basis for distinguishing between affirmative misrepresentations and fraudulently remaining silent, for liability in insider trading cases.

A. *Affirmative Misrepresentation Versus Material Omissions*

The linchpin for the Second Circuit's holding in *Dorozhko* is that there is an analytical basis for distinguishing between affirmative misrepresentations and material omissions in insider trading cases. Based on this distinction, the Second Circuit carved out an unprecedented exception to the fiduciary duty requirement for insider trading liability under § 10(b) and Rule 10b-5. While there is clearly a distinction in how each type of fraud is committed, the pertinent issue for this case is whether this distinction is one that permits a proper basis for carving out an exception to the requirement of a fiduciary relationship for insider trading liability under § 10(b), for affirmative misrepresentation cases.

As a threshold matter, the Court stated in *Superintendent of Insurance of NewYork v. Bankers Life & Casualty Co.* that § 10(b) "must be read flexibly, not technically and restrictively."[156] The Court concluded in *Bankers Life* that "[s]ince there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under § 10(b), whatever might be available as a remedy under state law."[157]

While the issue presented to the Second Circuit in *Dorozhko* dealt specifically with the "deceptive" element of § 10(b), liability under § 10(b) has three elements that must be satisfied: "(1) a 'device or contrivance'; (2) which is 'manipulative or deceptive'; and (3) used 'in connection with' the purchase or sale of securities."[158] Assuming *arguendo* that the Second Circuit is correct that the different types of fraud require different tests, the "in

154 *Id.* at 50.

155 *See Dorozhko*, 574 F.3d at 49.

156 Superintendent of Ins. of N.Y. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

157 *Id.*

158 SEC v. Dorozhko, 606 F. Supp. 2d 321, 328 (S.D.N.Y. 2008).

connection with" element of § 10(b) must still be satisfied.[159] Taking a broader view of the *Dorozhko* case, the issue is not only whether the alleged hacking is deceptive, but also whether Dorozhko's alleged hacking is sufficiently "in connection with" the purchase or sale of securities. If the affirmative misrepresentation is not found to be "in connection with" the purchase or sale of securities, the Second Circuit's exception may well be moot. An analysis of the key characteristics of these two types of fraud in light of this view illuminates why the Second Circuit's distinction is ultimately unsatisfactory for insider trading liability purposes.

First, for the fraud of material omission, the fraud is complete for § 10(b) purposes once the person trades on the basis of the material, nonpublic information without disclosing the source of the information.[160] Thus, as stated above, the fraud of a material omission and the securities transaction "coincide" because the fraud cannot be completed until the undisclosed or unauthorized securities transaction takes place.[161] Thus, if O'Hagan never used the information to effectuate a securities transaction, no fraud would have occurred for § 10(b) purposes.[162]

The fraud of an affirmative misrepresentation, however, contains a temporal aspect not present in a material omission. An affirmative misrepresentation is predicated upon an effort to mislead the recipient concerning a present or future transaction.[163] The key here is that the fraud occurs the moment the false or misleading statement occurs; it is at this time that the recipient is deceived. Unlike the fraud of a material omission, the fraud in an affirmative misrepresentation does not require any subsequent use or transaction using the fraudulently obtained information for the fraud to be complete.

In the present case, the "deceptive act" was Dorozhko's alleged hacking on October 17, 2007. This deceptive act was complete the moment that Dorozhko hacked into Thomson Financial's database and stole the information—no subsequent action was required to consummate the fraud. Thus, even assuming that computer hacking may be a "deceptive device"

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159 For purposes of this article, the first element, the "device or contrivance," is assumed not to be at issue.

160 United States v. O'Hagan, 521 U.S. 642, 656 (1997).

161 *Id.*

162 *Id.* at 643 (citing Chiarella v. United States, 445 U.S. 222, 228-229 (1980)).

163 The Court has held that an affirmative misrepresentation can occur when a company releases public statements that the company denied any knowledge of any potential corporate mergers. *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988). The issue in *Basic Inc. v. Levinson* was whether investors who sold their stock in the company could rely on the affirmative misrepresentations made by the company in the months prior to their sales of company stock in a § 10(b) suit against the company. *Id.* at 226.

for § 10(b) purposes, it is not clear that the affirmative misrepresentation would be "in connection with" the purchase or sale of securities.[164]

However, the SEC maintained that the information Dorozhko stole did not have any value outside of a securities transaction. Thus, Dorozhko did not complete the fraud until he used the stolen information in the subsequent securities transaction. Accordingly, the SEC argued that the court should focus on the whole scheme, not the initial fraudulent act of computer hacking, to determine if the deceptive act is "in connection with" the purchase or sale of securities.[165] The district court, relying upon *Zandford*'s "in connection with" test, which requires the deceptive act and the purchase or sale of securities to "coincide," agreed with the SEC that the "in connection with" element was satisfied.[166] The district court stated that, "[t]he hack and the subsequent purchases were clearly part of a single scheme, which was not complete until the securities transactions took place."[167]

This reasoning by the SEC and the district court, however initially appealing it may be, runs into problems. Since the Second Circuit distinguished this case as one involving an affirmative misrepresentation, the temporal aspect of an affirmative misrepresentation must be addressed. Dorozhko's allegedly deceptive act was the computer hack itself. When Dorozhko hacked into the database he completed the fraudulent act—it did not require any subsequent transaction to consummate the fraud. In *Zandford*, the broker's undisclosed sales of his client's securities over a two-year period were sufficiently "in connection with" the purchase or sale of securities because "each sale was made to further [Zandford's] fraudulent scheme; each was deceptive because it was neither authorized by, nor disclosed to, the [clients]."[168]

The issue in *Dorozhko* thus becomes whether Dorozhko's act of computer hacking should be characterized as a complete fraudulent act or as part of a fraudulent scheme that involved computer hacking and the purchase of securities. The deceptive act in *Zandford* was the securities broker's material omission to his client about the broker's securities transactions in the client's investment account.[169] The Court in *Zandford* held that each sale by the broker was deceptive because the broker did not have the

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[164] The Second Circuit did not discuss the "in connection with" element, as the court in this case focused solely on whether the hacking itself satisfied the "deceptive" element of § 10(b). The Court should be cognizant, however, that should the district court on remand find that Dorozhko misrepresented himself in order to gain access to the database, the "in connection with" issue must then be decided as well. However, for purposes of distinguishing affirmative misrepresentations from material omissions, the time when the fraud is consummated is a key distinction.

[165] *See Dorozhko*, 606 F. Supp. 2d at 336.

[166] *Id.* at 328-29.

[167] *Id.* at 329.

[168] SEC v. Zandford, 535 U.S. 813, 820-21 (2002).

[169] *Id.* at 820.

client's authorization for the sales of the client's securities.[170] The Court concluded that the deception was in connection with the sale of securities for purposes of § 10(b) because the breach of the broker's fiduciary duties coincided with the securities transactions.[171]

In *Dorozhko*, however, the fraudulent act was an affirmative misrepresentation that was complete the moment the hacker stole the information from the database. Dorozhko then made a subsequent transaction in which he purchased the securities in IMS. Unlike in *Zandford*, Dorozhko did not breach a fiduciary duty. Consequently, the type of deception in *Zandford* is distinguishable from the type in *Dorozhko*. This distinction affects whether the "in connection with" element can be satisfied. According to the *O'Hagan* Court, an embezzler of information does not commit actionable fraud under § 10(b) until the embezzled information has been used in a securities transaction.[172] Dorozhko cannot be characterized as an embezzler of information because Dorozhko never lawfully possessed the information.[173] Scheme liability in *Zandford* occurred because the fiduciary breach and the securities transaction happened at the same time.[174] In *Dorozhko* since he did not breach a fiduciary duty, there was no similar concurrence of events.

The Second Circuit remanded the case for the district court to determine whether computer hacking is deceptive and whether any affirmative misrepresentation occurred in this case.[175] The Second Circuit recognized that "misrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive' within the ordinary meaning of the word."[176] Thus, it appears that the Second Circuit recognizes that the deceptive act of an affirmative misrepresentation is complete once the theft of the material, nonpublic information occurs.[177]

To satisfy the "in connection with" element on remand, the SEC must argue that the affirmative misrepresentation of the computer hack was part of a fraudulent scheme not consummated until Dorozhko purchased the securities. In other words, the theft of material, nonpublic information is deceptive by itself, but when the deception is used in the context of an insider trading case, it is not complete until the purchase or sale of securities has occurred. Unlike the fraudulent scheme in *Zandford* where the broker breached a duty to disclose at the time of the securities transaction,[178] in

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170 *See id.* at 820-21.

171 *Id.* at 825.

172 United States v. O'Hagan, 521 U.S. 642, 656 (1997).

173 *See generally* 26 AM. JUR. 2D *Embezzlement* § 1 (2010).

174 *Zandford*, 535 U.S. at 825.

175 SEC v. Dorozhko, 574 F.3d 42, 50-51 (2d Cir. 2009).

176 *Id.* at 51.

177 *See id.*

178 *Zandford*, 535 U.S. at 820.

Dorozhko, there was not a duty to speak at the time of the securities transaction. The Court in *Zandford* used the embezzlement-of-money analogy from *O'Hagan*,[179] and stated that the client's "securities did not have value for [Zandford] apart from their use in a securities transaction and *the fraud was not complete before the sale of securities occurred*."[180] Given that the fraud in an affirmative misrepresentation case is complete prior to any subsequent securities transaction, the "in connection with" element may present a sizable obstacle for the SEC on remand. Thus, analyzing the case under all three elements for Rule 10b-5 liability, holding Dorozhko liable for insider trading, would entail expansion of the "deceptive act or contrivance" and the "in connection with" elements.

B. *Necessity of Identifying a Breach of Fiduciary Duty*

After assuming that the distinction between affirmative misrepresentations and omissions provided sufficient grounds for carving out an exception for fraud based on an affirmative misrepresentation, the Second Circuit held that a fiduciary duty is not required based on either the language of § 10(b) or the Supreme Court's holdings. The Second Circuit asserted that "what is sufficient is not always what is necessary, and none of the Supreme Court opinions considered by the district court (*Chiarella*, *O'Hagan*, and *Zandford*) *require* a fiduciary relationship as an element of an actionable securities claim under Section 10(b)."[181]

However, assuming *arguendo* that the Second Circuit is correct that a significant distinction can be made between an affirmative misrepresentation and a material omission, there is still a strong justification for requiring a fiduciary relationship as an element of liability under § 10(b) and Rule 10b-5. In 1952, the Second Circuit held in *Birnbaum v. Newport Steel Corp.* that § 10(b) and Rule 10b-5 only applied to actual "purchasers or sellers" of securities, and that investors who were dissuaded from purchasing securities based on fraud by corporate insiders in a misleading prospectus were not "purchasers" of securities.[182] Addressing this issue over twenty years later, the Supreme Court held in *Blue Chip Stamps v. Manor Drug Stores* that:

> The longstanding acceptance by the courts, coupled with Congress'[s] failure to reject Birnbaum's reasonable interpretation of the wording of § 10(b), wording which is directed toward

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179 *See supra* text accompanying note 63.

180 *Zandford*, 535 U.S. at 824-25 (emphasis added).

181 *Dorozhko*, 574 F.3d at 49 (emphasis in original).

182 Birnbaum v. Newport Steel Corp., 193 F.2d 461, 463 (2d Cir. 1952).

> injury suffered 'in connection with the purchase or sale' of securities, argues significantly in favor of acceptance of the Birnbaum rule by this Court.[183]

Thus, the Supreme Court recognized that continued congressional silence and routine application by lower courts in the wake of a court's reasonable interpretation of a statute provided strong evidence that the interpretation aligned with Congress's purpose or intent in enacting the statute.[184]

Pertinent to the case at hand, *Chiarella* (decided in 1980) established that a fiduciary duty is necessary for insider trading liability under § 10(b) and Rule 10b-5.[185] Consistent with *Chiarella*, the Supreme Court continued to require a fiduciary relationship as an element of an actionable securities claim under § 10(b) in *Dirks* (decided in 1983) and in *O'Hagan* (decided in 1997). During this thirty-year period between *Chiarella* and *Dorozhko*, Congress has not amended § 10(b) or Rule 10b-5 to exclude the fiduciary duty requirement that *Chiarella* initially established. Congressional silence during this period, coupled with the longstanding acceptance of this requirement by lower federal courts, strongly supports the conclusion that Congress intended, or at least has come to accept, that insider trading liability under § 10(b) and Rule 10b-5 requires a fiduciary relationship.

The Second Circuit's decision also mistakenly assumes that the ability to distinguish the type of fraud in *Dorozhko* from that in *Chiarella* and its progeny means that the distinction is significant enough to permit carving out an exception. The congruence among all three theories of insider trading (classic, tipper-tippee, and misappropriation) is the requirement that a fiduciary duty must exist in order for insider trading liability to attach.[186] As discussed above, the Supreme Court in *O'Hagan* had the opportunity to carve out the Second Circuit's proposed exception but declined to do so. The *O'Hagan* Court went to great pains to find a fiduciary duty that O'Hagan owed as the juridical hook on which to premise insider trading liability.[187] The *O'Hagan* Court, in line with the longstanding acceptance that a fiduciary relationship is required for insider trading liability, found that O'Hagan owed a duty to the source of the information, and that by trading on the information without a disclosure to the source, O'Hagan breached the fiduciary duty.[188] The breach of fiduciary duty fulfills the deceptive act requirement.[189] Since this deception is only complete upon the

183 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 (1975).

184 *Id.*

185 Chiarella v. United States, 445 U.S. 222, 231-32 (1980).

186 *See* discussion *supra* in Parts I.A-C.

187 *See generally* discussion *supra* Part I.C.

188 United States v. O'Hagan, 521 U.S. 642, 652 (1997).

189 *See generally O'Hagan*, 521 U.S. at 656.

purchase or sale of the securities transaction in violation of that fiduciary duty, the "in connection with" element is also satisfied.[190]

The Court reinforced this fiduciary duty requirement in *Zandford* when it stated that had Zandford informed his client that he planned to steal his client's assets, this breach would not have violated securities law, even though it was a breach of fiduciary duty.[191] Though the breach would have been in connection with the purchase or sale of securities, it would not give rise to a § 10(b) violation because it was not a "deceptive device or fraud."[192] Congress's failure to amend § 10(b) or Rule 10b-5 to exclude this fiduciary duty requirement strongly supports the conclusion that a fiduciary relationship is not only sufficient—it is necessary.

There are also policy reasons for requiring the existence of a fiduciary duty for insider trading liability to apply. First, this bright-line rule provides clear guidance to lower courts on what constitutes "deception" when determining whether a person is liable for insider trading—there must be a breach of a fiduciary duty. This threshold requirement would also help ensure uniform application of insider trading liability. Should the Second Circuit's opinion stand, the lower courts must then decide what constitutes a sufficient showing of an affirmative misrepresentation. This added layer of complexity would bog down the lower courts in making these factual determinations and could result in non-uniform application of the law. A chief objective of the law is to provide clear guidance to the public on what is legally acceptable behavior. Therefore, a law that is obscure, heavily fact-dependent, and inconsistently applied misses the mark.

The Second Circuit's *Dorozhko* decision is also unclear as to which party is being deceived. The Second Circuit stated that, "misrepresenting one's identity in order to gain access to information that is otherwise off limits, and then stealing that information is plainly 'deceptive' within the ordinary meaning of the word."[193] While this characterization of the term "deceptive" may be true, it overly simplifies and fails to acknowledge that "deceptive" is a term of art for § 10(b) purposes.

Using the Second Circuit's gloss of the term "deceptive" would capture behavior that has never given rise to insider trading liability. A thief who misrepresents himself to a security guard by wearing a mask of a company officer; steals material, nonpublic information; and trades on it has not been traditionally thought of as committing insider trading.[194] However, under the Second Circuit's definition of "deceptive," this masked thief may be liable. On the other hand, if the thief sneaks into the building by exploiting a weakness in its security, steals the same information, and trades on it,

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190 *Id.*

191 SEC v. Zandford, 535 U.S. 813, 825 n.4 (2002).

192 *Id.*

193 SEC v. Dorozhko, 574 F.3d 42, 51 (2d Cir. 2009).

194 *See* Nagy, *supra* note 98, at 1253.

the thief may not be liable. Given that the only difference between these instances is the thief's method of stealing information, it makes little sense to hold the thief liable for insider trading in the first instance but not in the second.

Some legal scholars, however, have advocated for expanding insider trading liability. In their view, thieves who steal material, nonpublic information and trade on it should be liable under § 10(b) and Rule 10b-5. Professor Robert Steinbuch of the University of Arkansas at Little Rock's William H. Bowen School of Law has observed that the Computer and Fraud Abuse Act[195] defines fraud in connection with computers as involving both the unauthorized access to and obtainment of information from a protected computer.[196] Professor Steinbuch concludes that computer hacking meets this standard and would seem to convincingly fall under "Rule 10b-5's simple fraud prohibition."[197] Professor Steinbuch then argues that case law concerning the misappropriation theory has moved back toward the parity-of-information standard discussed in *Chiarella*.[198] Given this reversion to the parity-of-information standard, Professor Steinbuch argues that, "the

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195 18 U.S.C. § 1030(a) (2008), known as the Computer and Fraud Abuse Act, states, in pertinent part:

> (a) Whoever–
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> . . . .
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> (2) intentionally accesses a computer without authorization or exceeds authorized access, and thereby obtains
> (A) information contained in a financial record of a financial institution, or of a card issuer as defined in section 1602(n) of title 15, or contained in a file of a consumer reporting agency on a consumer, as such terms are defined in the Fair Credit Reporting Act (15 U.S.C. 1681 *et seq.*);
> (B) information from any department or agency of the United States; or
> (C) information from any protected computer;
>
> . . . .
>
> (4) knowingly and with intent to defraud, accesses a protected computer without authorization, or exceeds authorized access, and by means of such conduct furthers the intended fraud and obtains anything of value, unless the object of the fraud and the thing obtained consists only of the use of the computer and the value of such use is not more than $5,000 in any 1-year period;
>
> . . . .
>
> (7)(C) shall be punished as provided in subsection (c) of this section.
>
> . . . .
>
> (c) The punishment for an offense under subsection (a) or (b) of this section is
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> . . . .
>
> (3)(A) a fine under this title or imprisonment for not more than five years, or both, in the case of an offense under subsection (a)(4) or (a)(7) of this section which does not occur after a conviction for another offense under this section, or an attempt to commit an offense punishable under this subparagraph; and
> (B) a fine under this title or imprisonment for not more than ten years, or both, in the case of an offense under subsection (a)(4) or (a)(7) of this section which occurs after a conviction for another offense under this section, or an attempt to commit an offense punishable under this subparagraph.

Computer and Fraud Abuse Act, 18 U.S.C. § 1030(a) (2008).

196 Robert Steinbuch, *Mere Thieves*, 67 MD. L. REV. 570, 592 (2008).

197 *Id.*

198 *Id.* at 606.

courts should replace the fiduciary duty requirement in the fraud-on-the-source approach of the misappropriation theory with the parity-of-information doctrine and a fraud-on-the-market approach."[199]

Professor Steinbuch acknowledges the response to his proposal: if Congress wants to include "mere thieves" as violators of the federal securities laws, then Congress should amend the law to include them explicitly.[200] Furthermore, imposing punishment for actions that the law does not clearly and explicitly prohibit presents a clear due process issue.[201] The rule of lenity states that an ambiguous statute should be read in the defendant's favor "for those situations in which a reasonable doubt persists about a statute's intended scope even after resort to 'the language and structure, legislative history, and motivating policies' of the statute."[202]

One can argue that the animating purpose and legislative history of the federal securities laws is to "insure the maintenance of fair and honest markets in [securities] transactions."[203] However, one must read this broad purpose in the context of the development of insider trading liability under § 10(b) and Rule 10b-5. In *Dorozhko*, the district court asserted that "no federal court has ever held that those who steal material nonpublic information and then trade on it violate § 10(b)."[204] This fact strongly supports application of the rule of lenity to interpret § 10(b) in Dorozhko's favor. Until Congress amends § 10(b) and Rule 10b-5 to explicitly include thieves, the courts should not refashion the law to achieve an equitable result. This is especially the case when criminal statutes may adequately address Dorozhko's fraudulent behavior.

C. *Alternative Deterrents*

The Supreme Court stated in *Blue Chip Stamps* that congressional silence and longtime acceptance of the lower courts' reasonable judicial interpretation of a statute is strong evidence that the Supreme Court would accept this interpretation.[205] Instead of expanding the scope of liability under § 10(b), the Supreme Court should focus on remedies currently available in the criminal statutes. As mentioned above, the Computer and Fraud Abuse Act (CFAA)[206] is one available alternative. The CFAA imposes liability for the unauthorized access of a protected computer, with punishment

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199 *Id.*

200 *Id.* at 612.

201 *See* Dunn v. United States, 442 U.S. 100, 112 (1979).

202 *See* Moskal v. United States, 498 U.S. 103, 108 (1990).

203 *See* 15 U.S.C.A. § 78b (West 2010).

204 SEC v. Dorozhko, 606 F. Supp. 2d 321, 339 (S.D.N.Y. 2008).

205 Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 (1975).

206 Computer and Fraud Abuse Act, 18 U.S.C. § 1030(a) (2008). *See supra* text accompanying note 195.

of either, up to five years' imprisonment or a $1,000 fine, or both, for a first time offense.[207] For a second offense, the fine increases to $5,000 and the sentence to ten years' imprisonment.[208] Another available alternative is the Mail Fraud and Wire Fraud Statute, which imposes liability for fraudulent schemes using the mail or wire services, with a fine of up to one million dollars and a sentence of twenty to thirty years' imprisonment.[209]

Both of these fraud statutes impose a prison term, a fine, or both, but they do not include a disgorgement remedy. Amending these statutes to include a disgorgement provision for any ill-gotten gains achieved from violating these statutes would not be too difficult. However, amending § 10(b) and Rule 10b-5 to include thieves would require much more legislative work. Such an amendment would also face numerous hurdles prior to becoming law.[210] However, it is ultimately Congress's constitutional duty to legislate.[211] Therefore, amending § 10(b) and Rule 10b-5 through the legislative process is clearly preferable to judicial expansion. A legislative amendment would also stand on stronger legal footing if challenged in court.

CONCLUSION

The Second Circuit impermissibly carved out an exception to the traditional requirement in insider trading cases that there must be a fiduciary relationship in order for liability to exist under § 10(b) and Rule 10b-5. *Chiarella*, *O'Hagan*, and *Zandford* all required a breach of a fiduciary duty for insider trading liability to attach. The Supreme Court recognized that the "longstanding acceptance by the courts" and the "failure of Congress to correct" a reasonable interpretation of a statute is strong support that the Court would accept the interpretation.[212] Thus, there must exist strong justifications for departing from this interpretation. The Second Circuit's distinction between frauds based on affirmative misrepresentations versus material omissions does not provide this justification. The Second Circuit's exception would expand the scope of insider trading liability to include persons who have never been traditionally considered as falling within the confines of securities law violations.

Furthermore, assuming the computer hacking and theft of information constitutes a "deceptive act," it is not clear that this fraudulent scheme was

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207 *Id.*

208 *Id.*

209 *See* 18 U.S.C. §§ 1341, 1343 (2008).

210 Potential issues include whether this should be delegated to the SEC, whether this expansion of insider trading liability is warranted or preferable, and whether this expansion is consistent with the original intent of the Exchange Act.

211 *See* U.S. CONST. art. I.

212 *See* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 733 (1975).

"in connection with" the purchase of securities. This is due to the fact that the fraud present in a material omission is not complete until the unauthorized or non-disclosed securities transaction occurs, whereas the deception in an affirmative misrepresentation case is complete prior to any subsequent securities transaction. Thus, in order for this exception to be viable, two elements of §10(b) liability would likely need to be expanded.

This expansion of liability in insider trading cases is unnecessary where there already exist remedies in the criminal law context that address this sort of fraudulent behavior. A better alternative would be for Congress to amend one of the current criminal statutes that already address computer and wire fraud to include a disgorgement provision of all ill-gotten gains from the fraudulent activity. If the Supreme Court ultimately decides to hear this case, it should reject the Second Circuit's current gloss on the definition of "deceptive device" and return to the traditional definition, implicitly accepted by the federal courts and Congress, that requires the existence of a fiduciary relationship for liability under §10(b) and Rule 10b-5.

NARROWING THE DISCLOSURE GAP: IS EMMA EDGAR FOR THE MUNICIPAL SECURITIES MARKET?

*Tesia Nicole Stanley**

INTRODUCTION

Financial federalism in the United States gives state and local governments free reign to use public finance as an engine for development.[1] In the late 1800s, as the number and population of U.S. cities grew, so did the country's interest in municipal securities.[2] During this time, local governments used municipal bonds to finance the construction of the Brooklyn Bridge,[3] the assembly of Milwaukee's Mineral Point Railroad,[4] and Chicago's hosting of the World's Fair.[5] By 1893, approximately $200 million in municipal securities were outstanding in the State of New York.[6] Over 70% of these securities were held by city savings banks.[7]

Investor interest in the municipal securities market continues to grow at a strikingly fast pace,[8] as the size and face of the U.S. market have transformed dramatically over time. The municipal securities market has grown

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1 *See* FREDERICK THOMPSON, HANDBOOK OF PUBLIC FINANCE 349-50 (Fred Thompson & Mark T. Green eds., New York Marcel Dekker, Inc. 1998). Construction of the nation's highways, water and sewer systems, parks, and courthouses were financed through issuing municipal bonds. *See States to Put Out $400,000,000 Bonds*, N.Y. TIMES, Apr. 27, 1924, at E10.

2 *Financial Affairs*, N.Y. TIMES, May 22, 1892, at 11. The term "municipal securities" includes all long-term and short-term debt securities issued by states, local governments, and conduit borrowers.

3 *See The Board of Apportionment*, N.Y. TIMES, June 9, 1876, at 2; *The Brooklyn Bridge*, N.Y. TIMES, June 24, 1872, at 5.

4 *Law Reports*, N.Y. TIMES, May 22, 1866, at 2.

5 *Bonds for the World's Fair*, N.Y. TIMES, Dec. 5, 1890, at 4. The Chicago World's Fair, also known as the World's Columbian Exposition, celebrated the 400th year anniversary of Christopher Columbus disembarking on American soil. *See The World's Columbian Exposition*, http://www.chicagohs.org/history/expo.html (last visited Nov. 22., 2010).

6 *The Savings Banks Bill*, N.Y. TIMES, Apr. 2, 1893, at 2.

7 *Id.*

8 In the last 20 years alone, the volume of municipal bonds issued per year has more than tripled. THE BOND BUYER 2009 YEARBOOK (Mun. Sec. Rulemaking Bd., New York, N.Y.), at 4-7 [hereinafter BOND BUYER YEARBOOK].

to an enormous $2.7 trillion,[9] with an average daily trading volume of over $21 billion in nearly 43,400 transactions.[10] In addition, more than two-thirds of the municipal securities market is now comprised, directly or indirectly, of individual investors.[11]

Despite the market's massive size and heavy investment by individuals, the regulatory framework for municipal securities is very weak compared to the disclosure-based regulation governing the rest of U.S. capital markets.[12] As a result, individual investors in municipal securities have limited access to the disclosure documents readily available to investors in corporate securities.[13] On the other hand, corporate securities markets benefit from timely and quality disclosures available on the Electronic Data Gathering, Analysis, and Retrieval system (EDGAR).[14] It is unlikely that the regulatory structure for municipal securities will ever directly mirror the framework for corporate securities.[15] However, the lack of uniformity between municipal and corporate securities regulation does not mean that participants in the municipal securities market should not benefit from the

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9 *U.S. Municipal Securities Holders*, listed within *SIFMA Research and Statistics*, SEC. INDUSTRY & FIN. MARKETS ASS'N, http://www.sifma.org/research/research.aspx?ID=10806 (last visited Oct. 18, 2010).

10 MUN. SEC. RULEMAKING BD., 2008 FACT BOOK 30 (2009) *available at* www.msrb.org/msrb1/pdfs/MSRB2008FactBook.pdf [hereinafter 2008 FACT BOOK].

11 *U.S. Municipal Securities Holders*, *supra* note 9 (showing that approximately $1.03 trillion in municipal securities is currently held by individuals, and an additional $955 billion is held by mutual funds).

12 Andrew Ackerman, *Discord on Disclosure; Cox Comment Sparks Spat on Standards*, THE BOND BUYER, Sept. 15, 2008, at 1; Christopher Cox, Chairman, Sec. & Exch. Comm'n, Speech by SEC Chairman: Integrity in the Municipal Market (July 18, 2007), *available at* http://www.sec.gov/news/speech/2007/spch071807cc.htm.

13 Lynnette Kelly Hotchkiss, *What's Behind the Disclosure Curtain? Just Ask EMMA*, THE BOND BUYER, July 6, 2009, at 32 (noting that "public disclosures about [municipal securities] have long been viewed by investors and others as murky and difficult, if not impossible, to find.").

14 EDGAR is the database used as the SEC's repository for electronic company filings. These filings are available to the public for free via EDGAR. *See Filings & Forms*, U.S. SEC. & EXCHANGE COMMISSION, http://www.sec.gov/edgar.shtml (last updated Aug. 20, 2009). EDGAR will be succeeded, at some point, by a database called the Interactive Data Electronic Applications (IDEA). Press Release, Sec. & Exch. Comm'n, SEC Announces Successor to EDGAR Database: "IDEA" Will Make Company and Fund Information Interactive (Aug. 19, 2008), *available at* http://www.sec.gov/news/press/2008/2008-179.htm.

15 First, federal oversight of the fundraising activities of local governments may raise federalism concerns. *See* Press Release, Sec. & Exch. Comm'n, SEC Chairman Cox Calls for Improved Investor Protections in the Market for Municipal Securities (July 26, 2007), *available at* http://www.sec.gov/news/press/2007/2007-148.htm. Second, repealing the Tower Amendment may face stiff resistance. Andrew Ackerman, *SEC Looks to Target Tower Amendment: Commission May Propose Repeal*, THE BOND BUYER, May 13, 2009, at 1. Third, the SEC simply does not have the budget to regulate municipal securities in the same manner in which it oversees the corporate securities markets. *See* BOND BUYER YEARBOOK, *supra* note 8, at 14 (showing that in 2008 alone, there were 14,234 issues of municipal securities totaling over $452 million).

same kind of information available to their corporate securities market counterparts through EDGAR. In an effort to reduce the disclosure disparity, the Municipal Securities Rulemaking Board (MSRB) launched the Electronic Municipal Market Access System (EMMA) in June 2009.[16]

Although still in its early stages, EMMA has the potential to permanently and substantially elevate the standard for disclosure in the municipal securities market.[17] EMMA is aimed at placing high-quality, current municipal market information "directly at the fingertips of retail investors."[18] To fill EDGAR's shoes for the municipal market successfully, EMMA will have to overcome a challenge that EDGAR operators do not face: eliciting timely, high-quality, non-mandatory disclosures from municipal securities issuers.[19]

Part I of this Article argues that enhanced disclosure of municipal securities market information is necessary and includes an overview of current municipal securities regulations. Part II of this Article evaluates the primary and continuous disclosure mechanisms EMMA employs. Part III provides recommendations to promote the smooth and successful operation of EMMA.

I. BACKGROUND

Initially, the municipal market was small in size and comprised primarily of institutional investors.[20] The current, heavily-traded, multi-trillion dollar municipal market, drawn mostly from the pocket of retail investors, barely resembles its initial form.[21] Recent increases in municipal securities defaults and demonstrated market abuses underscore the necessity of providing access to disclosures, allowing investors to make informed deci-

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16 Establishment of a Primary Market Disclosure Service and Trade Price Transparency, Exchange Act Release No. 59,636, 74 Fed. Reg. 15,190 (proposed Apr. 2, 2009). The secondary market component did not become permanent until July 2009. *See* Establishment of a Pilot Phase of Its Upcoming Continuing Disclosure Service of the Electronic Municipal Market Access System (EMMA), Release No. 59,964, 74 Fed. Reg. 25,778, 25,779 n.6 (May 29, 2009).

17 *See* Andrew Ackerman, *MSRB Ready to Launch Pilot Version of EMMA; Just 4 Months After Start of Development*, THE BOND BUYER, Mar. 31, 2008, at 1 (quoting MSRB chairman, Frank Chin, as stating, "[u]pon full implementation, EMMA will provide a permanent, centralized, and comprehensive Internet-based system for free real-time public access to all primary market, secondary market, and trade price data for municipal securities submitted to the MSRB.").

18 2008 FACT BOOK, *supra* note 10, at 1.

19 This is not to say that EMMA operators are striving to offer the exact same services as EDGAR, and the MSRB has attempted to make EMMA much more user-friendly than EDGAR. *See* Press Release, Sec. & Exch. Comm'n, *supra* note 14 (noting the "painstaking" manner in which EDGAR users currently must "sift through" Company filings).

20 *See* Cox Speech, *supra* note 12.

21 *See U.S. Municipal Securities Holders*, *supra* note 9.

sions in their investments.[22] Furthermore, federalism concerns have grown as state and local governments have begun to accept direct payments from the federal government to finance public projects with Build America Bonds.

A. *Market Evolution*

In 1908, a total of $530 million in municipal securities were sold on the primary market.[23] In 2008, over $452 billion in municipal securities were sold on the primary market, marking a 100-year increase of over 85,000%.[24] When Congress passed the Securities Act of 1933[25] (1933 Act) and the Securities Exchange Act of 1934[26] (1934 Act), only around $2.1 billion in municipal securities were sold each year on the primary market.[27]

Not only is the primary market for municipal securities active and growing, the trading volume of municipal securities is considerable. In 2008, market participants executed over nine million trades in municipal bonds.[28] Reflecting the presence of individual investors, approximately 43% of the average daily trades executed in 2008 were for under $25,000.[29] A total of $5.5 trillion in municipal securities changed hands in 2008.[30]

Along with the increase in size and trading activity of the municipal securities market, there has been a significant change in the composition of the market. This change raises investor protection concerns. While there is an economic argument that even a market comprised entirely of sophisticated investors would benefit from mandatory disclosure regulation,[31] the current securities laws in the U.S. only provide protection to sophisticated investors in instances of fraud, because they can presumably, "fend for themselves."[32] If the insurance companies and banking institutions that currently hold over $700 billion in municipal securities were the lone investors in the

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22 Jack Colombo, *Muni Bond Default Parade Plays On*, FORBES (Jan. 15, 2009), http://www.forbes.com/2009/01/15/monorail-vegas-ethanol-pf-ii-in_jc_0115distresseddebt_inl.html.

23 BOND BUYER YEARBOOK, *supra* note 8, at 15.

24 *Id.* at 14.

25 Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a-77aa (2006)).

26 Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (codified as amended in scattered sections of 15 U.S.C. §78a (2006)).

27 BOND BUYER YEARBOOK, *supra* note 8, at 15.

28 2008 FACT BOOK, *supra* note 10, at 33.

29 *Id.* at 37.

30 Proposed Amendment to Municipal Securities Disclosure, 74 Fed. Reg. 36,832, 36,834 n.27 (July 24, 2009).

31 Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1060 (2009).

32 *See* Sec. & Exch. Comm'n v. Ralston Purina Co., 346 U.S. 119, 124-27 (1953).

municipal market,[33] the securities would qualify for a private-placement exemption from registration even in the absence of an exemption for municipal securities.[34] Moreover, the individual investors' lack of involvement in the investment decisions of the banks and insurance companies would weaken the call for regulation under the current regulatory structure.[35] However, this simply is not the current market make-up.

Individual investors currently hold nearly $1 trillion in outstanding municipal securities;[36] mutual funds, money-market funds, and closed-end funds, all of which act as proxies for the individual investor, hold close to another $1 trillion.[37] Federal securities regulation is disclosure-based, and the individual investor is precisely the type of investor for whom Congress intended "full and fair disclosure" in order to promote "informed investment decisions."[38]

B. *Increased Risk*

Although municipal securities are generally recognized as a safe investment,[39] a substantial increase in the size of the municipal market correspondingly increases bondholders' risk of exposure. Record defaults have been recorded,[40] and regulators brought several actions for market fraud against municipal issuers and dealers.[41]

1. Default

Municipal securities are recognized as a sound investment, and second in safety only to securities issued directly by the federal government.[42] Re-

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33 *U.S. Municipal Securities Holders*, *supra* note 9.

34 Section 4(2) of the 1933 Act states that registration and prospectus requirements shall not apply to "transactions by an issuer not involving any public offering." Securities Act of 1933 § 4(2), 48 Stat. 74, 77 (1933) (codified as amended at 15 U.S.C. § 77d(2) (2006)). Thus, securities placed privately with institutional investors, such as banks, are subject only to the anti-fraud provisions of the Securities Acts.

35 *See Ralston Purina Co.*, 346 U.S. at 124-25.

36 *U.S. Municipal Securities Holders*, *supra* note 9.

37 *Id.*; *see* Langevoort, *supra* note 31, at 1030-31 (discussing the relationship of individual investors and mutual funds).

38 *See Ralston Purina Co.*, 346 U.S. at 124-25.

39 *Municipal Bonds and Defaults*, PUB. BONDS, http://www.publicbonds.org/public_fin/default.htm (last updated June 2004).

40 Colombo, *supra* note 22. This figure rose substantially from the 29 defaults recorded in 2007, totaling $329 million. *Id.*

41 *See* Sec. & Exch. Comm'n, Litigation Release No. 20522, 92 SEC Docket 3100 (Apr. 7, 2008).

42 *See Municipal Bonds and Defaults*, *supra* note 39.

gardless, municipal securities can still default.[43] In 2008, 136 defaults were recorded, totaling a record high of $7.5 billion.[44] Housing-related bond issues alone defaulted to the tune of $1.2 billion.[45] As of May 2009, municipal bond defaults totaled $436 million.[46]

Default does not necessarily mean that bondholders do not get paid. Municipalities can draw down reserves,[47] and many municipal securities issues are covered by insurance.[48] However, bondholders may be seeing less money in the near future due to a sharp decline in bond insurance,[49] amidst a record number of defaults.[50] In 2007, 46.8% of long-term municipal bonds carried insurance.[51] Whereas in 2008, 18.4% of long-term municipal bonds carried insurance, marking a 64.1% decline.[52]

As a last resort, municipalities can file for bankruptcy. On November 3, 1988, Congress amended the Bankruptcy Code to allow municipalities to institute Chapter 9 bankruptcy proceedings.[53] Further amendments to the Bankruptcy Code in 1994 made bankruptcy filings more viable for municipalities.[54] Although rare, Chapter 9 filings by municipalities likely involve a substantial amount of municipal debt.[55] For example, Jefferson County, Alabama, currently faces possible bankruptcy due to $3.2 billion in troubled sewer debt and $766.3 million in outstanding swap termination fees.[56] Governor Bob Riley warns that filing for bankruptcy will place "a toxic cloud" over Jefferson County.[57]

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43 "Default" occurs when a principal or interest payment is due, but remains unpaid. *See Municipal Bonds and Defaults*, *supra* note 39.

44 Colombo, *supra* note 22. This figure rose substantially from the 29 defaults recorded in 2007, totaling $329 million. *Id.*

45 Colombo, *supra* note 22.

46 Joe Mysak, *Municipal Defaults Don't Reflect Tough Times: Chart of Day*, BLOOMBERG (May 28, 2009, 6:30 AM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=arkJTEztA2wg&refer=home.

47 If a state or local government fails to pay bondholders from the funds pledged to back the bonds, the bonds are technically in default. However, many state and local governments maintain rainy day funds and operating reserves that can be used to pay bondholders should the pledged revenue stream dry up. *See Municipal Bonds and Defaults*, *supra* note 39.

48 BOND BUYER YEARBOOK, *supra* note 8, at 92.

49 *Id.* at 3 ("The once-mighty bond insurance industry, which began its steep decline in the latter month of 2007, saw the bottom truly drop out in 2008.").

50 *See* Colombo, *supra* note 22.

51 BOND BUYER YEARBOOK, *supra* note 8, at 3.

52 *Id.*

53 Act of Nov. 3, 1988, Pub. L. No. 100-597, 102 Stat. 3028 (amending the Bankruptcy Code).

54 Bankruptcy Reform Act of 1994, Pub. L. 103-394, 108 Stat. 4106 (1994).

55 *Municipality Bankruptcy*, U.S. CTS., http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter9.aspx (last visited Oct. 20, 2010).

56 Shelley Sigo & Jim Watts, *Southeast Bond-Watch*, THE BOND BUYER, Oct. 8, 2009, at 9.

57 *Id.*

Section 501(c)(3) municipal securities may pose a special risk to bondholders as they carry a higher default risk than other types of municipal securities.[58] Nongovernmental, private entities that fall under § 501(c)(3) of the Internal Revenue Code (IRC) are permitted to use the same tax and securities law exempt financing options available to state and local governments.[59] Section 501(c)(3) organizations include non-politically active corporations, funds, or foundations created for religious, charitable, scientific, educational, or national sports purposes.[60]

In a 501(c)(3) bond issue, the municipality acts as the "conduit issuer."[61] The municipality issues the bonds, and subsequently "reloans" the proceeds to the 501(c)(3) entity as the "conduit borrower."[62] The entity then services the debt through loan payments to the conduit issuer.[63] The conduit issuer is under no obligation to pay bondholders should the 501(c)(3) entity default on payments.[64] Thus, although these securities are labeled "municipal," the 501(c)(3) entity is solely responsible for the security of the bondholders' investment.[65]

2. Market Abuse

All securities offerings are subject to the antifraud provisions of the 1933 and 1934 Acts, whether or not an exemption applies.[66] There is no evidence that municipal securities dealers or issuers engage in widespread fraud; however, an increase in the number of issuers and participants in municipal securities transactions, necessarily increases the number of demonstrated market abuse cases.[67]

The SEC recently brought several fraud actions directly against government officials. In April 2008, the SEC filed fraud charges against five San Diego officials for deficient disclosures regarding intentionally underfunded pension obligations in 2002 and 2003 bond offerings.[68] In Novem-

58 *See Default Risks and Recovery Rates on U.S. Municipal Bonds*, FITCH RATINGS SPECIAL REPORT (Fitch, Inc., N.Y.), Jan. 10, 2007, at 1-2. Note that these default statistics only include Fitch-rated bonds. *See id.*

59 *See* Karen Schauble Leaffer, *Tax-Exempt Financing for Code § 501(C)(3) Organizations*, 29 COLO. LAW. 87, 87 (2000).

60 I.R.C. § 501(c)(3) (2006).

61 Leaffer, *supra* note 59, at 87.

62 *Id.*

63 *Id.*

64 *Municipal Bonds and Defaults*, *supra* note 39.

65 *See id.*

66 *See* Mary E. T. Beach, *Unregistered Offerings of Corporate Securities Including Regulation D and Regulation A*, *in* FUNDAMENTALS OF SECURITIES LAW 67 (American Law Institute 2009).

67 Theresa A. Gabaldon, *Financial Federalism and the Short, Happy Life of Municipal Securities Regulation*, 34 J. CORP. L. 739, 753 (2009).

68 Sec. & Exch. Comm'n, Litigation Release No. 20522, 92 SEC Docket 3100 (Apr. 7, 2008).

ber 2008, Birmingham Mayor Larry Langford was charged in a 101-count federal indictment for running a pay-to-play scheme.[69] The scheme involved the mayor funneling bond business to Montgomery bond dealer, William Blount, which earned Blount's firm over $7 million in fees.[70] In August 2009, Blount pled guilty to one count of bribery and one count of conspiracy, forfeited $1 million, and agreed to testify against the mayor.[71]

The SEC has also accused municipal securities broker-dealers of deceptive practices. Several such complaints accused securities firms of knowingly misrepresenting to customers the risks involved with investing in the Auction Rate Securities (ARS)[72] market.[73] Investors were left holding billions of dollars in securities that were nearly impossible to sell.[74]

Issuer and dealer fraud in connection with the municipal securities market highlights the importance of antifraud regulation and disclosure practices that can alert investors to possible market abuse. Fraud perpetrated by municipal issuers not only harms investors, but also undermines public trust and threatens the wallets of taxpayers who are left paying for financial mismanagement.[75]

C. *Build America Bonds*

Provisions of the American Recovery and Reinvestment Act of 2009[76] sought to improve the public financing options available to state and local

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[69] MSRB Rule G-37 prohibits broker-dealers from doing business with issuer officials to which they have made political contributions for a period of two years. *Rule G-37 Political Contributions and Prohibitions on Municipal Securities Business*, MUN. SEC. RULEMAKING BOARD, http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-37.aspx?tab=1 (last visited Sept. 12, 2010).

[70] Shelly Sigo, *PAY TO PLAY: Blount Pleads Guilty; Agrees to Testify Against Langford*, THE BOND BUYER, Aug. 19, 2009, at 1.

[71] *Id.*

[72] Auction Rate Securities are municipal securities for which the interest rates are reset periodically through a Dutch auction. *See Understanding Auction Rate Securities (ARS) Data*, MUN. SEC. RULEMAKING BOARD, http://emma.msrb.org/educationcenter/UnderstandingAuctionRates.aspx (last visited Sept. 12, 2010). Agents of the issuer conduct the auction, and authorized securities dealers submit customer orders. *Id.* The bottom of the ARS market fell out in February 2008 when municipal securities dealers withdrew their support for auctions because the dealers knew that the securities were backed by insurance from downgraded bond insurers. Lynn Hume, *AUCTION-RATE SECURITIES: Firm Urges Disclosure on ARS Rates*, THE BOND BUYER, Sept. 8, 2009, at 1. The auctions failed when banks stopped using their own capital to support the auctions. *Id.*

[73] Sec. & Exch. Comm'n, Litigation Release No. 21066 (June 3, 2009), *available at* http://www.sec.gov/litigation/litreleases/2009/lr21066.htm.

[74] See Gretchen Morgenson, *It's a Long, Cold, Cashless Seige*, N.Y. TIMES, Apr. 13, 2008, at C2 (noting that the auctions for auction rate securities "have simply stalled because of a lack of buyers.").

[75] *See* Cox Speech, *supra* note 12.

[76] American Recovery and Reinvestment Act of 2009, Pub. L. 111-005, 123 Stat. 115 (2009).

governments.[77] A new type of bond became available to issuers of municipal securities, Build America Bonds (BABs).[78] Under the BAB program, issuers may elect to either: (1) provide bondholders with a tax credit to apply against their federal income tax liability;[79] or (2) accept a direct payment from the U.S. Treasury Department equal to 35% of the paid interest on the bonds.[80] If the issuer selects the direct payment method, an unlimited amount of taxable bonds may be issued until the end of 2010.[81] Taken together, half the States issued nearly $12 billion of BABs as of June 2009.[82] Every issuer elected to use the direct payment method.[83]

Under the Tenth Amendment of the U.S. Constitution, it is improper for the federal government to interfere with the ability of state and local governments to raise money.[84] The federalism question asks whether "there is a constitutional impediment to subjecting municipal securities issuers to an offering regime of federal choosing."[85] The law is unclear regarding any constitutional impediment to direct federal regulation of municipal issuers.[86] Even with such a restriction, state and local governments voluntarily accept direct federal payments; therefore, the federal government would likely have the authority to protect that money by attaching regulatory strings. The federal government did just that with the federal bailout money that companies accepted under the Emergency Economic Stabilization Act of 2008.[87] If Congress does subject municipal issuers to a mandatory federal disclosure regime under a program such as BABs, issuers bringing a constitutional challenge on the basis of federalism would have to overcome the fact that municipal issuers are electing to interject the federal government in local financing by accepting money directly from the U.S. Treasury.[88]

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77 *See* William T. Conard II, *A Primer on Build America Bonds*, 21 OHIO MUN. SERV. 17 (2009).

78 *Id.*

79 *Build America Bonds*, listed within *SIFMA Research and Statistics*, SEC. INDUSTRY & FIN. MARKETS ASS'N, http://www.sifma.org/research/research.aspx?ID=12476 (last visited Oct. 6, 2010) (It is possible that bondholders could detach and sell the federal tax credits associated with their bonds, but no such market currently exists).

80 *Issuance and Trading Activity, 2009*, BUILD AM. BONDS (Mun. Sec. Rulemaking Bd.), Feb. 2010, at 1.

81 *Id.*

82 *Id.* at 2.

83 *Id.*

84 *See* Gabaldon, *supra* note 67, at 754.

85 *Id.* at 753.

86 *Id.* at 754-57. Though federalism jurisprudence has recently shifted in favor of states' rights.

87 Emergency Economic Stabilization Act of 2008, 12 U.S.C.S. § 5201 (LexisNexis 2010) (established the Troubled Assets Relief Program).

88 *Build America Bonds*, *supra* note 79.

D. *Current Regulatory Framework*

Municipal securities were exempt from the registration and the continuous disclosure requirements at the inception of both the 1933 Act and 1934 Act.[89] In 1975, Congress passed new legislation attempting to address the need for oversight of a complex and quickly evolving municipal securities market while retaining the exemption for municipal securities (1975 Amendments).[90] The legislation required registration of municipal securities brokers and dealers, and created the MSRB to promulgate rules governing the activities of municipal securities dealers.[91]

In the same legislation granting authority to regulate dealers in municipal securities, Congress passed an amendment to the 1934 Act proposed by Texas representative John Tower (Tower Amendment).[92] This amendment attempted to delineate the boundaries of the SEC's and the MSRB's authority with respect to municipal securities issuers.[93] The Tower Amendment prohibits the SEC and the MSRB from requiring "any issuer of municipal securities, directly or indirectly . . . to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities."[94] The Tower Amendment further prohibits the MSRB, but not the SEC, from "requir[ing] any issuer of municipal securities, directly or indirectly . . . to furnish to the Board or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer."[95] The 1933 Act and 1934 Act, together with the 1975 amendments, led to the rigmarole undertaken by the MSRB and the SEC to erect the improved but indirect regulation that currently governs the disclosure of issuer information.

1. Regulating the Activities of Municipal Securities Dealers

The MSRB is a self-regulatory organization overseen by the SEC.[96] The MSRB Board of Directors is comprised of fifteen members: five repre-

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89 15 U.S.C. § 78c(a)(12)(A)(ii) (2006).

90 Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended at 15 U.S.C. § 78o-4(b) (2006)).

91 Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended at 15 U.S.C. § 78o-4(b) (2006)).

92 *See* Andrew Ackerman, *SEC Looks to Target Tower Amendment: Commission May Propose Repeal*, THE BOND BUYER, May 13, 2009, at 1.

93 15 U.S.C. § 78o-4(d).

94 15 U.S.C. § 78o-4(d)(1).

95 15 U.S.C. § 78o-4(d)(2).

96 *Mission and Programs*, MUN. SEC. RULEMAKING BOARD, http://www.msrb.org/About-MSRB/Mission-and-Programs.aspx (last visited Oct. 6, 2010).

sentatives of bank dealers, five representatives of securities firms, and five public members.[97] The MSRB is authorized to promulgate rules applicable to municipal securities dealers that are designed "to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation . . . to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest."[98]

The MSRB first proposes rules and posts them on the MSRB's website for a comment period of up to sixty days.[99] The MSRB is required to file a proposed rule change with the SEC for approval.[100] The MSRB may finalize the rule after the SEC filing is published in the federal register and the comment period expires.[101] The rules promulgated by the MSRB are enforced by the SEC, the Financial Industry Regulatory Authority (FINRA), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board, the Comptroller of Currency, and the Office of Thrift Supervision.[102]

2. Primary Market Disclosure

Though the SEC's authority is limited with respect to the activities of issuers, the 1934 Act grants the SEC regulatory authority over brokers and dealers who underwrite municipal securities.[103] Pursuant to its authority over underwriters,[104] in 1989 the SEC adopted Rule 15c2-12, which modified the legal obligations of municipal securities underwriters.[105] Pursuant

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97 *By-Laws of the Municipal Securities Rulemaking Board*, MUN. SEC. RULEMAKING BOARD, http://www.msrb.org/About-MSRB/~/media/Files/Goverance/By-Laws.ashx (last visited Oct. 6, 2010); 15 U.S.C. § 78o-4(d)(2) (MSRB members serve staggered, three-year terms and elect the chairman who serves for one year); Andrew Ackerman, *FINRA Looks at 'Flipping': SEC Wants a More Independent MSRB*, THE BOND BUYER, Sept. 25, 2009, at 11 (Debate over whether the board should include more public members to prevent the MSRB's alignment with dealers of municipal securities).

98 15 U.S.C. § 78o-4 (b)(2)(C); *Mission and Programs*, MUN. SEC. RULEMAKING BOARD, http://www.msrb.org/About-MSRB/Mission-and-Programs.aspx (last visited Oct. 6, 2010).

99 *MSRB Rules*, MUN. SEC. RULEMAKING BOARD, http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules.aspx (last visited Oct. 6, 2010).

100 *Id.*

101 *Id.*

102 *Id.*

103 Securities Exchange Act of 1934, 15 U.S.C. § 78o(c)(2)(D) (2006) (gives the SEC authority "to define, and prescribe means reasonably designed to prevent, fraudulent, deceptive, or manipulative acts and practices and fictitious quotations by brokers and dealers.").

104 Municipal Securities Disclosure, 17 C.F.R. § 240.15c2-12(f)(8) (2010) (The term "underwriter" refers to "[A]ny person who has purchased from an issuer of municipal securities with a view to, or offers or sells for an issuer of municipal securities in connection with, the offering of any municipal security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking.").

105 *See* Investment Company Governance, Exchange Act Release No. 26,985 (June 30, 2005); 54 Fed. Reg. 28,799 (July 10, 1989) (to be codified at 17 C.F.R. pt. 240, 241).

to Rule 15c2-12, municipal securities underwriters who participate in primary offerings equal to or exceeding $1 million are required to obtain and review an issuer's Official Statement, and to distribute a copy of the Official Statement to potential investors who request it.[106]

An Official Statement contains information about the deal, including a description of the public project being financed, bond payment provisions, the potential risks to bondholders, and the tax-exempt status of the bonds.[107] The Official Statement also contains appendices with information about the issuer, such as management practices and audited financial statements.[108] The Official Statement is similar to a prospectus distributed in an offering for corporate securities.[109] Again, the Rule 15c2-12 requirement for review and distribution of the Official Statement is enforced against underwriters, not issuers.

3. Secondary Market Disclosure

While the 1989 version of Rule 15c2-12 increased the availability of primary market disclosures, it did not address the lack of post-issuance issuer information. In 1994, the SEC adopted amendments to Rule 15c2-12, again enhancing the responsibility of municipal securities underwriters.[110] For municipal securities that fall under Rule 15c2-12 in a primary offering, the 1994 amendments require underwriters participating in the transaction to reasonably determine that an issuer or obligated person has entered into a continuing disclosure agreement with investors prior to the underwriter's purchase or sale of the municipal securities. Under the amended rule, underwriters must determine that the issuer or obligated person has agreed to file annual, audited financial statements with each nationally recognized municipal securities information repository (NRMSIR)[111] and notices of material events, such as credit-rating changes, with each NRMSIR or with the MSRB.[112] Furthermore, the underwriter must determine whether the issuer has failed to file notices with each NRMSIR or with the MSRB.[113] Also, under the amended rule, the definition of "final Official Statement" included a description of any continuous disclosure for the securities currently being offered, and disclosure of any material failures to comply with continuing disclosure agreements in the past five years.

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106 17 C.F.R. § 240.15c2-12.

107 17 C.F.R. § 240.15c2-12(f)(3).

108 *Id.*

109 *See* Dianne Hobbs, *Tax-Exempt Financing*, NPOII MA-CLE 14-1 (2008).

110 *See* 17 C.F.R. § 240.15c2-12(b)(5)(i).

111 17 C.F.R. § 240.15c2-12(b)(5)(i)(A)-(B).

112 17 C.F.R. § 240.15c2-12(b)(5)(i)(C).

113 17 C.F.R. § 240.15c2-12(b)(5)(i)(D).

It is important to note that if issuers are delinquent or fail entirely to provide continuous disclosure documents, neither the SEC nor the MSRB have authority to compel disclosure.[114] The only remedy is for bondholders themselves to sue issuers for breaching a continuous disclosure agreement.[115] Furthermore, municipal issuers are not subject to any federally mandated uniform accounting standards.[116] Issuers do not have to comply with the standards established by the Governmental Accounting Standards Board (GASB). The GASB requirement that state and local governments report the estimated costs of employee benefits on their balance sheets incited a small-scale rebellion in Texas in 2007, with lawmakers encouraging noncompliance.[117] This lack of accounting uniformity may undermine the reliability of the financial statements provided by issuers, as it depends on voluntary issuer compliance.[118]

According to a study released by the firm DPC Data, Inc. in 2008, municipal issuers have taken advantage of the lack of regulatory consequences for delinquent or complete disclosure failures in the secondary market.[119] The study found that over 50% of the municipal bonds sold in the period between 1996 and 2005 had one or more years of delinquent financial disclosures.[120] Over half of these bonds had missing financial disclosures for three or more years.[121]

4. Push for Increased Regulation

In 2007 through 2008, SEC Chairman Christopher Cox called on Congress to address the problems in the municipal securities market and pushed for a more "aggressive use of our existing regulatory authorities."[122] Congress did not answer Chairman Cox's call with legislation, though his comments did spark debate in the municipal securities community. Members of the Government Finance Officers Association (GFOA) argued that

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114 15 U.S.C. § 78o-4(d) (2006).

115 Andrew Ackerman, *Delinquent Disclosure; Report Finds Fault With Secondary System*, THE BOND BUYER, Sept. 3, 2008, at 1 (Bondholders rarely sue issuers for breach of contract, and the SEC has never taken action against an underwriter for an issuer's failure to file).

116 Cox Speech, *supra* note 12.

117 *See, e.g.*, Susan Combs et al., *House Bill 2365 Protects Texans From Far-Reaching Consequences of Government Accounting Rule*, WINDOW ON ST. GOV'T, http://www.window.state.tx.us/newsinfo/columns/070611gasbshort.html (last visited Nov. 20, 2010).

118 *See* Cox Speech, *supra* note 12. In 2008, the SEC estimated that 20,000 of the 50,000 municipal issuers did not follow the accepted accounting principles set forth by GASB. Andrew Ackerman, *SEC: Nazareth Voices Support for GASB Standards*, THE BOND BUYER, Jan. 31, 2008, at 5.

119 Andrew Ackerman, *Delinquent Disclosure; Report Finds Fault With Secondary System*, THE BOND BUYER, Sept. 3, 2008, at 1.

120 *Id.*

121 *Id.*

122 Cox Speech, *supra* note 12.

isolated instances of financial mismanagement by municipalities, such as Jefferson County, would not be resolved by enhanced disclosure.[123] Furthermore, GFOA argued that investors in municipal securities do not read disclosure documents, and thus would not benefit from any risks exposed by them.[124]

By contrast, buy-side analysts argued that serious municipal disclosure concerns, such as stale annual reports, were widespread and not addressed by the current regulatory structure.[125] A member of the National Federation of Municipal Analysts noted that with "the weakest set of rules in the entire capital markets" it is "embarrassing that we even have to fight for [enhanced disclosure] in this sophisticated an economy."[126]

II. EMMA

One of the initiatives strongly encouraged by Chairman Cox and supported by many municipal market participants[127] was the creation of a free, centralized EDGAR-like database for the municipal securities market.[128] The MSRB responded, and on January 11, 2008, selected the name for EDGAR's sister database, EMMA.[129] EMMA would be rolled out in a multi-step process, launching first as a pilot portal.

A. *Primary Market Disclosure*

Prior to EMMA, MSRB Rule G-32 required municipal securities dealers selling securities from a new issue to deliver an Official Statement to the customer within twenty-five days of bond closing.[130] For dealers acting as underwriters, placement agents, or remarketing agents for primary municipal securities offerings, former MSRB Rule G-36 required the dealer to

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123 Andrew Ackerman, *Discord on Disclosure: Cox Comment Sparks Spat on Standards*, THE BOND BUYER, Sept. 15, 2008, at 1.

124 *Id.*

125 *Id.*

126 *Id.*

127 *See* U.S. SEC. & EXCH. COMM'N, DISCLOSURE AND ACCOUNTING PRACTICES IN THE MUNICIPAL SECURITIES MARKET n.25 (July 26, 2007) [hereinafter SEC White Paper to Congress], *available at* http://www.sec.gov/news/press/2007/2007-148wp.pdf; *see also* Exchange Act Release No. 59,062 n.9-10 (Dec. 5, 2008) (codified as 17 C.F.R. pt. 240 (Dec. 15, 2008)).

128 Andrew Ackerman, *SEC: Nazareth Voices Support for GASB Standards*, THE BOND BUYER, Jan. 31, 2008, at 5.

129 Andrew Ackerman, *MSRB Examines Rules; Chin: Unstable Insurers Spark Review*, THE BOND BUYER, Jan. 14, 2008, at 1.

130 Establishment of a Primary Market Disclosure Service and Trade Price Transparency, Exchange Act Release No. 59,636, 74 Fed. Reg. 15,190 (proposed Apr. 2, 2009).

submit an Official Statement along with Form G-36(OS) to the MSRB.[131] Furthermore, under former Rule G-36, the underwriter was required to submit the Advanced Refunding Document along with Form G-36(ARD) within five business days of the bond closing[132] in advanced refunding offerings[133] for which an Advanced Refunding Document had been prepared.

Prior to EMMA, the Municipal Securities Information Library (MSIL)[134] system collected the Official Statements and Advanced Refunding Documents, and the MSRB made them available to paid subscribers daily in portable document format (PDF) files.[135] If the public wanted free access to the MSRB's collection of Official Statements and Advanced Refunding Documents, they would have to visit the MSRB's facility in Alexandria, Virginia.[136]

In 2006, the MSRB issued a concept release suggesting the adoption of an "access equals delivery" standard for municipal securities dealers to fulfill their Official Statement and Advanced Refunding Document distribution obligations.[137] The MSRB proposed to provide customers online access to the documents via the MSIL.[138] The MSRB inched toward this "access equals delivery" standard in March 2008 when, pending the creation of EMMA, the MSRB began operating a "pilot portal" that provided free public access to offering documents for municipal issuers.[139] The MSRB made its collection of Official Statements and Advance Refunding Documents available,[140] along with forms G-36(OS) and G-36(ARD), on the pilot portal

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131 *Id.* at 15,191. For primary offerings falling under Rule 15c2-12, the Official Statement was required to be sent within one business day of receipt from the issuer. *Id.*

132 *Id.*

133 An advance refunding is a refinancing undertaken by an issuer in an effort to lower bond interest rates or release itself of legal obligations by paying off previously issued bonds with newly issued bonds. Mun. Sec. Rulemaking Bd., *What Is an Advance Refunding?*, EMMA-ELECTRONIC MUN. MARKET ACCESS, http://emma.msrb.org/EducationCenter/WhatIsARD.aspx (last visited Oct. 6, 2010).

134 The MSIL was established by the MSRB in 1991 for voluntary electronic submission of offering documents. Establishing the Municipal Securities Information Library System, Exchange Act Release No. 29,298, 56 Fed. Reg. 28,194 (proposed June 19, 1991).

135 Establishment of a Primary Market Disclosure Service and Trade Price Transparency, Exchange Act Release No. 59,636, 74 Fed. Reg. 15,190, 15,191 (proposed Apr. 2, 2009).

136 *Id.*

137 *MSRB Seeks Comments on Application of "Access Equals Delivery" Standard to Official Statement Dissemination for New Issue Municipal Securities*, MUN. SEC. RULEMAKING BOARD (July 27, 2006), http://www.msrb.org/msrb1/archive/2006/2006-19.asp.

138 Establishment of a Primary Market Disclosure Service and Trade Price Transparency, Exchange Act Release No. 59,636, 74 Fed. Reg. at 15,191.

139 Amendment to Municipal Securities Information Library Establishing a Pilot System, Exchange Act Release No. 57,577, 73 Fed. Reg. 18,022, 18,022-23 (proposed Apr. 2, 2008).

140 During the pilot period, all documents were submitted to the MSIL. Establishing the Municipal Securities Information Library System, Exchange Act Release No. 29,298, 56 Fed. Reg. 28,194 (proposed June 19, 1991).

in PDF files for the public to view, print, and download.[141] The pilot portal featured approximately 220,000 Official Statements and 30,000 Advanced Refunding Documents that the MSRB has collected since 1990.[142]

There was a dispute over the manner in which the MSRB planned to grant public access to the free, individual submissions on EMMA. The MSRB proposed that the implement used to unlock issuer information be the Committee on Uniform Securities Identification Procedures (CUSIP) nine-digit number used to identify municipal securities.[143] The American Bankers Association (ABA), as the owner of the CUSIP database, demanded that the MSRB enter into a licensing agreement to use CUSIPs on EMMA and take protective measures, such as required passwords for all EMMA users, to secure its intellectual property.[144] On May 15, 2009, the MSRB and CUSIP Global Services (CGS), the ABA's exclusive licensee, entered into a memorandum of understanding in which the CGS conceded to the MSRB's use of CUSIPs for EMMA's website portal and data feed in exchange for the MSRB's protection of the ABA's intellectual property and contract rights in the CUSIP database.[145] The terms of the MSRB-CGS agreement remain confidential; however, pricing model information from CGS's website suggests that 2009 annual fees for CUSIP service licensing agreements will not exceed $455,000.[146]

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141 Sec. & Exch. Comm'n, Litigation Release No. 20,522, 73 Fed. Reg. at 18,023; 92 SEC Docket 3100 (Apr. 7, 2008).

142 Andrew Ackerman, *MSRB Ready to Launch Pilot Version of EMMA; Just 4 Months After Start of Development*, THE BOND BUYER, Mar. 31, 2008, at 1.

143 Andrew Ackerman, *Cusip Dispute Pits ABA Against MSRB*, THE BOND BUYER, Apr., 28, 2009, at 1.

144 *Id.*

145 Order Granting Approval of Proposed Rule of Pilot Phase of EMMA, Exchange Act Release No. 59,964, 74 Fed. Reg. 25,778 at 25,779 (order May 29, 2009). For example, the following notice appears on the EMMA website:

> The CUSIP Service Bureau and the ABA assert that the CUSIP Database, including CUSIP numbers, CUSIP standard securities descriptions and other data, are and shall remain valuable intellectual property of the CUSIP Service Bureau and the ABA, and EMMA users acknowledge and agree that no proprietary rights are being transferred to EMMA users in such materials or in any of the information contained therein. Such information is provided on EMMA solely for the purpose of identifying municipal securities as an integral part of EMMA's trade price and rate information and to which the documents provided on EMMA are related. No other use of such information is granted by the MSRB, Standard & Poor's, the CUSIP Service Bureau or the ABA. EMMA users agree not to use such information for any other purpose. Redissemination of such information is strictly subject to the Terms of Use. Further, EMMA users agree that the use of such information is not intended to create or maintain, and does not serve the purpose of the creation or maintenance of, a file of CUSIP numbers or standard securities descriptions, and is not intended to create and does not serve in any way as a substitute for any CUSIP subscription services now or in the future offered by the CUSIP Service Bureau.

Mun. Sec. Rulemaking Bd., *About the Information Available on EMMA*, ELECTRONIC MUN. MARKET ACCESS, http://emmaportal.org/Search/Search.aspx (last visited Oct. 6, 2010).

146 *CGS License Fees*, CUSIP GLOBAL SERVICES, https://www.cusip.com/cusip/cgs-license-fees.htm (last visited Oct. 6, 2010). Municipal issuers are required to purchase CUSIPs. Recently, the

The EMMA pilot portal was initially set to expire and become permanently operational on March 31, 2009, one year from the start date of the pilot portal.[147] However, the MSRB pushed the launch date to June 1, 2009, in order to give market participants additional time to test the portal.[148] In March 2009, pending SEC approval, the MSRB adopted amendments to Rule G-32 and Rule G-36 to reflect an "access equals delivery" model.[149]

Under a revised Rule G-32, disclosures from underwriters are submitted electronically in PDF files to EMMA via password-protected interfaces.[150] Underwriters of a primary offering of municipal securities are required to submit an Official Statement to EMMA within one business day of receipt from the issuer, and in no event past the security's closing date.[151] If the underwriter fails to meet the submission deadline, the underwriter must submit a failure to file notice and provide the Official Statement no later than one business day after receipt from the issuer.[152]

In addition to the Official Statement, underwriters must submit Form G-32, which includes information such as the CUSIP number, principal amount, and a description of the issue.[153] Under revised Rule G-32, municipal securities dealers must notify customers that they can access primary offering documents on EMMA.[154]

B. *Secondary Market Information*

Prior to July 1, 2009, four national repositories (NRMSIRs) were available for the filing of secondary market documents.[155] Municipal market participants argued that this NRMSIR system was impaired by the inconsistent manner in which the repositories collected and displayed disclo-

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Regional Bond Dealers Association criticized CGS for imposing additional fees. Andrew Ackerman, *DISCLOSURE: RBDA Slams CUSIP Bureau Over Fees: Sends Letter Urging Action by SEC*, THE BOND BUYER, June 11, 2009, at 1.

147 Establishing the Municipal Securities Information Library System, Exchange Act Release No. 29,298, 56 Fed. Reg. 28,194 (proposed June 19, 1991).

148 Establishment of a Primary Market Disclosure Service and Trade Price Transparency, Exchange Act Release No. 59,636, 74 Fed. Reg. 15,190 (proposed Apr. 2, 2009).

149 *Id.*

150 *Id.* at 15,191. This service is free for underwriters. *Id.* Beginning January 1, 2010, the MSRB will require that all disclosure documents be searchable. *Id.*

151 *Id.* at 15,193.

152 Establishment of a Primary Market Disclosure Service and Trade Price Transparency, Exchange Act Release No. 59,636, 74 Fed. Reg. 15,190 (proposed Apr. 2, 2009).

153 *Id.*

154 *Id.* at 15,193.

155 *See* Andrew Ackerman, *FINRA Looks at 'Flipping': SEC Wants a More Independent MSRB*, THE BOND BUYER, Sept. 25, 2009, at 11.

sure documents.[156] At the MSRB's request, the SEC adopted amendments to Rule 15c2-12 in December 2008.[157] These amendments deemed the MSRB the single, central repository for electronic collection and distribution of secondary market information.[158] The amendments also made EMMA the central repository for continuous disclosure and became effective July 1, 2009,[159] the same date on which EMMA's continuous disclosure component would become permanent.[160] On June 1, 2009, the MSRB began operating a continuing disclosure pilot to allow issuers and investors to voluntarily test EMMA's system before it became permanent one month later.[161]

The secondary market disclosure component of EMMA accepts, indexes, and displays the Rule 15c2-12 disclosures in PDF files that issuers are required to make pursuant to a continuous disclosure agreement.[162] Such disclosures include material event notices as well as other categories of "additional disclosures," such as quarterly financial reports, changes in accounting standard notices, consultant reports, communications from the IRS, changes in obligated persons, and bankruptcy notices.[163] Of course, municipal issuers are under no regulatory or contractual obligation to produce these additional disclosures.[164]

For an annual fee of $45,000, the MSRB offers a real-time subscription to the continuous disclosure documents collected on EMMA,[165] which allows subscribers access to such documents as they are posted. Subscribers can tap into a real-time data stream showing:

> (i) submission data, including submission ID and submission transaction date/time; (ii) disclosure indexing data, including disclosure type, financial/operating disclosure category, event disclosure category, other voluntary disclosure description, disclosure dates, and CUSIP numbers; (iii) contact information data, including contact organization type, contact

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[156] Andrew Ackerman, *Regulation: Another NRMSIR Warns Against EMMA System: S&P Leery of Anti-Competitive Effects*, THE BOND BUYER, Sept. 25, 2008, at 1.

[157] *See* Securities Exchange Act Release No. 59,062 (Dec. 5, 2008), 73 Fed. Reg. 76,104 (Dec. 15, 2008).

[158] *See* Amendment to Municipal Securities Disclosures, Exchange Act Release No. 59,062, 73 Fed. Reg. 76,104 (Dec. 15, 2008) (to be codified at 17 C.F.R. pt. 240). For obvious reasons, the other NRMSIRs objected to the amendments. *See* Andrew Ackerman, *Regulation: Another NRMSIR Warns Against EMMA System: S&P Leery of Anti-Competitive Effects*, THE BOND BUYER, Sept. 25, 2008, at 1.

[159] *See* 73 Fed. Reg. 76,104.

[160] Exchange Act Release No. 59,964, 74 Fed. Reg. 25,778, 25,779 n.6 (May 29, 2009).

[161] *Id.*

[162] *See* Exchange Act Release No. 59,814, 74 Fed. Reg. 19,612, 19,613 (Apr. 23, 2009).

[163] For a full list, *see id.*

[164] Exchange Act Release No. 59,814, 74 Fed. Reg. 19,612, 19,613 (Apr. 23, 2009).

[165] Exchange Act Release No. 59,881, 74 Fed. Reg. 22,615, 22,616 (May 7, 2009).

name, address, phone number, and e-mail address; and (iv) document data, including document ID, document posting date, and document status indicator.[166]

A 2008 report released by DPC Data, Inc., one of the NRMSIRs displaced by EMMA, showed a lack of compliance by issuers with secondary market disclosure requirements due to a lack of consequences, and indicated EMMA would not resolve this noncompliance, as no change in the regulatory structure had been enacted.[167] The comprehensiveness of EMMA's database is vulnerable because delinquent issuers do not face any consequences, aside from bondholders' unlikely (but possible) legal actions.[168] The MSRB has already begun to address this concern by proposing that EMMA give special recognition to issuers that submit annual financial statements within 120 days of the end of the fiscal year, comply with accepted accounting practices established by the GASB, obtain certification of achievement from the GFOA, and link to other available pertinent financial and investor relation materials.[169]

C. *Price Transparency*

The price transparency service offered by EMMA makes transaction price data from municipal securities transactions publicly available.[170] The transaction price information includes the data collected by MSRB's Real-Time Transaction Reporting System (RTRS) since its creation on January 31, 2005.[171] EMMA currently provides trade data related to the following categories: trade time, settlement date, price, yield, trade amount, and trade submission type (customer bought, customer sold, or interdealer).[172]

In April 2009, the MSRB also launched the first phase of its Short-Term Obligation Rate Transparency (SHORT) System for ARS[173] and Vari-

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166 *Id.*

167 Andrew Ackerman, *SEC: No Action On Cox's Initiatives; Support for Plans Continues to Wane*, THE BOND BUYER, Sept. 5, 2008, at 1.

168 *See id.*

169 *See* Andrew Ackerman, *EMMA Efforts Criticized; Groups Wary of MSRB Proposals*, THE BOND BUYER, Aug. 13, 2009, at 1.

170 Exchange Act Release No. 59,636, 74 Fed. Reg. 15,190, 15,190 (Apr. 2, 2009).

171 *Id.*

172 *See, e.g.*, Utah Transit Authority Sales Tax Revenue Bonds Trade Activity, ELECTRONIC MUN. MARKET ACCESS, http://emma.msrb.org/SecurityView/SecurityDetailsTrades.aspx?cusip=917565BN2 (last visited Sept. 9, 2010).

173 For a description of ARS, *see* Gabaldon, *supra* note 67. The MSRB began collecting ARS information on January 30, 2009. *See Understanding Auction Rate Securities (ARS) Data*, ELECTRONIC MUN. MARKET ACCESS, http://emma.msrb.org/educationcenter/UnderstandingAuctionRates.aspx (last visited Sept. 9, 2010).

able-Rate Demand Obligations (VRDO).[174] EMMA's SHORT system provides ARS and VRDO information, such as the date and time of interest rate resets, CUSIP numbers, the responsible dealer for submitting orders in the case of ARS, the responsible dealer for resell in the case of VRDO, and the rate types (maximum rate, hold rate, or set-by-auction rate).[175]

III. RECOMMENDATIONS

EMMA has the potential to support further evolution of the municipal securities market. EMMA's greatest vulnerability in failing to live up to or surpass EDGAR standards lies in its secondary market disclosure component.[176] The MSRB can use EMMA to alter the disclosure expectations of investors, analysts, investment advisors, and broker-dealers of municipal issuers by placing easily accessible information at users' fingertips. If municipal market participants hold issuers to a higher standard, secondary market disclosure failures may have the effect of creating public support for legislation that enhances issuer regulation. Below are recommendations for EMMA's effective operation.

A. *To Issuers: Voluntary Now v. Mandatory Later*

One criticism of EMMA is that it violates the Tower Amendment by creating "de facto" mandatory regulation.[177] However, to date there has been no suggestion that an enforcement action against an issuer will be taken where the issuer fails to submit continuous disclosure documents to EMMA. If EMMA is successful in eliciting timely, high-quality disclosures from municipal issuers absent Congressional action, it will be in the form of voluntary, perhaps highly incentivized, self-regulation by municipal issuers.

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174 VRDOs are municipal securities that holders may liquidate at par value through a "put" or "tender" option. *See Understanding Variable Rate Demand Obligations (VRDO) Data*, ELECTRONIC MUN. MARKET ACCESS, http://emma.msrb.org/educationcenter/UnderstandingVRDOs.aspx (last visited Sept. 9, 2010). In the event that a dealer fails to resell the VRDO to another investor, a Letter of Credit or Standby Bond Purchase agreement is typically in place to ensure that an investor can liquidate her position. *Id.* VRDO interest rates reset periodically. *Id.* The MSRB began collecting VRDO information on April 1, 2009. *See id.*

175 *See Understanding Auction Rate Securities (ARS) Data*, ELECTRONIC MUN. MARKET ACCESS, http://emma.msrb.org/educationcenter/UnderstandingAuctionRates.aspx (last visited Sept. 9, 2010); *Understanding Variable Rate Demand Obligations (VRDO) Data*, ELECTRONIC MUN. MARKET ACCESS, http://emma.msrb.org/educationcenter/UnderstandingVRDOs.aspx (last visited Sept. 9, 2010).

176 *See* Andrew Ackerman, *SEC: No Action On Cox's Initiatives; Support for Plans Continues to Wane*, THE BOND BUYER, Sept. 5, 2008, at 1.

177 *See* Lynn Hume, *Regulation: MSRB's EMMA System Would Violate Tower Amendment, DPC Letter Says*, THE BOND BUYER, Sept. 22, 2008, at 26.

Municipal securities issuers and dealers self-regulation of voluntarily following acceptable accounting practices, and providing the MSRB with disclosure documents will reap benefits for two reasons. First, providing investors with timely and reliable disclosure will promote the integrity and efficiency of the municipal securities market.[178] All securities markets are predicated on transparency and timely disclosure,[179] and many organizations representing municipal issuers requested an electronic, central repository similar to EDGAR.[180] Municipal market investors, analysts, and dealers will benefit from the type of individual data provided by EMMA, as well as from the type of aggregate data that can be created by combining issuer information.

Second, there is the threat of a mandatory disclosure regime. As of May 2009, the SEC staff was considering not only seeking a repeal of the Tower Amendment, but calling on Congress for authority to directly regulate municipal issuers by eliminating the exemption from the securities laws.[181] Commissioner Walters echoed her support for such measures in October 2009.[182] With the current record-high number of municipal securities defaults,[183] support for mandatory measures may gain momentum. Comprehensive municipal default information was once confined to an obscure publication.[184] However, Forbes has recently made that information widely available.[185] As potential problems with the municipal securities market gain public visibility, pressure on Congress to take action to protect investors in this market will increase. In a situation of pending legislation, compliant issuers may turn on delinquent issuers. For example, a voluntarily compliant issuer, pharmaceutical giant Eli Lily, made such an about-face when it came to disclosing payments the company made to physicians in the midst of a pending Physician Payment Sunshine Act.[186]

Moreover, the SEC may not need to rely on Congress to turn up the heat on municipal issuers. Despite the Tower Amendment, the SEC has

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178 *See* SEC White Paper to Congress, *supra* note 127.

179 *See id.*

180 *Id.* at 6 n.25.

181 *See* Andrew Ackerman, *SEC Looks to Target Tower Amendment*, THE BOND BUYER, May 13, 2009, at 1.

182 Elisse B. Walter, Comm'r, U.S. Sec. & Exch. Comm'n, Speech at 10th Annual A. A. Sommer, Jr. Corporate, Securities, and Financial Law Lecture: Regulation of the Municipal Securities Market: Investors Are Not Second Class Citizens (Oct. 28, 2009) (transcript available at http://www.sec.gov/news/speech/2009/spch102809ebw-delivered.htm).

183 Colombo, *supra* note 22.

184 *See, e.g.*, *Distressed Debt Securities Newsletter*, BONDS ONLINE, http://www.bondsonline.com/Investor_Tools/Defaulted_bonds_newsletter.php (last visited Sept. 9, 2010).

185 Colombo, *supra* note 22.

186 *See Lilly Backs Federal Legislation to Inform the Public on Payments to Physicians*, ELI LILLY & CO. (May 13, 2008), http://newsroom.lilly.com/ReleaseDetail.cfm?releaseid=310110.

retained antifraud authority over municipal issuers,[187] and could begin to read this authority more broadly in proposing new rules affecting issuers.[188] Issuers could push back using the Tower Amendment, and the courts would be forced to draw the contours of the SEC's antifraud authority over municipal issuers.

If Congress allowed for direct federal regulation of municipal issuers, it is unclear whether courts would find such regulation in violation of our federal structure and, thus, unconstitutional.[189] The Constitution clearly permits the federal government to regulate interstate commerce.[190] The Commerce Clause has been interpreted by the Supreme Court very broadly and already encompasses the selling of corporate securities involving interstate commerce.[191]

By voluntarily submitting disclosures to EMMA, both required and discretionary, municipal issuers can protect their reputations and decrease the threat of a mandatory framework. Certainly issuers would prefer a voluntary disclosure system, as they would not be subject to enhanced federal regulation and would still retain flexibility with respect to disclosure.

B. *To The MSRB*

1. Purchasing Historical Continuous Disclosure Documents

Currently, for secondary market disclosures prior to July 1, 2009, EMMA prompts users to contact former NRMSIRs.[192] EMMA's purchasing of the continuous disclosure documents stored by these former NRMSIRS would be beneficial for two reasons. First, EMMA can aid investors in making informed decisions by allowing them to easily research an issuer's past secondary market disclosure behavior. If investors and analysts incorporate the timeliness and reliability of past issuer disclosures into their investment equations, municipal issuers planning to issue new municipal securities at any point in the future will have an enhanced incentive to maintain their reputations. The MSRB can provide valuable infor-

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187 Securities Act of 1933 § 17, 15 U.S.C. § 77q (2006); Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (2006).

188 Andrew Ackerman, *Cox: SEC to Propose New Disclosure Rules; Proposals Based on 2007 White Paper*, THE BOND BUYER, Sept. 9, 2008, at 1.

189 *See* Gabaldon, *supra* note 67.

190 U.S. CONST., art. I, § 8, cl. 3.

191 *See* Securities Act of 1933, § 5(1), 48 Stat. 74, 87 (1933) (codified as amended at 15 U.S.C. § 77x (2006)).

192 *See, e.g.*, Utah Transit Authority Tax Revenue Bonds Continuing Disclosure, ELECTRONIC MUN. MARKET ACCESS, http://emma.msrb.org/SecurityView/SecurityDetailsARD.aspx?cusip=917565BN2.

mation to investors and incentivize issuer behavior by purchasing historical secondary market disclosure documents from former NRMSIRs.

MSRB's executive director, Lynnette Hotchkiss, recently commented that the MSRB is not currently looking to purchase historical continuous disclosure documents because:

> [T]he problem with the four NRMSIRs and the lack of any kind of central index is that there was no complete repository of secondary market documents. So we were not able to, with any level of comfort, represent that if we purchased the library from one of the NRMSIRs, that it would be complete.[193]

However, the MSRB can represent that EMMA has a complete database of submitted secondary market documents if it purchases the libraries of all the former NRMSIRs. With the recent downturn in the economy, and the fact that the residual database retained by the former NRMSIRs will eventually become stale and less significant, the MSRB may be able to purchase the libraries for a reasonable price.

Second, the MSRB's purchasing of historical secondary market information will also help address a concern raised by the Securities Industry and Financial Markets Association (SIFMA) regarding MSRB Rule G–17.[194] Rule G-17 outlines fair dealing when trading with an unsophisticated customer. The MSRB recently issued an interpretive letter stating that Rule G-17 requires that a municipal securities dealer, whether trading on the primary or secondary market, disclose all material information about the security known by the dealer, as well as all material information "reasonably accessible to the market" prior to the sale.[195]

In a six-page letter to the SEC, SIFMA stated that if the MSRB is in fact equating the disclosure obligations of a dealer trading in the secondary market with the obligations of trading in the primary market, this secondary market obligation is overly burdensome, as dealers have a much shorter timeframe for market research in the secondary market.[196] SIFMA indicated that disclosure of the information found on EMMA, along with the information found on one other former NRMSIR, should be sufficient for most trades.[197]

However, dealers checking only one former repository would suffer from the potential incompleteness noted by Hotchkiss above.[198] Purchasing all available continuous disclosure documents could lighten, or eliminate

193 Andrew Ackerman, *FINRA Looks at 'Flipping': SEC Wants a More Independent MSRB*, THE BOND BUYER, Sept. 25, 2009, at 11.

194 Andrew Ackerman, *SIFMA Wary of MSRB Guidance: G-17 Disclosures Too Burdensome?*, THE BOND BUYER, Aug. 24, 2009, at 1.

195 *Id.*

196 *Id.*

197 *Id.*

198 *Id.*

entirely, a dealer's burden to provide all material information "reasonably accessible to the market." Prior to EMMA, it was warranted for the MSRB to act paternalistically with respect to ensuring that retail investors had access to information about a municipal security, as disclosure documents were very difficult to locate.[199] However, pending the MSRB's purchase of historical documents, the retail investor has the same access as the sophisticated dealer to current and historical information. If the MSRB does eliminate the "reasonably accessible" information disclosure obligation for dealers, it could require that dealers direct retail investors to EMMA for more information.

2. Trade Alerts

In March 2009, the MSRB was considering permitting users to sign up for free alerts to trades executed in a particular security.[200] EMMA currently allows users to sign up to receive email alerts when a primary or secondary disclosure document is submitted for a particular security by simply clicking on a link and filling out an email address.[201] If the MSRB could set up trade alerts at a low cost, it would make sense to permit users interested in a particular municipal security to receive alerts regarding trade data in addition to the disclosure alerts already operating.

3. 501(c)(3) Entities

The IRC favors 501(c)(3) entities, such as nonprofit hospitals, by allowing them to use tax-exempt financing.[202] Commenting on behalf of nonprofit issuers, the National Association of Health and Education Facilities Finance Authorities (NAHEFFA) has expressed concern over the MSRB's proposal to recognize issuers that follow GASB accounting standards, obtain certificates from GFOA, link investors to pertinent financial information, and file annual financial statements within 120 days of the end of the year.[203] NAHEFFA argues that the MSRB's recognition would have a "prejudicial" effect on borrowers who may not be capable of compliance due to the associated expense.[204]

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199 *See* Hotchkiss, *supra* note 13.

200 Notices, Exchange Act Release No. 59,636, 74 Fed. Reg. 15,190, 15,191 (Mar. 27, 2009).

201 *See, e.g.*, Utah Transit Authority Tax Revenue Bonds Continuing Disclosure, ELECTRONIC MUN. MARKET ACCESS, http://emma.msrb.org/SecurityView/SecurityDetailsARD.aspx?cusip=917565BN2.

202 For a discussion of Section 501(c)(3) financing, *see supra* I.B.1.

203 *See* Andrew Ackerman, *EMMA Efforts Criticized: Groups Wary of MSRB Proposals*, THE BOND BUYER, Aug. 13, 2009, at 1.

204 *Id.*

However, NAHEFFA's argument misses the primary purpose of disclosure: to protect public investors by promoting informed investment decisions. A 501(c)(3) nursing home pledging its revenue stream to repay bondholders places bondholders at a much higher risk than holders of general obligation bonds backed by the full faith and credit of a state or local government.[205] Section 501(c)(3) conduit borrowers are issuing securities that, generally, carry a higher default risk than other types of municipal securities.[206] It would not make sense to encourage financing of projects benefiting the public without also encouraging timely and reliable disclosure of the investment information. Otherwise, public investors would be at a disadvantage. It is important that tax-exempt financing options remain available to 501(c)(3) entities. However, the MSRB can help balance competing public policy considerations by not giving 501(c)(3) entities special treatment when it comes to public disclosure. Moreover, while the MSRB's proposals to enhance the timeliness and quality of issuer disclosure may generate some prejudice against non-compliant 501(c)(3) entities, regulators cannot seek penalties for non-compliance.[207]

C. *To The SEC*

The SEC should continue to push for increased regulation.[208] With municipal defaults at an all-time high[209] and EMMA paving the way for an easy implementation of mandatory issuer submissions, Congress may be receptive to the idea of direct regulation of municipal issuers. Even if Congress is as non-responsive as it was to Chairman Cox's initiatives,[210] the SEC should maintain a spotlight on the municipal securities market as EMMA begins to operate. This spotlight can help set a precedent for timely, high-quality issuer disclosure by pressuring issuers to reduce deficiencies that regulators can point to when calling on Congress. If EMMA users come to expect immediate access to issuer-disclosure documents, investors and analysts may be less forgiving when they click on EMMA tabs only to find missing information.

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205 *See Default Risks and Recovery Rates on U.S. Municipal Bonds*, FITCH RATINGS SPECIAL REPORT (Fitch, Inc., N.Y.), Jan. 10, 2007, at 1-2. Note that these default statistics only include Fitch rated bonds.

206 *Id.*

207 Regulators do not have direct authority over issuers of municipal securities. 15 U.S.C. § 78o-4(d).

208 Andrew Ackerman, *SEC Looks to Target Tower Amendment*, THE BOND BUYER, May 13, 2009, at 1.

209 Colombo, *supra* note 22.

210 Andrew Ackerman, *SEC: No Action On Cox's Initiatives: Support for Plans Continues to Wane*, THE BOND BUYER, Sept. 5, 2008, at 1.

D. *To Congress*

There is a sense among municipal market participants that the problems faced by the municipal securities market are often overshadowed on the Congressional agenda by other concerns.[211] In the wake of financial fallout in the U.S. capital markets, there is no better time for Congress to reexamine the regulatory framework governing the municipal securities market.[212]

1. The Tower Amendment

Federal regulation of municipal securities will likely never directly mirror regulation of the corporate securities market.[213] Even absent a valid constitutional challenge to direct federal regulation of issuers, there may be intergovernmental logistical reasons for not subjecting municipal issuers to precisely the same regulatory framework as corporate issuers.[214] Not even the SEC supports a type of pre-approval process for municipal securities offerings similar to the substantive review process undertaken by the SEC for corporate securities offerings.[215] However, investor protection concerns may warrant limited, direct federal regulation of issuers of municipal securities.[216]

For EMMA to be a wholly effective transparency tool for investors and analysts, municipal issuers and dealers must contribute timely and high-quality disclosures. Certainly, a repeal of the Tower Amendment allowing for the direct regulation of municipal issuers would help accomplish this transparency.[217] However, if issuers are reliable in submitting primary and secondary market disclosure documents to EMMA, a repeal of the Tower Amendment may not be necessary. Congress should evaluate municipal issuers' response to EMMA. If disclosure delinquency and accounting standards variations are still prevalent,[218] Congress should repeal the Tower Amendment to allow for limited federal regulation.

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211 *See* Michael Stanton, *If the Muni Market Falls, Will Anyone in Washington Hear It?*, THE BOND BUYER, Dec. 15, 2008, at 27.

212 *See* Colombo, *supra* note 22.

213 *See* Hotchkiss, *supra* note 13 and accompanying text.

214 *See* Gabaldon, *supra* note 67, at 754-55.

215 *See* Elisse B. Walter, Comm'r, U.S. Sec. & Exch. Comm'n, Speech at 10th Annual A. A. Sommer, Jr. Corporate, Securities, and Financial Law Lecture: Regulation of the Municipal Securities Market: Investors Are Not Second Class Citizens (Oct. 28, 2009) (transcript available at http://www.sec.gov/news/speech/2009/spch102809ebw-delivered.htm).

216 *See id.*

217 *Id.*

218 *See* Andrew Ackerman, *Delinquent Disclosure: Report Finds Fault With Secondary System*, THE BOND BUYER, Sept. 3, 2008, at 1.

2. 501(c)(3) Entities

Nongovernmental, conduit borrowers should not fall under the regulatory structure for municipal securities. These private, 501(c)(3) entities do not in any sense offer "municipal" securities, and should not be reported on EMMA.[219] The securities offered by 501(c)(3) entities do not carry any debt service obligation by a state or local government. Congress permitting the labeling of these securities as "municipal" may cause investors to miscalculate the risk associated with 501(c)(3) securities, which is generally higher.[220]

Congress could create a separate securities law exemption for 501(c)(3) entities that addresses the concerns raised by NAHEFFA in the MSRB's operation of EMMA,[221] or allow the entities to use the Regulation D exemptions currently available to corporate issuers.[222] Regardless of the available exemptions, Congress should no longer allow the treatment of 501(c)(3) securities as municipal securities.[223]

CONCLUSION

The municipal securities market in the U.S. is enormous.[224] Given the financial importance of the municipal market and the prevalence of individual investors, municipal market participants should have access to issuer-disclosure documents to bolster the integrity and efficiency of the municipal securities market. EMMA may be the long-awaited end to inconsistent, difficult-to-find issuer-disclosure documents.[225]

EMMA has consolidated a formerly fragmented disclosure system.[226] Aside from the NRMSIRs essentially replaced by EMMA, even municipal market participants raising concern over particular aspects of EMMA have generally supported the implementation of a centralized repository.[227] EMMA allows investors to view municipal securities information from introduction on the primary market through the life of the securities, in addition to providing real-time and historical trade price and interest rate information.[228] If the MSRB can successfully extract timely and reliable sec-

219 For a discussion of Section 501(c)(3) financing, *see supra* Part I.B.1.

220 *See Municipal Bonds and Defaults supra* note 39.

221 For a discussion of these concerns, *see supra* Part III.C.3.

222 17 C.F.R. §§ 230.501-230.508 (1997).

223 For a discussion of Section 501(c)(3) financing, *see supra* Part I.B.1.

224 *See U.S. Municipal Securities Holders, supra* note 9.

225 *Id.*

226 *Id.*

227 *See* Andrew Ackerman, *Cusip Dispute Pits ABA Against MSRB*, THE BOND BUYER, Apr. 28, 2009, at 1.

228 *See* Hotchkiss, *supra* note 13.

ondary market disclosures from issuers, EMMA will be successful in providing EDGAR-like service to investors, analysts, and dealers in the municipal securities market.

IGNORING IMPLEMENTATION COSTS OF THE CLEAN AIR ACT: A COSTLY MISTAKE

*Patrick A. McLaughlin**

INTRODUCTION

The Clean Air Act (CAA) in its present form is a complex and opaque 465-page document.[1] Inside this document is one of the CAA's primary goals—to "protect and enhance the quality of the Nation's air resources so as to promote the public health and welfare and the productive capacity of its population."[2] Congress mandated that the Environmental Protection Agency (EPA) must establish ambient air quality standards for each air pollutant that "cause[s] or contribute[s] to air pollution which may reasonably be anticipated to endanger public health or welfare."[3] Some CAA titles give an express grant of authority to the EPA to consider implementation costs devising their regulatory actions.[4] There is no such express grant for National Ambient Air Quality Standards (NAAQS), and the Supreme Court interpreted the CAA to prohibit the EPA Administrator from considering implementation costs.[5] Rather, the EPA's primary guideline in setting NAAQS is that it must set a standard that protects human health and allows "an adequate margin of safety."[6]

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1 Andrew P. Morriss, *The Politics of the Clean Air Act*, *in* POLITICAL ENVIRONMENTALISM: GOING BEHIND THE GREEN CURTAIN 263, 264-65 (Terry L. Anderson ed., 2000).

2 Clean Air Act, 42 U.S.C. § 7401(b)(1) (2010).

3 *Id.* at §§ 7408(a)(1)(A), 7409(b)(1).

4 *See id.* at § 7412(g)(2) (mandating the use of maximum achievable control technology).

5 Whitman v. Am. Trucking Ass'ns, Inc., 531 U.S. 457, 467-69 (2001).

6 42 U.S.C. § 7409(b)(1).

Some have cited the prohibition on the EPA to consider implementation costs as a victory for human health and welfare.[7] Reality is quite the opposite—setting NAAQS without considering costs could eventually lead to scenarios where EPA policies actually reduce human health and welfare. Every time the EPA sets a new ambient air quality standard, the resources devoted to compliance with the new standard necessarily have an opportunity cost because they take resources away from other uses. As a result, the allocation of scarce resources in the economy is forcefully altered, with more resources devoted to clean air activities at the expense of other investments. While improving air quality can impart health benefits, so can investing in health care research, buying safer cars, paving potholes, or reducing childhood diabetes. When considering new CAA regulations, the EPA should consider the costs of its actions and choose whichever action is most beneficial to society.[8] Sometimes the most beneficial action may be to not create a regulation at all, and instead allow the resources that would have been used for compliance to be used elsewhere.[9]

Amending the CAA to state that the EPA Administrator should consider implementation costs in setting NAAQS would allow the Administrator to carefully consider whether the EPA's regulatory actions improve human health and welfare. Tools for economic analysis of regulations such as cost–benefit analysis, cost–effectiveness analysis, and risk–risk analysis would help the EPA in making its regulatory decisions. However, in order to use these tools, the EPA must be empowered to consider costs when setting NAAQS.

I. BACKGROUND OF THE CLEAN AIR ACT

The political process that created the current version of the CAA and other environmental legislation over the past four decades has led one previous EPA Administrator, Alvin Alm, to compare the legislation to an archaeological dig in which "[e]ach layer represents a set of political and technical judgments that do not bear any relationship to other layers."[10] Another former Administrator, William Ruckelshaus, stated that the EPA

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[7] *See* Brief of Amici Curiae Envtl. Def., Am. Pub. Health Ass'n, et al. on Behalf of Cross-Respondents, Am. Trucking Ass'ns, Inc. v. Browner, 531 U.S. 457 (2000) (No. 99-1426) 2000 WL 1299554.

[8] *See generally* Richard D. Morgenstern, *Conducting an Economic Analysis: Rationale, Issues, and Requirements*, *in* ECONOMIC ANALYSES AT EPA: ASSESSING REGULATORY IMPACT 25, 31-32 (Richard D. Morgenstern ed., 1997) (stating "key questions" that economic analysis of proposed environmental regulations should address).

[9] *See generally id.*

[10] Morgenstern, *supra* note 8, at 5, 10 (quoting Al Alm, *A Dream That Hasn't Come True*, 16 EPA JOURNAL, no. 5, Sept./Oct. 1990 at 13, *available at* http://www.epa.gov/nscep/index.html (choose "1986-1990"; search "September/October")).

suffers from "battered agency syndrome" because it is "not sufficiently empowered by Congress to set and pursue meaningful priorities, deluged in paper and lawsuits, and pulled on a dozen different vectors by an ill-assorted and antiquated set of statutes."[11] The sentiments of these former Administrators are regularly echoed by regulators, academics, and environmental practitioners, some of whom have called every incarnation of the CAA since 1967 "overly cumbersome," "peculiarly complex and obscure," and "opaque."[12]

Air quality has improved despite the complexity and obscurity of the CAA, and the EPA's difficulty in administering it.[13] As of 2007, concentrations of the six common air pollutants for which the EPA sets national air quality standards (criteria pollutants) had decreased significantly compared to both 1980 and 1990.[14] For example, EPA data, as shown in Figure 1, suggest that in 2007 the amount of carbon monoxide in the air had decreased by 76% since 1980 and by 67% since 1990.[15] Additionally, airborne lead has decreased by 94% since 1980 and by 78% since 1990.[16] In fact, the air concentrations of all criteria pollutants[17] have decreased by more than 20% since 1980 even though the economic activities creating those pollutants have increased.[18]

These statistics raise an important question: If air quality has improved under the CAA, why have so many bemoaned its shortcomings to the point where an EPA Administrator has proposed rewriting the CAA?[19] The answer is simple: the CAA may not be efficient, or even cost-effective, in improving overall human health and welfare. Surely some of the improvement in air quality is due to the CAA. However, other factors, such as technological innovation, the threat of lawsuits, and consumer demand for environmentally friendly goods and services have likely contributed to air quality improvement too. In fact, the downward trend for many pollutants may actually predate federal control of those pollutants, indicating that fed-

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11 *Id.* at 12.

12 Morriss, *supra* note 1, at 264-65.

13 Press Release, Nat'l Acad. Nat'l Research Council, Clean Air Act Is Working, But Multipollutant, Multistate Approach and Stronger Focus on Results Are Needed to Meet Future Challenges (Jan. 29, 2004), *available at* http://www8.nationalacademies.org/onpinews/newsitem.aspx?RecordID=10728.

14 Morriss, *supra* note 1, at 264-65.

15 *See Air Trends: Basic Information*, U.S. ENVTL. PROT. AGENCY, http://www.epa.gov/air/airtrends/sixpoll.html (last updated Apr. 1, 2010); *infra* Figure 1.

16 *Id.*; infra Figure 2.

17 *Infra* Figure 2. The six criteria pollutants are carbon monoxide, ozone, lead, nitrogen dioxide, particulate matter, and sulfur dioxide. *Air Trends: Basic Information*, U.S. ENVTL. PROT. AGENCY, http://www.epa.gov/air/airtrends/sixpoll.html (last updated Apr. 1, 2010).

18 *Air Trends: Basic Information*, U.S. ENVTL. PROT. AGENCY, http://www.epa.gov/air/airtrends/sixpoll.html (last updated Apr. 1, 2010); *infra* Figure 2.

19 Juliet Eilperin, *EPA Tightens Pollution Standards*, WASH. POST, Mar. 13, 2008, at A1.

eral regulations are not the only cause of the reduction.[20] Nevertheless, it is possible that the resources devoted to improving air quality under the CAA could have improved human health and welfare to a greater degree in alternative investments. This possibility is true even if one assumes, for the sake of argument, that the improvements in air quality are entirely attributable to the CAA. Furthermore, even if the CAA has been relatively efficient and cost-effective so far, future regulation under the CAA may generate scenarios in which society is worse off than it would be without the regulation.

II. ASSESSING THE CAA

Many EPA regulations generate considerable costs and therefore require some portion of society's limited resources.[21] For CAA regulations, the primary reason compliance costs are incurred is ostensibly to promote public health and welfare—for example, by averting adverse health effects of air pollution such as asthma or lung cancer.[22] However, those resources allocated to CAA compliance could be used in other activities that improve human welfare. Therefore, when evaluating the CAA's success, one must ask whether the resources used to comply with the CAA could better improve human welfare if allocated elsewhere.

Many difficulties arise in attempting to determine whether the resources used for CAA compliance could be better used elsewhere in society. First, one must define "resources used to comply with the CAA," including all direct and indirect compliance costs arising out of its regulations. Direct compliance costs include research and development expenditures and capital costs, such as operation and maintenance costs. The cost of CAA compliance also includes a host of indirect costs: legal and lobbying actions for and against further regulation; production, trade, and consumption forgone as a result of decreased economic activity in the regulated industries; and decreases in economic activity in seemingly unrelated industries, as the effects of higher costs in one industry ripple through the entire economy. The result of these direct and indirect costs is that total compliance costs are almost always greater than the direct costs to the regulated industry itself.[23] It seems to be a common misconception that the costs of

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20 Morriss, *supra* note 1, at 263-64, 268. *See also* Indur Goklany, *Empirical Evidence Regarding the Role of Federalization in Improving U.S. Air Quality*, *in* THE COMMON LAW AND THE ENVIRONMENT 27, 39, 48 (Roger Meiners and & Andrew P. Morriss eds., 2000).

21 W. KIP VISCUSI ET AL., ECONOMICS OF REGULATION AND ANTITRUST 741 (4th ed. 2005).

22 One of the purposes of the Clean Air Act is "to promote the public health and welfare." 42 U.S.C. § 7401(b)(1).

23 It is theoretically possible, although highly unlikely, that the direct costs to the regulated industry equal the total costs for a society. Of course, this is not to say that regulatory intervention necessarily has a negative welfare effect. Indeed, in accordance with the theory of the second best, it may some-

environmental regulation fall only on polluters. However, while emitters of air pollutants bear some costs, ultimately all of society pays some of the CAA's compliance costs.

The second difficulty in determining the CAA's success is clarifying the CAA's goal in setting NAAQS—to improve human health and welfare.[24] As mentioned previously, the CAA directs the EPA Administrator to set NAAQS at a level that protects human health "allowing an adequate margin of safety."[25] Additionally, the Supreme Court's interpretation of the CAA prohibits the Administrator from considering implementation costs when setting NAAQS.[26] Prohibiting cost consideration could lead to the creation of ambient air quality standards that actually harm human health and welfare, rather than enhance them. Thus, failing to consider costs could undermine the CAA's goal of improving human health and welfare. Instead of prohibiting cost consideration, regulators would better serve the public interest by considering as much information as possible about a regulation's effects. The following section details some analyses the EPA Administrator could apply when considering costs.

III. TYPES OF REGULATORY ANALYSIS

Three methodologies could help decide whether a regulation harms or helps human health and welfare: cost–benefit, cost–effectiveness, and risk–risk. Cost–benefit analysis weighs the overall benefits of a variety of policy choices against their overall costs; most significant federal regulations pertaining to human health and welfare use this standard.[27] Cost–effectiveness analysis assesses ways of achieving a fixed goal. Risk–risk analysis recognizes that a regulation that reduces health risk of one sort may increase health-risk of another sort and analyzes the tradeoff.

One form of risk–risk analysis is health–health analysis, which highlights the relationship between health and wealth. For example, health–health analysis studies the tradeoffs regulations create when the regulations attempt to decrease health risk yet simultaneously decrease private expendi-

times be socially optimal for policymakers to offset one market failure by creating a second market failure (e.g., through regulatory action implementing a command-and-control regulation). *See* R.G. Lipsey & Kevin Lancaster, *The General Theory of the Second Best*, 24 REV. ECON. STUD. 11-32 (1957).

24 42 U.S.C. § 7408(a)(1)(A).

25 42 U.S.C. § 7409(b)(1).

26 *Whitman*, 531 U.S. at 468-70.

27 Executive Order 12866 directs Federal agencies in the Executive Branch to conduct regulatory analysis of economically significant rulemakings at § 6(a)(3)(c). Circular A-4 provides guidance on how to perform regulatory analysis, which is to include "an evaluation of the benefits and costs of the proposed action." OFFICE OF MGMT. & BUDGET, Circular A-4, To the Heads of Executive Agencies and Establishments: Regulatory Analysis, 2 (Sept. 17, 2003), *available at* http://www.whitehouse.gov/sites/default/files/omb/assets/omb/circulars/a004/a-4.pdf.

tures on other health risk reducing activities. The sections below use each type of analysis to evaluate the success of the current CAA, given the policy of not considering costs in setting air quality standards.

A. *Cost–Benefit Analysis*

Cost–benefit analysis attempts to monetize all relevant costs and benefits of a policy. There are necessarily ranges of uncertainty, and sometimes it can be impossible to monetize certain costs or benefits. Nevertheless, applying cost–benefit analysis to regulations informs policymakers, regulators, and the public about their choices. Creating a costly regulation entails sacrificing some other economic activity. In some cases, the benefits of a regulation may be so large that it is worth creating the regulation and sacrificing the benefits of the forgone activities. In other cases, the costs may outweigh the benefits so greatly that regulators decide against creating the regulation.

Cost–benefit analysis tries to determine the value of regulatory outcomes to consumers, typically through revealed preferences or contingent valuation. CAA regulations should attempt to improve human health and welfare as a primary goal.[28] Thus, the regulations' cost–benefit analyses include the monetized value of expected improvements in health as a result of the regulation. For example, the EPA recently conducted a regulatory impact assessment of the revisions to NAAQS for lead.[29] The assessment includes estimates of the adverse health impact of high-lead blood levels on the cognitive function of children.[30] In its cost–benefit analysis, the EPA included the calculated monetized benefits of each hypothetically avoided case.[31]

On the other hand, costs of a regulation can include direct costs, such as the engineering, operations, and maintenance costs of adding pollution controls to a factory. Costs of a regulation can also include indirect costs, such as the opportunity cost of physical and human capital devoted to compliance with the regulation, and general equilibrium costs incurred by the reallocation of resources from some previous set of goods and services to pollution control activity.[32] Cost–benefit analysis helps regulators and poli-

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28 42 U.S.C. § 7401(b)(1).

29 U.S. ENVTL. PROT. AGENCY, REGULATORY IMPACT ANALYSIS OF THE PROPOSED REVISIONS TO THE NATIONAL AMBIENT AIR QUALITY STANDARDS FOR LEAD (Oct. 10, 2008), *available at* http://www.epa.gov/ttn/ecas/regdata/RIAs/finalpbria.pdf.

30 *Id.* at ES-7.

31 *Id.* at ch. 5.

32 *See* Michael Hazilla and Raymond J. Kopp, *Social Cost of Environmental Quality Regulations: A General Equilibrium Analysis*, 98 J. POL. ECON. 853-73 (1990) (contrasting private costs of environmental regulation with social costs calculated in general equilibrium analysis).

cymakers select regulations and policies with positive net social benefits.[33] Furthermore, cost–benefit analysis can identify uncertainties in the costs and benefits of different policies, and identify areas where new information may be valuable for evaluating those policies.[34]

Economists in the government, academia, and the private sector have applied cost–benefit tests to federal regulations. One relatively recent article on the costs and benefits of federal regulations estimates that thirty-two of the seventy-six final regulations it studied did not pass a cost–benefit test—meaning that nearly half the regulations analyzed, costs society more than the benefit conferred.[35] In fact, many regulations are still promulgated even after failing the government's own cost–benefit test in its analyses of the regulations' potential impact on the economy. For example, when the EPA revised the NAAQS for ozone in 1997, they published a regulatory impact analysis that estimated the full attainment of the proposed ozone standard would produce "net benefits ranging from negative $1.1 billion to negative $8.1 billion" in 1990 dollars.[36] This example is not to suggest that cost–benefit analyses should be the only consideration when creating a new regulation.[37] Instead, cost–benefit analysis can inform all relevant parties about the consequences of taking a certain action and compare that action to its alternatives.[38]

B. *Cost–Effectiveness Analysis*

An alternative to cost-benefit analysis is cost–effectiveness analysis. To some degree, cost–effectiveness removes the subjective judgment from the analysis because the alternatives that are examined in a cost–effectiveness analysis are limited to a common objective.[39] While results of cost–benefit analysis may vary depending on, for example, beliefs about technological innovation and how to monetize benefits anticipated from a

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33 *See, e.g.*, Morgenstern, *supra* note 8, at 31 (stating "key questions" that economic analysis of proposed environmental regulations should address).

34 ROBERT W. HAHN & PATRICK DUDLEY, HOW WELL DOES THE GOVERNMENT DO COST–BENEFIT ANALYSIS? 2 (AEI-Brookings Joint Center For Regulatory Studies, Working Paper No. 04-01, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=495462&rec=1&srcabs=309754.

35 John F. Morrall, III, *Saving Lives: A Review of the Record*, 27 J. RISK & UNCERTAINTY 221, 237 (2003).

36 U.S. ENVTL. PROT. AGENCY, EPA'S REGULATORY IMPACT ANALYSES (RIA) FOR THE 1997 OZONE AND PM NAAQS AND PROPOSED REGIONAL HAZE RULE, ES-20 (1997), *available at* http://www.epa.gov/ttn/oarpg/naaqsfin/ria.html.

37 Paul R. Portney, *Foreward* to ECONOMIC ANALYSES AT EPA: ASSESSING REGULATORY IMPACT ix-x (Richard D. Morgenstern ed., 1997).

38 *Id.*

39 HENRY M. LEVIN & PATRICK J. MCEWAN, COST–EFFECTIVENESS ANALYSIS: METHODS AND APPLICATIONS (2nd ed., 2001).

regulation, cost–effectiveness analysis can circumvent such difficulties by simply comparing the costs of different ways of achieving some fixed goal.[40] For EPA regulations, one easily understood and comparable goal is the cost of a statistical life saved.[41]

As noted earlier, the CAA mandates that the EPA Administrator should set NAAQS for air pollutants that endanger public health or welfare.[42] Statistical lives saved is a health outcome that regulators typically cite as evidence of a regulation's benefits.[43] Analysts statistically model the number of human lives that would be saved by full or partial compliance with a regulation by incorporating scientific and medical studies on criteria pollutants' effects on human health. For example, according to the EPA, particulate matter can cause premature death in individuals with heart or lung disease.[44] Reducing the concentration of particulate matter in the air, may avert some of those premature deaths.

Since 1981, a number of significant environmental regulations have included some estimate of statistical lives saved.[45] Thus, it is now possible to review these regulations and determine each regulation's cost per statistical life saved. Table 1 presents a summary of findings from three reviews; however, not every review produced an estimate of the cost of a statistical life.

Estimates of the cost per life saved vary across regulations and years. The average estimated cost per life-saved ranges from $4.8 million to $67.7 billion (in year 2000 dollars).[46] Variance also exists across studies estimating the same regulation's costs per life saved.[47] However, most of that variance occurs for very high-cost regulations (i.e., greater than $20 million per

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40 *See* OFFICE OF MGMT. & BUDGET, *supra* note 27, at 11 (stating that "cost–effectiveness analysis is designed to compare a set of regulatory actions with the same primary outcomes (e.g., an increase in the acres of wetlands protected) or multiple outcomes that can be integrated into a single numerical index (e.g., units of health improvement).").

41 *See* Morgenstern, *supra* note 8, at 42.

42 42 U.S.C. § 7409(b)(1).

43 *See* Morgenstern, *supra* note 8, at 42.

44 *Health and Environment*, U.S. ENVTL. PROT. AGENCY, http://www.epa.gov/air/particlepollution/health.html (last updated Oct. 28, 2010).

45 Robert W. Hahn et al., *Environmental Regulation in the 1990s: A Retrospective Analysis*, 27 HARV. ENVTL. L. REV. 377, 414 (2003).

46 *See generally id.* at 377 (surveying environmental regulations in the 1990s); W. Kip Viscusi et al., *Measures of Mortality Risk*, 14 J. RISK & UNCERTAINTY 213, 228-29 (1997); Morrall, *supra* note 35, at 221 (reviewing the cost–effectiveness of saving lives from 76 different regulations). Because the cost estimates in these three articles are stated in different base year dollars, all estimates have been converted to year 2000 dollars using the Bureau of Labor Statistics Consumer Price Index for All Urban Consumers.

47 *Id.*

statistical life saved).[48] Estimates for moderate-to-low cost regulations are consistent across the studies.[49]

Table 1 is useful in understanding the opportunity cost of environmental regulations. If policymakers were allowed to consider information on regulations' implementation costs, then they would be better able to decide where to allocate scarce resources. For example, knowing that a regulation may cost many billions of dollars per statistical life saved could induce regulators to rethink such a rule. Allocated elsewhere, those billions of dollars may save more lives.

C. *Risk–Risk Analysis*

The third standard used to decide whether a regulation harms or helps human health and welfare is risk–risk analysis. Risk–risk analysis offers an alternative to the cost–benefit method of converting "health outcomes into a monetary metric."[50]

When creating regulations designed to reduce risk, a clear policy objective should be that the regulation actually reduces overall risk. Thus, one should consider risks broadly. Such a perspective is prudent because when "one is solely concerned with risk reduction, it [is not always] desirable to set risk regulations at their most stringent level."[51] Reducing one risk to nothing may have the paradoxical effect of increasing overall risk. Risk–risk analysis is useful in this regard because it studies the risk tradeoffs that may arise from setting risk regulations.

One type of a risk–risk tradeoff occurs when a policy poses multiple risks. For example, in the 1970s the Food and Drug Administration (FDA) considered an artificial sweetener, saccharin, a potential carcinogen, and considered banning it.[52] However, a ban to reduce the risk of cancer might have led to an increase in a different sort of health risk—obesity. If saccharin, a relatively low-calorie substitute for sugar, is unavailable, some individuals may use sugar or other high-calorie sweeteners instead.

A second type of risk–risk tradeoff occurs when a policy or regulation induces changes in behavior. A classic example of this tradeoff is mandatory airbags in cars. Some individuals may drive faster in cars equipped with airbags because they feel more secure. As a result, while using airbags may

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48 *Id.*

49 *Id.*

50 W. Kip Viscusi, *Risk–Risk Analysis*, 8 J. RISK & UNCERTAINTY 5, 5 (1994).

51 *Id.*

52 LASZLO P. SOMOGYI, *Food Additives*, *in* 2 HANDBOOK OF FOOD SCIENCE, TECHNOLOGY, AND ENGINEERING, 83-1, 16-17 (Y. H. Hui ed. 2006).

decrease health risks for the driver, faster driving speeds may increase health risks for pedestrians.[53]

A third type of risk–risk tradeoff occurs when regulatory expenditures lead directly to increases in risky economic activities. For example, some injuries and deaths may occur in the process of manufacturing and installing pollution control equipment that was required by an environmental regulation.[54]

Another type of risk–risk tradeoff is the health–health tradeoff. When regulations take resources away from other uses, there is a necessary reduction in spending on other goods and services; that reallocation may negatively affect individual health and welfare. Health–health analysis points to a relationship between wealth and health, where health is measured by mortality risk and morbidity risk.[55] As Lutter and Morrall point out in their 1994 article:

> Compliance with costly regulations affects the consumption of risk-reducing goods and services in the same way as a wealth decline. Spending on compliance necessarily reduces the resources that may be spent on all other goods and services. The effective size of the [economic] pie being smaller, less of it is put to the purchase of health and safety.[56]

Put differently, the health–health tradeoff occurs because regulations aimed at reducing one health risk may simultaneously increase some other health risk by inducing a reduction in the consumption of health risk-reducing goods and services. Because efforts to reduce target risk in one area may lead to increases in other health risks, there can be a mortality cost resulting from regulatory actions. That mortality cost may outweigh the health benefits of a regulation. To be sure, health–health analysis sometimes paints a bleak picture of the reality of some regulations: Costly regulations, regardless of their intention, can sometimes induce fatalities.[57] As former Office of Management and Budget economist John Morrall describes, this health–health tradeoff may lead to situations where the reduction in consumption of health risk-reducing goods and services costs lives. According to Morrall, a "key cutoff point [for assessing regulations] is where cost-ineffective regulations do more harm than good. Because resources are used to produce the benefits of risk reducing regulation, there is an opportunity cost to spending that can be measured in risk reduction."[58]

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53 ROGER LEROY MILLER ET AL., THE ECONOMICS OF PUBLIC ISSUES 8 (13th ed. 2003).

54 Viscusi, *supra* note 50, at 6.

55 Randall Lutter & John F. Morrall, III, *HealthHealth Analysis: A New Way to Evaluate Health and Safety Regulation*, 8 J. RISK & UNCERTAINTY 43, 44 (1994).

56 *Id.*

57 *Id.*

58 Morrall, *supra* note 35, at 232.

Morall and his colleagues estimate that "a diversion of $21 million induces one fatality,"[59] in 2002 dollars.

Morrall finds that twenty-seven of the seventy-six regulations studied in his 2003 article cost more than the $21 million per statistical life saved and therefore "cause more harm than good."[60] Sometimes the cost of reducing mortality risk of an activity (such as drinking contaminated water) through regulation increases mortality risk because of offsetting decreases in other activities, such as health care consumption. Morall points out that, although 70% of the EPA regulations he studied (16 of the 23 EPA regulations in the sample) were cost-ineffective using the $21 million cutoff, "[o]ne should not generalize . . . that, in particular, environmental regulations as a whole are cost-ineffective."[61] Some EPA regulations may indeed have been cost-effective.[62] Rather, the point is that risk-reducing regulations, including many CAA regulations, may in fact increase risk. Careful analysis prior to the enactment of a new regulation and ongoing study of its effects after a regulation's promulgation can help regulators and policymakers understand whether that is the case. Unfortunately, EPA's statutory authority severely restricts its ability to use this type of analysis prior to setting an ambient air quality standard.

Since the EPA's establishment of ozone and particulate matter standards in 1971, the pollutants' air concentrations have decreased.[63] Achieving further reductions in both particulate matter and ozone is likely to become more costly per unit of pollutant as the ambient air quality standards become more stringent. This increase in cost reflects the economic principle of increasing marginal costs: eventually, the cost of a further reduction in a unit of particulate matter, lead, ozone, or any criteria contaminant, is greater than the benefits of that reduction. Under the current interpretation of the CAA, however, the EPA Administrator cannot consider whether costs outweigh benefits.[64]

Additionally, ozone and particulate matter appear to be non-threshold pollutants, meaning that it is unlikely that there is a specific level at which scientists could state, with certainty, that they posed no health risk. As a result, every so often, during a mandatory review of the NAAQS for ozone and particulate matter, the EPA may tighten the standards, regardless of whether that tightening results in tremendous economic costs and only miniscule benefits. Under the current law, the possibility of achieving any

59 *Id.* (citing Lutter et al., *The Cost-Per-Life-Saved Cutoff for Safety-Enhancing Regulations*, 37 ECON. INQUIRY 599 (1999) (finding that government regulations that spend more than $15 million per life saved on balance kill more people than they save)).

60 Morall, *supra* note 35, at 232.

61 *Id.*

62 *Id.* at 233.

63 *Id.* at 267-68.

64 *See Whitman*, 531 U.S. at 486.

public health benefit, no matter how tiny, is the only hurdle the EPA must clear in order to set a more stringent NAAQS; implementation costs do not matter.[65] Prior to instituting environmental regulations, the EPA should consider the costs of achieving the stated goal of the regulation and whether that goal could be more efficiently realized. As a leading text on regulation put it, "[R]egulatory agencies should be cognizant of the harm that is done when they fail to take costs into account. The concern of economists with cost is not a professional bias, but ultimately has a link to individual welfare."[66]

IV. FUTURE REGULATORY CHOICES UNDER THE CAA

Despite the EPA's inability to consider costs in setting NAAQS, CAA regulations may have produced positive net benefits thus far. The EPA produced their own cost–benefit analyses of the CAA and concluded that between 1970 and 1990 the Act's benefits totaled between $5.6 and $49.4 trillion, while the direct costs were only $523 billion.[67] Some have doubted the validity of the EPA's study, questioning the methods and assumptions.[68] Regardless of the study's validity, the fact that air pollution levels have decreased so dramatically over the last few decades implies that, barring some dramatic advancements in technology, marginal costs of additional improvements will soon exceed marginal benefits, if they do not already. As the authors of one review of the influence of economics on 1990s environmental policymaking point out, "Emissions of many air and water pollutants declined dramatically from 1970 to 1990, when the 'low-hanging fruit' among air and water quality problems were being addressed."[69] They support this point with the example of lead reduction in gasoline.[70] After the 1987 shift to unleaded gasoline, the EPA did little to further reduce lead emissions.[71]

Importantly, whether EPA's cost–benefit analyses of previous CAA regulations were valid is immaterial when deciding whether to create new regulations. The regulations promulgated so far under the CAA may or

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65 *Id. See also* Brief of Amici Curiae AEI-Brookings Joint Center for Regulatory Studies et al., In Support of Cross-Petitioners, Am. Trucking Ass'ns, v. Browner, 531 U.S. 457 (2001) (No. 99-1426), 2000 WL 1015407; Richard J. Pierce, Jr., *The Appropriate Role of Costs in Environmental Regulation*, 54 ADMIN. L. REV. 1237 (2002).

66 VISCUSI ET AL., *supra* note 21.

67 *The Benefits and Costs of the Clean Air Act, 1970 to 1990*, ENVTL. PROT. AGENCY (Oct. 1997), *available at* http://www.epa.gov/air/sect812/copy.html.

68 *See* ROBERT W. HAHN, *The EPA's True Cost*, AM. ENTER. INST. (June 27, 1996), *available at* http://www.aei.org/issue/6699.

69 Hahn et al., *supra* note 45, at 379.

70 *Id.*

71 *Id.*

may not have produced positive net benefits, but at some point further regulation under the CAA will be more costly than beneficial because of increasing marginal costs. Instead of relying on historical estimates, regulators should consider the additional costs necessary to achieve a higher level of air quality and the additional benefits of doing so. Alternatively, regulators should consider cost-effectiveness, and determine how many statistical lives will be saved, and at what cost per statistical life.

Performing cost–benefit analyses in hindsight by aggregating the effects of regulation over a twenty-year period does not inform regulators about the cost and benefit of additional regulation. For this, the EPA must examine each regulation, both before and after its promulgation, as the costs and benefits of implementing it could differ severely from those of regulations promulgated in the past.

Graphing the data in Table 1 illustrates the important concept of increasing cost per-statistical-life-saved of environmental regulation. Environmental regulations are in fact becoming increasingly costlier per statistical life saved. Figure 3 plots the yearly average estimate of the cost per statistical life saved for every regulation reviewed by two or more of the studies listed in Table 1. For example, Table 1 lists three environmental regulations promulgated in 1986. The average estimates of the cost per statistical life saved for each of the three regulations is $18.1, $28.3, and $378.4 million. Averaging those three figures yields $141.8 million, which is plotted as the average cost per statistical life saved for regulations promulgated in 1986.

Examining Figure 3, there appears to be a clear upward trend in the cost per statistical life saved as the EPA promulgates additional environmental regulations over time. This development demonstrates the concept of increasing marginal costs for EPA regulations.[72] In theory, increasing marginal cost of environmental cleanup must eventually occur in a world where all other relevant factors, including technology, are held constant.[73] In fact, Figure 3 demonstrates that marginal cost has increased despite advances in technology. Over the timeframe shown in the graph, technology has advanced considerably, but that only serves to emphasize the costliness of environmental regulations. The fact remains that over time, environmental regulations cost increasingly more per statistical life saved, taking into account increases in technology.

If the EPA Administrator continues to set NAAQS without considering implementation costs, then society will eventually be made worse off, if it is not already. The costs of compliance with stricter and stricter regulations, including the costs of developing new pollution control technologies

[72] However, the regulations reviewed may not fairly represent all EPA regulations due to the sample size and the uniqueness of each regulation.

[73] *See* ALFRED MARSHALL, PRINCIPLES OF ECONOMICS (8th ed. 1920); VISCUSI ET AL., *supra* note 21.

and monitoring pollution output, may eventually increase. The resources used to comply with additional regulations could be used elsewhere, and if the alternative uses present greater benefit than that of stricter air quality regulations, then government will have failed its constituents.

CONCLUSION

One way to prevent a scenario in which setting NAAQS makes society worse off is to amend the CAA. Specifically, Congress could amend the CAA to state that the Administrator should consider the costs of compliance, including risk–risk tradeoffs and opportunities forgone, when setting NAAQS. Such an action would allow the EPA to use the tools that are already at its disposal to help inform its regulatory decisions. Cost–benefit analysis, cost–effectiveness analysis, and risk–risk analysis are just a few of the tools that could help regulators make decisions that are more likely to benefit society, and to avoid options that make society worse off.

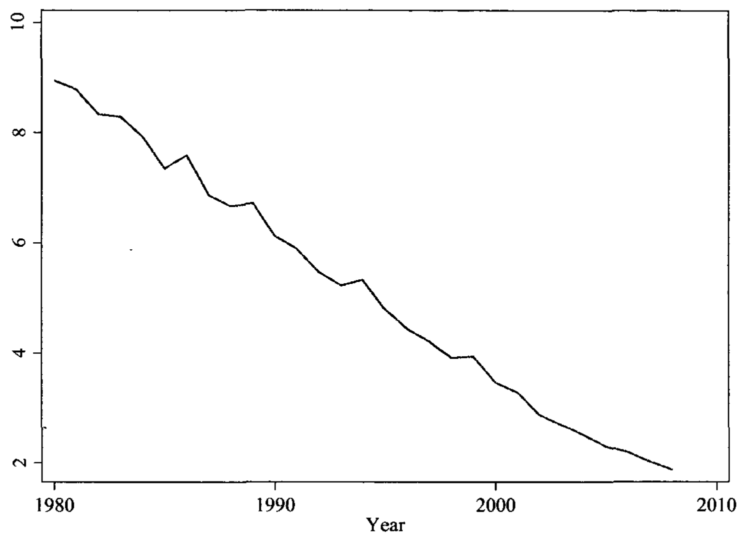
Of course, cost consideration has its own tradeoffs. A cost-consideration requirement when setting NAAQS may lead to an even greater number of legal challenges, given the CAA's history and the possibility of legal challenges to EPA rulemaking. This potential increase in litigation would increase court costs and delay implementation of pollution-reducing technologies. Conversely, if the EPA could consider costs, it might set NAAQS in a manner more acceptable to regulated entities. As a result, these entities would comply more quickly and challenge the regulations less often. While this outcome is uncertain, basic economic theory suggests that setting NAAQS without considering implementation costs will eventually lead to rules that cost society more than the benefit conferred. Indeed, such a point may have already been reached.

TABLE 1. COST OF ENVIRONMENTAL REGULATIONS PER STATISTICAL LIFE SAVED, MILLIONS (YEAR 2000 DOLLARS)[74]

Regulation	Year	Hahn et al.	Morrall	Viscusi et al.	Average
Benzene NESHAP (original: fugitive emissions)	1984	5		4.6	4.8
NOx State Implementation Plan (SIP) Call	1998		5.7		5.7
Ethylene dibromide in drinking water	1991		5.7	7.7	6.7
Benzene NESHAP (revised: coke by-products)	1988		6.1	8.2	7.2
Standards for radionuclides in uranium mines	1984	11	6.5	4.6	7.4
Arsenic emission standards for glass plants	1986		18	18.2	18.1
Arsenic/copper NESHAP	1986		25.6	31	28.3
Hazardous waste listing of petroleum refining sludge	1990		27.5	37.2	32.3
Cover/move uranium mill tailings (inactive)	1983		26.5	42.6	34.6
National prim. & sec. drinking water regs., Phase II	1991	28	47.4		37.7
Benzene NESHAP (revised: transfer operations)	1990		33.2	44.3	38.7
Cover/move uranium mill tailings (active sites)	1983		50.2	60.6	55.4
Asbestos ban	1989	21	73.9	148.9	81.3
Benzene NESHAP (revised: waste operations)	1990		170.6	226.2	198.4
Land disposal restrictions for third scheduled waste	1990	215			215
Sewage sludge disposal	1993	215	502.4		358.7
Hazardous waste: solids dioxin	1986	226	530.8		378.4
1,2-dichloropropane in drinking water	1991			878.4	878.4
Land disposal restrictions, Phase II	1994	1,030	2,464.5		1,747.2
Hazardous waste land disposal ban	1988	452	1,042.7	5,636.9	2,377.2
Drinking water, Phase V	1992	10,800	18,009.5		14,404.7
Municipal solid waste landfills	1988			25,702.6	25,702.6
Atrazine/alachlor in drinking water	1991			123,851.4	123,851.4
Solid waste disposal facility criteria	1991	40,700	94,786.7		67,743.4

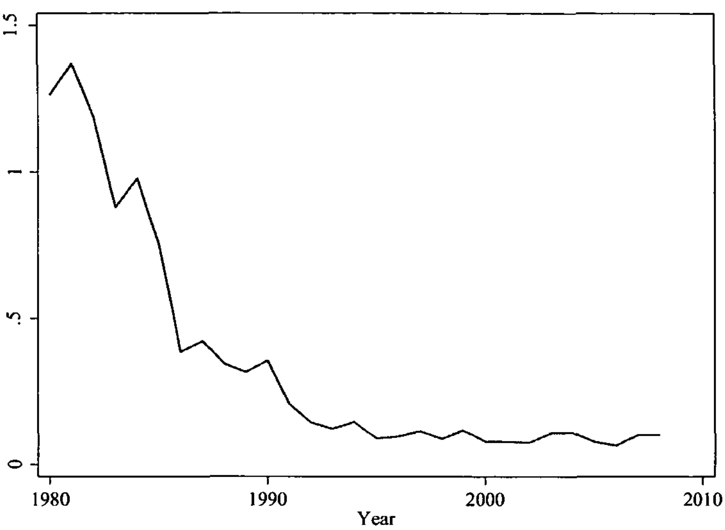
74 *See generally* Hahn et al., *supra* note 45, at 414 tbl.4; Morrall, *supra* note 35, at 231 tbl.2; Viscusi et al., *supra* note 46, at 228-29 tbl.9. Data from Morrall & Viscusi et al. were adjusted to year 2000 dollars via Consumer Price Index for All Urban Conusmers (CPI-U) using the U.S. Bureau of Labor Statistics's average Consumer Price Index for years 2002 and 1994, respectively. *See Bureau of Labor Statistics,* CONSUMER *Price Index*, U.S. DEP'T OF LAB., http://stats.bls.gov/cpi/ (last visited Nov. 22, 2010).

FIGURE 1. NATIONAL AVERAGE CARBON MONOXIDE CONCENTRATIONS OVER TIME[75]



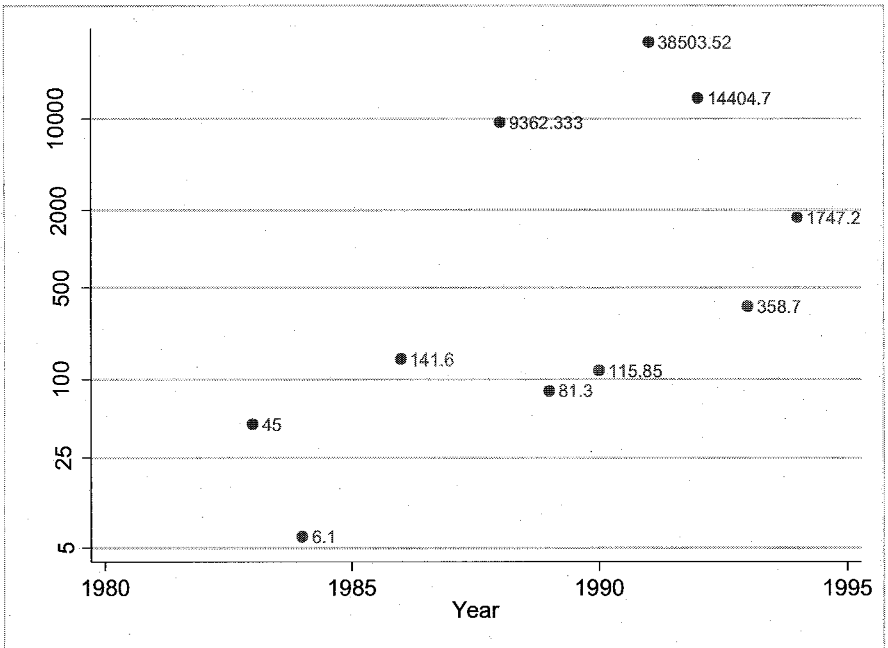
75 *Air Trends: Carbon Monoxide*, U.S. ENVTL. PROT. AGENCY, http://www.epa.gov/air/airtrends/carbon.html (last updated Oct. 6, 2009).

FIGURE 2. NATIONAL AVERAGE AIRBORNE LEAD CONCENTRATIONS OVER TIME[76]



[76] *Air Trends: Lead*, U.S. ENVTL. PROT. AGENCY, http://www.epa.gov/air/airtrends/lead.html (last updated Apr. 14, 2010).

FIGURE 3. COST-EFFECTIVENESS OF SOME MAJOR EPA REGULATIONS ON LOGARITHMIC SCALE[77]



[77] *See* Hahn et al., *supra* note 45, at 414 tbl.4; Morall, *supra* note 35, at 231 tbl.2; Viscusi et al., *supra* note 46, at 228-29 tbl.9; *infra* Table 1. Data from Morrall & Viscusi et al. were adjusted to year 2000 dollars via Consumer Price Index for All Urban Conusmers (CPI-U) using the U.S. Bureau of Labor Statistics's average Consumer Price Index for years 2002 and 1994, respectively. *See Bureau of Labor Statistics, CONSUMER Price Index*, U.S. DEP'T OF LAB., http://stats.bls.gov/cpi/ (last visited Nov. 22, 2010).

A CORPORATE CATCH-22: HOW DEFERRED AND NON-PROSECUTION AGREEMENTS IMPEDE THE FULL DEVELOPMENT OF THE FOREIGN CORRUPT PRACTICES ACT

*Allen R. Brooks**

INTRODUCTION

In deciding whether to invest in developing markets, business leaders must take into account ambiguities in American law.[1] Corporations entering into developing markets face a "statistically higher" chance of receiving a solicitation for a corrupt payment.[2] As the global leader in fighting corruption, the United States continually pressures countries to codify anti-corruption laws.[3] However, the central law governing foreign corruption lacks the clarity necessary for business leaders to make prudent business decisions.

There is a natural tension between business interests and reducing corruption. Balancing enforcement with investment creates a difficult policy choice for prosecutors and policymakers given today's economic climate. Due to a good deal of residual uncertainty in the market as the United States emerges from one of the nation's worst economic recessions,[4] the effects of regulating corruption may shun much needed investment that could help guide the global economy out of the doldrums.[5] American society, however, views anti-corruption enforcement laws as a public good necessary to restore confidence in the market.[6]

Corporations conducting international transactions incur unnecessary costs due to enforcement uncertainty arising from the vague language in the Foreign Corrupt Practices Act (FCPA).[7] Corporations under investigation for allegedly violating the Act often receive and accept deferred or non-

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1 *See* Editor, *A Fresh Look at the FCPA*, METRO. CORP. COUNS., Feb. 1, 2010, at 31.

2 *Id.*

3 *Id.*

4 Peter S. Goodman, *Clamps on Credit Tighten*, N.Y. TIMES, Oct. 13, 2009, at B1.

5 Robert J. Shiller, *Fear of a Double Dip Could Cause One*, N.Y. TIMES, May 16, 2010, at 5.

6 *See* Goodman, *supra* note 4.

7 *See infra* Part III.

prosecution agreements in order to quickly conclude the investigation, if they sufficiently cooperate with the United States Department of Justice (DOJ).[8] While these agreements provide several short-term benefits, the long-term consequences of these agreements perpetuate ambiguities surrounding enforcement of the FCPA.[9] Thus, the federal government's enforcement policy locks corporations into a cycle of regulatory uncertainty, resulting in increasing costs of doing business abroad. An efficient solution to the FCPA's ambiguity problem would be a legislative fix that clarifies the uncertainties surrounding the Act while preserving deferred and non-prosecution agreements.

The FCPA prohibits corporations from bribing foreign officials in order to obtain or retain business.[10] When Congress passed the FCPA in 1977, it sought to remove the unethical and uncompetitive business practice of bribing foreign officials that damaged public trust in the free market.[11] Over twenty percent of Fortune 500 companies voluntarily reported paying more than $300 million in bribes to foreign officials prior to the FCPA's enactment.[12] Bribery jeopardized American businesses' contracts, property, and credibility in foreign business communities, while also creating tension between the U.S. and foreign governments.[13] However, following the FCPA's enactment, enforcement actions were rare compared to the number and rate at which cases are brought today.[14] FCPA prosecutions between 1978 and 2000 averaged three per year.[15] In contrast, estimates place the number of active investigations today at 100.[16] Paralleling the rising tide of FCPA investigations are pretrial diversions—namely deferred prosecution agreements (DPA) and non-prosecution agreements (NPA)—which have also increased.[17]

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8 *See* Claudius O. Sokenu, *The Role of Corporate Internal Investigations*, 1679 CORP. L. & PRAC. COURSE HANDBOOK SERIES 83, 116-17 (2008).

9 *See infra* Part III.

10 15 U.S.C. §§ 78dd-1(a), 78dd-2(a), 78dd-3(a) (2006). *See also Foreign Corrupt Practices Act Antibribery Provisions*, U.S. DEP'T OF JUST., http://www.justice.gov/criminal/fraud/fcpa/docs/lay-persons-guide.pdf (last visited Nov. 10, 2010).

11 H.R. REP. NO. 95-640, at 4-5 (1977) (Conf. Rep.).

12 *Id.* at 4.

13 *Id.* at 4-5.

14 *See* William F. Pendergast & Nisa Gosselink-Ulep, *Comments Addressing Recent and Future FCPA Enforcement Issues*, 1665 CORP. L. & PRAC. COURSE HANDBOOK SERIES 113, 121 (2008).

15 Priya Cherian Huskins, *FCPA Prosecutions: Liability Trend to Watch*, 60 STAN. L. REV. 1447, 1449 (2008).

16 Roger M. Witten & Jay Holtmeier, *A Spiraling Caseload Under the Foreign Corrupt Practices Act*, N.Y. L.J., Feb. 9, 2009, at S4.

17 *See* Leonard Orland, *The Transformation of Corporate Criminal Law*, 1592 CORP. L. & PRAC. COURSE HANDBOOK SERIES 197, 210 (2007); Marcia Coyle, *Deferred, Nonprosecution Deals Fall by 60%*, 23 NAT'L L.J., no. 23, Feb. 9, 2009.

DPAs and NPAs provide formal legal recourse to resolve criminal disputes without subjecting corporations to a trial.[18] Although originally intended for juvenile defendants to mitigate the social stigma attached to convictions, the DOJ uses DPAs and NPAs in a variety of corporate disputes.[19] One significant consequence of utilizing these agreements in enforcing criminal law is that they do not create binding law.[20] Thus, corporations cannot rely upon past use of DPAs and NPAs in assessing the legal risk and cost exposure of their international investments.

This comment focuses solely on the DOJ's enforcement of the FCPA's anti-bribery provisions.[21] Part I describes the FCPA and certain provisions that present problems of regulatory uncertainty for corporations. Part II describes the development of DPAs and NPAs in U.S. law and then distinguishes between the basic features of both types of agreements. Part III analyzes the costs of using DPAs and NPAs as enforcement mechanisms of the FCPA. Part III also proposes a legislative solution to the vagueness of the FCPA by importing language from existing federal law. Finally, this comment concludes that Congress needs to break the regulatory "path dependency" that locks corporations into a high-cost business environment through the use of DPAs and NPAs in enforcing the FCPA.[22]

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18 Benjamin M. Greenblum, *What Happens to a Prosecution Deferred? Judicial Oversight of Corporate Deferred Prosecution Agreements*, 105 COLUM. L. REV. 1863, 1863-65 (2005).

19 *Id.* at 1866.

20 Matt A. Vega, *The Sarbanes-Oxley Act and the Culture of Bribery: Expanding the Scope of Private Whistleblower Suits to Overseas Employees*, 46 HARV. J. ON LEGIS. 425, 443 (2009).

21 The FCPA grants the federal government both criminal and civil enforcement authority. Congress also included the requirement that corporations must implement an internal accounting system that adequately keeps books and records of certain covered transactions. Additionally, corporations must establish an internal compliance system that ensures the corporation's adherence to the FCPA. The U.S. Securities and Exchange Commission enforces these provisions. *See* 15 U.S.C. § 78m(a)-(b) (2006).

22 For the purposes of this paper, "path dependency" refers to the theory that a particular decision, or set of decisions, locks into place a set of limited choices by which no party could escape, despite the existence of more appropriate alternatives. Specifically in regard to the FCPA, the lack of regulation enforcement creates a system where the DOJ and corporations are heavily incentivized to take advantage of DPAs and NPAs, rather than proceed to trial on the merits of the allegations. Incentives for the DOJ to utilize DPAs and NPAs in place of formal prosecution include limited resources, political ramifications within the Executive and Legislative Branches, and strategically keeping the law underdeveloped in order to place more pressure on corporations. Corporations also have an incentive to take advantage of DPAs and NPAs in order to protect shareholder value, minimize public scrutiny, and reduce litigation costs. Of course, path dependency is not inherently negative. Our common law system "locks" us into a set of judicial holdings via stare decisis. The problem in the case of the FCPA is the lack of litigation that produces precedent, which consequently limits delineation of the FCPA's statutory boundaries. For more information about path dependency, *see, e.g.*, Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999).

I. THE FOREIGN CORRUPT PRACTICES ACT

The FCPA represents the global standard for combating market corruption.[23] Enacted in 1977, Congress sought to restore public trust in the market, which suffered from substantial corruption and unethical business practices.[24] Following the political turmoil during the Watergate crisis, the Securities and Exchange Commission (SEC) investigated the extent to which corporations made illegal contributions to political campaigns.[25] The SEC instead discovered, amongst other things, that corporations were making corrupt payments to foreign officials.[26] In fact, over twenty percent of Fortune 500 companies voluntarily reported paying more than $300 million in bribes to foreign officials prior to the FCPA's enactment.[27] Congress responded by passing one of the most remarkable international regimens against corruption in the market, and it remains so today.[28]

In its simplest form, the FCPA prohibits corporations from bribing foreign officials into using their official capacity to assist the corporation in obtaining or retaining business in foreign markets.[29] Over the last three decades, Congress has only amended the FCPA twice.[30] In 1988, Congress amended the FCPA to narrow the knowledge requirement, and to allow corporations to make facilitating payments, or "grease" payments, in order to expedite routine governmental administrative matters.[31] Typically, corporations make grease payments to expedite routine, non-discretionary governmental tasks, such as permit applications.[32] Congress also amended the FCPA to grant corporations two affirmative defenses.[33] A corporation may successfully defend against an FCPA violation if the foreign country permits such payments "under their written laws and regulations."[34] Con-

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23 Alexandros Zervos, *Amending the Foreign Corrupt Practices Act: Repealing the Exemption for "Routine Government Action" Payments*, 25 PENN. ST. INT'L L. REV. 251, 283 (2006).

24 H.R. REP. NO. 95-640, at 4-5.

25 Andrew Brady Spalding, *Unwitting Sanctions: Understanding Anti-Bribery Legislation as Economic Sanctions Against Emerging Markets*, 62 FLA. L. REV. 351, 359 (2010).

26 *Id.* at 360.

27 H.R. REP. NO. 95-640, at 4.

28 *See* Spalding, *supra* note 25, at 353-54.

29 15 U.S.C. §§ 78dd-1(a), 78dd-2(a), 78dd-3(a) (2006).

30 Alejandro Posadas, *Combating Corruption Under International Law*, 345 DUKE J. COMP. & INT'L L. 345, 359 (2000).

31 Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, Title V, § 5003(a), 02 Stat. 1107. *See also id.*; *infra* Part I.C.

32 David Dworsky, *Foreign Corrupt Practices Act*, 46 AM. CRIM. L. REV. 671, 683-84 (2009). For more information, see Zervos, *supra* note 23, at 266-69.

33 International Anti-Bribery and Fair Competition Act of 1998, Pub. L. No. 105-366, § 2, 112 Stat. 3302.

34 Cortney C. Thomas, Note, *The Foreign Corrupt Practices Act: A Decade of Rapid Expansion Explained, Defended, and Justified*, 29 REV. LITIG. 439, 446 (2010) (citing 15 U.S.C. §§ 78dd-1(b), 78dd-2(b), 78dd-3(b)).

gress also provided an affirmative defense for corporations if they can demonstrate that "the payment 'was a reasonable and bona fide expenditure, such as travel and lodging expenses, [that] was directly related to [either] the promotion, demonstration, or explanation of products or services [or] the execution or performance of a contract with a foreign government or agency thereof.'"[35]

Congress's most recent FCPA revisions added language to comport with the ratification of the Organization of Economic Cooperation and Development (OECD) Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.[36] The treaty establishes a uniform legal system against bribery across each signatory country.[37] U.S. anti-bribery enforcement under the FCPA substantially eclipses enforcement of similar laws by other parties to the OECD Convention.[38] Because a greater risk comes from FCPA enforcement, business leaders subject to the Act frequently voice frustration with its ambiguous language and lack of clear guidance outlining lawful conduct.[39]

Business leaders should be aware of several key provisions within the FCPA. Broadly, the FCPA's anti-bribery provisions prohibit corporations from bribing foreign officials in order to retain or obtain business.[40] Congress wrote the FCPA expansively, subjecting both domestic and foreign corporations to the Act's jurisdiction.[41] Additionally, FCPA liability extends to public and private corporations, foreign subsidiaries, sole proprietorships, and individuals.[42] Due to the Act's broad scope and the continuing globalization of companies, business leaders and policymakers alike must understand the impact on investment decisions and regulatory challenges due to undefined or ambiguous language within the statute.

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35 *Id.* at 446-47 (citing 15 U.S.C. §§ 78dd-1(c)(2), 78dd-2(c)(2), 78dd-3(c)(2)).

36 Dworsky, *supra* note 32 at 753-54 n.61.

37 *See* Laura E. Kress, Comment, *How the Sarbanes-Oxley Act has Knocked the "SOX" Off the DOJ and SEC and Kept the FCPA on Its Feet*, 10 U. PITT. J. TECH. L. & POL'Y 2 (2009).

38 *Id.*

39 *See* Homer E. Moyer, Jr., *Voluntary Disclosure, Independent Compliance Monitors, and Other FCPA Enforcement Issues*, METRO. CORP. COUNS., June 1, 2005, at 41.

40 15 U.S.C. §§ 78dd-1(a), 78dd-2(a), 78dd-3(a) (2006).

41 *Id. See also* Roger M. Witten et al., *Prescriptions for Compliance with the Foreign Corrupt Practices Act: Identifying Bribery Risks and Implementing Anti-Bribery Controls in Pharmaceutical and Life Sciences Companies*, 64 BUS. LAW. 691, 697-98 (2009).

42 15 U.S.C. §§ 78dd-1(a), 78dd-2(a), 78dd-3(a).

A. *What Constitutes Knowledge?*

The FCPA delineates two types of payments generally: direct and indirect. Direct payments made by corporations to third parties require a willful state of mind, whereas indirect payments do not.[43] The FCPA considers direct payments to encompass payments made by corporations to third parties, who in turn make an illicit payment to a foreign official.[44] Under the original language of the FPCA, a corporation *knew* that a payment to a third party constituted a bribe when the corporation possessed positive knowledge of the payment or had reason to know such payment was going to occur.[45] As a result, corporations tended to "bury their heads in the sand" by avoiding investigations into third party transactions.[46]

Concerned with these perverse incentives,[47] Congress amended the FCPA in 1988 by expanding the knowledge requirement to include cases of nonfeasance.[48] The FCPA now prohibits corporations from making an indirect payment to a foreign official, foreign political party, or candidate for political office, *knowing* that the payment *may* influence or induce an act or omission by the official.[49] Congress effectively broadened the *mens rea* element for payments made to third parties.[50] The revision moved the definition of knowledge away from a strict positive knowledge requirement to high probability, a looser knowledge standard that includes "conscious disregard," "willful blindness" and "deliberate ignorance."[51] Thus, under the new definition a corporation meets the *mens rea* standard when, for example, it can reasonably infer that a payment to a third party would be made to a foreign official.[52]

Business leaders have difficulty determining when a corporation's knowledge sufficiently amounts to a level that constitutes a high probability of knowledge. Consider a typical scenario where a sales manager striving to meet her sales quota, pressures a third party business associate (e.g. consultant, distributor, or sales representative) to make an additional sale or

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43 15 U.S.C. §§ 78dd-1(a)(1)-(2), 78dd-2(a)(1)-(2), 78dd-3(a)(1)-(2).

44 15 U.S.C. §§ 78dd-1(a)(3), 78dd-2(a)(3), 78dd-3(a)(3).

45 Tor Krever, *Curbing Corruption? The Efficacy of the Foreign Corrupt Practices Act*, 33 N.C. J. INT'L L. & COM. REG. 83, 88 (2007).

46 *See* H.R. REP. NO. 100-576, at 919 (1988) (Conf. Rep.) *reprinted in* 1988 U.S.C.C.A.N. 1547, 1952.

47 2 OTTO G. OBERMAIER & ROBERT G. MORVILLO, WHITE COLLAR CRIME: BUSINESS AND REGULATORY OFFENSES § 16.02[3], at 16-10 (Robert J. Anello et al. eds., 39th rel. 2009).

48 *Id.*

49 15 U.S.C. §§ 78dd-1(a)(3), 78dd-2(a)(3), 78dd-3(a)(3).

50 H.R. REP. NO. 100-576, at 919.

51 *Id.*; *see e.g.* 2 OBERMAIER & MORVILLO, *supra* note 47.

52 Roger M. Witten et al., *Prescriptions for Compliance with the Foreign Corrupt Practices Act: Identifying Bribery Risks and Implementing Anti-Bribery Controls in Pharmaceutical and Life Sciences Companies*, 64 BUS. LAW. 691, 698 (2009).

recommendation to a government official to purchase the company's product.[53] The third party subsequently deviates from what otherwise would be lawful behavior and offers part of his commission to the government official to entice additional purchases. Although this hypothetical appears to be quite simplistic, the key question remains for business leaders: Under the high probability standard, how and at what point would a corporation know that its conduct amounts to an illicit payment under the FCPA?

The FCPA's legislative history provides little clarity for this issue. The House Conference Report on the 1988 amendments reported that Congress intended to define the high probability knowledge requirement to include instances involving the "conscious purpose to avoid learning the truth."[54] In other words, corporations cannot bury their heads in the sand in an effort to escape criminal liability. A corporation satisfies the knowledge requirement if it has reasonable knowledge that a payment to a third party would be used unlawfully under the FCPA. Unfortunately, for corporations attempting to build an adequate corporate compliance program, the legislative history fails to offer practical guidance for what is impermissible under the broad scope of the high probability standard.[55]

B. *Who is a Foreign Official?*

One of the most difficult challenges that corporations face involves determining whether a person falls within the definition of "foreign official" under the FCPA.[56] The FCPA broadly defines a foreign official to include persons employed as "instrumentalities" of governmental departments or agencies.[57] However, both case law and the Act's legislative history neglect to articulate how far removed from the central government a person may be and still qualify as a foreign official.[58] For example, could a doctor working in a free clinic partially sponsored by local government resources count as a foreign official under the FCPA? The DOJ interprets the instrumentalities provision to include employees of state-owned or controlled enterprises.[59] Some commentators question this interpretation, citing a lack of legal authority from legislative history or case law.[60] Further, the extent of control a government must exercise over the instrumentality is uncertain for the

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53 *See, e.g.*, Donald Zarin, *The Foreign Corrupt Practices Act 2009: Coping with Heightened Enforcement Risks, The Foreign Payments Provisions*, 1737 PLI/CORP. 109, 145-47 (2009).

54 H.R. REP. NO. 100-576, at 919.

55 Zarin, *supra* note 53, at 145-47.

56 *Id.* at 128-40.

57 15 U.S.C. §§ 78dd-1(a), 78dd-2(a) (2006).

58 Zarin, *supra* note 53, at 129.

59 Joel M. Cohen, Michael P. Holland & Adam P. Wolf, *Under the FCPA, Who is a Foreign Official Anyway?*, 63 BUS. LAW. 1243, 1250 (2008).

60 *Id.* at 1255-63.

purposes of determining if a person qualifies as a foreign official.[61] Through its opinion release procedure, the DOJ incorporated a broad definition of an instrumentality, which even encompassed employees of organizations with a minority governmental ownership stake.[62] Certainly, the lack of clear standards pose difficulties for business leaders making investment decisions in foreign countries with governments that are more intricately involved in their economic and political institutions.

C. *What Constitutes a Corrupt Payment?*

Does the FCPA allow a corporate officer to offer a gratuity to a foreign official, even though no pending transaction exists before the official? For corporations investing overseas, the FCPA may or may not prohibit gift giving as a courtesy. Specifically, the FCPA prohibits corporations from making corrupt payments to foreign officials in order to retain or obtain business.[63] While the Act forbids such corrupt payments, the statute fails to include a definition of "corrupt."[64] The Senate and House Committee Reports define the term as a corporate payment made with the intention to induce a foreign official to direct business to the corporation.[65] These reports further define the *mens rea* requirement as a payment made for an evil purpose.[66] Accordingly, this interpretation implies that a quid pro quo is symptomatic of a corrupt payment, thereby establishing a presumption any time a corporation makes a payment with a belief that its business will procure benefit from it.[67]

One of the rare FCPA cases addressed the issue of gift giving. In *United States v. Liebo*, a corporate officer provided airline tickets to an official in the Nigerian Air Force to assist in persuading the President of Nigeria to approve a military service contract under the United States Foreign Military Sales program.[68] The United States Court of Appeals for the Eighth Circuit affirmed the lower court's holding: the airline tickets met the definition of a corrupt payment under the FCPA because the corporate of-

61 Witten et al., *supra* note 52, at 697.

62 Zarin, *supra* note 53, at 134. The Fifth Circuit noted the connection between a payment and its purpose of obtaining or retaining as the "business nexus requirement." *See* United States v. Kay, 359 F.3d 738 (5th Cir. 2004).

63 15 U.S.C. §§ 78dd-1(a), 78dd-2(a), 78dd-3(a) (2006).

64 15 U.S.C. §§ 78dd-1(f), 78dd-2(h), 78dd-3(f) (2006).

65 Jennifer Dawn Taylor, Comment, *Ambiguities in the Foreign Corrupt Practices Act: Unnecessary Costs of Fighting Corruption*, 61 LA. L. REV. 861, 872 n.73 (2001); Witten et al., *supra* note 52, at 698 n.39.

66 Witten et al., *supra* note 52, at 698 n.39.

67 *See* Taylor, *supra* note 65, at 872.

68 U.S. v. Liebo, 923 F.2d 1308, 1309-10 (8th Cir. 1991).

ficer's gift was a catalyst for obtaining approval of the contract.[69] After *Liebo*, questions remain as to whether any form of gift giving can exist under the FCPA. For example, can a corporation entering into a new market give gifts to government officials to convey respect and acknowledgment of cultural practices? If so, how far removed must the actual gift be from the business involving the foreign official?

The seminal case highlighting the vagueness of the FCPA came in 2004, thirteen years after *Liebo*—this time before the U.S. Court of Appeals for the Fifth Circuit. In *United States v. Kay*, the Federal Government charged two executives of a Texas rice exporting company with bribing customs officials to reduce the amount of duties paid to the Haitian government.[70] The defendants successfully moved to dismiss the charges at trial, arguing that the FCPA prohibits only those bribes paid directly or indirectly to obtain or retain business—commonly referred to as the business nexus requirement.[71] The defendants contended that the bribes paid for tax avoidance fell outside the scope of the FCPA because the customs officials were not involved in facilitating the defendants' business contracts; thus, the bribes were not made in order to influence the defendants' business contracts.[72] The district court agreed with the defense that on its face, the statute does not prohibit corporations from making payments to foreign officials in order to reduce their customs duties and taxes.[73]

On appeal, the Fifth Circuit noted that the business nexus requirement under the FCPA presents an issue of attenuation.[74] The court questioned how far removed a payment a corporation could make and still face liability under the FCPA.[75] Nonetheless, the court reversed the trial court holding that although the plain language of the FCPA is vague, the legislative history shows that Congress intended to extend culpability to instances where bribes improved business opportunities.[76] As a result, *Kay* broadened the scope of the business nexus element to include payments made to gain a comparative business advantage.[77]

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69 *Id.* at 1312. The Court remanded the case for a new trial because newly discovered evidence of the corporation's president directing the defendant to give the airline tickets to the foreign official may cause a jury to conclude that the defendant did not act with a corrupt intent. *Id.* at 1313.

70 United States v. Kay, 359 F.3d 738, 740-41 (5th Cir. 2004).

71 *Id.*

72 *Id.*

73 Unites States v. Kay, 200 F. Supp. 2d 681 (S.D. Tex. 2002).

74 *Kay*, 359 F.3d at 743-44.

75 *Id.*

76 *Id.* at 749-50.

77 Juscelino F. Colares, *The Evolving Domestic and International Law Against Foreign Corruption: Some New and Old Dilemmas Facing the International Lawyer*, 5 WASH. U. GLOBAL STUD. L. REV. 1, 13-14 (2006).

However, the Fifth Circuit's holding neglects to address payments or gifts made in connection to an expectation of business.[78] *Kay* dealt with a comparative advantage immediately apparent and discernable by the reduction of duties and sales taxes; the court's opinion did not address cases of payments made with a substantial temporal gap between the payment and the foreign official's act. It remains unclear whether a corporate executive, who gave a gift to a high-level government official as a sign of respect, would be exposed to liability for a contract granted ten years later.

D. *Legislative Exceptions*

Congress provided three escape valves for corporations who are uncertain of the legality of certain actions. One exception to FCPA's corrupt payment provision permits corporations to make facilitating payments to foreign officials for the purpose of securing or expediting routine government action, which the corporation is normally entitled to do in the regular course of business.[79] Congress added this exception in 1988 when corporations complained that overseas investment and international trade with the United States would substantially suffer without these payments.[80] Further, Congress included more specific language in the amendment and provided examples of payments that meet this exception in the House Conference Report.[81] For example, a corporation may make a grease payment to a foreign official to obtain a zoning permit for employees traveling to the foreign country.[82]

A second exception to the corrupt payment provision is the "reasonable and bona fide expenditure" exception.[83] Corporations who seek protection under this exception must demonstrate that the payment is, "directly related to (A) the promotion, demonstration, or explanation of products or services; or (B) the execution or performance of a contract with a foreign government."[84] Although corporations must not en-

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78 *Cf. Kay*, 359 F.3d 738, 743-44 (5th Cir. 2004) ("Perhaps our most significant statutory construction problem results from the failure of the language of the FCPA to give a clear indication of the exact scope of the business nexus element; that is, the proximity of the required nexus between, on the one hand, the anticipated results of the foreign official's bargained-for action or inaction, and, on the other hand, the assistance provided by or expected from those results in helping the briber to obtain or retain business . . . .").

79 15 U.S.C. §§ 78dd-1(b), 78dd-2(b), 78dd-3(b) (2006).

80 H.R. REP. NO. 100-576, at 916.

81 *Id.* at 921.

82 15 U.S.C. §§ 78dd-1(f)(3)(A)(ii), 78dd-2(h)(4)(A)(ii), 78dd-3(f)(3)(A)(ii). The FCPA also provides for other examples of routine government actions for which the FCPA permits grease payments. *See id.*

83 Vega, *supra* note 20, at 445-46.

84 *Id.*

gage in a quid pro quo while paying these "reasonable business expenses," it is difficult to determine where to draw a bright line that allows companies to readily define permissible business conduct, while being neither over-inclusive nor under-inclusive.[85]

The final legislative exception allows corporations to seek the DOJ's advice through a unique, informal advisory process. The FCPA authorizes the United States Attorney General to provide guidance to a corporation inquiring about the implications of a potential violation.[86] The procedure requires the DOJ to issue an advisory opinion within thirty days, based upon the information provided by the corporation, regarding the legality of the issue presented by the corporation.[87] In court, a supportive DOJ opinion grants a rebuttable presumption in favor of the corporation that the issue at bar comports with the FCPA.[88] Finally, the opinion procedures permit the DOJ to disseminate advisory opinions to the public.[89] The publicized opinions serve only as guidance as the opinions are not binding and have no precedential value in court for anyone other than the company which requested the opinion.[90] Altogether, none of these three exceptions offer any remarkable clarification of the FCPA's statutory language that would not have otherwise developed from formal adjudication.

II. DEFERRED AND NON-PROSECUTION AGREEMENTS

A. *Historical Use of DPAs and NPAs*

DPAs and NPAs provide law enforcement with unique prosecutorial leverage that allows prosecutors to bypass adjudication in favor of alternative dispute resolution. The use and justification for these agreements have evolved from their origins. In the early twentieth century, DPAs and NPAs emerged as courts sought alternatives to prosecution for juvenile defendants and first-time offenders.[91] During this time, state courts relied on DPAs as an alternative to prosecuting juvenile offenders who suffered from society's stigma against criminal convicts.[92] During the last fifty years, prosecutors frequently used DPAs due to an increase in the number of juvenile and drug

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85 *Id.* at 446.

86 15 U.S.C. §§ 78dd-1(e), 78dd-2(f) (2006).

87 *Id.*

88 *Id.*

89 Witten et al., *supra* note 52, at 702-03.

90 *Id.*

91 Peter Spivack & Sujit Raman, *Regulating the 'New Regulators': Current Trends in Deferred Prosecution Agreements*, 45 AM. CRIM. L. REV. 159, 163 (2008) (citing Greenblum, *supra* note 18).

92 Greenblum, *supra* note 18, at 1866.

offenders.[93] In the juvenile crime context, legislators faced public pressure to convict juvenile offenders and therefore expanded prosecutorial power by giving prosecutors the discretion in filing charges against juveniles in general courts of law.[94] The development and use of DPAs in the federal criminal context, however, took a different route.

The Supreme Court in *Barker v. Wingo* noted the lack of legislation implementing the Sixth Amendment right to a speedy trial,[95] and created a multi-factor test to fill this void.[96] In response, Congress passed the Speedy Trial Act of 1974.[97] Acting immediately after *Barker*, Congress acknowledged the Court's observation and ended judicial rulemaking of the Sixth Amendment.[98] The House Report illustrates Congress's fear that the four-factor *Barker* test would be too cumbersome in defining the Sixth Amendment right to a speedy trial.[99] The substantive portion of the Speedy Trial Act imposes various time limits on the prosecution for bringing a trial and on the courts for sentencing a defendant.[100] However, the Act excluded DPAs in determining violations of a defendants' right to a speedy trial.[101] Over the next twenty-two years, formal federal guidance was largely lacking in regards to DPA use.

The evolution to the present application of DPAs and NPAs began with the Clinton Administration. In 1997, the DOJ issued its own guidelines governing DPA use in the United States Attorney's Manual (the Manual).[102] According to the Manual, pretrial diversion programs serve four objectives:

> [T]o prevent future criminal activity among certain offenders by diverting them from traditional processing into community supervision and services; to save prosecutive [sic] and judicial resources for concentration on major cases; to provide, where appropriate, a vehicle for

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93 *Id.*

94 *See* Sally T. Green, *Prosecutorial Waiver into Adult Criminal Court: A Conflict of Interests Violation Amounting to the States' Legislative Abrogation of Juveniles' Due Process Rights*, 110 PENN ST. L. REV. 233, 242-43 (2005).

95 Barker v. Wingo, 407 U.S. 514, 523-32 (1972).

96 *Id.*

97 Orland, *supra* note 17, at 211; H.R. REP. NO. 93-1508, at 3-4 (1974), *reprinted in* 1974 U.S.C.C.A.N. 7401, 7404-05.

98 *See* H.R. REP. NO. 93-1508.

99 *Id.* ("[T]he Court stressed four factors in determining whether the right to a speedy trial had been denied to a defendant: Length of delay, the reason for the delay, the defendant's assertion of his right, and prejudice to the defendant. The task of balancing these factors and arriving at a conclusion which is fair in all cases is a difficult task.").

100 H.R. REP. NO. 93-1508, at 5-6 (1974), *reprinted in* 1974 U.S.C.C.A.N. at 7406. *See* 18 U.S.C. § 1361 (2006).

101 H.R. REP. NO. 93-1508, at 14 (1974), *reprinted in* 1974 U.S.C.C.A.N. at 7415. *See* 18 U.S.C. § 1361(h)(2) (2006).

102 Greenblum, *supra* note 18, at 1867.

restitution to communities and victims of crime; and the period of supervision is not to exceed 18 months, but may be reduced.[103]

The Manual also sets out eligibility criteria precluding pretrial diversion programs in certain circumstances such as those involving persons convicted of felonies.[104] These standards provide general guidance to federal prosecutors for implementing pretrial diversion programs such as DPAs. Nonetheless, these standards fail to provide clear guidance in reference to corporate DPAs.

Federal guidance over the use of DPAs and NPAs clearly discount their use in the corporate context for several reasons. First, the Manual's language envisions pretrial diversion programs monitoring individuals, not corporations or business entities; one can hardly imagine that "community supervision and services" applies to corporations.[105] Second, federal prosecutors sparingly used DPAs and NPAs until recently.[106] The federal government initiated the very first corporate NPA in 1992 when the DOJ and the U.S. Securities and Exchange Commission declined to prosecute Salomon Brothers for violating federal antitrust and securities laws.[107] Between 1993 and 1996, the DOJ entered into a total of ten corporate DPAs and NPAs.[108] The DOJ filed six more corporate DPAs and NPAs by 2002.[109] Since 2002, the DOJ's use of corporate DPAs and NPAs drastically increased, reaching a historical high of forty filings in 2007.[110]

B. *Modern Use of Corporate DPAs and NPAs*

The DOJ realized the usefulness of DPAs and NPAs in prosecuting corporations when it produced the Holder Memorandum (Holder Memo). The Holder Memo represents the DOJ's first attempt at establishing guidelines for using DPAs and NPAs specifically in the corporate criminal context.[111] In 1999, then-Deputy Attorney General Eric Holder outlined eight

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103 U.S. Att'ys Manual 9-22.010, 1997 WL 1944677 (U.S.A.M.) § Introduction (2009).

104 *Id.* at § Eligibility Criteria (2009).

105 *Id.* at § Introduction (2009).

106 *See* Ralph F. Hall, *Deferred Prosecution and Non-Prosecution Agreements*, *in* PUNISH CORPORATE CRIME: LEGAL PENALTIES FOR CRIMINAL AND REGULATORY VIOLATIONS 119, 128 (Oxford Univ. Press 2009).

107 Greenblum, *supra* note 18, at 1872.

108 Orland, *supra* note 17, at 210.

109 Erik Paulsen, Note, *Imposing Limits on Prosecutorial Discretion in Corporate Prosecution Agreements*, 82 N.Y.U. L. REV. 1434, 1444 (2007).

110 Coyle, *supra* note 17, at 9.

111 Robert J. Ridge & Mackenzie A. Baird, *The Pendulum Swings Back: Revisiting Corporate Criminality and the Rise of Deferred Prosecution Agreements*, 33 U. DAYTON L. REV. 187, 190-92 (2008).

factors federal prosecutors should consider in determining whether to prosecute a corporation, a "rogue" employee, or both.[112] Holder further clarified that appropriate NPA use should comport with the general principles of entering into NPAs outlined in the Manual.[113] The Manual's principles established a basic framework for balancing the costs and benefits of prosecution with the public's interest in securing either a conviction or some form of documented criminal liability.[114] Accordingly, DOJ prosecutors would grant an NPA if prosecution, plea agreement, or a grant of immunity in exchange for defendant testimony, would not be effective or available for a corporation, and the prosecutor determines the "Holder factors" would justify entering into an agreement.[115] However, Deputy Attorney General Holder did not require DOJ prosecutors to follow these guidelines when prosecuting corporations.[116]

In 2003, then-Deputy Attorney General Larry Thompson issued a follow-up memorandum revisiting Holder's guidance.[117] Unlike its predeces-

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112 Memorandum from Eric Holder, Deputy Att'y Gen., U.S. Dep't of Justice, to Heads of Dep't Components and U.S. Att'ys, Bringing Criminal Charges Against Corporations, U.S. DEP'T OF JUST. (June 16, 1999), http://www.justice.gov/criminal/fraud/documents/reports/1999/charging-corps.pdf (last visited May 16, 2010).

These factors are:

> (1) The nature and seriousness of the offense, including the risk of harm to the public, and applicable policies and priorities, if any, governing the prosecution of corporations for particular categories of crime;
> (2) The pervasiveness of wrongdoing within the corporation, including the complicity in, or condonation [sic] of, the wrongdoing by corporate management;
> (3) The corporation's history of similar conduct, including prior criminal, civil, and regulatory enforcement actions against it;
> (4) The corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of the corporate attorney-client and work product privileges;
> (5) The existence and adequacy of the corporation's compliance program;
> (6) The corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies;
> (7) Collateral consequences, including disproportionate harm to shareholders and employees not proven personally culpable; and,
> (8) The adequacy of non-criminal remedies, such as civil or regulatory enforcement actions.

Id.

113 *Id.* ("In some circumstances, therefore, granting a corporation immunity or amnesty may be considered in the course of the government's investigation. In such circumstances, prosecutors should refer to the principles governing non-prosecution agreements generally.").

114 U.S. Att'ys Manual 9-27.600, 1997 WL 1944718 (U.S.A.M.) ("If he/she concludes that a non-prosecution agreement would be the only effective method for obtaining cooperation, the attorney for the government should consider whether, balancing the cost of foregoing prosecution against the potential benefit of the person's cooperation, the cooperation sought appears necessary to the public interest.").

115 Memorandum from Eric Holder, *supra* note 112.

116 *Id.*

117 Greenblum, *supra* note 18, at 1874.

sor, the Thompson Memorandum (Thompson Memo) required all U.S. Attorneys to adhere to its guidelines.[118] The memorandum also stipulated an additional factor in deciding whether to defer, decline, or prosecute a corporate defendant.[119] Nevertheless, the teeth of the memorandum came from Thompson's two-part message: Prosecutors must scrutinize the sincerity of corporations cooperating with an investigation, and whether compliance programs truly enhance corporate governance or merely act as paper tigers.[120] DOJ prosecutors would judge a corporation's cooperation along "a continuum between genuinely assisting the government and affirmatively impeding it."[121] Often, this meant that prosecutors required corporations to waive their attorney–client privilege as a condition to the DPA or NPA.[122] The DOJ justified this policy based on the Thompson Memo and insisted that it is necessary to conduct a complete investigation.[123]

The Thompson Memo's policy on aggressively seeking attorney–client privilege waivers came under scrutiny in 2006 in *United States v. Stein.*[124] In *Stein*, the DOJ indicted a former senior partner at the accounting firm KPMG, which stemmed from a criminal referral by the U.S. Internal Revenue Service.[125] Due to KPMG's corporate policy and its preexisting agreement with Stein, KPMG bore all legal fees associated with the case.[126] In accordance with the Thompson Memo, DOJ prosecutors inquired as to KPMG's obligation to pay Stein's legal fees in assessing the authenticity of KPMG's cooperation.[127] Additionally, DOJ prosecutors insisted that KPMG as well as its current and former employees waive their attorney–client privilege, rather than just Stein.[128] KPMG agreed to waive their privilege in order to obtain a DPA, which the DOJ granted.[129]

Judge Lewis Kaplan of the United States District Court for the Southern District of New York rebuked the DOJ for infringing the employees' Fifth Amendment rights to a fair trial and their Sixth Amendment rights to

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118 United States v. Stein, 435 F. Supp. 2d 330, 338 (S.D.N.Y. 2006).

119 Memorandum from Larry D. Thompson, Deputy Att'y Gen., U.S. Dep't of Justice, to Heads of Dep't Components and U.S. Att'ys, Principles of Federal Prosecution of Business Organizations, U.S. DEP'T OF JUST. (Jan. 20, 2003), http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm (last visited Nov. 10, 2010) ("[T]he adequacy of the prosecution of individuals responsible for the corporation's malfeasance.").

120 *Id.*; Ridge & Baird, *supra* note 111, at 192-93.

121 Christopher A. Wray & Robert K. Hur, *Corporate Criminal Prosecution in a Post-Enron World: The Thompson Memo in Theory and Practice*, 43 AM. CRIM. L. REV. 1095, 1103 (2006).

122 *Id.* at 1172-73.

123 *Id.* at 1175.

124 *See Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006).

125 *Id.* at 339.

126 *Id.*

127 *Id.* at 341.

128 *Id.* at 350.

129 *Id.* at 352-53.

access counsel.[130] Amongst other findings, the court found that the Thompson Memo interfered with KPMG's agreement to pay for current and former employees' access to effective counsel; in this way, the Thompson Memo undermined the adversarial process essential to a fair trial.[131] The *Stein* decision forced the DOJ to rethink the Thompson Memo's policy of giving prosecutors broad discretion in negotiating and entering into a corporate DPA.[132]

Immediately following the decision in *Stein*, the DOJ revised the Thompson Memo's guidelines granting broad prosecutorial discretion in utilizing a DPA or NPA. Then-Deputy Attorney General Paul McNulty issued a memorandum on December 12, 2006, establishing a new procedure for the DOJ in requesting a defendant corporation waive both the attorney–client privilege and the work–product doctrine.[133] First, federal prosecutors must seek leave from the supervising attorney—the Assistant Attorney General in charge of the DOJ's Criminal Division, and in limited cases the Deputy Attorney General—in order to demand that a corporation waive these rights.[134] Second, a corporation's payment of an employees' legal fees may only be used in extremely rare circumstances to calculate the authenticity of a corporation's cooperation, which is still largely determined based on the totality of the circumstances.[135] However, these changes lasted less than two years. The most recent guidance, issued by Deputy Attorney General Mark Filip in 2008, reframes the DOJ's handling of corporate criminal prosecutions.

The Filip Memorandum (Filip Memo) represents a dramatic shift in policy away from expansive prosecutorial discretion to a more restrained approach in deciding whether to implement a corporate DPA or NPA. This latest guidance eliminates from consideration whether a corporation waives its attorney–client privilege and the work–product doctrine when evaluating the authenticity of a corporation's cooperation.[136] Commentators view this shift merely as window dressing, believing that prosecutors still retain broad discretion and will continue to insist on these privilege waivers.[137]

Despite the DOJ's shifting policy guidance, DPAs and NPAs remain quite popular compared to years past (though not used as frequently as it

130 Spivack & Raman, *supra* note 91, at 169.

131 *Stein*, 435 F. Supp. 2d at 368-69.

132 Spivack & Raman, *supra* note 91, at 169-72.

133 Ridge & Baird, *supra* note 111, at 193.

134 Spivack & Raman, *supra* note 91, at 170; Ridge & Baird, *supra* note 111, at 193-94.

135 Spivack & Raman, *supra* note 91, at 170.

136 Memorandum from Mark R. Filip, Deputy Att'y Gen., U.S. Dep't of Justice, to Heads of Dep't Components and U.S. Att'ys, Principles of Federal Prosecution of Business Organizations, U.S. DEP'T OF JUST., 9 (Aug. 28, 2008), § 9-28.720: Cooperation: Disclosing the Relevant Facts, http://www.justice.gov/dag/readingroom/dag-memo-08282008.pdf (last visited Nov. 13, 2010).

137 *See e.g.* Mark L. Rotert & Bradley E. Lerman, *New Ethical Challenges in Internal Investigations*, 1745 PLI/CORP 857, 862-65 (2009).

was in 2007).[138] Following the Holder Memo, the frequency of the agreements grew rapidly in conjunction with the rise of corporate accounting scandals.[139] With the Obama Administration in the White House, experts expect a shift toward an increase in regulatory enforcement of white collar crime including the FCPA.[140]

C. *Functionality of DPAs and NPAs*

DPAs and NPAs serve as alternatives to litigation, initially designed to rehabilitate and reduce the stigma associated with first-time criminal offenders.[141] Cut from the same cloth, DPAs and NPAs enable a prosecutor to forgo a trial in exchange for an agreement that punishes, deters, and rehabilitates a defendant.[142] These agreements possess one fundamental difference: the filing of formal criminal charges. The prosecutor will file formal charges with a court before entering into a DPA with a defendant.[143] With NPAs, defendants may escape formal charges, subject to the corporation's adequate performance under the terms of its NPA.[144] However, the basic structure of both agreements follow a typical set of standard conditions and terms, modified to fit the circumstances of each case. The following are a list of four common elements found in corporate DPAs and NPAs:

> (1) Admission of Facts. DPAs and NPAs typically require that the corporate defendant admit to particular facts that effectively establish culpability for its conduct.[145] These facts are stipulated between the prosecutor and defendant, and may be admissible in court if the DPA or NPA terms are breached.[146] If admitted into evidence, these agreements amount to an admission of guilt.[147]
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> (2) Cooperation. Prosecutors often seek cooperation from the defendant corporation to facilitate investigation of the case.[148] Before the Filip Memo, prosecutors often pressured the defendant corporation to

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138 Hall, *supra* note 106 at 131.

139 *Id.* at 138-40.

140 Dean Gonsowski, *Under Obama, Justice Dept. Scrutinizing Global Practices*, LEGAL INTELLIGENCER, Oct. 7, 2009.

141 Greenblum, *supra* note 18, at 1866.

142 Richard S. Gruner, *Three Painful Lessons: Corporate Experience with Deferred Prosecution Agreements*, 1623 PLI/CORP 51, 56 (2007).

143 *See* Paulsen, *supra* note 109, at 1438.

144 *Id.*

145 Gruner, *supra* note 142, at 57; Paulsen, *supra* note 109, at 1441.

146 Paulsen, *supra* note 109, at 1441.

147 *See Id.*

148 *Id.* at 1439-40.

turn over documents and data, make witnesses available, and waive its attorney–client privilege in order to obtain a DPA or an NPA.[149] Presently, the 'continuum of cooperation' is no longer determinative in obtaining a DPA or NPA following the Filip Memo's attempt to comply with the ruling in *Kay*.[150] Prosecutors consider various methods of cooperation based upon the individual circumstances underlining an investigation, including: requiring corporations to conduct internal investigations; corporations submitting reports to prosecutors of all future internal investigations of alleged misconduct; and requiring directors, officers, employees, and agents to testify.[151]

(3) Time. DPAs and NPAs often require corporations to waive adherence to the statute of limitations. Such waivers result in open charges against a corporation for an indefinite period of time. In a study conducted by the U.S. Government Accountability Office, investigators found that the duration of DPAs and NPAs typically ranged from three months to five years.[152]

(4) Rehabilitation/Other. Finally, corporate defendants typically must implement rehabilitative reforms. Prosecutors often require corporations to institute corporate compliance programs with a federal monitor to prevent behavioral relapse.[153] Also, additional reforms proposed by a mutually agreed-upon neutral party may be imposed upon the defendant corporation.[154] Monetary consequences in the form of a fine, restitution, and/or forfeiture of financial gains resulting from the alleged misconduct often accompany DPAs and NPAs.[155]

III. THE UNINTENDED COSTS TO CORPORATIONS IN USING DPAS AND NPAS IN ENFORCING THE FCPA

Risk-taking is a focus of American entrepreneurship and corporate governance.[156] A successful corporation in today's global market must be

149 Gruner, *supra* note 142, at 57.

150 Paul E. McGreal, *Corporate Compliance Survey*, 65 BUS. LAW. 193, 198-99 (2009).

151 Gruner, *supra* note 142, at 57-61.

152 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-636T, CORPORATE CRIME: PRELIMINARY OBSERVATIONS ON DOJ'S USE AND OVERSIGHT OF DEFERRED PROSECUTION AND NON-PROSECUTION AGREEMENTS, 16 (2009).

153 Gruner, *supra* note 142, at 58.

154 *Id.*

155 *Id.*

156 Houman B. Shadab, *Innovation and Corporate Governance: The Impact of Sarbanes-Oxley*, 10 U. PA. J. BUS. & EMP. L. 955, 965 (2008).

able to accurately gauge the risks and rewards of its investment decisions.[157] Due to increasing competitive pressures, corporations constantly need to find new markets to be able to recognize opportunities and expand.[158] American corporate law values the importance of risk-taking and entrepreneurship by instituting legal mechanisms such as the business judgment rule and indemnity provisions in corporate charters.[159]

Statutory clarity is essential to factoring the costs associated with investment decisions by enabling corporations to accurately consider the costs of complying with the law. Although DPAs and NPAs may offer some short-term benefits, such as quicker resolution, long-term reliance on DPAs and NPAs as primary enforcement mechanisms in corporate law imposes significant costs, both to the market and federal law.

A. *The Continued Use of DPAs and NPAs Hinders the Development of Case Law and Increases Costs to Corporations*

The DOJ's use of DPAs and NPAs directly affects the development of case law under the FCPA because relevant precedent cannot develop from settling disputes outside the courtroom. American law depends, in part, on the judicial application of stare decisis.[160] The significance of legal precedent is: its continuous development through case law as courts clarify the boundaries of permissible legal conduct by resolving questions of ambiguity and vagueness; striking down overreaching laws as unconstitutional; and signaling to legislators where legal gaps exist.[161] DPAs and NPAs subvert this process by preventing courts from analyzing legal and factual issues and subsequently publishing judgments defining specific points of law related to the FCPA—the very process that is the essence of developing precedent.

According to Judge Richard Posner, development of precedent establishes capital goods in the form of legal knowledge that defines the boundaries of permissible legal behavior.[162] Litigation creates a production envi-

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157 Laurel S. Terry et al., *Transnational Legal Practice*, 43 INT'L LAW. 943, 964 (2009).

158 *See, e.g., id.* at 964-66 (some corporations are considering outsourcing legal services to India in order to lower costs).

159 *See* Perry E. Wallace, *Climate Change, Corporate Strategy, and Corporate Law Duties*, 44 WAKE FOREST L. REV. 757, 763-64 (2009) (citing *In re* Citigroup, Inc. Shareholder Derivative Litigation, 964 A.2d 106, 131-32 (Del. Ch. 2009)). The business judgment rule inoculates corporate directors from courts finding culpability in their business decisions, absent evidence of fraud, illegality, or conflict of interest.

160 David R. Cleveland, *Overturning the Last Stone: The Final Step in Returning Precedential Status to All Opinions*, 10 J. APP. PRAC. & PROCESS 61, 81-82 (2009).

161 John O. McGinnis & Michael B. Rappaport, *Reconciling Originalism and Precedent*, 103 NW. U. L. REV. 803, 805 (2009).

162 RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 583 (Aspen 6th ed. 2003).

ronment where attorneys engage in advocacy and judges formulate legal decisions—creating legal precedent as a by-product.[163] When dealing with a legal issue of first impression, legal uncertainty produces the most litigation because parties to a dispute cannot accurately gauge whether a settlement places them in a better position relative to pursuing adjudication based on the merits of their case.[164] Thus, litigants will often contribute much significant investment in attempting to define the contours of laws when uncertainty exists.[165] Once a decision, and thus precedent, encompasses these legal boundaries, litigation will decrease because then the law becomes more clearly defined with less unknown variables.[166] As a result, future settlements over similar disputes increase as disputing parties are able to more accurately assess their optimal settlement values.[167]

Judge Posner contends that the number of precedents "will rise when their social value rises as a consequence of increased legal uncertainty and fall as that value falls."[168] However, the number of precedents developed under the FCPA remains quite low despite great legal uncertainty surrounding the law, in large part due to the use of DPAs and NPAs.[169] Regardless of the demand for legal certainty, DOJ enforcement of the FCPA primarily relies upon DPAs and NPAs.[170] This enforcement policy increases market costs and inefficiencies.

Continued use of DPAs and NPAs will, in the long-run, drive up transaction costs for corporations investing abroad as they attempt to decipher the correct legal framework. Corporations want to operate under an optimally efficient legal framework in order to accurately assess the costs and gauge the risks associated with transacting with foreign clients. For example, a U.S. listed corporation that ventures to build a water treatment facility in a rapidly developing country must determine the target country's laws regarding matters such as: employing local citizens; the customs duties for importing equipment and raw materials; local zoning and environmental rules; and various licensing and registration requirements. Without knowing precisely which laws governs each input, the associated costs will increase because the corporation needs to hire legal experts, lobbyists, and on-the-ground consultants to chart the precise legal framework and defend

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163 *Id.* at 584.

164 *Id.*

165 *Id.*

166 *Id.*

167 *Id.*

168 RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 584 (Aspen 6th ed. 2003).

169 As noted in Part I, many questions remain as to the meaning and applicability of certain provisions of the FCPA. Moreover, the number of DOJ prosecutions of corporations for violations of the FCPA remains low. Very few cases have ended in a verdict on the merits because of the current DOJ policy to utilize DPAs and NPAs.

170 Cal. Annual Rev. Summaries, *Developments in White Collar Criminal Law and the "Culture of Waiver,"* 14 BERKLEY J. CRIM. L. 199, 224-26 (2009).

against litigation. These obstacles will delay the project due to uncertainties of criminal culpability, thus impeding construction and increasing the costs of purchasing materials and borrowing capital. Creditors and shareholders alike may become weary if they view corporate directors and managers as poorly informed and taking excessive risks. The net effect, risks damaging the financial position of the corporation, as it would forfeit revenues that would have been generated but for the uncertainty of legal rules and the costs associated with doing business in the target country.

The FCPA plays a similar role in driving up transaction costs for the corporation investing abroad because of the uncertainty of lawful corporate conduct outside the U.S. Firms investing and operating abroad cannot accurately gauge the legal boundaries of the FCPA because the continued use of DPAs and NPAs prevent precedent from developing that would otherwise define these boundaries. While litigation in the short-run would increase the cost of business on the margin, in the long-run legal costs would decrease as ambiguities disappear.

Revisiting the example of the corporation venturing to build a water treatment plant offers a good illustration of the FCPA's uncertainty. As discussed in Part II, questions remain as to who qualifies as a foreign official.[171] If the target country's political system is highly centralized, the corporation may need to do business with a local company that is partially state-owned in order to build key portions of the water treatment facility. What if the corporation takes the local foreman out to lunch or offers tickets to the local sporting match? Do these acts violate the FCPA even though the local company may be only partially owned by the central government? Did Congress intend to include a construction foreman as a foreign official?

Further, corporations under investigation by the DOJ for violating the FCPA, quite rationally, will accept a DPA or an NPA in order to quickly resolve a dispute that could otherwise substantially damage shareholder value. Corporate directors learned the fatality of alleged criminal misconduct after Arthur Andersen.[172] The events surrounding the case of Arthur Andersen encapsulated the severe ramifications resulting from a corporation's formal criminal indictment.[173] The lessons of Arthur Anderson will likely incentivize otherwise uncooperative corporate directors to work with the DOJ.[174]

Still, DPAs and NPAs benefit corporations in the short-term. DPAs and NPAs mitigate the risk of collateral damage such as the loss of clientele, decline in value of corporate shares, and loss of employees.[175] First,

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171 *See supra* Part I.B.

172 Hall, *supra* note 106, at 138-39.

173 Barry A. Bohrer & Barbara L. Trencher, *Prosecution Deferred: Exploring the Unintended Consequences and Future of Corporate Cooperation*, 44 AM. CRIM. L. REV. 1481, 1483 (2007).

174 *Id.* at 1483-84.

175 *Id.*

NPAs preclude formal indictment, thus delaying or stopping public dissemination of the criminal charges the corporation faces.[176] Second, DPAs give corporations the opportunity to rehabilitate and reform without facing formal adjudication of the allegations.[177] Additionally, the median penalty imposed upon a corporation with a DPA or NPA in place is $15.1 million.[178] However, other costs such as corporate compliance programs and federal monitors increase the total penalty incurred.[179] At the end of the day, corporations can justify these costs, as they are exponentially preferable to the alternative of an Arthur Andersen-like dissolution.

B. *A Legislative Fix of the FCPA*

Despite Congress's and the DOJ's attempts to reform the FCPA and use of DPAs and NPAs, even more substantial legislative reform is needed in order to restore proper incentives for corporations to undertake a reasonable level of risk-taking in foreign investments. As discussed earlier, the FCPA fails to provide clarity in defining what conduct amounts to an illicit payment under the anti-bribery provision.[180] Within the 1988 FCPA amendments, Congress required the DOJ to consult with other federal agencies and determine whether regulations were needed to identify specific types of permissible conduct.[181] Yet, the DOJ declined to offer any regulations after the public comment period because it believed that regulations would not assist the business community.[182] Today, corporate leaders voice dissatisfaction and confusion about the FCPA's ambiguity, arguing that it broadens the scope of the FCPA beyond Congress's original intent.[183] New legislation that adopts language found in existing domestic federal anti-bribery statutes and case law would reduce uncertainty under the FCPA by providing delineated boundaries of permissible conduct.

In particular, § 201 of Title 18 of the U.S. Code (Section 201) prohibits bribery of public officials in the United States under a regime similar to

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176 *See* Andrew J. Levander, *Financial Fraud Representations in a Post-Financial Crisis World*, 1763 PLI/CORP 525, 544-45 (2009).

177 Hall, *supra* note 106, at 140.

178 Ralph F. Hall, *Understanding and Complying with Compliance Agreements*, *in* PUNISH CORPORATE CRIME: LEGAL PENALTIES FOR CRIMINAL AND REGULATORY VIOLATIONS 155, 159 (Oxford Univ. Press 2009). Corporations often trade higher penalties in return for an NPA in order to lessen the stigma. This is largely due to the lack of formal charges that would otherwise be filed in a DPA.

179 *Id.* at 160 n.14.

180 *See supra* Part I.

181 15 U.S.C. §§ 78dd-1(d), 78dd-2(e) (2006).

182 Anti-Bribery Provisions, 55 Fed. Reg. 28,694, 28,694 (July 12, 1990).

183 Sheri Qualters, *Risk of Bribe Probes Grows for Business: DOJ Relying on Self-Reporting, More on Aggressive Investigation*, 30 NAT'L L.J., no. 17, Jan. 7, 2008 at 8.

the FCPA.[184] Although Section 201 punishes both the payor and payee, the fundamental prohibition of a quid pro quo provides a useful starting point for comparison and cross application to the FCPA.[185] It is worthwhile to compare the knowledge and corrupt payment provisions of the FCPA to Section 201. Similar to Section 201, the FCPA punishes corporations who knowingly make a corrupt payment through a third party.[186] However, the scope of the FCPA knowledge requirement broadens liability because the Act's statutory language and legislative history fails to provide guidance as to the extent to which a corporation should reasonably know when a third party makes an illicit payment.[187] On the other hand, Section 201 offers a narrower and clearer prohibition: it bans corporations from giving money to a third party with the intention of paying bribes indirectly to public officials.[188]

While Section 201 lacks a separate knowledge requirement for illicit payments made to third parties,[189] the payor remains liable, albeit at a heightened standard.[190] The *mens rea* requirement under Section 201 prohibits corporate payments to third parties with a "corrupt intent"—payments made with an explicit quid pro quo.[191] Hence, replacing the corresponding FCPA language with the language in Section 201 would effectively narrow the scope of liability for corporate payments made to third parties. As a result, the proposed language provides clearer boundaries for corporations by limiting the reach of the FCPA to third party agreements where corporations discover violations after the fact.

Section 201 also provides a brighter line in helping to clarify whether a person or organization functions as a foreign official or instrumentality under the FCPA. The language and case law of the FCPA fails to provide a test that defines how a foreign official falls under the instrumentality category.[192] Unfortunately, the same legislative disease plaguing the FCPA infected the plain language of Section 201 defining "public official."[193]

184 18 U.S.C. § 201(b)(1) (2006).

185 *Compare id. with* 15 U.S.C. §§ 78dd-1(a), 78dd-2(a), 78dd-3(a).

186 15 U.S.C. §§ 78dd-1(a)(3), 78dd-2(a)(3), 78dd-3(a)(3).

187 Zarin, *supra* note 53, at 152. The difficulty becomes thus: To what extent must a corporation conduct due diligence research on a third party in order to absolve itself of liability? This creates additional sources of increased costs. Corporations would need to retain local counsel in a foreign country in order to correctly verify a third party's compliance with that country's laws.

188 18 U.S.C. § 201(b)(1).

189 Zarin, *supra* note 53, at 145.

190 1 OBERMAIER & MORVILLO, *supra* note 47, § 3.03[1], at 3-10-11.

191 *Id.*

192 Zarin, *supra* note 53, at 145.

193 The plain language defining the term "public official" includes persons who perform an "official function." This is similar to the "official capacity" language in the FCPA. *See* 18 U.S.C. § 201(a)(1) (defining "public official" under domestic anti-bribery law); 15 U.S.C. §§ 78dd-1(f)(1), 78dd-2(h)(2) (defining "foreign official" as a person acting in an "official capacity" of the foreign government, agency, department, or instrumentality).

Notwithstanding this deficiency, the Supreme Court addressed the scope of the term "public official" in the domestic context in *Dixson v. United States*: the Government charged an executive of a federally funded non-profit organization for receiving bribes.[194] Recognizing that Congress intended a broad definition, the Court determined that a public official is one who acts under the authority of the federal government and occupies "a position of public trust with official federal responsibilities."[195] The Court further clarified that "an individual must possess some degree of official responsibility for carrying out a federal program or policy."[196]

Applying the statutory and case law of Section 201 provides a mixed result in attempting to solidify the definition of a foreign official under the FCPA. On the one hand, *Dixson* appears to distinguish between persons who help shape and manage official government policy and persons who act at the behest of governmental decision-makers. Returning to the water treatment project example, the foreman probably would not qualify as a public official under the *Dixson* definition, because his duties are limited to carrying out a construction plan developed by the builder's executives and architects. Even so, *Dixson* does not offer insight into the instrumentality requirement under the FCPA. While the facts in *Dixson* lend itself to the DOJ's inclusive approach, the presence of government funding is not synonymous with ownership and control.

Finally, Section 201 clarifies the attenuation of payments problem for official acts performed by a foreign official under the FCPA. Section 201 prohibits corporations from offering a gratuity to a public official for his past or future acts.[197] The FCPA does not address whether an act of a foreign official stemming from a gift constitutes a bribe.[198] On its face, the FCPA does not condemn payments to a foreign official that may influence his future acts as an illicit payment—but this is inconsistent with the purpose and legislative history behind the 1988 amendments.[199] A provision in Section 201 would address this ambiguity by prohibiting corporations from giving gratuities or payments intended to secure past or future official acts by a foreign official, at the time of the payment.

Importing language from Section 201 to the FCPA also brings the added benefit of harmonizing U.S. anti-bribery law. Congress passed the Bribery and Graft Act in 1964 for the purpose of consolidating an efficient and uniform criminal code.[200] By adopting Section 201 and its subsequent case law, transaction costs for foreign business ventures would decrease in

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194 Dixson v. U.S., 465 U.S. 482, 496-98 (1984).

195 *Id.* at 499.

196 *Id.*

197 18 U.S.C. § 201(c).

198 United States v. Kay, 359 F.3d 738, 743-44 (5th Cir. 2004).

199 *See* H.R. REP. NO. 100-576, at 916-20.

200 1 OBERMAIER & MORVILLO, *supra* note 47, § 3.03[1][a], at 3-8.

the long-term because regulatory uncertainties would eventually diminish. The corporation venturing to build a water treatment plant would achieve greater cost savings because it now could determine that the local foreman building the plant does not qualify as a foreign official under the FCPA; hence, the corporation would not have to make any unnecessary expenditure to realize this conclusion.

The following proposal adopts the framework and language from Section 201 while importing some elements and definitions from the FCPA:

> I. Any corporation who directly or indirectly, corruptly gives, offers or promises anything of value to:
> A. any foreign official;
> B. a person who has been selected to become a foreign official; or
> C. any other person whose receipt would benefit, directly or indirectly, a foreign public official or person selected to be a foreign public official;
>
> or offers or promises:
> A. any foreign official;
> B. a person who has been selected to become a foreign public official; or
> C. any other person whose receipt would benefit, directly or indirectly, a foreign public official or person selected to be a foreign public official;
>
> to give anything of value to any other person or entity, with intent
> A. to influence any official act;
> B. to influence such foreign official, or person who has been selected to become a foreign public official to commit or aid in committing, or collude in, or allow, any fraud, or make opportunity for the commission of any fraud, on the United States; or
> C. to induce such foreign official or such person who has been selected to be a public official to do or omit to do any act in violation of the lawful duty of such official or person.
>
> II. Definitions
>
> A. Corruptly: The intent by a payor to engage in a quid pro quo with a payee.
>
> B. Foreign Official: Any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or on behalf of any such public in-

> ternational organization whereby the government, department, agency, or any instrumentality thereof exercises, dictates, or in any other manner controls the actions or decisions of the officer, employee, or person.[201]

This proposed language aims to solve the problems of ambiguity and vagueness of the FPCA by adopting much of the language from Section 201. First, the new definition of foreign official solves the instrumentality problem because it distinguishes foreign officials as those with government control or influence. Second, the language clarifies the knowledge requirement for third party payments under the FCPA by prohibiting all payments made by corporations to third parties who, at the time of the payment intended to engage in a quid pro quo. Although this may reduce liability for corporations by heightening the *mens rea* standard, this is a policy choice that favors clarity over broader liability. The point of this provision is to provide much needed guidance for corporations. Finally, where the proposed statutory language remains unclear, under the borrowed canon of statutory construction, federal courts could fill in gaps with precedent developed under Section 201.[202] This would provide the historical precedent that is presently lacking to aid the FCPA's substantive development.

CONCLUSION

Enforcing the FCPA through the use of DPAs and NPAs produces regulatory uncertainties, consequently increasing transaction costs to businesses within the jurisdiction of the United States. Although DPAs and NPAs offer a practical short-term solution to corporations facing corporate criminal indictment, this enforcement practice inhibits the development of case law and locks corporations into a cycle of path dependency. Without a legislative fix, corporations will continue to face uncertainty when attempting to assess what is considered impermissible conduct under the FCPA. A legal foundation from which federal corporate criminal law can draw from already exists. Therefore, the ease of synthesizing domestic and international corporate criminal law should entice policymakers to amend the FCPA. Such uniformity in federal business law increases legal certainty, ultimately driving down transaction costs.

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201 This language borrows heavily with some modifications from 15 U.S.C. §§ 78dd-1(f), 78dd-2(h), 78dd-3(f) and 18 U.S.C. § 201(b)(1).

202 *See* Northcross v. Bd. of Educ. of the Memphis City Schs., 412 U.S. 427, 428 (1973). The borrowed state canon of construction states that whenever a legislature adopts language from another statute, it explicitly adopts the interpretation of the borrowed language until the moment the legislature passes the statute. Under this canon, courts may look to case law interpreting the borrowed statute to assist in interpreting the new statute. *See also* Molzof v. United States, 502 U.S. 301, 307 (1992); Metro. Life Ins. Co. v. Taylor, 481 U.S. 58, 65-66 (1987).

SEEKING STONES IN THE RED RIVER[1]: THE INEVITABLE EVOLUTION OF CHINA'S ANTI MONOPOLY LAW

*Eva Choi**

INTRODUCTION

In recent decades, China has exploded on to the world stage, astonishing the global economy with its tremendous capacity for change. The country's progression from a purely communist regime is largely due to extensive economic reform. China has truly experienced a complete transformation with the advancement of private domestic enterprises and enormous amounts of foreign capital flowing into domestic markets. However, the tremendous new market potential raises regulation obstacles within the Chinese economy, as well as compatibility issues with international business standards in the global community.

China has taken steps to ensure a stable and predictable market for investors, and to comply with its World Trade Organization membership; to this end, the Chinese government enacted and implemented the Anti Monopoly Law. Since the Chinese Anti Monopoly Law went into effect on August 1, 2008, the Ministry of Commerce has issued only six announcements regarding merger and acquisition transactions. Commentators criticized the rationale and enforcement policies underlying the Ministry's decisions as protectionist—a cardinal sin in the eyes of free market capitalism.

First, this comment will discuss the way in which China's social, political, and economic history have influenced the government to implement the Anti Monopoly Law in a manner that protects domestic enterprises. Second, this comment will detail the circumstances surrounding the drafting and enactment of China's Anti Monopoly Law, followed by a discussion of

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* George Mason University School of Law, Juris Doctor Candidate, May 2011; Executive Editor, JOURNAL OF LAW, ECONOMICS & POLICY, 2010-2011; University of California, San Diego, B.A. Political Science/Political Theory, minors in Law & Society and Literature/Writing, December 2007. I would like to thank my mentor, Professor Michael Kelly—for his expertise inspired the subject matter of this comment, his guidance sought through the successful completion of this piece, and his support ensured the avidity for antitrust law that I will carry with me throughout my career.

1 You Nuo, *Crossing River by Feeling the Stones?*, CHINA DAILY (Feb. 16, 2009), http://www.chinadaily.com.cn/opinion/2009-02/16/content_7479611.htm; Satya J. Gabriel, *Economic Liberalization in Post-Mao China: Crossing the River by Feeling for Stones*, SATYA GABRIEL'S ONLINE PAPERS & ESSAYS (Oct. 1998), http://www.mtholyoke.edu/courses/sgabriel/economics/china-essays/7.html. "Crossing the River by Feeling the Stones" is a famous quote by the late Chinese leader, Deng Xiaoping; Deng used the phrase in reference to the development of China's socialist market economy as a continuous experiment stemming from the Maoist revolution. The term embodies the notion of learning as one proceeds.

its relevant statutory provisions that govern mergers and acquisitions. Third, this comment will discuss and analyze the first merger that the Chinese government rejected pursuant to the Anti Monopoly Law and the justifications for their decision. Fourth, this comment will compare China's antitrust enforcement policies with recent antitrust enforcement cases in the United States. Finally, this comment will provide a brief overview of five conditionally approved mergers since the Anti Monopoly Law went into effect.

This comment does not advocate that protectionism is the correct long-term approach for applying the Anti Monopoly Law. Instead, it proffers that protectionist policies can be used as stepping stones to develop a viable domestic market, similar to the policies the United States implemented in the late 1960s when American society experienced a major cultural transformation. Eventually, the Chinese market will not have room for protectionist policies. But until then, the international community must recognize that for decades, protectionism has played an integral part in China's socialist market economy.[2] In striving to evolve its legal system to be compatible with a socialist market economy,[3] it is imperative that China is weaned off of its predisposition to protectionism, rather than shell shocked into a free market economy. Such an environment would not possibly allow domestic firms to survive, resulting in a prompt collapse of China's domestic markets.

I. BRIEF HISTORY OF CHINA'S ECONOMY AND POLITICAL SYSTEM

A. *China's Socialist Market Economy*

On July 12, 2005, Mr. Ma Kai, China's Minister of the National Development and Reform Commission declared, "China has basically completed the transition to the socialist market economy from [*sic*] highly centralized planning economy after 26 years' endeavor [*sic*] on reform."[4] Fundamentally, the new economy was a system of government macro-control of a market that consisted of both state-controlled enterprises and privately controlled enterprises.[5] The twenty-six year endeavor Mr. Ma Kai spoke of began in 1978 when Deng Xiaoping, Chairman of the Chinese Communist

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[2] STATE COUNCIL INFO. OFFICE, CHINA'S EFFORTS AND ACHIEVEMENTS IN PROMOTING THE RULE OF LAW (2008), *available at* http://www.china.org.cn/government/news/2008-02/28/content_11025486_6.htm.

[3] *Id.*

[4] *China Has Socialist Market Economy in Place*, PEOPLE'S DAILY ONLINE (July 13, 2005), http://english.peopledaily.com.cn/200507/13/eng20050713_195876.html.

[5] *Id.*

Party's Central Military Commission and revolutionist, led China into economic reform through a "socialist market economy."[6]

Prior to 1978, China was a centrally planned economy with the government controlling even the most specific details, going so far as to specify the types and amounts of crops peasants were to plant in a particular season and the prices at which they should be sold.[7] During the Deng Era, China sought to approach a socialist market economy based on a conflux of conservative and radical principles.[8] On the radical end, reformists worked to decentralize the economy by eliminating administrative controls and ineffective bureaucracies, delegating economic decisions into the hands of local officials.[9] However, the more conservative reformists touted the limits of the socialist economy, and supported the ideology that the government's central authority remained ultimately supreme.[10] Subsequently, in 1992 as Deng Xiaoping toured southern China, he observed the impoverished countryside regions hollowly existing in skeletal economies.[11] This tour prompted the Congress of the Chinese Communist Party to adopt resolutions to significantly accelerate the pace of economic reform.[12] As China overhauled fundamental institutions such as taxation, banking, and foreign currency systems, the presence of private enterprises and new foreign investments flourished.[13]

While the Chinese government has gradually come to understand that too much government interference is detrimental to the market economy, it still imposes a regulatory system that maintains control in key industries.[14] Prior to China's economic reform in 1978, virtually every industry was comprised of State Owned Enterprises (SOE), controlled by a specifically assigned ministry.[15] Thus, there was no need for additional regulatory structures as the Chinese government already owned and controlled the entire economy.[16] However, since the emergence of a market economy, the Chinese government discovered the need to implement a new regulatory

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6 Mark S. Blodgett et al., *Foreign Direct Investment, Trade, and China's Competition Laws*, 37 DENV. J. INT'L L. & POL'Y 201, 203 (2009).

7 Bruce M. Owen et al., *Antitrust In China: The Problem of Incentive Compatibility*, 1 J. COMPETITION L. & ECON. 123, 126 (2005).

8 CHINA IN THE ERA OF DENG XIAOPING: A DECADE OF REFORM 195 (Michael Y. M. Kau & Susan H. Marsh eds., M. E. Sharpe, Inc. 1993).

9 *Id.*

10 *Id.* at 196.

11 *See* Owen et al., *supra* note 7, at 128.

12 *Id.*

13 *Id.*

14 *Id.* at 129.

15 *Id.*

16 *Id.*

system that not only governs privately owned and foreign enterprises, but also enhances them, allowing China to assimilate into the global economy.[17]

B. *Entry into the World Trade Organization*

To become a member of the World Trade Organization (WTO), a country must have established antitrust laws and a functioning market economy.[18] In 2001, nearly fifteen years of negotiation between China and the WTO finally concluded with a preliminary agreement.[19] As a condition to its entry, China agreed to "open and liberalize its regime in order to better integrate in the world economy and offer a more predictable environment for trade and foreign investment in accordance with WTO rules."[20] China agreed to many commitments, including: 1) treating all foreign individuals and enterprises the same as domestic enterprises; 2) eliminating the use of price controls to protect domestic industries; 3) amending and enacting new legislation in accordance with the WTO agreement and exercising the legislation in a uniform and meaningful manner; 4) eliminating or significantly mitigating restrictions on foreign companies after a three-year phase out period; and 5) gradually eliminating trade barriers and expanding local market access to goods from foreign countries.[21]

China officially became a member of the WTO on November 11, 2002.[22] At the time, many were skeptical that China would actually adhere to the conditions set out in its WTO membership.[23] Foreign investors were not entirely confident that they would receive the same treatment as domestic firms when it came to business regulation; it was no secret that China has historically been hostile toward foreign enterprises.[24] Further, the sheer size of the nation facilitated tendencies for regional protectionism as local enterprises were insulated from competing with external enterprises.[25] The empirical evidence tended to support China's critics: if Chinese firms were to compete with foreign enterprises on an open market, the Chinese firms

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[17] Xiaoye Wang, *Highlights of China's New Anti-Monopoly Law*, 75 ANTITRUST L.J. 133, 133 (2008).

[18] Joel R. Samuels, *"Tain't What You Do": Effect of China's Proposed Anti-Monopoly Law on State Owned Enterprises*, 26 PENN ST. INT'L L. REV. 169, 170-71 (2007).

[19] *WTO Successfully Concludes Negotiations on China's Entry*, WORLD TRADE ORG. (Sept. 17, 2001), http://www.wto.org/english/news_e/pres01_e/pr243_e.htm.

[20] *Id.*

[21] *Id.*

[22] Blodgett et al., *supra* note 6, at 208.

[23] *Id.*

[24] *Id.*

[25] MARK FURSE, ANTITRUST LAW IN CHINA, KOREA AND VIETNAM 9 (2009).

would likely succumb to the experience and stability of foreign corporations.[26]

As a part of economic reform during the Deng Era, the Chinese government retreated from industries that were not essential to national security or general public welfare and were not likely to create a natural monopoly[27].[28] However, the government preserved its control in essential industries such as electricity, petroleum, banking, insurance, railroads, and aviation, with the largest firms being state-owned.[29] Even then, in relation to foreign firms on the global market, these SOEs were considered relatively weak by comparison.[30] At the time of China's accession in 2002, only eleven[31] firms were listed in Fortune's Global 500—all of them were SOEs and made the list because they flourished in a protected economy.[32] Considering that approximately one-third of China's gross domestic product was produced by SOEs, suddenly subjecting these vulnerable firms to a global free market would have disastrous repercussions.[33] If the existence of a controlled and protected market was a necessary condition to the prosperity of the SOEs, then exposing them to the competition of a free market economy would render them unsustainable.

Nonetheless, foreign firms expressed confidence in China's economy, as the desire to expand into a newly opened market outweighed foreign skepticism. Over 400 of the Fortune Global 500 companies have invested in China, two-thirds of the world's largest retailers have established businesses in the country, and there has been a significant increase in foreign direct investments.[34]

While the influx of foreign direct investments was beneficial for China's economy and global standing generally, the Chinese government rec-

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26 Youngjin Jung & Qian Hao, *The New Economic Constitution in China: A Third Way for Competition Regime?*, 24 NW. J. INT'L L. & BUS. 107, 120 (2003).

27 Natural monopolies are created when an industry cannot have more than one efficient supplier of a good or service. Oftentimes the first supplier to establish a service has invested a large initial capital and achieved economies of scale, thus creating high barriers to entry. Some examples of natural monopolies are railroads, telephone lines, and utilities. *See, e.g.*, LUDWIG VON MISES, HUMAN ACTION: A TREATISE ON ECONOMICS 677 (Scholar's ed., Ludwig von Mises Institute 1998) (1949) (explaining that monopolies may arise "in the absence of government policies aiming directly or indirectly at their establishment," and listing raw materials with scarce deposits and local limited-space monopolies as further examples).

28 Owen et al., *supra* note 7, at 129 (noting that the government left industries such as machinery, electronics, chemicals, and textiles to the private sector).

29 *Id.*

30 Jung & Hao, *supra* note 26, at 120.

31 Currently, Fortune's Global 500 list of 2009 features 37 Chinese firms. *Fortune Global 500*, CNN MONEY (July 20, 2009), http://money.cnn.com/magazines/fortune/global500/2009/countries/China.html.

32 Jung & Hao, *supra* note 26, at 120.

33 FURSE, *supra* note 25, at 9.

34 Jung & Hao, *supra* note 26, at 121.

ognized the dangers of "too much too soon," and the potential negative impact on comparatively less established and nascent domestic industries.[35] To address new market concerns ancillary to the new market economy and to fulfill its obligation to the WTO, China put in place "a series of laws in compliance with WTO rules to preserve fair competition and protect domestic industries," including China's new Anti Monopoly Law.[36]

II. DEVELOPMENT OF THE ANTI MONOPOLY LAW AND A COMPARISON TO THE WEST

After thirteen years of debate and multiple drafts, the National People's Congress enacted the Anti Monopoly Law (AML) on August 30, 2007.[37] During the drafting of the AML, international authorities in the legal and business communities such as the European Union Chamber of Commerce and the American Bar Association were invited to submit their comments.[38] In the end, the text of the AML fell within the bounds of international competition standards, with many commentators likening the statute to the European Union's antitrust law.[39]

While the United States' antitrust model is frequently seen as the benchmark of an ideal antitrust law on the global level, it is a system that would be very difficult for a country like China to adopt.[40] In the U.S., government enforcement agencies are responsible for identifying antitrust violations and these agencies bring suit on behalf of the government in court proceedings.[41] The Antitrust Division at the Department of Justice (DOJ) is responsible for addressing both civil and criminal antitrust violations, while the Federal Trade Commission (FTC) focuses solely on civil antitrust violations.[42] Both agencies rely heavily on the court system to facilitate hearings on alleged antitrust violations and to implement penalties and remedies.[43] Further, the U.S. system is more likely to subscribe to the

35 *Id.* at 122.

36 *Id.* (quoting STATE ECON. & TRADE COMM'N, GUIDELINES OF THE INDUSTRY STRUCTURE ADJUSTMENT FOR THE TENTH FIVE-YEAR PLAN (Oct. 2001)). The State Economic & Trade Commission no longer exists; it dissolved and the National Development & Reform Commission assumed its responsibilities. PETER HO, LEAPFROGGING DEVELOPMENT IN EMERGING ASIA: CAUGHT BETWEEN GREENING AND POLLUTION 81 (2008).

37 Steve Yu & Peter Come, *Essentials to Know About China's New Antitrust Law*, THE CORPORATE COUNSELOR (Nov. 12, 2007), http://www.law.com/jsp/law/international/LawArticleFriendlyIntl.jsp?id=900005558428.

38 *Id.*

39 *Id.*

40 Jung & Hao, *supra* note 26, at 124.

41 *Id.* at 123.

42 *Id.*

43 *Id.*

Chicago School's ideology of a free market economy, which places the ultimate emphasis on economic efficiency above all other factors when evaluating competition in a particular market.[44] This is dissimilar to the Chinese system where the socialist market economy requires antitrust review to encompass elements beyond stringent competitive factors, and into the ambiguous territory concerned with protecting competitors.

Further, unlike the court system in the U.S., the capabilities of the Chinese judicial system are quite limited.[45] Before 1995, judges were former military officers with no legal training or experience.[46] In 1995, China adopted the Judges Law, which requires all new judges to meet certain qualifications and subjects them to a public examination prior to appointment on the bench.[47] Nonetheless, there are still concerns about the qualifications of Chinese judges because they are not routinely educated in economics and may be unqualified to handle complicated antitrust cases.[48] Hence, the U.S. model, which relies on the court system to preside over trials and sanction antitrust violators, would not be practically feasible in China.[49] China's legal system is incapable of immediately adopting the level of sophistication the U.S. courts have honed over decades.

On the other hand, the Chinese Anti Monopoly Law is more akin to the European Union's structure.[50] The E.U. utilizes administrative agencies to enforce its antitrust laws.[51] In addition to an economic efficiency analysis, the E.U. structure considers factors such as market integration, effects on small and medium-sized firms, and fair competition.[52] The E.U. does not consider a firm's dominance in market share or market concentration as a per se violation of its competition laws; instead, the E.U. looks at whether the firm abuses its dominant position.[53] Additionally, it seems more intuitive that China would follow the E.U. model since both the E.U. and China follow a civil law system.[54] Finally, China's Constitution prescribes a socialist market economy.[55] This aspect alone contradicts the U.S.'s sole objective of economic efficiency in a free market economy.[56] With an appropriate Anti Monopoly Law, China may integrate into the global economy

44 *Id.*

45 Owen et al., *supra* note 7, at 137.

46 *Id.*

47 *Id.*

48 *Id.*

49 Jung & Hao, *supra* note 26, at 124.

50 *Id.* at 123.

51 *Id.*

52 *Id.* at 123-24.

53 *Id.* at 124.

54 *Id.*

55 Jung & Hao, *supra* note 26, at 125.

56 *Id.*

while prohibiting anticompetitive behavior in its domestic markets and providing foreign investors with guidance on its business practices.

III. CHINA'S ANTI MONOPOLY LAW: CHAPTER IV CONCENTRATION[57] OF BUSINESS OPERATORS

This section will first offer limited discussion of a few noteworthy provisions within the AML, but will focus discussion of China's AML on Chapter IV, which encompasses mergers and acquisitions.[58] Chapter IV spans from Articles 20 through 45, and defines the substantive considerations and procedures used in evaluating possible mergers or acquisitions.[59]

Chapter I of the AML, sets out general principles that govern the entire statute providing insight into social policies that will ultimately manifest when practically implemented.[60] Significantly, Article 1 establishes at the forefront of the statute that the AML is enacted for "the purpose of preventing and restraining monopolistic conducts [sic], protecting fair competition in the market, enhancing economic efficiency, safeguarding the interests of consumers and social public interest, [and] promoting the healthy development of the socialist market economy."[61] Also significant is Article 4: "The State constitutes and carries out competition rules which accord with the socialist market economy, perfects macro-control, and advances a unified, open, competitive, and orderly market system."[62]

The AML establishes an institutional structure that is responsible for the various branches stemming from the law itself.[63] First, the State Council[64] creates the Anti Monopoly Committee,[65] which is an advisory and coordinating panel under the State Council's control.[66] The State Council also designates a second body, the Anti Monopoly Enforcement Authority (AMEA), which is responsible for the daily enforcement of the AML.[67] The Anti Monopoly Enforcement Authority is split among three entities: the Ministry of Commerce (MOFCOM), the National Development and

57 "Concentration" in the text of the Anti Monopoly Law is synonymous with "consolidation," which refers to the consolidation of business practices by means of mergers or acquisitions.

58 FURSE, *supra* note 25, at 358-60.

59 *Id.*

60 *Id.* at 355.

61 *Id.*

62 *Id.*

63 *Id.* at 70.

64 MINISTRY OF COMMERCE OF THE PEOPLE'S REPUBLIC OF CHINA, *Provisions on Mergers and Acquisitions of a Domestic Enterprise by Foreign Investors*, BEIJINGREVIEW.COM.CN (Aug. 17, 2009), http://www.bjreview.com.cn/document/txt/2009-08/17/content_212277.htm.

65 FURSE, *supra* note 25, at 356.

66 *Id.* at 70.

67 *Id.* at 72.

Reform Commission, and the State Administration for Industry and Commerce.[68]

MOFCOM oversees mergers and acquisitions (M&A) and monopolistic practices involving international trade.[69] Within MOFCOM, the Anti Monopoly Investigation Bureau (AMB) is the division that is responsible for M&A supervision.[70] Despite the web of institutional authority splits, MOFCOM is the primary entity that applies the AML.[71]

Pursuant to Article 20, a "concentration"[72] encompasses: 1) the merger of two firms; 2) when one firm acquires controls of a another by attaining its equity interests or assets; or 3) when a firm acquires control over another, enabling the acquiring firm to exercise business decisions on behalf of the target firm through contracts or other means.[73] According to newly published guidelines regarding concentration filings, both parties must submit a pre-merger filing to MOFCOM; however, with acquisitions, the acquiring party is responsible for submitting the filing.[74] These filings include: 1) a declaration; 2) explanation of the effect of the transaction on competition; 3) the terms of the transaction agreement; 4) financial and accounting reports from the previous year; and 5) other documents MOFCOM may request.[75]

Subsequently, MOFCOM reviews the proposed concentration and considers: 1) the market share and market power of the firms in their respective relevant markets; 2) the market concentration in the relevant market; 3) the effect of the transaction on market access and technological progress; 4) the effect of the transaction on consumers and other competitors; 5) the effect of the transaction on the national economic development; and 6) any other factor that may affect market competition.[76] If the transaction is approved, MOFCOM will notify the parties, and no announcement is required.[77]

In cases where MOFCOM determines that the transaction will likely have anticompetitive effects, it may impose restrictive conditions to mitigate the adverse effects.[78] The AMB may implement one of three types of restrictive conditions, or "remedies": 1) structural remedies, in which the AMB may require some structural changes to the merger's original model

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68 *See id.* at 70-71.

69 *Id.* at 71.

70 Kevin Y. Bai et al., *MOFCOM Releases Interpretations on Several Issues Concerning Antitrust Review*, ANTITRUST UPDATE (Hogan & Hartson LLP, Beijing, China), Nov. 27, 2008, at 1, 3.

71 FURSE, *supra* note 25, at 71.

72 *See supra* note 57.

73 FURSE, *supra* note 25, at 358.

74 MINISTRY OF COMMERCE OF THE PEOPLE'S REPUBLIC OF CHINA, *supra* note 64.

75 FURSE, *supra* note 25, at 358-59.

76 *Id.* at 359-60.

77 *Id.*

78 *Id.* at 360.

by excluding certain assets; 2) behavioral remedy, in which the parties to the transaction may be forbidden from participating in certain business activities that may restrict or eliminate competition in the merger's relevant market; or 3) mixed remedy, in which the AMB applies a combination of both structural and behavioral remedies.[79] If MOFCOM decides to prohibit a transaction due to the potential anticompetitive effects, the parties may submit evidence to demonstrate that the beneficial effects on competition will outweigh the negative impacts, or that the transaction will serve the public interest.[80] If MOFCOM decides to prohibit a transaction or if it decides to limit one with conditions, it will make a timely formal announcement of its decision to the general public.[81]

IV. COCA-COLA CORPORATION'S ATTEMPTED ACQUISITION OF CHINA HUIYUAN FRUIT JUICE GROUP

Since China's Anti Monopoly Law took effect on August 1, 2008, there has been only one rejected merger, involving the Coca-Cola Corporation's (Coca-Cola) attempted acquisition of China Huiyuan Fruit Juice Group Limited (Huiyuan).[82] Not only did both firms have a respectable position in the Chinese beverage market, but Huiyuan is also one of the most recognizable national brand names in China.[83]

Huiyuan announced on September 3, 2008 that Atlantic Industries, a wholly owned subsidiary of Coca-Cola, offered to acquire all of Huiyuan's equity interest for about 18 billion Hong Kong dollars ($2.3 billion U.S. dollars).[84] If the merger were approved, it would have been the largest acquisition ever procured in the history of the Chinese food and beverage industry.[85] However, MOFCOM announced its decision to prohibit the proposed acquisition on March 18, 2009, making this the first transaction barred under China's Anti Monopoly Law.[86] MOFCOM issued a brief an-

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79 Bai et al., *supra* note 70, at 3.

80 FURSE, *supra* note 25, at 360.

81 *Id.*

82 Sherry Y. Gong et al., *MOFCOM Bars Coca Cola's Proposed Acquisition of Huiyuan*, CHINA ANTITRUST UPDATE, (Hogan & Hartson LLP, Beijing, China), Mar. 19, 2009, at 1 (China Huiyuan Fruit Juice Group Limited is incorporated in the Cayman Islands and listed on the Hong Kong Stock Exchange); Jin Sun, *The Implementation of China's Anti-Monopoly Law: A Case Study on Coca-Cola's Abortive Acquisition of Huiyuan Juice*, CHINALAWINFO.COM (Summer 2009), http://article.chinalawinfo.com/Article_Detail.asp?ArticleID=48398.

83 Gong et al., *MOFCOM Bars Coca Cola's Proposed Acquisition of Huiyuan*, *supra* note 82, at 1.

84 *Id.*

85 Sun, *supra* note 82.

86 Gong et al., *MOFCOM Bars Coca Cola's Proposed Acquisition of Huiyuan*, *supra* note 82, at 1.

nouncement justifying its decision for blocking the acquisition on the following grounds: 1) resulting dominant market position; 2) concerns that brand recognition would place the potential merged entity at a significant advantage; and 3) increased barriers for competitors to enter the market.[87]

The announcement also stated that MOFCOM solicited and considered "opinions from relevant government authorities, industry associations, fruit juice enterprises, upper-stream juice concentrate suppliers, down-stream fruit juice distributors, both parties to the concentration, the Chinese partners of the Coca-Cola Company, and relevant experts on law, economics, and agriculture."[88] By consulting outside sources so broadly, MOFCOM demonstrated that the central concern in its merger review was the effect on the market in its entirety, rather than just on competition.

After MOFCOM determined the acquisition would create anticompetitive consequences in the fruit juice market, the agency discussed with Coca-Cola the possibility of imposing restrictive conditions on the transaction to mitigate the anticompetitive effects.[89] Pursuant to Chapter IV, Article 28 of the AML, Coca-Cola could propose a solution that would address MOFCOM's concerns of the potential adverse effects on competition and the market.[90] Coca-Cola submitted both a preliminary solution and a revised solution.[91] After assessing the remedies, MOFCOM concluded that the proposals failed to provide a feasible solution that would mitigate the anticompetitive effects.[92]

Ultimately, MOFCOM cited the potential anticompetitive effect in the Chinese fruit juice market, the adverse effect on other competitors, and the harm to the development of the fruit juice industry, as reasons for blocking the concentration. These issues, coupled with the parties' inability to provide evidence that would outweigh adverse consequences or demonstrate that the transaction would be beneficial to the public interest, led MOFCOM to deny the acquisition.[93]

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87 Announcement No. 22 of 2009 of the Ministry of Commerce of the People's Republic of China (effective Mar. 18, 2009), *translated in* Sherry Y. Gong et al., *MOFCOM Bars Coca Cola's Proposed Acquisition of Huiyuan*, CHINA ANTITRUST UPDATE, (Hogan & Hartson LLP, Beijing, China), Mar. 19, 2009, [hereinafter P.R.C. Announcement No. 22].

88 *Id.*

89 *Id.*

90 *Id.*

91 *Id.*

92 *Id.*

93 P.R.C. Announcement No. 22, *supra* note 87.

A. *The Competition Issue*

1. Dominant Market Position

MOFCOM determined that if the acquisition was successful, then Coca-Cola could dominate not only the carbonated soft drinks market, but also the fruit juice market by bundling its products or imposing trade conditions.[94] Consumers would end up paying higher prices and would be forced to choose from a smaller selection of products.[95] Consequently, the transaction would eliminate or unduly hamper competition from existing fruit juice firms, harming consumer interests.[96]

At the time of the proposed acquisition, Coca-Cola controlled 54% of the carbonated-beverages market.[97] On the other hand, Huiyuan's market share varied depending on which definition of "relevant market" was implemented. If the relevant market was defined as "non-carbonated drinks," then Huiyuan's market share was less than 20%[98]; if the relevant market was the "pure fruit juice" market, then Huiyuan's market share fell between 42% and 46%.[99]

2. Branding Concern

The announcement asserted that branding is a major factor that affects competition in the beverage market.[100] MOFCOM believed that the more recognizable the brand, the more market influence a firm could yield.[101] Thus, an established firm with broad brand recognition such as Coca-Cola could potentially take advantage of its position and impose trade conditions on retailers.[102] Additionally, the Ministry believed the proposed acquisition would actually give Coca-Cola such market power because it would then control two major brand names in the fruit juice market, "Minute Maid"

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94 Andrew McGinty & Kirstie Nicholson, *Coca-Cola/Huiyuan: Ministry's Prohibition Sparks Controversy*, INTERNATIONAL LAW OFFICE (Apr. 2, 2009), http://www.internationallawoffice.com/newsletters/detail.aspx?g=76ff3c8f-0c3c-48c0-84e6-feaaf11f863c.

95 *Id.*

96 P.R.C. Announcement No. 22, *supra* note 87.

97 Jason Simpkins, *China Blocks Coke's Bid for Huiyuan, Jeopardizing Resource Deals in Australia*, INVESTMENT NEWS: MONEY MORNING (Mar. 18, 2009), http://www.moneymorning.com/2009/03/18/coke-china/.

98 Sun, *supra* note 82.

99 Simpkins, *supra* note 97.

100 P.R.C. Announcement No. 22, *supra* note 87.

101 Jun Wei et al., *MOFCOM Discloses Details Concerning Rejection of Coca-Cola/Huiyuan Transaction*, ANTITRUST UPDATE, (Hogan & Hartson LLP, Beijing, China), Mar. 27, 2009, at 3.

102 P.R.C. Announcement No. 22, *supra* note 87.

and "Huiyuan."[103] Coca-Cola's potential control in the fruit juice market, coupled with its dominant position in the carbonated soft drinks market, would lead to a market concentration that would significantly raise entry barriers for new competitors in the fruit juice beverage market.[104]

Under the sixth element enumerated under Chapter 4, Article 27 of the AML, MOFCOM may consider, at its discretion, any other elements that would have an effect on market competition when reviewing a proposed merger or acquisition.[105] In the present case, MOFCOM considered the potential effects of the parties' brand names, which appeared to have been an important factor to their final decision.[106]

3. Increased Barriers to Entry

The MOFCOM announcement also stated that the acquisition would make it difficult for mid- and small-sized firms in the fruit juice industry to persist in the market.[107] Similarly, the resulting entity would adversely affect domestic enterprises' ability to enter the market and compete by hampering innovation.[108] These consequences would harm the sustainability of existing enterprises and the development of the Chinese fruit juice industry as a whole.[109]

B. *Criticisms and Protectionist Accusations*

As soon as MOFCOM announced its decision to deny the Coca-Cola/Huiyuan acquisition, commentators asserted that the decision was rooted in nationalist and protectionist objectives that were thinly disguised as concerns about competition.[110] MOFCOM's written announcements regarding conditional or rejected mergers are typically very short, not offering much rationale or specific details underlying their decisions.[111]

Likewise, the anticompetitive effects listed in the Coca-Cola/Huiyuan announcement did not provide sufficient support for a valid reason to reject the merger. Further analysis would not necessarily yield the conclusion that

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103 *Id.*

104 *Id.*

105 FURSE, *supra* note 25, at 359-60.

106 Gong et al., *MOFCOM Bars Coca Cola's Proposed Acquisition of Huiyuan*, *supra* note 82, at 3.

107 P.R.C. Announcement No. 22, *supra* note 87.

108 *Id.*

109 *Id.*

110 Wei et al., *MOFCOM Discloses Details Concerning Rejection of Coca-Cola/Huiyuan Transaction*, *supra* note 101, at 3.

111 McGinty & Nicholson, *supra* note 94, at 1, 2.

allowing the merger would likely lead to competitive harm. The Ministry suggested that Coca-Cola would be able to use its dominant market position to engage in anticompetitive practices, such as bundling or imposing other trading conditions.[112] Commentators thought that the Ministry's assumptions about the potential anticompetitive effects of the concentration were merely speculative, and that there was no evidence to suggest this type of result.[113] Further, even if Coca-Cola did engage in such predatory practices, their actions would be investigated and sanctioned under other provisions of the AML.[114]

One of the Ministry's enumerated concerns fueled the protectionist rhetoric: the proposed transaction would lessen business opportunities for small and medium sized firms in the same industry.[115] These small and medium sized companies lobbied against the transaction, and their objections proved to be an influential factor surrounding the review of the acquisition.[116] Commentators who were accustomed to Western approaches in antitrust enforcement found this concern for competitors to be outright protectionist. After all, antitrust laws are implemented to protect fair competition and prevent anticompetitive behavior in the market, but the laws are not intended to protect the actual competitors themselves.[117] By considering the prosperity of smaller competitors, MOFCOM demonstrated that they believed industrial policies were an appropriate factor in competition analysis.[118]

Further, commentators suggested "nationalism and industry policy [would] likely be significant factors in China's antitrust review of transactions under its new Anti-Monopoly Law."[119] After MOFCOM initially rejected the transaction, rumors circulated that the Ministry's remedy to competition concerns was to order Coca-Cola to divest the rights to the Huiyuan trademark.[120] Considering that Coca-Cola offered to pay a 195% premium to acquire Huiyuan, divesting its rights to Huiyuan's brand would defeat the purpose of acquiring the company altogether.[121] Overall, commentators thought that the emphasis the Ministry placed on a major national brand was atypical to competition analysis and believed that brand analysis did

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112 *Id.* at 2.

113 *Id.*

114 *Id.*

115 Announcement No. 22, *supra* note 87.

116 McGinty & Nicholson, *supra* note 94, at 1, 2-3.

117 *Id. at 2.*

118 *Nationalism a Factor in China's Merger Antitrust Reviews*, GERSON LEHRMAN GROUP (Apr. 20, 2009), http://www.glgroup.com/News/Nationalism-a-Factor-in-Chinas-Merger-Antitrust-Reviews-37663.html.

119 *Id.*

120 *Id.*

121 Simpkins, *supra* note 97.

not have a proper place in antitrust law.[122] The Ministry's assessment of the brand name factor sparked the concern that nationalist sentiments would become a part of M&A reviews involving foreign firms.[123]

Predictably, the result of the Coca-Cola/Huiyuan transaction, coupled with massive media attention on the first rejected transaction under the AML, generated more uncertainty for foreign firms and investors looking to expand to the Chinese market.[124] Since the AML's enactment, commentators and legal analysts have been playing a guessing game, attempting to decipher the ambiguous language in the AML. The AML's meanings, definitions, transaction reviewing procedures, and cultural variations on commonly accepted approaches to antitrust law have been difficult for outside parties to interpret.[125]

Spectators only have limited materials to piece together a coherent idea of what MOFCOM considers important to competition analysis because the Ministry is only required to issue written announcements in cases where it decides to place conditions on a concentration transaction or reject it altogether.[126] The rationales expressed in announcements, such as those in the Coca-Cola/Huiyuan case, enlighten foreign investors as to what elements could possibly fall under the catch-all provision in Article 27 of the AML. Additionally, some of these reasons demonstrate the policies underlying the Ministry's decision and have sparked much criticism and controversy.

At its worst, the AML might completely deter foreign investors from investing in China. However, this is unlikely given the abundance of lucrative business opportunities in a country that has recently opened its markets and has a massive consumer population; domestic consumers reside in over 800 cities, 200 of which harbor populations of over a million.[127] While the AML has yet to establish the enforcement regime Western commentators and investors hoped for, its progressive trends in economic reform over the past fifteen years have made a significant movement toward the Western standard. It is only a matter of time until the AML's policy and enforcement catch up to a universally acceptable standard that is in consonance with the global market economy.

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122 *Nationalism a Factor in China's Merger Antitrust Reviews*, *supra* note 118.

123 *Id.*

124 McGinty & Nicholson, *supra* note 94.

125 Nathan Bush, *The PRC Antimonopoly Law: Unanswered Questions and Challenges Ahead*, THE ANTITRUST SOURCE, October 2007, at 1.

126 *See* Wei et al., *MOFCOM Discloses Details Concerning Rejection of Coca-Cola/Huiyuan Transaction*, *supra* note 101.

127 YUVAL ATSMON ET AL., MCKINSEY & COMPANY, 2009 ANNUAL CHINESE CONSUMER STUDY PART II: ONE COUNTRY, MANY MARKETS—TARGETING THE CHINESE CONSUMER WITH MCKINSEY *CLUSTERMAP* 7 (2009).

V. PROTECTIONISM AS A STEPPING STONE OF PROGRESSION: LOOKING TO THE WEST

A. *U.S. Antitrust Enforcement in the 1960s*

While Western commentators have criticized China's protectionist approach in implementing its Anti Monopoly Law, they overlook the fact that the U.S. was still enforcing protectionist measures through its own antitrust laws as recently as the late 1960's, as illustrated in a string of cases. Following the 1950 Celler-Kefauver Anti-Merger Act amendment to §7 of the Clayton Act, the Supreme Court interpreted the Act as taking a broad stance against mergers that *may* substantially lessen competition, or *tend* to create a monopoly.[128]

The Court interpreted the purpose behind ratifying the Celler-Kefauver amendment as preventing economic concentration in the hands of a few by ensuring that a large number of small competitors remain in the market.[129] Thus, the standard for reviewing mergers was whether a merger *may* substantially decrease competition in the present, as well as whether it *may* affect competition in the future.[130] It seems that "substantially lessen" was equated with the decline of the absolute number of competitors in the market.[131] Eventually, defining relevant markets was no longer necessary as the Court interpreted the statutory language as establishing that a merger need only affect competition "in *any* section" of the United States.[132] Finally, the Court considered an industry-wide trend toward concentration, regardless of cause, as a "highly relevant factor" when determining the significance of a merger's anticompetitive effect.[133]

In 1963, the Supreme Court enjoined a proposed merger between Philadelphia National Bank and Girard Trust Corn Exchange Bank in *United States v. Philadelphia National Bank*.[134] The Court found that the proposed merger would likely substantially lessen competition, without offering any

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128 Clayton Act, ch. 323, §7, 38 Stat. 730, 731 (1964) (current version at 15 U.S.C. §18 (2010)) ("That no corporation engaged in commerce . . . shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly.").

129 United States v. Von's Grocery Co., 384 U.S. 270, 275-76 (1966).

130 *Id.* at 278.

131 United States v. Pabst Brewing Co., 384 U.S. 546, 551 (1966) ("If not stopped, this decline in the number of separate competitors and this rise in the share of the market controlled by the larger beer manufacturers are bound to lead to greater and greater concentration of the beer industry into fewer and fewer hands.").

132 *Id.* at 549.

133 *Id.* at 552-53.

134 United States v. Phila. Nat'l Bank, 374 U.S. 321, 371 (1963).

procompetitive justification.[135] Three years later, the Supreme Court held that a merger between Von's Grocery Company and Shopping Bag Food Stores violated §7 of the Clayton Act and ordered the immediate divestiture of the merged entity six years after the merger was consummated.[136] That same year, the Court held that Pabst Brewing Company, the tenth largest beer brewery in the nation, may substantially lessen competition or tend to create a monopoly by acquiring the assets of Blatz Brewing Company, the eighteenth largest brewery in the nation.[137] The acquisition thus violated §7 of the Clayton Act and the Court ordered divestiture.[138]

B. *Philadelphia National Bank—1963*

In 1961, Philadelphia National Bank (PNB) and Girard Trust Corn Exchange Bank (Girard) were the second and third largest banks of the forty-two in their relevant market, which consisted of the Philadelphia metropolitan area and three neighboring counties.[139] When assessing the potential anticompetitive effects of the merger, the Supreme Court looked at the size of the two firms in conjunction with the increasing trend toward concentration in the commercial banking sector of the relevant market.[140] The Court noted the general decline in the number of commercial banks in the Philadelphia area, from 108 in 1947 to only forty-two in 1963.[141] Additionally, since 1950, PNB had acquired nine independent banks and Girard had acquired six.[142]

The boards of directors of both firms approved of the proposed merger, but their agreement was subject to the approval of the Comptroller of the Currency under 12 U.S.C. §215.[143] Pursuant to the Bank Merger Act of 1960, codified in 12 U.S.C. §1828(c), the Comptroller may not grant approval for the merger until he has received a report from the Federal Reserve, Federal Deposit Insurance Corporation, and the United States Attorney General.[144]

The Attorney General and the banking agencies generated reports that analyzed the competitive factors involved in the potential merger.[145] The agencies considered factors such as the banks' financial condition and his-

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135 *Id.*

136 United States v. Von's Grocery Co., 384 U.S. 270, 279 (1966).

137 United States v. Pabst Brewing Co., 384 U.S. 546, 547, 552-53 (1966).

138 *Id.*

139 *Phila. Nat'l Bank*, 374 U.S. at 330.

140 *Id.* at 331.

141 *Id.* at 331.

142 *Id.*

143 *Id.* at 332.

144 *Id.* at 332-34.

145 *Phila. Nat'l Bank*, 374 U.S. at 332-34.

tory, adequacy of its capital structure, future earnings projections, and character of management, and needs of the community.[146] Further, the reports also evaluated the effect of the transaction on competition, such as an increasing tendency toward monopoly.[147]

Despite all three reports stating that the PNB and Girard merger would likely have substantial anticompetitive effects, the Comptroller nonetheless approved the merger.[148] In his statement to Congress, the Comptroller claimed that the merger would not have an overall negative effect on competition; he based his assertion on the idea that there were still a sufficient number of alternative commercial banks in the relevant market.[149] Finally, the Comptroller believed that the merger would benefit international and national competition because the post-consolidation bank would have greater lending power, enabling it to compete with larger out-of-state banks that also operated in the geographical area.[150]

The Supreme Court established the statutory test as, whether the merger may substantially lessen competition "in any line of commerce in any section of the country."[151] The Court recognized that this test was not subject to a precise answer as to a merger's degree of impact on competition.[152] However, it stated that the antitrust laws before the court were "intended to arrest anticompetitive tendencies in their 'incipiency.'"[153] The Court ultimately found that the proposed merger would substantially lessen competition and held in favor of the Government, subsequently enjoining the proposed merger.[154]

The Supreme Court's analysis of the potential anticompetitive conduct in *Philadelphia National Bank* did not differ significantly from MOFCOM's analysis of the Coca-Cola/Huiyuan merger. Neither case could articulate a clearly defined anticompetitive harm. Rather, both cases rested on the speculation that the mergers could substantially lessen competition, which does not necessarily implicate anticompetitive conduct; the desire to merge could simply indicate the firms' efforts to become more efficient and competitive. The concept of a free market economy presumes that the market will naturally weed out weaker firms, ultimately benefiting consumer interests. Lawful competition results in firms becoming more efficient and more innovative. This type of competitive behavior is generally encouraged, and those who become successful in the market should not be punished. A merger that would cause the number of competitors in a

146 *Id.* at 334 n.8.
147 *Id.*
148 *Id.* at 332-33.
149 *Id.*
150 *Id.* at 332-34.
151 *Phila. Nat'l Bank*, 374 U.S. at 355.
152 *Id.* at 362.
153 *Id.*
154 *Id.* at 324.

given industry to decline is not by itself anticompetitive, according to traditional antitrust norms. Government intervention of a merger can be condemned as protectionist, or it can be interpreted as halting a merger's monopolistic potential at its incipiency—despite the different perceptions of government intervention, the result is still the same. Both MOFCOM and the Supreme Court's decisions were based on speculation, with no demonstrable support of a merger's propensity to lessen competition. Nevertheless, in both cases, the mergers were deemed anticompetitive and prohibited from consummating.

C. *Von's Grocery Company—1966*

Another example from U.S. antitrust enforcement history is *United States v. Von's Grocery Company*.[155] The dissenting opinion, authored by Justice Stewart, pointed out the critical flaws in the majority's opinion, which ordered the divestiture of the merger between Von's Grocery Company (Von's) and Shopping Bag Food Stores (Shopping Bag).[156]

The Supreme Court retroactively examined the retail grocery market in the Los Angeles area from 1958 to 1963, surrounding the time of the Von's and Shopping Bag merger in 1960.[157] In 1958, Von's ranked third in total annual sales in the market, and Shopping Bag ranked sixth.[158] After the merger, the combination became the second largest grocery chain in the area measured by annual sales.[159] The Court also found that during that period, the number of individual grocery stores was declining while the number of chains that operated two or more stores was increasing.[160] The Federal Trade Commission also presented statistics showing that acquisitions by other large grocery chains had continued to increase at a "rapid rate" since the Von's and Shopping Bag merger.[161] Based on these findings alone, without further analysis, the Supreme Court held that the merger violated §7 of the Clayton Act.[162]

Writing for the dissent, Justice Stewart referred back to *Brown Shoe Co. v. United States*, the first case decided after the Celler-Kefauver amendments to §7 of the Clayton Act.[163] In the *Brown Shoe* opinion the Court established two standards for assessing a §7 Clayton Act case: 1) that the merger be viewed in light of the current economic context of the rele-

155 United States v. Von's Grocery Co., 384 U.S. 270, 277-78 (1966).

156 *Id.* at 281.

157 *Id.* at 271-74.

158 *Id.* at 272.

159 *Id.*

160 *Id.* at 272-73.

161 *Von's*, 384 U.S. at 272-73.

162 *Id.* at 274.

163 *Id.* at 281-82 (Stewart, J., dissenting).

vant industry; and 2) that the purpose of §7 was to protect competition, and not competitors.[164] The majority did not analyze the possible competitive effects of the merger or the economic market concentration, but simply determined that the absolute number of competitors was decreasing, which indicated that competition was decreasing as well.[165]

Justice Stewart countered the majority's finding by asserting that it was not enough that the merger would affect competition; rather the merger needed to substantially lessen competition.[166] Moreover, the amendments' legislative history clarified the standard for the "substantiality" measure by requiring a finding that a "reasonable probability" that the merger would lessen competition.[167] To that end, the majority should have taken into account the extraordinary rise in population in the Los Angeles area, which was so expansive that even the largest grocery chain could not render single stores obsolete.[168] American society had been evolving since World War II, leading to increasing populations and the proliferation of highways and cars, which eventually led to the supermarket revolution.[169] The majority should have examined all of these factors as the contemporary backdrop in which to properly frame the merger in the economic context of the times. Setting aside all these factors, the Court still did not acknowledge that more than four years after the merger there was no evidence to demonstrate any effects the merger had on competition; therefore disproving the "reasonable probability" that the merger would lessen competition under §7 of the Clayton Act.[170]

Thus, as late as 1966 the U.S. implemented a protectionist policy by prohibiting mergers for the sake of preserving the absolute number of small local competitors. The U.S. era of effectuating protectionist policies occurred during the same time as a significant shift in American culture that began after World War II. In many instances, these changes led to a parallel shift in various industry dynamics and their respective economic markets. Similarly, China is currently undergoing such a shift in its cultural revolution. The Chinese markets are experiencing a dramatic shift in tandem with their cultural progression. However, unlike the U.S. in the 1960s, China is experiencing this current shift with the influence and pressures of a global market economy intertwined in its own domestic markets.

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164 *Id.* at 281-82 (citing, Brown Shoe Co. v. United States, 370 U.S. 294, 331-32 (1962)).

165 *Id.* at 283-84.

166 *Id.* at 283.

167 *Von's*, 384 U.S. at 285.

168 *Id.* at 287-88.

169 *Id.* at 288.

170 *Id.* at 300, 304.

VI. CHINA'S APPROVED MERGERS WITH CONDITIONAL CLEARANCES

Since China has opened its economy to the global market, its domestic enterprises understandably need time to adapt to new conditions in competition. To date, MOFCOM has issued a total of six opinions in cases arising out of the AML: 1) the prohibition of the Coca-Cola/Huiyuan acquisition,[171] 2) the conditional approval of InBev's acquisition of Anheuser-Busch Companies Incorporated (Anheuser-Busch),[172] 3) the conditional approval of Mitsubishi Rayon Company Limited's (Mitsubishi) acquisition of Lucite International Group Limited (Lucite),[173] 4) the conditional approval of General Motors Company's (GM) acquisition of Delphi Corporation (Delphi),[174] 5) the conditional approval of Pfizer Incorporated's (Pfizer) acquisition of Wyeth Incorporated (Wyeth),[175] and 6) the conditional approval of Panasonic Corporation's (Panasonic) acquisition of Sanyo Electric Company (Sanyo).[176] In these cases, MOFCOM indicated that they were very aware that China's domestic enterprises needed an adjustment period and they factored this into their review of these transactions.[177] On a more positive note, it also appeared that the government understood that this protectionist grace period was just that: a *period*—a limited phase where protectionism might cushion the shock of a rapidly transforming economy.

A. *InBev Acquires Anheuser-Busch*

The MOFCOM announcement issued on November 18, 2008 approving the InBev/Anheuser-Busch merger was the first published decision since the AML became effective on August 1, 2008.[178] In MOFCOM's very brief announcement, the ministry approved the merger with several restrictive conditions, citing the large scale of the merger, its competitive

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171 P.R.C. Announcement No. 22, *supra* note 87.

172 *China's MOFCOM Imposes Conditions on InBev's Acquisition of Anheuser-Busch*, BRIEFING (Freshfields Bruckhaus Deringer LLP, England), Nov. 2008, at 1-2.

173 Sherry Y. Gong et al., *MOFCOM Conditionally Clears Mitsubishi Rayon's Acquisition of Lucite*, CHINA ANTITRUST UPDATE, (Hogan & Hartson LLP, Beijing, China), Apr. 28, 2009.

174 Jun Wei et al., *MOFCOM Conditionally Clears Two Proposed Mergers*, CHINA ANTITRUST UPDATE, (Hogan & Hartson LLP, Beijing, China), Oct. 15, 2009.

175 *Id.*

176 Jun Wei et al., *China's Merger Review Regulator Conditionally Approves Panasonic's Proposed Acquisition of Sanyo*, CHINA ANTITRUST UPDATE, (Hogan & Hartson LLP, Beijing, China), Nov. 10, 2009.

177 Wei et al., *MOFCOM Discloses Details Concerning Rejection of Coca-Cola/Huiyuan Transaction*, *supra* note 101.

178 *China's MOFCOM Imposes Conditions on InBev's Acquisition of Anheuser-Busch*, *supra* note 172.

strength, and the resulting large market share in the beer industry.[179] To mitigate possible anticompetitive conduct, InBev may not take the following actions absent MOFCOM's approval: 1) increase Anheuser-Busch's 27% shareholding in Tsingtao Brewery Company; 2) increase current 28.56% shareholding in Guangzhou Zhujiang Brewery Group Company; 3) seek to hold any shares of China Resources Snow Breweries Company or Beijing Yanjing Brewery Company.[180] Finally, InBev is required to notify MOFCOM if the controlling shareholders of InBev change.[181]

These restrictions were implemented to ensure that no anticompetitive conduct would result from the merger.[182] It is also worth pointing out that the two companies in which MOFCOM prohibited InBev from acquiring any shares, China Resources Snow Breweries and Beijing Yanjing Brewery, were both among the larger domestic firms in the beer industry.[183]

Even as the earliest MOFCOM announcement issued pursuant to the AML, the InBev/Anheuser-Busch decision included considerations beyond what Western countries would typically include in an antitrust evaluation. Commentators questioned the decision's consistency with international practice, and suggested that it was inappropriate to impose restrictive conditions on a transaction that was not anticompetitive.[184] Based on the Ministry's restrictions, protecting the interests of domestic enterprises was anything but an afterthought during the merger review.

B. *Mitsubishi Rayon Acquires Lucite*

On April 24, 2009, MOFCOM reached a decision regarding the $1.6 billion acquisition of Lucite International Group, a British acrylics manufacturer, by the Japanese Mitsubishi Rayon Company.[185] Determining that the merger would result in Mitsubishi's market share effectuating a vertical foreclosure, MOFCOM again imposed several restrictive conditions on the transaction to mitigate adverse competitive effects.[186] Compared to the conditions imposed in the InBev/AB merger, the restrictions in the Mitsubishi/Lucite case were more detailed and elaborate. To alleviate anticompetitive concerns, MOFCOM accepted Mitsubishi's proposal to have

179 *Id.*

180 *Id.*

181 *Id.*

182 *Id.*

183 *Id.*

184 Hannah Cheuk-Ling Ha & Gerry O'Brien, *2009—The Year of China's Anti-Monopoly Law?*, MARTINDALE, July 2, 2009, http://www.martindale.com/international-law/article_JSM-Mayer-Brown-JSM_735678.htm.

185 Gong et al., *MOFCOM Conditionally Clears Mitsubishi Rayon's Acquisition of Lucite*, *supra* note 173.

186 *Id.*

Lucite sell half of its Chinese subsidiary's methylmethacrylate production capacity to a third party for five years.[187] MOFCOM gave the parties six months to find buyers, and if the parties were unable to sell the manufacturing capacity in time, the ministry would appoint a trustee to sell Lucite's entire interest in its Chinese subsidiary.[188] Additionally, the parties could not purchase or build any new manufacturing plants in China for a period of five years without MOFCOM's consent.[189]

Commentators found that these conditions were overreaching and beyond what traditional antitrust laws could justifiably regulate.[190] Many asserted that the Ministry could now use antimonopoly concerns as a premise to restructure an industry and place foreign firms at a competitive disadvantage.[191] Although there was also much criticism surrounding this case, commentators did acknowledge the fact that MOFCOM was willing to negotiate when it found the transaction would have adverse consequences on competition.[192]

C. *General Motors Acquires Delphi*

On September 28, 2009, MOFCOM issued an announcement conditionally approving General Motors Corporation's proposed acquisition of Delphi Corporation, less than a month after MOFCOM began its initial review of the transaction on August 31, 2009.[193] The announcement stated that as a part of MOFCOM's review, it considered comments from both parties to the transaction, other government agencies, industry associations, and other automakers.[194] The merger did not involve any horizontal overlap in product market between the two parties.[195] Rather, the merger would affect vertical upstream and downstream markets in the mainland Chinese market.[196] MOFCOM defined GM's relevant product markets as passenger

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187 *Id.*

188 *Id.*

189 *Id.*

190 *Id.*

191 Gong et al., *MOFCOM Conditionally Clears Mitsubishi Rayon's Acquisition of Lucite*, *supra* note 173.

192 *Id.*

193 Announcement No. 76 (2009) of the Ministry of Commerce of the People's Republic of China (effective Sept. 28, 2009), *translated in* Jun Wei et al., *MOFCOM Conditionally Clears Two Proposed Mergers*, CHINA ANTITRUST UPDATE, (Hogan & Hartson LLP, Beijing, China), Oct. 15, 2009 [hereinafter P.R.C. Announcement No. 76].

194 *Id.*

195 *Id.*

196 *Id.*

cars and commercial vehicles, and Delphi's relevant product markets spanned across ten different automobile parts markets.[197]

Unlike previous announcements made pursuant to Article 30 of the AML, MOFCOM's GM/Delphi announcement specified the potential anticompetitive effects the Ministry was concerned about.[198] The merger would result in both companies sharing control and newly aligned business interests, when both parties already held a leading position in the relevant global markets and in the Chinese domestic market.[199] The Ministry suggested that since Delphi was the exclusive supplier of auto parts for many domestic automakers, GM and Delphi's newly aligned business interests could lead to a change in Delphi's supply, prices, and quality of products to domestic automakers, causing anticompetitive effects in the domestic automobile market.[200] Also, as GM would join Delphi's board of directors, the Ministry wanted to ensure that GM would not have access to, and Delphi would not provide, any proprietary information regarding domestic automakers' technologies or similar trade information.[201] Further, due to the newly aligned business interest, Delphi could engage in adverse business tactics when domestic automakers try and switch auto part suppliers, effectuating anticompetitive consequences in that way.[202] Similarly, GM could also increase its purchasing parts through Delphi, placing domestic automobile parts suppliers at a disadvantage by making it difficult for other suppliers to enter GM's purchasing channel.[203]

In addressing the Ministry's concerns, both parties offered behavioral remedies that would reduce the merger's potential anticompetitive effects; the Ministry ultimately accepted the parties' proposal, and conditionally approved the merger.[204] Following the merger, Delphi and affiliated entities of which Delphi controls must continue to supply domestic automakers without discrimination or unreasonable prices or conditions.[205] Also, Delphi will not supply, and GM will not access any confidential information of competing domestic automakers.[206] Further, Delphi and its affiliated entities will assist any customer's request to switch suppliers, and will refrain from any activities that would inhibit the process.[207] Similarly, GM will continue to adhere to its policy of utilizing multiple supply sources and will

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197 *Id.*

198 *Id.*

199 P.R.C. Announcement No. 76, *supra* note 193.

200 *Id.*

201 Wei et al., *MOFCOM Conditionally Clears Two Proposed Mergers*, *supra* note 174.

202 *Id.*

203 *Id.*

204 *Id.*

205 *Id.*

206 P.R.C. Announcement No. 76, *supra* note 193.

207 *Id.*

continue to purchase supplies without bias against Delphi's competitors.[208] Finally, both parties must report their compliance to MOFCOM on a regular basis.[209]

D. *Pfizer Acquires Wyeth*

One day after the GM/Delphi announcement, MOFCOM issued another conditional approval of a proposed merger between two U.S. companies, Pfizer Incorporated and Wyeth Incorporated.[210] Encompassed in its review, MOFCOM consulted relevant government agencies, industry associations, competitors, held expert panels, and conduced on-site investigations.[211] MOFCOM determined that both companies had overlapping product markets in human pharmaceuticals and animal health products, occurring in the Chinese domestic markets.[212] After reviewing the proposed transaction, the Ministry's concerns were focused on anticompetitive consequences that would affect the competitive structure for the swine mycoplasma pneumonia vaccine.[213]

Significantly, MOFCOM's Pfizer/Wyeth announcement demonstrated the Ministry's evolving sophistication in merger review as it cited detailed market share and market concentration data; the anticompetitive analysis utilized the Herfindahl-Hirschman Index, which is commonly used by the U.S. and E.U. in analyzing market shares in antitrust cases.[214] MOFCOM found that the merger would cause the parties to attain a 49.4% market share, with the closest competitor only holding a market share of 18.35% and all other competitors holding less than a 10% market share each.[215] This advantageous standing would allow the parties to control the market price for the product.[216] Further, the merger would significantly increase concentration in a market that was already highly concentrated.[217] The Ministry's findings projected that concentration in the swine mycoplasma pneumonia vaccine market would increase by 336 to 2182 on the Herfindahl-Hirschman Index.[218] Finally, industry statistics showed that on average, pharmaceutical research and development takes three to ten years,

208 *Id.*
209 *Id.*
210 *Id.*
211 *Id.*
212 P.R.C. Announcement No. 76, *supra* note 193.
213 *Id.*
214 *Id.*
215 *Id.*
216 *Id.*
217 *Id.*
218 P.R.C. Announcement No. 76, *supra* note 193.

and costs about 2.5 to $10 million dollars.[219] Coupled with the Ministry's market surveys that showed the technical barriers for entering the relevant market are even higher than the average obstacles, the merger would likely result in the parties taking advantage of their vast scale to the detriment of their competitors.[220]

Like the GM/Delphi case, MOFCOM negotiated possible remedies with both Pfizer and Wyeth, ultimately accepting the combined remedies the parities proposed.[221] Pfizer agreed to divest the swine mycoplasma pneumonia vaccine businesses under its brands Respisure and Respisure One in the Chinese domestic markets.[222] All tangible and intangible assets necessary for Respisure and Respisure One would be included in the divestiture in order to ensure both businesses' competitive viability.[223] Pfizer must also utilize a trustee in finding an independent, approved buyer for the divested businesses and finalize the sale within six months after MOFCOM's approval of the merger.[224] Further, if Pfizer is unable to find a buyer, MOFCOM will designate a trustee to dispose of the businesses without regard to a reserve price.[225] During the divestment period, Pfizer will appoint an interim manager for the businesses with a primary objective of maintaining the businesses' competitiveness and merchantability.[226] Finally, for up to three years after divestment, upon the buyer's request, Pfizer will provide technical support, technical training and consulting services, as well as assist the buyer in purchasing the raw materials needed to produce the swine mycoplasma pneumonia vaccine.[227]

E. *Panasonic Acquires Sanyo*

On October 30, 2009, MOFCOM conditionally approved an offshore merger transaction between two Japanese companies, Panasonic Corporation and Sanyo Electric Company, both with a presence in China.[228] The parties announced the proposed acquisition of Sanyo by Panasonic in November of 2008, but the $8.87 billion dollar deal required the parties to attain clearances from various antitrust agencies around the world prior to

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219 *Id.*
220 *Id.*
221 *Id.*
222 *Id.*
223 *Id.*
224 P.R.C. Announcement No. 76, *supra* note 193.
225 *Id.*
226 *Id.*
227 *Id.*
228 Wei et al., *China's Merger Review Regulator Conditionally Approves Panasonic's Proposed Acquisition of Sanyo*, *supra* note 176.

executing the merger.[229] On May 4, 2009, MOFCOM began its preliminary review of the merger.[230] However, due to the Ministry's prediction that the merger would substantially increase the parties' market share in the Chinese domestic market, MOFCOM decided to investigate the case further by September 3.[231] On August 26, Panasonic requested that MOFCOM grant an extension of its deadline so that Panasonic could have more time to propose remedies that would address the Ministry's anticompetitive concerns; this was the first time that MOFCOM utilized Article 26 of the AML to extend its review under special circumstances by sixty days to November 3.[232]

MOFCOM determined that the proposed merger would have anticompetitive effects in the product markets of rechargeable coin-shaped lithium batteries, nickel-hydrogen batteries for general use, and nickel-hydrogen batteries for vehicles; all three markets were already highly concentrated with both parties holding high market shares and dominant positions across the board.[233]

With respect to rechargeable coin-shaped lithium batteries, the parties were the largest and second-largest producers this product market, and the merger would result in a 61.6% market share and would thus restrict consumer product choices.[234] As the relevant product markets were already concentrated, the parties would have even greater ability to raise product prices.[235]

Following the proposed merger, the parties would attain a 46.3% market share in the general use nickel-hydrogen battery market, which would be considerably higher than any other competitor.[236] During its investigations, MOFCOM found that users of downstream products saw Panasonic and Sanyo batteries as the only acceptable brands of batteries and refused to use batteries bearing another brand.[237] This brand designation would further enable the parties to raise prices, as well as adversely affect market competition by squeezing out other battery producers.[238] Finally, MOFCOM's investigations also showed that development in the nickel-hydrogen battery market had been relatively slow, and the anticompetitive effects of the proposed merger would increase market entry barriers, thus hindering innovation in product development.[239]

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229 *Id.*

230 *Id.*

231 *Id.*

232 *Id.*

233 *Id.*

234 Wei et al., *China's Merger Review Regulator Conditionally Approves Panasonic's Proposed Acquisition of Sanyo*, *supra* note 176.

235 *Id.*

236 *Id.*

237 *Id.*

238 *Id.*

239 *Id.*

The Panasonic/Sanyo merger would significantly impact the market of nickel-hydrogen batteries for hybrid or electric vehicles.[240] At the time, Panasonic was already engaged in a joint venture with Toyota Motor Corporation (Toyota), forming Panasonic EV Energy Company (PEVE).[241] PEVE held a 77% market share in the nickel-hydrogen battery for vehicles market, and its only formidable competitors were Panasonic and Sanyo; the proposed merger was sure to notably lessen competition in a highly concentrated market.[242]

Despite the dreary outlook on the likely anticompetitive effects of the Panasonic/Sanyo merger and after several rounds of negotiations, MOFCOM accepted the parties' proposed remedies to mitigate anticompetitive consequences and approved the merger.[243] Sanyo agreed to divest all of its rechargeable coin-shaped lithium battery business by selling all of its production facilities in Japan and related assets to an independent buyer.[244] In addition, Sanyo must also license the buyer to grant use of all intellectual property rights associated with the divested business.[245]

Furthermore, the conditional merger approval also required either Sanyo or Panasonic to divest its nickel-hydrogen battery for general use business; MOFCOM allowed the parties to determine which company was to sell their business, but required the parities to submit a detailed plan and obtain the Ministry's approval prior to executing the divestment.[246]

Further, Panasonic was required to divest its nickel-hydrogen battery for vehicles business by selling all its production facilities for nickel-hydrogen batteries in Japan to an independent buyer.[247] In addition, Sanyo was also to sell its related business assets to the buyer, as well as license the buyer to use its related intellectual property rights.[248]

Finally, MOFCOM conditioned its approval on Panasonic's agreement to essentially diminish any form of interest it held in PEVE.[249] With regards to financial interest, Panasonic must reduce its capital contribution from

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240 Wei et al., *China's Merger Review Regulator Conditionally Approves Panasonic's Proposed Acquisition of Sanyo*, *supra* note 176.

241 *Id.*

242 Announcement No. 82 (2009) of the Ministry of Commerce of the People's Republic of China (effective Oct. 30, 2009), *translated in* Jun Wei et al., *China's Merger Review Regulator Conditionally Approves Panasonic's Proposed Acquisition of Sanyo*, CHINA ANTITRUST UPDATE, (Hogan & Hartson LLP, Beijing, China), Nov. 10, 2009 [hereinafter P.R.C: Announcement No. 82].

243 *Id.*

244 *Id.*

245 *Id.*

246 Wei et al., *China's Merger Review Regulator Conditionally Approves Panasonic's Proposed Acquisition of Sanyo*, *supra* note 176.

247 P.R.C. Announcement No. 82, *supra* note 242.

248 *Id.*

249 *Id.*

40% to 19.5% in PEVE.[250] Panasonic also agreed to forfeit all control in its joint venture with Toyota, as it was to waive rights in voting, appointing PEVE's directors, and veto powers.[251] To complete the exorcism, PEVE's name must change to exclude the word "Panasonic."[252]

Similar to the Mitsubishi Rayon/Lucite and Pfizer/Wyeth divestitures, Panasonic and Sanyo were required to complete the divestments within six months of MOFCOM's merger approval.[253] However, unlike the previous divestitures the present case allowed another six-month extension for the parties to find another buyer; if the parties failed to find a buyer at the expiration of the grace period, then MOFCOM would appoint a trustee to divest the businesses.[254] Also, until the divestitures' completion, Panasonic and Sanyo were to operate as independent businesses, and could not disclose any business information to one another.[255]

CONCLUSION

Undoubtedly, the decisions since China recently implemented its Anti Monopoly Law have demonstrated that MOFCOM wears a protectionist hat when considering foreign M&A transactions. All of the restrictions that MOFCOM placed on the five conditionally approved mergers relate to the parties' interests in, or affect on, domestic enterprises. While this method of applying an antimonopoly law is certainly not ideal and perhaps contradictory to international norms, using protectionism as a stepping stone to a more unified application of the AML will benefit China's economy and its investors in the long run. Indeed, China's antitrust regime has already begun to demonstrate progression toward sophistication in review, and conformity with global norms in enforcement. Most importantly, MOFCOM announcements increasingly reflect a more amenable approach in balancing the involved parties' business interests and the Ministry's interests in ensuring a competitive socialist market economy.

Currently, analysts must take additional external elements into account when considering the impact of foreign M&As on the Chinese economy. Western antitrust laws have been reformed and refined over the span of decades. When taking Western antitrust standards for granted and addressing situations through a Western perspective, commentators tend to be quick to conclude that MOFCOM reached an erroneous decision in the Co-

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250 *Id.*

251 *Id.*

252 Wei et al., *China's Merger Review Regulator Conditionally Approves Panasonic's Proposed Acquisition of Sanyo*, *supra* note 176.

253 *Id.*

254 *Id.*

255 *Id.*

ca-Cola/Huiyuan case and that denying the transaction was protectionist. Perhaps a little protectionism is what the Chinese market needs to help it evolve to its maximum potential as a socialist market economy. This is not to discount the importance of economic ideologies, such as the fundamental concept that a free market economy will naturally adjust itself to allocate resources in the most efficient manner. However, when dealing with practical situations one must move beyond economic theory and take into account the very real social and political elements that constantly influence how institutions are implemented. New institutions take time to adapt, learn and evolve. Moreover, it also takes time for the citizen population in which these new institutions arise to accept and trust newly enacted regulations.

Critics should consider the bigger picture of the overall economic climate at the time, in addition to other ancillary factors specific to individual merger cases. As the inexperienced Chinese markets were still experiencing growing pains, the domestic enterprises that traditionally received a significant amount of government support that allowed them to flourish in a protectionist environment, were also struggling through the shift within market dynamics.

Foreign M&As in the Chinese market cannot always be presumed to be beneficial. On the one hand, foreign influences may challenge domestic firms to be more innovative, and expose the market to new ideas, standards, strategies, business practices, and products. It is also generally accepted that competition in a free market will eliminate inefficient entities and promote the quality and productiveness of competing firms, all to the benefit of consumers. However, when taking into account the general characteristics of China's domestic enterprises, foreign M&As can understandably become a very real threat to the nation's financial wellbeing.

The pattern of foreign M&As since the 1990s demonstrates why foreign M&As is often viewed as a double-edged sword. These trends began during the time China undertook a renewed effort to reform its market. While open markets have benefited China's economy tremendously, open markets have also raised some concerns. For example, foreign companies increasingly seek to acquire dominant interests in Chinese firms.[256] Regional and industry-wide M&As of domestic firms have become more commonplace.[257] Further, foreign firms have been seeking to acquire the more prominent Chinese companies that are considered the leaders in their respective industries.[258] Finally, large transnational corporations such as Coca-Cola have also increased their efforts to merge or acquire domestic businesses.[259]

256 Sun, *supra* note 82.

257 *Id.*

258 *Id.*

259 *Id.*

Some domestic firms might have benefited from foreign M&As if they were already struggling to persist before foreign firms invigorated market competition. But in the case of larger national firms such as Huiyuan, foreign acquisition could set into motion an undesirable trend. After all, if even larger and more established domestic firms cannot compete efficiently with foreign firms, then who can? At least larger firms like Huiyuan have the resources and the market standing and are sufficiently established to enable it to rethink their business methods. Perhaps steadily weaning domestic enterprises off of protectionism would better contribute to the strength of China's economy in the long run. Although China has opened up its markets, domestic firms still need time to learn how to become more efficient and adapt to the higher level of competition with their foreign counterparts.

To ensure that domestic enterprises have time to adjust to more rigorous market competition brought by foreign firms, the Chinese government has implemented its Anti Monopoly Law with protectionist tendencies. This era of incorporating protectionist practices can only be temporary as China's further economic growth would be limited if it were otherwise. In the meantime, hopefully spectators in the global economy can continue their patience during the transition period while China's economy stabilizes itself on the global level. China's new open market will stabilize itself as its Anti Monopoly Law gains experience and evolves from its mistakes—similar to the way Western nations have emerged due to growth and evolution from their past.