

# Surviving *Daubert*: Bad Benchmarking Puts Cases at Risk

## Expert Witnesses Misstep by Using the Wrong Benchmarks to Calculate Damages

BY DONALD M. MAY

*Donald M. May, Ph.D., is a Director in the Litigation and Corporate Financial Advisory Services Group at Marks Paneth & Shron LLP and a former professor at MIT's Sloan School of Management. Dr. May has prepared expert reports and expert witness testimony related to business valuation, hedge fund valuation, lost profits, lost enterprise value, time-series forecast models, asset and investment portfolio valuation and statistical forecasting models and methodologies. Contact: [dmay@markspaneth.com](mailto:dmay@markspaneth.com)*

To the challenges of managing complex litigation, add one more: Expert witnesses often make critical mistakes that put litigation at risk.

Specifically, experts often use the wrong benchmarks to calculate damages for lost profits, lost enterprise value, or shareholder damages, making assumptions that don't stand up to scrutiny, and causing their testimony to be excluded on *Daubert* challenge.<sup>1</sup>

In particular, these experts rely on benchmarks used for valuation analysis when estimating lost profits or enterprise value, and rely on benchmarks appropriate for lost enterprise value when estimating shareholder damages. Benchmarks should be based on the specific type of damages to be estimated. For lost profits and lost enterprise value, benchmarks should be based on what *actually happened* after the alleged event. For shareholder damages, benchmarks should be based on what

could be *foreseen* as of the date of the alleged event.

The consequences are significant. Benchmarking is critical in the analysis of damages from lost profits, lost enterprise value and shareholder damages. Using inappropriate benchmarks or methodologies can

CONTINUED ON PAGE 4

### Content HIGHLIGHTS

**The 2012 Annual Meeting Season: Targeted "Value Activism" Will Displace Traditional Governance Activism**  
By John C. Wilcox..... 8

**Supreme Court to Rule Whether Corporations Can be Sued in U.S. Courts for Human-Rights Abuses Abroad**  
By Gregg Wirth ..... 14

Complete Table of Contents listed on page 2.

## Table of CONTENTS

**Surviving *Daubert*: Bad Benchmarking Puts Cases at Risk**  
 By Donald M. May..... 1

**From the EDITORS**  
 By John Olson & Gregg Wirth ..... 3

**The 2012 Annual Meeting Season: Targeted “Value Activism” Will Displace Traditional Governance Activism**  
 By John C. Wilcox..... 8

**Supreme Court to Rule Whether Corporations Can be Sued in U.S. Courts for Human-Rights Abuses Abroad**  
 By Gregg Wirth ..... 14

**The Consumer Financial Protection Bureau: *The First 100 Days***  
*Testimony of Raj Date* ..... 19

**SEC/SRO Update:**  
 By Peter H. Schwartz & Crystal L. Gordon..... 24

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West LegalEdcenter  
610 Opperman Drive  
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One Year Subscription ■ 12 Issues ■ \$667.76  
(ISSN#: 1095-2985)

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## From the EDITORS

## Regulators Need to Dig for the Lessons in the MF Global Wreckage

While the details are still emerging from the bankruptcy of MF Global Ltd., it may not be too early for regulators to learn a few hard lessons from the situation.

MF Global—a relatively small and little-known futures brokerage house run by the relatively well-known Jon Corzine, a former U.S. senator and governor from New Jersey and former head of Goldman Sachs in the late-1990s—imploded at the end of October, amid reportedly massive bullish bets on the debt of several European countries. More alarmingly, news broke that more than \$630 million in brokerage customers' assets couldn't be located, and had possibly been mixed in with the firm's own money to make its outsized wagers, reportedly at 30-to-1 leverage. That last part, the mixing of monies, sent up all sorts of red flags because one of the brokerage industry's core rules concerns "segregation" of customer money from the brokerage's own capital. Of course, whether MF Global used just clients' excess collateral (which is legal) or lent the client's money to itself (which may not be, depending on how such a loan was structured), the question becomes, even if MF Global stayed within the legal boundaries, are those lines in the right place to protect customers?

Most ironically, and something regulators are certainly already taking note of, is that the Commodity Futures Trading Commission (CFTC)—one of six (yes, six!) regulatory agencies with overlapping oversight of MF Global—had very recently proposed a rule that would have reigned in these kind of speculative bets that might put customer money at risk. That proposed rule was abandoned by the CFTC amid heavy lobbying and complaints that the rule would make it much harder for brokerage firms to make money. Much of that intense

lobbying came from MF Global and more directly, from Corzine himself.

While that is an embarrassment for the CFTC—which is pursuing the MF Global case without its chief Gary Gensler who rescued himself from involvement because of his relationship with Corzine, who was his boss at Goldman—it does hint at another problem. Was the balkanization of regulation and regulatory agencies partially at fault here? With the CFTC, the CME Group (the exchange on which MF Global primarily traded), the Securities and Exchange Commission, the Financial Industry Regulatory Authority and even the Federal Reserve all with some oversight responsibility of MF Global, is it possible that with all these eyes, no one saw anything amiss? Or was it simply that all these eyes were easily distracted, assuming other agencies were keeping watch.

While Wall Street institutions often bristle at what they call the gauntlet of regulatory agencies they must deal with, many are very adept at playing the dangerous game of regulator roulette, in which a regulated entity can entice overlapping regulators to play-off one another, engaging them in a distracting turf war that allows the entity to either choose which regulator it wants to be overseen by (likely the most lax), or to escape much oversight altogether as each regulator assumes the other is standing guard.

With a banker well-versed in Wall Street and Washington like Corzine at the helm, was MF Global taking advantage of this multiplicity of regulators and exploiting either regulatory gaps or regulatory competition and approach differences?

As we mentioned, the details are still emerging. We at *Wall Street Lawyer* will be watching and reporting on the developments, likely for a long time to come.

*In this issue...* The December issue of *Wall Street Lawyer* features author Donald M. May, a Director at Marks Paneth & Shron LLP, examining how expert witnesses often make critical mistakes with their benchmark calculations that put litigation at risk and often result in their testimony being excluded on *Daubert* challenge.

—JOHN OLSON & GREGG WIRTH

CONTINUED FROM PAGE 1

lead to insupportable conclusions—which, in turn, lead to the exclusion of expert testimony, reduction in awards and the reversal of jury verdicts.

### **Critical Lesson: The Benchmarking Method Must Match the Type of Case**

Among the critical lessons to be learned about benchmarking:

**One benchmarking “size” does not fit all—**Both litigators and expert witnesses often fail to understand which benchmarking methodology is the right one for a particular situation. They use the same approach across a range of scenarios. That leads to erroneous conclusions.

**Benchmarking for estimating shareholder damages are not appropriate for estimating lost profits or lost enterprise value—**Valuation experts and investment bankers use metrics that are designed to forecast future performance. They measure past performance, then look ahead in order to create a prediction, using data that might include the company’s own forecasts. In estimating damages associated with events that lead to lost profits or business reputation (lost enterprise value), the task is different—the starting point is a given date in the past, the date when the alleged harmful event took place, and the requirement is to try to calculate two different scenarios. One scenario reflects what actually happened, and the other reflects what might have happened if the event had not occurred. There is more and different data available—including information about how the company, the industry, and economy actually performed. None of that would apply in projecting a valuation for shareholder damages, but it is essential for calculating lost profits or lost enterprise value. Many experts have had their testimony excluded specifically because they used valuation type metrics in cases involving damages from harmful acts. Benchmarking for damages to shareholders resulting from accounting or financial fraud does, however, need to be based on forward-looking valuation methods. It is critical that experts—and litigators—know the different

requirements and apply the right benchmarking methods for the particular type of case.

**Inaccurate benchmarking creates risks for both the inclusion of expert testimony and the outcome of the case—**Expert testimony is aggressively challenged. According to an annual study by PricewaterhouseCoopers, in 2010 more than 50% of accounting and financial expert witnesses were excluded in whole or in part on *Daubert* challenges.<sup>2</sup> Bad benchmarking is often the basis for successful *Daubert* challenges. In a recent case involving Celebrity Cruises,<sup>3</sup> five of seven experts testifying on behalf of Celebrity and one of three experts testifying on behalf of the defendants were excluded on *Daubert*, all because of their benchmarking assumptions. And the case as a whole shows that incorrect assumptions, such as using forward looking (or *ex-ante*) valuation benchmarks for damages related to lost profits or lost enterprise value, can greatly weaken the case.

**Benchmarks for lost profits and lost enterprise value need to be grounded in business and economic reality—**To be defensible, benchmarks for lost profits or lost enterprise value need to conform as closely as possible to actual business and economic conditions and control for all factors other than the alleged act of harm. In practice that means applying “*ex-post*” benchmarks—measurements applied after the period under scrutiny that factor in such details as operating costs, fluctuations in business demand, and changes in the economy. *Ex-ante* benchmarks—the kind of forward-looking assumptions used by valuation experts and investment bankers—are not appropriate for estimating damages in lost profits and lost enterprise value. But again, benchmarks for damages to shareholders as a result of accounting fraud and other fraudulent actions do require the application of *ex ante* benchmarks.

### **The Risks of Benchmarking: Small Initial Errors Lead to Major Distortions**

Why is benchmarking so inaccurate? The process of benchmarking involves making assumptions—about future business performance, eco-

conomic conditions and the competitive landscape of the litigant's industry. As we all know from well-worn bromides, making assumptions is a dangerous business. The particular problem here is that any error in assumption will be ramified through years of projected business or financial performance. Even a small error in the assumption can lead to a wildly inaccurate conclusion. When using peer companies to benchmark a particular company, the expert is always subject to the criticism that the peer benchmark is not similar enough to the company in question.

In addition to the general problem of making assumptions, there are specific problems as well. As discussed, one is reliance on a "one size fits all" approach. Many experts rely on a single benchmarking methodology that they apply across a wide range of situations. The methodology may or may not fit. If it does not, a successful *Daubert* challenge is likely to result.

### Case Study—Exclusion of Experts Who Used Valuation Techniques to Estimate Lost Profits and Lost Enterprise Value

The above-mentioned case, *Celebrity Cruises, Inc. v. Essef Corp.*, involved allegations of lost profits and lost enterprise value after a defective water filtration system led to a 1994 outbreak of Legionnaires' Disease aboard a Celebrity cruise ship, the *Horizon*. The question of enterprise value was particularly critical since three years after the incident, Celebrity was acquired by Royal Caribbean Cruise Lines (RCCL, later Royal Caribbean Cruises Ltd. or RCL). In the course of the case, several different errors, all related to the use of valuation techniques, led to the exclusion of Celebrity's expert witnesses' testimony on *Daubert*. Among the errors the expert witnesses made were:

Projecting lost enterprise value using rosy forecasts instead of peer or industry performance as the basis—Pamela M. O'Neill, a principle of XRoads Solutions Group, projected an expected growth rate for Celebrity's revenue which in turn was based on a proxy consisting of two other

cruise operators, RCCL and Carnival Corp. She took projected growth rates for each of the two companies as established by analysts in 1994, then applied them to Celebrity.

The problem is that the market proxy did not in fact display anything close to the projected growth rates. According to analysts, RCCL's revenue was expected to grow at rates ranging from 2.5% to 4.9% between 1994 and 2000; Carnival was expected to grow at rates ranging from 0.6% to 2.1%. As it happened, RCCL's growth in 1995, 1996 and 1997 was 0.21%, -1.08% and -1.25%, respectively. Carnival's growth rate during the same three years was -2.6%, -3.7% and -1.7%. Ms. O'Neill admitted in her deposition that she did not know these actual figures were available, and later acknowledged she would have considered this information had she known about it.

Forward-looking methodology such as this can be appropriate for valuing an enterprise at a single point in time. But it does not adequately measure damages that occur after the point when the projection was made. In this case, all three companies lost ground. But Ms. O'Neill attributes Celebrity's shortfall to the effects of Legionnaire's Disease, while making no attempt to determine why the other two companies declined.

Even worse, Ms. O'Neill's lost enterprise value calculation began with Celebrity's 1993 budget projections, which she then compared to 1997 actuals. As he excluded the evidence offered by Ms. O'Neill, Judge James C. Francis pointed out the main problem with using *ex-ante* benchmarks as opposed to *ex-post* benchmarks:

**Indeed, to take 1993 as an example, Celebrity budgeted earnings before interest, taxes, depreciation, and amortization (EBITDA) of \$61.9 million for the *Horizon* and its sister ships, the *Zenith* and the *Meridian*, but the actual EBITDA for those three vessels in that year was \$55.4 million. Using Ms. O'Neill's methodology, this would indicate damages of over \$83 million for that year, even though the Legionnaires' outbreak had not yet occurred.<sup>4</sup>**

Taking the company's word for growth rate projections—Dr. David B. Lasater, a senior man-

aging director of FTI Consulting Inc., did without industry proxies. Instead, he estimated projected profits based on Celebrity's own five-year plan as formulated by management in January 1994. He compared anticipated profits with actual profits and concluded that Celebrity had lost approximately \$101 million. He then adjusted his projections in various ways, calculating higher or lower lost-profit figures, but always using the company's own projections as the basis.

Judge Francis rejected this approach, stating:

**Dr. Lasater's lost profits analysis is flawed in at least one major respect: the projection of profits based on Celebrity's five-year plan is wholly unreliable. [T]he entrepreneur's 'cheerful prognostications' are not enough.<sup>5</sup>**

Indeed, Robert P. Schweihs, another of Celebrity's experts, explicitly rejected use of the five-year plan to project anticipated profits after December 31, 1994.

To calculate the value of the company after the outbreak, Dr. Lasater began with the \$1.312 billion purchase price paid by RCCL, then adjusted it for anticipated synergies. But he does not take into account that the purchase price—including the synergies—was negotiated between Celebrity and RCCL. Celebrity might have lost bargaining power because of the Legionnaire's outbreak, or there might have been balanced negotiations.

In either case, the synergy figure is the result of a negotiation—it is too subjective to be the basis for an enterprise value calculation. For his excessive reliance on the company's own projections, Judge Francis noted that “a methodology so sensitive to one highly subjective variable lacks the necessary reliability.” Thus, Dr. Lasater's testimony was excluded.

**Using more sophisticated methodologies... that still rely on the company's growth projections—** The lost-profits analysis by Allan Pfeiffer, managing director of Standard & Poor's Corporate Value Consulting, also relied on Celebrity's five-year plan. He used a more conservative approach than Dr. Lasater—for example, excluding out-of-pocket and “brand repair” costs—but still used Celeb-

city's projections as the basis for his calculations, projections that Judge Francis again rejected.

Judge Francis noted that:

**this analysis suffers from the same fatal flaw as Dr. Lasater's methodology: reliance on projections that were not borne out in reality. This defect drives the entire calculation and is not repaired by identifying a lower bound using a methodology which, standing alone, might be more reliable. Mr. Pfeiffer's lost profits analysis is therefore excluded.**

This fatal flaw is the basis for the entire calculation, and using lower boundaries for the estimate does not offset the fundamental problem. Mr. Pfeiffer's lost-enterprise value analysis used six different sets of calculations to arrive at an average figure, but still relied either on Celebrity's five-year plan or a 1995 projection prepared for the company by The Blackstone Group LLC that was nearly identical. Mr. Pfeiffer developed a reasonable rate of return analysis, but did not justify it by comparing it to other companies. Mr. Pfeiffer's testimony was thus excluded.

## **When Damages Arise from Accounting Fraud or Other Fraudulent Actions, the Ex-Ante Valuation Method of Benchmarking Is the Right One to Use**

But when harm is caused to shareholders as a result of accounting fraud or other fraudulent actions, the opposite approach is the right one to use. In such cases, the standard of value should be based on valuation methods traditionally used for valuing an entity on an ex-ante basis.

For example: In a case of fraudulent conveyance, an entity is sold and then goes bankrupt shortly after the sale. The new buyers claim the sellers should have known the company was insolvent at the time of the sale and thus was fraudulently conveyed.

A damages expert would determine what the value of the entity should have been at the time

of sale, based on what was knowable at the time. In this case other events that occurred in the economy or industry after the acquisition that were not known or knowable would not be relevant to estimating the solvency of the company at the time of sale and thus should not be used as part of the solvency test, unless it is to prove the fact that these events would not have been knowable by the sellers at the time the entity was sold.

For financial fraud, damages should be based on what the company would have been worth but for the fraud. This analysis would involve determining how the stock price reacted at the time the fraud was announced—an approach known as *event study benchmarking*—or by using Wall Street valuation methods such as earnings multiples based on revenues or earnings corrected for the fraud and comparing them with the value based on misstated earnings or revenues. Or there might be a combination of these two methods.<sup>6</sup>

In both cases the benchmark would be ex-ante and not ex-post. That is, it would be based on what the impact was at the time of the fraud or when the fraud was revealed or occurred and not what occurred subsequent to the fraud.

## Rx: Add a Financial Economist to the Litigation Team

How should litigators manage and supervise the benchmarking process? Expansion of the litigation team may be in order. While econometric and valuation experts are appropriate to cases involving financial fraud, in cases that require lost profits and lost enterprise value, a financial economist who understands the operating realities of a business is an essential partner in arriving at an accurate benchmark. In these instances, litigators need to make sure that they bring industry, institutional and operating experience to the table—either with the financial economist serving as an expert witness, or guiding the benchmarking work of other experts. The result will be expert witnesses and cases that have a much better chance of standing up in court.

### NOTES

1. A *Daubert* challenge is an argument concerning the rules of evidence regarding the admissibility of expert witnesses' testimony during legal proceedings in federal court. The standard takes its name from *Daubert v. Merrell Dow Pharmaceuticals*, 509 U.S. 579, 113 S. Ct. 2786, 125 L. Ed. 2d 469, 37 Fed. R. Evid. Serv. 1 (1993), one of three cases that articulate the *Daubert* standard.
2. *Daubert Challenges to Financial Experts: An 11-year study of trends and outcomes*; PricewaterhouseCoopers, February 2011.
3. *Celebrity Cruises, Inc. v. Esfef Corp.*, 434 F. Supp. 2d 169 (S.D. N.Y. 2006).
4. *Celebrity Cruises*.
5. *Schonfeld v. Hilliard*, 218 F.3d 164, 173 (2d Cir. 2000) (quoting Dobbs Law of Remedies § 3.4).
6. May, Donald M. *As Traditional Methods Fail in a Flood of Bad News, Courts Should Turn to Techniques Used by Investment Analysts to Calculate Shareholder Damages*; Securities Litigation Report, Dec/Jan 2011 (vol. 8, no. 1). The article provides more detail on how to derive benchmarks for such cases.

# The 2012 Annual Meeting Season: Targeted “Value Activism” Will Displace Traditional Governance Activism

BY JOHN C. WILCOX

*John C. Wilcox is the Chairman of Sodali, the corporate governance consulting arm of Global Wealth Management Group, a European-based wealth management firm. Mr. Wilcox is also a member of the Editorial Advisory Board of Wall Street Lawyer. Contact: [j.wilcox@sodali.com](mailto:j.wilcox@sodali.com).*

Sodali’s forecast for the 2012 annual meeting season contains both bad news and good news for companies. The bad news is that there will be a substantial increase in shareholder activism. The good news, which outweighs the bad, is that (1) activism in 2012 will be qualitatively different from previous years; (2) companies will be able to predict their vulnerability; and (3) companies that are well prepared can avoid being targeted.

These predictions are based on our analysis of both fundamental changes in governance trends that have been developing over the past two decades as well as important events that have occurred during the past year.

## The Legacy of 2010

A year ago we described the legacy of 2010—developments leading into the 2011 annual meeting season that constituted a major shift in the focus of corporate governance and a fundamental change in relations between companies and shareholders. Those developments were rooted in two decades of governance reforms as well as the financial crisis of 2008 and the resulting economic downturn. The legacy of 2010 altered the gov-

ernance landscape and relations between companies and shareholders in the following ways:

- With the theoretical work of corporate governance completed, implementation is the major concern of investors and regulators.
- Shareholders are focusing on business fundamentals, performance, and board accountability rather than governance compliance and external metrics.
- Targeted, company-specific, value activism is increasing, while generic governance activism continues to decline.
- Proxy advisory firms are under growing pressure to increase their knowledge of local markets, improve transparency, engage with companies, avoid box-ticking, and customize their vote recommendations.
- Both companies and investors acknowledge that ESG (environmental, social, and governance practices) and nonfinancial metrics are integral to business risk, financial performance and long-term sustainability.
- Regulators and private sector groups are turning their attention to the governance, fiduciary duties and business conduct of institutional investors and financial service providers.

## Developments in 2011

Against this background, a number of important developments and regulatory initiatives have occurred during the past year:

- The European Commission (EC) published in April a green paper entitled “The EU Corporate Governance Framework” that raises fundamental questions about the efficacy of the principles-based, comply-or-explain governance system. The green paper asks whether greater regulatory oversight and more prescriptive rules are necessary to ensure accountability. In the face of this challenge, European companies are under pressure to voluntarily improve their governance practices

and the quality of their explanations without delay. The 2012 annual meeting season may be the last chance to demonstrate that the comply-or-explain governance system is effective in practice.

- The United Kingdom Stewardship Code, published in July 2010, has established a strong precedent that calls for institutional investors to engage with companies, vote responsibly and explain how they fulfill their duties and manage conflicts of interest. The U.K. code is having a global impact, stimulating work on similar codes in other countries during the past year. In 2012, institutional investors will be under pressure to monitor and engage with portfolio companies, disclose their proxy votes and demonstrate that their practices are in line with their fiduciary duties. The proxy voting records of institutions will be subject to close scrutiny and second-guessing by shareholder advocacy groups and regulators.
- In France, the country's financial markets authority—the Autorité des Marchés Financiers (AMF)—published new practice guidelines for proxy advisory firms. The AMF guidelines require proxy advisors to increase their interaction with companies and to be more transparent with respect to their conflicts of interest and their methodology in formulating policies and vote recommendations. The EC and the U.S. Securities and Exchange Commission (SEC) have both made comparable proposals. Whether they issue regulations or not, proxy advisors' practices will be under the microscope during the 2012 proxy season.
- The United Nations' Global Compact's Principles for Responsible Investment (UNPRI) have steadily gained influence in the global business and investment community since 2005 and are now closely linked with the corporate governance movement. Today's list of 927 UNPRI signatories is a powerful endorsement of both the content of the Principles and support among both businesses

and investors for voluntary accountability in lieu of regulation. The Global Compact describes itself as “a strategic policy initiative for businesses that are committed to aligning their operations and strategies with ten universally accepted principles... .” In light of recent environmental disasters such as TEP/Fukushima and BP/Deepwater Horizon and the continuing economic downturn, it is clear that UNPRI will play a critical role in relations between companies and investors on environmental, social, ethical and sustainability issues. For the same reasons, the Global Reporting Initiative (GRI)—a network-based organization that produces one of the most widely used standards for sustainability and governance reporting—is increasingly associated with governance reform, shareholder rights, and board accountability.

- Twelve countries now require some form of shareholder vote on compensation. In a few countries, most notably the United States, controversy over the mechanics of Say-on-Pay (SOP) has overshadowed its benefits. Elsewhere companies have taken the vote requirement in stride and there is now a global consensus that SOP generates useful dialogue between companies and investors, thereby improving compensation fundamentals and linking pay to performance. In Europe, however, the EC's green paper raises questions as to whether a voluntary, comply-or-explain approach is effective in moderating pay abuses. The challenge for European companies in 2012 will be to improve the quality of their explanations for pay decisions or face more prescriptive rules from the EC. U.S. companies face a far more difficult challenge to supplement the management's Compensation Discussion and Analysis (CD&A) with a narrative explanation of the board's views on compensation incentives and strategic policy objectives.
- The prolonged struggle in the U.S. over shareholder proxy access appeared to reach a conclusion with the July ruling from the

U.S. Circuit Court of Appeals for the D.C. Circuit that invalidated SEC Rule 14a-11 (which would have mandated procedures for shareholder-nominated board candidates to be included in a company's proxy statement). However, the Commission's decision to permit shareholder resolutions on access under Rule 14a-8 keeps the issue alive. From a global perspective, shareholder access is a side show, reflecting idiosyncrasies in the U.S. governance system. The issue may have long-term consequences, however, because of the District Court's insistence that comprehensive economic cost/benefit analysis is a prerequisite for governance regulation. The court (and perhaps the SEC itself) seemed to give little weight to the prophylactic function of governance rules. Prevention is critically important but difficult to measure in economic terms. The intent of many governance rules is to influence board conduct and prevent abuses before-the-fact rather than to facilitate shareholder action after abuses occur. If the SEC cannot find ways to quantify the costs and benefits of governance rules in hard numbers, there will likely be less regulation in the future. In any case, the access drama will continue in 2012 with a high volume of shareholder proposals at U.S. companies.

- Despite the setback on proxy access and the new requirement for cost/benefit analysis, the SEC is expected to propose new rules implementing its July 2010 concept release on proxy system reform in time for the 2012 annual meeting season. It is not yet clear whether the rules will introduce fundamental changes to the proxy system structure and mechanics, increase oversight of proxy advisory firms, give companies greater access to beneficial owners, establish new transparency requirements for trading in stocks and derivatives, or all of the above.
- The Occupy Wall Street movement and other forms of social protest represent a wild card in relations between companies and shareholders. If the global economic downturn continues into 2012, these populist initia-

tives and the media attention they attract could encourage a backlash among retail shareholders against the entire business community without consideration of individual company achievements. High-profile expressions of popular discontent could escalate political and social pressure on institutional investors to support dissidents and activists or to vote against controversial management proposals. All these factors increase the likelihood of greater confrontation between companies and shareholders rather than a search for common ground and solutions to shared economic problems.

- Social networking, still used primarily for nonbusiness communication, is a development that requires close monitoring by the business community. Social networks present both a challenge and an opportunity—a tool for dissenters to mobilize support and a method for companies to communicate more effectively. Institutional investors are already studying the potential of social networking techniques. For example, at the June annual conference of the International Corporate Governance Network, about 50 twitter accounts extended the conference reach from the 500 delegates present in Paris to an estimated 55,000 people around the globe, demonstrating the power of social networks to reach a wide audience virtually instantaneously. The 2012 annual meeting season will produce more examples of social networking by shareholders, activists, and companies.

## Targeted Value Activism

These developments provide the ingredients for a perfect storm of shareholder activism in 2012. All the principal players—shareholders, regulators, companies, and boards—are under pressure to change in fundamental ways. Institutional investors (and their advisors) are being confronted with new codes, fiduciary expectations, regulatory evaluation, and pressure from peers. Regulators, under the scrutiny of politicians and industry watchdog groups, are moving aggressively

to improve the accountability of corporations, institutional investors, and the financial services industry. The general public, angry and frustrated because of the prolonged economic downturn, is in an activist, dissenting mood.

The focus of these forces will be on corporations, CEOs and boards of directors. Companies with the following characteristics are the predictable targets for value activism in 2012:

- companies with compensation practices that are egregious or out of step with peers, particularly when accompanied by downsizing and layoffs;
- companies with weak financial performance or undervalued stock;
- companies that do not comply with corporate governance best practices, particularly when high levels of dissent or votes in support of shareholder resolutions have been disregarded;
- companies with conflicts of interest, corrupt practices, scandals, or a high negative profile in the media;
- companies with a poor record on environmental practices, social policy, ethics, or risk oversight;
- companies experiencing unusual market volatility, short selling, or substantial changes in ownership;
- companies that lack transparency, have inadequate disclosure programs or poor board communications;
- controlled companies (including those with family or state ownership) that have inadequate protections for minority shareholder rights; and
- companies in industries targeted by protest movements and the media, including Wall Street firms and “too big to fail” financial institutions.

Value activism directed at these types of targets is qualitatively different from governance activ-

ism. Building on the model of strategic activism used by hedge funds and dissidents, value activists focus on individual companies’ business fundamentals, performance and board accountability in addition to their governance practices. Value activists usually do not have a specific strategic agenda and are not seeking control; their value proposition is to change the behavior of the target company’s board and management, thereby reducing risk and improving performance and sustainability.

## Be Prepared

In today’s unstable environment, it is not enough for companies to publish a corporate governance report and comply with proxy advisors’ guidelines. To avoid being targeted, a company should conduct a comprehensive self-evaluation that analyzes environmental, social and governance (ESG) practices, financial performance, business strategy, and reputation. The board and management should examine their conduct and their communications through the hard eyes of fiduciary investors, special interest groups, governance purists, disgruntled minority shareholders, labor union activists, opportunistic short-term investors, and strategic activists. To avoid being the target of activism, it is necessary to think like an activist.

A company’s annual self-evaluation, conducted in preparation for the annual shareholder meeting but commencing at least six months before the meeting date, should include the following activities:

- Conduct a comprehensive ESG benchmarking against peer companies and global standards.
- Review and analyze the voting results and shareholder feedback from last year’s annual meeting.
- Prepare an updated shareholder identification and ownership profile, analyzing the implications of recent ownership changes and market activity.

- Identify voting decision-makers at top institutional investors and compare them with Investor Relations contacts.
- Review the voting policies of proxy advisory firms and institutional investors and compare them with company practice.
- Assemble an internal team, including the General Counsel, Company Secretary, Investor Relations, Human Resources and Compensation executives and, as necessary, the CFO, CEO, Board Chairman and appropriate board committee chairs.
- Assemble a team of outside advisors that can provide legal and financial advice, as well as expertise in compensation, institutional investor relations, cross-border share voting, communications, public relations and crisis management.
- Review the company's legal and structural defenses with respect to takeover bids or election contests.
- Review feedback from investor relations meetings and road shows during the past year.
- Review recent correspondence and communications with top shareholders, both local and global, including members of controlling groups or families.
- Review analyst reports, media coverage, and market commentary about the company and the industry.
- Organize outreach to major shareholders if controversial management proposals or shareholder resolutions are expected to be on the annual meeting agenda.
- Prepare an objective analysis for the board and senior management that outlines the company's risks and vulnerabilities and recommends a plan to deal with them.
- Determine the appropriate role for the board of directors in engagement with sharehold-

ers before, during and after the shareholder meeting.

If the economic and regulatory environment continues to be unstable during 2012, these preparations will be more important than ever before. Companies that are not strategically prepared will be at risk of losing control of the agenda and being forced into a defensive posture at their annual meeting. A defensive posture will in many cases be a losing posture.

## Long-Term Challenges

Preparation is essential for companies to avoid surprises and maximize support from shareholders at annual meetings. Over the long term, however, more fundamental changes will be needed in relations between companies and shareholders to break the cycle of confrontation and short-termism. Directors and managers should look beyond quarterly financial reporting and find new ways to ensure that shareholders are well informed about the company's business, policies and long-term strategy. To accomplish this goal, companies will have to overcome three difficult challenges:

1. **Give directors a voice**—Board communication is the most important and difficult long-term corporate governance challenge. Because shareholders place the board at the apex of the corporate governance triangle, they expect to be kept fully informed about how the directors are fulfilling their duty to act in the best interest of the company. In the U.S., directors will have to find ways to “tell the company's story” beyond the constraints of prescriptive disclosure rules, without increasing their legal exposure. If not, they will face ever-increasing levels of shareholder activism. In Europe, boards must provide meaningful and substantive explanations for their decisions and policies. If not, they risk losing the benefits of voluntary, principles-based governance. Improvements in board communication must come from within the boardroom. Only the directors themselves can open the windows and turn on the boardroom lights.

2. **Develop holistic investor relations**—Most listed companies have investor relations programs that systematically communicate financial information from management to investors. However, few companies appreciate the need for a parallel program of institutional investor relations to communicate about ESG and board-level issues. A holistic investor relations program manages both the financial and governance expectations of shareholders. It identifies and establishes relationships with institutional investors' policy and voting decision-makers as well as the analysts and portfolio managers. It reaches out to proxy advisory firms, global custodians, sub-custodians and the back offices of intermediaries in the ownership chain. In addition to quarterly earnings, it deals with annual meeting disclosure and cross-border share voting. Defining, staffing, and implementing a holistic investor relations program—integrating financial results with board policies and coordinating all levels of board and management communications—is the second major long-term challenge for companies.

3. **Implement metrics for ESG and non-financial performance**—The third challenge is for companies to introduce performance metrics and incentives that support ESG and board-level goals. Academic and professional studies have made a persuasive case that non-financial performance measures are essential for effective management, risk reduction and long-term business success. The case is even more compelling in the context of corporate governance and relations with stakeholders, as many issues are not easily described or measured in financial terms. Responsibility falls on the board of directors, as the caretakers of corporate culture and reputation, to ensure that metrics and incentives within the company are aligned with the board's key oversight responsibilities and their duties to shareholders and stakeholders. The UNPRI and GRI offer a useful starting point, but each company's board and management must structure metrics customized to their

business strategy and circumstances. This challenge is complicated by institutional investors' overreliance on financial models in making investment decisions. Ultimately, the cycle of short-termism will be broken only when both companies and institutional investors integrate nonfinancial metrics and long-term goals into their decision-making.

Shareholder advocates have an old saying: "Every company gets the shareholders it deserves." The truth in this statement is not that companies are victims of the marketplace, but that companies can—by their own actions—influence which investors they attract. Companies also can build a stable and supportive base of long-term owners by keeping shareholders well-informed and confident that their interests and companies' are aligned.

# Supreme Court to Rule Whether Corporations Can be Sued in U.S. Courts for Human-Rights Abuses Abroad

## Ruling Would Decide Fate of Cases Brought Under Alien Tort Statute

BY GREGG WIRTH

*Gregg Wirth is the Managing Editor of [Wall Street Lawyer](#). Mr. Wirth is an award-winning investigative journalist with more than a decade of experience covering Wall Street, the economy, politics, crime and culture. Contact: [Gregg@gwirth.com](mailto:Gregg@gwirth.com).*

The U.S. Supreme Court announced on October 17 that it would hear a case that could decide the question of whether corporations can be held accountable for human rights abuses committed with their assistance in foreign countries.

The case—*Kiobel v. Royal Dutch Petroleum NV*<sup>1</sup>—will allow the Court to address the 222-year old Alien Tort Statute (ATS),<sup>2</sup> a law passed by the very first U.S. Congress in 1789, but one that has received scant attention from the Supreme Court until recently. The ATS allows foreign citizens to file lawsuits against any entity under U.S. governance—citizens, non-citizen residents, corporations—for alleged violations of international law, including human rights abuses, even if those abuses did not occur on U.S. soil.

In addition to *Kiobel*, the Court agreed to hear a second case—*Mohamad v. Rajoun*<sup>3</sup>—concerning the Torture Victim Protection Act (TVPA),<sup>4</sup> and whether organizations or corporations can

be held liable under the TVPA. The cases are likely to be heard in tandem.

While the question of whether corporations can be held liable under the ATS or the TVPA has been the subject of legal debate, some corporations—including Exxon Mobil Corp., Chevron Corp., Yahoo! Inc., Bridgestone Corp., and Coca-Cola Co.—have all been sued under the ATS to varying degrees of success.

Unlike any current ATS cases still winding their way through the federal court system, several lawyers noted that it's unlikely that any dismissed ATS cases—even if they were dismissed for lack of jurisdiction reasons—would be refiled if indeed the Supreme Court allows for corporate liability under the ATS.

The Supreme Court will begin hearing oral arguments in *Kiobel* and *Mohamad* early in 2012, with a decision expected by the end of June.

## History of the ATS

The ATS was part of the Judiciary Act of 1789, and was intended to assure foreign governments that the fledgling United States would act to prevent violations of customary international law and offer remedy to those wronged. Though little of the legislative history of the creation of the ATS has survived, it has been surmised by legal scholars that it was enacted in response to several international incidents in which foreign citizens living in the U.S. had no legal remedy for acts committed against them.

Most famous of these incidents was the assault of French diplomat François Barbé-Marbois<sup>5</sup> in 1784. Barbé-Marbois learned he had no legal standing in the U.S., prompting Congress to request that individual states allow for lawsuits brought by foreign citizens claiming violation of international law. However, after only a few states enacted such a provision, Congress created the ATS.

Despite its potentially weighty matter, the ATS gathered dust for almost two centuries, being cited and used only in the rarest of instances. In 1980, all that changed when the U.S. Court of Appeals for the Second Circuit decided *Filartiga v. Pena-Irala*<sup>6</sup> and revolutionized how the ATS

would be used and by whom. Human rights advocates, victims of torture under foreign dictatorships, foreign citizens claiming abuse overseen or directed by U.S. corporations all became the new face of ATS plaintiffs. Since 1980, dozens of ATS claims have been brought, although many of them have been dismissed by the courts. To date, there have been only two successful ATS claims against a corporation—one by jury verdict and one entered by default—according to a legal database that tracks such cases.

In *Filartiga*, two Paraguayan citizens living in the U.S. brought a lawsuit against another U.S. resident, a Paraguayan former police chief. The plaintiffs alleged that the former police chief had tortured and murdered a member of their family, and they claimed that under the ATS U.S. federal courts had jurisdiction over their suit. Although the district court dismissed the case, citing lack of jurisdiction, the Second Circuit reversed that decision, citing that U.S. courts were indeed a proper venue for ATS cases. Perhaps sensing the can of worms the ruling might open, one Second Circuit judge urged that the *Filartiga* ruling “should not be misread or exaggerated to support sweeping assertions” that any violation of international human rights is automatically under the umbrella of the ATS.

To date, the Supreme Court has heard only one case that directly addressed the ATS. In 2004, the Court ruled in *Sosa v. Alvarez-Machain*,<sup>7</sup> a case in which the plaintiff, Humberto Alvarez-Machain, had been indicted for the murder of U.S. Drug Enforcement Agency officer and was kidnapped in Mexico by agents working for the U.S. government and brought to the U.S. for trial. Alvarez-Machain sued under the ATS, claiming his abduction was illegal under international law, and the Ninth Circuit Court agreed.

The Supreme Court did not, however, and reversed the Ninth Circuit’s ruling, holding that Alvarez-Machain’s abduction and detention had not been a violation of international law under the ATS. The Court then used *Sosa* to establish some ground rules for ATS claims. The Court held that *Sosa* did not establish a cause of action under the ATS, meaning that federal courts are not required to recognize *any stated claim* that

infringes on any international law or any treaty; rather, the Court stated that ATS claims could only be made on what it called “a modest set of actions alleging violations of the law of nations.”

Despite the ground rules set by the Supreme Court, human rights activists continued to bring ATS cases on behalf of victims, citing abuses by corporations or foreign individuals and seeking relief.

## Recent Key Cases under the ATS

In addition to *Sosa* and *Filartiga*, there have been several other ATS cases that have helped define and refine the statute. These include:

### *Presbyterian Church of Sudan v. Talisman Energy, Inc.*

In October 2009, the Second Circuit Court established in *Presbyterian Church of Sudan v. Talisman Energy, Inc.*,<sup>8</sup> that the standard for establishing liability (corporate or otherwise) for aiding and abetting under the Alien Tort Statute must include “purpose rather than knowledge alone.” Some ATS legal scholars saw this as a big blow to activists who they claimed were using the statute to enforce international human rights law, mostly upon corporations they viewed as working in concert with repressive governments to violate human rights. With the standard now established in *Presbyterian Church* that plaintiffs had to demonstrate that defendants were not just aware of the violations, but indeed had acted to aid them with the *purpose* of committing those violations, human rights activists definitely had a more difficult hurdle to clear.

In the *Presbyterian Church* case, Talisman Energy of Canada was accused of aiding the government of the Sudan with the forced and brutal removal of Sudanese citizens living near Talisman oil facilities. In dismissing the ATS claims, the Second Circuit stated that plaintiffs had failed to establish the company’s “purposeful complicity in human rights abuses.”

Those critical of the use of the ATS for human rights abuse litigation praised the ruling. The Washington Legal Foundation stated: “The de-

cision could derail many other ATS suits against multinational corporations, including one highly publicized ATS suit against numerous companies that did business with apartheid South Africa.”

While the Second Circuit established the *purposeful* standard, other circuit courts, notably the Ninth and Eleventh Circuits, have disagreed.

### ***Chowdhury v. Worldtel Bangladesh Holding***

*Chowdhury v. Worldtel Bangladesh Holding Ltd.*<sup>9</sup> is one of the few identified ATS cases against a corporation that has been successfully brought to trial and won by the plaintiff.

In *Chowdhury*, the plaintiff—Nayeem M. Chowdhury, a Bangladeshi businessman—sued under the ATS, claiming defendants Worldtel, a landline telephone provider, and its CEO, a U.S. citizen named Amjad H. Khan, had hired Bangladeshi paramilitary police to arrest and torture him. When the U.S. District Court for the Eastern District of New York dismissed the claim in 2008, citing failure to establish liability of aiding and abetting, the plaintiff then amended his complaint to claim that the Bangladeshi police were hired by the defendants and in fact were acting as the defendants’ *agents* in their actions. Plaintiff also claimed the defendants *ratified* the illegal actions by orchestrating them and benefitting by them.

Under the new “agency and ratification” argument, the case was tried in 2009 with the jury finding for the plaintiff. The jury verdict showed that even the tougher standards set by the Second Circuit in ATS cases could be circumvented by unique arguments tailored to the circumstances of each individual case.

### ***SINALTRAINAL v. Coca-Cola Co.***

*SINALTRAINAL v. Coca-Cola Co.*,<sup>10</sup> was brought in 2001 on behalf of SINALTRAINAL—the major union representing Coca-Cola bottling plant workers in Colombia—and included as plaintiffs the families of two murdered union officers, Isidro Gil and Adolfo de Jesus Munera.

The *SINALTRAINAL* lawsuit charged Coca-Cola bottlers in Colombia with the systematic

intimidation, kidnapping, torture and murder of union leaders in efforts to crush their union. Plaintiffs claimed that seven union leaders and a friendly plant manager who was also a member of the union were murdered between 1990 and 2002. The lawsuit charged that Coca-Cola bottlers in Colombia “contracted with or otherwise directed paramilitary security forces that utilized extreme violence and murdered, tortured, unlawfully detained or otherwise silence trade union leaders.”

A Florida district court dismissed *SINALTRAINAL* in 2006, citing that U.S. federal courts had no jurisdiction under ATS in this case. In 2009, the 11th Circuit Court upheld the dismissal, also citing lack of jurisdiction. But what made *SINALTRAINAL* notable was that the Eleventh Circuit added a twist to its ruling, citing a recently decided Supreme Court case, *Ashcroft v. Iqbal*.<sup>11</sup> Under *Iqbal*, decided in May 2009, the Supreme Court invoked a greatly heightened standard of pleading, requiring that plaintiffs’ claims must have “facial plausibility” to survive dismissal. The Court explained in its *Iqbal* ruling that claims have facial plausibility when the facts as stated allow courts “to draw the reasonable inference that the defendant is liable.” Obviously, such a definition—ripe with subjective terms like “reasonable inference”—has given great leeway to courts to dismiss plaintiffs’ claims on their face and often, very early on in the proceedings.

Given that *Iqbal* hurdle and the problem of establishing proof of direct corporate involvement, it would not be possible to refile the *SINALTRAINAL* case even if the Supreme Court finds in *Kiobel* that corporations are liable under the ATS, said Dan Kovalik, senior counsel for the United Steelworkers and one of the plaintiff attorneys on *SINALTRAINAL*. “The Coca-Cola case was lost chiefly because the court found that, even if our allegations were taken as true, the defendants could not be tied closely enough to the human rights abuses alleged to hold them liable,” Kovalik said. “Of course, we disagree with this, but the Supreme Court’s decision in *Kiobel* would not change this outcome.”

## The Supreme Court & the *Kiobel* Case

*Kiobel v. Royal Dutch Petroleum*—the case now before the Supreme Court—involves a lawsuit against the Shell Oil co., the U.S. subsidiary of Royal Dutch Petroleum, that was brought under the ATS by a group of Nigerian citizens who claimed the oil company was complicit in massive human-rights abuses in the early- and mid-1990s. The plaintiffs allege that Shell Oil subsidiaries enlisted the help of the repressive Nigerian government to shut down opposition to oil exploration in the region. The situation received worldwide attention in 1995 when several activists and a well-known Nigerian author were executed by the Nigerian government after hastily-run military trials.

The *Kiobel* case was heard by a federal district court in 2006, which dismissed many of the plaintiffs' claims, refused to dismiss others, and turned the whole case over to the Second Circuit because of the seriousness of the charges.

In September 2010, the Second Circuit tossed out the *Kiobel* lawsuit, ruling that corporations can't be sued under the ATS, and refusing to recognize corporate liability for international crimes. In reaching its decision, the Second Circuit cited the previous 30 years of both Supreme Court and Second Circuit precedential rulings, stating that under those rulings, "corporate liability is not a discernible—much less a universally recognized—norm of customary international law."

The Second Circuit's dismissal of *Kiobel* under the principle that corporations face no liability under the ATS points up a sharp split among several Circuit Courts of Appeal.

That point was driven home on October 28, when the Ninth Circuit ruled in *Sarei v. Rio Tinto PLC*<sup>12</sup> that corporations could be held liable under the ATS for international law violations such as genocide and war crimes. The Ninth Circuit Court also clarified a point raised in *Sosa* that legal relief may depend on the plaintiffs first exhausting all possible local remedies.

In *Sarei*, which has been in the court system for more than a decade, plaintiffs—residents of Papua New Guinea (PNG)—brought claims against

mining group Rio Tinto alleging the company was involved in the PNG government's brutal treatment of residents living near or working in the mines. Often, plaintiffs claim, the government police used Rio Tinto company vehicles and helicopters in their actions.

In addition to the Ninth Circuit Court's ruling in *Sarei*, the liability of corporations under the ATS was upheld twice this year, by the Seventh Circuit Court in *Flomo v. Firestone Nat. Rubber Co., LLC*<sup>13</sup> and then by the D.C. Circuit Court in *Doe VIII v. Exxon Mobil Corp.*<sup>14</sup>

Seeming to draw a line in the sand with the Second Circuit Court, the D.C. Circuit Court wrote in its *Doe* ruling that "neither the text, history, nor purpose of the ATS supports corporate immunity for torts based on heinous conduct allegedly committed by its agents in violation of the law of nations."

Given this split, it's little surprise that the Supreme Court had to weigh in on whether corporations face liability under the ATS.

## What Could the Court Decide on Corporate Liability?

When the Supreme Court decided its only previous ATS case in *Sosa v. Alvarez-Machain* in 2004, it held that ATS claims in *Sosa* were made between individual people, and not entities such as corporations. (*Mohamad* also concerns whether language in the TVPA such as "individual" refers to corporations and other entities in addition to individual people.) It was this language that has greatly added to the split among the circuit courts.

Indeed, many in the legal community have been carefully watching to see if the Supreme Court would eventually address the corporate liability question in the ATS, said Paul Wolfson, a partner in the Litigation department of Wilmer Cutler Pickering Hale and Dorr LLP. "Many legal professionals have been asking the Court to decide this issue for quite a while," Wolfson said. "But it's difficult to predict at this point what the Court could decide."

One strategy that is being suggested by the Plaintiffs' Bar is having plaintiffs bring suit against

individual corporate executives, like CEOs, rather than the corporate entity itself, something the Second Circuit mentioned in its *Kiobel* ruling, saying that suing CEOs is directly allowed under the ATS.

Other legal observers note that the key to what the Supreme Court could do in *Kiobel/Mohamad*, may have its roots in the Court's 2010 ruling in *Citizens United v. Federal Election Commission*<sup>15</sup> that corporations and other entities had First Amendment rights in regards to political speech. Some observers contend the Supreme Court may not be able to walk back the *Citizens United* precedent, which invariably but not fully accurately became short-hand for "corporations are people."

Indeed, on its face, a Supreme Court decision in *Kiobel/Mohamad* that completely negates any corporate liability in the ATS could create an impression that under this Supreme Court, corporations may have rights, but little liability or responsibility.

Despite the uncertainty over what the Supreme Court could do in *Kiobel/Mohamad*, and even given the circuit-split and the confusion over corporate liability in the ATS/TVPA realm, the small but steady flow of such cases has not slowed over the years, Wolfson added. "A lot of cases have been brought already," he noted. "Plaintiffs keep bringing cases, assuming that the Supreme Court would sort it out at some point."

By the middle of next year, it's likely both sides of the debate will have the Supreme Court's answer to their request.

was allegedly assaulted in Philadelphia by a French military officer named Charles Julian de Longchamps. A public controversy arose because Longchamps was married to an American, and claimed to have taken an American oath of citizenship. Debate ensued over whether Longchamps was to be tried in Pennsylvania or in France, but because the U.S. at that time had no legal recourse for foreign citizens, Longchamps was eventually tried and sentenced in Pennsylvania courts.

6. *Filártiga v. Peña-Irala*, 630 F.2d 876 (2d Cir. 1980).
7. *Sosa v. Alvarez-Machain*, 542 U.S. 692, 124 S. Ct. 2739, 159 L. Ed. 2d 718 (2004).
8. *Presbyterian Church of Sudan v. Talisman Energy, Inc.*, 07-0016-cv; (Second Cir., Oct. 2009).
9. *Chowdhury v. Worldtel Bangladesh Holding Ltd.*, 588 F. Supp.2d 375 (E.D. N.Y. 2008).
10. *Sinaltrainal v. Coca-Cola Co.*, 578 F. 3d 1252, 74 Fed. R. Serv. 3d 410 (11th Cir. 2009).
11. *Ashcroft v. Iqbal*, 556 U.S. 662, 129 S. Ct. 1937, 173 L. Ed. 2d 868, 73 Fed. R. Serv. 3d 837 (2009).
12. *Sarei v. Rio Tinto PLC*, 02-cv-56256; 02-cv-56390; 09-cv-56381 (9th Cir. Oct. 25, 2011).
13. *Flomo v. Firestone Nat. Rubber Co., LLC*, 643 F. 3d 1013 (7th Cir 2011).
14. *John Doe VIII v. Exxon Mobil Corp.*, 658 F. Supp. 2d 131 (D.D.C. 2009), aff'd in part, rev'd in part and remanded, 654 F.3d 11 (D.C. Cir. 2011).
15. *Citizens United v. Federal Election Commission*, 130 S. Ct. 876, 175 L. Ed. 2d 753 (2010).

#### NOTES

1. *Kiobel v. Royal Dutch Petroleum*, 621 F.3d 111 (2d Cir. 2010), cert. granted, 2011 WL 4905479 (U.S. 2011).
2. The Alien Tort Statute, 28 U.S.C.A § 1350.
3. *Mohamad v. Rajoun*, No. 09-7109 (D.C. Cir. March 18, 2011).
4. The Torture Victim Protection Act of 1991 (TVPA), Pub.L. 102-256, 106 Stat. 73.
5. François Barbé-Marbois was a French politician, perhaps best known for negotiating the Louisiana Purchase as Minister of Finance under Napoleon. Barbé-Marbois also had a long diplomatic career in America, serving as secretary of the French legation to the newly-formed United States. In 1784, Barbé-Marbois

# The Consumer Financial Protection Bureau: *The First 100 Days*

## TESTIMONY OF RAJ DATE

*Raj Date, the Special Advisor to the Secretary of the Treasury for the Consumer Financial Protection Bureau (CFPB), testified about the CFPB's first 100 days on November 2 before the U.S. House of Representatives' Subcommittee on Financial Institutions and Consumer Credit, a subcommittee of the House's Committee on Financial Services. This is a partial transcript of that testimony.*

[...] Our mission at the Consumer Financial Protection Bureau (CFPB) is to help consumer financial markets work by making rules more effective, by consistently and fairly enforcing those rules, and by empowering consumers to take more control over their economic lives. We are here to restore confidence that markets for consumer financial products and services can work *for* families rather than *against* them. And we are here to give our nation's financial institutions a more level playing field on which to innovate and compete.

*As this issue of Wall Street Lawyer was going to press, Senate Republicans successfully filibustered the nomination of former Ohio attorney general Richard Cordray for director of the CFPB. The filibuster leaves the CFPB without a director, which could prevent the agency from exercising many of its powers. Pres. Obama has raised the possibility of making a recess appointment of Cordray, which could allow him to serve as director until at least late-2012.*

In the three months since we launched the CFPB, we have been hard at work building the agency.

We have hired some 700 employees, many of whom were hired from the prudential regulators' consumer protection divisions. We have travelled across the country to meet and listen to consumers, consumer groups, civil rights organizations, big banks, community banks, investors and trade organizations. And, among other things, we have started on-site examinations of the largest banks, we have started our consumer education campaign, and we have started to take consumer complaints and solve consumer problems. We are working on a summary of our consumer response efforts that will be provided to you. It has been an exceptional beginning.

Before the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), responsibility for administering and enforcing the various federal consumer financial laws was scattered across seven different federal agencies—the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corp., the Federal Reserve, the National Credit Union Administration, the Department of Housing and Urban Development, and the Federal Trade Commission. For each of these agencies, consumer financial protection was just one of their responsibilities. Not one of them was solely focused on consumer financial protection.

The CFPB is the first agency whose sole mission is making sure that consumer financial markets work for American families. In addition to rulemaking and enforcement responsibilities, we have authority to supervise large depository institutions and their affiliates. This supervisory jurisdiction covers the 100 or so largest banks, thrifts and credit unions in the United States, which collectively hold the majority of bank assets in the country and interact with the majority of consumers. When we have a Director in place, we will also supervise key nonbank providers of consumer financial products and services.

To achieve our goals, we are working to be transparent and participatory in everything we do. Our goal is to be an open agency, sharing with the public not only what we are doing but how we are doing it. And to carry out our mission, we have lots of tools in our toolkit—research, supervision, rulemaking, enforcement and consumer

education. Having a full range of tools means we do not have to force a square policy peg into a round hole. Our goal is to use each of these tools in the smartest way possible, matching solutions to problems.

In the first 100 days, we have been hard at work to promote a consumer financial market where consumers know what they are getting into, where firms follow the rules, and where consumers are protected and empowered.

## Transparency

One of the CFPB's primary objectives is to bring clarity to the marketplace by promoting easy-to-understand disclosures that make prices and risks clear up front. This will ensure that consumers get the information they need to make the financial decisions they believe are best for themselves and their families.

A basic premise of an efficient, well-functioning market is that the buyer and the seller both understand the terms of the deal, and that buyers are able to make comparisons among products. But in the years leading up to the financial crisis and continuing through today, in many consumer financial markets, that was not the case.

We saw the most egregious example of this in the mortgage industry during the housing bubble, when the fastest growing mortgage products were some of the most complicated: hybrid [adjustable rate mortgages] ARMs, option ARMs, interest-only loans. The potential costs and risks of these mortgages were often not clearly understood. To properly calculate the costs and risks, borrowers needed sophisticated knowledge of things like rate caps and rate spreads. The result was that too many consumers ended up with mortgages they couldn't afford.

The Bureau is doing what it can to fix this lack of transparency in financial product markets. With our *Know Before You Owe* mortgage initiative, we are creating a single, shorter, more useful mortgage disclosure form that satisfies the requirements of the Truth in Lending Act and the Real Estate Settlement Procedures Act. Congress asked us to combine these two forms, and our work in this area will both reduce regulatory bur-

den and make the costs and risks of a loan clearer so that consumers can choose the mortgage that best meets their needs.

Our goal with the form is to reduce unwarranted regulatory burden for industry at the same time that we improve the usefulness of information provided to consumers. Before we began designing the sample form, we reached out to the public, industry participants, and market experts to find out what on the current disclosure forms is helpful for consumers, what is not, and what is information overload. What do consumers really need to know? And what approach makes the most sense for the industry?

We incorporated that feedback as we developed alternative forms, the first two of which we introduced back in May. We invited comments from stakeholders and displayed the forms on our website. We have continued to seek public comments through four subsequent rounds of testing, and have received more than 22,000 comments to date.

And just last week we announced another exciting *Know Before You Owe* initiative with student loans. In partnership with the Department of Education, we are working to improve the way schools communicate loan and repayment information to students. At the CFPB, we are deeply committed to working cooperatively with other agencies in order to efficiently use resources and to further common goals.

In that vein, along with the Department of Education, we released a draft one-page "financial aid shopping sheet" that would provide students and their families with important information such as estimated monthly payment levels after leaving school, and school-related information like graduation rates. It gives information on how students from that school have fared in repaying their loans. Just like with our *Know Before You Owe* mortgage initiative, we are soliciting feedback from the public, industry, and other stakeholders on how to provide the best possible information for students.

The financial aid shopping sheet is intended to be a thought-starter to advance both the Bureau's mission in the student loan area and the Department of Education's interests in promoting more

informed decisions about higher education. We, and the Department of Education, hope that it is a first step toward greater transparency in this area, and that the process will result in useful tools for colleges, student loan providers, and others who are interested in providing better information to students and their families.

The Bureau is also working to bring greater transparency to the private student loan market—one of the least understood consumer credit markets. We are asking the public, the higher education community, students, families, and the student loan industry—both lenders and servicers—to provide us with information about this market voluntarily. What terms do these student loan products offer? Are students able to repay them? What rules apply to who is approved and who is denied a private loan? With this information, and as required by the Dodd-Frank Act, the CFPB and the Department of Education will draw up a detailed report to give to Congress next summer.

And, finally, part of the Bureau's commitment to transparency means taking stakeholders' views into account. As I mentioned earlier, we have reached out to market participants and the public for feedback on our *Know Before You Owe* projects, and we anticipate that their input will be important in our work to improve clarity for consumers and reduce regulatory burden for industry. We have taken a similar approach in our development of a "larger participant" rule to help define the scope of our nonbank supervision. This is part of our broad efforts to seek industry and public feedback to complement the requirements under the Dodd-Frank Act and other laws, including the Small Business Regulatory Enforcement Fairness Act (SBREFA).

## Following the Rules

In the lead-up to the worst financial crisis since the Great Depression, we saw a dramatic growth in lending. From 1999 to 2007, household debt almost tripled to more than \$12 trillion. But the regulatory system prior to Dodd-Frank failed to protect consumers from harmful practices in this gigantic lending market.

Perhaps the worst example of that was, once again, seen in the mortgage market. Because federal and state rules created a fragmented system of mortgage regulation, supervision, and enforcement, the mortgage market became an un-level playing field that encouraged irresponsible lenders to shop for the most permissive—or least monitored—legal regime. The opportunity for regulatory arbitrage accelerated a race to the bottom in lending standards.

The Dodd-Frank Act charges the Bureau with making mortgage markets work better for all consumers, regardless of what charter the business falls under. When we have a Director in place, brokers, originators, and servicers who are not part of a bank or bank affiliate will—for the first time—be subject to a regime of examination and supervision by federal regulators. Our mission is to ensure that brokers, originators, and servicers play by the rules, regardless of their charter. It doesn't matter if you're a thrift, bank, finance company, industrial loan company, or investment bank. If you want to be in the business of consumer finance, then you've got to play by the rules like everyone else.

To this end, the Bureau has published its Supervision and Examination Manual, the guide for our examiners to use in overseeing companies that provide consumer financial products and services. We have also released our examination procedures for mortgage servicing. Both provide direction to our examiners on how to determine if providers of financial products and services are complying with Federal consumer financial laws—and how to determine if the providers have adequate policies and procedures in place to ensure continued compliance.

We consider both the servicing procedures and the broader Supervision and Examination Manual to be evolving documents. We welcome feedback from all stakeholders. Over the coming months, we will release more guides that explain specific examination procedures for particular products and lines of business.

While the CFPB will examine large banks and their affiliates first, when the CFPB has a Director in place, these guides will be used across the markets we supervise. Our goal is to help pro-

mote fair, transparent, and competitive consumer financial markets where consumers can have access to credit and other products and services, and where providers can compete for their business on a level playing field where everyone has to play by the rules.

One of the Bureau's central responsibilities is to identify and address outdated, unnecessary, or unduly burdensome regulations. The Bureau has a unique opportunity to streamline and simplify rules to ensure that they are truly making consumer financial markets work better. The Bureau has inherited from other agencies numerous regulations, many of which have been on the books for years. Changes in technology, market practices, and the legal landscape may have caused some of these rules to be obsolete, unnecessary, redundant, or counterproductive.

Later this month, the Bureau will initiate a targeted review of these rules in search of ways to update and streamline the regulations. Consistent with the Bureau's philosophy, we will ask the public to participate in this process from the beginning. The Bureau will invite public input to identify specific rules that should be priority candidates for review, to provide a fact base to help the Bureau evaluate the costs, benefits, and impacts of those rules, and to suggest alternatives that may achieve the goals of the underlying statute at a lower cost. This input will be vital to the Bureau as we seek to determine how we can make regulations more effective at achieving intended benefits for consumers while lowering costs for lenders.

## Empowering Consumers

We have been hard at work building up the Bureau's capability to empower consumers.

Dodd-Frank directs the CFPB to create offices and positions within the agency to address the needs of specific populations, including servicemembers, seniors and students. These units will focus on improving the financial decision-making of these groups. This includes providing educational materials tailored to these groups' particular needs and situations and addressing unfair,

deceptive and abusive practices targeted against them.

Last month, we brought on Hubert "Skip" Humphrey III to head up our newly established Office of Financial Protection for Older Americans. This follows our hiring of Holly Petraeus to lead our Office of Servicemember Affairs. Mrs. Petraeus is doing a superb job. She is bringing important attention to the unique financial needs of our men and women in uniform.

CFPB's Office of Servicemember Affairs addresses financial issues faced by members of the military. Among other duties, the Office is charged with educating and empowering servicemembers and their families to make better informed decisions regarding financial products and services. Servicemembers face special circumstances such as deployments, relocations and overseas assignments—and these present unique challenges to the military members and their lenders. Under Mrs. Petraeus's leadership, the Bureau has been collecting data and other information from servicemembers, their advocates and counselors, and industry participants. The Office has hosted town hall meetings with military families and roundtable discussions with financial readiness program managers and counselors, legal assistance lawyers, chaplains, and other professionals servicing the military community.

With Mr. Humphrey's leadership of CFPB's Office of Older Americans, seniors have someone looking out for them when it comes to financial products and services. Seniors have been hard hit by the economic crisis. Even if they planned well, too many saw their retirement savings and home equity shrink. The Office of Older Americans will, among many of its plans, help seniors navigate financial challenges by educating and engaging them about their financial choices in areas such as long-term savings and planning for retirement and long-term care. The Bureau will coordinate with senior groups, financial institutions, law enforcement offices, and other Federal and state agencies to identify and take action against scams targeting seniors. And we will use data from the field to identify trends and bad practices in a timely and effective way.

With students, we are also making strong progress. In addition to our *Know Before You Owe* initiative, we now have a “Private Education Loan Ombudsman.” The Secretary of the Treasury recently designated Rohit Chopra to this position, which was created by the Dodd-Frank Act. The ombudsman will work with the Department of Education to receive, review, and attempt to resolve complaints from borrowers of private student loans. In this capacity, he will also work with institutions of higher education, lenders, guaranty agencies, loan servicers, and other participants in private education loan programs. In the Dodd-Frank Act, Congress directs the ombudsman to enter into a memorandum of understanding with the Department of Education’s student loan ombudsman; this will enable both agencies to coordinate closely and share information. This memorandum of understanding is complete, allowing us to begin planning how to intake these complaints. Last week, we began helping student loan borrowers by launching the Student Debt Repayment Assistant. Already, consumers have viewed the repayment tool over 28,000 times.

In July [2012], the ombudsman will provide a report to Congress on the CFPB’s efforts to assist borrowers of private education loans.

## Conclusion

I will conclude by explaining how we will approach every issue that we work on. First, we are committed to basing our judgments on research and data analysis. We will not shoot from the hip. We will not reason from ideology. We will not press a political agenda. Instead, we are going to be fact-based, pragmatic, and deliberative. And I am proud to say that we are building a team that is eminently capable of making good on that promise. We have hired top-notch regulators, researchers, lawyers and market practitioners.

Second, once we understand a problem and its causes, we will be careful to use the right policy levers to address it. As I mentioned earlier, we have a wide range of tools at our disposal. We will strive to use each of them in the smartest

way possible, matching policy solutions to policy problems.

Finally, and perhaps most importantly, we will tackle our mission knowing that we are singularly accountable for it. Consumer protection in financial services is a hard job. And by enacting Dodd-Frank, Congress recognized that if you do not make someone singularly accountable for doing a hard job, you shouldn’t expect it to get done well. You can count on us to make sure consumer financial markets actually work—for families, for the honest firms that serve them, and for the economy as a whole.

## SEC/SRO Update:

### SEC Charges China-Based Longtop Financial Technologies for Deficient Filings; SEC Commissioners Aguilar and Gallagher Confirmed; SEC Inspector General Releases Report on Destruction of Investigative Documents

BY PETER H. SCHWARTZ &  
CRYSTAL L. GORDON

*Peter H. Schwartz is a partner in the law firm of Davis Graham & Stubbs LLP and Crystal L. Gordon is Vice President and Associate General Counsel at Air Methods Corp., both in Denver, Colorado. The authors gratefully acknowledge the assistance of Beth C. Kramer in the preparation of this article. Contact: [peter.schwartz@dgs-law.com](mailto:peter.schwartz@dgs-law.com) or [cgordon@airmethods.com](mailto:cgordon@airmethods.com).*

#### SEC Charges China-Based Longtop Financial Technologies for Deficient Filings

On November 10, the Securities and Exchange Commission's (SEC's) Division of Enforcement charged China-based Longtop Financial Technologies Ltd. with failing to file current and accurate financial reports with the SEC.<sup>1</sup> The SEC previously filed a subpoena enforcement action against Deloitte Touche Tohmatsu CPA Ltd. in Shanghai for failing to produce documents related to the SEC's investigation into possible fraud by Longtop, the audit firm's longtime client.<sup>2</sup>

According to the press release, the SEC's Division of Enforcement alleged that "Longtop failed to comply with its reporting obligations because

it failed to file an annual report for its fiscal year that ended March 31, 2011 ...[and that] Longtop's independent auditor stated in May 2011 that its prior audit reports on Longtop's financial statements contained in annual reports for 2008, 2009 and 2010 should no longer be relied upon."

Section 12(j) of the Securities Act of 1934 provides that the SEC is authorized to bring an administrative proceeding to determine whether to revoke or suspend the registration of a security, if a public company fails to comply with the federal securities laws. If the administrative law judge overseeing the proceeding were to revoke the registration of Longtop's securities, broker-dealers would be prohibited from executing any trades in those securities. Revocation also would make Longtop ineligible as a public shell company.

In this litigated administrative proceeding, Longtop will have an opportunity to refute the Division's allegations. The administrative law judge will then determine whether the allegations are true and whether the registration of Longtop securities should be suspended for a period not exceeding 12 months, or revoked altogether. Longtop is required to file periodic reports with the SEC until a final decision is made in this proceeding.

#### SEC Commissioners Aguilar and Gallagher Confirmed

On October 21, the U.S. Senate confirmed Luis A. Aguilar to serve a second term and Daniel M. Gallagher to serve as a commissioner of the SEC.<sup>3</sup> Commissioner Gallagher, a Republican, was appointed to fill the vacancy created at the end of Commissioner Kathleen Casey's term. He had formerly served on the SEC staff, including as Deputy Director of the Division of Trading and Markets.

Commissioner Aguilar, a Democrat, began his first term as an SEC Commissioner on July 31, 2008.

#### SEC Inspector General Releases Report on Destruction of Investigative Documents

On November 1, the SEC's Office of the Inspector General (OIG) released its report regarding

the investigation into the SEC's policy of destroying documents gathered in preinvestigation inquiries (known as Matters Under Inquiry, or MUI), as well as statements made by the Commission to the National Archives and Records Administration (NARA) regarding that policy.<sup>4</sup>

On July 15, after receiving a letter from Gary Aguirre, counsel for Darcy Flynn (an SEC staff member who became a whistleblower), the Inspector General commenced its investigation regarding the alleged improper destruction of documents. The Inspector General found that the SEC had a long-standing policy calling for the destruction of documents even though the documents should have been preserved. The Inspector General also found that, when asked by NARA about the destruction of documents, representatives of the SEC did not disclose the existence of the policy and incorrectly stated it did not know if such documents had been destroyed.

The Inspector General stated that it did not find an improper motive for the policy; however, the OIG report did indicate that "there was a lack of clarity as to the rationale for the policy." Similarly, according to the report, the Inspector General was "not aware of a particular investigation that was hampered by the destruction of records for a MUI, although the OIG has not conducted an exhaustive audit or review..."

The OIG investigation also found that the SEC's Enforcement staff destroyed documents related to closed MUIs that should have been preserved as federal records, including anonymous correspondence and complaints, correspondence from the SEC requesting documents from companies in the course of a MUI, and correspondence accompanying companies' document production responses.

The report contained several recommendations for the Division of Enforcement, including:

- taking appropriate steps to determine what federal records from closed MUIs are retrievable, and ensure that any such federal records are retained in the same manner that investigative records are retained pursuant to the current schedule with NARA;

- working with the SEC's Office of Records Management Services and NARA to determine which MUI and investigative records are legally required to be retained;
- determining if there are additional federal records that, while not legally required to be retained, should be retained as a matter of policy; and
- review its guidance, including as it relates to automatically generated e-mails, to ensure that all guidance is consistent with federal record retention legal obligations.

#### NOTES

1. See SEC Press Rel. No. 2011-241 (Nov. 10, 2011), available at <http://www.sec.gov/news/press/2011/2011-241.htm>. See also SEC Rel. No. 34-65734 (Nov. 10, 2011), available at <http://www.sec.gov/litigation/admin/2011/34-65734.pdf>.
2. See SEC Press Rel. No. 2011-180 (Sept. 8, 2011), available at <http://www.sec.gov/news/press/2011/2011-180.htm>. See also SEC/SRO Update, *Wall Street Lawyer*, October 2011 (vol. 15, no. 10) © West Services, Inc., a division of Thomson Reuters.
3. See SEC Press Rel. No. 2011-219 (Oct. 21, 2011), available at <http://www.sec.gov/news/press/2011/2011-219.htm>. See also SEC Press Rel. No. 2011-232 (Nov. 7, 2011), available at <http://www.sec.gov/news/press/2011/2011-232.htm>.
4. "Destruction of Records Related to Matters Under Inquiry and Incomplete Statements to the National Archives and Records Administration Regarding that Destruction by the Division of Enforcement," *Report of Investigation, United States Securities and Exchange Commission, Office of Inspector General*, Case No. OIG-567 (Oct. 5, 2011); available at <http://www.sec.gov/foia/docs/oig-567.pdf>.







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