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Little Assurance from *Ambac*: New York's Refusal to Extend the Common Interest Doctrine to Negotiated Transaction Due Diligence

Matt Hortenstine[1]

I. INTRODUCTION

While there is no statutory definition of due diligence, the term is generally understood to refer to a party's investigation (and/or the party's reasonable reliance on others) in connection with a business transaction[2] such as a securities offering, investment advisory service, or negotiated transaction. This article addresses the attorney-client privilege and the "common interest exception"[3] thereto in the context of information sharing during the course of negotiated transaction due diligence.[4]

In Section II, I offer an overview of due diligence in the context of a negotiated transaction. In Section III, I explain the attorney-client privilege and the common interest doctrine. In Section IV, I present an analysis of the majority opinion and dissent in *Ambac Assurance Corp. v. Countrywide Home Loans, Inc.*, a recent New York case that rejected the common interest exception in the negotiated transaction context, and provide insight into the

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[1] J.D., SMU Dedman School of Law, May 2017; B.A. Political Science and Government, The University of Texas at Austin, May 2014.

[2] *See* GARY M. LAWRENCE, DUE DILIGENCE: LAW, STANDARDS, AND PRACTICE Ch. 1 (1st ed. 2016) ("Expressed in its simplest terms, 'due diligence' is the investigation conducted or the reliance placed on others in connection with a business transaction.").

[3] The common interest exception is referred to by many different names, including the "common legal interest doctrine," "joint litigant privilege," "joint defense privilege," and "common interest arrangement." This paper will use the phrases "common interest exception" and "common interest doctrine" interchangeably. *North Riv. Ins. Co. v. Columbia Cas. Co.,* 1995 WL 5792, *2 (S.D.N.Y.1995) ("The nomenclature is less important than a determination of the outer boundaries of the doctrine.").

[4] The common interest doctrine provides an exception to the general rule of waiver regarding communications otherwise protected by the attorney-client privilege that are shared with a third party. *See* United States v. Schwimmer, 892 F.2d 237, 243 (2d Cir. 1989) ("[The common interest exception] serves to protect the confidentiality of communications passing from one party to the attorney for another party where a joint defense effort or strategy has been decided upon and undertaken by the parties and their respective counsel.").

differing approaches undertaken by courts in other jurisdictions. Finally, I explain the reasoning behind my opinion that the common interest doctrine should apply to negotiated transaction due diligence.

II. OVERVIEW OF NEGOTIATED TRANSACTION DUE DILIGENCE

The term "negotiated transactions" refers to mergers, acquisitions, divestitures, joint ventures, lending, and other transactions.[5] This paper primarily explores public or private mergers and acquisitions, referred to herein as "corporate transactions." Such transactions typically involve a buyer (the "buy-side") and a seller (the "sell-side"), each of whom commonly conducts due diligence in connection with the transaction.[6] A buyer in a corporate transaction typically uses due diligence as a means of learning about the target company's business in order to safeguard its proposed investment and learn of any potential liabilities.[7] Correspondingly, the seller conducts due diligence to, among other things, verify representations and warranties required of it as the seller.[8]

Understandably, both buy-side and sell-side due diligence tends to involve information sharing since due diligence most often involves several parties, including principals, attorneys,

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[5] Lawrence, *supra* note 1, at 461.

[6] Reliance on terms "buyer" and "seller," though technically could be limited to an acquisition of a business, are used here for convenience to refer to all forms of asset and business transfers.

[7] *See* David M. Greenwald, *Disclosure During Negotiations and Arbitrations*, 1 TESTIMONIAL PRIVILEGES §1.86 (3d ed.) (noting that during a merger, acquisition or other transaction, "[o]ften, a potential purchaser or other transactional party will request access to privileged materials, such as litigation files, as part of the due diligence process."). *See also*, Lawrence, *supra* note 1 at 471 (noting that buy-side due diligence is "one of the ways [a buyer] learns about the target company, its business, assets, liabilities, risks, and prospects, and in so doing, helps to protect its proposed investment").

[8] *See* Thomas W. Van Dyke, THE M&A PROCESS: A PRACTICAL GUIDE FOR THE BUSINESS LAWYER – CHAPTER 5: PLANNING FOR A SALE, SN067 ALI-ABA 781, 783 (advising a business lawyer to "conduct sell-side due diligence to determine whether any issues exist that may concern a prospective buyer and affect a sale"); *see also* Lawrence, *supra* note 1 at 471 (noting that a seller might also conduct due diligence to determine an appropriate purchase price, investigate non-cash components of the purchase price, and minimize post-closing disputes).

accountants, and in some instances one or more subject matter experts. During this process of information sharing, sensitive information and communications otherwise guarded by the attorney-client privilege might be disclosed, raising the issue of whether the privilege has been waived.[9] A more complete description of the type of information likely to be shared in buyer/seller due diligence will provide a better understanding of the importance of maintaining privilege during corporate transactions.

In corporate transactions, buyers attempt to gain an understanding of, among other things, the legal risks, contractual obligations and liabilities or other exposures arising from or assumed in the proposed acquisition,[10] the appropriate economic terms of the transaction, and how best to avoid or manage post-closing disputes.[11] For example, if the transaction involves intellectual property, such as a patent owned by the seller, the buyer may want to determine the validity of the patent and the risk of infringement claims.[12] In such settings, the availability and strength of a

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[9] *See* Greenwald, *supra* note 6 (noting that courts are split on whether disclosure of attorney-client privileged material is waived when such disclosures are "necessary to close a deal or a settlement"). Though these concerns over waiver of the attorney-client privilege can arise on both sides of a transaction, they are most frequently encountered on the buyer-side and, thus, will be mostly addressed from that perspective.

[10] *Deal Points: The Newsletter of the Mergers and Acquisitions Committee*, AMERICAN BAR ASS'N, Vol. XXII, Issue 1 Winter 2017, *available at https://www.americanbar.org/content/dam/aba/administrative/business_law/newsletters/CL560000/full-issue-201701.authcheckdam.pdf* (detailing two issues that arise during the due diligence process, "[o]ne is some kind of legal problem at the target company that the buyer needs to understand for purposes of diligence – for example, a pending governmental investigation or the validity of a patent-related private lawsuit – where there has been a history of target company counsel advising the target company on that matter. Or two, there is a legal issue arising out of the transaction that the parties want to coordinate," such as violating the rights of a third party or requiring regulatory clearance) [hereinafter *Deal Points Newsletter*].

[11] *Id.* at 1415 ("The information collected during due diligence review affects the transaction's final price, influences the parties' negotiation of indemnification clauses, and may even lead to abandonment of the transaction.").

[12] *See, e.g.,* Tenneco Packaging Specialty & Consumer Products, Inc. v. S.C. Johnson & Son, Inc., 1999 WL 754748 (N.D. III 1999) (regarding a patent opinion letter provided to the buyer by

patent opinion letter from an independent law firm can influence both the purchase price and the types of indemnification clauses to be included in the definitive agreements. While communications such as patent opinion letters,[13] tax opinion letters,[14] and related communications among attorneys[15] and their clients are typically protected by the attorney-client privilege, disclosure of such communications to a party outside of such attorney-client relationship (such as a buyer/seller counterparty) may waive the attorney-client privilege, potentially opening such communications to discovery in future litigation.[16] To address this risk, parties often enter into a contract known as a common interest agreement, which serves to memorialize their shared legal interest as well as their intent to maintain privilege while sharing information.[17] While common interest agreements represent a standard practice in the litigation

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a seller during due diligence review of the corporate transaction) [hereinafter *Tenneco Packaging*].

[13] *See, e.g.*, *id.*; *see also* Hewlett-Packard Co. v. Bausch & Lomb, Inc., 115 F.R.D. 308 (N.D. Cal. 1987) (regarding a case in which a seller disclosed a patent opinion letter, which concerned potential infringement claims by a third party, to a potential buyer) [hereinafter *Bausch & Lomb*].

[14] *See, e.g.*, U.S. v. BDO Seidman, LLP, 492 F.3d 806 (7th Cir. 2007) (regarding a case in which the IRS was denied access to tax opinions shared by an accounting firm and outside counsel prior to engagement and absent a threat of litigation) [hereinafter *BDO Seidman*].

[15] *See, e.g.*, Ambac Assurance Corp. v. Countrywide Home Loans, Inc., 27 N.Y.3d 616 (N.Y. June 9, 2016) (regarding a case in which a third-party insurer requested over 400 communications between the merged company and merging company during the negotiation process) [hereinafter *Ambac Assurance*].

[16] *See Ambac Assurance*, 27 N.Y.3d 616 (holding that, because the controverted communications were shared between the merging and merged company, they were not protected by the common interest doctrine relating to the attorney-client privilege); *but see also Bausch & Lomb*, 115 F.R.D. 308 (holding that a patent opinion letter shared between a buyer and seller was protected by the common interest doctrine).

[17] *See* Christopher F. Dekker *et. al.*, *Level the Playing Field and Protect Privilege with Common Interest Agreements*, ACC DOCKET, July/August 2010 (providing an overview of the utility and mechanics of a common interest agreement); *see also* Eugene M. LaFlamme & Matthew R. Rosek, *The Unknown Litigation Tool: Common Interest Privilege*, 82 WIS. LAW. 14 (Dec. 2009), at 50 (noting the advantages of a common interest agreement include "the ability to share information with a party who has a common legal interest without waiving the attorney-client privilege, the pooling of resources, establishment of a uniform front against opponents, and the potential discovery of otherwise undiscoverable information.").

context, the utility of such agreements in a commercial context is questionable as they have not been respected by several courts.[18] Therefore, it is imperative that transactional attorneys understand clearly the attorney-client privilege and its limits in the negotiated transaction context.

III. OVERVIEW OF ATTORNEY-CLIENT PRIVILEGE

The attorney-client privilege protects confidential communications between an attorney and his or her client from required or mandated disclosures.[19] Protection from mandated disclosure allows for effective representation by fostering an open dialogue amongst an attorney and his or her client.[20] On the other hand, during the discovery phase of litigation, an opposing party is likely to seek disclosure of any communications that might help their case, often challenging the attorney-client privilege. In addressing such a challenge, judges weigh the privilege against policies that favor liberal discovery.[21] This tension is apparent when litigation involves a defendant that has recently engaged in a corporate transaction, and must confront the rule of waiver. The rule of waiver deems an otherwise privileged communication waived if it is

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[18] *See, e.g.*, *Ambac Assurance*, 27 N.Y.3d 616 (holding that Ambac waived privilege, despite the existence of a common interest agreement between the two parties to the merger); *see also Deal Points Newsletter*, *supra* note 9, at 29 (noting that when a seller must share privileged information with a potential buyer in order to coordinate legal analysis, a buyer will suggest a common interest agreement "under which parties agree that certain information is disclosed for purposes of pursuing the parties' common legal interest and disclosure is therefore not a waiver of privilege;" however, going on to note that "there's always been doubt as to how effective this technique is, or whether the privilege is lost by disclosure.").

[19] C.P.L.R. § 4503(a)(1) (In order to maintain privilege, the communications must be made in the context of the professional relationship between attorney and client for the purpose of obtaining or facilitating legal advice.).

[20] *Id.* at 377.

[21] *See Ambac Assurance*, 27 N.Y.3d at 624 ("Despite the social utility of the privilege, it is in '[o]bvious tension' with the policy of [New York] favoring liberal discovery.") (quoting Matter of Priest, 51 N.Y.2d 62, 67-68 (1980)).

knowingly disclosed to third parties.[22] An important common law exception to the rule of waiver of privilege is the common interest doctrine.[23]

The common interest doctrine is rooted in criminal law[24] and provides a means for two parties to share privileged information without waiving privilege.[25] The exception provides that, "[w]here two or more clients separately retain counsel to advise them on matters of common legal interest, the common interest exception allows them to shield from disclosure certain attorney-client communications that are revealed to one another for the purpose of furthering a common legal interest."[26] Many courts distinguish between the common interest doctrine in the litigation context where the doctrine is generally respected and applied, and the commercial transaction context where some courts refuse to apply the doctrine,[27] and some are willing to apply it.[28] Further, some courts have drawn a distinction based on the type of transaction at

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[22] *Id.*
[23] *See U.S. v. Schwimmer*, *supra* note 3.
[24] *See* Chahoon v. Commonwealth, 62 Va. [21 Gratt.] 822, 839-840 (1871) (recognizing the exception and permitting criminal attorneys, with clients under joint indictment for conspiracy to defraud an estate, to coordinate strategies for their defense while maintaining privilege) [hereinafter *Chahoon*].
[25] *See Ambac Assurance*, 27 N.Y.3d at 625.
[26] *Id.*
[27] *See, e.g.*, *Ambac Assurance*, 27 N.Y.3d 616 (declining to extend the common interest doctrine to a commercial transaction); *see also* Libbey Glass, Inc. v. Oneida, Ltd., 197 F.R.D. 342 (N.D. Ohio 1999) (holding that a company's disclosure of its lawyer's advice was not protected in the commercial, rather than litigation, context); Nidec Corp. v. Victor Co. of Japan, 249 F.R.D. 575 (N.D. Cal. 2007) (refusing to apply the common interest doctrine to a defendant who shared privileged information with a prospective buyer of a majority stock position); Bank Brussels Lambert v. Credit Lyonnais, 160 F.R.D. 437, 447 (S.D.N.Y. 1995) (concluding that "the common interest doctrine does not encompass a joint business strategy which happens to include as one of its elements a concern about litigation").
[28] *See, e.g., Tenneco Packaging*, 1999 WL 754748 (holding that sharing a patent opinion letter with the future purchaser of a patent in an asset purchase agreement did not constitute a waiver of privilege); *see also Bausch & Lomb*, 115 F.R.D. 308 (holding that attorney-client privilege not waived when party voluntarily disclosed its attorney's opinion letter to an outside party with whom it was attempting to negotiate the sale of business); *BDO Seidman*, 492 F.3d 806 (applying the common interest doctrine in order to sustain a law firm's claim of privilege as to

issue,[29] the stage of negotiations of a transaction,[30] whether steps were taken to maintain confidentiality of the information shared,[31] and whether the execution of a deal resulted in a common legal interest.[32] The majority opinion and dissent of a recent case in the New York Court of Appeals, which refused to apply the common interest doctrine to due diligence in corporate transactions, contains a detailed analysis of the policy justification for both a court's extending the common interest doctrine, and its refraining from doing so.

IV. *AMBAC ASSURANCE V. COUNTRYWIDE HOME LOANS*

Recently, the New York Court of Appeals decided a case regarding the common interest doctrine and its application to due diligence in a merger negotiation.[33] The plaintiff in the case, Ambac, had been forced to make payments on some of the defendant, Countrywide's, residential mortgage backed securities as a result of guarantees it had previously provided holders of such

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legal memorandum without a threat of litigation); Rayman v. American Charter Federal Sav. & Loan Ass'n, 148 F.R.D. 647 (D. Neb. 1993) (holding that a lender did not waive privilege when it revealed litigation reports to a second lender during merger negotiations).

[29] *See* Cheeves v. Southern Clays, Inc., 128 F.R.D. 128 (M.D. Ga. 1989) (declining to extend the common interest exception to communications shared during negotiations of a substantial asset sale, but suggesting that the exception would have been extended if the transaction were a merger).

[30] *See* In re JP Morgan Chase & Co. Securities Litigation, 2007 WL 2363311 (N.D. Ill. 2007) (determining that two parties to a merger "stood on opposite sides of a business transaction" prior to the signing of a merger agreement; thus, holding that any communications shared prior to the signing of the merger agreement waived the attorney-client privilege, whereas privileged communications shared after such signing did not waive privilege) [hereinafter *In re JP Morgan Chase*].

[31] *See* Memry Corp. v. Kentucky Oil Technology, N.V., 2007 WL 832937 (N.D. Cal. 2007) (distinguishing its case from *Bausch & Lomb* based upon defendant's failure to show any effort to maintain confidentiality when disseminating a privileged document to its predecessor-in-interest); *see also Tenneco Packaging*, 1999 WL 754748 (noting the efforts by defendant to maintain the confidential nature of the disputed communications).

[32] *See* Fresenius Medical Care Holdings, Inc. v. Roxane Laboratories, Inc., 2007 WL 895059, *3 (S.D. Ohio 2007) (holding that a patent-holder's privileged communications were protected by the common interest doctrine despite being shared with a purchaser of the patents after completion of the sale, as both the buyer and seller shared the legal interest of "[conveying and] obtaining a strong and enforceable patent").

[33] *See Ambac Assurance*, 27 N.Y.3d 616.

securities.[34] Subsequently, following Countrywide's merger with a subsidiary of Bank of America,[35] Ambac brought claims against both Countrywide and Bank of America and sought discovery of nearly 400 communications between the two during their merger negotiations.[36] The sought after communications occurred after the signing of the merger plan, but before close of the merger – during the course of due diligence between Countrywide and Bank of America.[37] The communications were posted on a privilege log by Bank of America and were claimed to pertain to "a number of legal issues the two companies needed to resolve jointly in anticipation of the merger closing, such as filing disclosures, securing regulatory approvals, reviewing contractual obligations to third parties, maintaining employee benefit plans and obtaining legal advice on state and federal tax consequences."[38] The merger agreement between Countrywide and Bank of America contemplated and instructed the parties to share such privileged information, and also included a "commitment to confidentiality" in an attempt to avoid a waiver of privilege and shield such communications from discovery.[39] Despite including such language in the merger agreement, the court found that the shared communications waived any claim to privilege and thus had to be disclosed.

A. Majority Opinion

The majority opinion determined that the common interest doctrine was most appropriate

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[34] *Id.* at 620.
[35] *Id.* at 621.
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] It is unclear from the case whether this was in the form of a typical common interest agreement, discussed above, or simply a clause in the merger agreement. Either way, it can be assumed that it was meant to function the same – "Bank of America argued that the merger agreement evidenced the parties' shared legal interest in the merger's 'successful completion' *as well as their commitment to confidentiality, and therefore shielded the relevant communications from discovery*." *Id.* (emphasis added).

in a litigation context, and refused to extend the exception to commercial transactions. In reaching such conclusion, the court relied heavily upon the necessity of shared communications and the need to minimize the risk of misuse of privileged information.[40] Further, the court supposed that co-defendants, co-plaintiffs, or persons that reasonably anticipate becoming co-litigants may maintain privilege through the common interest doctrine because such "parties are most likely to expect discovery requests and their legal interests are sufficiently aligned that 'the counsel of each is in effect the counsel of all.'"[41] Additionally, the court emphasized that the exception served to alleviate any chilling of information sharing that otherwise might occur in coordinating a legal strategy in litigation.[42] In regards to commercial transactions, the majority found unpersuasive the argument that a similar chilling effect would occur if the exception was not extended in such a context – noting both (i) that New York had continued to thrive in attracting commercial deals in the face of uncertainty over the application of the common interest doctrine in the commercial context and (ii) no resulting increase in non-compliance with the law had been demonstrated by the defendants.[43] Additionally, the majority believed that businesses' common interest in closing a complex transaction provide adequate incentive for the proper sharing of information required to consummate a deal.[44]

B. Dissenting Opinion

Justice Rivera of the New York Court of Appeals dissented from the *Ambac* decision, arguing that the common interest doctrine should extend to the commercial transaction context.[45] Central to his position is the belief that the majority's approach ignores the common legal

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[40] *Id.* at 628.
[41] *Id.* (quoting *Chahoon*, 62 Va. [21 Gratt.] at 841-842).
[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] *Id.* at 632 (Rivera, J. dissenting).

interests shared by parties to a merger,[46] which are furthered not only by determining the appropriateness of the transaction through due diligence, but also by mandated statutory and regulatory compliance governing such transactions.[47] By comparison to the need for the common interest doctrine in a litigation context, Justice Rivera noted that the doctrine should extend to commercial transactions because "[t]he privilege should apply where disclosure of client communications facilitates the provision of legal services to advance a joint strategy developed to ensure compliance with regulatory or other legal mandates for the production of documents, and the framing of legal positions, necessitated by regulatory and legal obligations."[48] Further, Justice Rivera rejected the majority's distinction among incentives for an open dialogue between parties in a commercial context versus a litigation setting,[49] as well as the idea that an extension of the exception could lead to abuse of the privilege by commercial parties.[50] Finally, the dissent noted that the majority's decision did not accomplish the goal of creating a bright-line rule with the common interest doctrine due to the "inherent vagueness" associated with the common interest doctrine's application to information shared "in reasonable anticipation of litigation."[51] Significantly, this point addresses a common issue that prompts information sharing in due diligence – future litigation risks posed by the consummation of a deal.

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[46] *Id.* at 641 (noting that the parties, in negotiating and consummating the merger, had to comply with: The Bank Holding Company Act; National Bank Act; Office of Thrift Supervision; SEC – including filing a Form 8-K, S-4, proxy statements, and further disclosures; Office of Comptroller; Federal Reserve Board; and give adequate notice of the acquisition).

[47] *Id.* at 636 ("[T]he rule adopted by the majority ignores the unique common legal interests of parties to a merger, and the statutory and regulatory compliance mandates as motivating factors for client exchanges in these types of commercial transactions.").

[48] *Id.* at 636-37.

[49] *Id.* at 638 (noting that incentives to close a deal as a means of facilitating an open dialogue are no greater than incentives to reach a mutually beneficial outcome in litigation).

[50] *Id.* at 638-39 (describing such an idea as "purely speculative").

[51] *Id.* at 638.

V. CONCLUSION

The *Ambac* case is illustrative of a split throughout the country regarding whether the extension of the common interest exception in the commercial transaction context is appropriate as a matter of policy. In states like New York, the utility of a common interest agreement in a commercial context, providing for confidentiality and a maintaining of privilege, is likely nullified.[52] Further, provisions calling for a more favorable governing law or forum selection also do not provide an answer because, as an evidentiary rule, the governing law of privilege is unclear.[53] Additionally, lawsuits that bring about the issue of privilege are typically brought by third parties not governed by the relevant governing agreement.[54]

The *Ambac* decision takes a strict approach to the common interest doctrine that seems to ignore the common and pervasive legal issues presented to parties conducting due diligence in a corporate transaction. While the common interest doctrine is clearly meant to apply to parties sharing identical, legal interests that are not solely commercial in nature,[55] corporate transactions, that may be motivated purely by commercial objectives, are often replete with legal concerns arising out of the due diligence phase of such transactions.[56] This can be seen in the form of patent concerns, government investigations, antitrust matters, regulatory issues, third

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[52] On the other hand, in jurisdictions that extend the common interest doctrine to certain commercial transactions, a confidentiality agreement proves useful as it evidences an intent to keep the shared information confidential. *See*, *supra* note 30.

[53] *Deal Points Newsletter*, *supra* note 9, at 30.

[54] *See id.*; *see also*, *e.g.*, *Ambac Assurance*, 27 N.Y.3d 616.

[55] DuPlan Corp v. Deering Milliken Inc., 397 F. Supp. 1146, 1172 (D. S.C. 1974) ("A community of interest exists among different persons or separate corporations where they have an identical legal interest with respect to the subject matter of a communication between an attorney and a client concerning legal advice."); *see also In re JP Morgan Chase*, 2007 WL 2363311 (distinguishing between the "opposing" interests of parties prior to the signing of a merger agreement and the shared interests of the parties post-signing of the merger agreement).

[56] *See*, *e.g.*, *In re JP Morgan Chase*, 2007 WL 2363311, at *5 (noting that after signing a merger agreement, two parties to a merger shared a common interest in ensuring legal compliance and shareholder approval).

party consents, and much more.

Justice Rivera's belief that privilege should be maintained in support of joint legal services intended to ensure legal compliance is certainly a context amply justifying application of the common interest doctrine in commercial transactions.[57] Such a restrictive view of the doctrine in the commercial context reasonably limits application of the exception within such context strictly to discussions regarding legal matters between the parties to a transaction and their respective counsel in pursuing a common interest of legal compliance. Further, practitioners as well have suggested a limited application of the common interest doctrine in the commercial context to allow for information sharing amongst certain corporate counterparties.[58] Even so, in a jurisdiction such as New York, corporate attorneys and clients should be aware that even in the limited context of striving for legal compliance in commercial transactions, they are likely waiving privilege when sharing privileged information during due diligence review and seek out risk-reducing alternatives.[59]

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[57] As noted, a similar approach was taken in the Northern District of Illinois, where the court extended the common interest doctrine to parties after they had signed a merger agreement because they both shared a common interest "in ensuring that the newly agreed merger met any regulatory conditions and achieved shareholder approval." *In re JP Morgan Chase*, 2007 WL 2363311, at *5.

[58] *See* Anne King, *The Common Interest Doctrine and Disclosures During Negotiations for Substantial Transactions*, 74 U. Chi. L. Rev. 1411 (2011) (recommending "that courts presume corporations share[] a common interest at the time of disclosure only if disclosure occurred during due diligence review and if the contemplated transaction would have resulted in succession to the seller's liabilities.").

[59] *See* Greenwald, *supra* note 6 (recommending that commercial parties "minimize risk of waiver by disclosing the non-privileged information that underlies the privileged material rather than the privileged material itself" and "enter into a confidentiality agreement that severely limits the receiving party's use of the material, including a requirement to return the material to the disclosing party"); *see also Deal Points Newsletter*, *supra* note 9, at 30 (suggesting alternative routes to sharing privileged information developed by a seller, such as having a buyer hire outside counsel and providing such counsel with all the non-privileged information regarding an area of concern in order to develop his own opinion on the matter; or engaging a common counsel to review a matter for both of the parties).

Cumulative Due Diligence and the Reservoir of Knowledge in Shelf Takedowns

Laura Jacobi[1]

I. INTRODUCTION

In the wake of Judge Denise Cote's 2004 denial of the underwriters' motion for summary judgment on their Section 11 reasonable investigation and reasonable reliance defenses in *WorldCom*,[2] due diligence scholars and practitioners throughout the country expressed concern that the ruling would unreasonably limit the ability of underwriters to prevail on affirmative due diligence defenses, particularly in shelf takedowns.[3] In fact, these concerns have proven to be well-founded as, in the thirteen years since Judge Cote's ruling, courts have increasingly limited the effectiveness of the reasonable investigation and reasonable reliance defenses.

While this paper, of necessity, explores some aspects of the *WorldCom* ruling, its primary focus is on the concept of the "reservoir of knowledge"[4] that derives from "continuous" or "cumulative"[5] due diligence, and its particular relevance in the context of the due diligence defenses often asserted by underwriters in shelf takedowns. In Section II, I briefly explain shelf

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[1] J.D., SMU Dedman School of Law, May 2017; B.A. Government, The University of Texas at Austin, May 2014.
[2] In re WorldCom, Inc. Securities Litigation, 346 F. Supp. 2d 628, No. 02 Civ. 3288 (DLC) (S.D.N.Y. 2004).
[3] The term "shelf takedown" refers to a public offering of securities pursuant to a previously filed shelf registration statement using a prospectus supplement. *See generally*, Lloyd S. Harmetz and Bradley Berman, *Frequently Asked Questions About Shelf Offerings* (2016) available at https://media2.mofo.com/documents/faqshelfofferings.pdf; *see also*, Gideon Schor, *The Due Diligence and Reliance Defenses in WorldCom: Retrospect and Prospect*, available at https://www.wsgr.com/PDFSearch/Due_Diligence_after_WorldCom.pdf (for an example of scholarly article that hails the WorldCom decision as placing an unreasonable burden on underwriters involved in expedited offerings and shelf takedowns).
[4] Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act, Securities Act Release No. 6335, 1981 WL 31062, at *11 (Aug. 6, 1981).
[5] These terms are often used interchangeably, as I do in the balance of this paper. They refer to the conduct of due diligence prior to the time of a particular offering, and therefore are distinct from "current" due diligence.

registrations and shelf takedowns. In Section III, I explain the importance of cumulative due diligence and the reservoir of knowledge in shelf takedowns and discuss some of the activities underwriters take in the course of cumulative due diligence to create a reservoir of knowledge.

II. SHELF REGISTRATION AND TAKEDOWNS IN GENERAL

Shelf registration allows certain classes of issuers of securities (including those who are subject to the periodic reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act")[6] to register securities when the issuer generally has no intention to immediately sell the securities.[7] This is accomplished through the filing of an initial "shelf registration statement" followed by the subsequent filing of one or more "prospectus supplements" at a later time when the securities are actually issued. This methodology was adopted by the Securities and Exchange Commission ("SEC") so that issuers might respond quickly to favorable market conditions without further SEC review[8] by allowing "a single registration statement to be filed for a series of offering."[9] Thus, shelf takedowns provide a means for a qualifying issuer to rapidly access capital markets.

The initial registration with the SEC is commonly referred to as the "shelf registration" and each future offering made under the shelf registration is typically referred to as a "shelf takedown."[10] If the issuer is a well-known seasoned issuer (commonly called a "WKSI"), it may

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[6] 17 C.F.R. § 230.415.
[7] *Overview of Shelf Registration Process,* GREENBERG TRAURIG (April 2015), http://www.gtlaw.com/portalresource/shelftakedowns.
[8] *See* GARY M. LAWRENCE, DUE DILIGENCE: LAW, STANDARDS, AND PRACTICE 545 (1st ed. 2016).
[9] *WorldCom*, 346 F. Supp. 2d at 667.
[10] *Id.*

incorporate by reference, various disclosures made in its periodic filings under the Exchange Act (such as in its annual Form 10-K or proxy statement, for example).[11]

The SEC has limited the availability of short form registrations to offerings where the benefits of shelf registration are most significant and where the disclosure of due diligence concerns are mitigated by other factors.[12] The shelf registration form is available only for those companies and classes of stock that mitigate the potential risks of a shelf takedown.[13] Thus, not all issuers are qualified to use the shelf registration process.

From a diligence perspective, shelf takedowns pose significant challenges for underwriters and other parties entitled to the benefits of the statutory due diligence defenses. For example, the time frame for conducting due diligence is significantly shorter (sometimes no more than a few days) than the time frame for conducing due diligence in a traditional offering (often a few weeks). Additionally, in the case of WKSI's, prior information (often produced without involvement of the underwriters) may be incorporated by reference.[14]

With respect to the abbreviated timeframe typical of most shelf takedowns, it is important to understand that this temporal factor does not reduce the standard of due diligence to be performed. Even in a shelf takedown, the standard is what a reasonable person would have done in the management of his or her own property in a similar context.[15] The SEC has, however, acknowledged the due diligence challenges presented by an expedited timeframe. In deference to those challenges, the SEC has made clear that such a context demands a willingness to credit

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[11] William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 Brandeis L.J. 549, 560 (2006).
[12] SEC Release No. 33-6499.
[13] *See Overview of Shelf Registration Process supra* note 7.
[14] *See generally* Joseph K. Leahy, *What Due Diligence Dilemma? Re-Envisioning Underwriters' Continuous Due Diligence After Worldcom*, 30 Cardozo L. Rev. 2001, 2019 (2009).
[15] *See* SEC Release No. 33-6383.

different kinds of due diligence activities as part of a reasonable investigation and/or of reasonable reliance.[16] Thus, the manner in which due diligence may be accomplished in a short form will vary from the traditional practice and will involve alternative "investigatory practices."[17]

Indeed, the time consuming "current" due diligence procedures that underwriters are expected to conduct in traditional offerings (such as initial public offerings, "IPO"s) effectively prevent issuers from rapidly accessing the market during windows that the issuer and/or underwriters may perceive as particularly favorable for effecting a securities offering. This circumstance, combined with changes in the offering practices in other international capital market jurisdictions, led the SEC to adopt Rule 415 permitting expedited offerings.[18]

III. IMPORTANCE OF CUMULATIVE DUE DILIGENCE AND THE RESERVOIR OF KNOWLEDGE IN SHELF TAKEDOWNS

Cumulative due diligence is the process of using alternative investigatory methods to conduct due diligence prior to the offering.[19] Some common examples of these methods are

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[16] Circumstances Affecting the Determination of What Constitutes Reasonable Investigation and Reasonable Grounds for Belief Under Section 11 of the Securities Act, Securities Act Release No. 6335, 1981 WL 31062, at *11 (Aug. 6, 1981) ("Circumstances Affecting Reasonableness Release No. 33-6335"). ("Although the basic requirements of due diligence do not change in an integrated system, the manner in which due diligence may be accomplished can properly be expected to vary from traditional practice in some cases. To this end, underwriters and others can utilize various techniques. Historical models of due diligence have focused on efforts during the period of activity associated with preparing a registration statement, but the integrated disclosure system requires a broader focus. Issuers, underwriters and their counsel will necessarily be reevaluating all existing practices connected with effectuating the distribution of securities to develop procedures compatible with the integrated approach to registration. In view of the compressed preparation time and the volatile nature of the capital markets, underwriters may elect to apply somewhat different, but equally thorough, investigatory practices and procedures to integrated registration statements.").

[17] *Id*.

[18] *See* SEC Rule 415.

[19] In the context of ordinary offerings and shelf takedowns, participating underwriters rely on the lead underwriters to perform due diligence. *See* Hazel J. Johnson, The Banker's Guide to

explored in more detail below. By conducting cumulative due diligence, underwriters create what the SEC has described as a "reservoir of knowledge,"[20] that offers an alternative means of satisfying their due diligence obligations in accordance with the standard of reasonableness without having to employ the traditional, time consuming due diligence techniques.[21] The SEC's underlying rationale is that, by establishing a reservoir of knowledge and building upon it, current due diligence (regardless of the timeframe involved) is enhanced, making current due diligence more effective and appropriate in the context.

Courts consider cumulative due diligence to be an important factor in assessing reasonableness in a shelf offering.[22] Cumulative due diligence is a valuable tool in light of the reasons that an underwriter performs due diligence:

- to minimize the risk of post-closing disputes and litigation;
- to enhance the quality of investments and other business decisions;
- to protect reputations and business franchises
- to protect investments;
- to confirm statements made in offering documents;
- to confirm the accuracy of representations and warranties;
- to comply with applicable laws and regulations; and
- to be availed of any available due diligence defense.[23]

Without being able to avail themselves of cumulative due diligence and the reservoir of knowledge, underwriters would likely be unable to satisfy the requirements of reasonable investigation and reasonable reliance in a shelf takedown. This is especially true in the case of a WKSI where prior filing information is incorporated by reference in the offering documents.

Investment Banking 35 (2006); The Investment Banking Handbook 107 (J. Peter Williamson ed., 1988). The SEC still expects the participating underwriters to confirm that the lead underwriters are doing at least the same kind of investigation that the participating underwriter would have done had it been the lead underwriter. *See* SEC Release No. 33-5275, July 27, 1972; *see also* SEC Release No. 9671 and Exchange Act Release No. 34-9671.

[20] Circumstances Affecting Reasonableness Release No. 33-6335 at *11 (Aug. 6, 1981).

[21] *See generally* Lawrence *supra* note 8 at 127.

[22] *See WorldCom*, 346 F. Supp. 2d at 670.

[23] *See* Lawrence *supra* note 8 at 49.

A. Implications of *WorldCom*

In *WorldCom*, the underwriters participated in a shelf takedown and were subsequently sued by purchasers of the securities who alleged that the offering documents—specifically the financial information that had been incorporated into the registration statements— contained material misstatements and omissions. Given nearly fifty years of judicial interpretation of the affirmative due diligence defense, in particular, the reliance defense involving "expertised material,"[24] Judge Cote's rejection of the underwriters' motion for summary judgment on their due diligence defenses[25] came as a shock to the due diligence community. Indeed, some scholars have argued that the opinion discourages underwriter involvement in expedited offerings and shelf takedowns by adding investigatory burdens for underwriters that are inappropriate, especially as relates to expertise material.[26] However, even the *WorldCom* court acknowledged that underwriters may satisfy their due diligence obligation in the context of a shelf takedown by utilizing "anticipatory and continuous due diligence programs."[27] Thus, cumulative due diligence is a relevant consideration even for courts inclined toward limiting an underwriter's due diligence defenses.

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[24] Section 11(b) provides an affirmative defense for any part of the registration statement that is made on the authority of an expert—a defendant relying on this defense will not be liable if he demonstrates he "*had no reasonable ground to believe and did not believe,* at the time such part of the registration statement became effective, *that the statements therein were untrue* or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading." *WorldCom*, 346 F. Supp. 2d at 664. Section 11(b) does not define "expert" or indicate what portions of a registration statement are made pursuant to the authority of an expert, but it is a well settled principle that an accountant is an expert and audited financial statements are expertised portions of a registration statement. *Id.* at 664 (citing In re Software Toolworks Inc. Sec. Litig., 50 F.3d 615, 623 (9th Cir.1994); In re Enron Corp. Sec., Derivative & ERISA Litig., 235 F.Supp.2d 549, 613 (S.D. Tex. 2002); SEC Rel. 7606A, 63 Fed. Reg. at 67233).

[25] *WorldCom*, 346 F. Supp. 2d at 664.

[26] *See* Schor, *supra* note 3.

[27] *WorldCom*, 346 F. Supp. 2d at 670.

B. Selected Methods for Conducting Cumulative Due Diligence

Underwriters may use a wide range of activities to conduct cumulative due diligence and create a reservoir of knowledge.[28] The SEC has proposed specific activities underwriters should engage in to perform cumulative due diligence. Some of these activities include designating underwriters' counsel,[29] regularly meeting with management, receiving ratings from highly regarded rating agencies, reviewing financial reports on a regular basis, designating a team to read and review company reports and other materials regularly, interviewing and conversing internally as much as possible, discussing information with an independent auditory, and obtaining third party support that due diligence may require, including legal opinions, officer's certificates certifying that there are no material misstatements or omissions in the offering documents, and comfort letters from auditors.[30] Further, underwriters should endeavor to obtain outside verification of information when feasible. Although internal verification of information in connection with a shelf takedown or any offering might be sufficient and in some instances may be the most prudent form of verification,[31] outside verification will likely be more favorably viewed by a court assessing the reasonableness of the due diligence performed, if outside verification was possible. In addition, documentation of due diligence is especially important in the context of a shelf takedown. Because of the condensed time frame in a shelf takedown, underwriters should specifically document the due diligence they perform in connection with the

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[28] Note that an in-depth analysis of the various activities that underwriters engage in when conducting continuous due diligence is beyond the scope of this paper.

[29] Designating underwriter's counsel entails employing a single law firm to act as counsel to an underwriter. This practice facilitates continuous due diligence by ensuring continuous access to the registrant on behalf of the underwriter. *Id.*

[30] *See* SEC Release No. 33-6335; *see also* SEC Rule 176; Lawrence *supra* note 8 at 124–25.

[31] See Joseph K. Leahy, *The Irrepressible Myths of BarChris*, 37 Del. J. Corp. L. 411, 417–18 (2012).

shelf takedown in order to potentially prove to a court that they have both met their due diligence defense and that they have satisfied their duty to perform due diligence.[32]

V. CONCLUSION

Shelf registration and shelf takedowns allow issuers to register securities in advance of actual issuance of the securities. This allows issuers to rapidly access markets when conditions are favorable. This condensed timeframe, however, poses issues to underwriters in satisfying their due diligence obligations. The reasonable investigation and reasonable reliance defenses protect underwriters from claims that they have made material misrepresentations or omissions in their registration statements. The 2004 *WorldCom* decision has cast doubt on the effectiveness of the reasonable investigation and reasonable reliance defenses in the context of shelf registration and shelf takedowns. Cumulative due diligence and the reservoir of knowledge, coupled with continuing diligence efforts, provide a solution to this problem. Cumulative due diligence includes various diligence activities that have been prescribed by the Securities and Exchange Commission which, when actively documented, take the place of traditional diligence activities. Both the SEC and the *WorldCom* court have expressed approval of cumulative due diligence, the reservoir of knowledge, and continuing due diligence, as a means of restoring the utility of the reasonable investigation and reasonable reliance defenses. Cumulative due diligence, therefore, allows underwriters to fulfill their due diligence obligations, providing them with statutory defenses to claims, without sacrificing their ability to rapidly access markets.

[32] *See* In re Richmond, 41 S.E.C. 398 (1963) (holding that due diligence is an affirmative obligation for underwriters, not merely a defense).

Director Due Diligence in Public Offerings of Securities: Selected Insights from *In re WorldCom, Inc. Securities Litigation*

David Thompson[1]

I. INTRODUCTION

The primary objective of the United States' securities law is to ensure disclosure of material information to protect the integrity of the financial markets and enable investors to make informed investment decisions.[2] The principal means by which this objective is achieved is the "imposition of liability for failure to comply with…disclosure obligations."[3] Section 11 of the Securities Act of 1933 ("Securities Act"), for example, imposes liability for materially false or misleading information contained in public offering disclosure documents.[4] Among potential defendants are the issuer, the parties who signed the registration statement, the underwriters, any experts such as accountants or appraisers, and the issuer's directors.[5]

Section 11, while imposing broad liability, also provides certain defendants, including directors, with two affirmative "due diligence" defenses[6] commonly referred to as the "reasonable investigation" defense and the "reasonable reliance" defense.[7] To prevail on the

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[2] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976); *see also* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963) ("A fundamental purpose . . . was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics").
[3] David I. Michaels, *No Fraud? No Problem: Outside Director Liability for Shelf Offerings Under Section 11 of the Securities Act of 1933*, 26 Ann. Rev. Banking L. 345, 345 (2007).
[4] *See* 15 U.S.C. § 77k.
[5] *See* 15 U.S.C. § 77k.
[6] 15 U.S.C. § 77k(b)(3).
[7] *See* 15 U.S.C. § 77k(b) (providing affirmative defenses to Section 11 defendants "other than the issuer"). While both defenses make up the due diligence defense, many refer to the reasonable investigation defense as the due diligence defense because it requires the claiming party to have taken an affirmative action). Note that Section 12(a)(2) of the Securities Act also contains a "reasonable care" defense.

"reasonable investigation" defense, the defendant must prove that it conducted a reasonable investigation into the issuer's registration statement and, based on that investigation, reasonably believed in the accuracy of the alleged material misstatement or omission.[8] To prevail on the "reasonable reliance" defense, the defendant must prove that it reasonably relied on an expert's opinion as to any expertised portions of the registration statement that are deemed to contain material misstatements or omissions.[9]

Section 11 establishes the standard for reasonableness (whether reasonable investigation or reliance) as being "that required of a prudent man in the management of his own property."[10] Historically, courts have applied this "prudent man" standard contextually, considering factors such as whether, for example, a director was an insider with substantial access to information or an outsider whose relationship with the issuer was less substantive and more tangential.[11] Thus, a preliminary inquiry for due diligence defenses, including those asserted by directors, is defining the defendant's positional context and then determining what level of "prudent man'" standard should be applied.[12]

[8]*See* 15 U.S.C. § 77k(b)(3)(A)-(C); *see also* Michaels, *supra* note 3, at 366.
[9] *See* 15 U.S.C. § 77k(b)(3)(A)-(C); *see also* Michaels, *supra* note 3, at 366.
[10] 15 U.S.C. § 77(k)(C); *see* Vance Beagles, *Harnessing the Power of the Due-Diligence Defense to Protect Outside Directors*, 11 Andrews Telecomm. Indus. Litig. Rep. 13 (2008); *see also* Richard C. Sauer, *The Changing Dimensions of Director Liability Under the Federal Securities Laws*, 37 Sec. Reg. & L. Rep. 413, 414 (2005) (for a discussion of the "notoriously subjective" prudent man standard).
[11] *See* Escott v. BarChris Const. Corp., 283 F. Supp. 643, 689–691 (S.D.N.Y. 1968) (the court, at great length, differentiates the various forms that reasonableness can take depending on the role/position of the party to the registration statement); *see also* Feit v. Leasco Data Processing Equip. Corp., 322 F. Supp. 544, 577–78 (E.D.N.Y. 1971) ("What constitutes 'reasonable investigation' and a 'reasonable ground to believe' will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data. What is reasonable for one director may not be reasonable for another by virtue of their differing positions").
[12] *See* Beagles, *supra* note 10, at *2.

This paper focuses on director due diligence in public offerings of securities, in particular on the ruling of Judge Denise Cote (Federal District Court for the Southern District of New York) in *In re Worldcom, Inc. Securities Litigation* ("*WorldCom*"),[13] in which the court denied an ostensibly outside director's motion for summary judgment on his due diligence defense.

II. OVERVIEW OF DIRECTOR DUE DILIGENCE IN SECURITIES OFFERINGS

In addressing the issue of liability for material misstatements and omissions in offering documents and the corresponding director due diligence defenses, courts generally have applied a "sliding scale," which recognizes the substantial differences between inside directors who have a close relationship to the issuer and outside directors who typically have a more peripheral affiliation to the issuer.[14] Using this "sliding scale" approach, courts commonly impose "heavier demands [on directors] with more central roles and greater access to confirm the accuracy of the registration statement [such as inside directors]."[15] Thus while the standard itself remains constant (i.e., reasonableness), inside directors typically have a higher bar for meeting the standard, given the more substantive nature of their relationship to the issuer.[16]

In contrast, outside directors, who are not employees or officers of the issuer, typically have more limited involvement with the issuer and, as a result, lack the data and perspectives available to insiders. While outside directors are held to the same "standard" of reasonableness, courts historically have respected this important distinction by imposing a "lower bar" for meeting the standard of reasonableness required in order to successfully assert a due diligence

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[13] In re WorldCom, Inc. Securities Litigation, 346 F. Supp. 2d 628, No. 02 Civ. 3288 (DLC) (S.D.N.Y. 2004).
[14] *See* Michaels, *supra* note 3, at 345.
[15] Gary M. Lawrence, Due Diligence: Law, Standards and Practice 7, 8 (1st ed. 2016); Fed. Hous. Fin. Agency v. Nomura Holding Am. Inc., 68 F. Supp. 3d 439, 468 (S.D.N.Y. 2014) [hereinafter FHFA v. Nomura].
[16] *See* Michaels, *supra* note 3, at 347.

defense.[17] Indeed, some scholars have expressed the view that outside directors should have no liability in securities offering cases barring fraud or recklessness.[18]

The logical and equitable basis for this distinction is often expressed in terms of "informational asymmetry," that is, the knowledge gap between corporate insiders (i.e. inside directors) and outsiders (i.e. outside directors). In the case of outside directors, courts have observed that this asymmetry can derive from, among other things: (1) non-employee status, (2) lack of access to information not provided to the board, (3) potential lack of industry experience, and (4) limited participation in ongoing operational, financial, legal, and other meetings.[19] Moreover, the Securities and Exchange Commission ("SEC") has observed that:

> "a director who has another relationship with the issuer involving expertise, knowledge or responsibility with respect to any matter giving rise to the omission or misstatement will be held to a higher standard of investigation and belief than an outside director with no special knowledge or additional responsibility."[20]

This contextual distinction is both logical and equitable given that the "more involved a party is in a given offering, the more thorough [the public wants] them to be and, thus,

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[17] *See generally* Donald C. Langevoort, *Deconstructing Section 11: Public Offering Liability in a Continuous Disclosure Environment*, 63 Law & Contemp. Probs. 45 (2000); Michaels, *supra* note 3.

[18] Langevoort, *supra* note 17, at 56; *see* Michaels, *supra* note 3, at 349.

[19] Daniel C. Zinman and H. Rowan Gaither, *Building a Due Diligence for Directors and Officers; From the Experts*, Corporate Counsel, 2015, https://advance.lexis.com/search?crid=f2d8ea55-1ecb-4915-8650-2c606e2f730c&pdsearchterms=LNSDUID-ALM-CORPCM-1202720294456&pdbypasscitatordocs=False&pdmfid=1000516&pdisurlapi=true&cookieBanner=0%2C0.

[20] *Circumstances Affecting the Determination of What Constitutes Reasonable Investigation & Reasonable Grounds for Belief Under Section 11 of the Sec. Act Treatment of Info. Inc. by Reference into registration Statements*, Release No. 6335 (Aug. 6, 1981).

the more liability [the public wants] to impose on in order to deter them from neglecting their duties."[21]

III. THE *WORLDCOM* DECISION

One of the most important cases challenging the traditional bounds of director liability under Section 11 was *WorldCom*.[22] WorldCom, a telecommunications and Internet data company, perpetrated a fraudulent financial accounting scheme for the purposes of artificially inflating WorldCom's stock price.[23] The scheme focused on decreasing WorldCom's operating expenses by improperly recording certain operating expenses to capital accounts, leading to understated expenses and subsequently greater earnings.[24] The resulting bankruptcy of WorldCom, the then largest bankruptcy in U.S. history,[25] sparked an immense amount of litigation. The case involved alleged misstatements in the offering documents for two shelf takedowns of debt securities, and sought damages from a range of defendants including the issuer's directors.

While the case involved a number of rulings by Judge Cote, the most significant from the perspective of director due diligence was the denial of a motion for summary judgment by purported outside director Bert C. Roberts, Jr. on his Section 11 due diligence defense.[26] Roberts, chairman of the board of WorldCom at the time of the subject securities offerings and

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[21] Michaels, *supra* note 3, at 347-348.
[22] *In re WorldCom, Inc. Sec. Litig.*, No. 02 CIV. 3288DLC, 2005 WL 638268 (S.D.N.Y. Mar. 21, 2005).
[23] Peter Elstrom, *How to Hide $3.8 Billion in Expenses*, BLOOMBERG (2002), https://www.bloomberg.com/news/articles/2002-06-27/how-to-hide-3-dot-8-billion-in-expenses (discussing the technical process of the accounting fraud committed by WorldCom).
[24] *See, e.g.*, *id*.
[25] Simon Romero and Riva D. Atlas, *WorldCom's Collapse: The Overview; WorldCom Files for Bankruptcy; Largest U.S. Case*, NEW YORK TIMES (2002), http://www.nytimes.com/2002/07/22/us/worldcom-s-collapse-the-overview-worldcom-files-for-bankruptcy-largest-us-case.html (Last visited April 27, 2017).
[26] *Id.*; *see* Michaels, *supra* note 3, at 370–371.

the former chairman of MCI Communications, which had been acquired by WorldCom, asserted that he was an outside director who reasonably relied on expertised material including the company's audited financial statements.[27]

Without ruling on Roberts' assertion that he was an outside director, Judge Cote denied the summary judgment motion. Among other things, she held that: "directors also may not fend off liability by claiming reliance where 'red flags' regarding the reliability of the financial statement, or any other expertised statement emerge."[28] More specifically, Judge Cote held that WorldCom's low expense to revenue ratio (compared to its competitors) presented an issue of fact for the jury regarding whether such a "red flag" should have "caused him [Mr. Roberts] to question his reliance on the audited financial statements."[29] In coming to this conclusion, Judge Cote referenced her extensive analysis in a prior ruling denying a similar motion by WorldCom's underwriters.[30]

This holding in *WorldCom* is a substantial departure from previous court rulings involving outside directors.[31] Indeed, under previous decisions granting summary judgment to outside directors, Roberts' conduct most likely would have been construed as sufficient as a matter of law to satisfy the requirements of the reliance defense.[32] As discussed previously, a threshold issue in establishing a director's due diligence defense is understanding his or her positional context and then applying the "sliding scale" of reasonableness in a way that logically

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[27] *In re WorldCom*, 2005 WL 638268 at *2.
[28] *Id.* at *8.
[29] *Id*. at *11.
[30] *Id.* at *17 (focusing on footnote 21 with detail into WorldCom's expense to revenue ratio).
[31] *See generally* Laven v. Flanagan, 695 F. Supp. 800, 812 (D.N.J. 1988) [hereinafter *Laven*]; In re Allergan Inc. Sec. Litig., No. SACV89-643AHS(RWRX), 1993 WL 623321, (C.D. Cal. Nov. 29, 1993) [hereinafter *Allergan*].
[32] For example, *compare In re WorldCom, 2005 WL 638268* at *3, *with Laven*, 695 F. Supp. at 812; *Allergan*, 1993 WL 623321, at *4–*5, 23; *see* Beagles, *supra* note 10, at 7.

and equitably reflects the director's role and the other elements of context presented. However, in *WorldCom*, the court failed to address this threshold issue. Despite many decades of judicial acknowledgement that inside and outside directors have a different bar for meeting the standard of statutory reasonableness, Judge Cote never ruled whether Roberts' assertion that he was an outside director was correct.[33] This failure is a central shortcoming of the ruling and one that presents the risk that outside directors may in the future be held to an unrealistic standard of conduct.

WorldCom altered the landscape of director liability for material misstatements and omissions in public securities offering documents,[34] creating the potential for an increased level of outside director liability under Section 11 which is inconsistent with historical interpretations and logic.[35] The court's weakening of the outside director's due diligence defense at the summary judgment phase (and the minimal pleading requirements for plaintiffs under Section 11) contributes to an increasing sense that corporate indemnification of directors and limited personal liability for those serving as outside directors "is viewed as against public policy and strongly disfavored."[36]

IV. SELECTED INSIGHTS FOR OUTSIDE DIRECTORS

Following is a brief description of a few ways (this list is intended to be illustrative, not exhaustive) in which outside directors might consider responding to the changing liability landscape as seen through the lens of the *WorldCom* ruling:

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[33] *See generally In re WorldCom*, 2005 WL 638268.
[34] *See* 15 U.S.C. § 77k(b); *Feit v. Leasco,* 322 F. Supp. at 578 (noting that inside director liability "approaches that of the issuer as a guarantor of the accuracy of the prospectus"); *see also* Michaels, *supra* note 3, at 369; *In re WorldCom*, 2005 WL 638268 at *9 ("liability [for inside directors] will lie in practically all cases of misrepresentation.").
[35] *See* Michaels, *supra* note 3, at 349.
[36] Zinman and Gaither, *supra* note 19.

1. **Regular Attendance at Board Meetings:** Regular attendance goes to the heart of basic corporate governance theory and the purpose of a board of directors.[37] Courts consistently find regular board meeting attendance to be a relevant consideration in outside director due diligence defense at the summary judgment phase.[38]

2. **Ability to Demand Accuracy:** Before joining a board, a director should understand the role the board plays in securities offerings, including shelf takedowns, and satisfy himself that he or she will be able to facilitate accuracy in the offering document disclosures. [39]

3. **Reviewing Offering Documents:** As a general rule, directors should perform some basic level of review of the offering documents.[40] Failure to conduct any level of review of the offering documents, while not dispositive, can complicate the effort to prove that a director has reasonably relied.[41]

4. **Reasonable Reliance on Others:** While reasonable reliance is a longstanding, customary part of any due diligence investigation, including that conducted by outside directors, blind reliance is impermissible and may lead to an inability to

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[37] Zinman and Gaither, *supra* note 19.

[38] *See generally* Weinberger v. Jackson, No. C- 89- 2301-CAL, 1990 WL 260676 (N.D. Cal. Oct. 11, 1990); *Laven*, 695 F. Supp. At 812; *Allergan*, 1993 WL 623321 at *4; In re Avant-Garde Computing Inc. Sec. Litig., No. CIV. 85- 4149(AET), 1989 WL 103625, at *8 (D.N.J. Sept. 5, 1989).

[39] *See* Corp. Laws Comm., *Corporate Director's Guidebook* 118-119 (Hillary A. Sale et al. eds., 6th ed. 2012); *see also* Zinman and Gaither, *supra* note 19.

[40] *FHFA v. Nomura* at 464 (the court notes that the directors could not positively assert they had ever met as a group and at least one director could not recall serving as a director of any of the related entities).

[41] *See* Corp. Laws Comm., *supra* note 39, at 119 ("each director should personally review the registration statement for accuracy, with particular attention to those statements and disclosures in the registration statement that are within the director's knowledge and competence.") (It is also important to note that directors are liable for material misrepresentations even if they do not the sign the registration statement).

successfully assert a due diligence defense.[42] Prior to *WorldCom*, directors could safely rely on expertised material without the need to conduct a reasonable investigation into it. However, after *WorldCom*, the matter is far less certain.[43] This is not to say that reliance itself is inappropriate (it is not, provided it is reasonable), but rather that post-*WorldCom*, reliance should be undertaken with care.

5. **Understand the Due Diligence Process:** Some degree of interaction with the individuals completing due diligence tasks related to offering and registration statements can be constructive in establishing a basis for a director's due diligence defense.[44] Understanding the processes and procedures as to how representations in registrations are made and supported is a prudent step for any director. According to some commentators, directors should probe the conduct and procedures of the due diligence team in the same fashion,[45] noting that an issuer's substantial compliance with corporate governance standards may not be sufficient in establishing reasonable reliance on these practices.[46]

6. **Be Alert to Potential "Red Flags":** While Judge Cote noted that what constitutes a red flag can only be assessed in context, there is broad regulatory and industry agreement that the presence of a true "red flag" triggers an affirmative obligation of further investigation by a director. In this regard, *WorldCom* expanded the range of what kinds of facts and circumstances may constitute red flags, going so far as to rule

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[42] *See In re WorldCom*, 2005 WL 638268, at *8.
[43] *See generally* William K. Sjostrom, Jr., *The Due Diligence Defense Under Section 11 of the Securities Act of 1933*, 44 Brandeis L.J. 549, 608 (2006).
[44] *See* Zinman and Gaither, *supra* note 19.
[45] *See* Zinman and Gaither, *supra* note 19.
[46] *See In re WorldCom*, 2005 WL 638268 at *11.

that they may be contained in expertised material. Thus, directors must be alert to potential red flags, even in expertised material.

V. CONCLUSION

For the reasons discussed in this paper, the *WorldCom* decision has potentially narrowed the range and utility of an outside director's due diligence defenses and, as a result, spawned new and more aggressive litigation against outside directors involving material misstatements in public securities offering documents.[47] Accordingly, outside directors should exercise caution. Among other things, they should take care in accepting new directorships and in electing to continue existing ones. The suggestions and practices outlined above may prove helpful to outside directors in developing their own prophylactic responses to the ruling. While they do not guarantee insulation from liability, they should be helpful in establishing the basis for an outsider director's due diligence defenses.

[47] Zinman and Gaither, *supra* note 19, at 2.

Self-Regulatory Organization Due Diligence Guidance in the United States and Canada

Grace Whiteside[1]

I. INTRODUCTION

The Financial Industry Regulatory Authority (FINRA) in the United States and the Investment Industry Regulatory Organization of Canada (IIROC) are self-regulatory organizations (SRO) that supervise and regulate the financial and investment industries within their respective jurisdictions. This paper compares and contrasts their approaches to underwriter and broker-dealer due diligence for public and private securities offerings. First, I begin with a brief overview of the background and similarities between FINRA and IIROC. Then, I analyze their divergent due diligence guidance regarding fraud and sales product abuses in private placements in the United States and fraud in securities offerings of emerging-market issuers in Canada. In Part IV, I offer a few concluding observations.

II. OVERVIEW OF THE SIMILARITIES BETWEEN FINRA AND IIROC

An understanding of the extensive similarities between the two organizations helps to highlight the distinctions between FINRA and IIROC's due diligence guidance.

A. Formation

Both FINRA and IIROC were formed to increase investor protection and enhance the integrity of financial markets.

FINRA traces its roots to the founding of the National Association of Securities Dealers (NASD) in 1939, FINRA's predecessor.[2] The NASD was established by Congress to supervise,

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[1] J.D., SMU Dedman School of Law, May 2017; B.A. Political Science, Southern Methodist University, May 2013.

[2] Press Release, Nancy Condon, FINRA Marks 75th Anniversary of Protecting Investors, FINRA (Sept. 18, 2014) available at http://www.finra.org/newsroom/2014/finra-marks-75th-anniversary-protecting-investors.

under the oversight of the Securities and Exchange Commission (SEC), the conduct of broker-dealers (including in their capacity as securities underwriters).[3] In 2007, the NASD and the member regulation and enforcement arms of the New York Stock Exchange (NYSE) consolidated to create FINRA, as the successor to the NASD, to serve as the nation's SRO for securities firms and registered representatives.[4] Just as with the NASD, FINRA's mandate was to increase investor protection and market integrity.[5] The proponents of FINRA believed the new SRO could better aide "effective and efficient supervision" and streamline regulation "[b]y eliminating overlapping regulation and establishing a uniform set of rules placing oversight responsibility in a single organization."[6]

IIROC's origin stems from the Investment Dealer's Association of Canada (IDA), which began in 1934 as a traditional lobby group and transitioned over a fifty-year period into a watchdog for business conduct of Canadian securities firms.[7] In 2008,[8] the IDA merged with the Canadian equity exchange regulator, the Market Regulation Services Inc. (RS), to form the new investment dealers and trading activities regulator of Canada, IIROC.[9] The motivations behind

[3] *Id.*
[4] Press Release, Nancy Condon & Herb Perone, NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority- FINRA, FINRA (July 30, 2007) *available at* http://www.finra.org/newsroom/2007/nasd-and-nyse-member-regulation-combine-form-financial-industry-regulatory-authority.
[5] *Id.*
[6] *Id.*
[7] WILLIAM DONALD COLEMAN, BUSINESS AND POLITICS: A STUDY OF COLLECTIVE ACTION 188 (McGill-Queen's Press 1988).
[8] *See Self-Regulatory Organizations (SROs)*, ONT. SEC. COMM'N, http://www.osc.gov.on.ca/en/Marketplaces_sro_index.htm (last visited Mar. 24, 2017).
[9] *See Market Regulation*, TORONTO STOCK EXCH., https://www.tsx.com/trading/tsx-venture-exchange/trading-rules-and-regulations/market-regulation (last visited May 11, 2017, 9:47 AM); *see also* INV. DEALERS ASS'N OF CAN., *Information Circular: Regarding the Special Meeting of IDA Member Firms to Consider the Proposed Combination of the Association and Market Regulation Services Inc. in a New Regulatory Organization*, IRROC.ca (Nov. 15, 2007), http://www.iiroc.ca/about/Documents/InformationCircular_en.pdf.

the merger paralleled those of the NASD and NYSE merger, including desires to enhance the quality and effectiveness of investor protection and market integrity by simplifying and streamlining regulation through a "more effective allocation of regulator resources."[10]

B. Self-Regulatory Organization and Independence

Both FINRA and IIROC function as SROs, which as non-governmental organizations possess a "statutory responsibility to regulate its own members through the adoption and enforcement of rules of conduct for fair, ethical, and efficient practices in its industry."[11] Together with the adoption of rules of conduct, SROs also release guidance for their members and levy sanctions upon members for violations and misconduct.[12] SRO regulation supplements federal and state/provincial legislation,[13] such as the Exchange Act of 1934[14] and the Securities Act (Ontario),[15] allowing government regulators to expand the reach of regulation without direct, intrusive government intervention. To guard against possible conflicts of interests, governmentally empowered securities commissions oversee SROs.[16] For example, the SEC possesses "the power to supervise" FINRA "as a matter public interest,"[17] and the Canadian Ontario Securities Commission (OSC) likewise possesses supervisory powers over IIROC.[18]

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[10] *Id.*
[11] *Glossary: Self-regulatory Organization (SRO)*, Practical Law.
[12] GARY M. LAWRENCE, DUE DILIGENCE: LAW, STANDARDS AND PRACTICE 160 nn.26 (CADDS Scholar Press, 1st ed.).
[13] *See id.*
[14] The Securities Exchange Act of 1934, 15 U.S.C.A. § 780-3 (2010).
[15] The Securities Act, R.S.O. 1990, c. S.5., § 21.1.
[16] *See* Press Release, Commissioner Luis A. Aguilar, The Need for Robust SEC Oversight of SROs, SEC (May 8, 2013), https://www.sec.gov/news/public-statement/2013-spch050813laahtm.
[17] *Id.*
[18] Self-Regulatory Organizations (SROs), *supra* note 3.

Despite the oversight, both SROs receive independent funding primarily through membership fees and fines.[19]

C. Rules and Guidance

As SROs, FINRA and IIROC enact rules and issue guidance, including with respect to the conduct of due diligence in securities offerings.[20] For instance, both organizations maintain a review process for proposed rules whereby research teams conduct initial investigations to form the rule that then moves from one advisory committee to another through a review and approval process.[21] Boards for each organization approve the publication of any proposed rule for comment for a period typically of thirty or sixty days.[22] Final approval rests with the SEC for FINRA and the Ontario Securities Administrators (OSA) for IIROC.[23] Unlike rules, which define mandatory obligations, guidance issued by the organizations serves to assist members in complying with rules.

D. Enforcement

Both FINRA and IIROC possess enforcement powers that enable the organizations to levy sanctions against members in violation of the rules.[24] Both organizations publish sanction

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[19] *See* Lawrence, *supra* note 7, at 160 & n. 26; *see also* IIROC History & FAQ, IIROC, http://www.iiroc.ca/about/ourroleandmandate/Pages/IIROC-History-FAQ.aspx#3.

[20] *See Proposals for Regulation*, INV. INDUS. REG. OF CAN., http://www.iiroc.ca/industry/policy/Pages/Proposals-for-Regulation.aspx; *see also FINRA Rulemaking Process*, FIN. INDUS. REG. AUTH., http://www.finra.org/industry/finra-rulemaking-process.

[21] *See Proposals for Regulation*, *supra* note 19; *see also FINRA Rulemaking Process*, *supra* note 19.

[22] *See Proposals for Regulation*, *supra* note 19; *see also FINRA Rulemaking Process*, *supra* note 19.

[23] *See Proposals for Regulation*, *supra* note 19; *see also FINRA Rulemaking Process*, *supra* note 19.

[24] FINRA Rule 8310; *Penalties What the Panels Can Impose*, IIROC.ca, http://www.iiroc.ca/industry/enforcement/Pages/Penalties-What-the-Panels-Can-Impose.aspx.

guidelines to inform members of the justifications and rationales for specific sanctions.[25] FINRA's sanction guideline provides an outline of specific conduct and the respective sanctions, including principal considerations employed to determine the sanctions.[26] IIROC's sanction guideline primarily discusses the overall "framework that should be considered in connection with the imposition of sanctions in all cases," and "provides a list of factors commonly taken into consideration when making a determination as to an appropriate sanction."[27] Although the level of detail in the sanction guidelines differs, FINRA and IIROC may impose the following identical sanctions: censure, monetary penalties, suspension, expulsion, and any "other fitting sanction."[28]

E. Memorandum of Understanding Between FINRA and IIROC

In 2009, FINRA and IIROC entered into a memorandum of understanding (MoU) in order "to establish a formal basis for co-operation between the Authorities, including the exchange of information or other assistance."[29] Through these information-sharing practices, FINRA and IIROC aim "to work together on issues related to firm oversight and examinations."[30] While the MoU has mostly received positive reception, some critics view the

[25] *Sanction Guidelines*, FIN. INDUS. REG. AUTH. (Apr. 2017), http://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf; *IIROC Sanction Guidelines*, INV. INDUS. REG. ORG. OF CAN. (Feb. 2, 2015), http://www.iiroc.ca/industry/enforcement/Documents/IIROCSanctionGuidelines_en.pdf.
[26] *Sanction Guidelines*, *supra* note 24.
[27] *IIROC Sanction Guidelines*, *supra* note 24, at 3.
[28] FINRA Rule 8310, *supra* note 23; *Penalties What the Panels Can Impose*, *supra* note 23.
[29] Memorandum of Understanding Between U.S. Fin. Indus. Reg. Auth., Inc. and Can. Inv. Indus. Reg. Org. of Can. (Feb. 23, 2009), *available at* https://www.finra.org/sites/default/files/Industry/p122062.pdf [hereinafter MoU].
[30] Kanupriya Vashisht, *IIROC, FINRA Plan to Collaborate*, ADVISOR.CA (July 27, 2009), http://www.advisor.ca/news/industry-news/iiroc-finra-plan-to-collaborate-21086.

MoU "merely as a press event" so "FINRA…can go to Congress and claim it's active on the world stage."[31]

III. DIVERGENCE IN DUE DILIGENCE GUIDANCE FOR UNDERWRITERS AND BROKER/DEALERS IN SECURITIES OFFERINGS

Despite the practically identical missions, FINRA and IIROC differ in some respects in their views regarding due diligence in public and private securities offerings. Section III. A. of this paper discusses FINRA's Notice 10-22 which relates to deficient due diligence practices of a broker-dealer in a fraudulent private placement. Section III. B. examines IIROC's due diligence guidance for underwriters of a public offering for an emerging-market company. While the two transactional contexts are not identical (one involves due diligence in private placements, the other in public offerings made by an emerging-markets issuer), comparing the two is nonetheless instructive because a number of the diligence topics considered are substantially identical.

A. FINRA Notice 10-22 Regarding Private Placements

On April 20, 2010, FINRA Chairman and CEO, Rick Ketchum, announced that FINRA uncovered "fraud and sales product abuses" through its nationwide initiative to investigate broker-dealers in private placements due to "an increased number of investor complaints" and SEC actions regarding private placements.[32] These findings raised particular concern because many small businesses rely on private placements as an important source of capital.[33] In fact, around this time, the SEC estimated that "companies intended to issue approximately $609 billion of securities" in private placements.[34] In light of its findings, FINRA also announced the

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[31] *Id.*
[32] Press Release, Nancy Condon & Brendan Intindola, FINRA Sets Regulatory Guidance for Investigating Private Placements (Apr. 20, 2010), http://www.finra.org/newsroom/2010/finra-sets-regulatory-guidance-investigating-private-placements.
[33] *Id.*
[34] *Id.*

publication of guidance Notice 10-22, which serves as a reminder to "broker-dealers of their obligation to conduct a reasonable investigation of the issuer and the securities they recommend in offerings" made under the SEC's Regulation D.[35]

1. Violations and Notice 10-22 Recommendations

As FINRA discovered a surge of abuses in private placements, FINRA began to bring enforcement actions against various firms, including Dallas-based registered broker-dealer, Provident Asset Management, LLC. (PAM) and Massachusetts-based registered broker-dealer, Investor Capital Corporation (ICC).[36] From 2006 to 2009, PAM marketed and sold a series of fraudulent private placements as the sole wholesale broker-dealer for an affiliated issuer, Provident Royalties, LLC. (Provident).[37] While Provident publicly endeavored to raise money to acquire interests in the U.S. oil and gas business, Provident primarily used capital from the offerings to pay dividends and returns of capital to the earlier unknowing investors, a classic Ponzi scheme.[38] More than fifty U.S. retail broker-dealers associated with the Provident offering raised approximately $485 million from 7,700 investors.[39] Of those broker-dealers, PAM entered into a sales agreement with ICC to sell three offerings.[40] ICC brokers completed ninety-four transactions valued at $5,090,000, including $386,075 in total gross commissions.[41] In November 2011, following several FINRA enforcement actions that cumulatively required ICC

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[35] *Id.*
[36] Press Release, Nancy Condon & Michelle Ong, FINRA Sanctions Eight Firms and 10 Individuals for Selling Interests in Troubled Private Placements, Including Medical Capital, Provident Royalties and DBSI, Without Conducting a Reasonable Investigation (Nov. 29, 2011), http://www.finra.org/newsroom/2011/finra-sanctions-eight-firms-and-10-individuals-selling-interests-troubled-private.
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] Financial Industry Regulatory Authority Letter of Acceptance, Waiver and Consent No. 2009018609501 (Nov. 28, 2011) at 5 [hereinafter FINRA Letter].
[41] *Id.*

to pay $400,000 in restitution, ICC submitted a Letter of Acceptance, Waiver and Consent (Letter) to settle alleged rule violations and prevent FINRA from bringing future actions based upon the known factual violations.[42] Interestingly, FINRA's guidance issued under Notice 10-22 tracks ICC's FINRA due diligence violations listed in the Letter issue by issue.[43]

a. Due Diligence Documentation

In the Letter, FINRA declared ICC's due diligence documentation insufficient to support its contention that it conducted appropriate due diligence.[44] Among other things, FINRA noted ICC failed to adopt any "written procedures *or* formal system for conducting due diligence."[45] For example, instead of implementing a review chain consisting of several individuals, ICC "relied on an informal process that placed responsibility" to review and approve of new investment products upon one person (Product Approver) and possessed no system to review the diligence efforts of the Product Approver nor required firm management approval of the product selection.[46] Rather, upon notice of the product, the Product Approver would request from the issuer the private placement memoranda, marketing materials, and business plan for review.[47] If satisfied, then the Product Approver would finish his due diligence efforts by acquiring and reviewing a third-party due diligence report, which the product sponsor generally pays for.[48] Even though ICC claimed to have followed an informal process, it was unable to prove that it

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[42] *Id.*
[43] *See id.* at 3–8; *see also* Regulatory Notice: 10-22, FINRA (Apr. 2010), *available at* https://www.finra.org/sites/default/files/NoticeDocument/p121304.pdf.
[44] FINRA Letter, *supra* note 39, at 3.
[45] *Id.* (emphasis added).
[46] *Id.* at 6.
[47] *Id.*
[48] *Id.*

conducted its own financial analysis or due diligence review independent of the third-party reports.[49]

In paragraph E. of Notice 10-22, FINRA advises that "retain[ing] records documenting both the process and results of its investigation" can enhance a party's ability to prove that it conducted appropriate due diligence.[50] Examples of such records may include: meetings held to fulfill an investigation (such as, with the issuer or other related party); people in attendance at the meetings; diligence tasks to perform and subsequently performed; documents reviewed and results; and dates of occurred events.[51] FINRA also includes several examples of customary investigation practices, none of which ICC completed.[52] FINRA suggests that broker-dealers thoroughly investigate the issuer, its management, business prospects, and assets, considering among other things: issuer's governing documents; financial statements; auditor's letter; the viability of affiliates; internal controls; issuer's relationships with customers and suppliers; various agreements; past securities offerings; pending litigation; regulatory issues; executive compensation; business plan or model; financial models to confirm targeted returns; industry in which issuer conducts business; regulatory restrictions; onsite visits; geographical or land reports; and expert opinions.[53]

b. Supervision and Reliance

In addition to the shortcomings in ICC's due diligence, the Letter also stated that ICC neglected to appropriately supervise the Product Approver.[54] Among other things, ICC instructed the Product Approver to "only execute selling agreements relating to investment

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[49] *Id.*
[50] Regulatory Notice: 10-22, *supra* note 42, at 7.
[51] *Id.*
[52] *Id.*; *see also* FINRA Letter, *supra* note 39.
[53] Regulatory Notice: 10-22, *supra* note 42, at 8–9.
[54] *See* FINRA Letter, *supra* note 39, at 7.

offerings that he has proved per his due diligence," with the understanding that the Product Approver limited his due diligence efforts to a review of the "third-party due diligence reports funded by the issuers."[55]

In Notice 10-22, FINRA reiterated past guidance promulgated in NASD Rule 3010, advising a firm engaging in private placements to adopt supervisory procedures so the firm makes appropriate inquiries to ensure suitability of a recommended transaction or investment for a customer.[56] Additional purposes include firms properly identifying their customers as accredited investors pursuant to Regulation D and firms avoiding a violation of the "antifraud provisions of the federal securities laws or FINRA rules."[57] If ICC hired outside legal counsel to assist with due diligence, then under Notice 10-22, ICC could rely on counsel or other experts as long as ICC thoroughly reviews the expert's reports to identify any omissions or red flags and then independently addresses those issues.[58] Similarly, if ICC participated in an underwriting syndicate and relied on syndicate managers, FINRA advises that ICC should then undertake their own investigation of the syndicate manager to ensure that the broker-dealer "retains its own responsibilities, to the extent" the syndicate manager's efforts do not address them.[59]

c. Treatment of Red Flags

The Letter also noted that ICC approved the offerings for sale despite several "red flags" contained in the third-party due diligence reports.[60] For example, the third-party reports represented that Provident depleted existing credit lines with no plan to acquire additional credit; therefore, "operating funds would need to come from increased production revenue and/or the

[55] *Id.*
[56] *See* Regulatory Notice: 10-22, *supra* note 42, at 7; *see also* FINRA Rule 2111.
[57] Regulatory Notice: 10-22, *supra* note 42, at 7.
[58] *Id.* at 6.
[59] *Id.*
[60] *See* FINRA Letter, *supra* note 39, at 3.

divestiture of assets."[61] Additionally, the reports inconsistently projected that Provident would deviate from their business plan and acquire mineral interests by directing capital towards drilling operations, an area in which they conceded to have limited experience.[62] The reports expressed clear concerns themselves, including, unease regarding transparency of inter-company transactions—one Provident affiliate making loans or advancing money to another—and a lack of audited financials.[63] The report further stated, that "'it is difficult to discern how the asset and liability positions of these entities stand at this time'" and that they would "'like to see audited financial statements, or alternatively, a report from an independent accounting firm validating financial information reported by Provident.'"[64] Despite the red flags and knowledge of the unsubstantiated financials, ICC failed to run to ground the issues and scrutinize the offerings' promised high rates of return to rule out a Ponzi scheme.[65]

In consequence, FINRA included guidance in Notice 10-22 explaining the best practices for broker-dealers if they encounter "red flags."[66] Here, FINRA describes "red flags" as any information a broker-dealer encounters that would "alert a prudent person to conduct further inquiry."[67] Notice 10-22 specifically states that to best demonstrate reasonable due diligence upon the discovery of a red flag, the broker-dealer must look beyond the representations in the due diligence report of issuer's counsel and those made by issuer's management.[68] Even if the private placement memoranda provided to ICC included audited financials ("expertised" material which typically may be relied upon without further investigation), Notice 10-22 cautions that

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[61] *Id.* at 8.
[62] *Id.*
[63] *Id.*
[64] *Id.* at 8–9.
[65] *See id.* at 9.
[66] *See* Regulatory Notice: 10-22, *supra* note 42, at 6.
[67] *Id.*
[68] *Id.*

even with respect to expertised material, broker-dealers must conduct "a further, independent investigation of the financial condition of the issuer under the circumstances."[69] Additionally, FINRA found that if ICC had requested the financials or any other information needed in the investigation and the issuer withholds that information, then that by itself could also establish a red flag.[70]

d. Other Specific Issues Related to Broker-Dealer Responsibilities

Aside from the issues that align with ICC's violations, Notice 10-22 also stresses two additional factors a broker-dealer must take into consideration when conducting due diligence.[71] First, whether or not the broker-dealer is an affiliate of the issuer and second, if the broker-dealer prepares the private placement memorandum.[72] Ultimately, FINRA advises that the broker-dealer should ensure that their independence remains intact despite the relationship with the issuer and that FINRA holds the broker-dealer involved in preparing the private placements documents to a higher standard and subjects them to clear rule violations if the documents contain material misstatements and omissions.[73]

B. IIROC's Guidance Respecting Underwriting Due Diligence in Public Offerings

In 2011, Sino-Forest Corporation (Sino-Forest), one of the largest forestry companies publicly traded on the Toronto Stock Exchange, collapsed amid multiple allegations of fraud.[74] Sino-Forest engaged in the purchase and sale of standing timber in Mainland China and from 2003 to 2010, Sino-Forest publicly issued equity and debt securities to investors raising $3

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[69] *Id.*
[70] *Id.*
[71] *See* Regulatory Notice: 10-22, *supra* note 42, at 5.
[72] *Id.*
[73] *Id.*
[74] Farah Master, *Sino-Forest Says Independent Panel Finds No Evidence of Fraud*, FIN. POST (Nov. 15, 2011), http://business.financialpost.com/investing/sino-forest-says-independent-panel-finds-no-evidence-of-fraud.

billion in capital.[75] Three months before the allegations of fraud surfaced, Sino-Forest's market capitalization exceeded $6 billion and it claimed to have a forestry portfolio of more than 780,000 hectares in China.[76] Sino-Forest's share price plummeted in June of 2011, losing nearly two-thirds of its value[77] when the private analyst firm, Muddy Waters, made allegations of fraud against Sino-Forest, calling the company a "'multibillion-dollar ponzi scheme' that was "accompanied by substantial theft.'"[78] Five days later, the OSC commenced an investigation, levying charges of fraud and overstating assets in May of 2012.[79] In the interim period, Sino-Forest conducted an independent investigation and the findings materialized in a report that raised concerns "about the challenges of verifying timberland holdings in China."[80] Besides the OSC charges, investors brought a class-action lawsuit against Sino-Forest, their auditors, E&Y, and underwriters, Credit Suisse Canada and Merrill Lynch Canada, to name a few, which the

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[75] In the Matter of the Securities Act, R.S.O. 1990, c S.5, as Amended and In the Matter of Sino-Forest Corporation, Allen Chan, Albert Ip, Alfred C.T. Hung, George Ho, Simon Yeung and David Horsely, Statement of Allegations, Ont. Sec. Comm'n, May 22, 2012, http://www.osc.gov.on.ca/documents/en/Proceedings-SOA/soa_20120522_sino-forest.pdf [hereinafter Statement of Allegations].

[76] Andy Hoffman & Mark Mackinnon, *The Roots of the Sino-Forest Mystery*, THE GLOBE AND MAIL (Sept. 3, 2011), http://www.theglobeandmail.com/globe-investor/the-roots-of-the-sino-forest-mystery/article594111/?page=all.

[77] The Canadian Press, *Timeline of the OSC Sino-Forest Case*, SOUTHWESTERNONTARIO.CA (Apr. 26, 2016), https://www.southwesternontario.ca/news-story/6515466-timeline-of-the-osc-sino-forest-case/.

[78] Ian Austen, *Canada Halts Trading in Sino-Forest of China*, N.Y. TIMES (Aug. 26, 2011), https://dealbook.nytimes.com/2011/08/26/canadian-regulators-order-sino-forest-executives-to-resign/?_r=0.

[79] Vanessa Lu, *OSC Files Formal Fraud Charges Against Sino-Forest Executive*, THE STAR (May 22, 2012), https://www.thestar.com/business/2012/05/22/osc_files_formal_fraud_charges_against_sinoforest_executives.html.

[80] Hoffman & Mackinnon, *supra* note 75; *see also Sino-Forest Releases Final Report of the Independent Committee*, CNW (Jan. 31, 2012), http://www.newswire.ca/news-releases/sino-forest-releases-final-report-of-the-independent-committee-509527541.html.

underwriters settled for $32.5 million.[81] The investors accused the underwriters of performing deficient due diligence in relation to their underwritings of the June 2007, June 2009, and December 2009 offerings.[82]

1. OSC Findings, Class-Action Allegations, and IIROC Due Diligence Guidance

In March of 2012, Chair of the OSC, Howard Wetston, announced that an investigation into twenty-four foreign emerging-market firms listed in Canada "unearthed concerns" including "a number of areas where issuers and gatekeepers need to improve in order to meet their obligations."[83] For purposes of the review, OSC characterized emerging-market issuers as firms "whose mind and management are largely outside of Canada and whose principal active operations are outside of Canada, in regions such as Asia, Africa, South America and Eastern Europe."[84] The examined companies operated in various industries similar to Sino-Forest, including, mining, forestry, oil and gas, technology and clean technology, and diversified industries.[85] The OSC published their findings in the OSC Staff Notice 51-719: Emerging Markets Issuer Review (OSC Report), which mentioned that "the level of rigor and independent-mindedness applied by boards, auditors and underwriters in doing their important jobs—management oversight, audit, due diligence on offerings—should have been more thorough."[86]

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[81] Jeff Gray, *Sino-Forest Underwriters Settle for $32.5-Million*, THE GLOBE AND MAIL (Jan. 26, 2015), http://www.theglobeandmail.com/report-on-business/industry-news/the-law-page/sino-forest-underwriters-settle-for-325-million/article22638013/.
[82] In the Matter of the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as amended and In the Matter of a Plan of Compromise and Arrangement of Sino-Forest Corporation (2013), CV-11-431153-00CP (Can. Ont. Sup. Ct. J.) [hereinafter Plan of Compromise].
[83] Barbara Shecter, *OSC Probe Reveals 'Concerns' about Foreign Firms Listed in Canada*, FIN. POST (Mar. 20, 2012).
[84] OSC Staff Notice 51-719, *Emerging Markets Issuer Review* (Mar. 20, 2012), http://www.osc.gov.on.ca/documents/en/Securities-Category5/sn_20120320_51-719_emerging-markets.pdf.
[85] *Id.*
[86] *Id.*

Although the Sino-Forest scandal prompted the OSC to begin its investigation, the final OSC report discusses the findings and issues in emerging-market offerings generally, "rather than citing specific instances or examples."[87] In direct response to these findings, IIROC published Guidance Note: Guidance Respecting Underwriting Due Diligence (IIROC Guidance) to promote consistency and enhanced standards among IIROC dealer members in the underwriting due diligence process for emerging-market issuers.[88] Like FINRA's Notice 10-22, IIROC intends their guidance to suggest helpful practices, rather than "create new obligations or modify existing ones."[89] Understandably, the due diligence deficiencies listed in the OSC report, as well as a few allegations provided in the lawsuit against the underwriters, align with IIROC's issued guidance.

a. Variations in Due Diligence Practices

The OSC report noted that underwriters subject to the review "adopted a varied array of policies, procedures and practices."[90] For example, while some underwriters implemented checklists and formal procedures, others possessed "limited processes" that excluded the maintenance of "internal committee memoranda, due diligence committee minutes and due diligence checklists."[91] The OSC discovered other differences between the due diligence efforts, including, level and depth of review, documentation of issues, and follow-up on issues.[92] The

[87] *Id.*; *see also* Andy Hoffman & Janet McFarland, *OSC to Probe Foreign Issuers*, THE GLOBE AND MAIL (July 5, 2011), http://www.theglobeandmail.com/report-on-business/osc-to-probe-foreign-issuers/article599144/.
[88] IIROC Notice: Proposed Guidance Respecting Underwriting Due Diligence, 2 (Mar. 6, 2014), http://www.iiroc.ca/Documents/2014/15fc9926-64f3-421c-87f9-23b997bef292_en.pdf.
[89] IIROC Notice: Guidance Respecting Underwriting Due Diligence, 4 (Dec. 18, 2014), http://www.iiroc.ca/Documents/2014/279cda7b-5ec5-4cb0-8bc9-a921b7af54a0_en.pdf [hereinafter IIROC Notice]; *see also* Regulatory Notice: 10-22, *supra* note 42.
[90] OSC Staff Notice 51-719, *supra* note 83, at 15.
[91] *Id.*
[92] *Id.*

OSC report also mentioned instances where the underwriters failed to raise some skepticism in response to particular issuer's answers and abandoned attempts to conduct necessary on-site visits of the issuer.[93] The report suggests that the lack of "explicit, standard requirements for the conduct of due diligence by [Canadian] underwriters" has caused the variations in underwriter due diligence.[94]

Section 2.1 of the IIROC Guidance provides an overarching policy that IIROC expects "each dealer member…to have written policies and procedures in place relating to all aspects of the underwriting process" in order to effectively oversee those activities.[95] Additionally, the process adopted should include reasonable steps the underwriter should take to verify information provided in the offering documents and the information relied on to craft those documents to ensure the prospectus contains proper disclosures.[96] IIROC notes that one reasonable due diligence investigation or plan may differ from another given different circumstances and contexts, which may require "effective due diligence [to] go beyond prescriptive checklists."[97] But the differences should exist because of appropriate responses given the context, not because of overall deficient due diligence efforts as seen in the OSC report.[98]

b. Level of Professional Skepticism and Rigor; Failure to Address Red Flags

The OSC report brought forth the discovery of inadequate professional skepticism and rigor in the due diligence process.[99] Specifically, OSC reported "several instances" where

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[93] *Id.*
[94] *Id.*
[95] IIROC Notice, *supra* note 88, at 4.
[96] *Id.* at 4–5.
[97] *Id.* at 5.
[98] *See id.*; *see also* OSC Staff Notice 51-719, *supra* note 83.
[99] OSC Staff Notice 51-719, *supra* note 83, at 13.

underwriters encountered “red flags” and failed to further investigate.[100] Such red flags included “significant growth or a change in the issuer’s business in the recent past, financial metrics that were superior to an industry average, unusual year-over-year growth results and a high degree of reliance on government relationships or the founder/CEO.”[101] Similarly, in the class-action lawsuit against the Sino-Forest underwriters, the investors accused the underwriters of ignoring “red flags” which indicated “the existence of fraudulent transactions.”[102] These red flags included “the lack of transparency into Sino-Forest’s complex corporate structure and opaque business practices,” the existence of “[c]ircular cash flows and unusual offsetting arrangements,” the absent “documentation from Sino-Forest’s…timber purchase contracts,” and “the simple fact that the Company did not have sufficient proof of ownership of ‘a majority of its standing timber assets….’”[103]

Unlike FINRA Notice 10-22, IIROC’s guidance does not address the treatment of red flags by its self.[104] Instead, IIROC mentions red flags in the discussion of other suggested due diligence practices.[105] For example, IIROC recommends that “dealer members should perform business due diligence to ensure that the dealer member understands the business of the issuer” and possesses the ability to recognize red flags.[106] According to IIROC, business due diligence includes an extremely thorough investigation of the issuer’s business, accounting practices and records, business plans, financials, comfort letters, annual reports, litigation or regulatory

[100] *Id.* at 15–16.
[101] *Id.* at 15.
[102] Plan of Compromise, *supra* note 81, at 40.
[103] *Id.*
[104] *See* IIROC Notice, *supra* note 88; *see also* Regulatory Notice: 10-22, *supra* note 42.
[105] *See* IIROC Notice *supra* note 88, at 7, 9, & 12.
[106] *See id.* at 9.

matters, and "external information relating to the issuer and its business."[107] In particular, IIROC notes additional business due diligence considerations for underwriters working with foreign issuers and emerging market issuers by highlighting the importance of understanding the issuer's political, cultural and legal environment and that the underwriter "should be prepared to deal with differences in time zones, language and/or cultural barriers which may affect the quality of due diligence…."[108] IIROC describes red flags as inconsistencies, which can be oral or written, that raise significant doubt, concern, or reservation "about an issuer's public disclosure, financial statements, financial condition, accounting practices, management integrity, and internal control or compliance with laws."[109] But like FINRA Notice 10-22, IIROC suggests underwriters document the red flags and have procedures to follow in the event an underwriter encounters a red flag.[110] The procedures could include involving independent experts, noting the red flags in risk factors, or undertaking remedial action when appropriate.[111]

In Section 2.2.2, IIROC also touches on red flags in the context of due diligence "Q&A sessions," where underwriters meet with relevant parties throughout the due diligence process to "ask detailed questions" in order to confirm the validity of the prospectus.[112] IIROC recommends that underwriters use these meetings as an opportunity to inquire about any discovered red flags.[113] Similar to FINRA Notice 10-22, red flags may include an issuer's insufficient or evasive answers and the underwriter should plan to further investigate.[114]

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107 *Id.* at 7–8.
108 *Id.* at 10.
109 *Id.* at 9.
110 *Id.*; *see also* Regulatory Notice: 10-22, *supra* note 42, at 6.
111 IIROC Notice, *supra* note 88, at 9.
112 *Id.* at 6–7.
113 *Id.* at 7.
114 *Id.*; *see also* Regulatory Notice: 10-22, *supra* note 42, at 6.

c. Approval Process for Offerings

Due to an overall lack of documentation of due diligence practices among underwriters, OSC reported that they could not identify whether the underwriters followed their own approval processes.[115] The approval process relates to both the listing approval of the underwriter that acts as a sponsor for the issuer in the listing process and the due diligence supervisory and compliance framework.[116]

Section 2.3 of IIROC's guidance addresses the latter, stating that IIROC expects underwriters to implement a "comprehensive and effective supervisory and compliance framework….to ensure that the business unit itself takes responsibility for the oversight of the due diligence activity on an ongoing basis."[117] Specifically, IIROC wants underwriters to appoint an involved "senior investment banking professional" or committee to bear responsibility for the due diligence effort."[118] Therefore, if underwriters uncover red flags or "[a]ny difficult or unusual disclosure issues" then they should bring the issues before the senior supervisor or committee.[119] Compared to FINRA Notice 10-22, IIROC sets out more specific guidance that focuses on who should hold responsibility for the due diligence rather than looking primarily at what they should accomplish.[120] While IIROC says underwriters may rely on the due diligence of legal counsel or experts if "supplemented by appropriate checks and balances," IIROC primarily limits the discussion to reliance on "expertised portions" of offering materials.[121] Nonetheless, IIROC suggests that underwriters need to consider "the expertise,

[115] OSC Staff Notice 51-719, *supra* note 83, at 16.
[116] *Id.* at 14, 16; *see also* IIROC Notice, *supra* note 88, at 14–15.
[117] IIROC Notice, *supra* note 88, at 14.
[118] *Id.* at 14, 15.
[119] *Id.*
[120] *See id.*; *see also* Regulatory Notice: 10-22, *supra* note 42, at 7.
[121] IIROC Notice, *supra* note 88, at 11.

experience and reputations of each such expert" to determine the correct level of reliance.[122] In regard specifically to legal counsel, liability for misrepresentations in the prospectus follows the underwriters although legal counsel should have discovered the issues as part of their due diligence.[123] Underwriters need to know the scope of legal counsel's due diligence and discuss any significant issues with counsel as they arise, keeping themselves informed as to the progress of the due diligence.[124] Like FINRA, underwriters under IIROC need to fill in the due diligence gaps when necessary.[125] Also, IIROC advises that in the circumstances where the underwriter is a part of a syndicate, the underwriters need "to be a position to satisfy itself that the lead underwriter performed the kind of due diligence investigation that the syndicate member would have performed on its own behalf as lead underwriter."[126]

d. Understanding of Emerging Market Jurisdictions

The OSC report reflected the existence of risks associated with emerging-market issuers, primarily in the issuer's operations.[127] Despite these risks, the OSC report noted that underwriters neglected to document any discussion regarding concerns with emerging-market issuers.[128] In the limited instances where an underwriter's due diligence procedure suggested additional steps to take or factors to consider "in light of [such] additional risks," the OSC recognized that these underwriters ignored those factors and steps in later due diligence.[129] In addition, the lawsuit against the Sino-Forest underwriters stated that given the fact Sino-Forest

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[122] *Id.* at 12.
[123] *Id.* at 10.
[124] *Id.* at 10–11.
[125] *See id.*; *see also* Regulatory Notice: 10-22, *supra* note 42, at 6.
[126] IIROC Notice, *supra* note 88, at 11.
[127] OSC Staff Notice 51-719, *supra* note 83, at 16.
[128] *Id.*
[129] *Id.*

operated in an emerging economy, the underwriters "ought to have exercised heightened vigilance and caution in the course of discharging their duties to investors."[130]

To appropriately address due diligence responsibilities in the face of an emerging-market issuer, IIROC suggests that underwriters develop a due diligence plan in light of that particular context.[131] An understanding of the context helps determine the scope and potential issues of the due diligence review.[132] For example, IIROC explains that certain particular circumstances may require more due diligence than others, like when an issuer becomes a reporting issuer through a reverse take-over or when an issuer is an emerging-market issuer, both of which applied to Sino-Forest.[133] But IIROC notes that on occasions when the issuer and underwriter have an ongoing relationship and have worked together extensively in the past, then a more limited due diligence plan may suffice.[134] Additionally, IIROC advises that underwriters need to take into consideration any "experts who reside in foreign (and especially emerging) markets" when determining the "experts' credentials, knowledge and experience…and assess whether they are similar to what would be expected of a Canadian expert in the same field."[135] Even if the auditor does not reside in a foreign market, given the circumstances of the offering, the underwriter still needs to review the financials and engage with the auditors to satisfy their due diligence responsibilities.[136] The context of the public emerging-marking offering highlights one of the main and largest differences between the underwriter due diligence guidance of FINRA and IIROC. Specifically, the IIROC Guidance note does not apply to underwriters participating in

[130] Plan of Compromise, *supra* note 81, at 19.
[131] IIROC Notice, *supra* 88, at 5.
[132] *Id.*
[133] *Id.* at 6; *see also* Hoffman & Mackinnon, *supra* note 75.
[134] IIROC Notice, *supra* note 88, at 5–6.
[135] *Id*. at 6.
[136] *Id.*

private placements and FINRA applies to underwriters only in private placements and does not consider the emerging-market context.[137]

e. Due Diligence Documentation

As noted in passing above, the OSC report recognized "that the amount and degree of due diligence documentation varied widely."[138] Even underwriters with adopted due diligence processes neglected to document as required under their own protocols.[139] The OSC noted the underwriters documented lists of questions underwriters asked issuers on due diligence calls, however, the documentation was often incomplete as "in some cases the names of the participants on the calls were not provided and written transcripts were not provided."[140]

IIROC's guidance advises underwriters to "document the due diligence process" in order to show the underwriter complied with its policies and procedures, as well as "IIROC requirements and applicable securities laws."[141]

IV. CONCLUSION

Despite the considerable similarities between FINRA and IIROC, including formation, structure, and rule and guidance adoption and enforcement, each organization's response to prevalent issues plaguing their respective securities markets led to a divergence in U.S. and Canadian underwriter due diligence guidance. The primary distinction between the issued guidance arises from FINRA and IIROC's focus on different transactional contexts. While FINRA addressed sales product abuses in private placements in the United States, IIROC concentrated on fraudulent practices of emerging-market issuers participating in public offerings

[137] *See id.* at 2; *see also* Regulatory Notice: 10-22, *supra* note 42.
[138] OSC Staff Notice 51-719, *supra* note 83, at 16.
[139] *Id.*
[140] *Id.*
[141] IIROC Notice, *supra* note 88, at 13.

in Canada. Each organization expressly limited the application of their guidance to their specified contexts. In fact, FINRA issued an investor alert regarding risks of Chinese stocks and reverse merger companies, but did not indicate plans to issue tailored guidance for this situation.[142] Although the transactional contexts differ, the due diligence topics covered largely mirror one another, which include documentation of due diligence, the treatment of red flags, and the adoption of supervisory/approval processes. The parallels between FINRA and IIROC's due diligence guidance highlight the importance and universality of particular due diligence practices, regardless of context. Whether or not FINRA and IIROC adopt one another's underwriter due diligence guidance, the overlap of the guidance subject matter underscores the critical due diligence practices that underwriters should maintain in different contexts, even those not explicitly covered by guidance. Therefore, even though FINRA and IIROC's underwriter due diligence guidance diverged in terms of context, the substantially identical topics may allow underwriters to apply each set of guidance to different contexts to achieve sufficient due diligence practices.

[142] Investor Alert, Fin. Indus. Regulatory Auth., "China" Stocks—Look Beyond the Name Before You Invest (Aug. 1, 2012), available at http://www.finra.org/investors/alerts/china-stocks.