

SECURITIES ENFORCEMENT & FRAUD

Supreme Court Decision Apparently Changes The Concept Of Willfulness

ABSTRACTED FROM: *A New Burr Under The SEC's Saddle: Changing Standards For SEC Enforcement Remedies*

BY: Kenneth Winer and Samuel Winer, Foley & Lardner, Washington, DC

Insights: Corporate & Securities Law Advisor, Vol. 21, No. 7, Pgs. 9-14

Out of left field. According to securities attorneys Kenneth Winer and Samuel Winer, a June 2007 Supreme Court decision under the Fair Credit Reporting Act, *Safeco Insurance Co. v. Burr*, will have profound implications for SEC enforcement of antifraud statutes. In *Safeco*, the Court construed the recklessness component of the concept of willfulness—a term in common use in a wide variety of regulatory statutes, including the securities laws—to encompass only the actions of the defendant taken in disregard of a known or highly probable violation of law that would generate significant harm. In the absence of statutory language compelling a different understanding, the Court's interpretation requires a "reckless disregard of a legal requirement." The *Safeco* Court reached this conclusion based on the traditional common-law gloss on the word "reckless" in a civil-liability context, which the Court said ought to govern statutory language that Congress has not otherwise defined.

Not exactly what we had in mind. While the authors do not criticize the Supreme Court's analysis of recklessness or willfulness in *Safeco*, they emphasize that it could produce a radical change in how courts handle securities enforcement actions. The prevailing authorities in securities cases for nearly 60 years have traditionally viewed willfulness—including recklessness—as applying not to the defendant's legal duty but to the physical conduct that the SEC charged as being a violation of the law. For example,

IN THIS ISSUE

SECURITIES ENFORCEMENT & FRAUD

1

- Supreme Court Decision Apparently Changes The Concept Of Willfulness

GLOBAL MARKETS

2

- Foreign Private Issuers Must Decide Whether To Delist And Deregister In The US Markets
- New Law Governs Foreign Investors' LLCs In China

CORPORATE GOVERNANCE & DIRECTORS' DUTIES

4

- Negotiate D&O Liability Insurance Carefully And Knowledgeably
- Board Membership A Good Fit For The Diligent CPA

FINANCIAL REPORTING, TAXATION & ACCOUNTING

7

- Spending The Company's Compliance Dollars Wisely
- The SEC Dominates The Accounting Arena After Sarbanes-Oxley

in the leading 1949 District of Columbia Circuit case of *SEC v. Hughes*, the court drew a sharp distinction between criminal-law willfulness, which requires an improper motive, and civil-liability willfulness, which requires only knowingly or recklessly doing the complained-of action. The courts and the SEC have consistently taken this more lenient approach. The SEC in a 2007 administrative case, *In re Philo*, had reaffirmed this approach only three months before the Supreme Court decided *Safeco*. Although the SEC has argued that its broad interpretation of willfulness was an application of the old saying that ignorance of the law is no excuse, the authors conclude that *Safeco's* reasoning contradicts the Commission's approach and will require serious adjustment in the SEC's enforcement methodology.

Abstracted from *Insights: Corporate & Securities Law Advisor*, published by Aspen Publishers, 76 Ninth Avenue, 7th Floor, New York, NY 10011. To subscribe, call (800) 638-8437; or visit www.aspenpublishers.com/product.asp?catalog_name=Aspen&product_id=SS08943524.

GLOBAL MARKETS

Foreign Private Issuers Must Decide Whether To Delist And Deregister In The US Markets

ABSTRACTED FROM: *Should Non-US Companies In The SEC's Reporting System Get Out Now?*

BY: Donald Meiers, Steptoe & Johnson, Washington, DC

International Journal of Disclosure & Governance, Vol. 4, No. 4, Pgs. 236-278

Bloom off the rose. Foreign issuers raise a strong voice in the chorus of complaint concerning the application of Sarbanes-Oxley reporting obligations on US public companies. With the June 2007 effectiveness of the SEC's new procedures for delisting and deregistering securities under the 1934 Act, corporate/securities lawyer Donald Meiers observes that it is now easier than ever for a registered foreign private issuer (as the term is used in the 1934 Act) to head for the door. Under new Rules 12h-6 and 12g3-2(b), a foreign private issuer whose average daily US trading volume for the past year is less than 5% of its worldwide total or whose US stockholders are fewer than 300 within the previous 120 days can deregister its equity under 1934 Act Section 12(g) and stop filing periodic reports under 1934 Act Section 15(d). These two provisions represent the bottom line in the SEC's hierarchy of reporting requirements. In addition, Rule 12g3-2(b) eliminates prior waiting periods and grants an immediate registration exemption to foreign private issuers who comply with the Rule 12h-6 requirements and deregister.

Recipe for deregistration. The author sets out the several steps a foreign private issuer must take to accomplish delisting and deregistration under the new rules. To delist, the issuer must notify the exchange, issue a press release, and file SEC Form 25 to certify compliance with the deregistration requirements. Delisting becomes effective 10 days after filing the form, while deregistration has a 90-day lead time. To complete the process of exemption from Section 12(g) registration and Section 15(d) reporting, the foreign private issuer must now file Form 15F and publish a notice, which immediately terminates reporting (subject to a 90-day SEC objection period). If the issuer becomes aware of facts negating its eligibility for the exemption—for example, it had too many US shareholders—it must withdraw the form.

No sugar-coating the pill. In evaluating whether a foreign private issuer should take advantage of the new ease of exit, the author acknowledges that the problems exasperating many issuers will not go away quickly. Neither the SEC's recent guidance on reporting internal accounting controls under Sarbanes-

Oxley Section 404 nor the related PCAOB statements will provide any significant relief, since the recent statements suffer from the same vagueness as the prior ones. The author also sees nothing new or exciting in the PCAOB's Auditing Standard No. 5; nothing in it will make identifying and testing for weaknesses in internal controls any less frequent or complex, a factor that has typically increased auditing costs. There also seems to be little appetite at the SEC for any convergence of accounting standards between US Generally Accepted Accounting Principles and the International Accounting Principles, a convergence that would reduce disclosure obligations.

Think hard about it. Notwithstanding the difficulties surrounding Sarbanes-Oxley Act compliance and the traditional complaints of foreign companies about America's litigious culture, the US regulatory system retains a significant benefit that foreign private issuers should consider carefully before withdrawing: submission to stringent regulation and public trading in US capital markets results in measurably higher stock valuations for the registered company. Other potential benefits to issuers include establishing their branding and profile for commercial and employment purposes, such as equity-based compensation. As for avoiding the terrors of US-style securities class action litigation, foreign private issuers may not be able to decrease their risk as much as they think. Many European countries are developing class action procedures with similar effects as the American model, and foreign shareholders are becoming less reluctant to bring suit in US courts. In addition to these forces that even out the risks and burdens of staying in the US market, the author believes a deregistered foreign private issuer can maintain a low-level presence in the US capital markets and still avoid most of the costs associated with Sarbanes-Oxley compliance, chiefly through Level I American Depositary Receipts or quotation through the International OTCQX system for "quality" companies listed on foreign securities exchanges.

Abstracted from *International Journal of Disclosure & Governance*, published by Palgrave Macmillan Journals, Houndmills, Basingstoke RG21 6XS, England. To subscribe, call 44(0)12 5630-2959; or visit www.palgrave-journals.com/jdg/.

New Law Governs Foreign Investors' LLCs In China

ABSTRACTED FROM: *Introduction To The New Company Law Of The People's Republic Of China*

BY: Steven Dickinson, Harris & Moure, Seattle, WA

Pacific Rim Law & Policy Journal, Vol. 16, No. 1, Pgs. 1-11

Eliminating cookie-cutter charters. After 13 years of application, China has completely revised the 1993 law on limited liability companies. Attorney Steven Dickinson, an expert in Chinese law, explains that LLCs are the only operational vehicles open to foreigners under China's foreign-direct-investment statutes. While the old law dictated the provisions of every company's articles of association, the new statute encourages shareholders to tailor the articles to the company's size, nature, and distinctive needs. For example, the company is no longer required to distribute profits in proportion to shareholders' ownership interests. The new law drastically cuts its predecessor's minimum-capital requirements and discards its different capital requirements for different kinds of businesses. Another change permits a company to have only one shareholder, rather than two or more, although the minimum-capital requirement is higher for a single-shareholder company.

Researching companies is now as easy as pie. Under the 1993 law, the public and shareholders faced great difficulty in accessing corporate information. To protect creditors, the new law gives the public the right to obtain basic corporate registration information (such as registered capital, type of business, and shareholders' names) and requires the registration authority to help the public in doing so. In addition, the company must keep—and make available at a shareholder's request—the articles of association, minutes for meetings of the directors or supervisors, tax returns, and financial reports.

Access rights extend to the complete financial records, the author notes, although the company can withhold them to prevent harm to itself (e.g., if the shareholder is a competitor). The new law also introduces liability for shareholders who misuse the company's independent status as a legal person or their own limited-liability rights so as to hurt the company, its creditors, or other shareholders.

Thwarting management's half-baked schemes. The author points out other significant aspects of the new law. Shareholders can now prevent directors' and officers' self-interested dealings, a major problem under the old law. A company may invest in another company but may not become jointly liable for all the latter's debts. The directors or the shareholders, as specified in the articles of association, must approve any investment in another company or guaranty of its debt, up to the maximum specified therein. A majority of disinterested shareholders must approve a guaranty given to a shareholder or the person in control of the company. In addition, the new law prohibits directors and senior managers from misappropriating corporate funds, using their corporate authority to seek business opportunities for themselves without the shareholders' consent, and accepting commissions on corporate deals. When a violation occurs, shareholders owning at least 1% of the shares may force the company to sue and, if it declines, may sue on its behalf (or their own behalf, when they are the victims).

Icing on the cake: tax breaks. Foreigners' limited-liability companies can take the form of a wholly foreign-owned entity or a joint venture of the equity or contractual type. The statute and regulations governing each of the three forms give foreigners preferential tax treatment, which survives enactment of the new law. The favorable treatment includes a reduction in the income tax rate from 33% to 15% (plus exemptions for specified periods) and a rebate of taxes paid on reinvested profits. Local authorities can give foreigners extra tax breaks, the author adds. The new law applies to all three organizational forms, since each one's statute and regulations are silent on day-to-day management, although the new law's promise of revolutionizing companies is liable to remain unfulfilled. Local authorities can mechanically implement some of its changes (e.g., reducing capital requirements and permitting single-shareholder companies), but the author fears that China's feeble judicial system and bureaucracy—inexperienced at contending with complicated corporate-law issues—cannot implement the more dramatic ones.

Abstracted from *Pacific Rim Law & Policy Journal*, published by University of Washington School of Law, William H. Gates Hall, Box 353020, Seattle, WA 98195. To subscribe, call (206) 543-6649; or visit www.law.washington.edu/PacRim/.

CORPORATE GOVERNANCE & DIRECTORS' DUTIES

Negotiate D&O Liability Insurance Carefully And Knowledgeably

ABSTRACTED FROM: *10 Issues To Consider When Negotiating Your Company's D&O Coverage*

BY: John Tanner and Anthony Tatum

McGriff Seibels & Williams, Birmingham, AL (JT); King & Spalding, Atlanta, GA (AT)

ACC Docket, Vol. 25, No. 6, Pgs. 92-102

D&O ABCs. Mindful of the recent corporate scandals that intensified legislative, investigative, and enforcement activity, directors and officers are pressuring their attorneys to negotiate the broadest obtainable D&O liability-insurance policies. Standard policies have three-sided coverage: *Side A* shields directors and officers when the company cannot legally or financially indemnify them; *Side B* reimburses the company when it does indemnify them and advances their defense costs; and *Side C*

protects against securities claims. The three sides usually share one liability limit, insurance claims counsel John Tanner and business litigator Anthony Tatum indicate. Sides B and C are payable only above a substantial retention amount for which the company is responsible. Policies exclude coverage for almost all claims involving fraud. The event entitling the insurer to invoke the fraud exclusion might be a judgment against the insured or merely the occurrence of the misconduct.

I v. I exclusion. The *insured v. insured exclusion* reaches any claim brought by, for the benefit of, or with the help of any insured. Many D&O policies define “insured” to encompass past, present, and future directors and officers of a company, its parents, and its subsidiaries. The authors advise that corporate counsel attempt to limit this exclusion to claims that the company brings directly; failing that, counsel should at least negotiate for the many available exceptions to the exclusion, including those for derivative and whistleblowing claims. Another danger is that a company’s shareholders (when investing) and insurer (when underwriting) might both rely on the same material misrepresentations in its public filings. Arguing that the company had fraudulently induced issuance of the policy, the insurer could rescind coverage of any shareholder suits. To avert this danger, the policy should specify that the insurer relied only on the written information submitted with the application. Insurers also offer numerous endorsements making coverage nonrescindable or severing the coverage of innocent directors and officers from the rescindable coverage of those who made the misrepresentations.

DIC coverage. A company’s excess D&O policies follow the primary policy’s terms and conditions “except as otherwise provided” and therefore might substantially limit vital provisions. Many companies buy Side A excess *difference-in-conditions (DIC) coverage*, which can cover claims that a Side A policy customarily excludes. Examples of DIC coverage are less restrictive fraud and insured-versus-insured exclusions, no pollution or ERISA exclusions, and coverage when the company wrongfully declines to indemnify directors and officers. Policies’ notice provisions often define “claim” as any written demand to any insured, not just a formal complaint, and require the company to give notice as soon as possible after the making of a claim. An insurer might agree to a more lax notice provision, note the authors, but with a deadline of 60-90 days beyond the policy period.

Securities claims from A to Z. Attorneys should make sure that *Side C*, which most public companies buy, covers the full range of “securities claims.” While the typical definition of that term includes all alleged federal-securities-law violations, the authors offer a caveat: several recent court decisions imply that, due to public policy, the damages an issuer pays under 1933 Act Sections 11 and 12 are uninsurable restitution or disgorgement. Many policies do not cover secondary liability (e.g., SEC or state-law charges of aiding and abetting), because they define “securities claims” against the company and its non-officer employees as only those claims resulting from buying or selling company stock. In-house attorneys, including those serving as directors or officers, could ask the company to buy separate coverage for in-house counsel. Even though a typical D&O policy covers worldwide claims, a company should contemplate buying a policy in any other country where it has substantial exposure and where the insurance laws might prevent a US insurer from paying local insureds.

Abstracted from *ACC Docket*, published by Association of Corporate Counsel, 1025 Connecticut Ave. NW, Suite 200, Washington, DC 20036-5425. To subscribe, call (202) 293-4103; or visit www.acc.com/php/cms/index.php?id=38.

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Board Membership A Good Fit For The Diligent CPA

ABSTRACTED FROM: *CPAs As Corporate Directors: Be Diligent, Not Fearful*

BY: Prof. Deborah Archambeault and Prof. John Friedl, University of Tennessee

Journal of Accountancy, September 2007, Pgs. 52-57

With opportunity comes responsibility. The Sarbanes-Oxley Act does not require companies to include a financial expert on the board's audit committee, but if there is none, the company must explain why. As accounting professors Deborah Archambeault and John Friedl point out, companies are probably better served by just adding an expert. CPAs seem the perfect choice to fill this role: they already are familiar with corporate structure and board function, and they have the financial expertise necessary to complement the other directors. The CPA/director would take on both the customary responsibilities of a director and the added duties of a member of the audit committee, monitoring the company's plans and objectives, unusual transactions, and corporate performance as well as participating in nominating members and assessing the board's performance. Many CPAs with experience and knowledge can assume a director's role to provide some assurance that the corporation is complying with Sarbanes-Oxley as well as SEC reporting regulations.

Do the homework first. The authors make several suggestions to CPAs who are considering board service. Go through a due diligence process to learn about the company, its directors, and auditors. Remember that a board member must act in good faith and make a considerable time commitment, especially if on the audit committee. Be sure to understand the business and the responsibilities incumbent on a director. Prepare to be scrutinized carefully, especially if you will be the board's financial expert. Be certain that adequate liability insurance is in place to protect the directors, but make sure there is no conflict with the CPA's malpractice insurance. Once on the board, however, the CPA/director can avoid needless liability concerns by acting with diligence and in good faith.

Potential liability may dissuade some. Given a few recent personal liability judgments against directors, some CPAs may be skeptical about the prospects of joining a board. The authors offer the reassurance of the business-judgment and prudent-person standards; as long as a corporate director acts in good faith, makes informed judgments, and does not act for self-gain, the director should be able to avoid unwanted liability. Even the board member who is the designated financial expert benefits from an SEC safe harbor exemption, which precludes that person from being considered an expert under civil liability law. This exemption places the financial expert on the same footing as the other board members.

Recent cases favor the board. A number of recent cases have been brought against corporate directors as a group as well as individuals. In three separate cases heard in 2006, district courts found that board members had to have specific knowledge of wrongdoing before they could be held liable. Being a board member does not place someone in greater jeopardy unless the director does not exercise due diligence. CPAs were concerned in 2006 when the Delaware chancery court found that a director who was an M&A expert had to meet a higher standard due to his experience and specific knowledge of the area. He and the other directors had approved a merger that significantly undervalued the company. Suggesting that he had either disregarded relevant information or acted in his own best interest, the court decided that he, unlike the less expert directors, could not defend himself by citing an outside expert's opinion. Nevertheless, the authors reassure, this was an isolated case. Most of the decisions apply the less-burdensome business-judgment rule as the standard for directors' liability.

Abstracted from *Journal of Accountancy*, published by American Institute of CPAs, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311. To subscribe, call (888) 777-7077; or visit www.aicpa.org/pubs/jofa/index.htm.

FINANCIAL REPORTING, TAXATION & ACCOUNTING

Spending The Company's Compliance Dollars Wisely

ABSTRACTED FROM: *Finding Your Cost-Of-Compliance Sweet Spot*

BY: John Schneider, Navigant Consulting, Boston, MA

Strategic Finance, August 2007, Pgs. 27-31

Compliance now a major investment. Since compliance emerged as a major concern for corporate America, the costs of adhering to the growing number of governmental regulations and demands for information have risen dramatically. Observers estimate that, in 2007, the heavily regulated securities industry will spend over \$28 billion on compliance programs, up 22% from 2004 expenditures. Compliance with the Sarbanes-Oxley Act alone will cost securities firms approximately \$6 billion. Most of the compliance dollars, 94%, go to support staff salaries and related overhead; capital expenditures, including IT software and hardware, take another 3%; and the balance is spent on related IT supplies and services such as auditing. Consultant John Schneider wonders if the burgeoning expense is the result of overspending in an attempt to mitigate against every conceivable circumstance. Too many companies have not yet located what the author terms the "budgetary sweet spot," an expense level that will ensure adequate compliance while allowing a small degree of risk. Overspending on compliance robs a company of dollars that should be used to enhance its strategic position and growth.

Hidden price of overspending. The author cautions that many hidden costs lurk behind the misallocation of resources to compliance. Management needs to determine what resources must be reallocated and whether, in the case of staff, overworked employees have the technical skills to handle new responsibilities and take up the slack. The need to rely on outside counsel also increases costs dramatically. Another risk is sacrificing business relationship building to the demands of compliance-related activities. Today's top executives already devote nearly one-quarter of their time on compliance issues; five years ago, the commitment level was 5%. Multinational, complex, and newly merged organizations present their own set of compliance challenges. For example, the merged entity may yield inefficiencies that require a restructuring of the entire compliance program. The costs of compliance can also be a deterrent to going public, especially for foreign companies. The author notes only 20 new foreign listings in 2005 on both the NYSE and the NASDAQ. As a comparison, London's exchange had 129 new foreign listings. Far and away the most startling, most expensive result of additional compliance is the increase in corporate earnings restatements. In 2006, for example, there were approximately 1,876 restatements of earnings, an increase of 17% in one year, and more than treble the number in 2001.

The upside of compliance. Despite the bad news, the author recognizes the benefits of the additional compliance. It has helped to restore investor confidence in the wake of well-publicized, unsavory illegal corporate activities, which aids individual companies and the economy as a whole. Arduous compliance efforts have forced the development of new products, systems, and procedures. Often this results in strengthened internal controls by aligning operational capabilities with governance. In the last analysis, compliance forestalls potential legal responsibilities. In the long run, integrating compliance and governance into an organization's culture can add value to a company's brand. Compliance must be part of a broader effort to protect a company's reputation. It is helpful to initiate the search for balance between cost and compliance with an analysis of operations, including the size and scope of the organization, its level of complexity, the jurisdiction in which it operates, and the possibilities for

automating compliance. Just as compliance requirements have evolved over time, the capabilities to fulfill them will too, with no single program suiting every company.

Abstracted from *Strategic Finance*, published by Institute of Management Accountants, 10 Paragon Drive, Montvale, NJ 07645. To subscribe, call (800) 638-4427 x1547; or visit www.strategicfinancemag.com.

The SEC Dominates The Accounting Arena After Sarbanes-Oxley

ABSTRACTED FROM: *The SEC Rules*

BY: Kate O'Sullivan

CFO, August 2007, Pgs. 46-52

Regulators try to impose clarity and consistency on accounting practices. Accounting practices change continuously, as financial structures and markets evolve. In this ongoing process of accounting innovation, companies may categorize items in their financial reports differently, thus obviating the usefulness of having reports at all. The accounting scandals that led to the Sarbanes-Oxley Act in 2002 piqued regulators' and investors' interest in standardized accounting practices. Since then, the leading accounting regulators—the SEC, the FASB, the PCAOB, and the AICPA—have been jostling to define what the rules should be and, perhaps more importantly, who should set them. Since the SEC approves the FASB's budget, it can exercise a good deal of control, although the two agencies have not always agreed on particular items (for example, the treatment of stock options). In fact, reports Kate O'Sullivan, the SEC recently refused to approve the FASB's budget unless the Commission could also approve nominees to the FASB, thus giving the SEC far greater control. Under Sarbanes-Oxley, the SEC also has jurisdiction over the PCAOB, which oversees auditors.

Should accounting be political? Many corporate players believe that accounting should be business-driven and objectively defined to facilitate business. Many view the post-Enron crackdown on financial reporting as a political overreaction to a specific accounting fraud. Congress controls the SEC, whose chair is a political appointment. The SEC enforces the rules, which are largely made by boards it controls. This structure, the author frets, can subject American business to political whim—which may or may not be good for it. Critics argue that current regulation has had a negative impact on American markets to the benefit of major foreign markets. Business people want to ensure global competitiveness for American and US-listed companies. Although it may disagree on how to achieve global competitiveness, the SEC is also explicitly working toward global accounting standards.

Globalization necessitates increased standardization. As more and more companies operate and list in multiple countries, similar accounting practices across jurisdictions would facilitate global commerce. The SEC has confirmed that it would like to establish international accounting principles. The FASB has been working with the International Accounting Standards Board (IASB) to establish a universal standard. Although convergence is still a long way off, the SEC has proposed allowing foreign companies listing in the United States to use IASB accounting rules. The SEC's push toward convergence could result in its becoming the dominant international securities and accounting regulator, or it could result in the SEC ceding power to an as-yet undefined global standards regulator. The only certainty, the author observes, is that the current regulatory structures and standards will change dramatically during globalization.

Abstracted from *CFO*, published by CFO Publishing Corp., 253 Summer Street, Boston, MA 02210. To subscribe or for more information, call (800) 877-5416; or visit www.cfo.com.