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ONLINE ONBOARDING:
CORPORATE GOVERNANCE TRAINING IN THE COVID-19 ERA

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INTRODUCTION

Director onboarding is the process by which an organization facilitates a new director stepping into the role. It is a means by which an incoming director becomes familiar with their new surroundings, the organization, their fellow board members, and other organization leaders. As such, it is an inherently personal experience that has always necessitated face-to-face interaction, whether it takes place in the boardroom and adjacent offices, company retreats, or happy hours. Until 2020, tried-and-true onboarding methods functioned effectively, and there was no reason to reimagine the onboarding process as a potentially virtual procedure. Unfortunately, the novel coronavirus brought about unprecedented and confusing circumstances, and organizations worldwide were forced to shift their entire business platforms online with little or no time to prepare.

In the COVID-19 era, it is increasingly apparent that traditional business models are simply impossible to maintain, and proven methods of director onboarding are no exception. If boards wish to integrate new directors and perform as effectively as they had before the pandemic, they will need to translate their onboarding procedures to an online format. To do so, organizations must first assess their onboarding procedures to identify their strengths and weaknesses. To this end, we first must ask: what are the key components of an effective onboarding program in ideal circumstances?

After the key components of director onboarding before COVID-19 are identified, we may attempt to translate those components into their online analogs. As we will see, some components of effective onboarding programs are more easily adaptive to an online format than others. Moreover, organizations may find that methods used to onboard new directors remotely are, in fact, less time-consuming and more efficient than traditional, in-person practices. Moving director onboarding to an online format will include utilizing traditionally pedagogical methods paired with online data sharing applications, as well as using services such as Zoom to stay connected through informal, community-building events.

The pandemic has thrown traditional business practice into disarray. Onboarding organizers should see this as an opportunity to rethink and reshape their onboarding practices. Even after business returns to a state of normalcy, onboarding organizers can employ online techniques to be more efficient and better equipped to handle unforeseen circumstances. Shifting the perspective from a state of chaos to a chance to refine onboarding practices benefits both current and future directors and results in a more effective board.

I. THE ESSENTIALS OF ONBOARDING

Before determining how to best move onboarding to an online format, the orgnization must identify key components and best practices of its pre-pandemic director onboarding. In this section, we identify and outline those practices which should be implemented in any onboarding program.

Director onboarding typically begins with the organization delivering to the new director as much tangible information as possible, as quickly as possible, including details on finances, risks, and business strategies. Informal information, such as details on intangible group dynamics within the organization itself, must also be conveyed.

The delivery of informal information is illustrative of the socialization process, which is equally important to the efficacy of the board as is familiarizing new directors with business data and strategy. Socialization can be achieved through a number of onboarding techniques, including creating a mentor-mentee system in which a fellow director acts as a mentor for the incoming director in the first weeks of their employment. Ethical and responsible behavior from the executive team and onboarding planners will also introduce the new director to board culture, accelerating their understanding of the organization and making their transition into their role as smooth as possible.

The third key component of director onboarding is motivation of new directors. This is perhaps more important now than ever as business moves online and directors work from home. Motivating incoming directors means maintaining a focus on the organization's mission by connecting the mission to the day-to-day goals of the director. Ultimately, the onboarding process should be designed to motivate the new director to "own" their work, internalize the organization's mission, and move toward greater autonomy.

A. Information

At the highest level, directors transform information into value. Therefore, someone transitioning into a director role must learn to access information in order to create value.[1] At the outset, the director onboarding process should provide enough information about the company to enable a new director to add value as quickly as possible.[2] The starting point for all onboarding programs should be focused on conveying as much company information to the new director as possible. Information on how the company operates and their role in the organizational structure equips an incoming director with the tools necessary to become a valuable member of the board in the shortest amount of time possible. Without the necessary information, a new director may be disoriented in their first crucial weeks or months with the board, severely diminishing their efficacy. In this section, we cover the crucial information that must be conveyed at the outset of the onboarding process, and methods for conveying the information—the "data dump," personally tailored information, and informal information.

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[1] Mary Driscoll & Michael D. Watkins, *Onboarding a New Leader—Remotely*, HARVARD BUSINESS REVIEW (May 18, 2020), https://hbr.org/2020/05/onboarding-a-new-leader-remotely.

[2] *New director onboarding*, KPMG (2016), https://boardleadership.kpmg.us/content/dam/boardleadership/en/pdf/2016/new-director-onboarding-strategy.pdf.

i. Data Dump

A data or document "dump" is an effective way to ensure that a new director possesses enough information to adequately familiarize themselves with the company's tangible characteristics.[3] An initial data dump should include, among other items, any organizational charts, financial reports, company charters and bylaws, codes of ethics and conduct, strategic plans and project documentation, and other key corporate policies.[4] This is usually accomplished in the form of a comprehensive package of key documents assembled by an organization's secretary or a committee of the board for the incoming director's review. In a recent survey of over 200 senior interim executives, 95% stated that access to such information made them more effective in their first few weeks.[5] Furthermore, access to information broadens the incoming director's view of the organization and their role in the organizational structure.[6] Minutes for the past few board meetings and all committee meetings, regardless of whether the new director is assigned to a particular committee or committees, will give the director a more comprehensive view of the company as they enter their new executive position.[7]

ii. Personally Tailored Information

"The best [onboarding] programs are formalized and tailored to take into account the unique backgrounds, experiences, and expected committee responsibilities of each new director."[8] Onboarding organizers must provide new directors with information on their particular role in the organization, such as how to administer and manage company policies and programs.[9] In this area, the challenge for any board is to tailor the program to the specific needs of the new director, as new directors have varying familiarity with the role of the director.[10]

Onboarding organizers should be mindful of the varying experience levels of incoming directors. For this reason, onboarding programs may be separated into two tracts to compensate for a new director's prior experience, or lack thereof. A program incorporating general training on the role of the board and its directors may be necessary for first-time directors without previous board experience.[11] The same program may not be necessary, however, for a more familiar new hire. Some experts suggest that onboarding should be tailored for each individual board member. This may be the best way to ensure that the board members are aware of their duties, but may not be feasible for small organizations. At a minimum, most organizations can

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[3] Driscoll & Watkins, .*supra* note 3.
[4] Jeff Levinson, Scott Hodgdon & N. Peter Rasmussen, *All Aboard! Facing the Challenges of Recruiting and Onboarding Directors*, ACC DOCKET (October 2018), https://www.accdigitaldocket.com/accdocket/october_2018/MobilePagedArticle.action?articleId=1427564#articleId1427564.
[5] *Interim Candidate Questionnaire*, SAVANNAH GROUP, https://savannahgroup.typeform.com/report/Q9PFQz/uYUvkmMrREPwyNhe (last visited Oct. 26, 2020).
[6] Driscoll & Watkins, *supra* note 3.
[7] *Supra* note 4.
[8] *New Director Onboarding: 5 Recommendations for Enhancing Your Program*, SPENCERSTUART, at 3 (2018), https://www.spencerstuart.com/-/media/2018/october/new_director_onboarding_final.pdf.
[9] *Managing the Employee Onboarding and Assimilation Process*, SHRM, https://shrm.org/resourcesandtools/tools-and-samples/toolkits/pages/onboardingandassimilationprocess.aspx?_ga=2.221433439.614587024.1602300895-356364448.1602300895 (last visited Oct. 24, 2020).
[10] Levinson et al., *supra* note 6.
[11] *Supra* note 10, at 3.

provide the bare necessities for both experienced and inexperienced board members. Legal, fundraising, ethical, and advocacy responsibilities of the board, as well as any specific matters over which the particular new director is responsible, should be a main focus of onboarding programs.[12] Additionally, any special roles and responsibilities associated with being a representative of a particular stakeholder or constituency must be communicated to the incoming director by senior board members, the executive team, or a combination of the two.[13]

In order to personally tailor the onboarding process to a new hire, onboarding organizers already must be familiar with the new hire. To obtain the necessary information, onboarding organizers should assess the new hire's experience in the director capacity, their familiarity with the industry, and any past experience with the company.[14] This can be done with relative ease, and will most likely occur naturally through the interview process and following meetings with the executive team. Once onboarding organizers understand the incoming director's level of experience and familiarity, they will be better equipped to deliver any nuanced or personal information the director may need, such as the sensitive information covered in the following section.

iii. Informal Information

Not everything can be conveyed in documents and binders. Some information—especially information about key people and relationships—needs to be communicated in more conversational or subtle ways. A priority for onboarding organizers should be to brief new directors on information regarding potential company influencers, such as employee organizations, shareholder activists, institutional investors, and issue-driven investors.[15] Understanding the interests of potential influencers and the company's past interactions with particular organizations will help a new director contextualize the relationship between the company and outside sources in the present, as well as identify potential issues in the foreseeable future.

Informal information may be conveyed casually over happy hour drinks, a cup of coffee, or a regular lunch meeting. The web of relationships and group dynamics inherent in an organization can be hard to navigate for any newcomer, and understanding this information is arguably as critical to the smooth functioning and effectiveness of the organization as the documents and binders provided in the initial data dump. This process of enculturation in the workplace brings about the second component of director onboarding—socialization.

B. Socialization

Organizational socialization is the process of quickly familiarizing new employees with an organization's practices, culture, and values in order to help them become effective members of

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[12] *Board Roles and Responsibilities*, NATIONAL COUNCIL OF NONPROFITS, https://www.councilofnonprofits.org/tools-resources/board-roles-and-responsibilities (last visited Nov. 16, 2020).

[13] *See generally* Humphry Hung, *Directors' Roles in Corporate Social Responsibility: A Stakeholder Perspective*, 103 J. Bus. Ethics 385, (Oct. 2011).

[14] *Supra* note 10, at 3.

[15] David A. Katz & Laura McIntosh, *Director Onboarding and the Foundations of Respect*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 29, 2019), https://corpgov.law.harvard.edu/2019/03/29/director-onboarding-and-the-foundations-of-respect/.

the professional community.[16] Socialization is integral to creating and maintaining a productive company culture. Even in elaborate onboarding programs, organizations need to be cognizant of the power of informal interactions between new employees and their peers and superior officers.[17] Here, we discuss three key aspects of socialization that any organization should be attentive of and should implement in their onboarding program—setting the tone, mentor-mentee systems, and meetings.

i. Setting the Tone

Setting the tone in the workplace means to establish a particular atmosphere and character for the organizational culture.[18] When starting a new job, newcomers must not only learn the tasks and expectations of their work, but must also decipher the unwritten rules and norms of the company's culture to achieve membership and a sense of belonging among their peers.[19] Incoming directors are no exception. Boards must keep in mind that document sharing and meetings are not only used to provide new directors with information. Every initial step in the onboarding process sets the tone of the general ethical atmosphere of the board and company leadership at the outset of the onboarding program. The board should convene to determine whether the materials they provide a new director are conveying what is important to the company.[20] Effective onboarding—that which sets the right tone in the boardroom—will produce board members who merit immediate respect and attention of their new colleagues.[21]

Onboarding an incoming director necessitates that the tone be set "from the top." Onboarding organizers, the executive team, and senior board members can all contribute to setting the tone at the top through several methods, but consistency and integrity should be central to any onboarding program and organization. Unethical and dishonest behavior among company leaders is a quick way to undermine credibility, and it is no way to introduce a new director to company culture.[22] Instead, the executive team and board must clearly communicate their principles, exude the company's ethics and values, have a written code of conduct, hold frequent staff meetings, and engage in informal conversations that communicate and promote the company's

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[16] Acendre Talent, *Organizational Socialization & How it Impacts Employee Onboarding-Part One*, ACENDRE (Oct. 15, 2015), https://www.acendre.com/blog/posts/organizational-socialization-how-it-impacts-employee-onboarding-part-one/.
[17] Allison M. Ellis, Sushil S. Nifadkar, Talya N. Bauer & Berrin Erdogan, *Your New Hires Won't Succeed Unless You Onboard Them Properly*, HARV. BUS. REV. (June 20, 2017), https://hbr.org/2017/06/your-new-hires-wont-succeed-unless-you-onboard-them-properly.
[18] Jemi Sudhakar, *LEADERSHIP IT SETTING THE TONE ALWAYS!!!*, LINKEDIN (Feb. 7, 2018), https://www.linkedin.com/pulse/leadership-setting-tone-always-ms-jemi-sudhakar.
[19] Russell Korte & Shumin Lin, Abstract, *Getting on Board: Organizational Socialization and the Contribution of Social Capital*, 66 HUM. RELS. 407 (2012).
[20] Brett Safford, *Are You Setting the Right Tone at the Beginning?*, COMPLI (May 26, 2016), https://www.compli.com/blog/are-you-setting-the-right-tone-at-the-beginning/.
[21] Katz & Mclntosh, *Supra* note 17.
[22] Michael Coates, *Five ways to set the tone from the top*, GLOBE & MAIL (Mar. 12, 2014), https://www.theglobeandmail.com/report-on-business/careers/leadership-lab/five-ways-to-set-the-tone-from-the-top/article17438855/.

ethics and values.[23] In addition, an effective mentorship program helps existing directors transfer institutional norms to new directors.

ii. Mentor-Mentee System

A mentor-mentee system in the context of director onboarding means pairing the incoming director with an experienced peer with whom the new director may confer and consult throughout the onboarding process.[24] It is imperative that the mentor be a peer, and not a superior in the new director's chain of command. A near peer will have an immediate understanding of the new director's role in the company and onboarding needs.[25]Mentors provide incoming directors with context in a situation where the whole picture is necessary to fully understand how to contribute to the board and company's success.[26] Additionally, mentors can shed light on cultural and unspoken social norms, broadening the new director's understanding of the organization.[27]

When instituting a mentor-mentee program, onboarding organizers should select knowledgeable board members who embody the mission and direction of the organization.[28] These individuals will be most familiar with the roles and responsibilities the incoming director will be expected to fulfill. Board members who are enthusiastic, empathetic, and respected in the organization typically make good mentors.[29] Likewise, mentors should possess the skills necessary for constructive dialogue and feedback with mentees. This prevents the repetition of "mentee missteps," or common self-destructive mistakes.[30] The role of the mentor in the director onboarding context means making an important commitment to the acclimation of the incoming director. The mentor must follow up with the mentee after giving constructive feedback to ensure the new director fully understands what is expected of them.[31]

iii. Meetings

One-on-one meetings with the CEO, CFO, the CRO (Chief Risk Officer or the equivalent), and the various leaders of departments like HR and Operations are crucial in the initial weeks of director onboarding.[32] Such meetings are valuable socialization tools that inform the new director about the tone and culture of the organization, the strengths and weaknesses of the board, and candor of communications between management and the board, and among

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[23] *Tone at the Top*, CFI, https://corporatefinanceinstitute.com/resources/knowledge/finance/tone-at-the-top/ (last visited Oct. 30, 2020).

[24]Designing a Mentoring Program for Onboarding, INSALA (Aug. 6 ,2019), https://www.insala.com/blog/designing-a-mentoring-program-that-improves-onboarding.

[25] Driscoll &Watkins, *supra* note 3

[26] Dawn Klinghoffer, Candice Young, & Dave Haspas, *Every New Employee Needs an Onboarding "Buddy"*, HARV. BUS. REV. (June 6, 2019), https://hbr.org/2019/06/every-new-employee-needs-an-onboarding-buddy.

[27] *Id.*

[28] Penny Loretto, *Top Qualities of a Good Professional Mentor*, THE BALANCE CAREERS (May 2, 2017), https://www.thebalancecareers.com/top-qualities-of-a-good-mentor-1986991.

[29] *Id.*

[30] Vineet Chopra & Sanjay Saint, *6 Things Every Mentor Should Do*, HARV. BUS. REV. (March 29, 2017), https://hbr.org/2017/03/6-things-every-mentor-should-do.

[31] *Being Intentional with Your Mentoring Time*, MENTORLOOP, https://mentorloop.com/blog/intentional-mentoring-time/ (last visited Oct. 30, 2020).

[32] S*upra* note 10.

directors.[33] These one-on-one meetings are necessarily formal, but informal get-togethers with the full board have their place in introducing the new director to boardroom dynamics, board culture, and the backgrounds and perspectives of other directors.[34]

Senior board members and executives should encourage the incoming director to attend all committee meetings, regardless of the incoming director's particular area of focus. Some boards invite new directors to attend all committee meetings during their first year of board service to help new directors gain a full understanding of the range of issues facing the company.[35] Attendance at committee meetings, therefore, familiarizes the new director with their own committee assignments and provides an introduction to the company and the risks it faces as a whole.[36]

Of course, even in the most ideal circumstances, getting individuals to give up time and energy to attend committee meetings can be a chore. People tend to avoid and disregard mandatory meetings for a variety of reasons, so having practical means of encouraging meeting attendance will go a long way in the onboarding process. The easiest, and most obvious method, is to publish the starting and ending times of the meeting, and make a point of sticking to the scheduled times.[37] Additionally, including a meeting agenda in the same memo or email used to invite participants to the meeting makes attendees more likely to understand and appreciate their role at the meeting, and it gives attendees extra time to prepare which makes the actual meeting progress smoothly and quickly.[38] Encouraging active meeting engagement generally comes down to using different means of motivating new directors, but attendance is the bare minimum. The real goal is active participation. In the next section, we explore ways in which onboarding organizers can proactively motivate new directors through the duration of the onboarding process, producing active participation and the most effective director performance.

C. Motivation

Motivation, in the context of director onboarding, means effectuating within the director a sense of personal identification with the organization's purpose.[39] No matter how thorough an onboarding program is, a director must be properly incentivized in order to perform effectively. In the for-profit context, board directors may be substantially motivated by financial gains. This is not so in the case of non-profit organizations, where it is important to motivate incoming directors through other factors. However, motivational techniques traditionally found in non-profit literature can further incentivize for-profit directors, and should be applied both during and beyond the onboarding process of any organization. In this section, we discuss two motivational techniques any organization can implement in their onboarding process in order to encourage director autonomy.

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[33] *Supra* note 4.
[34] S*upra* note 10.
[35] Katz & McIntosh, *supra* note 17.
[36] *Id.*
[37] Mary Gormandy White, *Ways to Get People to Attend Business Meetings*, LOVETOKNOW https://business.lovetoknow.com/business-operations-corporate-management/ways-get-people-attend-business-meetings (last visited Oct. 30, 2020).
[38] *Id*.
[39] Grant MacDonald, *Motivating Board Members: It's Complicated*, GOVERNING GOOD (Jan. 16, 2017), http://www.governinggood.ca/motivating-board-members-its-complicated.

i. Stay Mission-Oriented

From the outset of the onboarding process, the executive team, onboarding organizers, and senior board members must clearly identify the organization's mission for the incoming director. The executive team must ensure that the new director is aware of how their work contributes to the mission's success.[40] Moving forward, the mission should be central to all board meetings, programs, and policy discussions.[41] Involving the new director in as many programs and activities as possible in the first months of their employment will highlight the mission's place in the organization's day-to-day operations, which will help the director internalize the mission and apply it to their work moving forward. That said, it is paramount that the mission be articulated and expressly aligned with the day-to-day work of the board.[42]

Staying mission-oriented is a concept that is equally applicable to for-profit and nonprofit organizations alike. Traditionally a facet of nonprofit literature, today many for-profit organizations categorize themselves as "mission-driven." Indeed, some experts indicate that any organization *must* be mission-driven in order to produce the most proactive and engaged employees who will view their contributions to the organization more broadly.[43] A 2014 Gallup study found that mission-driven leadership was linked to greater *marginal* productivity in for-profit organizations.[44] Whether a given organization is for-profit or nonprofit, focusing attention on the organization's societal impact will help leaders make informed, strategic, and mission-oriented decisions.

It is important to note that "mission" refers to the organization's "why." It is the impact or difference the organization as a whole aims to make on society. A corporation's mission is closely related to the topic of the next section, "goals," which succinctly describe the organization's mission and values through director expectations.[45] Goals should be thought of as the short-term investments that further the interests of the organization's mission.

ii. Goal Setting

Goals are targets set by an organization as specific, quantifiable outcomes that it commits to attain in order to achieve its mission and objectives.[46] Psychologists have recognized that having a set of goals to work toward helps guide focus and develop strategies to enable performance at the requisite level, which reaffirms the widely held belief that goal setting has a beneficial impact

[40] Kelly Medwick, *How to Motivate and Engage Your Board of Directors*, FIRESPRING (Jan. 24, 2017), https://firespring.com/solutions-for-nonprofits/how-to-motivate-and-engage-your-board-of-directors.
[41] *20 Ways to Involve and Motivate Board Members*, RICHARD MALE AND ASSOCIATES, http://richardmale.com/20-ways-to-involve-and-motivate-board-members (last visited October 26th).
[42] David DuVal, *Staying Mission-Focused During Times of Change*, MCKINLEYADVISORS (Oct. 31, 2019), https://www.mckinley-advisors.com/blog/staying-mission-focused-during-times-of-change.
[43] Lindsay Mullen, *Should For-Profit Companies Have a Mission Statement?*, PROSPER STRATEGIES (May 25, 2017), https://prosper-strategies.com/for-profit-mission-statement.
[44] Chris Groscurth, *Why Your Company Must Be Mission-Driven*, GALLUP (March 6, 2014), https ://www.gallup.com/workplace/236537/why-company-mission-driven.aspx.
[45] Tara Duggan, *Examples of Corporate Goals*, AZ CENTRAL (Apr. 13, 2018), https://yourbusiness.azcentral.com/examples-corporate-goals-14839.html.
[46] *How to Write Corporate Goals*, WRITING HELP CENTRAL, http://www.writinghelp-central.com/corporate-goals.html (last visited Oct. 30, 2020).

on productivity[47] Indeed, setting goals in the workplace is a crucial component of employee motivation, and the board room is no exception.[48] Goal setting produces an atmosphere of innovative thinking and collaboration that motivates team members to do their jobs as effectively as possible while they grow to understand that their contributions matter to the goal's achievement.[49]

Any organization onboarding a new director should bear in mind the importance of communicating goals that are clearly linked to the success of the organization. Of companies with effective performance management systems, 91% of them say that goals are linked to business priorities. The reason for the effective performance is that individual employees are more motivated if they can see how their individual goals fit into the big picture.[50] When onboarding a new director, it is paramount that the director understand, as quickly as possible, the company's culture and how they fit in the achievement of the organization's mission. Clear, concise, and business-prioritized goal setting can help facilitate each of these critical onboarding components.

Onboarding organizers must operate with the intention that incoming directors be comfortable setting goals for themselves as quickly as possible. Director onboarding is, in essence, a process designed to allow the incoming director to internalize the organization's mission and set personal goals in accordance with the organization's direction. Director autonomy, or the freedom from external control, enables new directors to take charge of their transition and best manage their day-to-day operations.[51]

iii. Moving to Greater Autonomy

Director autonomy comes directly from the organization's board culture. It is the freedom of directors to think for themselves, to make decisions independently, and to "own" their roles.[52] The purpose of a thorough onboarding program is to set up a new hire to effectively work on their own.[53] An incoming director's position is inherently one that they must be trusted to fill, or else they would not (or should not) have been hired. Moving toward autonomy, and thus the natural end of the onboarding process, really finds its roots in the beginning: recruiting potential directors with the right mindset and attitude, who thrive on their own initiative and innovation.[54] Self-direction is at the core of humankind's natural inclination. It makes sense then for

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[47] Leslie Riopel, *The Importance, Benefits, and Value of Goal Setting,* POSITIVE PSYCHOLOGY (Jan. 9, 2020), https://positivepsychology.com/benefits-goal-setting/.

[48] April Parks, *Motivation in the Workplace: The Value of Setting Goals,* TEDS (Oct. 30, 2014), http://blog.teds.com/motivation-in-the-workplace-the-value-of-setting-goals.

[49] *Id.*

[50] Sabrin Chowdhury & Elizabeth Hioe, *How effective goal-setting motivates employees,* MCKINSEY & COMPANY (Dec. 27, 2017), https://www.mckinsey.com/business-functions/organization/our-insights/the-organization-blog/how-effective-goal-setting-motivates-employees#.

[51] Grant Simmons, *Want Onboarding That Drives New Hire Productivity?* TIER1 PERFORMANCE (Aug. 29, 2019), https://tier1performance.com/onboarding-and-new-hire-productivity/.

[52] David Lee, *For More Motivated, Engaged Employees, Give Them More Autonomy*, TLNT (Dec. 7, 2015), https://www.tlnt.com/for-more-motivated-engaged-employees-give-them-more-autonomy/.

[53] *Ways to Motivate New Employees*, SKILLGIGS (Dec. 29, 2016), https://skillgigs.com/ways-to-motivate-new-employees/.

[54] Lindsay Harriss, *Why job autonomy Is vital for success - and how to encourage it*, CIPHR (Sept. 24, 2019), https://www.ciphr.com/advice/employee-autonomy/.

executives to motivate incoming directors through "autonomy support", or giving the director the appropriate flexibility and choice, when possible to engage in business-prioritized work that mirrors personal values and interests.[55]

There are several practical ways to promote autonomy in the boardroom, but the first step is always to create a culture of trust. Senior board members or executives must consult the new director on projects and tasks, in order to allow trust to grow and new ideas to emerge.[56] Consultations of this sort manifest as inviting directors to share their thoughts and feelings on various work activities, demonstrating patience and providing time for self-learning, and providing meaningful information and feedback regarding choices.[57] This type of communication produces a cycle of autonomy and motivation. Trusting a director to make good decisions and contributions motivates that director to step into that role and add value, which in turn furthers the organization's initial vote of confidence, which creates an intrinsic motivation for them to continue adding value to the company.[58]

Motivation is no easy task even when onboarding under normal circumstances, and the barriers created by an online format will only increase that level of difficulty. As all of the facets of businesses move online as a result of the coronavirus, it is important for business leaders and onboarding organizers to be mindful of what made things work before the crises and attempt to implement similar methods online. The next section focuses on how to apply the key components of corporate onboarding in an online, post-COVID era.

II. HOW TO MOVE ONBOARDING ONLINE

When the novel coronavirus promoted a worldwide economic shutdown, many businesses were forced to continue operating online. The experience was trying, and some firms failed this stress test.[59] But this disaster also prompted many to think critically about many aspects of life to determine which activities are essential. Many reconsidered how to go about these activities differently. The silver lining is that the pandemic revealed myriad ways to go about things more efficiently. Necessity is the mother of invention—and that invention can be useful even after it is no longer necessary.

This section will discuss how to succeed in the essential activity of onboarding new corporate directors when in-person meetings are impossible. But the advice herein is not limited to these trying times. Rather, some or all of these techniques can be implemented for in-person onboarding, too. By drawing comparisons between how things were done before and how things are done in the "new normal", this essay highlights how all of these processes can be improved.

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[55] Carly Stone, *Examples of Autonomy in the Workplace & How To Get More of It*, GQR (Aug. 6, 2019), https://www.gqrgm.com/examples-of-autonomy-in-the-workplace-how-to-get-more-of-it/.
[56] Harriss, supra note 56.
[57] Stone, supra note 57.
[58] Christian Nielson, *Autonomy: Empowering the Individual to Do Their Best Work*, DECISIONWISE, https://decision-wise.com/autonomy-empowering-the-individual-to-do-their-best-work/ (last visited Oct. 30 2020).
[59] Indiana Lawyer Staff, *One of City's Largest Law Firms Closes Offices Amid Coronavirus Concerns*, INDIANAPOLIS BUSINESS JOURNAL (Mar. 10, 2020), https://www.ibj.com/articles/one-of-citys-largest-law-firms-has-closed-its-offices-amid-coronavirus-concerns.

A. Provide Information Ahead of Time (The Flipped Boardroom)

Traditional in-person onboarding often occurs at a one half- or full-day retreat. But online onboarding need not be so sharply time-bound. Instead, online board education can occur over a longer period of time. Moreover, board members can learn at their own pace. This self-paced learning is especially useful where board members have different backgrounds, expertise, and experience levels with corporate governance in general and this corporation in particular. By giving board members information ahead of time, organization leaders can shorten the live portion of online onboarding. This makes planning easier for busy executive schedules while making learning more effective and efficient.

Presenting information ahead of time is part of a tried-and-true pedagogical method called "flipping the classroom." In a standard classroom, information is presented during class. In a flipped classroom, information is presented before class, thus freeing up class time for discussions, problem solving questions, group work, and other engaging learning activities. This has been shown to be more effective than lecture as measured by students' long-term retention and comprehension of material.[60]

This essay suggests that "flipping the boardroom" can be equally effective for onboarding directors. This requires onboarding organizations to be strategic and deliberate about creating informative learning resources and engaging the board in active learning exercises, but the investment will pay dividends over time. A flipped onboarding program will generate efficiencies in board member time and retention of key information—and flipped programs are more fun and engaging for participants, too.

i. Create a Virtual Data Room

The online analog to the physical data dump—which often amounts to little more than giving new directors reams of information in three-ring binders—is a virtual data room (VDR). Put simply, a VDR is a digital space where files are organized and stored. When properly implemented, data rooms have many advantages for the conveying of generic information to several new directors at once. VDR may be more secure, more affordable, and easier to set up and use than the traditional data dump. Onboarding organizers should consider employing a VDR even after it becomes an option again to safely hand a new director a towering stack of paper.

VDR can be made very secure. Professional solutions offer 256-bit Advanced Encryption Standard (AES) encryption and various data center certifications.[61] More modest security needs can be met by common enterprise file-sharing apps like Box.[62] On a small scale, or when information is not competitively sensitive, users can create VDR environments in free apps like Dropbox.[63] VDR administrators can even prevent viewers from downloading, printing, or taking

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[60] *See* Livia Mihai, *8 Flipped Classroom Benefits for Students and Teachers*, ELEARNING INDUSTRY (Oct. 11, 2017), https://elearningindustry.com/8-flipped-classroom-benefits-students-teachers.
[61] Kison Patel, *The Ultimate Guide to Virtual Data Rooms (VDRs)*, DEALROOM, https://dealroom.net/faq/what-is-virtual-data-room (last visited Oct. 30, 2020).
[62] *Enhanced Security*, BOXSUPPORT (Apr. 2020), https://support.box.com/hc/en-us/articles/360043693854-Enhanced-Security.
[63] Jane Fazackarley, *Virtual Data Rooms VS. Generic File Sharing Solutions*, IDEALS (Oct. 30, 2018), https://www.idealsvdr.com/blog/virtual-data-rooms-file-sharing/.

screenshots of highly sensitive information. Access can be controlled remotely and in real time—which can be useful for offboarding as well.

VDR is affordable. An annual subscription to Box can cost less than professionally printing and shipping just one dozen onboarding information binders.[64] While professionally managed high-security VDR platforms are available for high-end customers, most organizations can simply administer their own onboarding VDR using already established corporate cloud solutions like Box, Google Drive, Microsoft OneDrive and others.

Finally, VDR is easy to set up and use. Data rooms function like hard drives on a computer. Documents can be organized just as they would be in printed tabbed binders, or new organization can be applied using app features like hashtags and comments. In addition, VDR hosts large spreadsheets, high-resolution graphics, video clips and other hard-to-print items. This creates new opportunities to explain and personalize onboarding information, even before the live onboarding event begins. The next section will discuss how to create personalized content that will engage new board members with the significant work of absorbing corporate information.

ii. Tailor VDR Content

Video and other interactive content is shared with new directors in advance of the onboarding program through VDR content. This creates new opportunities to begin the onboarding learning process in advance of a live meeting, enabling a more swift and efficient live session that reduces “Zoom fatigue” and enhances learning and engagement.

Tailoring VDR content means creating videos that personally introduce the corporation’s new board members to the institution and then, to the onboarding environment. Corporations with sufficient resources should record a tightly edited two- to five-minute video that briefly welcomes the new director to the board, then explains the organization and intentionality behind the data room. The video should give directors clear direction about which files and folders to review carefully and which are meant to be skimmed as background or merely maintained for reference.

VDR personalization is also an opportunity for the corporation to show its new directors that they are valued. For example, the CEO may record a 30-second personal address to each new member, followed by a 2-minute description of the VDR from the CFO.

The VDR content itself can also be customized for specific directors or groups of directors. For example, a folder with information about executive compensation can be shared only with new directors who are assigned to serve on the compensation committee. In this way, both enhanced security and a more tailored and streamlined user experience can be achieved online.

iii. Engage!

Receiving huge reams of information can be boring or overwhelming, whether in binders or online. To avoid information overload, design learning activities that engage the new directors in learning about the most important information. This section will introduce how learning activities are offered ahead of the meeting to complement a data dump and ensure that data is processed by the new directors’ so they acquire information efficiently. The next part will focus

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[64] *See* Melissa Pardo-Bunte, *Box Pricing: Features, Costs and Top DMS Alternatives,* BetterBuys (June 12, 2019), https://www.betterbuys.com/dms/box-pricing/.

on how to reinforce information acquisition at the live session. Once again, we can draw upon classic pedagogical tools to engage adult learners: the Testing Principal and Learning by Doing.

The Testing Principle states that people learn better when they take a practice test on the material rather than restudy it.[65] The idea is that the test primes the mind for learning the material, much like a warmup primes the body for a workout. Depending on corporate culture, however, it may not be appropriate to give new directors a pop quiz. Instead, onboarding organizers can achieve the testing effect through more conventional means, as discussed below.

"Learning by Doing means learning from experiences resulting directly from one's actions, as contrasted with learning from watching others perform, reading others' instructions or descriptions, or listening to others' instructions or lectures."[66] Although a director may access a vast amount of information by getting access to a VDR, the director will not automatically become familiar with how to access specific information or may not even be aware of what information is in the VDR. To accelerate directors' familiarity with important information, onboarding organizers should encourage directors to explore and use the VDR.

Instead of a formal quiz, present the directors with a checklist that sets forth tasks that require each new director to explore the VDR. For example, if the VDR employs tags, ask each director to identify which tags correspond to their expertise. This requires the director to learn how to use tags in a VDR while providing the corporation with actionable information about director expertise.

Videos may facilitate learning by doing. Consider making a video that shows the directors how to use VDR features (like tagging files), and then make that video available in the VDR so directors can reference it when going about their tasks. These videos thus serve the additional purpose of "flipping the boardroom." By covering low-level information like this before the directors' first meeting, onboarding organizations can make the meeting more efficient and focused on high-level understanding.

Directors should also complete a brief survey during their pre-meeting learning time. The survey should ask questions that aim to reveal the directors' skill set and interests. This information will help onboarding organizers plan the upcoming meeting. As discussed in the next section, the online meeting should be tailored to meet the needs and skills of the incoming directors.

Offer a checklist of key information to be learned in advance of the meeting. This is also the first opportunity to set the tone[67] as goal-oriented.[68] A task list or agenda for the upcoming live onboarding meeting also showsdirectors what they will be required to know. Organizers should endeavor to connect the introductory checklist, the VDR activities, and the meeting agenda so that directors intuit the value of preparing for the meeting by exploring the VDR.

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[65] Richard E. Mayer, *Applying the Science of Learning to Undergraduate Science Education*, NAT'L. ACAD. BD. OF SCI. EDUC. (Jan. 16, 2011), https://sites.nationalacademies.org/cs/groups/dbassesite/documents/webpage/dbasse_072589.pdf.
[66] Hayne W. Reese, *The Learning-by-Doing Principle*,17 BEHAV. DEV. BULL., no. 1, 2011, at 1, https://psycnet.apa.org/fulltext/2014-55719-001.pdf.
[67] *See Id.* at 89.
[68] *See Id.* at 13–14.

B. Host a Virtual Meeting

Onboarding generally requires a meeting. There are aspects of the onboarding experience, such as socialization, that cannot be readily accomplished on one's own time. The meeting traditionally occurred in person as a half-day or full-day retreat. However,an in-person retreat may be impossible or impracticable. For example, governments prohibit large in-person gatherings due to the COVID-19 pandemic. Nevertheless, even when in-person meetings are possible, are they the optimal use of corporate resources? In some cases, such as where directors live far from corporate headquarters or where the corporation lacks the funds to host a day-long event, a virtual meeting may be a good substitute.

Virtual meetings can be buggy and boring. But careful planning and strategic use of online meeting technology can result in a great experience for new directors. Once again, onboarding organizers need to think like online educators. Here are some tips and tricks from the online law professor's playbook that are sure to engage board members in active learning and socialization.

i. Plan a Plenary Session

Plenary sessions—where all board members and executives are to attend—are a great opportunity to kick off the onboarding experience with motivation and energy.[69] They are especially helpful in online onboarding. The plenary session is the organization's opportunity to introduce substantive goals, handle technical concerns, and set the tone for the meeting and the work going forward.

There are many different formats for plenary sessions, but a good rule of thumb is to keep them short. To give people time to log on and work out any technical issues, plan to spend the first ten minutes or so in an unstructured format. Ask the directors to turn on their microphone and webcam and briefly introduce themselves as they enter the meeting. This will reveal any audio and video problems. During this introductory time, display a slide that provides the agenda and other key information while organizers communicate one-on-one with any directors who are having trouble with connectivity. Wise conference organizers will have alternative contact information (such as a cell phone number) so they can reach directors and help them get online before the conference begins.

After any technical bugs are worked out, the plenary session can proceed much as it would in live. Usually, the CEO or Chair of the Board makes brief welcome remarks to kick off the event. The master of ceremonies, who may be the CEO or the conference organizers, should explain how the rest of the event will work. Creative organizers might also use the plenary sessions to demonstrate how the breakout groups, discussed below, will operate.

The plenary session is a good time to introduce the new directors to each other. An effective way to do this while highlighting positive attributes of the incoming team members is to discuss the skills and interests that were highlighted by the survey that was discussed in the prior section.

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[69] *See* Rob Hard, *Why Conferences Begin With a Plenary Session*, THE BALANCE SMALL BUSINESS (Aug. 10, 2019), https://www.thebalancesmb.com/why-conferences-begin-with-an-opening-general-session-1223626.

ii. Break Out for Active Learning

Depending on the size of the incoming class of directors, it may be necessary to break up into smaller groups. Online meeting attendees tend to participate less frequently in large groups than small ones. Large groups are hard for online presenters to monitor. Larger groups tend to have more problems with microphones being unmuted and disruptive background noise. When more people are added to an online conference room, each person's image gets smaller, and some software cannot display more than a certain number of attendees at one time. Seeing one another is an important aspect of socializing new team members, and this is lost when the group is too large. Limit groups to ten or fewer members.

Each group or cohort can rotate through four or five learning stations. Each station will cover a different topic and should be facilitated by the key institutional person for that knowledge domain. For example, the general counsel may lead a discussion on fiduciary duties, while the Chief Financial Officer reviews accounting basics. By using breakout rooms on virtual meeting software such as Zoom, these learning stations can occur simultaneously for maximum efficiency.

Onboarding organizers should make these breakout sessions as interactive as possible. This can be accomplished in many ways. A popular teaching device for adult learners is called the Socratic method. In this method, the discussion leader will ask questions to various participants. The questions are designed to lead the participants to identify, understand, and analyze issues that may arise during their tenure as board members. If the groups are small enough, the discussion leader should be able to call on each attendee during the breakout group. This keeps attendees mentally engaged and attentive.

Keeping the breakout groups short is key to their success. Although the techniques discussed in this section help to engage adult learners online, attendees will still experience "Zoom fatigue."[70] Ideally, breakout activities are limited to about 20 minutes, and then five minutes should be provided for questions and answers and another five for an off-camera comfort break. In this manner, six training activities can be completed within three hours.

If the corporation needs certain directors to specialize on certain functions, such as accounting professionals serving on the audit committee, then the breakout rooms can be designed accordingly. Members of the audit committee should be grouped as a cohort that attends a session on advanced accounting, while the rest of the class may not need to attend that session.

As for which topics to address in breakout sessions, these are the same important topics for new directors to discuss during in-person sessions. Corporate needs will vary, but the following are generally regarded as important aspects to cover:

- Corporate Governance and Fiduciary Duties
- Accounting and Finance
- Operations
- Products, Services, Customers, and Chief Competitors
- Acquisition Strategy

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[70] *See* Liz Fosslien & Mollie West Duffy, *How to Combat Zoom Fatigue*. HAR. BUS. REV (Apr. 29, 2020), https://hbr.org/2020/04/how-to-combat-zoom-fatigue.

- Risk Management[71]

The breakout sessions should deliberately be designed to be relatively fast-paced. Shifting between concept areas and having new discussion leaders every thirty minutes or so will help keep directors engaged in learning their new role and stave off Zoom fatigue.

iii. Come Together for Hot Topics

After the breakout sessions are complete, bring the group back together for a final all-hands session. Accomplish this technologically by setting all the breakout rooms to expire simultaneously, returning all members to the main virtual room for concluding remarks. This last session is the organizer's best opportunity to begin the socialization process and to motivate the directors to succeed in their new roles.

One way to achieve this is to hold a discussion on hot topics. The CEO or Chair of the Board can ask the new board members to discuss an issue that currently and substantially impacts the corporation. This experience should resemble a mock board meeting, except that the mundane and droll topics that must be handled in real board meetings should be excluded from the hot topics session. The CEO or Chair should establish that the goal of the meeting is to come up with action-oriented resolutions to deal with the issue, and then he or she should facilitate the conversation.

Facilitating a conversation among a large group of online attendees can be challenging (hence the suggestion for breakout rooms) but learning to do so effectively is important for organizational leaders in this online era. Thus, online onboarding is an opportunity for existing leadership to extend their skill sets.

If the breakout sessions go well, the new directors should be warmed up and ready to engage in dialogue. If the group contains fewer than 30 members, the online host may ask people to virtually raise their hands and be called upon to unmute their microphones and speak their points to the group.

When online groups are larger than 30 members, it becomes harder to manage the raise-hands function. Instead, the chat function is the best way to gather input from a large number of people in an online meeting. Participants can chat to everyone and express their views in writing, or they can chat to the host and ask to be recognized or to have the comment read aloud.

However the host manages participation in the meeting, they should keep the meeting focused, short, and goal oriented. The hot topic must be straightforward enough that it can be communicated and discussed in about a half hour. The host should start to wrap up the discussion at least ten minutes before the end of the allotted time period so they can express the emerging consensus of the group and effectuate it by writing a resolution. The meeting should conclude with a vote on the resolution using the polling feature in the video conferencing software. In this way, the group will learn how to be effective online board members by practicing the actual process. By staying goal oriented and accomplishing the stated objective, this meeting provides a positive model for an effective meeting that the new board members will carry forward into their future work for the corporation.

After the issue is resolved, the CEO or Chair should take a few minutes to emphasize the importance of the Board in accomplishing the organization's goals. This is also an opportunity to

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[71] *See supra* note 4 (listing recommended topics for director onboarding meetings, from which this list was adapted).

inspire the directors to greater service by discussing how the organization can make a significant positive impact on society. Remember that the directors have just succeeded in tackling a major issue of concern, so this is the moment to reinforce the message that the board can and will accomplish major strategic goals.

In other words, inspire them to create connections before opening up the meeting for relatively unstructured social time. Make concluding remarks a timely, brief, and positive call to action and inspiration: We will lead this organization through any adversity! Hopefully, this inspiration will encourage directors to converse about how to advance corporate goals during the unstructured socialization period.

C. Socially-Distant Socialization

Most in-person onboarding retreats offer many opportunities for new and old board members and corporate leadership to get to know each other.[72] These social interactions are not as easy to cultivate online, but there are several strategies to help start the socialization process with new board members.

i. Virtual Happy Hour

In-person meetings typically conclude with a happy hour. This social event can be brought into the online space. Consider physically mailing each of your directors a commemorative glass that features the corporate logo and arrives before the in-person meeting. Depending on state liquor laws, the corporation might also include a small bottle of wine. These gifts can be employed to enhance the social atmosphere and the feeling of community, and directors will be pleased to receive them.

At the conclusion of the hot topics sessions, the Chair or CEO can kick off the happy hour by inviting all attendees to grab their glasses and join in a virtual toast with their beverage of choice. The experience of all drinking from the same glass, so to speak, despite being separated in space provides a team atmosphere of a common community.

What happens after the toast depends on the size of the group. If the group is relatively small, the host can stimulate conversation by asking casual questions and continuing to keep the conversation going until the appointed time for the conclusion of the happy hour. If the group contains more than a dozen people, however, conversation and socialization may be better served by the host playing matchmaker.

ii. Pair and Share: Play Matchmaker

Pair and Share is a pedagogical term for the practice of organizing students into small groups and giving them discussion questions to resolve. This same concept can be applied strategically to online onboarding. When members have similar interests, the host can play matchmaker and group them in a small breakout room to meet and greet during the virtual happy hour. Encourage three to four members to discuss a topic related to their board function while hoisting a glass "together."

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[72] *See Welcome Aboard: The Ultimate Guide to Successful Employee Onboarding*, HUMANITY: THE HUMANITY BLOG (Aug. 2, 2018), https://www.humanity.com/blog/employee-onboarding-guide.html.

The survey described earlier can be a good source of information about directors' interests that can be applied here to pair directors who are likely to have commonalities. Posing discussion questions to each small group can help spark conversation about those interests. One can never guarantee that two people are going to connect, but a carefully planned group of three or four directors who are selected for their common interests and given an on-point discussion question is likely to result in worthwhile conversation and connections.

Consider inviting existing directors and leadership staff to the virtual happy hour. Staff members can each be responsible for connecting a small group of directors. If the corporation has a staggered board, or a board made up of different classes of directors that serve different term lengths and are elected at different times of the year,[73] having both new and existing directors helps integrate new board members. Pairing directors in this way also may lead to organic mentor-mentee relationships. For suggestions on how to stimulate these relationships, see the next section.

iii. Mentor-Mentee Pairs

In the real world, directors with common interests may simply find each other during happy hour and strike up a conversation organically. Unfortunately, it is not easy for online meeting attendees to self-select their happy hour group on the spot. But empowering directors to select a mentor or mentee, and then putting those mentor-mentee pairs into the same happy hour group, can be an effective way of jump-starting a long-term relationship.

Although the effectiveness of corporate mentoring programs is unclear,[74] the research shows that board members benefit both from mentoring and becoming a mentor.[75] There are several purposes for corporate mentoring programs, including leadership development.[76] Setting up mentor-mentee pairs that match new and existing directors can improve director retention and deepen both mentor and mentee leadership strength. Mentorship programs may especially help develop female leaders.[77] Improving diversity on corporate boards is just one of many reasons why an effective mentorship program can improve corporate leadership.

Online mentoring, also called e-mentoring, has grown in popularity over the last 20 years.[78] In older e-mentoring programs, the mentoring was delivered asynchronously, via email, message

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[73] *Staggered Board: Everything You Need to Know*, UPCOUNSEL, https://www.upcounsel.com/staggered-board (last visited Oct. 26, 2020).

[74] For a thorough analysis of whether and when corporate mentoring programs are impactful, see Christina M. Underhill, *The Effectiveness of Mentoring Programs in Corporate Settings: A Meta-Analytical Review of the Literature*, 68 J. VOCATIONAL BEHAVIOR 292, (2006); for a more anecdotal approach, see Mel Jones, *Why Can't Companies Get Mentorship Programs Right?*, THE ATLANTIC (June 2, 2017), https://www.theatlantic.com/business/archive/2017/06/corporate-mentorship-programs/528927/.

[75] David F. Melcher and A. John Procopio, *Board Members Benefits from Becoming Mentors,* HARV. BUS. REV. (Dec. 16, 2014), https://hbr.org/2014/12/board-members-benefit-from-becoming-mentors.

[76] *The Top 5 Workplace Mentoring Program Types,* CHRONUS, https://chronus.com/how-to-use-mentoring-in-your-workplace (last visited Oct. 30, 2020).

[77] Chrystal Turner-Moffatt, *The Power of Mentorship:* Strengthening Women in Leadership Roles, AMERICAN SOCIETY OF SAFETY PROFESSIONALS (Aug. 2019), https://www.assp.org/docs/default-source/psj-articles/bp_turner_0819.pdf?sfvrsn=0&utm_campaign=general&utm_content=1565126723&utm_medium=social&utm_source=facebook.

[78] *E-Mentoring,* NAT'L MENTORING RESOURCE CENTER, https://nationalmentoringresourcecenter.org/index.php/30-topic-areas/204-e-mentoring.html (last visited October 30, 2020).

board, chat, or text functions.[79] More recently, massive multiplayer online games, such as Second Life, have created virtual spaces where mentoring takes place.[80] If that sounds too futuristic and far out for your board members, do not be concerned. E-mentoring can occur in much more familiar ways, such as on Zoom web conferencing or even via phone calls.

To facilitate the development of mentoring relationships between new and existing board members, the first step is to think carefully about establishing pairs that are likely to be compatible. Organizers can accomplish this by asking the directors to take a DISC assessment, which reveals "how" a person does what they do.[81] To keep mentors and mentees engaged, try pairing them up based on their DISC styles.[82] You might also pair based on skill set and common interests, but this may lead to the pitfall of mistaking superficial similarities, such as a shared interest in golfing, for a deeper foundation on which to build a long term relationship of trust and confidence.

However, onboarding organizers establish mentorship pairs, they should remember that online interactions require much more deliberate forethought. At an in-person happy hour, directors might circulate among each other until pairs click, forming natural and unofficial mentoring relationships. This does not happen as easily online (unless the directors are all hanging out together in Second Life during their free time), so a deliberate effort to pair the right people at the right time is essential to getting a director mentoring program to work well. If an organizer follows the suggestion above about having a virtual happy hour, consider using breakout rooms during the happy hour to introduce the mentor-mentee pairs to each other.

III. CONCLUSIONS

Moving director onboarding online presents new challenges. But the inability to meet in person should not prevent corporations from moving forward with vital processes, such as onboarding. This Article has shown how essential components of the onboarding process are translated to the online format. Moving onboarding online may also be preferable in some respects due to greater efficiency and sustainability. Even after the existential threat posed by the novel coronavirus, replacing three-ring binders with VDRs and holding meetings through Zoom may become more commonplace. Online alternatives offer greater flexibility in the onboarding process, making the move toward greater autonomy more organic.

While nothing can replace the comradery of meeting for a casual drink at the local bar, online team building exercises like virtual happy hours and matchmaking must fill the socialization role for the time being. At the very least, it will familiarize the new director with other members of the board in advance of work resuming in person. It will be difficult for new directors to navigate the ins and outs of the organizational culture through virtual communications. Onboarding organizers can, however, mitigate that difficulty by being attentive to the new board member's engagement during online team building exercises. Virtual

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[79] *Id.*

[80] *See* CHRISTOPHER LANGSTON, ET AL., *LEVERAGING VIRTUAL WORLDS FOR ELECTRONIC MENTORING* (Springer Int'l 2015).

[81] *Mentoring Using DISC,* TTI SUCCESS INSIGHTS (Feb. 27, 2019), https://blog.ttisi.com/mentoring-using-disc.

[82] TTI Success Insights provides suggestions for pairing up mentors and mentees based on DISC styles on their web site. *Id.*

communication may not be ideal for all things, but an effective onboarding program will make the best of online technology.

In making the transition to online formats, onboarding organizers in the post-COVID-19 era must be adaptive. They must be prepared to deal with a process of trial and error, as all organizations are unique and there is no single, uniform onboarding program. By maintaining an open and adaptive state of mind and implementing the methods and techniques described in this Article, onboarding organizers can begin to shape a comprehensive online onboarding program that works for their organization.

FIXING THE JOBS ACT AND INVITING THE TOKENIZED FUTURE, THE NEED FOR CONGRESSIONAL ACTION

PAUL H. JOSSEY*

CONTENTS

INTRODUCTION

On November 2, 2020 the Securities and Exchange Commission (Commission or SEC) published its much anticipated private-offering framework revisions (Final Rules).[1] A June 2019 Concept Release[2] and March 2020 proposals[3] requested comment and suggested ways the Commission could ease burdens on companies (issuers) seeking capital and expand private-market investor opportunities.[4] Commenters offered numerous ways to smooth the discordant, confusing, and often exclusionary exemption rules.[5] To its credit, the Commission recognizes the current disharmony and its negative impacts on certain entrepreneurs and small businesses, particularly related to geography and demography. Unfortunately, its fixes fall well short.

Congress tried to address existing inequities nearly a decade ago with the Jumpstart Our Business Startups Act of 2012 (JOBS Act).[6] The JOBS Act created and expanded registration exemptions to open private investment to all Americans and give smaller issuers more capital options. For reasons described below, the JOBS Act failed that goal. Indeed, the Proposed and Final Rules devote much attention to JOBS Act underuse. Regrettably, the Commission's revisions expose its worst instincts and highlight the need for further Congressional action. But a JOBS Act 2.0 will repeat past failure without a sober view of Commission priorities and culture.

To be sure, the Final Rules enhance the current framework.[7] But progress must be measured against opportunity costs: time to enactment, conditions placed on them, and ignored alternatives that would have forthrightly bolstered capital formation and protected investors. Despite measured progress, the Commission hamstrings job creators through archaic rules, some used nowhere else. Without statutory direction the Commission will keep impeding American entrepreneurs' capital needs in an increasingly competitive geo-environment. Commission-induced hardships will grow starker as tokenized systems evolve that ignore national borders

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[1] Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Securities Act Release Nos. 33-10884; 34-90300 (November 2, 2020) https://www.sec.gov/rules/final/2020/33-10844.pdf [hereinafter Final Rules].

[2] Concept Release on Harmonization of Securities Offering Exemptions, 84 Fed. Reg. 30460 (June 26, 2019), https://www.govinfo.gov/content/pkg/FR-2019-06-26/pdf/2019-13255.pdf [hereinafter Concept Release].

[3] Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, Release No. 33-10763 (Mar. 4, 2020) https://www.sec.gov/rules/proposed/2020/33-10763.pdf [hereinafter Facilitating Capital Formation].

[4] This article analyzes "private" issuers, *i.e.* those that have not registered their securities pursuant to the Securities Act of 1933, ch. 38, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§77a-77aa (2018)), and are not subject to reporting obligations under the Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a–78aa (2018)).

[5] Section 5 of the Securities Act of 1933 prohibits the sale of securities without an effective registration statement unless the issuer claims a valid exemption. 15 U.S.C. §77e(c) (2018). Exempt offerings are not "public offerings." *See e.g.*, SEC v. Ralston Purina, 346 U.S. 119, 122 (1953) (interpreting Securities Act Section 4(a)(2) transactions "not involving a public offering."). Smaller businesses and startups typically offer securities through exemptions because they cannot meet the rigors of registration. *See* Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J. L. & Bus. 1, 7–10 (2007) (discussing the impracticality of registration for smaller issuers), http://scholarship.law.ufl.edu/faculty/pub/248.

[6] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

[7] The Final Rules become effective 60 days after publication in the Federal Register.

much less state-based sub jurisdictions. Particularly in exempting state-level review, offer regulation, and secondary trading, the Commission burdens issuers with restrictions and ambiguities that waste resources and invite crippling investigations.

While public-market advocates insist only more Commission-created barriers would protect investors and capital by forcing registration and thereby channeling issuers into the public markets,[8] evidence suggests a better way. A lighter regulatory touch which encourages private ordering while maintaining fairness for entrepreneurs and investors would produce superior results at less cost. A second JOBS Act could accomplish this.

This article reviews the private-market milieu including what makes it incredibly successful but also exclusionary for most of the five million U.S. small businesses.[9] It examines—including through market-actor perspectives—how SEC hostility thwarted the JOBS Act via empirically questionable investor protections. It also proposes statutory solutions to push American capital raising into the 21st century. These bright-line proposals abjure overreliance on SEC staff or state-equivalent interpretation and "facts and circumstances" analysis. These solutions may jar lawmakers accustomed to ceding discretion to agencies with immense power over the nation's entrepreneurial spirit. But the world will not wait for the Commission to change cultures and the Final Rules prove if left alone it will remain inert.

I. THE CURRENT PRIVATE MARKETS

Former SEC Chair Jay Clayton[10] describes the U.S. private capital markets as "unrivaled and coveted around the globe."[11] They foster U.S. economic might and help our firms become global powers. They catalyze unrivaled innovation in places like Silicon Valley, Boston, and New York.[12] But this was not happenstance. Late 1970s economic turmoil, lack of entrepreneurial capital, and confusing Commission rules led Congress to pass the Small Business Investment Incentive Act of 1980.[13] This law and resulting Commission action[14] seeded the venture-capital

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[8] *See infra* Part IV.D.

[9] According to data from the Small Business Administration, in 2015 there were 5.27 million U.S. firms with less than 20 employees. These firms employed around 20 million people. U.S. SMALL BUS. ADMIN. OFF. OF ADVOC., 2018 SMALL BUSINESS PROFILE (2018), https://www.sba.gov/sites/default/files/advocacy/2018-Small-Business-Profiles-US.pdf.

[10] Mr. Clayton ended his tenure as SEC Chair on December 23, 2020. *See*, Letter from Jay Clayton, SEC Chairman, to President Donald J. Trump (Dec. 23, 2020) (available at https://www.sec.gov/news/public-statement/clayton-2020-12-23).

[11] Jay Clayton, Chairman, U.S. Sec. and Exch. Comm'n, Remarks to the Economic Club of New York, (Sept. 9, 2019) (transcript available in U.S. Securities and Exchange Commission), https://www.sec.gov/news/speech/speech-clayton-2019-09-09).

[12] *See National Venture Capital Association 2020 Yearbook*, Nat'l Venture Cap. Ass'n 2020 Y.B., 5, https://nvca.org/wp-content/uploads/2020/04/NVCA-2020-Yearbook.pdf ("Outside of California, Massachusetts, and New York, median VC fund size reached $43 million in 2019, an increase of 57% compared to 2018, but still relatively small to the dominant venture hubs—the median for California, Massachusetts, and New York, collectively, was $100 million.").

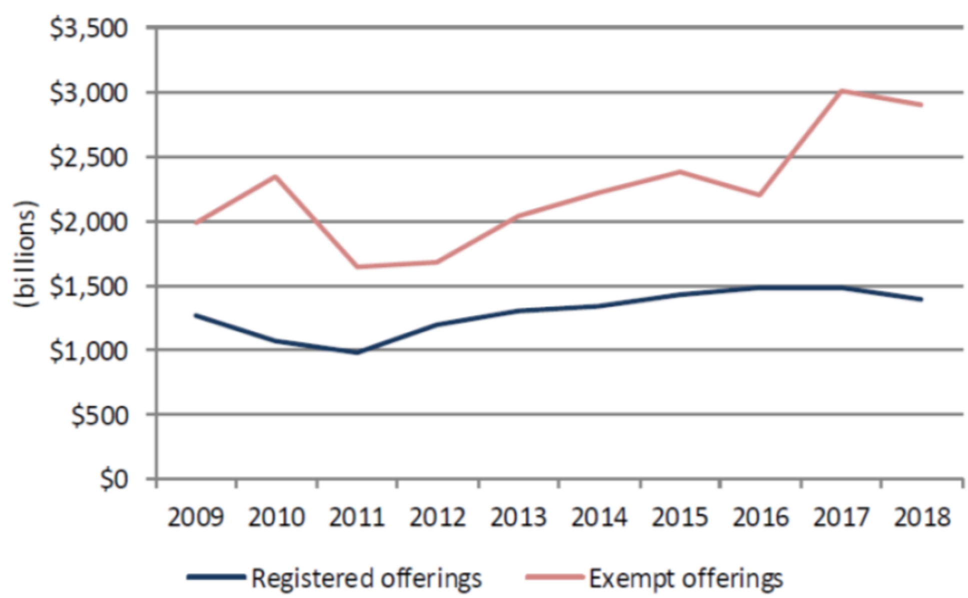
[13] Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, 94 Stat. 2275 (1980).

[14] In 1978, the Commission began reexamining the exemptions after complaints about hardships small businesses faced accessing private capital. This included a new rule, public hearings, a concept release, and a simplified form for registered small IPOs. Regulation D, the most important Commission action of the era was "a major response to the new Congressional mandate." David B. H. Martin, Jr. & L. Keith Parsons, *The Preexisting Relationship Doctrine Under Regulation D: A Rule Without Reason?*, 45 WASH. & LEE L. REV. 1031, 1032 (1988), https://scholarlycommons.law.wlu.edu/wlulr/vol45/iss3/6.

explosion that propelled so many iconic companies in the 1980s and 1990s and nurtured American prosperity decades hence. Two private capital-raising hallmarks arose from this era: the "accredited investor"[15] and Regulation D 506 (Reg D, private placements).[16]

In 1996 Congress enacted the National Securities Market Improvement Act (NSMIA).[17] This statute "covered" Reg D securities,[18] therefore exempting them from Blue Sky laws[19]—state-level registration and merit review, depending on each state. The impact of these changes is irrefutable. In 2018, the SEC estimates exempt offerings raised $2.9 trillion while registered offerings raised $1.4 trillion. Reg D 506(b) alone outpaced public offerings with an estimated $1.5 trillion.[20]

FIGURE 1: CAPITAL RAISED IN EXEMPT AND REGISTERED CAPITAL MARKETS 2009-2018



Source: Securities and Exchange Commission

Reg D dominates the private-capital landscape. Only accredited investors use it, severely restricting the potential-investor pool.[21] But it requires minimal upfront effort and cost before capital becomes available. Issuers gauge interest (test the waters) with accredited investors in

[15] The Commission had defined accredited investors before the passage of the statute. *See* Exemption of Limited Offers and Sales by Qualified Issuers, Securities Act Release No. 33-6180, 45 Fed. Reg. 6462 (Jan. 28, 1980). (Rule 501(a) [17 C.F.R. § 230.501(a) (2019)] contains the current definition. For natural persons it includes net worth and annual income thresholds. In August 2020, the SEC expanded the Accredited Investor definition to add sophistication criteria enabling natural persons to qualify beyond financial indicia. *See*, Accredited Investor Definition, Securities Act Release Nos. 33-10824; 34-89669, 85 Fed. Reg. 64234 (Oct. 9, 2020).

[16] Unless otherwise noted "Reg D" refers to the current Regulation D 506(b) [17 C.F.R. § 230.506(b) (2019)].

[17] National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (1996).

[18] *Id.* at §102(b)(4)(D) (codified as amended at 15 U.S.C. § 77r(b)(4)(F

[19] The origin of the term Blue Sky law is subject to different theories. The most known is from Hall v. Geiger-Jones Co., 242 U.S. 539, 550 (1917) ("The name that is given to the law indicates the evil at which it is aimed; that is . . . 'speculative schemes which have no more basis than so many feet of 'blue sky'. . . .").

[20] Concept Release, *supra* note 2, at 78.

[21] As a technical matter Reg D is available to a limited number of unaccredited investors. *See Id.* at 79.

their circles before filing paperwork, accredited investors declare their status via "substantive, preexisting relationships" with issuers or their agents,[22] the SEC only requires notice filing, and states cannot interfere. No monetary limits exist for investors or issuers.[23]

Investors, however, do not surrender their loot blindly. Reg D private-placement memorandums disclose issuer information about structures, plans, and risks. The reason is simple. According to Heritage Foundation Senior Fellow David Burton, "In the absence of meaningful disclosure about the business and a commitment, contractual or otherwise, to provide continuing disclosure, few would invest in the business and those that did so would demand substantial compensation for the risk they were undertaking by investing in a business with inadequate disclosure."[24] Further, federal law protects these offerees against misleading statements and fraud.[25]

Reg D provides the private capital-raising model. Its success arose from balancing regulation with parties' freedom to contract. Because investors are accredited the Commission accepts they can "fend for themselves" without mandatory disclosures.[26] Wise policy may require extra safeguards when gauging exemptions open to all, as with certain JOBS Act titles. But lawmakers must test this purported need for higher scrutiny against what experience shows works.

II. DISPARITIES IN THE REG D-CENTRIC PARADIGM

Reg D-centered private-market success has a price; data reveals disturbing inequities. First, only 13% of U.S. households with sufficient annual income or net-worth use it.[27] The dearth of private-investment opportunities for retail investors has been called "Securities Law's Dirty Little Secret."[28] And as one might expect, this cohort is not evenly dispersed either geographically or demographically.

A. *Geographic Disparities*

Not only are 87% of households barred from Reg D but the eligible 13% mass in entrepreneurial hubs. Geographic outsiders often cannot access these funding channels. Indeed,

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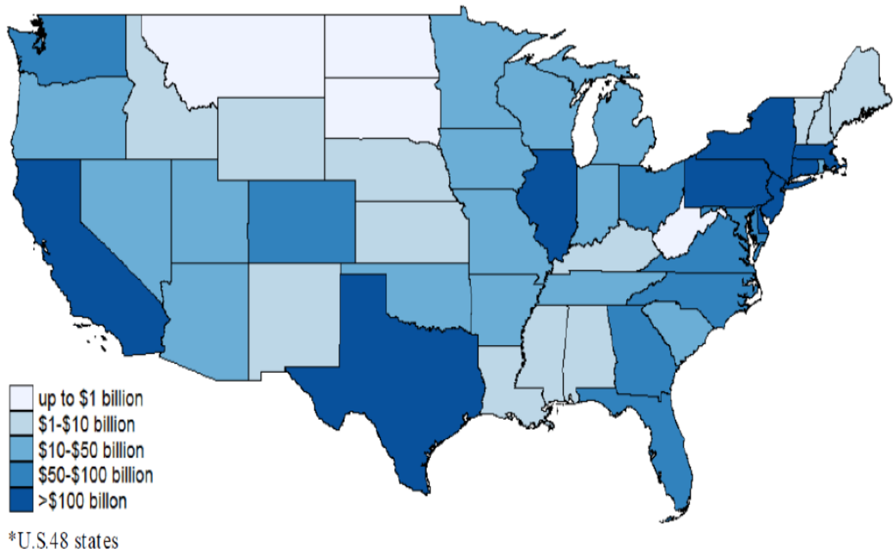
[22] Broker Dealers are not subject to general solicitation prohibitions who solicit existing customers from a pre-determined, screened list of potential investors. *See, e.g.*, Arthur M. Borden, SEC Staff No-Action Letter, 1978 SEC No-Act. LEXIS 2001 (Oct. 6, 1978).
[23] 17 C.F.R. § 230.500 (2019); *cf*. Joe Wallin et al., Comment Letter on SEC Concept Release (Sept. 23, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6182683-192407.pdf (describing the procedure for Reg D 506(b) raises).
[24] David R. Burton, Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions (Sept. 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6193328-192495.pdf [hereinafter Burton Letter].
[25]*Frequently asked questions about exempt offerings*, U.S. SEC. AND EXCH. COMM'N, (July 12, 2019), https://www.sec.gov/smallbusiness/exemptofferings/faq; *cf.* 15 U.S.C. § 77q ("All securities transactions, even exempt transactions, are subject to the antifraud provisions of the federal securities laws.").
[26] *See* Regulation D Revisions; Exemption for Certain Employee Benefit Plans, 52 Fed. Reg. 3015 (Jan. 30, 1987).
[27] Concept Release, *supra* note 2, at 36. *See supra* note 15 for a recent, but yet-quantified Commission expansion of natural persons eligible for Accredited Investor classification.
[28] Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 3389, 3390–91 (2013), https://digitalcommons.law.uga.edu/fac_artchop/939 [hereinafter Rodrigues, *Dirty Secret*] ("The dirty little secret of U.S. securities law is that the rich not only have more money-they also have access to types of wealth-generating investments not available, by law, to the average investor."); *Id.* at 3422 ("Although not driven by malicious intent, this regulatory evolution [of the private markets] had the effect of creating a world divided into investing haves and have-nots.").

aggregate Reg D-capital concentrates where accredited investors cluster.[29] This has real effects on American prosperity. One study found lack of access to accredited 'angel' networks experience reduced startup activity and compounded negative economic impacts.[30]

FIGURE 2: AGGREGATE AMOUNT RAISED IN REG D RULE 506 OFFERINGS BY ISSUER LOCATION, 2009-2018



Source: Securities and Exchange Commission

B. Demographic Disparities

Reg D exacerbates disparities and curbs wealth creation in other ways. If capital raising only occurs in select areas, exclusionary conventions and cultures will form. In 2019 the SEC Office of the Advocate for Small Business Capital Formation found 29.5% of angel investors and 11% of venture capitalist were women and 71% of venture capital firms had no women.[31] From 2013-2017 venture capital backed-businesses were 1% Black, 2% Latino, 2% Middle Eastern, 18% Asian, and 77% White.[32] Moreover, new black-owned businesses start with around three times

[29] Jason Rowley, *Where Venture Capitalists Invest and Why*, TECHCRUNCH (Nov. 9, 2017), https://techcrunch.com/2017/11/09/local-loyalty-where-venture-capitalists-invest-and-why/ (describing how venture-capital funds tend to invest in firms within close geographic proximity); *cf.* Dana M. Warren, *Venture Capital Investment: Status and Trends*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 1, 12 (2012) ("Venture capital investment almost always involves significant participation in and oversight of each of the portfolio companies by the venture capital professionals. As a result, simple logistics makes venture capital investment an inherently local, or at most regional, activity.").

[30] LAURA ANNE LINDSEY & LUKE C.D. STEIN, ANGELS, ENTREPRENEURSHIP, AND EMPLOYMENT DYNAMICS: EVIDENCE FROM INVESTOR ACCREDITATION RULES (Sixth Annual Conference on Financial Market Regulation 2019), https://ssrn.com/abstract=2939994.

[31] SEC, OFF. OF THE ADVOC. FOR SMALL BUS. CAP. FORMATION, ANNUAL RPT. FOR FISCAL YR. 2019, at 28, https://www.sec.gov/files/2019_OASB_Annual%20Report.pdf.

[32] *Id.* at 32 (internal citation omitted).

less capital than new white-owned businesses.[33] Further, minority entrepreneurs report lack of capital disproportionately affects their profitability.[34]

III. Congress Enacted the JOBS Act to Create Opportunities Beyond Reg D

Lawmakers saw how the flawed Reg D model failed small businesses and entrepreneurs outside select hubs or lacking certain profiles.[35] Legislators sought to democratize investing for both entrepreneur and backer.[36] A rare bipartisan moment birthed the JOBS Act. At a Rose Garden signing ceremony President Obama gushed about the law's potential for unconventional capital formation and retail investors to support companies at their earliest and most lucrative stages. "Right now, you can only turn to a limited group of investors -- including banks and wealthy individuals -- to get funding. Laws that are nearly eight decades old make it impossible for others to invest. . . Because of this bill, start-ups and small business will now have access to a big, new pool of potential investors -- namely, the American people. For the first time, ordinary Americans will be able to go online and invest in entrepreneurs that they believe in."[37]

The JOBS Act contained three titles that expanded issuer access to investor pools.[38] Title II directed the Commission to allow general solicitation for Regulation D. Title IV created a "new" Regulation A with higher limits and other enhancements open to "Qualified Purchasers." Title III created a new "investment" or "equity" crowdfunding exemption.

The JOBS Act also crucially changed another capital-raising factor. Title V amended Section 12(g)(1)(A) of the Securities Exchange Act of 1934[39] known as the '12(g) Rule.' This rule states companies with $10 million in total assets and a class of equity securities "held of record" by a certain number of holders, must register their securities. Title V increased the threshold from 500 persons to 2,000 persons or 500 unaccredited investors. The JOBS Act directed the Commission to appropriately apply the 12(g) Rule to the law.

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[33] *Id.* at 30 (internal citation omitted).

[34] *Id.* at 31 (internal citation omitted); *cf.* Kendrick Nguyen, Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions (Sept. 24, 2019), at 2, https://www.sec.gov/comments/s7-08-19/s70819-6189775-192417.pdf ("[F]emale, minority, veteran and immigrant entrepreneurs, as well as entrepreneurs based in Middle America, often struggle to obtain exposure to and capital from traditional venture investors.").

[35] *See, e.g.*, 157 Cong. Rec. S8458-02 (daily ed. Dec. 8, 2011) (statement of Sen. Jeff Merkley) ("In recent years, small businesses and startup companies have struggled to raise capital. The traditional methods of raising capital have become increasingly out of reach for many startups and small businesses. . . . Low-dollar investments from ordinary Americans may help fill the void, providing a new avenue of funding to the small businesses that are the engine of job creation."); *cf.* Seth C. Oranburg, *Bridgefunding: Crowdfunding and the Market for Entrepreneurial Finance*, 25 CORNELL J. L. & PUB. POL'Y 397, 413–14 (2015) (discussing funding gap between $1-5 million where businesses fail for lack of capital access).

[36] U.S. SEC. AND EXCH. COMM'N, GOV'T-BUS. F. ON SMALL BUS. CAP. FORMATION, FINAL RPT. (2019) at 20, https://www.sec.gov/info/smallbus/gbfor37.pdf [hereinafter 2018 Forum Report], (discussing the intent of Regulation Crowdfunding).

[37] President Barack Obama, Remarks by the President at JOBS Act Bill Signing (Apr. 5, 2012), https://obamawhitehouse.archives.gov/the-press-office/2012/04/05/remarks-president-jobs-act-bill-signing.

[38] This article covers only the private exemptions in the JOBS Act, other titles such as Title I, Reopening American Capital Markets to Emerging Growth Companies, Pub. L. No. 112-106, 126 Stat. 306, 307 (2012), which eases private company transition into the public markets are beyond its scope. It also does not cover changes to Rule 144A. 17 C.F.R. § 230.144A (2019); Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 201(a)(2), 126 Stat. 306, 314 (2012). Compare with note 132.

[39] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306, 325 (2012) (codified as amended at 15 U.S.C. § 78l(g)(1)(A)).

A. *Regulation D 506(c)*

JOBS Act Title II did not expand the investor pool per se. Instead it loosened communication rules, allowing accredited-investor searches beyond familiar circles. As noted above, Reg D reigned well before the JOBS Act. Reg D arose from 1970s political and economic turmoil. Oil crises, weak economic growth, high interest rates, plunging stock prices, and an SEC determined to force registration[40] meant entrepreneurs struggled to raise capital.

After the 1980 statutory push,[41] in 1982 the Commission created Reg D as a safe harbor to ensure compliance with nonpublic offerings defined in Securities Act Section 4(a)(2)."[42] Reg D sought to simplify and clarify rules and harmonize state and federal exemptions.[43] Reg D allowed unlimited numbers of accredited investors to join these offerings without investment limits or mandatory disclosures. It also allowed small numbers of unaccredited investors to join with daunting mandatory disclosure[44] and sophistication thresholds.[45] The Commission also created two lesser-used exemptions, Regulation D 504[46] and Regulation D 505.[47] None of these exemptions preempted Blue Sky laws.

After Reg D, private placements grew from $18 billion in 1981 to $202 billion in 1988.[48] In 1996 Congress further nurtured Reg D with NSMIA.[49] This Act amended Securities Act Section

[40] As more issuers offered securities under what is now Section 4(a)(2) of the Securities Act, 15 U.S.C. § 77d(a)(2) "transactions by an issuer not involving any public offering," the Commission curtailed the exemption by "clarifying" limitations on its availability. *See* U.S. Sec. and Exch. Comm'n, Non-Public Offering Exemption, Release No. 33-4552, 27 Fed. Reg. 11316 (Nov. 6, 1962)..

[41] *See supra* note 14.

[42] 15 U.S.C. § 77d(a)(2).

[43] U.S. Sec. and Exch. Comm'n, Revision of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Release No. 33-6389, 47 Fed. Reg. 11251 (Mar. 16, 1982).

[44] Although Reg D 506(b) allows up to 35 unaccredited investors, issuers wishing to accept such investors must provide disclosures pursuant to Rule 502(b) 17 C.F.R. § 230.502(b)(2)(i)-(vii)) (2019). Previously the financial disclosures for non-reporting companies operated on a tri-tiered basis depending on offer amount, 17 C.F.R. § 230.502(b)(2)(i)(B)(1-3) (2019), The Final Rules simplified and slightly relaxed these disclosures to align them with Reg A+ Tier 1 requirements (offerings up to $20 million) and Reg A+ Tier 2 Requirements (offerings above $20 million). Final Rules, *supra* note 1, at 115-116, 118. The SEC estimates in 2015, 2016, 2017, and 2018 unaccredited investors joined only 6% of Reg D 506(b) offerings and raised between 2%-3% of Reg D 506(b) capital during that time. Concept Release, *supra* note 2 at 79.

[45] 17 C.F.R. § 230.506(b)(2)(ii).

[46] Reg D 504 permits issuers to raise up to $5 million in a 12-month period from an unlimited number of investors without regard to whether those investors are accredited. The Final Rules raised the offer limit to $10 million. Facilitating Capital Formation, *supra* n. 1 at 140. Issuers conducting a Rule 504 offering are not subject to the information requirements in Rule 502(b) but are subject to Blue Sky laws. 17 C.F.R. § 230.504 (2019).

[47] The Commission repealed Reg D 505 in 2016. *See* Exemptions to Facilitate Intrastate and Regional Securities Offerings, Release No. 33-10238, 81 Fed. Reg. 83494 (Nov. 21, 2016). Reg D 505 ceased on May 22, 2017.

[48] Kellye Y. Testy, *The Capital Markets in Transition: A Response to New SEC Rule 144A*, 66 IND. L.J. 233, 242 (1990). Testy uses the term 'private placement' which connotes securities sold under Securities Act Section 4(a)(2), not only Regulation D its Commission-created nonexclusive safe harbor. But as experience shows and noted by Testy, Reg D is the primary means of effectuating private placements.

[49] *See supra* note 17.

18 to "cover" certain securities from Blue Sky laws, including Commission safe harbors under Securities Act Section 4(a)(2).[50] After NSMIA, the private-placement market exploded.[51]

JOBS Act Title II required the Commission to adopt rules for generally solicited accredited investors. Instead of a simple declaration, issuers needed to verify status through "reasonable steps." Congress directed the Commission to define "reasonable steps." It also exempted broker dealer registration for website offers under the title meeting certain requirements.[52]

The Commission finalized rules on July 10, 2013.[53] It split Reg D into two parts. Reg D 506(b) would remain the "old" Reg D that forbade general solicitation. Reg D 506(c) would sate Title II.[54] The Commission defined two "reasonable steps" methods. First was "principles based." The second was a non-exhaustive list of verification documents.

For the first, issuers could reasonably determine status by analyzing each purchaser and transaction via 'facts and circumstances.' The Commission listed factors such as the nature of the purchaser and the type of accredited investor the purchaser claimed; the amount and type of information the issuer had about the purchaser, the offering nature, such as how the issuer solicited the purchaser, and the offering terms, such as minimum investment.[55]

The non-exhaustive verification documents were imposing. Verifying through income included: two most recent years of IRS forms including W2, 1099, Schedule K-1 to Form 1065, and Form 1040, and a declaration stating the purchaser reasonably expected to reach necessary income levels during the current year.[56] Net-worth verification included: bank statements, brokerage statements and other statements of securities holdings, certificates of deposit, tax assessments, and independent third-party appraisal reports. With respect to liabilities: a consumer report from at least one nationwide consumer-reporting agency. And a declaration stating the purchaser had disclosed all liabilities needed to determine net worth. All only valid if dated within three months.[57] The Commission also allowed certain third-party professionals such as broker dealers, investment advisors, attorneys, and CPAs to verify status.[58]

B. Regulation A+

Unlike Reg D, issuers had mostly shunned Regulation A. The Commission adopted Regulation A under the authority of Securities Act Section 3(b) soon after the Securities Act of

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[50] *See* 15 U.S.C. § 77r(b)(4)(F) (2018); 17 C.F.R. § 230.506(a) (2019).

[51] Rutheford B. Campbell, Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions (June 18, 2019) at 9, https://www.sec.gov/comments/s7-08-19/s70819-6240706-192714.pdf [hereinafter Campbell Letter] ("The migration to the Rule 506 exemption was driven by state blue sky laws requiring registration. State registration authority over Rule 506 offers was preempted by the National Securities Market Improvement Act (15 U.S.C. § 77r (2019))."); *cf.* Burton Letter, *supra* note 23, at 32 ("Regulation D is a success story. . . . It is a success because it is a lightly regulated means of raising capital and because of the preemption of state Blue Sky registration and qualification laws with respect to Rule 506 offerings since the enactment of the National Securities Markets Improvement Act of 1996.").

[52] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306, 313–15 (2012).

[53] Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Release No. 33-9415, 78 Fed. Reg. 44771 (July 24, 2013).

[54] *Id.* at 17-18.

[55] *Id.* at 27-28.

[56] 17 C.F.R. § 230.506(c)(2)(ii)(A).

[57] 17 C.F.R. § 230.506(c)(2)(ii)(B).

[58] 17 C.F.R. § 230.506(c)(2)(ii)(C).

1933 to shield smaller issuers from registration.[59] Current Regulation A issuers must traverse a Commission-led qualification process, which averages over two months and involves back and forth between issuer and staff.[60] The exemption floundered despite the Commission repeatedly raising the offer limit and eventually loosening communication rules.[61] Use spiked slightly after 1992 changes but quickly crested. Issuers filed 116 Regulation A offerings in 1997, dropping to 19 in 2011. Qualified offerings dropped from 57 in 1998 to 1 in 2011.[62] Issuers spurned Regulation A because of its complexities, time-consuming qualification process, lack of Blue Sky preemption, low limits, and Reg D options.[63]

Congress again tried to boost Regulation A with JOBS Act Title IV, which added Section 3(b)(2) to Regulation A statutory authority in Securities Act Section 3(b). This became known as Reg A+.[64] It increased the offer limit from $5 million to $50 million, securities could be offered and sold publicly, were "unrestricted" under federal law, and issuers could 'test the waters.' Congress also, however, mandated disclosure and compliance obligations including audited financial statements and periodic reports. It also limited available security types. It ordered biennial offer-limit reviews and commissioned a Government Accountability Office report on Blue Sky-law impact.[65] It also "covered" the securities from Blue Sky laws for "Qualified Purchasers," a term Congress charged the Commission with defining.[66]

The Commission adopted final rules on March 25, 2015.[67] It split Reg A+ into two tiers. The Commission limited Tier 1 to $20 million annually, while Tier 2 retained the $50 million limit.[68] It cabined how much selling securityholders could sell at first offering and within the following 12 months to 30% aggregate offering price. And further limited affiliates to a hard ceiling. Federally, Reg A+ shares would be freely tradable.[69] Tier 2 accredited investors were uncapped but the Commission limited unaccredited investors to the greater of 10% annual income or net

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[59] *See generally* Amend. to Rules of Prac., Securities Act of 1933 Release No. 33-632 (West) (Jan. 21, 1936).
[60] *Compare Get Your Reg A+ Offering Qualified by the SEC*, MANHATTAN STREET CAPITAL, https://www.manhattanstreetcapital.com/faq/for-fundraisers/get-your-reg-a-offering-qualified-sec (last visited Sept. 21, 2020) (pegging average time at 71 days and "dealing with the SEC is likely to be a multi-step process"), *with* Rod Turner, *These 32 Companies Raised $396 Mill Using Regulation A+, Entrepreneurs: You Have A New Option*, FORBES (Mar. 14, 2017, 6:54 AM), https://www.forbes.com/sites/rodnturner/2017/03/14/how-they-did-it-32-companies-successfully-raised-capital-via-regulation-a/#6e4c45f37cde (pegging the average at 78 days).
[61] Concept Release, *supra* note 2, at 86 n.272. The initial Regulation A offering limit was $100,000. *Id.* The Commission raised it several times thereafter. *Id.* Finally, in 1992, it raised it to $5 million and allowed 'testing the waters' communications. *Id.*; *see generally* Small Business Initiatives, FR-391 (July 30, 1992) (as codified by 57 FR 36442-01 (Aug. 13, 1992)); Small Business Initiatives, Release Nos. 33-6949, 34-30968, 39-2287 (West) (July 30, 1992).
[62] A. NICOLE CLOWERS, U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-839, SECURITIES REGULATION: FACTORS THAT MAY AFFECT TRENDS IN REGULATION A OFFERINGS (2012), at 8-9.
[63] See Rutheford B. Campbell, Jr., Article, *Regulation A: Small Businesses' Search for "A Moderate Capital"*, 31 DEL. J. CORP. L. 77 (2006) and Brian T. Kloeblen, Comment, *Splitting the Baby: The Death of Small Business*, 48 SETON HALL L. REV. 535 (2018), for a review of Regulation A's lack of use prior to the JOBS Act.
[64] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 401, 126 Stat. 306, 324 (2012) (codified as amended at 15 U.S.C. § 77c(b)(2–5)); 17 C.F.R. §§ 230.250–263.
[65] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 401, 126 Stat. 306, 323–25 (2012) (codified as amended at 15 U.S.C. § 77c(b)(2–5)).
[66] 15 U.S.C. § 77r(b)(4)(D)(ii).
[67] Amendments for Small and Additional Issues Exemptions Under the Securities Act (Regulation A), Release No. 33-9741 (West) (Mar. 25, 2015) [hereinafter Regulation A Release]; 80 Fed. Reg. 21805 (Apr. 20, 2015).
[68] 17 C.F.R. § 230.251.
[69] Regulation A Release, *supra* note 67, at 35 n. 98.

worth.[70] It defined Qualified Purchasers as any Tier 2 purchaser.[71] The Commission conditionally exempted Tier 2 from the 12(g) Rule provided issuers remained compliant with ongoing reporting, hired a transfer agent, and remained under certain public float or revenue thresholds,[72] in addition to 12(g) Rule recordholder and asset criteria.[73]

The Commission made offering circulars and disclosures akin to smaller registered offerings, especially for Tier 2.[74] This meant ongoing reporting including annual reports,[75] semi-annual reports,[76] and “current event” reports.[77] Annual reports cover among other topics: three years’ business operations, interested transactions, beneficial ownership of voting securities, identities of directors, officers, and significant employees, executive compensation, management discussion and analysis of liquidity, capital resources, two years’ operation results, and two years’ audited financial statements.[78] Semi-annual reports include additional management discussion and analysis and financial statements similar to registered offering’s Form 10-Q.[79] Moreover Tier 2 issuers must disclose within four business days any Commission-deemed “significant and substantial” event.[80] The final rules did not require Tier 1 ongoing reporting. These issuers must only file Form 1-Z exit reports 30 days after completing or terminating an offering.[81] This contains only summary information including qualification date, amount of securities qualified, amount sold, price, amount sold by selling security holders, fees, and net proceeds.[82]

The Commission reversed itself in one respect and failed to act in others. It originally proposed to exempt offers from Blue Sky laws for both tiers and sales for Tier 2. But the final rules exempted only offers and sales for Tier 2, Tier 1 offers and sales would be subject to state-by-state compliance.[83] The Commission reasoned Tier 1’s anticipated local nature should portend state regulatory authority. After a vigorous and coordinated effort to kill Reg A+ preemption,[84] the North American Securities Administrators Association (NASAA), the state regulators’ association, responded to the JOBS Act and complaints about onerous double review

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[70] The Commission deserves credit for defining “Qualified Purchasers” in Tier 2 as purchasers of those securities without additional complexities requested by state regulators and consumer groups. *See generally* 17 C.F.R. § 230.251(d)(2)(C) (2020); Regulation A Release, *supra* note 67, at 208–10 and attending footnotes.
[71] 17 C.F.R. § 230.256.
[72] 17 C.F.R. § 240.12g5-1(a)(7).
[73] 17 C.F.R. § 240.12g-1.
[74] Regulation A Release, *supra* note 67, at 98.
[75] 17 C.F.R. § 230.257(b)(1).
[76] 17 C.F.R. § 230.257(b)(3).
[77] 17 C.F.R. § 230.257(b)(4).
[78] Part II of Form 1-K.
[79] *See* Regulation A Release, *supra* note 67, at 170. Part I (Financial Information) of Form 10-Q, does not include other parts of Form 10-Q like quantitative and qualitative market risk, controls and procedures, updates to risk factors, or defaults on senior securities. Form 10–Q, for Quarterly and Transition Reports Under Sections 13 or 15(d) of the Securities Exchange Act of 1934, 17 C.F.R. § 249.308a (2020).
[80] Form 1-U, 17 C.F.R. § 230.257(b)(4).
[81] 17 C.F.R. § 230.257(a).
[82] 17 C.F.R. § 230.257(b)(4); Regulation A Release, *supra* note 67, at 160.
[83] *Id.* at 206, 213-214.
[84] Rutheford B. Campbell, Jr., *The SEC's Regulation A+: Small Business Goes under the Bus Again*, 104 KY. L.J. 325, 334 (2016), https://uknowledge.uky.edu/cgi/viewcontent.cgi?article=1589&context=law_facpub [hereinafter Campbell, *Under the Bus*]; *cf.* Letter from NASAA to Mary Jo White, Chair, Sec’y, U.S. Sec. and Exch. Comm’n (Feb. 19, 2014), https://www.nasaa.org/wp-content/uploads/2014/02/NASAA-Letter-Regarding-Reg-A+_021914.pdf [NASAA Letter]

with a "Coordinated Review Plan"[85] it claimed would "ease regulatory burdens for filers without sacrificing investor protection."[86] The Commission also declined to exempt Reg A+ secondary trading despite commenter support.[87] The Commission stated it needed time to "review and consider changes" but preempting secondary trading would not be "appropriate at the outset."[88] Thus, despite Congress designating Reg A+ securities unrestricted, the Commission ensured Tier 1 offers, sales, and resales and Tier 2 resales would face state scrutiny.

C. Regulation Crowdfunding

JOBS Act Title III created a crowdfunding tool for smaller issuers and retail investors. It amended the Securities Act to add Section 4(a)(6).[89] Issuers could raise $1 million per 12-months with periodic inflation adjudgments.[90] In 2017, the Commission adjusted the limit to $1.07 million.[91] The law set individual limits based on an aggregate net worth, annual-income formula. Investors could devote $2,000 or 5% of annual income or net worth if either was less than $100,000 (it did not specify which financial marker applied, for instance 'greater of' or 'lesser of' the two) or 10% if either was equal or more than $100,000, with a maximum aggregate cap of $100,000.[92] Issuers would sell through broker dealers or a new statutory creation: funding portal intermediaries (portals).[93]

The statute set issuer disclosures, including business plan, officers and directors, capital structure, tiered financial documents up to audits, use of proceeds, amount sought, valuation, risks, and promoter compensation. It restricted communication about offers and sales and required annual reports.[94] The statute restricted first-year resales except to certain offerees.[95] It directed the Commission to exempt Title III securities "conditionally or unconditionally" from the 12(g) Rule,[96] and preempted Blue Sky laws.[97] Congress also limited state filing fees to issuer principal place of business or where it sold 50% or more securities.[98] Title III also ordered

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[85] *NASAA's Coordinated Review Program for Regulation A Offerings*, NASAA, https://www.nasaa.org/industry-resources/securities-issuers/coordinated-review/regulation-a-offerings/. Some states do not participate in program including Arizona, Florida, and New York. *See* NASAA, APPLICATION FOR COORDINATED REVIEW OF REGULATION A OFFERING, https://www.nasaa.org/wp-content/uploads/2016/09/20160721-Coordinated-Review-Application-Sec-3b.pdf [hereinafter NASAA APPLICATION].
[86] *See* NASAA Letter, *supra* note 84, at 1.
[87] Regulation A Release, *supra* note 67, at 212 n. 791 (listing commenters supporting state preemption of secondary trading).
[88] *Id.* at 228 n. 833.
[89] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306, 315–23 (codified as amended at 15 U.S.C. § 77d(a)(6)).
[90] *Id.* § 302(a)(6)(A) (codified as amended at 15 U.S.C. § 77d(a)(6)(A)).
[91] Inflation Adjustments and Other Technical Amendments under Titles I and III of the JOBS Act (Technical Amendments; Interpretation), Release No. 33-10332, 82 Fed. Reg. 17545 (Apr. 12, 2017).
[92] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 302(a)(6)(B), 126 Stat. 306, 315 (2012) (codified as amended at 15 U.S.C. § 77d(a)(6)(B)).
[93] *Id.* at § 302(a)(6)(C) (codified as amended at 15 U.S.C. § 77d(a)(6)(C)).
[94] *Id.* at § 4A(b) (codified as amended at 15 U.S.C. § 77d–1(b)).
[95] *Id.* at § 4A(e) (codified as amended at 15 U.S.C. § 77d–1(e)).
[96] *Id.* at § 303 (codified as amended at 15 U.S.C. § 78l(g)(6)).
[97] *Id.* at § 305 (codified as amended at 15 U.S.C. § 77r(b)(4)(C)).
[98] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 305(c)(F), 126 Stat. 306, 315 (2012), (codified as amended at 15 U.S.C. § 77r(c)(2)(F)).

certain portal requirements[99]and exempted them from state interference with respect to their businesses as such.[100]

The Commission adopted Regulation Crowdfunding (Reg CF) rules on October 30, 2015.[101] The rules restricted Reg CF further where the Commission deemed public interest required and did not expand any material rules. For instance, despite warnings the modest $1 million statutory limit would hamper use,[102] the Commission kept it for consistency and because of Reg CF's novelty.[103] The Commission also conservatively approached individual limits. The final rules clarified limits applied to all Reg CF investors, even accredited investors. The Commission recognized the capital-formation burden but justified it on Congressional intent and to minimize investor risk in crowdfunding transactions.[104] Final rules required investors to meet the $100,00 threshold for *both* annual income and net worth for the 10% bracket and $100,000 cap. If investors did not meet both they faced the lower 5% bracket. And it imposed the *lesser of* annual income or net worth as the limit once in either bracket. The Commission kept the statutory tiered financial-statements review but did exempt first-time issuers from audits.[105] It also kept the statutory discussion of risk factors.[106]

The Commission required further disclosures beyond statutory mandates.[107] For example, while the statute only required director and officer names (and any persons occupying a similar status or performing similar functions) the Commission required three-years' business experience including principal occupation and employment, including positions with other corporations or organizations.[108] It also regulated oversubscriptions,[109] how investors could complete or cancel investments,[110] and required investors reconfirm commitments after material changes, or the investment would cancel and funds automatically return.[111]

The Commission required several other 'public interest' disclosures.[112] These included intermediary compensation and other interests in the transaction,[113] number of issuer employees,[114] material indebtedness,[115] past three years of exempt capital raises,[116] transactions by interested persons including officers, directors, major equity holders, promoters, or family

[99] *Id.* at § 304 (codified as amended at 15 U.S.C. § 78(c)–(h)).
[100] *Id.* at § 305(d) (codified as amended at 15 U.S.C. § 78o(i)(2)).
[101] Crowdfunding, Release No. 33-9974, 80 Fed. Reg. 71387 (Nov. 16, 2015) [hereinafter Crowdfunding Release]. Regulation Crowdfunding became effective on May 16, 2016.
[102] *Id.* at 16 n. 21.
[103] *Id.* at 17.
[104] *Id.* at 25, 28.
[105] 17 C.F.R. § 227.201(t)(3).
[106] 17 C.F.R. § 227.201(f).
[107] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 4A(b)(1)(F), 126 Stat. 306, 317 (2012) (codified as amended at 15 U.S.C. § 77d–1(b)(1)(F)); 17 C.F.R. § 227.201(g).
[108] 17 C.F.R. § 227.201(b).
[109] *Id.* at § 227.201(h).
[110] *Id.* at § 227.201(j).
[111] *Id.* at § 227.201(k).
[112] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, § 4A(b)(1)(I), 126 Stat. 306, 318 (2012) (codified as amended at 15 U.S.C. § 77d–1(b)(1)(I)).
[113] 17 C.F.R. § 227.201(o).
[114] *Id.* at § 227.201(e).
[115] *Id.* at § 227.201(p).
[116] *Id.* at § 227.201(q)

members that exceed a commission-defined 5% threshold,[117] a narrative discussion and analysis by management of financial condition, including, to the extent material, liquidity, capital resources, and historical operation results.[118] The Commission also mandated issuers include additional material information to make the disclosures not misleading "in light of the circumstances in which they were made."[119] And it required disclosure of any missed annual reports.[120] As for the 12(g) Rule the Commission conditionally exempted Reg CF provided issuers remained current in reporting, had less than $25 million in assets, and hired a registered transfer agent.[121]

The Commission also limited issuer communication aligned with and beyond the statute. First it required all transactions occur through portals.[122] This essentially forbade in person investor meetings.[123] The Commission restricted issuer advertising outside portals to "tombstone" ads[124] that contained statutory "terms" and other factual information about issuer legal identity, location, contact information, and a brief business description.[125] Adverts could not include more information but instead must hyperlink to portals. The Commission further clarified "terms" as amount of securities offered, security type, price, and offer closing date.[126] The Commission did provide flexibility for the online and social-media environs offers would appear.[127]

IV. THE JOBS ACT FAILED TO CREATE EXPECTED OPPORTUNITIES

Despite President Obama's hope, the JOBS Act changed little. Eight years hence, it has not democratized investing.[128] Critics have labeled various provisions "generally

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[117] *Id.* at § 227.201(r).
[118] *Id.* at § 227.201(s).
[119] *Id.* at § 227.201(y).
[120] *Id.* at § 227.201(x).
[121] *Id.* at § 240.12g–6.
[122] *Id.* at § 227.100(a)(3).
[123] Crowdfunding Release, *supra* note 101, at 31-32.
[124] 17 C.F.R. § 230.134.
[125] 17 C.F.R. § 227.204(b).
[126] Instruction to 17 C.F.R. § 227.204.
[127] Crowdfunding Release, *supra* note 101, at 140-141.
[128] 2018 Forum Report, *supra* note. 36

disappointing,"[129] a "dismal failure,"[130] "unmitigated disaster for investors," [131] and "widely regarded as not being worth the effort."[132]

Data confirm the sour labels. Through 2019 all JOBS Act titles had at least three-and-half years to mature. Yet the SEC estimates Reg D still captured 95.7% of the main private investment market.[133]

TABLE 1: OVERVIEW OF THE AMOUNTS RAISED IN THE EXEMPT MARKETS IN 2019

Exemption	Amounts Reported or Estimated as Raised in 2019
Rule 506(b) of Regulation D	$ 1,492 billion
Rule 506(c) of Regulation D	$ 66 billion
Regulation A: Tier 1	$ 0.044 billion
Regulation A: Tier 2	$ 0.998 billion
Rule 504 of Regulation D	$ 0.228 billion
Regulation Crowdfunding	$ 0.062 billion
Other exempt offerings	$ 1,167 billion

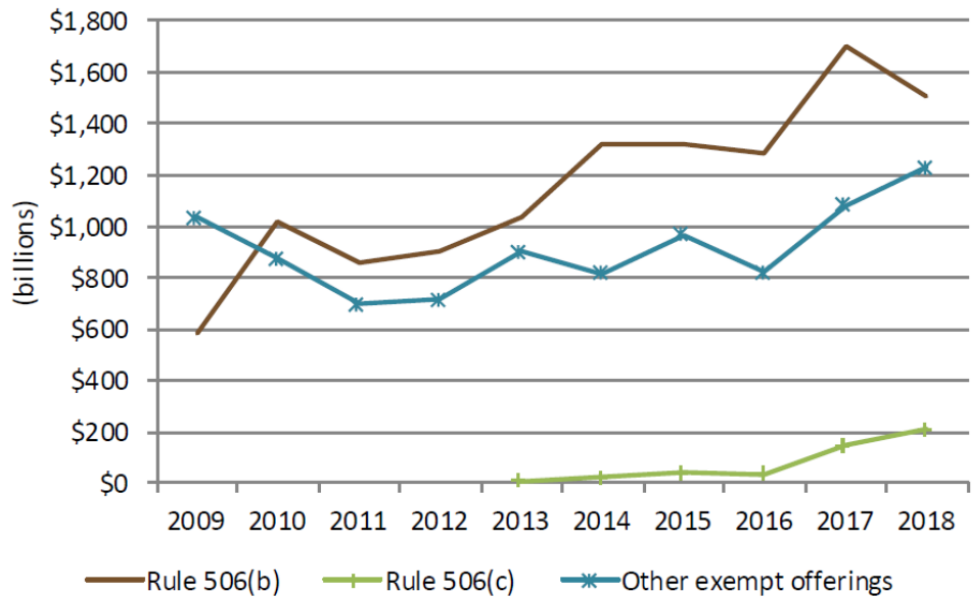
Source: Securities and Exchange Commission

A. *Regulation D 506(c) so far*

Reg D 506(c) sought to widen accredited investor circles beyond known funding channels through general solicitation. But Reg D 506(c) only dots the private-placement landscape capturing 4.2% of the Reg D market.[134] Reg D beats Reg D 506(c) both in aggregate and average.[135]

[129] Peter Rasmussen, *ANALYSIS: Rule 506(c)'s General Solicitation Remains Generally Disappointing*, BLOOMBERG L., May 26, 2017, 3:00 PM, https://www.bna.com/rule-506cs-general-b73014451604/; *cf.* Sec. Indus. & Fin. Mkts. Ass'n, Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions (Sept. 24, 2019), at 3, https://www.sec.gov/comments/s7-08-19/s70819-6193329-192494.pdf (stating that the reliance on Reg D 506(c) is "lower than expected"); Xavier Becerra. et al., Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions (Sept. 24, 2019), at 6, https://www.sec.gov/comments/s7-08-19/s70819-6193375-192522.pdf [Becerra Letter] (stating that participation in Reg CF and Reg A+ "significantly less than anticipated" referencing comments by SEC Investor Advocate).
[130] Campbell Letter, *supra* note 51 at 18.
[131] Consumer Fed'n of Am., Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions (Oct. 1, 2019), at 56, https://www.sec.gov/comments/s7-08-19/s70819-6235037-192692.pdf [hereinafter Consumer Federation Letter] (referring to Reg A+).
[132] Usha R. Rodrigues, *Financial Contracting with the Crowd*, 69 EMORY L.J. 397, 400 (2019), http://law.emory.edu/elj/content/volume-69/issue-3/articles/financial-contracting-with-crowd.html [hereinafter Rodrigues, *Financial Contracting*] (referring to Reg CF); *cf.* Burton Letter, *supra* note 23, at 47 ("Few firms have proven willing to deal with the costs and obligations of Regulation CF to raise under a million dollars.").
[133] This figure does not count "Other Exempt Offerings" which contain mainly Rule 144A buyers and Regulation S. Rule 144A is a nonexclusive safe harbor for resales of restricted securities. It typically involves a two-step process involving a sale to a financial institution and a resale to a "Qualified Institutional Buyer." Regulation S transactions involve offshore transactions not involving direct selling in the U.S. *See* Concept Release, *supra* note 2, at 19–20; 15 U.S.C. § 77d(a)(2).
[134] *See* Table 1.
[135] Concept Release, *supra* note 2, at 80.

FIGURE 3: CAPITAL RAISED IN REGULATION D RULE 506(B), RULE 506(C), AND OTHER EXEMPT OFFERINGS, 2009-2018



Source: Securities and Exchange Commission

B. Regulation A+ so far

From June 2015 through 2019, Reg A+ issuers raised $2.446 billion.[136] Issuers preferred Tier 2 raising about 91% despite ongoing reporting.[137] Even issuers who sought amounts within Tier 1 range and thus could choose either often chose to avoid state-level review. According to the Commission, "The larger Tier 2 offering limit does not appear to be the sole factor for issuers' decision between tiers, given that approximately 43% of filed Tier 2 offerings and 41% of qualified Tier 2 offerings sought amounts not exceeding the Tier 1 offering limit of $20 million."[138] The reasons Tier 1 should be abandoned are discussed below. But after five years, its disfavor is manifest.

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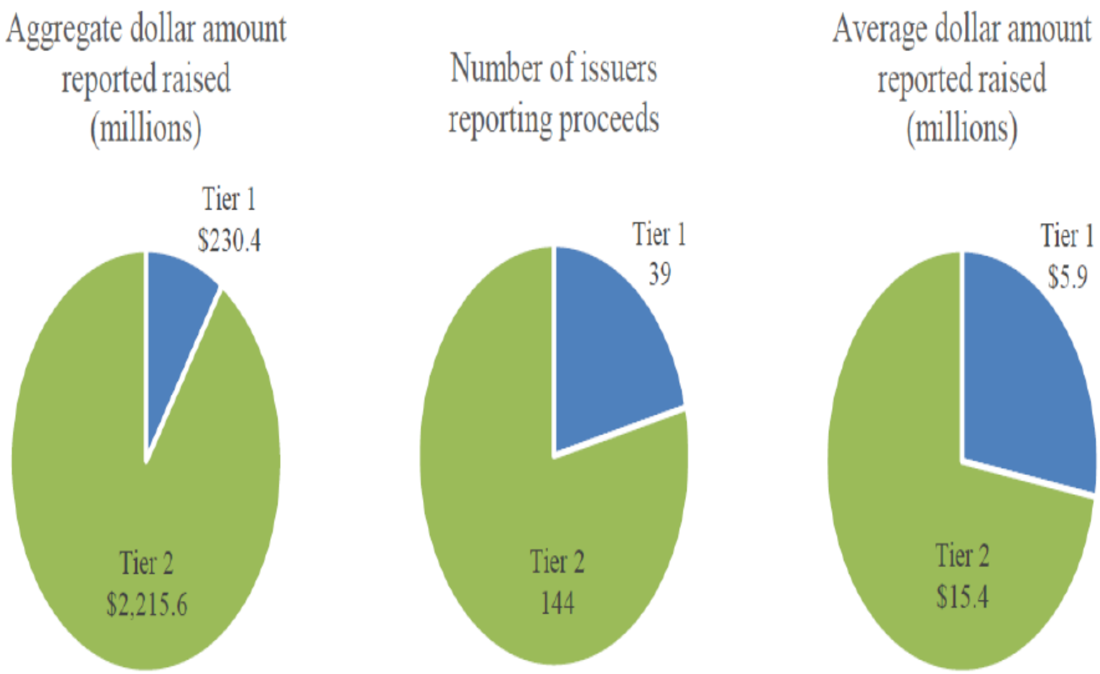
[136] RPT. TO THE COMM., REGULATION A LOOKBACK STUDY AND OFFERING LIMIT REVIEW ANALYSIS, at 5 (Mar. 4, 2020), https://www.sec.gov/files/regulationa-2020.pdf [hereinafter Regulation A Report].
[137] *Id.* at 9.
[138] *Id.*

FIGURE 4: CAPITAL REPORTED RAISED UNDER REGULATION A, 2015-2019



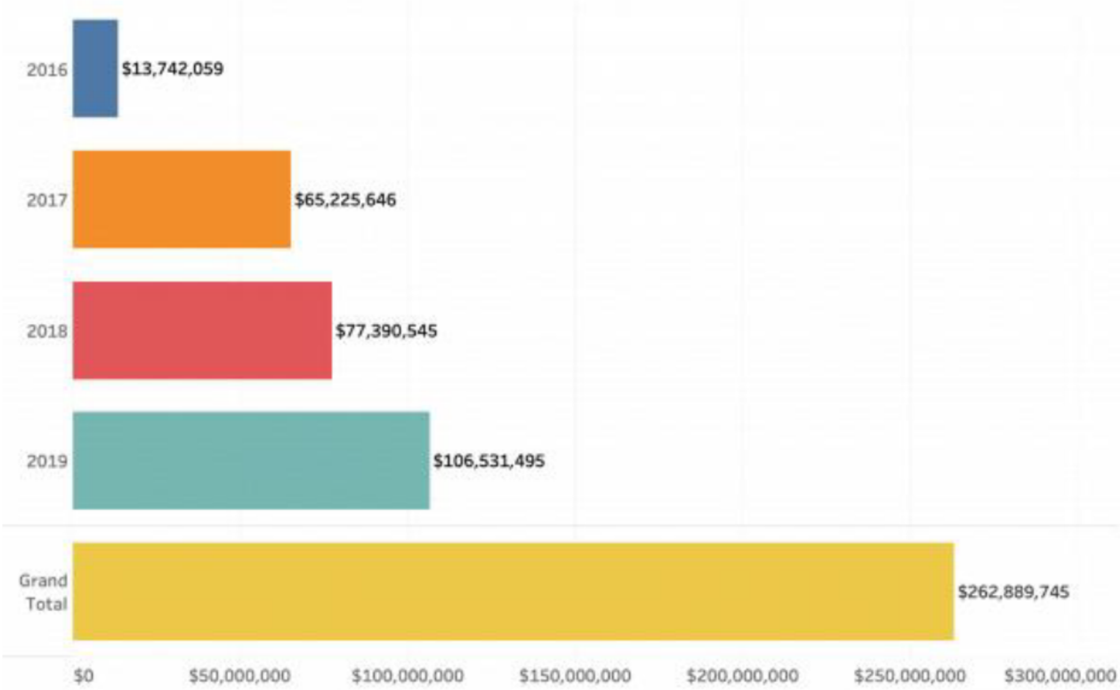
Source: Securities and Exchange Commission

C. Regulation Crowdfunding so far

Unlike Reg A+ and Reg D 506(c), Reg CF had no analog and was Congress's boldest move. It has also disappointed though adoption has steadily grown as awareness increased and successes emerged. Crowdfund Capital Advisors, which curates Reg CF data estimates that from May 2016 through 2019 issuers raised almost $263 million, with gaudy 2018-2019 year-to-year growth of 37%, and had pumped almost one billion into local economies.[139]

[139] JD Alois, *Sherwood Neiss of Crowdfund Capital Advisors Updates on Reg CF Progress: "Successful Reg CF companies have pumped almost $1 billion into local economies."* CROWDFUND INSIDER (Feb. 10, 2020), https://www.crowdfundinsider.com/2020/02/157163-sherwood-neiss-of-crowdfund-capital-advisors-updates-on-reg-cf-progress-successful-reg-cf-companies-have-pumped-almost-1-billion-into-local-economies/.

FIGURE 5: PROCEEDS INTO REGULATION CROWDFUNDING CAMPAIGNS/YEAR



Source: Crowdfund Capital Advisors

Despite impressive Reg CF growth,[140] Reg D still dwarfs it with almost $1.5 trillion raised in 2019.[141] Comparing Reg D within Reg CF constraints, differences remain stark. By SEC data, from mid-2016 through 2018 Reg CF had 519 completed raises totaling $108.2 million. During that time and within Reg CF limits, approximately 12,700 Reg D issuers raised $4.5 billion.[142]

D. Critics contend JOBS Act disappointments mean its titles should be scrapped or curtailed

Despite progress and allowing issuer and regulator adjustment time, the JOBS Act has mostly floundered. The Commission admits "modest" use.[143] This has led hostile interests—state

[140] Due in part to the COVID-19 pandemic, which has limited in-person issuer-investor interaction, Reg CF has enjoyed exponential growth in 2020. According to Crowdfund Capital Advisors, as of October 31, 2020 nationwide online investment is up 62.5% and the number of investors is up 80% from the first ten months of 2019. Crowdfund Capital Advisors, *Monthly Funding Recap October 2020: Highest Amount Ever for Investments as SEC Increases Maximum Raise to $5M*, (November 12, 2020), https://crowdfundcapitaladvisors.com/monthly-funding-recap-october-2020-highest-amount-ever-for-investments-as-sec-increases-maximum-raise-to-5m/.
[141] Final Rules, *supra* note 1 at 9.
[142] Concept Release, *supra* note 2, at 148.
[143] Facilitating Capital Formation, *supra* note 3, at 119 ("While the 2015 amendments have stimulated the Regulation A offering market, aggregate Regulation A financing levels remain modest relative to traditional IPOs and the Regulation D market."); Facilitating Capital Formation, *supra* note 3, at 265 ("[T]he use of Regulation A by reporting companies has been modest to date."); Facilitating Capital Formation, *supra* note 3, at 126 ("The study found that during the considered period, while the [Regulation Crowdfunding] market exhibited growth . . . the number of offerings and the total amount of funding were relatively modest.").

regulators, consumer groups, and academics—to call for its elimination or severe curtailing,[144] particularly the 12(g) Rule.[145] In support they cite underuse and fraud concerns.[146] Under this view only the bulwark of registration and revitalized public markets can protect retail investors and revive gloried mid-20th century days. But this path would hinder U.S. global competitiveness, particularly with the emerging token economy, which will never conform to registered offerings.

V. THE JOBS ACT FAILURE IS A FAILURE OF THE ADMINISTRATIVE STATE

A. SEC culture contributed to JOBS Act failures

Instead of scrapping the JOBS Act, a more fruitful analysis may explain why these exemptions underperformed. This task must begin with the legal authority and people who made the rules. The bureaucratic mindset is self-regarded, slow, ponderous, and risk averse.[147] Bureaucrats view themselves as 'white hat' protectors, defending the public from dodgy private-sector actors. This view pervades Western tradition.[148] But it did not originally ensconce the

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[144] *See e.g.*, Consumer Federation Letter., *supra* note 131, at 103–04, ("[G]iven the abysmal performance of Reg A+ securities since the JOBS Act was adopted, the Commission should give serious consideration to whether the exemption should be scaled back or eliminated entirely."); Americans for Fin. Reform Educ. Fund & AFL-CIO, Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions (Sept. 30, 2019), at 3, https://www.sec.gov/comments/s7-08-19/s70819-6233332-192690.pdf (stating that further proposed expansion of private exemptions to encourage utilization is "highly disturbing"); Letter from Tyler Gellasch, Exec. Dir., Healthy Markets to the SEC on the Concept Release (Sept. 30, 2019), at 29, https://www.sec.gov/comments/s7-08-19/s70819-6233891-192709.pdf ("[W]e urge the Commission to consider curtailing or eliminating some of the obvious failures of past efforts to spur capital formation."); Erik Gerding et al., Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions (Sept. 24, 2019), at 9,15, https://www.sec.gov/comments/s7-08-19/s70819-6193340-192501.pdf (commenting that retail investors should be "encouraged" and "steered" into low-cost index funds of public securities and stating that "Congress and the Commission may need to take more aggressive action to usher firms into the public markets"); Christopher Gerold, Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions, (Oct. 11, 2019), at 1, https://www.sec.gov/comments/s7-08-19/s70819-6288085-193367.pdf [hereinafter Gerold Letter] ("NASAA supports a reexamination of the private offering framework with a goal towards strengthening and growing our public securities markets and rejects the view that modernizing the securities regulatory framework requires expanding the availability of private offerings.").

[145] Elisabeth de Fontenay, The Deregulation of Private Capital and the Decline of the Public Company, 68 HASTINGS L. J. 445, 469 (2017) (stating that JOBS Act rendered Rule 12(g) "toothless"); *cf.* Written Testimony of Renee M. Jones (Sep. 11 2019), https://financialservices.house.gov/uploadedfiles/hhrg-116-ba16-wstate-jonesr-20190911.pdf ("The most effective way for Congress to shore up shrinking public equity markets is to reverse the JOBS Act amendments to Section 12(g)."); Usha R. Rodrigues, *The Once and Future Irrelevancy of Section 12(G)*, 2015 U. ILL. L. REV. 1529 (2015).

[146] Corrie Driebusch & Juliet Chung, *IPO Shortcuts Put Burden on Investors to Identify Risk*, WALL ST. J., (Feb. 6, 2018), http://on.wsj.com/2p4n8kf (stating that questionable offerings and fraud allegations have plagued some early Reg A+ offerings as it finds its market footing); Bill Alpert et al., *Most Mini-IPOs Fail the Market Test*, BARRON'S, (Feb. 13, 2018), https://www.barrons.com/articles/most-mini-ipos-fail-the-market-test-1518526753?mod=rss_barrons_this_week_magazine; Alexander Osipovich, *Exchanges Shy Away From Mini-IPOs After Fraud Concerns*, WALL ST. J., (June 10, 2019), https://on.wsj.com/2lrPWET.

[147] Burton Letter, *supra* note 24, at 14.

[148] Indeed, the morality of government actors traces from Plato (The Republic) and Aristotle (Politics) to the present. *See, e.g.*, Cass R. Sunstein & Adrian Vermeule, *The Morality of Administrative Law*, 131 HARV. L. REV. 1924 (2018). *But see* RICHARD A. EPSTEIn, THE DUBIOUS MORALITY OF MODERN ADMINISTRATIVE LAW 240 (Rowan & Littlefiend, Manhattan Institute, 2020).

American project. It prevailed only after intense early 20th Century battles.[149] The thesis professed during the Progressive Era and accepted during the New Deal was modern life was too complex and its problems too complicated for legislators. A government of administration was needed, one staffed with apolitical technocrats.[150] In the decades since, these administrative-state features have rarely been questioned.[151] Administrative experts bathe in minutia. They disdain hard rules in favor of nuanced multi-factor analysis. This provides officials maximum flexibility and impedes courts from second guessing them.

Created as a direct response to the country's worst economic crisis, the SEC, perhaps more than any other agency, typifies the New Deal mindset.[152] This culture tracks the larger government mindset but is particularly pronounced given Commission prominence. Staff write prolix rules, reserve immense power for themselves, are skeptical of innovation, and distrustful of outsiders. Cultural hostility manifests through rules designed for established and familiar actors.[153] Despite stated Commission belief its "rules and regulations should be drafted to enable market participants to clearly understand their obligations under the federal securities laws and to conduct their activities in compliance with law."[154] And its aim to "promulgate rules that are clearly written, easily understood, and tailored toward specific ends."[155] Reality is different. Smaller issuers must traverse sprawling rules, many strewn with unweighted factors, that confuse even seasoned securities lawyers.

As Commissioner Hester Peirce stated in 2019, "Entrepreneurship and innovation do not have the happiest of relationships with regulation. Regulators get used to dealing with the existing players in an industry, and those players tend to have teams of people dedicated to dealing with regulators. . .. Regulators . . . tend to be skeptical of change because its

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[149] R. J. Pestritto, *The Progressive Origins of the Administrative State: Wilson, Goodnow, and Landis*, 24 SOCIAL PHILOSOPHY AND POL'Y, 16–54 (2007).
[150] R. J. Pestritto, *The Birth of the Administrative State: Where It Came from and What It Means for Limited Government*, HERITAGE FOUND. 4–5, 7 (Nov. 20, 2007), https://www.heritage.org/political-process/report/the-birth-the-administrative-state-where-it-came-and-what-it-means-limited ("[T]he fathers of progressive liberalism envisioned a delegation of rulemaking, or regulatory, power from congressional lawmakers to an enlarged national administrative apparatus, which would be much more capable of managing the intricacies of a modern, complex economy because of its expertise and its ability to specialize.").
[151] Mistretta v. United States, 488 U.S. 361, 372 (1989) ("[O]ur jurisprudence has been driven by a practical understanding that in our increasingly complex society, replete with ever changing and more technical problems, Congress simply cannot do its job absent an ability to delegate power under broad general directives."); *cf.* Gillian E. Metzger, The Supreme Court, 2016 Term — Foreword: 1930s Redux: The Administrative State Under Siege, 131 HARV. L. REV. 1, 7 (2017) ("[T]he administrative state today is constitutionally obligatory, given the broad delegations of authority to the executive branch that represent the central reality of contemporary national government. Those delegations are necessary given the economic, social, scientific, and technological realities of our day.").
[152] 15 U.S.C. § 78d. Congress created the Commission under Section 4 of the Securities Exchange Act of 1934. *Id.*
[153] It must be noted whatever regulatory burdens the SEC placed on registered companies, in the first two decades after the Securities Act, nonregistered issuers had fairly straightforward paths to capital. That changed starting in 1953. *See* Cohn & Yadley, *supra* note 5, at 25-28.
[154] *Fiscal Year 2018 Cong. Budget Justification Ann. Performance Plan*, U.S. SEC. & EXCH. COMM'N, at 22, https://www.sec.gov/files/secfy18congbudgjust.pdf [hereinafter *2018 Cong. Budget*].
[155] *Id.*

consequences are difficult to foresee and figuring out how it fits into existing regulatory frameworks is difficult."[156]

The Commission's enforcement-first mindset further augurs resistance to innovation and outsiders.[157] The SEC Enforcement Division has 1,400 Full Time Equivalent staff, more than any other.[158] The division's FY 2019 budget request was its largest at almost $532 million.[159] The Commission's enforcement approach explains stocked personnel and massive budgets. Staff wrench potential violations through "facts and circumstances" analysis.[160] This can mean intrusive years-long investigations that bleed companies dry. The Commission meets its stated goal to bring enforcement actions within two years of investigation starts barely half the time.[161] One securities lawyer described SEC investigations like "living in hell without dying."[162] The Commission boasts (though in bureaucratic terms) of its power to bleed companies that may or may not have violated a law. "In addition to victories in the cases the agency brings to trial, the SEC's litigation efforts also help the SEC obtain strong settlements in other cases by providing a credible trial threat and making it clear that the SEC will go deep into litigation and to trial, if necessary, in order to obtain appropriate relief."[163]

B. Overemphasis on Investor Protection Hurts Entrepreneurs and Curtails Innovation

The Commission justifies its approach through laudable investor-protection goals. The Commission's mission is tripartite, to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation."[164] But in practice, protecting investors always trumps

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[156] Hon. Hester M. Peirce, Sec. & Exch. Comm'n Comm'r, Regulation: A View from Inside the Machine, Keynote Address at the university of Missouri school of law's symposium Protecting the Public While Fostering Innovation and Entrepreneurship: First Principles for Optimal Regulation (Feb. 8, 2019) *in* 3 Bus. Entrepreneurship & Tax L. Rev., 2019, at 267.

[157]Hon. Hester M. Peirce, Sex. & Exch. Comm'n Comm'r, The Why Behind the No: Remarks at the 50th Annual Rocky Mountain Securities Conference, (May 18, 2019) (describing the SEC's 'broken windows' approach to enforcement and the pressure staff felt to continually boost enforcement actions, opining tongue-in-cheek the agency should have been renamed the "Sanctions" and Exchange Commission. This era supposedly lasted from 2013-2016).

[158] *Fiscal Year 2019 Cong. Budget Justification Ann. Performance Plan*, U.S. SEC. & EXCH. COMM'N, at 15, https://www.sec.gov/files/secfy19congbudgjust.pdf [hereinafter *2019 Cong. Budget*].

[159] *Id.* at 17.

[160] Search of the phrase "fact and circumstances" yielded 6,151 results, SEC. & EXCH. COMM'N (last visited July 5, 2020) https://secsearch.sec.gov/search?affiliate=secsearch&query=%22facts+and+circumstances%22.

[161] The number is 53% per the Commission's latest data. *2019 Cong. Budget*, *supra* note 158, at 109.

[162] Amy Wan, *First Regulated Initial Coin Offering Conference ICO 2.0 Summit Dives Deep into ICO Legal, Regulatory & Economic Implications*, CROWDFUND INSIDER (Nov. 13, 2017), https://www.crowdfundinsider.com/2017/11/124483-first-regulated-initial-coin-offering-conference-ico-2-0-summit-dives-deep-ico-legal-regulatory-economic-implications/.

[163] *2018 Cong. Budget*, *supra* note 154, at 35.

[164] *What we do*, SEC. & EXCH. COMM'N (June 10, 2013), http://www.sec.gov/about/whatwedo.shtml#intro; *see* Securities Exchange Act of 1934 §3(f), 15 U.S.C. §77b(b); and *see* Securities Act of 1933 §2(b), 15 U.S.C. §77b(b) ("Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.").

its conflicting prongs.[165] States go even further. Currently, thirty conduct merit review or reserve the right to,[166] despite past glaring failures.[167]

In balancing its conflicting mission, the Commission not only over-relies on investor protection but also one type. David Burton states four investor-protection ideas.[168] First is prosecuting fraud. This is a clear government function and securities regulation reifies antifraud. The second is providing potential investors with issuer background for informed decisions. This requires weighing useful disclosure to ensure company validity with issuer-bourne costs. It is worth noting Reg D has succeeded without mandatory disclosure.[169] Third is protecting investors from what regulators deem imprudent choices. The Commission does this by investment limits, barring unaccredited-investor opportunities, favoring certain exemptions through policy, and subjecting some exemptions to state-level registration and merit review. One Concept Release commenter put it colorfully, "It feels absurd that the average person can buy a $5,000 wedding cake and sit down in front of the bakery to eat the whole thing in one sitting… BUT they cannot invest that same amount in a technology business. People make bad financial decisions every day: drive cars they can't afford, blow their whole paycheck at the casino, have a $50,000 wedding followed by a $50,000 divorce a year later… and the law is silent!"[170] Fourth is protecting investors' freedom to risk their money. This was and remains a major flaw in the Reg-D-centric regime the JOBS Act sought to change.

The latter two investor-protection concepts are dubious government functions. Protecting people from what regulators consider "bad" choices through either limits, "creeping federal merit review,"[171] or barred opportunities is paternalistic.[172] Regulators are naturally risk averse and have no special market acumen. Further, as explained below, private-ordering systems where large investors perform due diligence and retail investors join has worked elsewhere.

Mandatory disclosure has sturdier foundation but questionable utility. This is particularly true for small issuers and must be weighed against imposed costs. Disclosure has hallmarked federal securities law since the Commission's advent. Congress championed it among policy

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[165] Professor Usha Rodrigues suggests political risk and lack of private-sector rewards reinforces Commission focus on investor protection. Rodrigues, *Dirty Secret*, *supra* note 28, at 3396 ("[R]egulators' incentives are skewed against enlarging investment access in an area that (1) offers little for the rent-seeking regulator and (2) could cause average investors to lose their shirts."); *Id.* at 3397 ("[P]ublic choice theory suggests that the status quo may well continue: those who stand to benefit most are rationally uninterested, and the SEC would face political risk far outweighing reward were it to push for change.").
[166] *See* NASAA APPLICATION, *supra* note 85.
[167] Richard E. Rustin & Mitchell C. Lynch, *Apple Computer Set to Go Public Today: Massachusetts Bars Sale of Stock as Risky*, THE WALL ST. J. (Dec 12, 1980), at 5, http://online.wsj.com/public/resources/documents/AppleIPODec12_1980_WSJ.pdf.
[168] Burton Letter *supra* note 24, at 13.
[169] *But see* Becerra et al., *supra* note 129, at 9 ("Rule 506/Reg D is often associated with fraudulent investment schemes, making exempt offerings under this category particularly risky.").
[170] Silicon Prairie Portal and Exchange, Comment Letter on Concept Release on Harmonization of Securities Offering Exemption (Sept. 24, 2019) [hereinafter Barker Letter].
[171] Burton Letter, *supra* note 24, at 17.
[172] SEC Commissioner Hester Peirce earned the moniker 'Crypto Mom' making these points in her dissent in the Winklevoss Bitcoin Trust, Bats BZX Exchange case. Commissioner Hester M. Peirce, Dissent of Commissioner Hester M. Peirce to Release No. 34-83723; File No. SR-BatsBZX-2016-30, (July 26, 2018) https://www.sec.gov/news/public-statement/peirce-dissent-34-83723.

alternatives.[173] Disclosure follows the aphorism 'Sunlight is the best disinfectant.' But it has nebulous empirical value. In fact, much scholarly disclosure research shows no definitive benefits.[174] As former SEC Chair Mary Schapiro testified, "It is notoriously hard to quantify the benefits of any regulation. How do you quantify the benefits of preventing a fraud?"[175] Scholars have criticized burdens on public companies for this difficult-to-quantify benefit.[176] Those companies can presumably absorb imposed costs. But it does not translate to smaller companies the JOBS Act tried to help.

Regulators have not balanced fraud-prevention goals with its impact on legitimate issuers and investors' freedom to contract. No regulatory regime even in principle should aim to be completely free of fraud.[177] Costs are too high, and the goal contradicts human nature. And it has proven impossible despite the best intentions, decades of experience, and rules designed solely to prevent it.[178] Comparing Reg A+, Reg D, and Reg CF illustrates this. Critics point to questionable Reg A+ issuers in the first few years,[179] and state regulators complain about Reg D fraudsters.[180] Yet Reg A+ issuers undergo a thorough Commission-led qualification process to ensure adequate disclosure and accurate financial status. Reg D with the least oversight garners more capital than public markets—an impossibility if investors feared fraud. Reg CF has avoided

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[173] De Fontenay, *supra* note 145, at 474 ("Many options exist for regulating the offering and trading of securities. The federal securities laws introduced in the New Deal overwhelmingly favor one approach: mandatory disclosure, primarily by securities issuers themselves.").

[174] *See, e.g.*, George J. Stigler, *Public Regulation of the Securities Markets*, 19 BUS. LAW. 721, 725 (1964) (examining the effects on new-issue stock returns before and after the SEC imposed mandatory disclosure); *Cf.* George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934*, 63 AM. ECON. REV. 132 (1973) (examining the effects of the Exchange Act's financial disclosure requirements); Robert Daines & Charles M. Jones, *Truth or Consequences: Mandatory Disclosure and the Impact of the 1934 Act* (draft working paper) (May 2012) https://www.law.stanford.edu/publications/truth-or-consequences-mandatory-disclosure-and-the-impact-of-the-1934-act; Paul M. Healy & Krishna G. Palepu, *Information Asymmetry, Corporate Disclosure, and The Capital Markets: A Review of the Empirical Disclosure Literature*, 31 J. OF ACCT. AND ECON., 405–440 (2001), https://www.sciencedirect.com/science/article/pii/S0361368217300132; J. Richard Zecher, *An Economic Perspective of SEC Corporate Disclosure*, 7 U. PA. J. INT'L L. 307 (1985). https://scholarship.law.upenn.edu/jil/vol7/iss3/7; Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984), http://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2176&context=journal_articles.

[175] The JOBS Act in Action Part II: Overseeing Effective Implementation that can Grow American Jobs, 112th Cong. 26 (June 28, 2012) (testimony of the Hon. Mary L. Schapiro, Chair of the SEC).; *Cf.* Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation after the JOBS Act*, 101 GEO. L. J., 337, 361 (2013), http://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=1985&context=facpub (describing securities regulation as "educated guesswork.").

[176] Mercantus Center, Comment Letter on Concept Release on Harmonization of Securities Offering Exemptions (Sept. 24, 2019) at 5 [hereinafter Mercantus Center Letter] ("Prospectuses in public offers and annual reports from public companies are constantly criticized for prolixity, complexity, obfuscation, and repetitiveness." (collecting scholarly authorities)).

[177] Burton Letter, *supra* note 24, at 13 (discussing the balance needed in designing regulatory regimes and presence of some degree of fraud is inherent in human nature).

[178] Cohn & Yadley, *supra* note 5, at 72, ("[E]xamination of the securities violations that are of principal concern reveals that no amount of technical exemption requirements will hinder the fraud artists from their endeavors. . . . Fraudulent and deceptive schemes have unfortunately continued unabated and independent of formal registration or exemption requirements.").

[179] *See supra* note146.

[180] *See* Gerold Letter, *supra* note 144, at 3 n. 9 (collecting cases).

substantive fraud accusations thus far[181] likely because portals are liable but as shown below private-ordered systems function just as well.[182] Thus of the three exemptions, the most regulated had the highest proportion of questionable issuers. Yet not even the Commission shares critics gloomy view, noting the dearth of legal actions under Reg A+.[183] The contradiction should augur a reexamination of the current Commission balance between investor protection and individual and investor freedom.

C. SEC JOBS Act Hostility was Open and Straightforward

These factors: penchant for prolix rules, distrust of outsiders and innovation, and overemphasis on investor protection converged in the Commission's hostile attitude to the JOBS Act.

Commissioners flaunted enmity from its start. While Congress debated, Chair Schapiro wrote the Senate Committee on Banking, Housing, and Urban Affairs concerned the act would subject investors to "fraudulent schemes designed as investment opportunities."[184] She specifically deigned crowdfunding as lacking sufficient safeguards. In a later hearing Rep. Patrick McHenry (R-NC) described the letter as "being sideswiped by a regulatory body at the eleventh hour" and lamented the Chair hadn't earlier addressed her concerns to the bill's sponsors.[185] Fellow Commissioner Luis Aguilar was forthright, "I cannot sit idly by when I see potential legislation that could harm investors. This bill seems to impose tremendous costs and potential harm on investors with little or no corresponding benefit."[186] Commission opposition pervaded both drafting and implementation.[187] Edward Knight, Executive Vice President and General Counsel of NASDAQ, testified in a congressional hearing: "From the outset the SEC's view of [equity crowdfunding] was they were not for this they and made it, shall I say, needlessly complicated

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[181] Securities and Exchange Commission, RPT. TO THE COMM. ON REGULATION CROWDFUNDING (Jun. 18, 2019), at 42 [hereinafter SEC, REGULATION CROWDFUNDING].

[182] *See infra* Part VII.A.

[183] Regulation A Report, *supra* n. 136 at 25 (While acknowledging concerns with certain Reg A+ issuers that obtained exchange listings, describing "relatively few" legal proceedings and stating, it was "not clear additional investor protections are necessary at this time.").

[184] Hon. Mary L. Schapiro SEC Chair letter to Chair Hon. Tim Johnson Chair and Ranking Member Hon. Richard Shelby, Ranking Member, Comm. on Banking, Housing, and Urban Affairs, U.S. Sen. (Mar. 13, 2012). https://www.aicpa.org/Advocacy/Issues/DownloadableDocuments/404b/3-13-12_SEC_Chm_Schapiro_Letter_to_Johnson.pdf. *Cf*. David S. Hilzenrath, *Jobs Act Could Remove Investor Protections, SEC Chair Schapiro Warns,* WASH. POST (Mar. 14, 2012), http://www.washingtonpost.com/business/economy/jobs-act-could-open-a-door-to-investment-fraud-sec-chief-says/2012/03/14/gIQA1vx1BS_story.html; Edward Wyatt, *Senate Seeks to Toughen a Bill Aimed at Startups*, N.Y. TIMES (Mar. 19, 2012), https://www.nytimes.com/2012/03/20/business/senate-seeks-to-toughen-jobs-bill-aimed-at-easing-rules-on-start-ups.html.

[185] The JOBS Act in Action Part II: Overseeing Effective Implementation that can Grow American Jobs, *supra* note 175, at 26-7.

[186] Hon. Luis A. Aguilar, SEC Comm., quoted in speech by Sen. Jack Reed (Mar. 16, 2012), https://www.reed.senate.gov/news/speeches/jobs-act.

[187] CrowdFund Beat, *The JOBS Act – Legislative History and Future Opportunities* (May 11, 2017), https://www.youtube.com/watch?v=zn97Cwzg5YA (Dina Ellis Rochkind discussing SEC opposition to the JOBS Act during bill formation).

and did not approach it except as this this was something where the public is going to get harmed and we need to narrow it as much as possible."[188]

D. Hostility to JOBS Act Innovations has Far-Reaching Consequences for the Future U.S. Economy

Commission hostility plagues more than Reg CF issuers raising small amounts. The JOBS Act is currently the best available emissary to the approaching token economy because it can meld network users and investors. Ongoing Commission grapples with token sales and blockchain thwart this potential. These innovations will never fit registered offerings and thus issuers must use private exemptions. Bitcoin, the first public blockchain, emerged out of the 2008-2009 financial crisis. The first Initial Coin Offering (ICO)—selling crypto tokens that act as potential keys and currency on future blockchain ventures—occurred in 2013.[189] Yet digital assets so flummoxed the Commission, in 2018 it created a Senior Advisor for Digital Assets and Innovation post and filled it with career SEC bureaucrat Valerie Szczepanik.[190]

After ICOs exploded in 2017, the Commission flooded issuers with subpoenas and enforcement actions. To be sure, many ICOs were frauds deserving prosecution.[191] Still, good-faith actors requested Commission guidance. The Commission spent at least six months[192] forming a 13-page "Framework for 'Investment Contract' Analysis of Digital Assets."[193] But instead of clarifying, the document obfuscated. The guidance steeped numerous factors over already unclear direction. While the unsigned document reiterated prior Commission statements it would determine compliance via individual "facts and circumstances" grounded in the decades-old *Howey* test,[194] it expounded further factors that conceivably could trap anything from baseball cards to premier liquors.[195] Commissioner Peirce described the guidance as a "Jackson Pollock painting," further explaining, "While *Howey* has four factors to consider, the framework lists 38 separate considerations, many of which include several sub-points. A seasoned securities lawyer might be able to infer which of these considerations will likely be

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[188] The JOBS Act at Five: Examining Its Impact and Ensuring the Competitiveness of the U.S. Capital Markets, H.R. Doc. No. 115-9 (1st Sess. Mar. 22, 2017) (testimony of Mr. Edward Knight, Exec. Vice Pres. and Gen. Coun., NASDAQ).

[189] Laura Shin, *Here's The Man Who Created ICOs And This Is The New Token He's Backing*, FORBES (Sept. 17, 2017), https://www.forbes.com/sites/laurashin/2017/09/21/heres-the-man-who-created-icos-and-this-is-the-new-token-hes-backing/#37fa4f0d1183. *Cf.* Ivona Skultetyova, *Short History of ICOs: From Crypto Experiment to Revolution in Startup Financing*, MEDIUM (Feb. 2, 2018), https://medium.com/@ehvLINC/short-history-oficos-from-crypto-experiment-to-revolution-in-startup-financing-709c23839ffc.

[190] Press Release, SEC, SEC Names Valerie A. Szczepanik Senior Advisor for Digital Assets and Innovation, (June 4, 2018) (on file with author).

[191] A *Wall Street Journal* study of 1,450 ICOs revealed 271 with fraud concerns, including "plagiarized investor documents, promises of guaranteed returns and missing or fake executive teams." Shane Shifflett & Coulter Jones, *Buyer Beware: Hundreds of Bitcoin Wannabes Show Hallmarks of Fraud*, WALL ST. J. (May 17, 2018), https://www.wsj.com/articles/buyer-beware-hundreds-of-bitcoin-wannabes-show-hallmarks-of-fraud-1526573115.

[192] Nikhilesh De, *SEC's Crypto Token Framework Falls Short of Clear and Actionable Guidance*, COINDESK (Apr. 4, 2019), https://www.coindesk.com/secs-crypto-token-framework-falls-short-of-clear-and-actionable-guidance.

[193] Strategic Hub for Innovation and Financial Technology, *Framework for "Investment Contract" Analysis of Digital Assets, Securities and Exchange Commission* (Apr. 3, 2019), https://www.sec.gov/files/dlt-framework.pdf.

[194] The *Howey* test, derives from SEC v. W.J. Howey Co., 328 U.S. 293 (1946). It is the foundational case on whether nontraditional assets qualify as "investment contracts" and therefore fall under SEC domain.

[195] JD Alois, *When Howey, the SEC & CorpFin Met Bourbon*, CROWDFUND INSIDER, (May 29, 2019), https://www.crowdfundinsider.com/2019/05/147688-when-howey-the-sec-corpfin-met-bourbon/.

controlling and might therefore be able to provide the appropriate weight to each. . . . I worry that non-lawyers and lawyers not steeped in securities law and its attendant lore will not know what to make of the guidance."[196]

The confusion should not surprise given Ms. Szczepanik's disposition. When queried she stated, "The lack of bright-line rules allows regulators to be more flexible."[197] She later opined 'prescriptive rules' may allow sneaky entrepreneurs to evade law.[198] From the entrepreneur standpoint this creates worry. First Commission "flexibility" under years-long investigations and "facts and circumstances" analysis may benefit regulators but destroys companies exploring new technologies and ideas. Unweighted multi-factor analyses that leave even Commissioners guessing lends itself not to law but relationships. Clear rules and open competition, not which law firm hires former regulators should dictate market winners.

When innovative companies try following the rules, Commission "flexibility" leads to legal limbo and obscene bills. During the 2017 ICO craze Blockstack's approach was different. Blockstack is a decentralized platform trying to create a more user-controlled and directed internet through blockchain, decentralized applications, and a tokenized ecosystem.[199] Instead of testing Commission resolve or wrangling with the *Howey* test, Blockstack ensured compliance through Reg A+. The qualification process reportedly took 10 months and cost $2.8 million in legal fees.[200] It cost more than the average IPO for issuers with revenue less than $100 million.[201] While "bleeding edge" companies can except higher costs, six-seven figure compliance budgets will remain unviable for all but the most well-funded startups. And Blockstack's qualification does not end potential liability. It plans to stop reporting once "Stacks Tokens" are fully decentralized,[202] as SEC Director of Corporate Finance Bill Hinman approved in theory.[203] But should SEC staff decide "facts and circumstances" dictate prolonged reporting it could sue Blockstack and kill the project.

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[196] Hon. Hester M. Peirce, SEC Comm'r., How We Howey, (May 9, 2019) (transcript available at https://www.sec.gov/news/speech/peirce-how-we-howey-050919).
[197] Brady Dale, *SEC's Valerie Szczepanik at SXSW: Crypto 'Spring' Is Going to Come*, COINDESK, (May 16, 2019), https://www.coindesk.com/secs-valerie-szczepanik-at-sxsw-crypto-spring-is-going-to-come.
[198] Valerie Szczepanik, Address, ACT-IAC 2018 Blockchain Forum (Apr. 3, 2018), quoted in Kik Wells Submission, In re Kik *Interactive* (HO-13388), (Nov. 16, 2018) at 30, https://cdn.crowdfundinsider.com/wp-content/uploads/2019/02/Kik-wells_response.pdf. This sentiment pervades the SEC. *See* Manuel F. Cohen & Joel J. Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 LAW & CONTEMP. PROBS. 691, 699 (1964) (noting twenty-two rules issued by the Securities and Exchange Commission but denying that the Commission has "sought to develop a group of rules to comprehend all, or even most, fraudulent practices.").
[199] *About Blockstack*, BLOCKSTACK, https://blockstack.org/about.
[200] Paul Vigna, *SEC Clears Blockstack to Hold First Regulated Token Offering*, WALL ST. J., (July 10, 2019), https://www.wsj.com/articles/sec-clears-blockstack-to-hold-first-regulated-token-offering-11562794848.
[201] PwC, CONSIDERING AN IPO TO FUEL YOUR COMPANY'S FUTURE? INSIGHT INTO THE COSTS OF GOING PUBLIC AND BEING PUBLIC 6, 8–9 (2017), https://www.pwc.com/us/en/deals/publications/assets/cost-of-an-ipo.pdf.
[202] *See* BLOCKSTACK PBC, ANNUAL RPT. PURSUANT TO REGULATION A, FORM 1-K 4–5 (2019), https://www.sec.gov/Archives/edgar/data/1693656/000119312520124379/d918967dpartii.htm.
[203] William Hinman, Dir., SEC Div. of Corp. Fin., Digital Asset Transactions: When Howey Met Gary (Plastic), (June 14, 2018), (Transcription available at https://www.sec.gov/news/speech/speech-hinman-061418). For a discussion of decentralization as a component of securities law *see* Angela Walch, *Deconstructing 'Decentralization': Exploring the Core Claim of Crypto Systems* (Jan. 30, 2019). Crypto Assets: Legal and Monetary Perspectives (OUP, Forthcoming), https://ssrn.com/abstract=3326244.

VI. THE FINAL RULES WILL NOT REVIVE THE JOBS ACT OR ENCOURAGE THE FUTURE TOKEN ECONOMY

The Commission's Final Rules expose its lack of imagination and boldness. The Final Rules repeatedly fall short despite some welcome steps such as higher overall and individual limits. The Commission even mars outwardly promising changes with the incrementalism. In the years since President Obama described JOBS Act provisions as "game changers," the Commission has proven incapable of fostering its lofty goals. Indeed, despite the thoroughness of the review, its impact will likely be slight. And like the JOBS Act, commenters may years later diagnose its failure. The Final Rules are a microcosm of why Congress must act.

Strikingly, the Commission avers—allegedly satisfied by Concept Release commenters—that major changes are unnecessary.[204] Some exemptions like Reg D work well. But recalling the JOBS Act goals of expanding retail-investor wealth opportunities and capital options for underserved entrepreneurs, the exemptions falter. The Final Rules do not substantively address these goals.[205]

A second theme is Commission belief it can solve underuse by raising overall or individual limits. From a relative standpoint these moves lower capital costs. But they do not address underlying issues that plague exemptions save Reg D. Only rarely does the Commission recognize its own or states' rules as hardships. And any movement toward relaxing those rules is cautious and halting—a movement befitting the Commission's New Deal pedigree but misaligned with modern capital raising.

Rule 241 is emblematic.[206] Piggybacking on Regulation A Rule 255, Rule 241 exempts issuers generally soliciting interest before committing to a particular exemption. This rule could help novice issuers and those living outside areas concentrated with securities lawyers or angel networks. Discerning appetite for a raise and addressing investor concerns beforehand could tighten issuer planning and focus. All receivers of these solicitations would be offerees for federal antifraud law.[207] Rule 241 also includes logical disclaimers like legends, no acceptance of funds, and no binding commitments.[208] But Rule 241 is likely dead on arrival[209] because it fails

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[204] Final Rules, *supra* note 1, at 9 and n.15 collecting supporting comments. ("[A] consistent theme . . . was that many elements of the current structure work effectively and a major restructuring is not needed."); *Cf.* Facilitating Capital Formation, *supra* note 3, at 6.

[205] According to SEC data Regulation A and Regulation CF along with Rule 504 account for only 0.1% of private capital raised through exemptions. Regulation D 506(c) part of the JOBS Act boosts this total but only minimally, *see* Facilitating Capital Formation, *supra* note 3, at 115.

[206]Facilitating Capital Formation, *supra* note 3, at 349-350.

[207] *Id.* at 349.

[208] *Id.* at 350.

[209] Letterfrom Sara Hanks, CEO, Crowdcheck, Inc., to Vanessa A. Countryman, Sec'y, Sec. & Exch. Comm'n (June 11, 2020) (on file with author) ("We believe that the lack of state preemption would make the exemption almost useless.") [hereinafter Hanks Letter]; *Cf.* Letter from David Burton, Senior Fellow, Heritage Found. To Vanessa A. Countryman, Sec'y, Sec. & Exch. Comm'n (June 1, 2020) (on file with author) (discussing added costs and delays of Blue Sky laws and ineffectiveness of federal provisions that don't preempt them.) [hereinafter Burton Letter]; Letter from Rutheford B. Campbell, Jr., Proffessor of Ky. Coll. of Law, to Vanessa A. Countryman, Sec'y, Sec. & Exch. Comm'n (August 3, 2020) (on file with author) ("Rule 241 will be impossible (or at least nearly so) for an issuer to use. This outcome is a result of the failure of the Commission to exercise its delegated authority to preempt state registration requirements for an issuer's testing the water under Rule 241.") [hereinafter Campbell Letter].

to preempt these solicitations of interest from Blue Sky laws.[210] If from nothing else, the Commission should have learned from its Reg A+ Tier 1 experiment, issuers will rarely suffer state-level processes.

Rule 148 the Commission's new "Demo Day" rule exempting some actions from the throes of 'general solicitation' also shows its chary approach.[211] Demo Days are sponsored events where founders discuss their companies with potential investors. After years of questions about whether these events invoke dreaded general solicitation, the Commission addressed the issue. To be sure, after endless handwringing a limited safe harbor is welcome. But as proposed, the rules may provide issuers and lawyers trouble, or may ultimately be ignored. The Commission defines a discrete set of forums exempt from general solicitation. Specifically, the exemption would cover "a seminar or meeting in which more than one issuer participates that is sponsored by a college, university, or other institution of higher education, State or local government or instrumentality thereof, nonprofit organization, or angel investor group, incubator, or accelerator."[212] It then defines "angel investor groups."[213] It also bans sponsor investment advice, recommendations or negotiations, bans fees for introductions and limits sponsors to "reasonable administrative fees."[214] The Commission avers sponsor limitations will deter "profit motive."[215]

Most concerningly, are restrictions the Commission places on advertising, founder demo "pitches," and audience. Sponsor advertising cannot mention the Demo Day presenters are offering or plan to offer securities.[216] Founders are limited to a list of four bits of offer information: (i.) the issuer is offering or planning to offer securities; (ii.) the type and amount of securities offered; (iii.) the intended use of proceeds; and (iv.) the unsubscribed amount the offering.[217] The Commission's policy goal is to prevent the Demo Day event from devolving into a de facto mini-road show.[218] But the limitations hinder Demo Day presenters from answering basic and common questions about the investment and founders may just ignore them in the adrenaline-infused rush of post-presentation Q&A. One commenter likened the restrictions to forcing founders to read out tombstone advertisements on a platform and compared letter-of-the-law compliance to a "Monty Python Cheese Shop sketch."[219] Finally the Commission restricted the audience in virtual Demo Days,[220] lest scores of unaccredited individuals have the opportunity to attend.[221] The Commission describes this as a "tailored approach." Time will tell

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[210] See Final Rules, *supra* note 1, at 77; *Cf.* Facilitating Capital Formation, *supra* note 3, at 95 (describing its refusal to preempt Blue Sky laws as a "measured approach").
[211]Facilitating Capital Formation,, *supra* note 3, at 342-344.
[212] Facilitating Capital Formation, *supra* note 3, at 342.
[213] *Id.* at 343-344, Instructions to paragraph (a).
[214] *Id.*
[215] *Id.* at 82.
[216] *Id.* at 342.
[217] *Id.* at 343.
[218] Transcript of SEC Small Business Capital Formation Advisory Committee (May 8, 2020), at 67, https://www.sec.gov/info/smallbus/acsec/sbcfac-transcript-050820.pdf.
[219] Hanks Letter, *supra* note 209, at 8-9, (listing commonly asked questions the presenter would have to find various ways to decline to answer).
[220] Facilitating Capital Formation, *supra* note, 3 at 343.
[221] Facilitating Capital Formation, *supra* note, 3 at 84 (agreeing with commenters worried large numbers of non-accredited investors could be exposed to "broad offering-related communications" and thus imposing virtual Demo Day restrictions).

how workable it is, but Commission efforts to police human interaction with the precision of a fitted suit are foreboding.

A. Final Rules for Regulation D 506(c)

The proposed Reg D 506(c) changes again typify Commission plodding. The Commission realizes Reg D 506(c) has disappointed and proffers why: (i) the principles-based methodology for "reasonable steps" heaps uncertainty on issuers fearful regulators will deem their steps "unreasonable"; and (ii) the non-exhaustive documents list has privacy concerns.[222] The Commission admits the list, as the only surefire way to avoid "facts and circumstances" inquiries, "may be creating uncertainty for issuers and inadvertently encouraging [them] . . . to rely only on the non-exclusive list."[223] In Commission fashion, after years' experience, it proposes slight progress by adding investors may declare themselves accredited on subsequent raises after previous verification.[224] But in a change from the Proposed Rules, the Final Rules added a five-year limit to this verification method.[225]

B. Final Rules for Regulation A+

The most important Reg A+ change is to raise the offer limit to $75 million.[226] This marks the first time the Commission upped the limit Congress requires it to review biennially.[227] It also raises the maximum amount security holders could sell under Tier 2 from $15 million to $22.5 million,[228] consistent with its established 30% marker.[229] Other Reg A+ changes involve redacting confidential information from certain Form 1-A exhibits instead of having to apply for confidential treatment beforehand[230] and technical amendments to smooth the filing process.[231] These will likely have little adoption effect.

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[222] Letter from Tom Quaadman, Exec. Vice President, Chamber of Commerce Ctr. for Capital Mkts. Competitiveness, to Vanessa A. Countryman, Sec'y, U.S. Sec. and Exch. Comm'n. 5 (Sept. 24, 2019) (Chamber Letter), https://www.sec.gov/comments/s7-08-19/s70819-6193319-192490.pdf [hereinfafter Quaadman Letter] ("In practice, the enhanced accredited investor verification requirements have discouraged many issuers from taking advantage of Rule 506(c), and issuers continue to rely primarily on the Rule 506(b) exemption, which continues to prohibit general solicitation."); *Cf.* Manning G. Warren, *The Regulatory Vortex for Private Placements*, 45 SECS. REG. L.J. 9 (2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3037492 (discussing chilling effect Reg D 506(c) requirements to turn over sensitive documents); Letter from Patrick Gouhin, CEO, et al., Angel Capital Ass'n, to Hon. Jay Clayton, Chairman, U.S. Sec. and Exch. Comm'n. 5(Sept. 23, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6170303-192393.pdf ("Many angels view getting a three-month certification from a third party as being expensive and time-consuming and a major risk in terms of sensitive personal and financial data.").

[223] Final Rules, *supra* note 1, at 87.

[224] *Id.* at 88; Facilitating Capital Formation, *supra* note, 3 at 108.

[225] Facilitating Capital Formation, *supra* note 3, at 109; *Cf. id.* at 359, § 230.506(c)(2)(ii)(E).

[226] Facilitating Capital Formation, *supra* note 3, at 350.

[227] *See* Pub. L. No. 112-106, § 401(b)(5), 126 Stat. 325 (15 U.S.C. § 77c(b)(5) (2018)); *Cf.* Facilitating Capital Formation, *supra* note 3, at 134.

[228] Facilitating Capital Formation, *supra* note 3, at 350.

[229] *Id.* at 135 n. 380.

[230] *Id.* at 120-22.

[231] These include changes to how issuers make nonpublic correspondence public via EDGAR, the SEC database, incorporating by reference previously filed financial statements in Form 1-A, and an amendment to the abandonment provision of Regulation A, Rule 259(b). *Id.* at 113–14 (17 C.F.R. § 230.259(b) (2019)). *See generally* Final Rules, *supra* note 1, at 119-127 (explaining these changes).

C. Final Rules for Regulation Crowdfunding

The biggest disappointment is Reg CF. The Final Rules do make progress.[232] For example Reg CF issuers can now 'test the waters' before filing the legal document, Form C.[233] The SEC would require these solicitations to disclaim the inability to accept funds until filing and the offer's nonbinding nature.[234] But importantly, because Reg CF offers are "covered" under 15 U.S.C. § 77r(b)(4)(c), Blue Sky laws are preempted.[235] This change should benefit novice issuers or those living outside entrepreneurial hotspots. Issuers must choose Reg CF beforehand to avoid Rule 241 state processes. The Final Rules also helpfully clarify that issuers may discuss offers orally after filing if they follow Rule 204 proscriptions.[236]

In response to comments, however, the Commission added two additional terms: "use of proceeds" and "progress toward funding goals."[237] The Commission describes this as an "incremental increase" in useful, nonharmful information for investors.[238] In reality, it has likely burdened issuers by further limiting "non-terms communications" allowed outside the portal or beyond the strictures of tombstone adverts.[239]

Raising the aggregate offer limit from $1.07 million to $5 million also helps.[240] Although this contradicts the statute, the Commission used its general exemptive authority under Securities Act Section 28.[241] For individual limits, Congress hamstrung the Commission with confusing text. But the Commission further clouded the situation by using "lesser of" instead of "greater of" in the ambiguous statutory formula and not exempting accredited investors. The Commission now seeks to remedy this by exempting accredited investors[242] and using "greater of" for unaccredited investors.[243] However, welcomed unaccredited investor limits are still confusing and unenforceable.

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[232] One area of progress came from a Commission reversal. The Proposed Rules sought to eliminate certain nontraditional Reg CF financial instruments including Simple Agreements for Future Equity (SAFE), token instruments, and revenue shares. Final Rules, *supra* note 1, at 157 & n. 351. The Final Rules rejected this proposal in favor of adequate disclosure of the terms of these instruments. Final Rules, *supra* note 1, at 185.
[233] Final Rules, *supra* note 1, at 333.
[234] *Id.* Rule 206(b) [§ 227.206(b)].
[235] 15 U.S.C. § 77r(a)(2)(A); *Cf.* Final Rules *supra* note 1 at 149 ("Currently, securities issued pursuant to the exemption under Section 4(a)(6) are deemed to be "covered securities" and thus the offer and sale of such securities by an issuer are not subject to State securities law registration and qualification requirements pursuant to Section 18 of the Securities Act."). To allay any confusion about the covered nature of these offers and sales, the Commission added 17 CFR 227.504. *Id.* It defines a "qualified purchaser" for the purposes of Section 18(b)(3) of the Securities Act, as any Reg CF offeree or purchaser. *Id.* at 149 & n. 443, 338.
[236] Final Rules, *supra* note 1, at 84–85; *Cf.* 17 C.F.R. § 227.204 (listing advertisement requirements).
[237] Final Rules, *supra* note 1, at 103; *Cf. Id.* at 332-333 (providing instructions to § 227.204).
[238] *Id.* at 103.
[239] *See* Crowdcheck Letter, *supra* note 209, at 12 ("Most communications outside the investment platform are either through social media, which by virtue of the character limits are limited to basic information about the company, or are designed to be "non-terms communications" in which the issuer can freely discuss its business without discussing any term of the offering. Adding additional categories of information to be considered "terms of the offering" would work to limit what issuers may say, rather than enable additional disclosure about use of proceeds or progress of the offering. This would have the effect of suppressing communications rather than providing more flexibility").
[240] *See* Final Rules, *supra* note 1, at 325.
[241] Final Rules, *supra* note 1 at 148.
[242] Final Rules, *supra* note 1, at 154.
[243] *Id.* at 325-26..

Unfortunately, other Proposed Rules will likely have little impact despite positive baby steps. First are the long-clamored-for Special Purpose Vehicles (SPVs). The JOBS Act Title III prevented use of certain "investment companies" as defined or excluded in the Investment Company Act of 1940.[244] Practically, this means SPVs that invest in only one company could not participate in Reg CF. From the start, government and market actors recognized how disallowing SPVs would thwart Reg CF growth.[245] In theory, SPVs could ease regulatory burdens for Reg CF issuers by cabining all Reg CF investors in a separate legal entity. Concerns focus on unwieldly numbers of record holders on issuers' capitalization tables for the 12(g) Rule and other administrative hurdles linked to unaccredited investors. The SEC proposed an exception to the JOBS Act statutory prohibition through a "crowdfunding vehicle" SPV, that would channel all Reg CF investors into one bucket.[246] But in typical fashion, the Commission's rule-heavy approach may kill this innovation before it flourishes. At the least, the Commission admits its crowdfunding-vehicle exception[247] will limit its utility, forcing issuers into a cost-benefit analysis.[248]

While the proposed rule purports to solve the capitalization table and 12(g) Rule issue, the Commission larded in investor protections that will retard use. The Commission's proposed design "would serve merely as a conduit for investors to invest in a single underlying issuer and would not have a separate business purpose."[249] The instrument's structure "provide[s] investors in the crowdfunding vehicle the same economic exposure, voting power, and ability to assert State and Federal law rights, and receive the same disclosures under Regulation Crowdfunding, as if they had invested directly in the crowdfunding issuer."[250]

While supportive of the crowdfunding vehicle concept, critics panned the rule's costs and complexities.[251] Wefunder, the largest portal by investment volume, has already stated it will not support it.[252] As envisioned, one raise may require multiple crowdfunding vehicles. The SPV also saddles the issuer with cost burdens, substantially increasing upfront outlays for an already expensive option. Even with proxies, the need to gain permission from security holders for transactions will cost time and money. There are also additional disclosure obligations and

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[244] Pub. Jumpstart our Business Startups Act, Pub. L. No. 112-106, § 4A(f)(3), 126 Stat. 306, 320; (2012) (banning investment companies as defined in Section 3 of the Investment Company Act of 1940 [15 U.S.C. § 80a-3(a)(1)] or those excluded from the definition of investment company by Sections 3(b) and (c) of that Act [15 U.S.C. §§ 80a-3(b), (c)] from participating in Title III transactions). *See also* 15 U.S.C. § 77d-1(f)(3) (2018); 17 C.F.R. § 227.100(b)(3) (20192020).

[245] *See* Crowdfunding Release, *supra* note 101, at 36-37 and n. 94; *Cf.* Final Rules, *supra* note 1, at 140-144; Final Rules, *supra* note 1, at 158-59 (noting that by requiring investors to hold the investment in their own name, issuers are somewhat restrained).

[246] *See* Proposed Rule 3a-9 under the Investment Company Act, Final Rules, *supra* note 3, at 144.

[247] *See generally* Final Rules, *supra* note 1, at 375-77. The Commission also altered the 12(g) Rule to ensure natural persons investing through crowdfunding vehicles may be excluded when they are deemed to be co-issuers. *Id.* at 371.

[248] *See id*. at 173-74 (acknowledging the "costs and burdens" of the crowdfunding vehicle's structure and surmising the "balance of tradeoffs" will likely vary depending on a number of factors and influence use).

[249] Final Rules, *supra* note 1, at 159-160, 162 n. 477.

[250] Final Rules *supra* note 1, at 173, *Cf. Id.* at 177-178.

[251] *See e.g.* Burton Letter, *supra* note 209, at 12 (describing SPV structure as "so utterly prescriptive that it is unlikely to be much used."); Crowdcheck Letter, *supra* note 209, at 21 (describing SPV structure as "not workable in practice."); Letter from Nicholas Tommarello CEO, Wefunder, to the SEC on the Proposed Rules at 5 (May 28, 2020), https://www.sec.gov/comments/s7-05-20/s70520-7246786-217248.pdf (describing SPV structure as "too costly with little benefit to either investors or issuers") [Hereinafter Tommarello Letter].

[252] Tommarello Letter, *supra* note 251, at 5.

questions about who will manage the crowdfunding vehicle and distribute required paperwork.[253] These issues will hamper and may foreclose crowdfunding-vehicle use altogether.

VII. FIXING THE JOBS ACT

The JOBS Act has not reached its promise. Geographic and demographic disparities remain in who gets funded and who profits. Uncertainty also persists in Commission approaches to the JOBS Act role in tokenized structures. After eight years and a complete private-exemption framework review the Commission has few answers. Commissioners pay lip service to problems but overemphasis on investor protection, insistence on "fact and circumstances" analysis, and a lumbering bureaucracy thwart progress.

A. Lessons from Overseas

The United States is not alone in grappling with new capital-raising methods, token economics, and disruptions to calcified monetary systems. In aligning America's entrepreneurial ambitions with changing global dynamics, we can see what works elsewhere and adapt our rules. Fulbright Scholar and University of Colorado professor Andrew Schwartz has researched equity crowdfunding models.[254] His New Zealand study is particularly useful because it copied Regulation Crowdfunding yet stripped it of obstacles domestic entrepreneurs face.[255] The result has been spectacular. Scaled for economy and focusing on the first year, New Zealand had thirteen times more crowdfunding campaigns and raised thirty times more capital. And did so without any reported fraud. Even accounting for Reg CF's healthy year-to-year growth and other available options for U.S. entrepreneurs, New Zealand's model is notable. New Zealand focuses on private ordering where portals and lead investors take responsibility for issuer quality. Reputational awareness and financial skin-in-the-game self-regulate the system without equivalents of Form Cs, Annual Reports, individual limits, or offer regulation.[256]

While New Zealand's model may be too radical for the current Congress it presents a striking alternative to the rule-heavy U.S. approach. Yet it is not only from this small country we can learn. The U.K. with a comparable financial system has also succeeded. According to the 2019 SEC Regulation Crowdfunding Report[257] in 2017 alone U.K. equity-crowdfunding issuers raised $450 million, "significantly higher" than Reg CF's first two-and-half-years. The SEC cautions about comparisons because of "differences in regulatory regimes and tax treatments of crowdfunding securities investments."[258] One difference is the U.K. "Regulatory Sandbox." Sandbox tools include "restricted authorization, individual guidance, informal steers, waivers and no enforcement action letters."[259] Within its first two years the Sandbox accepted 89 firms

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[253] JD Alois, *Crowdfunding Industry Insider Criticizes SEC Proposal on Special Purpose Vehicles for Reg CF*, CROWDFUND INSIDER (Apr. 15, 2020, 3:00 PM), https://www.crowdfundinsider.com/2020/04/160187-crowdfunding-industry-insider-criticizes-sec-proposal-on-special-purpose-vehicles-for-reg-cf/.

[254] Letter from Prof. Andrew Schwartz, Professor of Law, Univ. of Colo., to the SEC on the Concept Release (Sept. 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6193349-192506.pdf [hereinafter Schwartz Letter].

[255] Andrew Schwartz, *Equity Crowdfunding in New Zealand*, 2018 NEW ZEALAND L. REV. 243 (2018).

[256] Professor Schwartz notes Australia has a flat individual limit of $5,000 instead of the clunky Regulation CF formula, which avoids privacy concerns and is straightforward. Schwartz Letter, *supra* note 254, at 5.

[257] SEC, REGULATION CROWDFUNDING, *supra* note 181, at 16.

[258] *Id.* at 16-17.

[259] *Regulatory Sandbox*, FINANCIAL CONDUCT AUTHORITY, https://www.fca.org.uk/firms/innovation/regulatory-sandbox (last visited Jan. 30, 2022).

with innovative products. According to an outside report, "The unequivocal message is that the sandbox has delivered real value to firms, ranging from guidance relating to the application of regulation to innovative propositions, to 'kicking the [tires]' on the risks relating to their business model."[260] It recently announced a partnership with the City of London Corporation to support firms addressing the COVID-19 challenge.[261] Commissioner Peirce has proposed the same concept, though with less hands-on government guidance, for U.S.-based token projects.[262] While this regulatory originality may or may not work for domestic firms, the U.K. embrace of innovation is in short supply across the Atlantic.

B. Regulators must Heed Private Exemption Costs

Currently, and including the Final Rules, the costs of forgoing Reg D for retail-investor raises are infeasible for most issuers. Reg A+ and Reg CF costs dwarf private-ordered Reg D. Reg A+ estimates range from lower six figures to well into seven figures.[263] In relative costs, Reg CF is potentially worse. The Commission estimates average Reg CF campaigns cost almost $22,500 and 241 manhours.[264] Reg D 506(c) is not only more costly than Reg D but invites substantial

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[260] *A Journey Through The FCA Regulatory Sandbox, The Benefits, Challenges, and Next Steps*, DELOITTE, (2018) at 2, https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-fca-regulatory-sandbox-project-innovate-finance-journey.pdf.

[261] JD Alois, *UK Financial Conduct Authority Partners with City of London Corporation to Pilot Digital Sandbox Supporting Firms Addressing COVID-19 Challenge*, CROWDFUND INSIDER (July 16, 2020, 8:40 AM), https://www.crowdfundinsider.com/2020/07/164130-uk-financial-conduct-authority-partners-with-city-of-london-corporation-to-pilot-digital-sandbox-supporting-firms-addressing-covid-19-challenge/.

[262] Hon. Hester M. Peirce, Comm'r, SEC Comm., Speech: Running on Empty, A Proposal to Fill the Gap Between Regulation and Decentralization (Feb. 6, 2020), https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06.

[263] JD Alois, *How Much Does a Reg A+ Offering Cost?*, CROWDFUND INSIDER (Nov. 6, 2019, 3:48 PM), https://www.crowdfundinsider.com/2019/11/153797-how-much-does-a-reg-a-offering-cost/ ("In total, on the low end, Manhattan Street Capital estimates a Reg A+ offering will cost $300,000 to complete. That amount will come straight off of the top of any funding raised – which means a percentage of investor money."); Anzhela Knyazeva, REGULATION A+: WHAT DO WE KNOW SO FAR?, at 14 (Nov. 2016) (unpublished manuscript) (on file with the SEC Division of Economic and Risk Analysis), https://www.sec.gov/dera/staff-papers/white-papers/Knyazeva_RegulationA-.pdf (The average costs including using an intermediary at over $1 million, without an intermediary at $111k this doesn't count other fees, for instance state filing fees which can be as much as $45k); JD Alois, *Report Updates on Reg A+ & Reg CF Investment Crowdfunding Progress During 2017*, CROWDFUND INSIDER (Feb. 25, 2018, 7:22 AM), https://www.crowdfundinsider.com/2018/02/128794-report-updates-reg-reg-cf-investment-crowdfunding-progress-2017/ ("The average company that reported costs associated with a Regulation A+ offering spent just over $93,000 in legal fees. The average audit cost was reported as approximately $33,735. Significantly fewer companies reported costs associated with remaining fees. From the limited data available, the average costs were as follows: sales commissions, $1.8 million; finders' fees, $800,000; underwriters' fees, $1.3 million; promoters' fees, $529,630; and Blue Sky compliance fees, $19,819."); Campbell Letter, *supra* note 50, at 13 (discussing how Reg A+ is cost prohibitive for small issuers).

[264] SEC, REGULATION CROWDFUNDING, *supra* note 181, at 25; *cf. A Financial System That Creates Economic Opportunities Capital Markets*, U.S. DEPT. OF THE TREASURY, at 40 (Oct. 2017), https://www.treasury.gov/press-center/press-releases/documents/a-financial-system-capital-markets-final-final.pdf ("[M]arket participants have expressed concerns about the cost and complexity of using crowdfunding compared to private placement offerings."); Letter from David V. Duccini, Founder & CEO, Silicon Prairie Holdings, Inc., to the SEC on the Concept Release, at 8 (Sept. 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6184555-192415.pdf [Duccini Letter] ("REG-CF is literally the MOST EXPENSIVE cost of capital option."); Campbell Letter, *supra* note 51, at 21("The costs of ex ante and ex post disclosures of investment information and the costs of the limitations on reasonable marketing strategies (i.e., limiting selling strategies to posting offers on third party

privacy concerns.[265] In fact, the Wefunder portal returned to Reg D after Reg D 506(c) compliance headaches.[266] In examining how to bring Reg D opportunities to all, cost of capital must be paramount.

C. Where Congress Should Act

In our deeply polarized time, the JOBS Act convened supporters across ideological and partisan lines to help America's overlooked entrepreneurs. Unfortunately, one constituency not on board was the Securities and Exchange Commission. The results speak for themselves. It is Congress's duty to intervene before another lost decade occurs. A JOBS Act sequel can succeed where the first failed by adhering to a few key insights. First the Commission will not fix the JOBS Act *sua sponte*. The Final Rules show that. Second, Congress should trust citizens to make investment choices as they do other life choices. This means allowing options that fit their budgets, aspirations, and risk tolerance subject to federal antifraud law. As Professor Usha Rodrigues aptly states, "Securities law . . . in theory, as in practice, marginalizes the average investor without acknowledging that it does so, let alone justifying it."[267] Third, states should not conduct additional reviews or require fees that do not protect investors but harm entrepreneurs.

Regulate sales not offers. Offer regulation has hallmarked U.S. securities law since its federalization.[268] The Commission interprets offers broadly and beyond common-law understandings.[269] That offers, in effect, *speech* can harm potential investors, even those not

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websites) overwhelm the value of the Crowdfunding exemption for small businesses."); Schwartz Letter, *supra* note 254, at 2 ("By imposing significant disclosure and regulatory hurdles, Regulation Crowdfunding imposes high costs on issuers relative to the low level of funding startups can and do obtain, dissuading issuers from relying on the exemption.").

[265] Final Rules, *supra* note 1, at 87–88; *cf.* Letter from Anthony Chereso, President & CEO, Inst. for Portfolio Alternatives, to the SEC on the Concept Release, at 4 (Sept. 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6193369-192518.pdf (discussing privacy concerns and fear of rescission long after raise with principle-based verification method); Quaadman Letter, *supra* note 222, at 5 ("In practice, the enhanced accredited investor verification requirements have discouraged many issuers from taking advantage of Rule 506(c)."); Burton Letter, *supra* note 24, at 35 ("Many investors are reluctant to provide such sensitive information to issuers with whom they have no relationship as the price of making an investment and, given the potential liability, accountants, lawyers and broker-dealers are unlikely to make certifications except perhaps for very large, lucrative clients."); Letter from Stuart M. Rigot, Esq., Wyrick Robbins LLP, to the SEC on the Concept Release, at 3 (Sept. 17, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6132204-192257.pdf ("[S]ophisticated funds and/or high net-worth angel investors are very much reluctant to share sensitive financial information, whether about themselves or their limited partners.").

[266] Letter from Nicholas Tommarello, CEO, Wefunder, to the SEC on the Concept Release, at 13 (Sept. 13, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6132124-192256.pdf [hereinafter Tommarello Letter] (also noting about 10% of accredited investors dropped out of potential investments because of the verification hassles, even if they had previously verified the year before).

[267] Rodrigues, *Dirty Secret*, *supra* note 28, at 3427.

[268] *See* 15 U.S.C. § 77b(a)(3) (2018); 15 U.S.C. § 77e.

[269] Securities Offering Reform, Release No. 33-8591, [70 FR 44722 (Aug. 3, 2005)], at 39 n. 88 (July 19, 2005) ("The term 'offer' has been interpreted broadly and goes beyond the common law concept of an offer."(citing Diskin v. Lomasney & Co., 452 F.2d 871 (2d. Cir. 1971); SEC v. Cavanaugh, 1 F. Supp. 2d 337 (S.D.N.Y. 1998))). *cf.* Securities Act of 1933 §2(a)(3), 15 U.S.C. § 77b(a)(3) (noting that an offer includes "every attempt to dispose of a security or interest in a security, for value; or any solicitation of an offer to buy a security or interest in a security."); Cohn & Yadley, *supra* note 5, at 38 ("Although the 1933 Securities Act's use of the term "offer" could readily be interpreted in a contract sense, the SEC has interpreted the provision to encompass statements or notices that fall far short of normal contractual concepts.").

investing is a uniquely American concept.[270] And its repeal has been bandied since at least the 1990s.[271] No one is harmed by receiving investment opportunities[272] and that speech is still subject to federal antifraud law. Speech policing factual information ties issuers and their lawyers in knots, ups legal bills, and foments less information. This is true even for Reg D where general solicitation squabbles spur angst, stalled raises, and minutia-level speech parsing.[273]

The Commission's revised Demo Day rules illustrate the bizarre contradictions that can result from trying to police truthful information. As noted above, the Commission will allow presenters to state four information pieces: "(i.) Notification that the issuer is in the process of offering or planning to offer securities; (ii.) The type and amount of securities being offered; (iii.) The intended use of the proceeds of the offering; and (iv.) The unsubscribed amount in an offering."[274] It considers this limitation an investor protection.[275] Yet, it then states potential investors can meet afterwards "outside of the event setting" to get further disclosure.[276] Thus, the same information that requires shielding at the event loses its investor-protection function at a next-day lunch meeting.

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270 Letter from Sara Hanks, CEO, Crowdcheck, to the SEC on the Concept Release, at 6 (Oct. 30, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6368811-196431.pdf [hereinafter Hanks Letter].
271 Linda Quinn, Dir. of SEC Div. of Corp. Fin., Speech: Reforming the Securities Act of 1933: A Conceptual Framework, *reprinted in* INSIGHTS, Vol. 10, No. 1 (Jan. 1996), https://www.sec.gov/info/smallbus/acsec/reformingsa33.pdf.
272 Hanks Letter, *supra* note 270, at 2; Letter from Robert E. Buckholz Chair, Federal Regulation of Securities Committee ABA Business Law Section, to the SEC on the Concept Release, at 4 (Oct. 16, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6297110-193413.pdf [hereinafter Buckholz Letter] ("Although the Securities Act regulates offers and sales, true damage rarely occurs unless there is an actual sale."); Burton Letter, *supra* note 24, at 9 ("An offeree that never buys a security needs little 'protection'."); Barker Letter, *supra* note 170 ("[I]nvestors need protection, but that belongs at the point-of-sale."); Letter from Georgia Quinn, Gen. Couns., Coinlist, to the SEC on the Concept Release, at 6 (Sept. 26, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6220398-192608.pdf [hereinafter Quinn Letter] ("Instead of system of potential foot faults, issuers should be able to communicate broadly as long as before investing, potential investors are directed to the intermediary with appropriate education and risk disclosures."); Campbell Letter, *supra* note 51, at 10 ("Issuers should be allowed and, indeed, encouraged to solicit broadly for investors, so long as the investor protection condition is imposed at sale.").
273 Quaadman Letter, *supra* note 222, at 5 ("Determining what activities constitute general solicitation or general advertising has been an area of uncertainty for years. . . . [T]he Staff's guidance has been inconsistent at times and still leaves open a number of compliance uncertainties."); Letter from Maria Wolvin, Vice President & Sr. Couns., Pub. Pol'y Ass'n for Corp. Growth, to the SEC on the Concept Release, at 6 (Sept. 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6190715-192477.pdf ("[Those] seeking to undertake a Rule 506(b) offering [must] either navigate a host of SEC No Action Letters, staff guidance and enforcement activity, or expend resources to retain outside counsel to determine the parameters of prohibited and permissible activities under Rule 506(b)."); Hanks Letter, *supra* note 270, at 5 (unfamiliarity with general solicitation nuances "leads to pointless arguments between issuer and counsel as to what the issuer hopes to achieve with the communications they are making, and frantic efforts to 'fix' communications that the issuer has made without realizing the light in which the communication may be viewed by regulators."); Letter from James P. Dowd, CEO, N. Cap. Inv. Tech., to the SEC on the Concept Release, at 2 (Sept. 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6193359-192511.pdf [hereinafter Down Letter] (describing decades-long issues with when an investor relationship is sufficiently "preexisting" and "substantive" to avoid general solicitation).
274 Final Rules, *supra* note 1, at 85.
275 *Id.* (finding the additional fourth prong "is unlikely to affect investor protection in light of the limits on the overall information about the offering that may be conveyed . . . .").
276 *Id.* ("[P]otential investors will be able to seek additional disclosure about the investment opportunity outside of the event setting.").

The virtual-audience restriction is also head-scratching. The Commission distinguishes in-person Demo Days, which have inherent physical limitations to curtail unaccredited investor attendance from virtual Demo Days which lack such barriers.[277] The Commission limits attendance at these virtual events but allows certain unaccredited investors to attend, for instance students, faculty, and alumni of a university host. The Commission is wary that unaccredited persons may hear broad offering communications.[278] But it does not explain why a student at the hosting college benefits by virtually attending the event but her friend at a nearby junior college or sibling saving to start a business does not.

Less experienced Reg CF issuers and investors are especially vulnerable to offer proscriptions. Regulating speech between these parties for small-dollar amounts and often where prior relationships exist runs counter to the crowdfunding model,[279] as well as Reg CF's goal to democratize private investing.[280] Offer strictures not only harm Reg CF issuers pre-raise but also during, limiting term communications outside portals to nondescript 'tombstone' ads.[281] This confuses novice issuers and investors alike and factors into Reg CF's soft start.[282] The rules force even knowledgeable issuers into vagaries and weasel words lest they trip the "terms" – "nonterms" dichotomy.[283] These issues will keep plaguing raises as new communication methods emerge. One commenter described hours spent trying to format a Reg A+ solicitation in Instagram Stories with proper text and links.[284]

The Final Rules embody Commission failure to address these concerns. Its refusal to preempt Rule 241 from Blue Sky laws, laborious and mine-laden definitions for 'Demo Days,'

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[277] *Id.* at 84-85.

[278] *Id.* at 84, ("[S]ome commenters raised concerns about [Demo Day] events allowing for broad offering-related communications to non-accredited investors. We share this concern, particularly in light of the increasing prevalence of virtual "demo days" that are more accessible and widely attended by the general public.").

[279] Barker Letter, *supra* note 170 ("At this scale, the ROI for attempting to police the flow of information is futile at best and oppressive at worse."); Letter from Ed Engler, Managing Partner, Pittsburgh Equity Partners, to the SEC on the Concept Release, at 6 (Sept. 30, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6231639-192668.pdf [hereinafter Engler Letter]("The goal of Reg CF should be to increase investor access to information and transparency of the security being offered/sold."); Letter from Mainvest, Inc. to the SEC on the Concept Release, at 1 (Sept. 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6193357-192513.pdf [Mainvest Letter] (discussing the localized nature of crowdfunding); Campbell Letter, *supra* note 81, at 7 ("The idea that a neutral posting (my term) of investment with a third party, coupled with strict limitations on other contacts between the issuer and investors, would enable issuers to sell securities obviously was misplaced.").

[280] *See* 2018 Forum Report, *supra* note 36, at 20.

[281] 17 C.F.R. § 227.204.

[282] *See* Campbell Letter, *supra* note 51, at 19 (pointing toward limitations in marketing strategies as one reason Reg CF has failed).

[283] Quinn Letter, *supra* note 272, at 6; Engler Letter, *supra* note 279, at 6 (describing "very careful line" businesses must walk when promoting their Reg CF raises); Tommarello Letter, *supra* note 266, at 7 (describing "absurd result" that potential investors can't look Reg CF issuers in the eye and ask them questions about their raise); Letter from Sherwood Neiss, Principal, Crowdfund Cap. Advisors, LLC, to the SEC on the Concept Release, at 7 (Sept. 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6190712-192475.pdf [hereinafter Neiss Letter] (suggesting only limitation on nonportal communication should be potential investors directed to portal for more information); Letter from Hon. Patrick McHenry (R-NC), Vice Chair, H. Comm. on Fin. Serv., to the SEC on the Concept Release, at 5 (Oct. 15, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6293559-193383.pdf [hereinafter McHenry Letter] (describing how current rules hamper issuers by limiting contact with third-party media).

[284] Hanks Letter, *supra* note 270, at 8.

and the general desire to shield investors from information to protect them is paternalistic[285] and discordant with the nation's free speech values.[286]

Exempt Secondary Trading for Regulation A+ and Regulation CF. A major barrier for both Reg A+ and Reg CF is the lack of state preemption for secondary trading. Although federally both are freely tradable (Reg CF after one year), Blue Sky laws thwart its potential.[287] Impairing investor liquidity does not protect investors.[288] The Commission has broad authority to preempt Regulation A securities.[289] But it refuses to act despite habitual cajoling both inside[290]

[285] Mercantus Center Letter, *supra* note 176, at 5 ("The federal securities laws were meant to increase the flow of accurate information and not to protect investors in a paternalistic way from potentially bad investments. . . . Investor protection was the spirit of the federal securities laws, but it was protection consistent with the country's history and tradition of freedom and self-reliance.").

[286] U.S. CONST. amend. I.

[287] Dowd Letter, *supra* note 273, at 3 ("Simply put, without federal preemption, secondary markets for exempt securities are dead before launch. They will be crippled by the high cost of compliance. The failure of Reg A / Tier 1 offers convincing evidence of this point."); Burton Letter, *supra* note 24, at 38 (discussing unattractiveness of Reg A+ because the lack of Blue Sky preemption in the secondary trading market means, "investors have no cost-effective means of selling their investment."); Hanks Letter, *supra* note 270, at 47 ("[T]he patchwork of rules applying to [Reg A+] issuers and brokers facilitating secondary transactions makes secondary liquidity excessively expensive and unavailable to many small issuers. This poses a harm to investors as well, as they do not have any real opportunity for liquidity until an issuer is listed on a national securities exchange.").The Final Rules reiterated the Commission's refusal to preempt secondary trading for Reg A+ Tier 2. Final Rules, *supra* note 1, at 137 n. 389, 148 n. 439 (stating any change would come through a specific proposal with notice and comment).

[288] Letter from Mark Schonberger, Goodwin Proctor LLP, to the SEC on the Concept Release, at 9 (Sept. 24, 2019), https://www.sec.gov/comments/s7-08-19/s70819-6193382-192525.pdf [hereinafter Schonberger Letter] ("Public policy suggests that impairing liquidity of securities does not protect investors."); McHenry Letter, *supra* note 283, at 7 ("The liquidity provided by a secondary market is an investor protection in and of itself, because it would allow individuals whose financial situation has changed to exit these investments in times of need.").

[289] The Court of Appeals in *Lindeen v. SEC* confirmed the breadth of this delegation to the Commission to preempt state registration authority over Regulation A+ offerings. 825 F. 3d 646 (D.C. Cir. 2016).

[290] *See generally* ADVISORY COMMITTEE ON SMALL AND EMERGING COMPANIES: RECOMMENDATIONS REGARDING SECONDARY MARKET LIQUIDITY FOR REGULATION A , TIER 2 SECURITIES (May 15, 2017), https://www.sec.gov/info/smallbus/acsec/acsec-recommendation-051517-secondary-liquidity-recommendation.pdf (recommending Commission preempt from state regulation the secondary trading in securities of Tier 2 Regulation A issuers current in their ongoing reports); FINAL RPT. OF THE 2019 SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, at 10 (Aug. 2019), https://www.sec.gov/files/small-business-forum-report-2019.pdf; 2018 Forum Report, *supra* note 35, at 21; FINAL RPT. OF THE 2017 SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, at 17 (Mar. 2018), https://www.sec.gov/files/gbfor36.pdf (recommending Commission preempt Blue Sky laws for secondary trading of securities issued under Tier 2 of Regulation A and consider overriding advance notice requirements and limit fees); FINAL RPT. OF THE 2016 SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, at 16 (Nov. 2016), https://www.sec.gov/info/smallbus/gbfor35.pdf (recommending preempting all secondary sales of Reg A+ Tier 2); FINAL RPT. OF THE 2015 SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, at 23 (Nov. 2015), https://www.sec.gov/info/smallbus/gbfor34.pdf (describing the status of issuers that have satisfied for the past two years and are current in their reporting obligations); FINAL RPT. OF THE 2014 SEC GOVERNMENT-BUSINESS FORUM ON SMALL BUSINESS CAPITAL FORMATION, at 29 (May 2015), http://www.sec.gov/info/smallbus/gbfor33.pdf (including Tier 1); U.S. Treasury Dep't, *supra* note 264, at 40 (recommending state securities regulators update their regulations to exempt from state registration and qualification requirements secondary trading of securities issued under Tier 2 of Regulation A or alternatively that the Commission use its authority to preempt state registration requirements for such transactions). Unfortunately, this is not a new development. *See* Cohn & Yadley, *supra* note 5, at 3–4 ("The Small Business Forum, mandated by Congress as an annual SEC event, has resulted in 25 years of repeated and strongly-worded recommendations from small business advocates to lessen the SEC's regulatory burdens on raising capital. Yet, with rare exception, the SEC has turned a deaf ear to the Forum's recommendations and concerns.").

and outside government.[291] If Reg A+ and Reg CF are to emerge from novelty stage and counter Reg D dominance, Congress must cover resales. It is telling that well before the JOBS Act, the Commission had broad authority to "cover" securities to "Qualified Purchasers" which it could freely define, limited only by investor protection and public interest.[292] Congress even amended Securities Act Section 2(b) to make the Commission "consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation."[293] A quarter century hence, the Commission has not materially acted without Congressional mandate.[294]

Secondary trading also has massive future implications. Blockchain-based endeavors and tokenized systems are incompatible with state-by-state secondary-trading regimes.[295]As tokens express multiple uses acting as network keys, as well as having currency and security traits, it is imperative states with their stifling and dissonant rules not interfere. While some states have sought to brand themselves blockchain havens[296] others cannot even define the term.[297] Little reason exists to think this ineptitude will dissipate as technology advances and digital assets acquire more and varying functions.

Preempt state filing requirements and notice fees for Regulation A+ and Regulation Crowdfunding. State filing and notice fees serve no cognizable purpose. They do not protect investors, facilitate capital, or improve markets. They are regressive, expensive, and disproportionately hurt smaller issuers.[298] Reg A+ fees are littered with waste, inconsistencies, and timing issues, with no related benefit.[299] This model departs from Reg D, where issuers

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[291] *See* SEC, *supra* note 87 (collecting support in Regulation A Release); *cf.* Burton Letter, *supra* note 24, at 38 (Reg A+ has been a disappointment because of two Commission decisions, "Probably the most important reason was the Commission's decision to not preempt Blue Sky laws for Tier 1 offerings or Tier 2 secondary offerings."); Dowd Letter, *supra* note 273, at 3 ("Simply put, without federal preemption, secondary markets for exempt securities are dead before launch."); Schonberger Letter, *supra* note 288, at 9 ("[T]he pre-emption of state laws with respect to resales of Tier 2 offerings needs to be reviewed and addressed."); Quinn Letter, *supra* note 272, at 5 (Blue Sky preemption would make Reg A+ Tier 2 more workable); Hanks Letter, *supra* note 270, at 47; Campbell Letter, *supra* note 51, at 15 ("The failure of the Commission to preempt, to the full extent of its Congressionally delegated power, state registration authority has been a significant failure on the part of the Commission.").
[292] National Securities Markets Improvement Act of 1996 §18(b)(3), 15 U.S.C. § 77r(b)(3).
[293] 15 U.S.C. § 77b(b).
[294] Campbell, *supra* note 84, at 348 (describing Commission's decades-long failure to expand preemption over exempt offerings "even as states' registration obligations have continued to choke small business capital formation and wreck the Commission's rational, efficient exemptions from federal registration."); *Id.* at 350 ("Indeed, a moment of reflection reveals that the only preemptions of state authority over exempt offerings by small businesses have been the result of statute, specifically the preemption over Rule 506 offerings and crowdfunding.").
[295]*See* Schonberger Letter, *supra* note 288, at 9–10 (discussing Reg A+ potential for blockchain-related endeavors).
[296] Gregory Barber, *The Newest Haven for Cryptocurrency Companies? Wyoming*, WIRED (June 6, 2019, 7:00 AM), https://www.wired.com/story/newest-haven-cryptocurrency-companies-wyoming/.
[297] Preston J. Byrne, *The States Can't Blockchain*, COINDESK (Mar. 2, 2020), https://www.coindesk.com/the-states-cant-blockchain.
[298] Engler Letter., *supra* note 279 at 2, (discussing burden of filing requirements and fees on Reg CF issuers).
[299] Barker Letter., *supra* note 170 (discussing state regulators lack knowledge about newer exemptions and inability to interpret federal statutes, and in the case of Reg A+ issuers often pay fees by to states where no transaction occurs); Schonberger Letter, *supra* note 288, at 8 ("Tier 2 issuers, some issuers pay upwards of $25,000 per year in notice and filing fees to the 50 states – and, because this fee is paid before sales take place, it is a cost that issuers must incur regardless of whether an offering ultimately has a single investor in a given state in which the fee is paid."); Hanks Letter, *supra* note 270, at 29 ("[T]he states have differing requirements with respect to the timing of notice filings ranging from requiring filing 21 days prior to 'offers' (which is not consistent with the ability to test

invoke state filing costs only after local sales. Reg A+ and Reg CF issuers place all offer documents on EDGAR[300] making them publicly available for fraud investigations. At the least, Congress should reconcile Reg A+ issuers that often pay fees to all possible jurisdictions with Reg CF where at most issuers pay two.[301]

Exempt Regulation A+ and Regulation Crowdfunding from the 12(g) Rule. The Commission in its familiar style conditionally exempts these issuers from the 12(g) Rule. Congress could simplify worries for those choosing these innovative exemptions by removing this hinderance completely. The 12(g) Rule constantly foments angst for growing companies.[302] Even if applied to Reg D, where investors are likely accredited, it should not worry issuers crowdfunding investment from ordinary Americans.[303]

Raise the Regulation A+ Offer Limit to $100 million. Congress should raise the Reg A+ 12-month aggregate offer limit to $100 million. After previous considerations, the Commission has now raised it to $75 million.[304] Given the usual pace it may be several more years before it is raised again, despite Congressional directive.[305] Congress should skip this potentially years-long wait while keeping Title IV's biennial review.

Raise the Regulation Crowdfunding Offer Limit to $20 million. Congress should raise Reg CF's 12-month aggregate offer limit to $20 million and add a statutory requirement like Reg A+ that the Commission biennially review it. The Commission raise to $5 million took almost four years and another change will likely follow this pace. Without significant encouragement to monied investors, Reg CF adoption will remain hampered despite recent spectacular gains.[306]

Simplify or eliminate individual limits for Regulation A+ and Regulation Crowdfunding. Congress should remove individual formulas for unaccredited investors in Reg A+ and Reg CF and replace them with hard dollar amounts per investment, not aggregate per 12 months. The Commission has now eliminated Reg CF accredited investor limits.[307] But both Reg A+ and Reg CF still impede unaccredited investors with annual income, net worth formulas. This confuses investors and invokes security and privacy concerns.[308] A hard inflation-adjusted

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the waters under Rule 255) to requiring filing prior to qualification, to not accepting filings before qualification."); Buckholz Letter, *supra* note 272, at 12 ("State advance notice and filing fee requirements for Tier 2 offerings impose a substantial burden on the issuers without any corresponding benefit.").

[300] *About EDGAR*, U.S. SECURITIES AND EXCHANGE COMMISSION, (Aug. 24, 2020), https://www.sec.gov/edgar/about.

[301] 15 U.S.C. § 77r(c)(2)(F).

[302] Hanks Letter, *supra* note 270, at 24 ("Issuers and their counsel currently contort themselves into legal pretzels trying to structure deals in such a way that 12(g) is not triggered."); *cf.* Concept Release, *supra* note 2, at 141 (discussing reluctance by issuers using Reg CF to take more than 500 unaccredited investors because of Rule 12(g) concerns).

[303] Campbell Letter, *supra* note 51, at 14–15 (discussing how Rule 12(g) and reporting requirements impose "what amounts to penalties on small issuers using particular exemptions from registration, such as Regulation A+ (or Crowdfunding.)").

[304] *See* Final Rules, *supra* note 1, at 117–120 for Commission rationale.

[305] Jumpstart Our Business Startups Act, Pub. L. No. 112-106, sec. 401(a)(5), 126 Stat. 325 [15 U.S.C. § 77c(b)(5)].

[306] *See*, *supra* note 140.

[307] Final Rules, *supra* note 1, at 147-148.

[308] Schwartz Letter, *supra* note 254, at 5 (discussing privacy and security concerns investors have with the current model and the benefits of Australia's hard-number model).

number would be simpler and straightforward. For instance, $10,000 per Reg CF investment and $20,000 per Reg A+.[309] Alternatively, Congress should remove the limits completely.

Limit financial and reporting requirements for Regulation A+ and Regulation CF. Without a robust secondary market, post-raise reports for Reg A+ and Reg CF make no sense.[310] These reports are expensive and time consuming. Moreover, audits make no sense for companies with little operating history.[311] Congress should limit Reg A+ post-raise reports to annual and remove Reg CF post-raise reporting altogether. It should also end Reg CF audit requirements and allow CPA financial-statement reviews for all raises over $250,000, including subsequent raises.[312]

Combine Regulation D 506(b) and Regulation D 506(c) and allow accredited investor verification via affidavit. The Commission's Reg D 506(c) "reasonable steps" verification methods are cumbersome and invasive. Congress should allow investors to represent under penalty of perjury they understand the accredited investor definition and meet the thresholds. If investors willfully lie, fault should lie with them.

Upon these changes, issuers may split between consumer-focused companies that thrive with heavy adoption choosing Reg A+/Reg CF and issuers with business to business focus choosing Reg D. Or issuers may tailor combinations. But under simplified rules accepting numerous unaccredited investors as brand ambassadors would be more appealing for issuers and potentially profitable for those investors. This is especially true of tokenized offerings.

D. Where the SEC Should Act

The Commission should recognize its failures. When state regulators meddle, policy failures occur. The Commission should not encourage state-review mechanisms.[313] It sometimes dryly

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[309] Duccini Letter, *supra* note 264, at 8 (contrasting the simple $10,000/investor/year individual investment limit for the Minnesota intrastate crowdfunding to the "largely ineffective (and wholly unenforceable)" federal model).
[310] Quinn Letter, *supra* note 272, at 5 ("It is not clear what the necessity of providing ongoing disclosure is if the securities cannot be transferred."); *cf.* Rodrigues, *Dirty Secret*, *supra* note 28, at 3427 ("The secondary market is where the payoff for issuer disclosure really emerges.").

[311] Letter from Nicholas Tommarello, Chief Exec. Officer, Wefunder, to Countryman, Secretary, U.S. Sec. and Exch. Comm'n (Sept. 13, 2019) (on file with author) ("We know from three years of experience that the accounting requirements are the single most burdensome disclosure requirement (arguably, the only burdensome disclosure requirement) of Regulation Crowdfunding."); Burton Letter, *supra* note 24, at 46 ("Requiring audited financial statements for a crowdfunding company is ludicrous. It is one of the most obvious examples of how the disclosure requirements do not fit together across exemptions. Issuers offering ten times this much (or more) need not obtain audited financials using other exemptions."); Schwartz Letter, *supra* note 254, at 4 ("[A] significant percentage of crowdfunding issuers have very little income or assets to report, making financial statements practically irrelevant for them."); Mainvest Letter, *supra* note 279, at 6 ("In most cases, adding the CPA review to the upfront costs, provides almost no value to investors and adds an often-prohibitive cost to entrepreneurs.").
[312] Due to the COVID-19 pandemic, the Commission temporarily allowed Reg CF issuers offering under $250,000 in securities to have the principal executive officer certify the financial statements and certain information from the issuer's Federal income tax returns instead of an independent public accountant. Temporary Amendments to Regulation Crowdfunding, 85 Fed. Reg. 27116 (proposed May 7, 2020)].) (to be codified at 17 C.F.R. pt. 227, 239). The Final Rules extended this relief until August 28, 2022. Final Rules, *supra* note 3, at 284-85.
[313] Final Rules, *supra* note 3, at 125 ("We believe that raising the threshold would permit issuers to seek more capital at a lower marginal cost than under the current [Reg D 504] rule and may encourage regional multistate offerings and the use of state coordinated review programs, resulting in more issuers conducting offerings under the exemption . . . .").

notes how Blue Sky laws affect exemption use[314] but never completely solves it. The Commission should admit private markets will never return to 1970s bad old days or pre-NSMIA. States should prosecute fraud after citizen complaints, in other words, reactive.[315] No evidence shows career civil-service personnel have the acumen or mindset to evaluate new companies or ideas.

Eliminate Regulation A+ Tier 1. No issuer should be subject to double review. Federal processes suffice. Efforts by state regulators to streamline reviews have failed and should be acknowledged as such.[316] After five years, the plague-like attitude toward Tier 1 should provide ample evidence the Commission should scrap it. Raising Reg CF to $20 million and Reg A+ to $100 million provides a better solution.[317]

Eliminate Regulation D 504. The same issues that animate Reg A+ Tier 1 resound to Reg D 504. The Final Rules raise the Reg D 504 offer limit to $10 million from $5 million.[318] The Commission should not keep trying to "fix" decades-old failures with higher caps without addressing underlying reasons for nonuse. Eliminating the Reg D 504 cap completely will not boost it given looming Blue Sky burdens. As it stands Reg D 504 (and the now-repealed Reg D 505) account for 2% of all Regulation D raises under $5 million.[319] One must wonder what raising the Reg D 504 limit to $10 million will achieve.[320] Would raising the 2% level to 5% (an unlikely outcome) be good public policy? If so straightforward rules with three exemptions would be better.

CONCLUSION

Despite Commission belief, private-capital raising needs a paradigm shift. The Commission should recognize its presuppositions do not match the current age much less the one coming. Paternalistic investor protections that deter capital formation and efficient markets hamper America's global competitiveness. Its tendency to include state brethren leads to policy

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[314] *See, e.g.*, Regulation A Report, *supra* note 136, at 9 ("The larger Tier 2 offering limit does not appear to be the sole factor for issuers' decision between tiers . . . Blue sky law preemption, facilitating nationwide solicitation and solicitation over the Internet, may have contributed to the popularity of Tier 2 offerings among issuers seeking the lower amount."); *Id.* at 15 ("Some commenters have noted that state registration requirements for secondary market transactions in Regulation A securities limit liquidity in the Regulation A market."); Concept Release, *supra* note 2, at 87 (discussing the vast differential in number of states issuers offer in Tier 2 compared to Tier 1, "We recognize that this differential observed in the data may be related to the fact that, under the 2015 Regulation A amendments, state registration requirements apply to Tier 1 but not to Tier 2 offerings.")..

[315] Rutheford B. Campbell, Jr., *Federalism Gone Amuck: The Case for Reallocating Governmental Authority over the Capital Formation Activities of Businesses*, 50 WASHBURN L.J. 573, 573–574 (2011) (arguing that states should reallocate "scarce state resources to their most efficient use, which is the support of the states' enforcement of their antifraud provisions").

[316] Burton Letter, *supra* note 24, at 38 ("The NASAA coordinated review program is a failure and should be acknowledged as such."); *cf.* Campbell, *Under the Bus*, *supra* note 83, at 339 (describing previous failed NASSA attempts at uniformity).

[317] Neiss Letter, *supra* note 283, at 4 (suggesting eliminating Reg A+ Tier 1 because Blue Sky laws make it impractical and replacing it with Reg CF at $20 million offering limit).

[318] Facilating Capital Formation, *supra* note, 3 at 125.

[319] *Id.* at 122-123.

[320] In 2016 the Commission raised the aggregate amount an issuer may offer and sell in any 12-month period for Reg D 504 from $1 million to $5 million but notes, "[The] data suggests that the higher threshold limits have not encouraged more issuers to conduct new offerings under the Rule 504 exemption, although those using the exemption are able to raise more capital in each offering and in the aggregate." *Id.* at 124.

failures that can last decades.[321] The Commission recognizes these failures begrudgingly if at all. Its inability to adjust to innovation and New Deal era "fact and circumstances" analysis already harm domestic entrepreneurs.

As David Burton aptly states, "The core problem with the current U.S. securities regulation system is its negative impact on small, start-up and emerging growth companies and, therefore, the adverse impact it has on entrepreneurship and the growth potential of the economy."[322] This is not a new insight. Four decades ago, Congress and the Commission recognized the capital-raising burdens it placed on small businesses and entrepreneurs.[323] In 2012, Congress tried to help via the JOBS Act. Unfortunately, even before enactment, the Commission treated the law as adversarial with predictable results. The future U.S. economy is too important to leave to well-intentioned Commission staff. Congress should improve the JOBS Act with a second try that fulfills the first's promise while curtailing discretionary powers that caused it to falter.

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[321] Campbell, *Under the Bus*, *supra* note 84, at 347 (describing Commission actions and inactions over the last 20 years that have enabled NASAA obstruction of small business capital formation); *Id.* at 350 ("Simply stated, my conclusion is that the Commission will continue to enable NASAA and state regulators to preserve a regime to makes it unnecessarily difficult, inefficient, and unfair for small businesses to access external capital. My other simple, related conclusion is that only Congress can break this gridlock by enacting statutory preemptions of state authority over registration.").

[322] Burton Letter, *supra* note 24, at 22.

[323] *See* Martin & Parsons, *supra* note 14.

WHEN JUSTICE IS SERVED: USING DATA ANALYTICS TO EXAMINE HOW FRAUD-BASED LEGAL ACTIONS AFFECT EARNINGS MANAGEMENT

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CONTENTS

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I. INTRODUCTION

How do firms supposedly engaged in earnings management respond to the filing of fraud-based legal actions and to the issuance of fraud-based legal rulings? Do they cease or continue their suspected earnings management activities? Using data analytics, this paper examines the impact of fraud-based legal actions on earnings management.

Corporate governance is the responsibility of an entity to any persons or groups who are affected by the various decisions, policies and operations of that entity.[1] While corporate governance is a significant factor in ensuring the presence of control mechanisms, it sometimes fails to prevent financial malpractice.[2]

Investors' trust in corporate financial reporting has been seriously shaken in recent decades. The corporate accounting scandals involving large well-known companies such as Enron, WorldCom, Xerox, Tyco and a number of lesser known companies – all audited by large accounting firms – suggest serious deficiencies in the accounting standards and corporate governance and regulatory systems designed to guide and monitor the financial information process.[3] Recent examples include Microsoft smoothing its earnings in order to stabilize profits and Coca-Cola overstating its assets by $9 million.[4]

Financial statement fraud occurred more frequently in smaller companies (companies with total assets of less than $100 million) than larger ones. In other findings of the study, computer companies were among those who topped the list of companies involved in financial statement fraud, according to a study done by the Committee of Sponsoring Organizations of the Treadway Commission.[5]

Research confirms the anecdotal evidence that the quality of reported earnings has deteriorated starting in the 1990s. For example, the gap between taxable corporate income and aggregate earnings has been continuously widening throughout the 1990s.[6] Another example would be the gap between corporate profits and earnings reported in the national product and income accounts, which are based on firms' taxable income adjusted for current values of depreciation and inventory. Although part of the gap between corporate profits and earnings may be due to the increasing sophistication of tax planning, earnings manipulation plays a major role.[7] There is evidence indicating that both CFOs and CEOs have idiosyncratic styles in withholding

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[1] Ayu Laksmi & Zulfia.Kamila, *The Effect of Good Corporate Governance and Earnings Management to Corporate Social Responsibility Disclosure*, 22 ACAD. OF ACCT. & FIN. STUD. J. 1–16 (2018).

[2] Malek El Diri, Costas Lambrinoudakis & Mohammad Alhadab, *Corporate Governance and Earnings Management in Concentrated Markets*, 108 J. OF BUS. RES. 291, 291–92 (2020).

[3] Baruch Lev, *Corporate Earnings: Facts and Fiction*, 17 J. OF ECON. PERSP. 27, 27 (Spring 2003).

[4] El Diri, *supra* note 2, at 291.

[5] MARK S. BEASLEY, JOSEPH V. CARCELLO, DANA R. HERMANSON &THE COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION, FRAUDULENT FINANCIAL REPORTING: 1987-1997 AN ANALYSIS OF U.S. PUBLIC COMPANIES 17 (1999).

[6] Francois Degeorge, Jayendu Patel & Richard Zeckhauser, *Earnings Management to Exceed Thresholds*, 72 THE J. OF BUS. 1, 29 (1999); Mihir Desai, *The Corporate Profit Base, Tax Sheltering Activity, and the Changing Nature of Employee Compensation*, 1–4 (Nat'l Bureau of Econ. Research, Working Paper No. 8866,2002); Lev, *supra* note 3, at 27.

[7] Baruch Lev & Doron Nissim, *Taxable Income as an Indicator of Earnings Quality* (N.Y. Univ., Working Paper, 2002); Baruch Lev, *Corporate Earnings: Facts and Fiction*, 17 J. OF ECONOMIC PERSP. 27, 27 (Spring 2003).

bad news;[8] apparently, more competent managers tend to be overconfident about future outcomes and therefore more likely to withhold bad news.[9]

Firm-specific data corroborates the use of earnings manipulation or earnings management by corporations. The number of earnings restatements by listed companies, often after admitted irregularities, has tremendously increased in the last several years.[10] In addition, the frequency of firms beating analyst's earnings forecasts increased sharply in the 1990s, suggesting earnings management as a possible cause.[11] Lev and Zarowin[12] provide evidence that the usefulness of reported earnings, cash flows, and equity values has been deteriorating for two decades. Rayman[13] stated a case that accounting is often distorted and inaccurate and called for a revision of the conventional accounting system nearly five decades ago.

Data analytics has been a growing field in the past two decades and, more recently, an emerging field in the legal sector.[14] Analytics can help predict outcomes in court.[15] Legal services providers need to go beyond merely accessing copies of statutes, regulations, interpretive documents and other primary law sources.[16] Client cases include more than substantive law issues and a regulatory question may involve accounting, finance, marketing and other issues.[17] While data analytics are not infallible, they can provide insights that increase the odds of an accurate prediction, enabling lawyers and clients to pursue a more accurate litigation strategy.[18] This paper employs the data analytic technique of linear regression to examine how fraud-based legal actions impact earnings management policies.

II. DEFINITION OF EARNINGS MANAGEMENT

Since earnings management is deemed to be a critical factor affecting the quality of earnings in recent decades, a definition of earnings management is in order. Earnings management is when managers use their judgment in financial reporting and transaction structuring in order to alter their firms' financial reports so as to either mislead some stakeholders (i.e., investors, creditors, employees, regulatory authorities) about the basic economic and financial performance

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[8] Jiaxin Liu, Do Executives Have Fixed Effects on Firm-Level Stock Price Crash Risk? (2016) (PhD. dissertation, CUNY) (on file with CUNY Academic Works).
[9] Jeong-Bon Kim & Liandong Zhang, *Accounting Conservatism and Stock Price Crash Risk: Firm-Level Evidence*, 33 CONTEMP. ACCT. RES. 412, 413 (2016).
[10] Min Wu, *Earnings Restatements: A Capital Market Perspective* (N.Y. Univ., Working Paper, 2002).
[11] Russell Lundholm, *Reporting on the Past: A New Approach to Improving Accounting Today*, 13 ACCT. HORIZONS 315, 315 (1999).
[12] Baruch Lev & Paul Zarowin, *The Boundaries of Financial Reporting and How to Extend Them*, 37 J. OF ACCT. RES. 353, 365 (1999).
[13] R. Anthony Rayman, *An Extension of the System of Accounts: The Segregation of Funds and Value*, 7 J. OF ACCT. RES. 53, 54 (1969).
[14] Patrick Flanagan & Michelle H. Dewey, *Where Do We Go from Here? Transformation and Acceleration of Legal Analytics in Practice*, 35 GA. ST. U. L. REV. 1245 (2019).
[15] Marilyn Odendahl, *Big Data Is Predicting Outcomes in Court*, THE IND. LAW. (May 13, 2020), https://www.theindianalawyer.com/articles/big-data-is-predicting-outcomes-in-court.
[16] Kenneth A. Grady, *Mining Legal Data: Collecting and Analyzing 21st Century Gold, in* DATA-DRIVEN LAW 11, 18 (Ed Walters ed., 2017).
[17] *Id.* at 19.
[18] Owen Byrd, *Moneyball Legal Analytics Now Online for Commercial Litigators*, COM. L. WORLD, Apr.-June 2017, at 12, 16.

of the firm or to obtain more favorable contractual and/or legal results that depend on accounting numbers.[19]

This definition of earnings management merits discussion. Managers may exercise their judgment in financial reporting in many ways. Their judgment is required in estimating various future economic events such as obligations for pension benefits, losses from asset impairments and bad debts, deferred taxes and salvage values of long-term assets. Managers can choose among many acceptable accounting methods for reporting the same economic transactions, such as the LIFO, FIFO, weighted-average inventory valuation methods or the accelerated or straight-line depreciation methods. Managers can exercise their judgment in working capital management, such as the timing of inventory purchases/shipments, receivable policies and the maintenance of inventory levels, which affects net revenues and cost allocations. Managers can also choose to make or defer expenses such as advertising, maintenance, or research and development.[20] Furthermore, managers can manage earnings in the form of transaction structuring. For example, lease contracts can be structured so that lease obligations are on- or off-balance sheet and equity investments can be structured to require or avoid consolidation.[21]

III. DISCRETIONARY ACCRUALS

One common form of earnings management is the use of discretionary accruals.[22] Under accrual-basis accounting, transactions that change a firm's financial statements are recorded in the same periods in which the events occur. Under the accrual basis, revenues are recognized when earned rather than when the cash is actually received and expenses are recognized when incurred rather than when the cash is paid. On an accrual basis, information presented reveals relationships likely to be important in predicting future results.

Under cash-basis accounting, revenues are recorded only when received in cash and expenses are recorded only when paid in cash. Because cash-basis accounting does not always match earned revenues with expenses, it is not in accordance with Generally Accepted Accounting Principles. Cash basis accounting may be used by individuals and small companies because they usually have few receivables and payables but most companies use accrual-basis accounting.[23] Accruals, in particular, are the non-cash items that determine regular accounting income.[24]

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[19] Paul M. Healy & James M. Wahlen, *A Review of the Earnings Management Literature and Its Implications for Standard Setting*, 13 ACCT. HORIZONS 365, 368 (1999).
[20] *See* Sterling Huang, Sugata Roychowdhury & Ewa Sletten, *Does Litigation Deter or Encourage Real Earnings Management?*, 95 THE ACCT. REV., no. 3, 2020, at 251.
[21] Paul Healy & James M. Wahlen, *A Review of the Earnings Management Literature and its Implications for Standard Setting*, 13 ACCT. HORIZONS 365, 369 (1999); *see generally* François Degeorge, Jayendu Patel and Richard Zeckhauser, *Earnings Management to Exceed Thresholds*, 72 THE J. OF BUS. 1 (1999).
[22] Scott B. Jackson & Marshall K. Pitman, *Auditors and Earnings Management*, THE CPA J. (July 2001) Available at http://archives.cpajournal.com/2001/0700/features/f073801.htm.
[23] Jerry J. Weygandt et al., PRINCIPLES OF FINANCIAL ACCOUNTING 91 (7th ed. 2005).
[24] Gene D'Avolio et al., *Technology, Information Production and Market Efficiency*, HARV. INST. OF ECON. RSCH., Sept. 2001, at 20 (explaining that Net income = Cash Flows + Accruals; Accruals = Δ Current Assets (excluding cash) – Δ Current Liabilities – Depreciation).

By their very nature, accruals require subjective judgments and estimation. Before they are realized, accruals are difficult for auditors to objectively verify.[25] Though determining what component of accruals is discretionary is also difficult, empirical models have been developed to measure discretionary accruals[26]

As an illustration of how discretionary accruals reflect earnings management, consider "channel stuffing." Channel stuffing is the process of "borrowing" sales from future periods by persuading customers to purchase large inventory amounts before these amounts are actually needed. The customers are not expected to pay for these inventory amounts for several months and the retailers possess the right to a full refund for any unsold items; furthermore, the original company pays for the storage of the inventory until it is sold. The sudden surge in accounts receivable may be classified by one or more of the empirical models as an abnormal or discretionary accrual.[27]

The Securities Exchange Commission investigated Sunbeam, Inc., a United States electric home appliance company, for channel stuffing. Industry insiders claimed that Sunbeam's revenues were padded because its chief executive officer at the time, Albert John Dunlap, strong-armed retailers into buying a lot more merchandise than they needed. The retail stores became hopelessly overstocked and unsold inventory piled up in Sunbeam's warehouses. Eventually investors panicked, and Dunlap was fired. Sunbeam was forced to restate its earnings and file for bankruptcy in 2001. Dunlap agreed to pay $15 million to settle a shareholder lawsuit.[28]

IV. THE IMPACT OF FRAUD-BASED LEGAL ACTIONS

After years of engaging in earnings management, suppose a firm is facing a fraud-based lawsuit or regulatory enforcement action and the court or regulatory authority issues a legal ruling. How would this legal ruling impact managerial incentive for discretionary accruals-based earnings management? If the legal ruling is in the firm's favor, would the firm continue its current accruals policy or change it? If the firm does change it, would the change lead to an income-increasing accruals policy or an income-decreasing accruals policy? The same questions can be asked if the legal ruling is against the firm. Furthermore, are there industry factors that determine the way a firm changes its discretionary accrual policy in response to a fraud-based legal ruling, regardless of whether it is favorable or unfavorable? The prior discretionary accrual models and studies do

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[25] Jackson, *supra* note 22.

[26] *See* Jennifer Jones, Earnings Management During Import Relief Investigations, J. OF ACCT. RSCH. 193, 212 (Autumn 1991); Patricia Dechow et al., *Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC*, CONTEMP. ACCT. RSCH., Spring 1996, at 23-24; Sok-Hyon Kang & K. Sivaramakrishnan, *Issues in Testing Earnings Management and an Instrumental Variable Approach*, J. OF ACCT. RSCH. 353, 354 (Autumn 1995); Xavier Garza-Gómez et al., *Discretionary Accrual Models and the Accounting Process* 10-12 (Nagoya City University, Working Paper No. 259, 1999) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=209073; K. V. Peasnell et al., *Detecting Earnings Management Using Cross-Sectional Abnormal Accruals Models*, 30 ACCT. & BUS. RSCH. 318 (2000); Jacob Thomas & Xiao-Jun Zhang, *Identifying Unexpected Accruals: A Comparison of Current Approaches*, 19 J. OF ACCT. & PUB. POL'Y 347 (2000).

[27] D'Avolio, *supra* note 24, at 20-21.

[28] Kelly Greene, *Dunlap Agrees to Pay $15 Million to Settle Lawsuit Filed by Sunbeam Shareholders*, THE WALL ST. J. (Jan. 15, 2002) https://www.wsj.com/articles/SB1011029024354167520.

not directly address these questions or the effects of a lawsuit and subsequent ruling on the magnitude of entity discretionary accruals; rather the prior discretionary accrual studies focus on how economic, contractual, and regulatory conditions affect discretionary accruals.

It can be argued that when faced with a favorable legal ruling, a firm will either: (1) continue to use the same discretionary accruals policy it did before the legal action since a court or regulatory authority found in the firm's favor, thereby "validating" the policy; or (2) change its discretionary accruals policy so as to avoid a fraud-based legal action in the future. Of course, how the firm changes its discretionary accruals policy depends on what type of discretionary accruals the firm was using before the favorable legal ruling was issued. If the firm used income-increasing discretionary accruals before the ruling, it may now use income-decreasing discretionary accruals after the ruling. Following the same logic, if it used income-decreasing discretionary accruals before the ruling, it will use income-increasing discretionary accruals after the ruling.

When faced with an unfavorable legal ruling, it can be reasoned that a firm will try to adopt a more conservative discretionary accrual policy because it does not want to report larger net income that will be used to calculate larger litigation awards or penalties in the future. On the other hand, it can be argued that when faced with an unfavorable legal ruling, a firm will try to report larger net income to provide assurance to its stockholders and creditors that it can easily pay off any litigation awards or penalties it may have to pay and still be profitable.

This study empirically examines how fraud-based legal rulings impact discretionary accruals. It extends extant research on discretionary accruals by providing another possible incentive – a legal incentive – for earnings management besides capital market, contracting and regulatory incentives.

V. HYPOTHESIS DEVELOPMENT

For the purposes of this study, the following hypotheses were formulated to accompany various legal settings and outcomes:

A. *Hypothesis 1: The Impact of a Legal Action Filing*

By the time a legal ruling is issued, a firm is already aware that there is a legal action pending against it; therefore, this firm adjusts its discretionary accrual policy in response to the filing and notice of the legal action. Legal actions are more common against firms that use income-increasing discretionary accruals[29,30] The decrease in the use of income-increasing discretionary accruals leads to an increase in the transparency of accounting information. This leads to the following hypothesis:

[29] Orie Barron, Jamie Pratt & James Stice, *Misstatement Direction, Litigation Risk, and Planned Audit Investment*, 39 J. OF ACCT. RSCH. 449, 451 (2001).
[30] Mark Bradshaw, Scott Richardson & Richard Sloan, *Do Analysts and Auditors Use Information in Accruals?*, 39 J. OF ACCT. RSCH. 45, 70 (2001).

H1: *When a firm manages its earnings via discretionary accruals, the magnitude of the firm's discretionary accruals decreases in response to the filing of a fraud-based legal action against that firm in the measurement period after the filing when compared to the measurement period preceding the filing.*

B. *Hypothesis 2: The Impact of a Favorable Fraud-based Legal Ruling*

When a firm receives a favorable fraud-based legal ruling from a court or regulatory authority, it is a general indication that the firm has not engaged in any fraudulent accounting practices. A favorable fraud-based legal ruling provides assurance as to the reliability of that firm's financial information. Once a firm has been through the legal process, this firm may not want to be sued again on the basis of providing fraudulent financial or accounting information. Consequently, the firm will reduce the use of discretionary accruals because it has become <u>more risk-adverse</u> from a legal standpoint. This leads to the following hypothesis:

H2: *When a firm manages its earnings via discretionary accruals, the magnitude of this firm's discretionary accruals decreases in response to the issuance of a favorable fraud-based legal ruling in the measurement period after the issuance when compared to the measurement period preceding the issuance.*

C. *Hypothesis 3: The Impact of an Unfavorable Fraud-Based Legal Ruling*

If the firm was using income-increasing discretionary accruals before the issuance of the unfavorable legal ruling, it can be argued that the firm will now reverse this policy and use income-decreasing discretionary accruals after the issuance of the unfavorable legal ruling because it does not want to incur more litigation risk in the future. By the same token, if a firm was using income-decreasing discretionary accruals before the issuance of the unfavorable legal ruling, that firm may now use income-increasing discretionary accruals after the issuance of such a ruling. Basically, <u>an unfavorable fraud-based legal ruling</u> will lead a firm to <u>reverse its discretionary accrual policy</u> because the firm managers may feel that it was this policy that led to that adverse ruling. This leads to the following hypothesis:

H3: *When a firm manages its earnings via discretionary accruals, the magnitude of the firm's discretionary accruals decreases in response to the issuance of an unfavorable fraud-based legal ruling in the measurement period following the issuance when compared to the measurement period preceding the issuance.*

D. *Hypothesis 4: The Impact of a Mixed Fraud-Based Legal Ruling*

Not all legal rulings are entirely favorable or unfavorable to a firm. In some cases, the court or regulatory authority dismisses some of the fraud charges against the firm but maintains others. In other cases, the firm wins on some charges but loses on the other charges. In still other cases, the firm agrees to settle without admitting any guilt or fault. These cases, where there are no clear and concise favorable or unfavorable legal rulings, are called mixed rulings for the purpose of this study.

How a mixed ruling impacts the discretionary accrual policy of a firm may depend on the terms and conditions that accompany the mixed legal ruling. In some cases, a court or regulatory authority may dismiss certain charges if the defendant company agrees to comply with certain terms. In some settlement cases, the defendant company admits no guilt or fault but agrees to fulfill certain conditions in order to end the case. The nature of these settlement negotiations and agreements may not always be public information, which means that it may not be possible to ascertain why a defendant company's managers changed their discretionary accrual policies in the way that they did after the issuance of a mixed legal ruling; however, it is logical to assume that a defendant company would reduce the magnitude of its discretionary accruals after the issuance of a mixed legal ruling because it does not want to go through the laborious legal and settlement process again. This leads to the following hypothesis:

H4: *When a firm engages in earnings management via discretionary accruals, the magnitude of the firm's discretionary accruals decreases in response to the issuance of a mixed legal ruling in the measurement period following the issuance when compared to the measurement period preceding the issuance.*

E. *Hypothesis 5: The Impact of Industry Factors*

Industry factors affect firm managers' decisions to implement earnings management via discretionary accruals. Firms in a particular industry adjust discretionary accruals based on their relative earnings performance, which is defined against industry. Furthermore, firm-industry earnings correlation and relative announcement timing, along with industry-defined relative earnings performance, are significant factors affecting individual firms' discretionary accrual decisions.[31]

Some industries may have more incentives than others to manage earnings via discretionary accruals. Certain industries, such as the pharmaceutical, airline, and motor carrier industries, are either the subjects of stringent government regulations or the recipients of certain government benefits when compared with other industries; therefore, they may use discretionary accrual policies in order to avoid the consequences of tight government regulations or to reap the rewards of generous government benefits.[32] In particular, it has been claimed that the value relevance of accounting information provided by firms in the high-technology, knowledge-

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[31] Myung Park & Byung Rob, *The Effect of Firm-Industry Earnings Correlation and Announcement Timing on Firms' Accrual Decisions*, 36 BRIT. ACCT. REV. 269-89 (2004).

[32] Kurt Wojdat, Politically Motivated Accounting Choice and Financial Indicators of Political Risk: The Pharmaceutical Industry (Apr. 30, 1999) (unpublished Ph.D. dissertation, St. Univ. of N.Y. at Buffalo); Joseph Legoria, Political Costs, Health Care Reform and Earnings Management in the Pharmaceutical Industry (May, 1997) (unpublished Ph.D. dissertation, Univ. of Ark.); Lydia Rosencrants, Conflicting Incentives for Earnings Management in Regulated Companies: A Study of the United States Airline Industry (1999) (unpublished Ph.D. dissertation, Mich. St. Univ.); Kevin Sachs, Accounting and Deregulation: The Case of Motor Carriers (Mar. 5, 1999) (unpublished Ph.D. dissertation, St. Univ. of N.Y. at Buffalo).

intensive, service-oriented industry has declined over time.[33] Furthermore, Healy and Wahlen (1999)[34] have pointed out that the banking, insurance and utility industries deal with regulation that is specifically tied to accounting numbers. This leads to the following hypothesis:

H5: *When a firm engages in earnings management via discretionary accruals there is an industry-differential impact on the magnitude of discretionary accruals in response to the issuance of a fraud-based legal ruling in the measurement period following the issuance when compared to the measurement period preceding the issuance.*

VI. RESEARCH DESIGN

This study extends existing literature and develops an empirical model that emphasizes and explains how firm managers adjust their discretionary accrual policies in response to the issuance of a fraud-based legal ruling.

A. *Sample Selection*

A sample of 183 firms facing fraud-based financial reporting legal rulings was selected by searching the Commerce Clearinghouse Federal Securities Law Reports for the years 1982 to 2007. A 25-year period was selected to obtain more trend information. Since legal actions can take years and are sometimes settled out of court, obtaining cases after 2007 that included both lawsuits and rulings was limited. Accounting data needed to estimate accruals[35] for these 183 firms was obtained from the COMPUSTAT Industrial Quarterly database. Of these 183 firms, 106 had to be eliminated from the final sample due to missing information in the COMPUSTAT database. Missing information means either that the company was not listed at all in the COMPUSTAT database or was listed but had either large gaps of missing accounting variables or no accounting variables at all. If a particular firm had less than 20 observations for each predictor variable,[36] or had 20 or more sporadic observations, then the firm was eliminated from the final sample.

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[33] Robert Elliot & Peter Jacobsen, *U.S. Accounting: A National Emergency*, 172J. OF ACCT. 54 (1991); Edmund L. Jenkins, *An Information Highway in Need of Capital Improvements*, 177 J. OF ACCT. 77 (1994); Mark Sever and Ronald Boisclaire, *Financial Reporting in the 1990s*, 170 J. OF ACCT. 36-41 (1990); K. Ramesh and R. Thiagarajan, *Inter-Temporal Decline in Earnings Response Coefficients* (Northwestern Univ.Working Paper, Paper No. #, 1995); Raymond Chiang & P. C. Venkatesh, *Insider Holdings and Perceptions of Information Asymmetry: A Note*, 43 THE J. OF FIN. 1041, 1046 (1988); Baruch Lev & Paul Zarowin, *The Boundaries of Financial Reporting and How to Extend Them*, 37 J. OF ACCT. RSCH. 353, 361 (1999); Jennifer Francis & Katherine Schipper, *Have Financial Statements Lost Their Relevance?*, 37 J. OF ACCT. RSCH. 319 (1999); Stephen Brown, Kin Lo & Thomas Lys, *Use of R^2 in Accounting Research: Measuring Changes in Value Relevance Over the Last Four Decades*, 28 J. OF ACCT. AND ECON. 83 (1999); Alex Dontoh, Suresh Radhakrishnan &Joshua Ronen, *The Declining Value Relevance of Accounting Information and Non-Information-Based Trading: An Empirical Analysis*, 21 CONTEMP. ACCT. RSCH.795 (2004).

[34] Paul M. Healy & James M. Wahlen, *A Review of the Earnings Management Literature and its Implications for Standard Setting*, 13 ACCT. HORIZONS 365, 380 (1999).

[35] William G. Heninger, *The Association Between Auditor Litigation and Abnormal Accruals,* 76 THE ACCT. REV. 111 (2001).

[36] JOSEPH F. HAIR, JR., ET AL., MULTIVARIATE DATA ANALYSIS 258 (7th ed. 1998).

The sample selections by type of legal ruling and industry category are presented in **Tables 1 and 2**, respectively. Note that in **Table 2**, the industries with the largest and second largest number of fraud-based legal rulings in the sample happen to be the science/technology and brokerage/investment/financial services industries, respectively. These outcomes are consistent with those of the Treadway Commission's financial statement fraud study,[37] which found that computer companies (considered part of the science/technology industry) and financial service providers topped the list of companies involved in financial statement fraud.

Table 1: Sample Selection by Type of Legal Ruling

Type of Legal Ruling	Number of Companies
Favorable	27
Unfavorable	42
Mixed	8
TOTAL	**77**

Table 2: Sample Selection by Industry Category

Industry Category	Number of Companies
Retail/Food Service	10
Waste Management/Environmental Compliance/Sewers, Tunnels, Pipelines	3
Pharmaceuticals	7
Healthcare	5
Brokerage/Investment/Financial Services	14
Science & Technology	20
Aerospace/Airlines	2
Media	6
Vehicles/Transportation	4
Natural Resources (Oil, gas, petroleum production/exploration/mining)	4
Utilities/Power Supply	2
TOTAL	**77**

B. *Measures of Accounting Discretion*

The main proxy for client managers' reporting flexibility will be the income-increasing discretionary accruals estimated using the Modified Jones model because although other models may provide better results in certain manipulation tests, the Modified Jones model is consistently

[37] Committee of Sponsoring Organizations of the Treadway Commission, *Shedding Light on Fraud*, J. OF ACCT. (September 2003).

better overall for measuring discretionary accruals and in detecting earnings management [38] The Modified Jones model estimates discretionary accruals (**DISCRETIONARY_ACCRUALS**) as the prediction error from firm-specific ordinary least square regressions:

(1) $\mathbf{TOTAL\_ACCRUALS_{it} = A_0 + A_1(\Delta\ REV_{it} - \Delta\ REC_{it}) + A_2(PPE_{it}) + \varepsilon_{it}}$

where:

$\mathbf{TOTAL\_ACCRUALS_{it}}$ = Δ Current assets$_t$ – Δ Cash$_t$ – Δ Current liabilities$_t$ +

Δ Current portion of long-term debt – Depreciation and amortization expense;

$\mathbf{A_0}$ = the intercept or an item of the regression equation indicating the criterion score when all the predictor variables are zero;[39]

$\mathbf{\Delta\ REV_{it}}$ = revenues in year t less revenues in year t-1;

$\mathbf{\Delta\ REC_{it}}$ = receivables in year t less receivables in year t-1;

$\mathbf{PPE_{it}}$ = gross property, plant and equipment in year t;

$\boldsymbol{\varepsilon_{it}}$ = prediction errors;

i = 1…..n firm index; and

t = 1…..T(i) year index for the number of years included in the estimation period for firm i.

DISCRETIONARY_ACCRUALS are the prediction errors (ε_{it}) from applying the Modified Jones model to estimate normal accruals in the year of the legal ruling:

(2) $\mathbf{DISCRETIONARY\_ACCRUALS_{it} = TOTAL\_ACCRUALS_{it} - A_0 + A_1(\Delta\ REV_{it} - \Delta\ REC_{it}) + PPE_{it}}$

C. *Specification of the Discretionary Accrual Model*

The model in this study investigates the possibility that firm managers change their discretionary accrual policies in response to the issuance of legal rulings. This model specifies control variables that may contribute to changes in discretionary accrual policies that are unrelated

[38] Patricia M. Dechow, Richard G. Sloan & Amy P. Sweeney, *Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC*, CONTEMP. ACCT. RSHC. 1, 19 (1996); Eli Bartov, Ferdinand Gul & Judy Tsui, *Discretionary Accruals Models and Audit Qualifications*, 30 J. OF ACCT. AND ECON. 421, 425 (2001); Alcarria Jaime &Gill de Albornoz Noguer, *Specification and Power of Cross-Sectional Abnormal Working Capital Accruals Models in the Spanish Context*, 13 EUR. ACCT. REV. 73-104 (2004); Ho Young Lee & Vivek Mande, *The Effect of the Private Securities Litigation Reform Act of 1995 on Accounting Discretion of Client Managers of Big 6 and Non-Big 6 Auditors*, 22 AUDITING: A J. OF PRAC. & THEORY 93, 97 (2003); Mary L. Chai & Samuel Tung, *The Effect of Earnings-Announcement Timing on Earnings Management*, 29 J. OF BUS. FIN. & ACCT. 1337, 1341 (2002).

[39] *See* LAURENCE G. GRIMM & PAUL R. YARNOLD, READING AND UNDERSTANDING MULTIVARIATE STATISTICS 137 (1995).

to the issuance of legal rulings. Specifically, coefficients are estimated in the following discretionary accrual regression model:

(3) DiscAccr = A_0 + A_1(FEarnGrowth$_{it}$) + A_2(FGrowth$_{it}$) + A_3(FLeverage$_{it}$) + A_4(FSize$_{it}$) + A_5(LAWSUIT) + A_6(RULING) + ε_{it}

where:

DiscAccr = Dependent variable: **DISCRETIONARY_ACCRUALS** or the prediction errors (ε_{it}) derived in estimating **TOTAL_ACCRUALS** in regression equation **(1)** (the Modified Jones model) above. (Income-increasing discretionary accrual: **DiscAccr** ≥ 0; Income-decreasing discretionary accrual: **DiscAccr** < 0);[40]

A_0 = the intercept or an item of the regression equation indicating the criterion score when all the predictor variables are zero;[41]

FEarnGrowth$_{it}$ = Independent control variable: Firm earnings growth measured by the percentage changes in net income. Watts and Zimmerman (1986, 1990)[42] and Defond and Jiambalvo (1993)[43] both have claimed that management compensation, such as bonuses and pay increases tied to earnings growth, may provide firm managers with strong incentives to manage discretionary accruals; therefore, the percentage change in net income is included as a control variable in this model;[44]

FGrowth$_{it}$ = Independent control variable: Firm growth measured by the percentage changes in total assets. Dechow and Skinner (2000)[45] claim that growth firms have capital-market motivations to manipulate earnings in order to meet earnings benchmarks, so the percentage change in total assets is used as a control variable for firm growth;[46]

FLeverage$_{it}$ = Independent control variable: Firm leverage measured by total liabilities/total assets. Since debt contracts employ accounting numbers in deciding whether a debtor has behaved unfavorably, the firm managers of debtor companies may choose accounting methods that

[40] Ho Young Lee and Vivek Mande, *The Effect of the Private Securities Litigation Reform Act of 1995 on Accounting Discretion of Client Managers of Big 6 and Non-Big 6 Auditors*, 22 AUDITING: A J. OF PRACTICE & THEORY 97 (2003).
[41] *Id.* at 102.
[42] Ross L. Watts and Jerold L. Zimmerman, Positive Accounting Theory at 74 (Prentice-Hall) (1986); Ross L. Watts and Jerold L. Zimmerman, *Positive Accounting Theory: A Ten-Year Perspective*, 65 THE ACCT. REV. 131–56 (1990).
[43] Mark L. DeFond and James Jiambalvo, *Factors Related to Auditor-Client Disagreements Over Income-Increasing Accounting Methods*, 9 CONTEMP. ACCT. RES. 415, 425 (1993).
[44] *Id.* at 419.
[45] *See* Patricia Dechow and Douglas J. Skinner, *Earnings Management: Reconciling the Views of Accounting Academics, Practitioners and Regulators*, 14 ACCT. HORIZONS 235, PG (2000).
[46] *Id*. at 243.

minimize debt costs so as not to violate debt contract covenants;[47] therefore, this variable is included to control for the effects of high leverage;[48]

$FSize_{it}$ = Independent control variable: Firm size measured by the log of total assets.

Large firms are more likely to use earnings management to reduce their costs than small firms according to the political cost hypothesis;[49] therefore, the log of total assets is used as a proxy for firm size;[50]

LAWSUIT = Independent categorical variable: Equals -1 in the 12 firm-quarters before the filing of the legal action, 1 in the 12 firm-quarters after the filing, and 0 otherwise;

RULING = Independent categorical variable: Equals -1 in the 12 firm-quarters before the issuance of the legal ruling, 1 in the 12 firm-quarters after the issuance, and 0 otherwise;

ε_{it} = prediction errors;

i = 1…n firm index; and

t = 1…(i) year index for the number of years included in the estimation period for firm i.

LAWSUIT and **RULING** are independent dummy variables used to account for the effect that the filing of a legal action and the issuance of a legal ruling, respectively, have in predicting the dependent variable, discretionary accruals, or DiscAccr. Dummy variables are qualitative variables (e.g., gender, race, religion, wars, lawsuits, legal rulings, etc.) that are quantified by assigning them numerical values such as 1 or 0, 0 indicating the absence of a qualitative factor and 1 indicating the presence of that factor (it is not essential that the dummy variables only take the values of 0 and 1). Dummy variables are also referred to as *binary variables, categorical variables, dichotomous variables, indicator variables, and qualitative variables*.[51]

The method of assigning the reference group the value of -1 for the dummy variables is termed "effects coding." This differs from the more commonly used method of indicator coding, where the reference group is assigned the value of 0 for the dummy variables. Both forms of dummy variable coding will give the same predictions, coefficients of determination, and regression coefficients for the continuous variables; however, there will be differences in the interpretation of the dummy-variable coefficients.[52]

Effects coding provides an advantage over indicator coding in the interpretation of the dummy-variable coefficients. In effects coding, the dummy-variable coefficients represent

[47] Clifford W. Smith, Jr. and Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. OF FIN. ECON. 117, 144 (1979); Richard Leftwich, *Accounting Information in Private Markets: Evidence from Private Lending Agreement*, 58 THE ACCT. REV. 23, 24 (1983); Ross L. Watts and Jerold L. Zimmerman, *Positive Accounting Theory: A Ten-Year Perspective*, 65 THE ACCT. REV. 131, 133 (1990).
[48] Mary L. Chai and Samuel Tung, *The Effect of Earnings-Announcement Timing on Earnings Management*, 29(9) & (10) J. OF BUS. FIN. & ACCT. 1340, 1348 (2002).
[49] Kurt Wojdat, Politically Motivated Accounting Choice and Financial Indicators of Political Risk: The Pharmaceutical Industry, (Apr. 30, 1999) (Ph.D. dissertation, State University of New York at Buffalo) (ProQuest); Doreen Gilfedder and Ciaran O'Hogartaigh, *The Grasshoppers and the Great Cattle: Participation and Non-Participation in the ASB's Standard-Setting Process*, 2 J. OF MGMT. & GOVERNANCE 287, pg. number (1997).
[50] *See* Committee of Sponsoring Organizations of the Treadway Commission, *supra* note 37.
[51] DAMODAR N. GUJARATI, BASIC ECONOMETRICS 77 (2nd ed. 1988).
[52] JOSEPH HAIR, JR. ET AL., MULTIVARIATE DATA ANALYSIS 235 (5th ed.1998).

differences for any group from the mean of all groups, whereas in indicator coding the dummy-variable coefficients represent differences only to the omitted category of the nominal scale.[53] This means that effects coding is a more appropriate method whenever the group variables are to be compared to all other groups rather than to just one reference group.[54]

Effects coding is ideally suited to the analysis in this study because the baseline for comparison can be interpreted as a comprehensive average for all of the years (rather than just the omitted three years or 12 quarters before the filing of the lawsuit or issuance of the legal ruling, as with indicator coding). Under effects coding, the intercept is the grand mean, and the regression coefficients of the dummy variables are such that they specify the deviation of the identified group (i.e., the legal action or legal ruling) from the grand mean or intercept.[55] As a result, an analysis of the impact of a legal action and/or a legal ruling on a firm's discretionary accrual policy over a long period can be done instead of an analysis of the short period immediately before the filing/issuance of the legal action/legal ruling.

The NCSS statistical program generates four variables in the regression equation related to the effects coding of the dummy variables, **LAWSUIT** and **RULING**:

(LAWSUIT = -1) = the period of reference for the **LAWSUIT** dummy variable, which is the 12 firm-quarters before the filing of the legal action;

(LAWSUIT = 0) = the period of interest for the **LAWSUIT** dummy variable, which is the 12 firm-quarters after the filing of the legal action;

(RULING = -1) = the period of reference for the **RULING** dummy variable, which is the 12 firm-quarters before the issuance of the legal ruling; and

(RULING = 0) = the period of interest for the **RULING** dummy variable, which is the 12 firm-quarters after the issuance of the legal ruling.

VII. EMPIRICAL RESULTS

The value of the regression coefficient indicates how much change occurs in the dependent variable (DiscAccr) for a one-unit change in the particular independent variable when the remaining independent variables are held constant. The regression coefficients for the independent variables for the various sample categories are presented in **Table 3**.

A. *The Regression Coefficients*

The regression coefficients for the variables (LAWSUIT = -1) and (LAWSUIT = 0) represent deviations from the intercept (or sample mean for discretionary accruals when all the predictor variables are zero) for the 12 firm-quarters before and after, respectively, the filing of the legal action. The regression coefficients for the variables (RULING = -1) and (RULING = 0)

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[53] *Id.*; William J. Dixon & S.M. Gaarder, *Presidential Succession and the Cold War: An Analysis of Soviet-American Relations, 1948-1988*, 54 J. POL. 156, 156–75 (1992).
[54] Dixon & Gaarder, *supra* note 53, at 156–75.
[55] *Id.*

represent deviations from the intercept for the 12 firm-quarters before and after, respectively, the issuance of the legal ruling.

According to **Table 3**, the greatest deviation between the intercept and the (LAWSUIT = -1) variable is among the sample of companies that are in the science and technology industry with a deviation of -5,489.47 percent [(134.3326 – (-2.4925))/(-2.4925%)]. The deviation between the intercept and the (LAWSUIT = 0) variable is -6,367.97 percent [(156.2293 – (-2.4925))/(-2.4925%)], indicating an overall industry increase in the use of income-increasing discretionary accruals by 878.50 percent [(-6,367.97%) – (-5,489.47%)] (compared to the sample mean for discretionary accruals used in the science and technology industry) after the filing of the legal action. In a direct comparison between the variables (LAWSUIT = 0) and (LAWSUIT = -1), the use of income-increasing discretionary accruals increased by 16.30 percent [(156.2293 – 134.3326)/134.3326%] in the 12 firm-quarters after the filing of the lawsuit when compared to the 12 firm-quarters before the filing of the legal action.

Table 3: Regression Coefficients for the Independent Variables

$DiscAccr = A_0 + A_1(FEarnGrowth_{it}) + A_2(FGrowth_{it}) + A_3(FLeverage_{it}) + A_4(FSize_{it}) + A_5(LAWSUIT) + A_6(RULING)$

Sample Category	A_0 Intercept	A_1 FEarnGrowth	A_2 FGrowth	A_3 FLeverage	A_4 FSize	A_5 (LAWSUIT = -1)	A_5 (LAWSUIT = 0)	A_6 (RULING = -1)	A_6 (RULING = 0)
All companies	-273.4083	0.0328	15.0375	9.8142	22.9360	176.7795	187.2059	140.6360	39.8986
t-value	*-2.645*	*0.033*	*0.136*	*0.213*	*1.143*	*1.718*	*2.379*	*1.389*	*0.508*
Favorable rulings	-356.8550	-0.0344	-85.6371	21.7957	29.3361	356.4621	225.0149	346.7699	12.9523
t-value	*-2.039*	*-0.021*	*-0.589*	*0.341*	*0.905*	*2.210*	*1.794*	*2.161*	*0.106*
Unfavorable rulings	-281.4777	0.0758	135.1413	16.3508	22.5929	80.7080	192.1265	40.0185	72.1394
t-value	*-1.827*	*0.057*	*0.717*	*0.222*	*0.750*	*0.527*	*1.659*	*0.268*	*0.622*
Mixed rulings	-49.0404	-0.0194	24.5722	-51.6314	2.7165	87.8554	20.9649	90.9502	46.7108
t-value	*-1.004*	*-0.024*	*0.373*	*-0.959*	*0.302*	*1.148*	*0.368*	*1.203*	*0.797*
Retail/food service	25.9540	-0.2177	-4.5095	-12.3492	7.1394	-65.8218	-59.8221	28.0719	16.8055
t-value	*1.347*	*-0.423*	*-0.164*	*-0.677*	*1.556*	*-3.726*	*-4.568*	*1.628*	*1.296*
Waste management	85.5367	1.6249	-21.5787	-166.0287	18.0543	-31.7641	-29.1671	-10.3982	-21.6713
t-value	*1.499*	*0.272*	*-0.224*	*-1.821*	*0.971*	*-0.536*	*-0.642*	*-0.175*	*-0.473*
Pharmaceuticals	-150.0035	0.1871	-1.0648	-39.7318	8.5034	119.9101	85.2534	143.7851	66.5850
t-value	*-2.574*	*0.031*	*-0.027*	*-0.710*	*0.612*	*2.072*	*1.859*	*2.453*	*1.500*
Health care	-70.9538	0.2091	-6.4371	172.4326	6.5858	-5.3304	61.5394	-52.5209	-70.6523
t-value	*-0.902*	*0.194*	*-0.060*	*2.013*	*0.395*	*-0.075*	*1.121*	*-0.740*	*-1.294*
Brokerage/investment	-1,338.7058	0.1087	195.2954	-108.7428	80.6945	807.8754	806.7775	534.7754	526.0587
t-value	*-2.627*	*0.039*	*0.286*	*-0.307*	*0.857*	*1.548*	*1.962*	*1.022*	*1.273*
Science & technology	-2.4925	0.0629	-9.8619	15.3813	11.7132	134.3326	156.2293	131.6102	-249.8072
t-value	*-0.027*	*0.073*	*-0.140*	*0.611*	*0.654*	*1.560*	*2.290*	*1.540*	*-3.765*
Aerospace/airlines	-46.9819	0.9586	-0.1282	77.8240	-17.3394	12.6469	1.7077	33.4602	40.3122
t-value	*-1.911*	*0.628*	*-0.003*	*3.061*	*-2.044*	*0.467*	*0.089*	*1.314*	*2.085*
Media	-104.6009	-0.2373	41.5709	213.4780	-32.5735	118.2540	47.8812	25.6184	11.1106
t-value	*-2.409*	*-0.781*	*0.876*	*4.974*	*-3.307*	*3.603*	*1.931*	*0.775*	*0.431*
Vehicles/transportation	-8.4148	-0.0083	10.9570	2.7041	0.1007	8.8095	8.6954	-12.6761	0.8923
t-value	*-2.441*	*-0.081*	*1.575*	*1.717*	*0.129*	*2.682*	*3.871*	*-4.666*	*0.428*
Natural resources	36.9567	1.1129	75.1580	-96.2370	17.4102	-320.4834	-111.8918	236.0789	55.8625
t-value	*0.611*	*0.633*	*0.550*	*-1.574*	*1.696*	*-5.048*	*-2.736*	*4.341*	*1.302*
Utilities/power supply	-22.7668	-16.7454	112.5409	38.2768	13.6383	-71.9264	-40.8041	8.0597	23.1075
t-value	*-0.232*	*-1.257*	*0.822*	*0.441*	*0.476*	*-0.581*	*-0.463*	*0.065*	*0.263*

The second greatest deviation between the intercept and the (LAWSUIT = -1) variable appears in the natural resources industry with a deviation of -967.19 percent [((-320.4834) – 36.9567)/36.9567%]. The deviation between the intercept and the (LAWSUIT = 0) variable is -402.76 percent [((-111.8918) – 36.9567)/(36.9567%)], indicating an overall industry decrease in the use of income-decreasing discretionary accruals by 564.43 percent [(-402.76%) – (-967.19%)] (compared to the sample mean for discretionary accruals used in the natural resources industry) after the filing of the legal action. In a direct comparison between the variables (LAWSUIT = 0) and (LAWSUIT = -1), the use of income-decreasing discretionary accruals decreased by 65.08% [((-111.8918) – (-320.4834))/(-320.4834%)] in the 12 firm-quarters after the filing of the legal action when compared to the 12 firm-quarters before the filing of the legal action.

B. *Hypothesis 1 Contradicted*

As noted in **Table 4**, the sample categories in which the use of discretionary accruals increased after the filing of the legal action are: (1) all companies; (2) companies with unfavorable rulings; (3) health care companies; and (4) science and technology companies.

Table 4: Use of Discretionary Accruals Increased After Legal Action Filed

Category	**Percent Increase**
All companies	164.66%
Companies with unfavorable rulings	128.67%
Health care companies	92.49%
Science & technology companies	878.50%

In the remaining 11 sample categories, the use of discretionary accruals decreased after the filing of the legal action. These results contradict Hypothesis 1, which postulates that the magnitude of a firm’s discretionary accruals decreases in response to the filing of a fraud-based legal action against that firm.

C. *Hypothesis 2 Supported*

Of the categories based on type of legal ruling, companies that received favorable rulings had the second largest percentage deviation between the (RULING = -1) variable and the intercept with -197.17 percent [(346.7699 – (-356.855))/(-356.855%)]; however, these companies had the third largest percentage deviation between the (RULING = 0) variable and the intercept with -103.63 percent [(12.9523 – (-356.855)/(-356.855%)]. The favorable ruling companies decreased the use of income-increasing discretionary accruals by 96.26 percent [(12.9523 – 346.7699)/346.7699%] in a direct comparison of the (RULING = -1) and (RULING = 0) variables. This result supports Hypothesis 2, which postulates that the magnitude of a firm’s discretionary accruals decreases in response to the issuance of a favorable fraud-based legal ruling.

D. *Hypothesis 3 Contradicted*

As noted in **Table 5**, companies with unfavorable rulings had the third largest deviation among the categories based on the type of legal ruling between the (RULING = -1) variable and the intercept, with a percentage deviation of -114.22 percent [(40.0185 – (-281.4777))/(-281.4777%)]. The companies with unfavorable rulings had the second largest deviation between the (RULING = 0) variable and the intercept with a percentage deviation of -125.63 percent [(72.1394 – (-281.4777))/(-281.4777%)]. In a direct comparison of the (RULING = -1) and (RULING = 0) variables, it appears that companies with unfavorable rulings increased the use of income-increasing discretionary accruals by 80.27% [(72.1394 – 40.0185)/40.0185%] in the period after the issuance of the unfavorable legal ruling when compared to the period before the issuance of that ruling. This result contradicts Hypothesis 3, which postulates that the magnitude of a firm's discretionary accruals decreases in response to the issuance of an unfavorable fraud-based legal ruling.

Table 5: Use of Discretionary Accruals Increased After Ruling Issued	
Category	**Percent Increase**
Companies with unfavorable rulings	114.20%
Science & technology companies	5,380.25%
Natural resources companies	538.80%

E. *Hypothesis 4 Supported*

When it comes to the type of legal ruling (i.e., favorable, unfavorable and mixed), the greatest deviation between the (RULING = -1) and the intercept appears in the sample of companies that received mixed rulings with a deviation of -285.46 percent [(90.9502 – (-49.0404))/(-49.0404%)]. The deviation between the intercept and the (RULING = 0) variable for companies with mixed rulings is -195.25 percent [(46.7108 – (-49.0404))/(-49.0404%)], indicating a decrease in the use of income-increasing discretionary accruals by mixed ruling companies of 90.21 percent [(-195.25%) – (-285.46%)] (compared to the sample mean of -49.0404 for discretionary accruals used by the mixed ruling companies). In a direct comparison of the (RULING = -1) and (RULING = 0) variables, the use of income-increasing discretionary accruals by companies with mixed rulings decreased by 48.64% [(46.7108 – 90.9502)/90.9502%] in the 12 firm-quarters after the issuance of the mixed ruling when compared to the 12 firm-quarters before the issuance of the mixed ruling. This supports Hypothesis 4, which postulates that the magnitude of the firm's discretionary accruals decreases in response to the issuance of a mixed fraud-based legal ruling.

Among the sample of companies categorized by industry type, the greatest deviation between the (RULING = -1) and the intercept once again appears in the sample of companies that are in the science and technology industry with a deviation of -5,380.25 percent [(131.6102 – (-2.4925))/(-2.4925%)]. The deviation between the intercept and the (RULING = 0) variable is 9,922.36 percent [((-249.8072) – (-2.4925))/(-2.4925%)] indicating an overall industry switch from the use of income-increasing discretionary accruals to the use of income-decreasing discretionary accruals, or a change of 15,302.61 percent [9,922.36% - (-5,380.25%)] (compared to the sample mean for discretionary accruals used in the science and technology industry), after the issuance of the legal ruling. In a direct comparison of the (RULING = -1) and (RULING = 0) variables, it also appears that the science and technology industry used income-increasing discretionary accruals before the issuance of the legal ruling and then switched to income-decreasing discretionary accruals after such issuance, resulting in a change of -289.81 percent [((-249.8072) – 131.6102)/131.6102%].

The companies in the natural resources industry have the second greatest deviation between the (RULING = -1) variable and the intercept, with a deviation of 538.80 percent [(236.0789 – 36.9567)/36.9567%] (compared to the sample mean for discretionary accruals used in the natural resources industry). The deviation between the (RULING = 0) and the intercept for the natural resources industry is 51.16 percent [(55.8625 – 36.9567)/36.9567%]. When directly comparing the (RULING = -1) and (RULING = 0) variables with each other, it appears that the use of income-increasing discretionary accruals decreased by 76.34% [(55.8625 – 236.0789)/236.0789%] after the issuance of the legal ruling.

F. *Hypothesis 5 Supported*

Upon examination of the industry categories as presented in **Table 3**, it appears that four industries increased their use of discretionary accruals, while five industries decreased their use of discretionary accruals. The remaining two industries either switched from income-increasing discretionary accruals to income-decreasing discretionary accruals (i.e., the science and technology industry) or vice versa (i.e., the vehicles/transportation industry). These results support Hypothesis 5, which postulates that the magnitude of a firm's discretionary accruals depends upon industry factors in response to the issuance of a fraud-based legal ruling.

VIII. NULL HYPOTHESIS CONCLUSIONS: REGRESSION COEFFICIENTS

To test a hypothesis regarding a regression coefficient, the following equation is used:

$$t_{n-p-1} = b_k/S(b_k)$$

where p = number of independent variables in the regression equation;
$S(b_k)$ = standard error of the regression coefficient b_k

In order to determine whether one of the independent variables (such as FEarnGrowth, LAWSUIT, or RULING) has a significant effect on discretionary accruals, the null and alternative hypotheses would be:[56]

$$H_0: \text{beta} = 0$$
$$H_1: \text{beta} \neq 0$$

If the null hypothesis, H_0, is rejected then the conclusion is that there is a significant relationship between the independent variable and discretionary accruals. The test of significance

[56] MARK L. BERENSON & DAVID M. LEVINE, BASIC BUSINESS STATISTICS 121 (4th ed. 1989).

for a particular regression coefficient is a test for the significance of adding a particular variable into the multiple regression model given that the other variables have been included. The null hypothesis conclusions for each regression coefficient tested at the five percent level of significance are presented in **Table 6**. A "Yes" means that the null hypothesis is rejected and that there is a significant relationship between that independent variable and discretionary accruals. A "No" means that the null hypothesis is accepted and that there is no significant relationship between that independent variable and discretionary accruals.

According to the results presented in **Table 6**, there does not appear to be that many significant relationships between the control variables (FEarnGrowth, FGrowth, FLeverage, and FSize) and discretionary accruals at the five percent level of significance. It appears that there is no significant relationship at all between the FEarnGrowth and FGrowth variables and discretionary accruals at the five percent level of significance. As for the FLeverage and FSize variables, some significant relationships exist for these variables in the health care (only for the FLeverage variable), aerospace/airlines, and media industries at the five percent level of significance.

It seems that at the five percent level of significance, the categorical variables [(LAWSUIT = -1), (LAWSUIT = 0), (RULING = -1), and (RULING = 0)] have more significant relationships with discretionary accruals than the control variables do, according to **Table 6**. In particular, the LAWSUIT variables have more of a significant relationship with discretionary accruals than the RULING variables do. It also appears that the (LAWSUIT = -1) and the (RULING = -1) have more significant relationships with discretionary accruals than the (LAWSUIT = 0) and the (RULING = 0) variables do, respectively.

Table 6: Null Hypothesis Conclusion Concerning the Regression Coefficients (5%)

DiscAccr = $A_0 + A_1(FEarnGrowth_{it}) + A_2(FGrowth_{it}) + A_3(FLeverage_{it}) + A_4(FSize_{it}) + A_5(LAWSUIT) + A_6(RULING)$

Reject Null Hypothesis (H_0): beta (β_j) = 0 at 5%?

Sample Category	A_0 Intercept	A_1 FEarnGrowth	A_2 FGrowth	A_3 FLeverage	A_4 FSize	A_5 (LAWSUIT = -1)	A_5 (LAWSUIT = 0)	A_6 (RULING = -1)	A_6 (RULING = 0)
All companies	Yes	No	No	No	No	No	Yes	No	No
Favorable rulings	Yes	No	No	No	No	Yes	No	Yes	No
Unfavorable rulings	No	No	No	No	No	No	No	No	No
Mixed rulings	No	No	No	No	No	No	No	No	No
Retail/food service	No	No	No	No	No	Yes	Yes	No	No
Waste management	No	No	No	No	No	No	No	No	No
Pharmaceuticals	Yes	No	No	No	No	Yes	No	Yes	No
Health care	No	No	No	Yes	No	No	No	No	No
Brokerage/investment	Yes	No	No	No	No	No	Yes	No	No
Science & technology	No	No	No	No	No	No	Yes	No	Yes
Aerospace/airlines	No	No	No	Yes	Yes	No	No	No	Yes
Media	Yes	No	No	Yes	Yes	Yes	No	No	No
Vehicles/transportation	Yes	No	No	No	No	Yes	Yes	Yes	No
Natural resources	No	No	No	No	No	Yes	Yes	Yes	No
Utilities/power supply	No	No	No	No	No	No	No	No	No

IX. DISCUSSION

A. *Analysis of Results*

The results of this study indicate that the magnitude of a firm's discretionary accruals: (1) increases in response to the filing of a fraud-based legal action; (2) decreases in response to the issuance of a favorable fraud-based legal ruling; (3) increases in response to the issuance of an unfavorable fraud-based legal ruling; (4) decreases in response to the issuance of a mixed fraud-based legal ruling; and (5) increases, decreases, and/or changes from the income-increasing type to the income-decreasing type and vice versa depending upon industry factors in response to the issuance of a fraud-based legal ruling.

These results warrant further discussion. It is expected that a firm would decrease the magnitude of its discretionary accruals after the filing of a fraud-based legal action against that firm because the firm will now try to reverse the discretionary accrual policy that may have led to this legal action. To this extent, it is logical to assume that a firm will cease its alleged fraudulent financial reporting after receiving an unfavorable ruling in a fraud-based legal action or at least diminish it to some extent thereby resulting in a decrease in discretionary accrual magnitude.

What seems less plausible are the findings that a firm would increase the magnitude of its discretionary accruals after the filing of a legal action and increase it after the issuance of an unfavorable legal ruling. If a fraud-based legal action is initiated against a firm it is logical to assume that the firm would decrease the magnitude of its discretionary accruals since its accounting policies would now be under the scrutiny of a court or judicial authority. Furthermore, if that court or other judicial authority has found against the firm in a fraud-based legal action, it can be logically assumed that the firm would see this legal loss as a reason to decrease the magnitude of its discretionary accruals out of fear that another legal action would be initiated against that firm for continuing to engage in deceptive accounting practices.

There are plausible explanations for these somewhat surprising results. The control variables of firm leverage and firm size do show statistically significant relationships with discretionary accruals. It is quite possible that the amount of debt a firm has incurred and the size of the firm may affect the way a firm reacts to the issuance of a legal ruling.

Debt contracts often use accounting numbers to decide whether a debtor firm has behaved unfavorably;[57] therefore, a highly-leveraged firm that has received an unfavorable fraud-based legal ruling may have no choice but to continue the discretionary accrual policy that appeases its creditors if that firm wants to continue its operations.

By the same token, a large firm that has received an unfavorable fraud-based legal ruling may have no choice but to continue to use the discretionary accrual policy that reduces its political visibility. According to the political cost hypothesis,[58] a large firm's reported earnings increase its

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[57] *See* Clifford Smith & Jerold Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 125–26 (1979); Richard Leftwich, *Accounting Information in Private Markets: Evidence from Private Lending Agreement*, 58 ACCT. REV. 23, 26 (1983); Ross Watts & Jerold Zimmerman, *Positive Accounting Theory: A Ten-Year Perspective*, 65 ACCT. REV. 131, 132–33 (1990).

[58] *See* Kurt Wojdat, Politically Motivated Accounting Choice and Financial Indicators of Political Risk: The Pharmaceutical Industry (1999) (Doctoral Dissertation, State University of New York at Buffalo) (ProQuest); Robert Hagerman and Mark Zmijewski, *Some Economic Determinants of Accounting Policy Choice*, J. OF ACCT. & ECON. 141–61 (1979); Richard Bowen, John Lacey and Eric Noreen, *Determinants of the Decision by Firms to*

political visibility, which increases that firm's bookkeeping costs, regulatory costs, taxes, and wage claims. As a result, a larger firm will use earnings management to reduce its costs[59] even in the face of an unfavorable fraud-based legal ruling.

Thus, it would appear that a larger, high-leveraged firm may choose to increase the magnitude of its discretionary accruals, even in the wake of an unfavorable legal ruling, in order to avoid problems with corporate stakeholders. On the other hand, a smaller, low-leveraged firm may decide to decrease the magnitude of its discretionary accruals in the wake of an unfavorable fraud-based legal ruling simply because it wants to avoid future legal problems and does not have to appease corporate stakeholders in the way a larger, high-leveraged firm does.

Of course, firm leverage and firm size are not the only explanations as to why a firm may increase the magnitude of its discretionary accruals even though it received an unfavorable fraud-based legal ruling. The results of this study indicate that industry factors play a role in the reaction of a firm to a legal ruling. Certain industries showed significant relationships with the issuance of a fraud-based legal ruling more than other industries did in this study. Some industries do have more incentives than other industries to manage earnings through the use of discretionary accrual policies, either because they are the subjects of government regulation that may be tied to accounting numbers,[60] or because particular industries adjust discretionary accrual policies based on industry-defined relative earnings performance.[61]

In one particular industry, firms appeared to have switched from income-increasing discretionary accruals to income-decreasing discretionary accruals after the issuance of fraud-based legal rulings. This indicates that these firms switched from upward earnings management to downward earnings management as a result of these legal rulings, which means that the magnitude of their discretionary accruals did not necessarily improve after the issuance of the legal rulings. Downward earnings management can also reduce the quality of accounting information[62] as much as upward earnings management does because financial statement users are not seeing a true picture of the firm's financial position.

The findings of this study indicate that the filing of fraud-based legal actions and the issuance of fraud-based legal rulings impact discretionary accrual policies; however, this impact may not necessarily increase the reliability of the affected firms' financial statements. Other factors, such as firm size, firm leverage, and industry characteristics also help to determine how firms adjust their discretionary accrual policies so that financial statement reliability is either increased or decreased based on their particular operating needs. This study has found that fraud-

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Capitalize Interest Costs, J. OF ACCT. & ECON. 151–79 (1981); Mark Zmijewski and Robert Hagerman, *An Income Strategy Approach to the Positive Theory of Accounting Standard Setting Choice,* J. OF ACCT. & ECON. 129–49 (1981).

[59] Doreen Gilfedder and Ciaran O'Hogartaigh, *The Grasshoppers and the Great Cattle: An Exploration of Participation in the ASB's Standard-Setting Process*, (Dublin City Univ. Bus. Sch., Working Paper No. 29 (1997), http://www.dcu.ie/dcubs/research.

[60] Susan Moyer, *Capital Adequacy Ratio Regulations and Accounting Choices in Commercial Banks,* 13(2) J. OF ACCT. & ECON. 123–54 (1990); Myron Scholes, G. Peter Wilson and Mark Wolfson, *Tax Planning, Regulatory Capital Planning, and Financial Reporting Strategy for Commercial Banks*, 3 REV. OF FIN. STUD. 625–50 (1990); J. Collins, D. Shackelford and J. Wahlen, *Bank Differences in the Coordination of Regulatory Capital, Earnings and Taxes*, 33(2) J. OF ACCT. RES. 263–91 (1995).

[61] Myung Seok Park and Byung Ro, *The Effect of Firm-Industry Earnings Correlation and Announcement Timing on Firms' Accrual Decisions*, 36 BRIT. ACCT. REV. 269–89 (2004).

[62] Baruch Lev and Paul Zarowin, *The Boundaries of Financial Reporting and How to Extend Them,* 37 J. OF ACCT. RES. 353–385 (1999); Stern Stewart & Co., *Accounting is Broken, Here's How to Fix It*, 5 Eval. (2002).

based legal actions do not generally improve corporate governance – at least with respect to financial reporting activities.

B. *Implications*

In light of this study, independent auditors should more closely examine more closely the discretionary accrual policies of firms that have recently: (1) been served with legal papers; and/or (2) received legal rulings concerning their accounting information and financial reporting. It is true that discretionary accruals are very difficult to audit or verify[63] and independent auditors cannot be expected to gather all of the information and resources necessary to develop statistical discretionary accrual models; however, there are certain field procedures that can be used to determine a firm's discretionary accrual policy to some extent.

The independent auditor can compare the bad debt expense policy before the issuance of a fraud-based legal ruling with the bad debt expense policy after such issuance in order to determine if any significant changes have been made. Specifically, the auditor should examine the Allowance for Bad Debts (or the Allowance for Doubtful Accounts) to see if any changes have been made in estimating bad debts after a legal ruling has been issued. If this allowance account had been understated (income-increasing discretionary accrual) before the issuance of a legal ruling and overstated (income-decreasing discretionary accrual) after such issuance, it could be that the change may have been made in response to the legal ruling.

Another field procedure the independent auditor can use to detect the possible use of discretionary accruals after the issuance of a fraud-based legal ruling is to examine the depreciation account of the firm in question. The auditor should see if there have been any changes in depreciation estimates and/or a switch from one depreciation method to another around the period of the legal ruling issuance. The purchase and/or sale of assets around the time of the issuance of the legal ruling should be examined to see if assets were acquired or disposed of in order to manipulate discretionary accruals with corresponding increases or decreases in depreciation expenses.

The inventory amounts of a firm that has just received a fraud-based legal ruling should be carefully examined by the independent auditor. The auditor should verify the ownership of these inventory amounts by requesting the proper documentation and pay particular attention to inventories that were purchased and sold around the period of the legal action. The relationship of the firm with its retailers should be investigated in order to determine if the firm has been pressuring retailers to purchase more inventory than is needed (channel stuffing) in light of the legal ruling.

The auditor can also find out how employees of a firm that has just received a fraud-based legal ruling feel about the ruling by: (1) interviewing the employees on an informal basis or (2) checking the Internet for any possible employee chat rooms discussing the legal ruling (SAS 99).[64] Any information the employees provide about the legal ruling issued against their employer firm can become part of an audit plan.

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[63] Scott Jackson and Marshall Pitman, *Auditors and Earnings Management*, 2001 THE CPA J. 38–40. Available at http://www.nysscpa.org.

[64] CODIFICATION OF ACCT. STANDARDS & PROCS., Statement on Auditing Standards No. 99 § 603 (AM. INST. OF CERTIFIED PUB. ACCTS. 2002). Statement on Auditing Standards No. 99: Consideration of Fraud in a Financial Statement Audit.

The list of procedures an independent auditor can conduct in order to determine how a firm has adjusted its discretionary accrual policy in response to the issuance of a fraud-based legal ruling is by no means limited to what has been discussed here. The independent auditor does have guidance in the form of accounting and auditing standards issued by various authorities. What the auditor should consider, however, is that the type of legal ruling (i.e., favorable, unfavorable, or mixed) a firm receives may not necessarily mean the end of any discretionary accrual policy. A firm may simply end one policy and begin another, which is why the auditor should take special precautions in dealing with a firm that has been through litigation recently.

C. *Limitations*

While this study has provided valuable implications for accounting research and audit fieldwork, it is subject to certain limitations. First, the sample was not drawn from the full population of United States fraud-based legal actions, but from a group of federal legal cases listed in the Commerce Clearinghouse Federal Securities Law Reports. Although many attorneys, judges, researchers, and others use this federal reporter in their work, it does not include financial reporting fraud cases of firms that are not subject to United States federal securities law.

Second, the final sample in the study was not taken from all of the annual volumes of the Commerce Clearinghouse Federal Securities Law Reports. It only includes companies taken from cases litigated in the years 1982 to 2007 and companies whose financial information was available in the COMPUSTAT database. The process of finding financial reporting fraud cases for companies that have extensive financial information publicly available for the purposes of this study has been difficult.

Lastly, the total sample consists of only seventy-seven companies categorized into eleven industries. A follow-up study with a sample consisting of a larger number of companies representing a wider variety of industries may obtain results different from the results obtained in this study.

D. *Suggestions for Future Research*

This study provides a number of opportunities for further research. First, the results of this study indicate that the filing of a legal action and the issuance of a legal ruling further down the road do have an effect on discretionary accruals, which affects the reliability of financial statements. Another study could consider another variable, namely appeals. Many firms appeal their legal rulings and a study analyzing the period starting with the legal filing, the initial legal ruling, and the legal appeals process may provide insights into how the legal system impacts the reliability of financial statements from the beginning of the litigation to its final resolution.

Second, the study of the legal process should not be limited to United States firms. Fraud-based financial reporting legal actions occur in nations around the world and a comparative study of how firms in different nations adjust their discretionary accrual policies in response to legal rulings would be a benefit to many international stakeholders such as investors, creditors, employees, tax authorities, and many others. Cultural and economic factors could be integrated into the model as control variables to see how they impact discretionary accrual policies along with the legal process.

Third, a study of how other types of legal actions besides fraud-based financial reporting legal actions could be done in order to determine their impact on discretionary accrual policies. A comparative study of the different types of legal actions could be done to see how each type impacts accounting information; for example, a study comparing the impacts of environmental, wrongful termination, accident-related, discrimination, and financial reporting-related legal actions could be done to determine if any of these types of legal actions impact the reliability of accounting information more than others.

In general, this study provides useful information about the impact of the legal process on earnings management and the reliability of financial statements. In a world characterized by increasing amounts of litigation, an examination of the role litigation plays in the accounting information process is necessary in order to increase the quality of such information. I hope that the findings of this study are a benefit to both academics and practitioners alike and lead to more insightful and interesting research opportunities in the field of law.

DO TRADERS BECOME ROGUES OR DO ROGUES BECOME TRADERS?
THE OM OF JEROME AND THE KARMA OF KERVIEL

RAVI KASHYAP*

CONTENTS

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I. ABSTRACT

We present a study of Jerome Kerviel, a trader at Société Générale, and how he racked up positions far exceeding his authorized risk limits resulting in a spectacular loss and in the process becoming the perpetrator of the biggest rogue trading scandal, thus far, in recorded history. We focus on many aspects of the financial markets and attempt to provide an appropriate context to the proceedings by considering some historical matters and furnishing an alternate definition for a rogue trader. With the goal of highlighting policy relevant insights, we look at the organization structure, trading profits, risk management, regulation, ethics and the many conflicts that arise therein with some focus on Kerviel and his immediate environment. We provide a simple guide for the budding rogue trader that could also be helpful for the aspiring control agent. We conclude by delving deeper into the ethical issues regarding rogue trading and provide possible ways to mitigate, if not resolve, the many moral dilemmas that arise in business, life and elsewhere.

We consider many conundrums related to: the question of size of financial firms, organization behavior, designing social systems, ethics, enhancing human welfare, excessive reliance on mathematics, the role played by auditors, better comprehension of history, evolution and the need for universal education. We have strived to ensure that the manuscript is written in a style such that it can be read by almost anyone, with or without a strong business background. Some of the topics we discuss are: A Joke at First and Also at Last; History: A Product Structured by Winners; Rogue One on Delta One; Depart-Mental Drill Down; Confessions of The Control Agents; A Slow Walk On A Tight Rope; The Glass Castle Called Basel; "e" for Everything, Everyone, Everywhere including Evolution, Education and Ethics; Sick Lesson from Nick Leeson; Rogue Trading Guide for Dummies; Mathematically Sophisticated Models or Merely Superior Mora.

II. A JOKE AT FIRST AND ALSO AT LAST

On January 24, 2008, Société Générale (SG) declared a "[l]oss of EUR 4.9 billion (US $7.2 billion) on position of EUR 50 Billion (US $73.26 billion)"[1]. This was the largest rogue trading scandal, thus far, in recorded history.[2] One of the biggest scandals in the financial markets and the

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[1] A few additional sources have been used to get a good understanding of Jerome Kerviel and the trading losses he brought about (Weiss 2008; Canac & Dykman 2011; Gilligan 2011; Rafeld, Fritz-Morgenthal & Posch 2017)

[2] The following are some references and links related to the list of rogue trading scandals in (Figure 1):Orlando Joseph Jett (born 1958) is an American former securities trader, known for his role in the Kidder Peabody trading loss in 1994. At the time of the loss it was the largest trading fraud in history (Egan & Kaeter 1994; Freedman & Burke 1998; Werhane 1998; CEO MAGSylvia Nasar, *Kidder Scandal Tied to Failure of Supervision*, N.Y. TIMES, Aug. 5, 1994, https://www.nytimes.com/1994/08/05/us/behind-kidder-scandal-overview-kidder-scandal-tied-failure-supervision.html.; Nick Leeson (Section 4.8)Toshihide Iguchi (born 1951) was an Executive Vice President and U.S. Government Bond trader at Daiwa Bank's New York Branch, who was responsible for $1.1 billion in unauthorized trading losses accumulated over a period of 12 years beginning in 1983 (Walker 1995; Kane & DeTrask 1999; Weston 2005;
Katie Holliday, *I'm not a criminal: Daiwa rogue trader who lost $1billi*on, CNBC, Apr. 29, 2014, https://www.cnbc.com/2014/04/29/im-not-a-criminal-daiwa-rogue-trader-who-lost-1-billion.html;The Serious Fraud Office (SFO) has charged Peter Young, the former Morgan Grenfell fund manager, with conspiracy to defraud and offenses under the 1986 Financial Services Act. Although Peter Young was found guilty on all charges, the judge promptly voided the verdict due to reasons of insanity. (Leith 2002; Ramage 2005; Peter Young Charged, The Independent Link; How Did Rogue Trader Peter Young Become Infamous?, Investopedia Link; How to lose a billion?, NYU Stern Link); Yasuo Hamanaka (born 1950) was the chief copper trader at Sumitomo Corporation, one

largest ever Ponzi scheme[3] happened when Bernard Madoff "made off" with $64.8 billion dollars of investor funds.[4] There have been other spectacular trading scandals, though they have not been labeled as rogue trading incidents since there was no suspicion of fraudulent activity[5],[6].

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of the largest trading companies in Japan. He was known as "Mr. Copper" because of his aggressive trading style, and as "Mr. Five Percent" because that is how much of the world's yearly supply he controlled. On June 13, 1996, Sumitomo Corporation reported a loss of US$1.8 billion in unauthorized copper trading by Hamanaka on the London Metal Exchange. In September 1996, Sumitomo disclosed that the company's financial losses were much higher at $2.6 billion (285 billion yen) (Nasi 1996; Kozinn 2000; Weston 2003; *Futures black as copper boss shows his mettle*, THE IRISH TIMES, June 15, 1996, https://www.irishtimes.com/business/futures-black-as-copper-boss-shows-his-mettle-1.58775.; John Rusnak is a former currency trader at Allfirst bank, then part of Allied Irish Banks Group, in Baltimore, Maryland, United States. On January 17, 2003 he was sentenced to 7½ years in prison for hiding US$691 million in losses at the bank in 2002, after bad bets snowballed in one of the largest ever cases of bank fraud (Burke 2004; Butler 2009; Wexler 2010;
Erik Portanger et al., *Allied Irish Banks Say a Rogue Trader Lost $750 Million in Unauthorized Deals*, WALL ST. J., Feb. 7, 2002.
Former senior National Australia Bank trader Luke Duffy has been sentenced to at least 16 months jail for his part in an alleged $360 million unauthorized trading scandal (Ford & Sundmacher 2004; Dellaportas, Cooper & Braica 2007; Wexler 2010; NAB rogue trader jailed, Sydney Morning Herald Link); Chen Jiulin (born October 20, 1961) is the former Managing Director and CEO of China Aviation Oil (Singapore) Corporation Ltd (CAO). During his leadership CAO's net asset worth increased from US$176,000 to US$150,000,000, an increase of 85,200%. In 2004 CAO suffered huge losses due to oil future trading. Chen Jiulin was forced to leave the company and was arrested by the Singapore police. In March 2006, the Singapore court sentenced Chen Jiulin to four years and three months imprisonment (Wexler 2010; Hornuf & Haas 2014; *Lessons from History's Worst CEOs*, CEO MAG., July 18, 2018, https://www.theceomagazine.com/business/management-leadership/lessons-from-historys-worst-ceos/; Former Goldman Sachs Group Inc trader Matthew Taylor was sentenced Friday to serve nine months in prison and pay $118 million in restitution to his former employer after he pleaded guilty to pursuing an unauthorized $8.3 billion futures trade in 2007 (Becker, ... & Watt 2013; Goldman rogue trader gets Prison, Reuters Link); Kweku Adoboli (born 1980) is a Ghanaian born investment manager and former stock trader. He was convicted of illegally trading away US$2 billion (GB£1.3 billion) as a trader for Swiss investment bank UBS. While at the bank he primarily worked on UBS' Global Synthetic Equities Trading team in London where he engaged in what would later be known as the 2011 UBS rogue trader scandal (Scholten & Ellemers 2016; Rafeld, Fritz-Morgenthal & Posch 2017a; b; Rocchi & Thunder 2017; Paul Clarke, *Ex-UBS rogue trader Adoboli seeks $6m for Ghana bond venture*, FIN. NEWS, Jan. 22, 2020, https://www.fnlondon.com/articles/ex-ubs-rogue-trader-adoboli-seeks-6m-for-ghana-bond-venture-report-20200122.

[3] A Ponzi scheme (also a Ponzi game) is a form of fraud that lures investors and pays profits to earlier investors with funds from more recent investors. The scheme leads victims to believe that profits are coming from product sales or other means, and they remain unaware that other investors are the source of funds. The scheme is named after Charles Ponzi, who became notorious for using the technique in the 1920s. Greg Iacurci, *Ponzi Schemes, Other Investment Fraud on Rise During Pandemic, SEC Says*, CNBC, Dec. 15, 2020, https://www.cnbc.com/2020/12/15/ponzi-schemes-other-investment-fraud-on-rise-amid-pandemic-sec-says.html.

[4] Bernard Lawrence Madoff (born April 29, 1938) is an American former market maker, investment advisor and financier who is currently serving a federal prison sentence for offenses related to a massive Ponzi scheme. Prosecutors estimated the fraud to be worth $64.8 billion based on the amounts in the accounts of Madoff's 4,800 clients as of November 30, 2008. Martha Graybow, *Madoff Mysteries Remain as He Nears Guilty Plea*, REUTERS, Mar. 11, 2009, https://www.reuters.com/article/topNews/idUSTRE52A5JK20090311?pageNumber=2&virtualBrandChannel=0&sp=true.

[5] Long-Term Capital Management L.P. (LTCM) was a hedge fund management firm based in Greenwich, Connecticut that used absolute-return trading strategies combined with high financial leverage. LTCM was founded in 1994 by John W. Meriwether, the former vice-chairman and head of bond trading at Salomon Brothers. Members of LTCM's board of directors included Myron S. Scholes and Robert C. Merton, who shared the 1997 Nobel Memorial Prize in Economic Sciences for a "new method to determine the value of derivatives". Ron Rimkus, *Long-Term Capital Management*, FINANCIAL SCANDALS, Scoundrels & Crises (Apr. 18, 2016), https://www.econcrises.org/2016/04/18/long-term-capital-management/.

[6] Brian Hunter (born 1974) is a Canadian former natural gas trader for the now closed Amaranth Advisors hedge fund.

This loss by one trader, Jerome Kerviel, wiped out almost an entire year's profits by all other employees at SG.[7] Nicolas Rutsaert, an analyst for European banks at Dexia in Brussels said, "[a]t first, this seemed like a Joke . . . SG was a leader in derivatives and was considered one of the best risk managers in the world."[8] While funny now, Kerviel's conduct gets more hilarious as other events happen

We attempt to provide an appropriate context to the proceedings. Section (3) considers some historical matters, definitions and the main question we wish to answer. Section (4) is about organizational structure, trading, risk management, profits, regulation and the many conflicts that arise therein with some focus on Kerviel and his surroundings. Section (5) provides a simple guide for the budding rogue trader that could also be helpful for the aspiring control agent. Section (6) delves deeper into the ethical issues regarding rogue trading and concludes by providing possible ways to mitigate, if not resolve, the many moral dilemmas that arise in business, life and everywhere else. We have tried to ensure that the bulk of the narrative within the main body of the paper is mostly self-contained so that it can be easily followed by a wider audience. But for those wishing to have more details and a deeper comprehension we have provided a rich set of End-notes that supplement the central arguments and provide explanations for terms that might not be easily understood by someone not intimately familiar with the workings of the financial industry and other professional areas.

Though the paper has numerous policy relevant insights, it is written in a style such that it can be read by almost anyone, with or without a strong business background. We consider many conundrums related to: the question of size of financial firms, organization behavior, designing social systems, ethics, enhancing human welfare, excessive reliance on mathematics, the role played by auditors, better comprehension of history, evolution and the need for universal education. Some of the topics we discuss are: A Joke at First and Also at Last; History: A Product Structured by Winners; Rogue One on Delta One; Depart-Mental Drill Down; Confessions of The Control Agents; A Slow Walk On A Tight Rope; The Glass Castle Called Basel; "e" for Everything, Everyone, Everywhere . . . including Evolution, Education and Ethics; Sick Lesson from Nick Leeson; Rogue Trading Guide for Dummies; Mathematically Sophisticated Models or Merely Superior Morals?

All of this is funny only if our goal is to have a good time; if this is not our intention we need to consider what else would be a better option in the face of such incidents? As we proceed further, let us remind ourselves that a good joke gets funnier as it unfolds.

A. The Jokers are Among Us

French President, Nicolas Sarkozy, called for the resignation of SG CEO and Chairman, Daniel Bouton[9]. Monsieur Sarkozy was furious to have been kept in the dark[10]. This makes us

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Amaranth had over $9 billion in assets but collapsed in 2006 after Hunter's gamble on natural gas futures market went bad. Leah M. Goodman, *The 'Rogue Trader' Who Got Away with It*, NEWSWEEK, Sept. 17, 2014.

[7] Jérôme Kerviel (born 11 January 1977) is a French trader who was convicted and imprisoned for the 2008 Société Générale trading loss for breach of trust, forgery and unauthorized use of the bank's computers, resulting in losses valued at euro 4.9 billion. Nicola Clark, *Rogue Trader at Société Générale Gets 3 Years*, N.Y. TIMES, Oct. 5, 2010.

[8] The events surrounding this incident are covered by the popular press and include statements by many of the parties involved.Rogue trader blamed for $7.3B loss 5 Billion Euro fraud drains off capital at SocGen.

[9] Sarkozy strongly hinted that he wanted Daniel Bouton, the boss, to quit. Sarkozy v Jerome Kerviel.

[10] France's top banker will be hauled before French MPs this week to explain why he and Société Génerale kept the

wonder why he believed he had to be in the light especially when most of high finance and the biggest trades happen in the dark[11],[12]. Perhaps he knew (or merely had a hunch), that everyone else was in the light and felt left out. We are even more curious as to what Monsieur Sarkozy would have done if he had been brought into the light. Also, it remains to be completely pinned down as to who should have been responsible for bringing him into the light.

The Prime Minister, Francois Fillon, somehow sensed that this incident was distinct from the financial market turmoil.[13] Christine Lagarde, Ministry of Finance jumped in with more skipping rope (regulations) to tighten the players[14],[15]. We need to be fair and give others the benefit of doubt. Just because we do not know something does not mean others do not; perhaps some of us might know, "everything about everything". With so much happening, of course, how could the rest of France stay out of this? The French public known to criticizing financial circles showed support to Kerviel and grieved that "he was a victim of greed . . . of a large, profit-obsessed bank."[16] If this sounds like echoes of a distant past (French revolution), let us leave it at that.[17] Lastly, was

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French government in the dark for nearly four days about the impending fraud crisis. Nicolas Sarkozy furious at SocGen delay.

[11] In finance, a dark pool (also black pool) is a private forum for trading securities, derivatives, and other financial instruments. Liquidity on these markets is called dark pool liquidity. The bulk of dark pool trades represent large trades by financial institutions that are offered away from public exchanges like the New York Stock Exchange and the NASDAQ, so that such trades remain confidential and outside the purview of the general investing public. GARY SHORTER & RENA S. MILLER, CONG. RESEARCH. SERVS., DARK POOLS IN EQUITY TRADING: POLICY CONCERNS AND RECENT DEVELOPMENTS 1-3 (2014).

[12] A block trade is a permissible, noncompetitive, privately negotiated transaction either at or exceeding an exchange deter- mined minimum threshold quantity of shares, which is executed apart and away from the open outcry or electronic markets. Major broker-dealers often provide "block trading" services—sometimes known as "upstairs trading desks"—to their institutional clients. James F. Gammill, Jr. & Terry A. Marsh, *Trading Activity and Price Behavior in the Stock and Stock Index Futures Markets in October 1987*, 3 J. OF ECON. PERSP. 25, 33 (1988).

[13] Both the governor of the French central bank, Christian Noyer, and the French prime minister, François Fillon, insisted that the Kerviel case had nothing to do with the volatile stock markets around the world, or with the subprime mess. French Trader Is Remembered as Mr. Average.

[14] On February 4th Christine Lagarde, the French finance minister, published her hastily produced report into the affair. Ms Lagarde's report identified no fewer than eight ways in which SocGen (SG) should have kept a tighter watch, including a more skeptical attitude to "atypical behavior", such as not taking any holiday. The rogue rebuttal

[15] Any attempt at regulatory change is best exemplified by the story of Sergey Bubka, the Russian pole vault jumper, who broke the world record 35 times. Attempts at regulatory change can be compared to taking the bar higher. Clearly regulatory efforts in this case are to ensure that no fraud or scandals take place in the financial markets. Sergey Nazarovich Bubka (born 4 December 1963) is a Ukrainian former pole vaulter. He represented the Soviet Union until its dissolution in 1991. Sergey has also beaten his own record 14 times. He was the first pole vaulter to clear 6.0 meters and 6.10 meters. Bubka was twice named Athlete of the Year by Track & Field News and in 2012 was one of 24 athletes inducted as inaugural members of the International Association of Athletics Federations Hall of Fame. Surgey Bubka Press Kit, SURGEYBUBKA.COM, http://www.sergeybubka.com/frontend/www/uploads/PressKitList/file Biography%20and%20achievements.pdf (last visited Jan. 18, 2021).

[16] Many French citizens saw the situation differently: Kerviel was the victim of a profit-obsessed bank, which largely existedto extract revenue from the struggling working and middle classes while enriching its top officers and shareholders. The Omen

[17] Historians have pointed to many events and factors that led to the Revolution. Rising social and economic inequality, new political ideas emerging from the Enlightenment, economic mismanagement, environmental factors leading to agricultural failure, unmanageable national debt, and political mismanagement have all been cited as laying the groundwork for the Revolution. Keith Michael Baker, French Political Thought at the Accession of Louis XVI, 50 J. OF MODERN HIST. 279 (1978).

this event a tipping point[18] for the financial crisis or was it just pure coincidence that the largest rouge trading scandal until this point in time happened around the time of the largest financial crisis till date?[19] Are these connections to be discerned beyond our five senses? How badly do we need a sixth or seventh sense?

III. HISTORY: A PRODUCT STRUCTURED BY WINNERS

History is generally forgotten because "His-Story" is not of great interest to a specific individual. Is it any wonder that Mysteries (My-Stories) are more appealing than Histories (His-Stories)? But, if the message from history books are made applicable to everyday life, it stays relevant. What we can learn from the simple yet perhaps tough lessons from the financial markets are that, if wealth is lost, nothing is lost; if health is lost, something is lost; if character is lost, everything is lost. What we see in scandal after scandal in finance and everywhere else is that we usually end up losing everything for nothing.

To make it a proper historical narrative let us now look at some facts, which we cannot easily remember. Facts can be helpful if we remember that history books are written by the winners and the losers are made to seem like whiners. SG was founded in 1864. It was listed on the French Stock Exchange in 1871. It was nationalized in 1945, and the government sold its interest in SG to the public in July 19, 1987—not too long before another crisis in the financial markets[20],[21].

[18] Gladwell defines a tipping point as "the moment of critical mass, the threshold, the boiling point". The book seeks to explain and describe the "mysterious" sociological changes that mark everyday life. As Gladwell states: "Ideas and products and messages and behaviors spread like viruses do". MALCOLM GLADWELL, THE TIPPING POINT: HOW LITTLE THINGS MAKE A BIG DIFFERENCE 12 (Little, Brown and Company, 2000).

[19] The financial crisis of 2007–2008, also known as the global financial crisis and the 2008 financial crisis, was a severe worldwide economic crisis considered by many economists to have been the most serious financial crisis since the Great Depression of the 1930s, to which it is often compared. Gita Gopinath, The Great Lockdown: Worst Economic Downturn Since the Great Depression, INT'L. MONETARY FUND BLOG (Apr. 14, 2020), https://blogs.imf.org/2020/04/14/the-great-lockdown-worst-economic-downturn-since-the-great-depression/.

[20] Société Générale S.A. is a French multinational investment bank and financial services company headquartered in Paris, France. More details about its history and expansion can found at this link: Societe Generale, Wikipedia Link; see also Our History, SOCIETE GENERALE, https://www.societegenerale.com/en/societe-generale-group/identity/history (last visited Jan. 18, 2021).

[21] Black Monday on October 19, 1987 was the date when a sudden and largely unexpected stock market crash affected markets around the world. The crash began in Hong Kong and spread west to Europe, hitting the United States after other markets had already sustained significant declines. Black Monday (1987).

A. Rogues and Traders as Entertainers and Educators

Questions & Answers (Q&A) are important, but Definitions & Assumptions (D&A) are, perhaps, more important. If we change the latter, the former might change. The good news is that Q&A and D&A might be in our very DNA, the biological one.[22] We start with one widely accepted definition for a rogue trader. "A rogue trader is an employee authorized to make trades on behalf of their employer [subject to certain conditions] who makes unauthorized trades."[23]

The unapproved financial transactions can of course turn out to be profitable or cause a loss. Generally, the profits are overlooked, though it is not uncommon for traders to get warnings when such unauthorized trades are made. Though, as is widely acknowledged in the financial markets, the profits take care of themselves, it is the losses that keep us at work for long hours or lead to loss of employment. The other aspect to keep in mind is that when losses happen, the heat is turned up on whoever is causing the losses. It is then said that the trader has turned rogue. This last aspect provides us with an alternate definition of not just rogue traders, but rogues in general.

Definition 1. Let us define "Rogues" as those that are not limited by the limits under which they are supposed to operate.

With this new definition, some people might think that "Rogue" means being street-smart. We simply note that being street-smart is considered an education in itself, which allows us to steer away from providing detailed and complex clarifications for what street-smart is. With this alternate meaning for rogues, we hope to cast the Rogue, the central figure or the real hero of the plot, in a more positive light. With this definition, we can view "Rogues and Traders as Entertainers and Educators." This brings up the most important question of this article, as hinted at in the very title of this paper.

Question 1. *Do Traders become Rogues? Or Do Rogues become Traders?*

We will attempt to address this question more concretely towards the conclusion (Section 6), but first we portray the specifics of what happened and how they happened.

B. A Popularity Contest

Returning to the historical focus of this section, we consider first whether rogues will be remembered by history. Surely, this is more important than how someone will be remembered by history, which could be distorted in many ways as discussed in the introduction to this section. It

[22] Deoxyribonucleic acid (DNA) is a molecule composed of two chains that coil around each other to form a double helix carrying the genetic instructions used in the growth, development, functioning, and reproduction of all known living organisms and many viruses. Maybe, DNA hold the lessons from the lives of every ancestor we have ever had. Evolution is constantly coding the information, compressing it and passing forward what is needed to survive better and to thrive building what is essential right into our genes. For information storage in DNA and related applications see, Church, Gao & Kosuri (2012). Gregory A. Wray, Dating branches on the Tree of Life using DNA, 3 Genome Biology 0001.1, (2001).

[23] The term rogue trader is most often applied to financial trading, when professional traders make unapproved financial transactions. This activity is often in the Grey area between civil and criminal transgression, because the perpetrator is a legitimate employee of a company or institution, yet enters into transactions on behalf of their employer without permission. In several cases traders have initially made very large profits for their employers, and bonuses for themselves, from trades in breach of the rules, and it has widely been said that employers turned a blind eye to transgressions due to the profits involved. Christopher Land, Scott Loren & Jorg Metelmann, Rogue Logics: Organization in the Grey Zone, 35 Organizational Studies 233, 239 (2014).

would not be entirely incorrect to state that the more popular someone is, the more they will be remembered. If the popular ones can be deemed celebrities, it still begs a proper definition appropriate for this age of too much information.

Definition 2. We define a celebrity as someone who has a Wikipedia page in their name. The longer the page, the more famous the person.

The following examples illustrate: Michael Jackson is a Megastar (223 pages long); Isaac Newton is an Icon (197 pages long); and Jerome Kerviel is somebody Cool (58 pages long).[24] Jerome Kerviel has one of the longer Wikipedia pages among individuals involved in finance and economics, but it is much shorter than the Wikipedia page for someone in the natural sciences and much shorter still than artists. Perhaps, this is another way of telling us that artists are the ones that people resonate with the most. An additional point to be noted, which can seem like an objection voiced by some parties, is that the Wikipedia page can be edited and its contents change over time. But surely, we don't expect popularity to stay the same always, do we?

IV. ROGUE ONE (ALONE?) ON DELTA ONE

Rogue One is the name of a popular movie within the Star Wars franchise (Edwards 2017).[25] In this film, there are a group of rebels who are in conflict with an evil empire. As the plot unfolds there arises another group of rebels, within the original group of rebels, who are the main protagonists of the story. These rebels within rebels decide to do all that is needed to stop the evil empire from engaging in certain destructive activities. Referring to Definition (1), tells us that Rogues in movies and elsewhere can sometimes simply be heroes that are prepared to transcend boundaries that might seem restrictive to do what they deem necessary.

In our case study, as many have maintained over the years and many others have pointed out otherwise, there was only one Rogue operating alone on a trading desk called Delta One[26],[27]. To better understand what might have actually transpired we need to delve deeper into "Extremely

[24] The page counts indicated include all text when we export the Wikipedia web page. As an alternative, we could, of course use the size of the file as well. Though this is sometimes misleading due to presence of pictures and other graphics. Jerome Kerviel, https://en.wikipedia.org/wiki/J%C3%A9r%C3%B4me_Kerviel; Isaac Newton, https://en.wikipedia.org/wiki/Isaac_Newton; Michael Jackson, https://en.wikipedia.org/wiki/Michael_Jackson.

[25] Rogue One: A Star Wars Story (or simply Rogue One) is a 2016 American epic space-opera film directed by Gareth Edwards.Rogue One follows a group of rebels on a mission to steal the plans for the Death Star, the Galactic Empire's super-weapon, just before the events of A New Hope. Rogue One, STAR WARS, https://www.starwars.com/films/rogue-one (last visited Jan 18, 2021).

[26] Delta One products are financial derivatives that have no optionality and as such have a delta of (or very close to) one– meaning that for a given instantaneous move in the price of the underlying asset there is expected to be an identical move in the price of the derivative. Delta one products can sometimes be synthetically assembled by combining options. What is Delta One Trading?, FINANCIAL EDGE TRAINING (Sept. 26, 2019), https://www.fe.training/free-finance-resources/trading-ideas/what-is-delta-one-trading/.

[27] In finance, a derivative is a contract that derives its value from the performance of an underlying entity. This underlying entity can be an asset, index, or interest rate, and is often simply called the "underlying." Derivatives can be used for a number of purposes, including insuring against price movements (hedging), increasing exposure to price movements for speculation or getting access to otherwise hard-to-trade assets or markets. Derivatives, OFFICE OF THE CONTROLLER OF CURRENCY, (2021), https://occ.gov/topics/supervision-and-examination/capital-markets/financial-markets/derivatives/index-derivatives.html.

Exotic Structured Products, also known as, Business Divisions."[28],[29],[30].

A. *Depart-Mental Drill Down!!!*

Most of the large financial firms are divided into three important departments each with numerous compartments. While reminding ourselves that divisions are usually created for ease of governance and sometimes to appease the politics of power brokers,[31] we note that within SG the three main entities were: Retail Banking and Financial Services; Global Investment Management Services; and Corporate and Investment Banking ("SGCIB"). There were three more sub-departments within SGCIB: Global Equities and Derivatives Solutions ("GEDS"); Fixed Income, Currency and Commodities ("FICC"); and Capital Raising and Financing. Such an organizational structure tells us that when we perform a depart-mental drill down, large companies are somewhat like a not so small, Matryoshka doll.[32]

Within any business, executives from different divisions rise to the top of the management hierarchy or dominate senior level positions at different times depending on how much their departments have contributed to the total profits of the firm. Traders had come to rule the roost around the time of the financial crisis. Trading divisions had become the engines of success with traders being lauded for their ability to anticipate and execute profitable trades. In 2007, the Equity

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[28] A structured product, also known as a market-linked investment, is a pre-packaged structured finance investment strategy based on a single security, a basket of securities, options, indices, commodities, debt issuance or foreign currencies, and to a lesser extent, derivatives. Katrina Lamb, An Introduction to Structured Products, INVESTOPEDIA, (Jan. 12, 2020), https://www.investopedia.com/articles/optioninvestor/07/structured_products.asp.

[29] An exotic derivative, in finance, is a derivative which is more complex than commonly traded "vanilla" products. This complexity usually relates to determination of the derivative payoff. The category may also include derivatives with a non- standard subject matter (i.e., underlying), developed for a particular client or a particular market. The term "exotic derivative" has no precisely defined meaning, being a colloquialism that reflects how common a particular derivative is in the marketplace. As such, certain derivative instruments have been considered exotic when first conceived of and sold, but lost this status when they were traded with significant enough volume. *Exotic Derivatives*, FINANCIAL ADVISORY, (2021), https://www.financialadvisory.com/dictionary/term/exotic-derivatives/.

[30] In finance, an exotic option is an option which has features making it more complex than commonly traded vanilla options. Like the more general exotic derivatives they may have several triggers relating to determination of payoff. An exotic option may also include non-standard underlying instrument, developed for a particular client or for a particular market. Exotic options are more complex than options that trade on an exchange, and are generally traded over the counter (OTC). *Exotic Options*, CORPORATE FINANCE INSTITUTION (2021), https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/exotic-options/.

[31] An Investment bank is a financial services company or corporate division that engages in advisory-based financial trans- actions on behalf of individuals, corporations, and governments. Such a bank might assist in raising financial capital by underwriting or acting as the client's agent in the issuance of securities. An investment bank may also assist companies involved in mergers and acquisitions (M&A) and provide ancillary services such as market making, trading of derivatives and equity securities, and FICC services (fixed income instruments, currencies, and commodities). Most investment banks maintain prime brokerage and asset management departments in conjunction with their investment research businesses. *See* Sean Ross, *How Do Investment Banks Help the Economy?*, INVESTOPEDIA (Jan. 8, 2021), https://www.investopedia.com/ask/answers/032515/how-do-investment-banks-help-economy.asp.

[32] Matryoshka dolls, also known as Babushka Dolls, Russian Tea dolls, stacking dolls, or Russian dolls, are the set of wooden dolls of decreasing size placed one inside another. *See* Mary Stillwell, *What You Ought to Know About Russian Nesting Dolls,* Nesting Dolls (Mar. 15, 2018), https://nestingdolls.co/blogs/posts/russian-nesting-dolls-what-you-ought-to-know.

Derivatives SGED trading division accounted for twenty percent of the entire bank profits.[33] It was widely hailed by wall street analysts that "SGED are probably the best, quantitatively and qualitatively, in the world." The SGED division had made profits in every quarter since 1993, and between 2003 and 2006, had only thirteen days with losses of more than EUR five million. It is to be noted that SG has invested significantly in improving its technology and infrastructure, the result of which was its reputation in having a sophisticated risk management process. In 2006, there were fifty-nine profit centers within this division and all of them profitable and none contributed more than ten percent of revenues.[34]

Achieving such stable and diverse source of revenues is an amazing feat. If this sounds like a money machine, we need to bring ourselves down to Earth since money machines generally exist only for central banks. SG also hired many individuals with quantitative training from the prestigious Grandes Ecoles,[35] which is known for imparting rigorous education in mathematics and financial principles. 385 of the 1,365 employees in GEDS worked in arbitrage and volatility trading and Jerome Kerviel was one of them.

B. *"e" for Everything, Everyone, Everywhere ... including Evolution, Education and Ethics*

"*e*"**,** is commonly known in mathematics and finance as the exponential constant.[36] Arguably, it is the second most important number after zero.[37],[38]. The exponential is commonly

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[33] Profit in the derivatives unit mounted as swiftly as one of the graphs in their elegant mathematical models. A French style of capitalism is now stained, New York Times, January 2008

[34] Merrill Lynch estimates that SocGen has 59 separate profit centers in equity derivatives, offering products linked to everything from European hedge funds to U.S. equity volatility to Asian equity indexes. Every one of those centers is profitable, and none accounts for more than 10 percent of overall revenues, according to Merrill. "The diversity and resilience of its revenues should not be underestimated." SocGen may be smaller than most of its rivals, but it outshines them in profit margins. Deutsche Bank had nearly three times as much investment banking revenue last year, E15.9 billion, but its pretax profits were E4.3 billion, only 72 percent larger than SocGen's E2.5 billion. Barclays Capital's revenues were 9 percent greater, at E6.2 billion, but its pretax profits were 27 percent lower at E1.84 billion. The French bank's core equity derivatives business is anything but volatile, executives insist. Pardon my French, Institutional Investor, April 2006.

[35] The grandes écoles (literally in French "High Schools") of France are higher education establishments that are outside the main framework of the French public university system. Grandes écoles are highly selective, elite, and prestigious institutions; their graduates have dominated upper levels of the private and public sectors of French society for decades. Barsoux JL & Lawrence P, The making of a French manager, HARVARD BUSINESS REVIEW (June 30, 1991) https://europepmc.org/article/med/10112921.

[36] The number e is a mathematical constant that is the base of the natural logarithm: the unique number whose natural logarithm is equal to one. It is approximately equal to 2.718281828, and is the limit of 1 + 1 n as n approaches infinity, that is as n → ∞, an expression that arises in the study of compound interest; hence e is found in many mathematical models used in financial theory. The pattern that repeats itself twice towards the beginning, 1828, is the birth year of Leo Tolstoy, something that individuals familiar with Russian culture and having a fondness for mathematics are likely to be aware of. It can also be calculated as the sum of the infinite series, e, Mathematical Constant, https://en.wikipedia.org/wiki/E_(mathematical_constant); James Chen, *Exponential Growth*, Investopedia (April 2, 2020) https://www.investopedia.com/terms/e/exponential-growth.asp.

[37] In mathematics, an exponential function is a function of the form, $f(x) = ab^x$, where b is a positive real number, and in which the argument x occurs as an exponent. The real exponential function, e^x {exp : R → R} can be characterized in a variety of equivalent ways. Most commonly, it is defined by the following power series, *See* Exponential Function, Wikipedia Link. As in the real case, the exponential function can be defined on the complex plane in several equivalent forms. Exponential Function, https://en.wikipedia.org/wiki/Exponential_function.

[38] The importance of the exponential function in mathematics and the sciences stems mainly from its definition as the

used to indicate variables that rapidly go up or increase exponentially. It could also denote change in the other way or a decrease.[39],[40]. In finance, it is used for the compounding and discounting of money due to interest rates, a concept studied under the banner of time value of money.[41] Derivatives in finance have a namesake, and are best understood using derivatives, which is a fundamental tool of mathematical calculus.[42],[43] If the derivative of one variable with respect to another is one, they change at the same rate. Also, the exponential function is the unique function which is equal to its derivative. "e" shows up in many others areas of life as well.[44]

It is tempting to conclude that *e* stands for Everything, Everyone, Everywhere, including Evolution, Education and Ethics given how prevalent it is. The importance of evolution for all life and its perpetuity is not a matter up for debate. To connect evolution with ethics we suggest that one goal of all evolution would be to reach a state where ethics are no longer a primary concern. A highly-evolved being would not be bothered about ethical issues and would have no hesitation making decisions that are unencumbered by ethics. In other words, he would immediately know what is the right thing and how to do the right thing without getting drawn into the ethical implications of the situations. Education is meant to accelerate or to be a catalyst for Evolution.

Kerviel started working for SG in 2000 in the middle office. His supervisors noted that he excelled at using information technology and was efficient. Within two years, he moved to the front

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unique function which is equal to its derivative and is equal to 1 when $x = 0$. That is, $d/e^x = e^x$ and $e^0 = 1*dx$, See Duane Q. Nykamp, The Exponential Function, MATH INSIGHT (Jan. 14, 2021), https://mathinsight.org/exponential_function.

[39] Exponential growth is exhibited when the rate of change—the change per instant or unit of time—of the value of amathematical function is proportional to the function's current value, resulting in its value at any time being an exponential function of time, i.e., a function in which the time value is the exponent. See James Chen, Exponential Growth, INVESTOPEDIA (Apr. 2, 2020), https://www.investopedia.com/terms/e/exponential-growth.asp#:~:text=Exponential%20growth%20is%20a%20pattern,curve%20of%20an%20exponential%20function.&text=The%20population%20is%20growing%20to,case%20(i.e.%2C%20exponentially); Exponential Growth, Mathworld Link. The exponential function x(t) = x(0)ekt , k > 0 , satisfies the linear differential equation: dx/dt =kx, saying that the change per instant of time of x at time t is proportional to the value of $x(t)$, and $x(t)$ has the initial value$x(0)$. In the above differential equation, if $k < 0$, then the quantity experiences exponential decay.

[40] A quantity is subject to exponential decay if it decreases at a rate proportional to its current value. See Duane Q. Nykamp, The Exponential Function, MATH INSIGHT (Jan. 14, 2021), https://mathinsight.org/exponential_function; Exponential Decay, Mathworld Link. Symbolically, this process can be expressed by the following differential equation, where N is the quantity and λ (lambda) is a positive rate called the exponential decay constant: dN/dt= λN. The solution to this equation is: $N(t) = N_0 e^{-\lambda t}$ where $N(t)$ is the quantity at time t, and $N_0 = N(0)$ is the initial quantity, i.e. the quantity at time $t = 0$.

[41] Compound interest is the addition of interest to the principal sum of a loan or deposit, or in other words, interest on interest. Compound Interest, Wikipedia Link; ; Jason Fernando, *Compound Interest*, INVESTOPEDIA (Jan 13, 2021), https://www.investopedia.com/terms/c/compoundinterest.asp#:~:text=Compound%20interest%20(or%20compounding%20interest,accumulated%20interest%20from%20previous%20periods. The present value, PV, at time 0 of a future payment, FV, at time t can be restated in the following way, where e is the base of the natural logarithm and r is the continuously compounded rate: $PV = FV \cdot e^{-rt}$.

[42] In finance, a derivative is a contract that derives its value from the performance of an underlying entity. This underlying entity can be an asset, index, or interest rate, and is often simply called the "underlying". *Derivatives*, OFF. OF THE COMPTROLLER OF THE CURRENCY, https://occ.gov/topics/supervision-and-examination/capital-markets/financial-markets/derivatives/index-derivatives.html (last visited Jan. 15, 2020).

[43] The derivative of a function of a real variable measures the sensitivity to change of the function value (output value) with respect to a change in its argument (input value). The process of finding a derivative is called differentiation. GILBERT STRANG & EDWIN "JED" HERMAN, CALCULUS Volume 1 224 (Rice Univ. ed. 2016).

[44] The following link has a list of topics that are related to exponential functions: List of Exponential Topics, https://en.wikipedia.org/wiki/List_of_exponential_topics.

office as a trading assistant to assist other senior traders—this essentially involves answering phones and maintaining records for senior traders. A trading assistans other duties may include getting traders coffee, breakfast and running other such errands. As any apprentice would admit, it is a rite of passage and a good way to learn the ropes from an experienced individual on how to manage the risk of derivative trades. Around 2005, Kerviel became part of the Delta One Listed Products ("DLP") trading desk on the back of a budding reputation as someone that could design complicated derivative trading strategies. He then received a warrant to turbo-charge his career. Essentially, he started trading a specialized product called turbo warrant, a kind of stock option with a knock-out barrier feature.[45]

Soon, his contribution to the profits of the desk seemingly sky rocketed displaying an almost exponential increase. At one point, around 59 percent of DLP profits and 27 percent of all Delta One Trading were due to Kerviel's positions. As we explore how he was able to generate such high profits and became known among his colleagues as a "cash machine," let us remind ourselves again that cash machines (more formally referred to in monetary policy circles under the banner of quantitative easing)[46] exist only for central banks. We also need to note that listed products are traded on an exchange and generally do not generate huge commissions, fees, spreads and hence profits.

C. Confessions of The Control Agents

Financial trading firms have elaborate structures of people assigned to monitor and support the activities of trading desks. Most of the support functions are handled by operations teams in terms of booking trades, ensuring they are cleared on the exchanges or settlement houses and the reporting into the technology infrastructure is done correctly and on time. The monitoring roles can be broadly viewed as: controllers, compliance officers and risk managers, while keeping in mind that there are significant overlaps in the day to day tasks and responsibilities of these groups of individuals. Risk managers focus on obtaining numeric measures indicating the extent of risk or the potential for loss due to trading activities. Controllers focus on ensuring that trades are booked correctly, that the counterparties are valid organizations, and that the Profits and Losses, (P&L) and related accounting is accurate and reported correctly. Compliance officers ensure compliance with current and expected regulatory guidelines.

In addition, traders on each desk are quizzed in an in-depth manner about the trades that are being conducted by desk heads and trading managers who are experienced traders themselves. Along with the products he was authorized to trade, Kerviel started taking

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[45] Turbo warrant (or Callable bull/bear contract) is a kind of stock option. Specifically, it is a barrier option of the Down
and Out type. For comparison, a regular call option will have a positive value at expiry whenever the spot price settles above the strike price. A turbo will have a positive value at expiry when the spot settle above the strike and the spot has never fallen below the strike during the life of the option (if it had done so the option would have crossed the barrier and would have become worthless). James Chen, *Warrant*, INVESTOPEDIA, (Feb. 4, 2020), https://www.investopedia.com/terms/w/warrant.asp.

[46] Quantitative easing (QE), also known as large-scale asset purchases, is a monetary policy whereby a central bank buys predetermined amounts of government bonds or other financial assets in order to inject liquidity directly into the economy. A central bank enacts quantitative easing by purchasing, regardless of interest rates, a predetermined quantity of bonds or other financial assets on financial markets from private financial institutions including commercial banks, thus raising the prices of those financial assets and lowering their yield, while simultaneously increasing the money supply. This action increases the negative effect of that event on the insurance sector.

directional bets on many securities. The first instance of such unauthorized activity happened around July 2005 by which time Kerviel had figured out that intraday trades—trades opened and closed within a single day—did not show up as open positions on the bank's daily account reconciliations. His experience in the middle office and his knowledge of the accounting system proved valuable, and he knew how to enter fictitious trades and conceal his trading records. He made decent profits on some of these unauthorized trades. He claimed later that he revealed some of his initial profits to his supervisors who told him things could have just as easily gone the other way; though Kerviel sensed that they were mostly satisfied with the outcome. This indicates that he might have even received mild warnings for some of these positions at times.

As he was taking bigger unapproved positions without the bank batting an eye, he took it as tacit agreement regarding his actions from his supervisors. Also, over a period of time, when his immediate supervisor resigned and a new one took over, who was more trusting, he had sometimes traded positions worth billions of dollars, far in excess of the position limits that he was supposed to adhere to. In July 2005, Kerviel built a short position of about EUR 10 million on Allianz shares, one of the world's largest insurance companies. Clearly, such a directional position was outside his remit of trading turbo warrants. His position received some good fortune in terms of the terrorist bombings in London and he realized large profits due to excess reserves that banks hold. The goal of this policy is to ease financial conditions, increase market liquidity, and facilitate an expansion of private bank lending.

In 2006, Kerviel started increasing his directional bets on equities to about EUR 135 million. He had positions in Allianz and two German companies who specialized in photo-voltaic products. He also traded heavily on futures contracts on the DAX, one of the major German stock indices.[47],[48]. By early 2007, as the U.S. subprime crisis was developing, Kerviel was betting that the crisis would spill over to Europe and the major market indices would crash. He took a short position on DAX futures to the tune of around EUR 850 million on January 24, 2007 and kept increasing it to EUR 2.5 billion by the end of February and reaching almost EUR 5.6 billion by the end of March. By July his futures position had reached a peak of around EUR 30 billion. He also had individual stock positions of around EUR 350 million.

To conceal his real trades, he booked many fake offsetting trades. Figure 14 shows his actual earnings on unauthorized positions; Figure 15 shows his official or reported earnings; Figure 16 shows his official or reported earnings versus his actual earnings plotted on the same graph along the same axis to illustrate how disproportionate they were; and Figure 17 gives an estimate of the earnings from the fictitious offsetting index trades. He closed out most of his trades by the end of December 2007 and he later claimed a realized gain of nearly EUR 1.5 billion or $2.2 billion from this unwinding. Specifically, to offset the gains for 2007 he created eight fictitious

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[47] The DAX (Deutscher Aktienindex, German stock index) is a blue chip stock market index consisting of the 30 major Germancompanies trading on the Frankfurt Stock Exchange. It is the equivalent of the FT 30 and the Dow Jones Industrial Average, and because of its small selection it does not necessarily represent the vitality of the economy as whole. James Chen, *DAX Stock Index*, Investopedia (Apr. 7, 2020), https://www.dax-indices.com/index-details?isin=DE0008469008.

[48] In finance, a futures contract (more colloquially, futures) is a standardized forward contract, a legal agreement to buy or sell something at a predetermined price at a specified time in the future, between parties not known to each other. Contracts are negotiated at futures exchanges, which act as a marketplace between buyers and sellers. *See* CFTC v. Zelener, 373 F.3d 861, 864 (7th Cir. 2004).

trades on money losing forward contracts.[49] Though in a few days, between January 2 and 18, 2008 he built up a long position on index futures for a total of EUR 49 billion, before being apprehended.

While all these unauthorized transactions were happening, Kerviel, due to the fear of being discovered, did not take any vacations. He managed to get around the regulation that front-office personnel are required to take two-weeks mandatory vacation every year, which ensured that someone else would take over his accounts, by saying that he was troubled by the recent passing of his father. Given this situation of working without vacations, it is very likely that Kerviel was even dreaming of work and somehow balancing his life, unlike many of us who dream of our lives and try to balance that with work. Kerviel also recorded pairs of fictitious trades that offset each other in terms of the quantities of shares but not prices. For example, on March 1, 2007 he booked a fake trade to purchase 2,266,500 shares of SolarWorld at EUR 63 per share and a sale of the same number of shares at EUR 53 each, hence recording a fictitious loss of around EUR 22.7 million. He would cancel most of these fictitious trades before they could be picked by internal control systems. It is believed that he had made at least 115 transactions of this nature.

For about two years, the controllers received numerous email alerts (at least 93) regarding abnormalities in Kerviel's trading patterns. They merely paid lip service to these alerts. To be fair to them, several hundred emails are received by controllers and operations personnel related to various aspects of different trades.[50] While there are many valid reasons as to why controllers, risk managers and compliance officers cannot fully be expected to completely understand the intricacies of every trade they are monitoring, we highlight a few subtle points about what stands in the way of more precise monitoring in Section 4.4.

D. A Slow Walk On A Tight Rope

As an aside, it is worth looking at the role of a Risk Manager. If they do their job well, it is hard to know the extent of the risks they have averted. If there is a blow up, such as a huge loss in a portfolio, they have failed at their jobs. The one way they can do their jobs perfectly, is by not letting their traders or portfolio managers take on risky trades. But, then again, they get compensated by the very profits from the P&L of their traders that depends on taking on bigger risks. So really, what risk managers look for is some way to identify portions of the portfolio they are risk managing using some criteria and issue reports saying these are risky trades and hope that if there is a blow up the risky trades are in those outlier reports they had put out earlier. Let us just say their daily work lives might feel like a slow walk on a tight rope.

Another aspect to consider are the motivations for someone to become a trader or a risk

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[49] In finance, a forward contract or simply a forward is a non-standardized contract between two parties to buy or sell an asset at a specified future time at a price agreed on at the time of conclusion of the contract, making it a type of derivative instrument. *See* 11 U.S.C.A. § 25(a) (West 2020).

[50] A study conducted in one of our previous employers about the extent of emails being received by various trading desks
showed that on average there would be a minimum of around three hundred emails that were sent to the main group mailing list on a daily basis from clients inquiring about various aspects of their trading positions. In addition, there would be many messages on Bloomberg, internal chat applications and hundreds of automated messages related to their trading positions. Also, there would be emails received as part of being other mailing groups and numerous emails each person received individually. Staying on top of all these sources of information can be a challenge and we were exploring various automated technology solutions for the same.

manager. Any talented individual starting a career in financial services would be keener to become a trader rather than a risk manager. This is because traders are generally compensated more than risk managers. This leads to a bias within and even outside the organization that someone that ends up as a trader is more skilled. Viewing this from the flip side leads to be belief that someone ends up as a risk manager because they could not become a trader or they were bad at performing the role of a trader or even because they lack the necessary skills to make complex decisions involved in deciding which trades to execute. This perception is fueled regularly on trading desks when traders routinely tell risk managers they do not understand certain aspects of trading when asked about why a certain trade was made. Sometimes this can even be via the use of condescending words such as, "you don't even know such simple things or how did someone make you a risk manager?"

Nobody likes to be told they cannot understand something and certainly not by someone who is deemed to have less knowledge. This bias means that many times risk managers do not challenge traders or try to pursue matters in depth when they fail to comprehend certain things related to trading strategies they are supposed to risk manage. We will see a classic example of this in Section (4.6). We wish to emphasize that there are many excellent risk managers who are passionate and extremely skilled at what they do. The discussion here covers more common observations rather than the exception.

E. The Glass Castle Called Basel

Basel is a set of risk guidelines.[51] There have been three sets of accords over time, which indicates trial and error or iterations with changes based on outcomes from the previous ones. The one concern is that these rules are getting more complex in each iteration implying that more regulation seems to be answer. It is important to consider whether this is really the case since more regulation and/or more complex rules are generally easier to break. This makes the guidelines more fragile, which leads us to wonder if the Rules of Basel are like a Glass Castle.

F. Cooke Ratios and the Way the Cookie Crumbles

On January 2, 2008, new risk guidelines went into effect in Europe as a result of the Basel II accord. The Cooke ratio is a Basel II measure for capital adequacy. This ratio for a counterparty on eight forward contracts entered by Kerviel was abnormally high. Kerviel had entered the name of Baader Bank, a German brokerage, as a counterparty. When asked to name the counterparty in those fictitious trades, Kerviel sent the following email to the control agent: "This materialized the give up of puts made late; I owe money to the counter-party. We'll re-book it a.s.a.p." The control agent later confessed that he did not understand Kerviel's explanation, but did not follow up on it

[51] The Basel Accords refer to the banking supervision Accords (recommendations on banking regulations)—Basel I, Basel II
and Basel III—issued by the Basel Committee on Banking Supervision (BCBS). They are called the Basel Accords as the BCBS maintains its its secretariat at the Bank for International Settlements in Basel, Switzerland and the committee normally meets there. The Basel Accords is a set of recommendations for regulations in the banking industry. *See* James Chen, *Basel Accord*, INVESTOPEDIA, https://www.investopedia.com/terms/b/basel_accord.asp#:~:text=The%20Basel%20Accords%20are%20three%20series%20of%20banking%20regulations%20set,was%20agreed%20in%20November%202010 (last updated July 22, 2019).

either.[52] We have asked many individuals to explain what they understand by the explanation Kerviel provided and most people say that it is something related to the trades he was doing. No one had previously said that the sentence makes no sense, which is the most likely conclusion.

After this incident, there was greater scrutiny on Kerviel's actions. Compliance officers checked the data regarding the forward trades more closely and called for a meeting with Kerviel. Kerviel admitted that he made a mistake with respect to the identity of the counterparty. He said it was Deutsche bank and forwarded two emails, which were forged, to substantiate his explanation. However, a control agent eventually decided to contact Deutsche Bank, which found no record of those transactions.

G. Paying Billions with Less Than a Million

Sensing that the discrepancies were much larger than what they seemed, the auditors escalated the matter internally to the highest levels of management. Kerviel was asked to cut short a weekend getaway and return to the office. There were many senior officials who questioned him wanting to know the exact details of his trading strategies. Kerviel still tried to mislead them by initially stating that he had found an angel for speculators called the martingale strategy[53],[54]. Repeated inquiries and further investigation by the bank officials and auditors revealed that there were unhedged long futures positions worth about EUR fifty billion. Kerviel was asked not to return to work, not to speak to anyone regarding this matter and to stay at home. He was formally charged on January 28, 2008 with abuse of confidence and illegal access to computers.

His trial began on June 8, 2010. On October 5, 2010, he was found guilty and sentenced to five years imprisonment with two years suspended. If it seemed like a joke at first, the courtroom must be filled with a sense of humor since he was told to fully restore the $6.7 billion which was lost. He also faced a permanent ban from working in financial services. Caroline Guillaumin, a spokeswoman for Société Générale, stated that the restitution was "symbolic," and that the bank had no expectation that the sum would be paid. Olivier Metzner, Kerviel's lawyer, described the sentence as "extraordinary" and said that Kerviel would appeal. Kerviel's sentence was suspended until his appeal was completed. On 24 October 2012, a Paris appeals court upheld the October 2010 sentence to three years in prison with another two suspended, and ordered Kerviel to reimburse EUR 4.9 billion to Société Générale for its loss—even though his largest bonus was well short of that. In March 2014, a French high court upheld Kerviel's prison sentence but ruled he would not

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[52] When asked for an explanation, Kerviel replied, "This materialized the give up of puts made late; I owe money to the counter-party. We'll re-book it a.s.a.p." According to SocGen's internal report, the risk-control officer later admitted that he did not understand this explanation. On January 9th, Kerviel annulled the contracts and was told that the problem had been resolved. The Omen

[53] A martingale is any of a class of betting strategies that originated from and were popular in 18th century France. The simplest of these strategies was designed for a game in which the gambler wins the stake if a coin comes up heads and loses it if the coin comes up tails. The strategy had the gambler double the bet after every loss, so that the first win would recover all previous losses plus win a profit equal to the original stake. The martingale strategy has been applied to roulette as well, as the probability of hitting either red or black is close to 50%. Since a gambler with infinite wealth will, almost surely, eventually flip heads, the martingale betting strategy was seen as a sure thing by those who advocated it. Nigel E. Turner, Doubling vs. Constant Bets as Strategies for Gambling, 14 J. GAMBLING STUD., 413, 414 (1998).

[54] More generally, in probability theory, a martingale is a sequence of random variables (i.e., a stochastic process) for which, at a particular time, the conditional expectation of the next value in the sequence, given all prior values, is equal to the present value. Yuan Shih Chow & Henry Teicher 239 Probability Theory: Independence, Interchangeability, Martingales (Stephen Feinberg et al. eds., 3rd ed. 1997).

have to repay EUR 4.9 billion.[55]

H. Sick Lesson from Nick Leeson

Nick Leeson, another trader, caused United Kingdom's oldest merchant bank, Barings, and one of the oldest banks in the world to go bankrupt[56], [57],[58]. On February 26, 1995, when Barings bank declared bankruptcy, it came as a big surprise and shock to everyone and especially to the financial industry. Nick Leeson, one of the bank's traders in Singapore had lost $1.4 billion on derivatives trading while the bank's reported capital was only about $600 million. The loss came principally from a long position in the Nikkei 225 futures of notional value around $7 billion on the Osaka and Singapore Exchanges.[59] What Nick Leeson's employers believed was that he was arbitraging the Nikkei 225 futures contracts on two different exchanges, the Singapore International Monetary Exchange (SIMEX) and the Osaka Stock Exchange (OSE), by buying the same futures at a low price in one exchange and selling simultaneously at a higher price on the other exchange.[60] Such a trading strategy has little to no risk exposure as the long position offsets the short position and hence from the official view point of Barings London, Nick Leeson was presumably fully hedged.

A key similarity with Kerviel's case was that due to the rapid expansion of Barings settlements, Nick quickly found himself in charge of both the front and back office. He was responsible for trading on the futures market and he was also in charge of booking and reporting the various trades. This meant that Nick Leeson would be the only one to check and to know if the records matched the actual trades. It is conventional practice that a different person is meant to be doing the back-office accounting, to detect any misconduct in the deals. However, this was not the case at Barings, which meant that Nick Leeson had the power to cover his tracks in case there were

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[55] In answer to the rumors that Kerviel had fled Paris following the discovery of the unauthorized trading, on 24 January 2008
Kerviel's lawyer denied that he attempted to disappear and said he remained in Paris to face the accusations. Also on 24 January 2008, Société Générale filed a lawsuit against "a 31-year-old person" for creating fraudulent documents, using forged documents and making attacks on an automated system, according to Clarisse Grillon, a spokeswoman for the Nanterre prosecutor. Gilligan, George & Jérôme Kerviel. The 'Rogue Trader' of Société Générale: Bad Luck, Bad Apple, Bad Tree or Bad Orchard? 32, 12 THE COMPANY LAWYER, 355, 355.

[56] Barings Bank was a British merchant bank based in London, and the world's second oldest merchant bank (after Berenberg Bank). Ian Greener, *Nick Leeson and the Collapse of Barings Bank: Socio-Technical Networks and the 'Rogue Trader'*, 13 ORGANIZATION 421, 425 (2006).

[57] Nicholas William "Nick" Leeson (born 25 February 1967) is a former English derivatives broker famous for bringing down Barings Bank, the United Kingdom's oldest merchant bank, into bankruptcy. Andrew D. Brown, *Making sense of the collapse of Barings Bank*, 58 HUMAN RELATIONS 1579, 1579 (2005).

[58] Rogue Trader is a 1999 British biographical drama film written and directed by James Dearden and starring Ewan McGregor and Anna Friel. The film centers in the life of former derivatives broker Nick Leeson and the 1995 collapse of Barings Bank. It was based on Leeson's 1996 book Rogue Trader: How I Brought Down Barings Bank and Shook the Financial World. Rogue Trader (Granada Film Productions and Newmarket Capital Group 1999).

[59] The Nikkei 225, more commonly called the Nikkei, the Nikkei index, or the Nikkei Stock Average, is a stock market index for the Tokyo Stock Exchange (TSE). Oliver Dale, *What is the Nikkei 225? Complete Begginers Guide*, MoneyCheck, (March, 15, 2019). https://moneycheck.com/what-is-the-nikkei-225/.

[60] In economics and finance, arbitrage is the practice of taking advantage of a price difference between two or more markets: striking a combination of matching deals that capitalize upon the imbalance, the profit being the difference between the market prices at which the unit is traded. James Chen, *Arbitrage*, Investopedia, (Feb. 1,2020), https://www.investopedia.com/terms/a/arbitrage.asp.

substantial losses.

Barings London thought that Leeson's long futures position on the OSE, which was publicly known since the exchange reports such positions each week, was matched by a short position of the same notional value on the SIMEX. This implied being short twice as many contracts since a SIMEX contracts has a notional value of half as that of one OSE contracts. Nick Leeson was in fact long the same amount on the SIMEX exchange and this was completely contrary to what the senior managers at Barings were thinking. Nick Leeson had managed to hide his real position in a secret account, which was known as an error account and had the famous number of 88888. On January 17, 1995, the Kobe earthquake sent the Asian financial markets, and with that Leeson's investments, into a tailspin. As the value of the futures contracts started falling, the exchanges started issuing massive margin calls on the long positions. Despite urgent transfer of funds from Barings Tokyo and London to Barings Singapore in January and February to cover the margin calls on SIMEX, the continued decline in the value of the positions and the extent of the margin calls made Barings bankrupt.

V. Rogue Trading Guide for Dummies

Let us imagine that we are in scenario where we are on the trading desk of a large financial firm, struggling to make profits by finding good trading strategies. If it seems like all else has failed, we have nothing to worry since we have the following guide to become a rogue trader and bring in lots of cash. Surely, this guide will also be useful to train good auditors who can watch out for the below signs.

- Covering up is crucial. This requirement is the most important of all the guidelines since if we are unable to cover our tracks thoroughly, whatever will do will be eventually found out. As discussed earlier, an understanding of how the middle office works is extremely valuable. In particular, knowing how trades are recorded, how they can be amended or moved to different accounts and canceled is useful. Given the number of transactions that a decent sized bank will see on a daily basis, there will be error accounts where trades that cannot be reconciled will be moved till they can be settled or sorted out. It is important to know who is taking care of the error accounts and if possible learn how to designate certain accounts as error accounts or create new error accounts for our own use. The good news is that there will be a lot of electronic information, noise and footprints. Initially, as we start our rogue journey, we can hide things without too much worries for a while and any trail we leave will be lost in too much information. But given the amount of electronic records, it is hard to wipe all traces of our actions and to remain unnoticed for a long time. It is important to keep moving our trades and records so that auditors will go around in circles. Mastery of this element will ensure survival for a long time and will make the difference between a great rogue and a decent one. Clearly, the longer we can cover our tracks the better, or at the very least, we need to remain clear and eliminate all our trails until we can find alternate employment or leave the country with enough money to find a paradise where there are no extradition treaties with our home country. If you have not done your time in the middle office, there are ways in which you can make up for it. Ask someone in the middle office to explain to you how things work, dangle the "soon you can be a trader" carrot in front of him. Remember someone in the middle office is stuck in a tedious job with long hours and would welcome the opportunity to be a part of the front office glamour.
- Fictitious trades will keep us within trading limits and far away from the risk managers. All

the trades we execute will show up in risk reports and financial firms are keen to ensure that most positions are hedged. What this also means is that profits from one trade will be balanced by the profits from other trades. If we venture down the rogue track, we do not want to bother with trades that make pennies. We are after the real money. This means taking directional bets and not hedging all our trades. So, we need to book fake trades that hedge the risk from some of our real trades. Many times, it is also useful to book trades with different prices but with the same quantity. This can show up as a profit or a loss and can reduce the risk we are holding. While losses will bring tons of attention, profits can cause lots of surveillance as well.

- Create a "Technical/Unknown" counterparty. All trades we do need someone on the other side who takes the opposing position. If we are booking fictitious trades, we need to assign some counterparty for those. These days, there is increased due diligence regarding counterparties in all financial institutions since there are many concerns about money laundering and funding for terrorist organizations and arms dealers. Since the due diligence can take many days, book new counterparties but make sure before they go into due diligence you change them. Kerviel was undone by this particular facet of rogue trading. It would be beneficial to have friends at other financial institutions with whom you trade sometimes so if they get questioned, they will say you have done trades with them before. Why stop there, see if you can bring them into the action. What one rogue can do, two can do better and a dozen can excel at misleading anyone investigating the matter. Create a network early on an and unknown counterparties while essential for loners, known friends who are rogues working as a team means greater chances of evasion. This of course means ensuring that none of them turns on you. Everyone needs to be equally involved.
- All models are wrong, but some are useful. In our case, it does not matter if the model is right or wrong. We will leave that debate for the quants, mathematicians and philosophers. For our purposes, the more complicated the model the more useful it will be. Every day we need to mark the positions in our trading book with the latest price point for the corresponding securities. This is known as marking the book. We can mark the book using market prices for instruments that are regularly traded. For illiquid instruments, we need to use a model price. But, the main thing we are trying to do is that we are trying to mark using whatever source so that the risk managers will believe the price is valid. We need to understand that this is the essential goal of marking the books. If the models are complex, there is less understanding and more leeway in terms of which model parameters we can tweak and hence the price we can use. When questioned about this, we can say that we are correcting modeling bias or we are making a provision for model errors.
- Unlocked computers of other traders or other personnel on the trading floor are like gold mines. But if we need to educate someone on some of the potential uses of unlocked computers towards rogue trader status, perhaps it is time to rethink if rogue trading is meant for that someone. Suffice is to say, unlocked computers can be used for to create lots of mischief and mayhem such as booking trades from different user accounts, and sending emails to controllers or senior managers to mislead or confuse them. If you find unlocked computers of senior managers and you play your cards right, it might even be possible for you to take the throne for yourself.
- Forge emails to clear up any inquiries from controllers or better still provide clarifications using forged emails before any questions arise related to fictitious trades or counterparties. Forging an email does not need a certificate in computer engineering. All that is necessary is

the header from one email copied onto another one so that wrong information can be made to seem like a legitimate email forward or reply. For the more sophisticated rogue, figuring out more technical details about how email headers are created and the protocols used can be priceless to evade discovery.

- For the serious rogue trader, vacations are an annoying distraction. Not to mention there could be unwanted and unwelcome visitors that will probe and get their dirty paws all over your trades. Find ways in which you can postpone vacations till your job is done. Making up sob stories about dead family members that haunt your memories when you are away from work. And when you run out of close family members, remember the dead aunt that raised you and made you the person you are up. Send mild clues that you might be a jumper.[61] Such passive threats that you might one day succumb to the pressures of trading and all the stress created by wrong suspicions will unnerve any trading manager and he is likely to cover for you with controllers. No one wants a dead subordinate and no one wants to spend months answering questions about how they might have caused someone in their team to commit suicide and the cruel and terrifying methods they used to improve employee productivity.
- Ernst and Young have re-branded themselves as EY, perhaps because it was becoming well-known that they were too Earnest and certainly not Young.[62] If you have some influence in who gets hired to do your external audit, make sure it is EY. Even if you have no direct powers in deciding who your external auditor will be, sing praises about EY and the wonderful work ethic they follow. You might just be pleasantly surprised that EY will be the one to check if you are cooking your books. Chances are they won't find a thing wrong with your trading books. Do not worry, they are on your side because you are paying them. This issue of potential conflicts of interest between a client and its auditor is a topic that has spawned many papers and will be material for many more papers and books.
- Bury compliance, risk managers, controllers and auditors in emails and ask them for information that you don't really need but is hard for them to obtain. Say that you need all this information to ensure you stay within risk limits and to understand the full extent of scenarios that can potentially cause losses. If you have assigned them a lot of hard tasks and follow up regularly asking for updates and more information, they will be less likely to show up to ask you something since they will worried about providing you updates. Remind them who is the rainmaker and emphasize that their inputs are crucial to ensure that the trading profits are sustained. In addition to asking for information send them updates, alerts and

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[61] The phone calls from the bank persisted, and Kerviel replied to one, in a text message, "I don't know if I'm going to come back or throw myself under a train." How serious was he? When he sent the message, he was just outside the bank headquarters, far from a railroad track. But bank officials were alarmed that he might be suicidal, and not without reason: the previous summer, a SocGen trader had jumped off a bridge, reportedly after unauthorized trading losses were uncovered. So, when Kerviel called to say that he was in the lobby, the bank dispatched a physician to evaluate his mental state. After concluding that he was stable, the doctor took him to a conference center on the sixth floor. The Omen.

[62] Ernst & Young (doing business as EY) is a multinational professional services firm headquartered in London, England, United Kingdom. Along with Deloitte, KPMG and PricewaterhouseCoopers (PwC), EY is considered one of the Big Four accounting firms. The firm dates back to 1849 with the founding of Harding & Pullein in England. The current firm was formed by a merger of Ernst & Whinney and Arthur Young & Co. in 1989. It was known as Ernst & Young until 2013 when it underwent a re-branding to EY. Jeff Swystun, Ewww & Why?: The Ernst & Young Rebranding, Business 2 Community, (July 21, 2013). https://www.business2community.com/branding/ewww-why-the-ernst-young-rebranding-0559411#:~:text=The%20Ernst%20&%20Young%20Rebranding%20Jeff%20Swystun%20July,provided%20some%20really%20weak%20rationale%20for%20the%20change.

reminders about many aspects of your trading desk. Almost everyone in big business these days and especially in big banks is struggling with too much information, add more noise to the already noisy and chaotic environment. It is also helpful if you can benefit from the efforts of the many academics that are creating lots of papers. Universities that fund all this research are secretly concerned that not much of it is being used and that there is not enough of an audience for all this work. Get to know some academics and send some of their long and technical articles to the auditors to read, you will win some friends that will be pleased with material they can to add to their resume about how applied their research is and friends in such circles will lend you more credibility. Suggest to the controllers that these research papers are crucial to understanding the business, the products, their risk management and the regulatory implications. When you see them, quiz them about the material you have sent them. The papers will not only create an amazing impression of you as someone who has a strong foundation and has a sound knowledge of the products, but most importantly if someone owes you many answers, they are unlikely to come up with questions for you.

- Despite all these precautions, there will always be a controller or two brave enough to venture close to you. Tell those controllers, who are hard to shake off and keep showing up, that you are working with someone else in their group and prefer it that way because the other person understands these things better and is a team player who is easier to work with. No one wants to be branded as abrasive and hard to work with, especially these days when all the business world is prioritizing teamwork and communication. Promotions, bonuses, entire careers, and sometimes even your very job, hinges onbeing seen as someone who can take one for the team. In spite of all that you have said and done, if someone persists in pestering you, tell them that they do not have a clue how these complex positions work and you do not have the time to give them a risk management certification or a beginner financial products course.
- Hire a few disabled assistants who can keep their silence and will not hear or realize most things happening around them. This might even get you some badges for helping the disabled. Every company wants to do more for causes that help the less fortunate and employees that show that they care by willing to work with such people will be prized. Even if they are not really disabled, but if they play the part of the assistant that is mute and hearing impaired it can be a valuable asset. If things go really south, you also have some suckers to blame for the mistakes for which you are being held responsible. To put it more subtly, it is priceless having an internal accomplice who could be the clueless criminal.

VI. MATHEMATICALLY SOPHISTICATED MODELS OR MERELY SUPERIOR MORALS?

With the above background, let us now attempt to answer the most important question related to this case by considering a few related questions. We try to weave in varying points of view since a difference of opinion is what makes horses race, markets trade, and life interesting.

A. What would you do if you find yourself in situations similar to those faced by Jerome Kerviel?

i. If you believe that no one is watching, would you build up positions outside your authorized limits?

We need to understand the environment in which traders operate. They are under tremendous pressure to generate profits. The lives of traders can be epitomized by the adrenaline-charged behavior of race car drivers[63] and fighter pilots in the early era of jet engines.[64]

Many a time, corporate success in most spheres of the business realm simply boils comes down to kicking the asses you can and kissing the asses you have to. Trading is freedom from having to follow this unwritten rule of the modern business conglomerate. A trader's profits provide a more objective view of his efforts and contribution. In addition to the thrill of the trade, this promise of independence from kowtowing to others, partly explains the allure of making a living as a trader. A good sequel to the book "Men are from Mars and Women are from Venus" from celebrated author John Gray would be, "Sales/Trades people are from Saturn and Product Managers are from Pluto." What this highlights is that depending on what identity we assume, our views change and conflicts are natural when there are different perspectives.

Any trader, good or bad in terms of P&L, will lose money at some point. This can be summarized in terms of what life throws at all of us. There are days we get paid; there are days we get laid; and there are days we get laid off . . . that is life. The financial speculators that adorn magazine front pages have obtained winning gambles before losers. George Soros has suffered from many Gorge Soros (bad bets),[65] but he is remembered most vividly as the man who broke the Bank of England. This suggests that lady luck might not have smiled favorably at the right time upon many a rogue.

Surely, there are many differences in terms of the authorized trades that speculators on the buy side and traders, such as Kerviel, on the sell side are permitted.[66],[67]. But, their fundamental

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[63] Rush is a 2013 biographical sports film centered on the Hunt–Lauda rivalry between two Formula One drivers, the British James Hunt and the Austrian Niki Lauda during the 1976 Formula 1 motor-racing season. Rush (Exclusive Media Group 2013).

[64] The Right Stuff is a 1979 book by Tom Wolfe about the pilots engaged in U.S. postwar research with experimental rocket-powered, high-speed aircraft as well as documenting the stories of the first Project Mercury astronauts selected for the NASA space program. The Right Stuff is based on extensive research by Wolfe, who interviewed test pilots, the astronauts and their wives, among others. Wolfe wrote that the book was inspired by the desire to find out why the astronauts accepted the danger of space flight. He recounts the enormous risks that test pilots were already taking, and the mental and physical characteristics—the titular "right stuff"—required for and reinforced by their jobs. Tom Wolfe, The Right Stuff (Farrar, Straus and Giroux 1979).

[65] George Soros, (born Schwartz György; August 12, 1930) is a Hungarian-American investor and philanthropist. Soros is known as "The Man Who Broke the Bank of England" because of his short sale of US$10 billion worth of pounds sterling, which made him a profit of $1 billion during the 1992 Black Wednesday UK currency crisis on 16 September, 1992. Andrew Beattie, How Did George Soros Break the Bank of England?, Investopedia, (September 18, 2020) https://www.investopedia.com/ask/answers/08/george-soros-bank-of-england.asp. After gaining more than 100 percent in 1980, the Quantum fund was down 23 percent the following year, its first ever loss, and Soros was hit by a wave of redemptions that halved his capital from $400 million to $200 million. The Quantum Funds lost $800 million a short while before the October, 1987, stock market crash, betting the wrong way on Japanese stocks (Mallaby 2010). Quantum Funds suffered a $600 million loss on Feb. 14, 1994 the first full day of trading after trade talks between the United States and Japan collapsed. A $600 Million Miscalculation, https://www.nytimes.com/1994/02/26/business/a-600-million-miscalculation.html.

[66] Buy-side is a term used in investment firms to refer to advising institutions concerned with buying investment services. Private equity funds, mutual funds, life insurance companies, unit trusts, hedge funds, and pension funds are the most common types of buy side entities. In sales and trading, the split between the buy side and sell side should be viewed from the perspective of securities exchange services. The investing community must use those services to trade securities. The "Buy Side" are the buyers of those services; the "Sell Side", also called "prime brokers", are the sellers of those services. Julie Young, Buy-Side, INVESTOPEDIA (Nov. 28, 2020), https://www.investopedia.com/terms/b/buyside.asp.

[67] Sell side is a term used in the financial services industry. The three main markets for this selling are the stock, bond, and foreign exchange market. It is a general term that indicates a firm that sells investment services to asset

goal of pursuit of profits by combating uncertainty in the financial markets, requires that they have to possess a certain amount of aggressiveness to put on seemingly risky trades. That very aggression can sometimes take one too far across the line.

B. Would you believe that because no one is telling you anything, someone is watching and implicitly permitting?

There are cameras everywhere and this means that we are not just being watched but whatever else we do is also being monitored in various ways. Phone conversations are tapped; emails are read and even our internal organs are scanned, many times without our awareness or consent. The day when someone would be reading even our very thoughts and dreams does not seem far off, if it is not already happening. Given this state of affairs, it is proper to live under the assumption that everything we do can be known by everyone. If that is the case, we should only do something that we are okay to admit to everyone.

When we look back many years later at present day human resource practices such as: productivity incentives, time logs, email and chat filters, phone conversation recording, management notifications, performance reviews, evaluations and ratings, these methods of today can be compared and might one day seem like the whipping of slaves in ancient times.

While Point (1a) conveys the message that desperation combined with frustration could lead to unethical behavior, there could be many benefits to having formal corporate ethics programs. It also seems sensible that organizational structures try and weave the ethical dimension into their process, especially in terms of education and development. This can be construed as an open invitation to ramp up our efforts at education aimed at better values from all corners of life since if all of us could clear our doubts ourselves, we would not need universities and Nobel prizes, right?

C. You have received a bonus of less than EUR one million, how would you pay back a loss of around EUR five billion?

The one way in which we can come up with EUR five billion starting with a EUR one million is by going about putting on another set of rogue traders or we would need to create another scam or a Ponzi scheme. The courtroom is implicitly suggesting that the accused must perpetrate another crime. If not, the courtroom must be filled with jokers.

This brings up the topic of why people crave astronomical salaries. We could state that we live in a world that requires around 2000 IQ points to consistently make correct decisions.[68] But, the problem is that the best of us has around 200 IQ points. No matter how intelligent one is, the

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management firms, typically referred to as the buy side, or corporate entities. One important note, the sell side and the buy side work hand in hand and each side could not exist without the other. These services encompass a broad range of activities, including broking/dealing, investment banking, advisory functions, and investment research. Adam Barone, *Sell-Side*, INVESTOPEDIA (Jul. 7, 2020), https://www.investopedia.com/terms/s/sellside.asp.

[68] Ismail (2014) mentions the following quote from Taleb, "Knowledge gives you a little bit of an edge, but tinkering (trial and error) is the equivalent of 1,000 IQ points. It is tinkering that allowed the industrial revolution". This means that to match trial and error we need 1000 IQ points. But trial and error could still give the wrong outcomes. We can try and fail many times and still be wrong. So in our paper we make the assumption that we need 2000 IQ points to consistently make the right decisions. The subtle point that arises from this discussion is that: we need 2000 IQ points to be right all the time, but the problem is that the best of us has somewhere around 200 IQ points. Nassim Taleb and Daniel Kahneman discuss Trial and Error / IQ Points, among other things, at the New York Public Library on Feb 5, 2013.

intelligence of the world that we confront around us is many times more. Hence many human actions might seem that they are motivated by stupidity, envy and flashes of brilliance; though the common element we can trace in all these efforts is that they can be viewed as the pursuit of happiness, well-being and a perpetual desire to have more or to breach any boundaries that we encounter. There is no everlasting success. This does not make one short sighted. We do need to have long-term goals. But a goal once reached becomes another milestone and it must point us in the direction of what to do next. This explains our longing to have large bonuses, promotions and the next level of advancement.

If we did not have this eternal craving for more and if we had started living within our means, we would still be living in caves—which may or may not be a bad thing. The question of what is absolutely imperative to lead a good life is a constantly changing one, as luxuries end up becoming necessities. To determine what is intrinsic to well-being, requires acknowledging its subjectivity. While well-being has dependencies on the external environment, the most crucial elements for contentment are internal. Poverty is a state of mind and happiness must come from our hearts. If people start offering more than what is asked, there will be no need for businesses and profit maximization. A small price to pay for perhaps peace on Earth. The parallels between profit maximization and piracy are worth pondering about. If everyone pursues profit maximization, we will only end up as a society of rich pirates. It seems that all the tools of modern business such as economics, finance, marketing, law, accounting, management, organization behavior and such other disciplines are sciences created to give legitimacy to profit maximization or a less crude form of piracy.

D. What would be your verdict regarding the following vital and broader questions which necessitates that we ponder them more carefully?

We need to remember this before passing our judgment: there are no good or bad people, just seemingly tough situations and mediocre role models. Most would agree that there is no bad child; but if the good child might later come up with questionable conduct, there must have been bad examples that the good child might have been exposed to. There is strong evidence suggesting that high profile business persons serving as ethical role models can make a difference in developing the proper behavior within an organization, while the reverse also holds true when unethical charismatic leaders take charge.

i. Was SG trying to pick a scapegoat?

Scandals and secrets are like mice, where there is one there are usually many more. But a scapegoat, or the fall guy, is generally a solitary creature. Once someone has been picked to take the blame, the focus shifts on putting the matter to the grave and moving further away from it. Selecting a whipping boy, which has always been a clever ruse given our affinity to history and how less of it we generally incorporate into our lives, will take care of the rest and the topic gets forgotten. Kerviel was the undisputed King of Liars Poker since his deception went unnoticed.[69]

[69] A game often associated with Wall Street traders who use statistical reasoning and behavioral psychology tactics to gamble. Liar's Poker is fairly similar to the card game "cheat." Players hold random dollar bills with close attention to their own bill serial number and without letting any other players see it. Each player has to guess how often a particular digit appears among all the bills held by all the players. Each guess or bid must be higher in quantity, or equal in quantity but higher in value, than the previous bid. The round ends when all the other players

Despite many speculations regarding whether he was a sole operator and who else on the desk might have been aiding him, he was the only one convicted. Whenever someone stands accused of any criminal charges, a well-known way to reduce your sentence is to provide information about others who might be violating any regulations. The norm in rogue trading scandals seem to that very few others are shown to be deeply involved in the wrong doings. Clearly, in this case, Kerviel was the master mind behind what happened.

ii. Is this a question of too big to be good or excellent? Are small partnerships better than large public companies?

When the question of size comes up, we need to acknowledge that: what one person can do, two or more people can do better if the social issues in this situation are handled appropriately. This implies that bigger companies are better and brings to light many the social issues inherent in large firms. Tremendous amount of resources are expended in balancing the power and politics within large organization. Where there are people there will be politics.

The recent financial crisis raised the related question of too big to fail. It has been much talked about that the financial crisis was a credit problem. People need to get credit for what they do, but they should only get as much credit as they deserve. Because, if too many people that do not deserve credit get too much credit, people that really deserve credit will not get any and we will have a crisis on our hands. So, this financial crisis, is no longer just a credit problem. It is about what is fair and it becomes an ethical issue. So, unless we tackle this real credit problem, there will always be issues when someone will get too much monetary or other forms of credit. We can extend this ethical and fairness credit issue and try and explain almost every crisis we have on planet Earth.

As financial firms have moved from being partnerships, where the net worth of the partners was directly tied to the risks the firms could take, to public companies, where much of the capital comes from shareholders, there have been lapses in oversight. When playing with other people's capital, especially when you benefit from the profits and you are not penalized by the losses, there is every incentive to take riskier bets. Hence, it is especially important that when the business risks can be extremely high such as in the trading of financial instruments, it is wiser to curtail the extent of investments and also hold people accountable for the losses.

E. Do the managers at SG and other large public financial services firms no longer have their skin in the game?

The previous Point makes it explicit that there has been a trend towards decreasing ownership and lack of accountability. But here we clarify many difference between management and leadership. Management is about making sure things are done. Leadership is about making sure the right things are done. Let us say there will be a team lunch meeting. The manager is the one

challenge a bid. The objective of the game is to bluff the opponents into believing that your bid does not exceed the combined sum of all of the serial numbers. For example, if the first player bids three 6s, he is predicting there are at least three 6s among all the players including himself (that is, he predicts that within all of the dollar serial numbers held by all players, there are at least three 6s). The next player can bid a higher number (or digit) at that level (or frequency) (three 7s), any number at a higher level (four 5s), or challenge the previous player's bid (this means the previous player's bluff is called). The game continues clockwise around the table until a particular bid is challenged by every other player. If the challenge is correct, and the total number of the digit on all the bills is lower than the bid, the bidder loses. If the challenge is incorrect, the bidder wins. Will Kenton, Lier's Poker, INVESTOPEDIA (Oct. 10, 2019), https://www.investopedia.com/terms/l/liars-poker.asp.

to call for the meeting, ensure that people show up and the relevant discussions happen. There is no real need for a leader here. The true leader in this scenario would arise only when there is no food on the lunch menu.

Let us illustrate further with the titles we have in the corporate world. We might report to Executive Directors (ED) or Managing Directors (MD), but we need to remember that who we ultimately report to is the Greatest Of Directors (GOD), our conscience. There is a method to (or a message in) this madness where we have people titled Managing Directors and Vice Presidents, but no Leading Directors and Wise Presidents. This is because leadership and wisdom can come from anyone.

It is widely expected that the corporate executive will be a philosopher king, a concept dating back to Plato, someone wise enough to know what is right, with the authority to enforce it and the self-control to not abuse his power. But, philosophers do not want to be kings and the ones that end up as kings are, let us just say, not philosophers. Smart men fulfill needs and wise men eliminate needs. Smart men solve problems and wise men eliminate problems or ensure that problems do not arise in the first place. Until philosophers kings rule, the best we can do is ensure that the power vested in anyone is not enormous.

F. Is right or wrong easier to determine than legal or illegal?

Right or wrong has been around for much longer than legal or illegal. It is generally true that our sense of ethics will change with cultures and with time; but the variation in right or wrong will be less so than the differences in legal intricacies. Also, the basic intuition to differentiate right from wrong is more abundant in most of us than the ability to call something legitimate or not. There are principles and then there are rules that dictate many aspects of our lives. The rules or the legality of situations are driven by the principles. The rules are tweaked to ensure that they adhere to certain principles. Hence, the rules can change more easily and generally do change more often than the principles. Living by the rules when the principles are forgotten is a pointless and pathetic existence, which can be the cause of many a caucus; whereas it might be more tolerable if rules are overlooked, when necessary, to uphold principles. Many enthusiastic students arrive at law school enamored about the law's capacity to further social justice. However, soon they are disillusioned once they start perceiving that lawyers wield law without regard for its impact on society.

This implies that lawyers are extremely intelligent people with perhaps a misguided or foolish sense of purpose, which at times makes them more dangerous to society when compared to foolish people with or without a sense of purpose. The discussion in Point (1c) suggests that everyone is an idiot, though here we make are making a relative comparison. This is simply because lawyers are more empowered with their education, their license to practice, their representation of the law and their intelligence. Lawyers are accused of living in their world of fancy frameworks and legal precedents. But then again, if you are not living in your own world, you are living in somebody else's world.

Ethics can be understood as doing the right thing so that it increases human well-being, which may be at odds to many conventional rules or guidelines. Ethical issues arise and are exacerbated when erroneous decisions are justified by subsequent atrocious actions. This can be understood as consciously performing wrongful deeds to defend the earlier blunder. This is mostly because the focus shifts to proving someone correct or wrong rather than on deciding what is correct or wrong. That is the emphasis rests on showing who is right rather than on discerning what is right. The solution to such issues is greater disclosure of information and repeated interactions among the participants. It is prudent to aim for complete transparency unless it is established that such a state can be harmful. Hence, we need to design social systems that minimize complexity and establish an ambience where repeated games can be played with public transparency, so that guileful practices are curtailed.

Art, science and love can transcend the boundaries of region, religion, race and language, but, so can hatred, violence and weapons. If we are to make the right choices, perhaps it is education which will lead to faster evolution and better ethics as discussed in Section 4.2. As we go about creating knowledge by trying to understand the world better and disseminating this knowledge, which we can term education, we might just end up understanding one another better, perhaps, becoming more tolerant in the process, an unintended yet very welcome consequence. This must make us wonder whether the true purpose of all knowledge, creation and education might be to make us more tolerant. We need everyone to be educated so they can make their choices independently or we can just educate a few people who can tell others what to do or decide for them. This suggests that universal education is one way to ensure that we do not put too much power in someone's hands.

G. What do we need more of: Mathematically Sophisticated Models or Merely Superior Morals?

Thankfully the models used in the financial industry are not as sophisticated as the models that come to the minds of most people when they hear the word model. Perhaps, the financial models are not even the models that most people wish to work with. Despite the relative simplicity of the models used in finance and admitting the fact that there is long way to go before models can determine morals, we need to question the over-dependence on very complex mathematical models for decision making in financial services.

As models get more complex the assumptions behind the models stand upon shakier ground. Assumption is the mother of all "duck-ups." Here we define a duck-up as a beautiful mistake that teaches us how to make something better. Models are filled with assumptions and morals are hindered by suspicions. Another fundamental objection to greater morals might stem from the very intrinsic selfish behavior of organisms to ensure survival of oneself. The one way around these obstacles is trial and error and trust, which happens with evolution and education.

Our present attempts at moral education will run into a wall unless we can address the issue of trust. There will always be distrust when we see ourselves as separate and distinct from the others around us. Education, which is empowerment, must start by imparting everyone a cosmic identity. What this means is that each person must view himself as an extension of the universe around him. As an example, if every human being were to view trees as an extension of their lungs or their breathing apparatus, no one would have to be drilled on the finer points of protecting trees. To illustrate this further, on the flip side, if someone is getting trained to become a nuclear scientist and associates themselves with a nation, a terrorist organization or with any limited group of people, they would have fewer qualms regarding the use of their training to possibly obliterate the group they deem themselves not to belong to.

Hence, if we associate ourselves with our nation or our religion or our business or our university, we will make decisions to benefit the restricted identity we have chosen and our ethics will be aligned towards that parochial goal. This means that we might be willing to compromise on our ideals to benefit what we consider to be who we are or what is closer to us and even possibly act to the detriment of or sacrifice what we deem to be further away from us. The way around this is a belief that we are deeply connected to everything around us, which will obliterate the artificial boundaries we have erected all around us. Our ever-present longing to have more taken to the extreme or asymptotically, can become a belief that everything in the universe is a part of us, or that we are a part of everything. Such an attitude can be inculcated by first transferring to everyone a limitless identity and then beginning the rest of their schooling or any form of formal or informal training that molds the person and develops their abilities. When this happens, we will trust others just as much or just as little as we would trust ourselves. Also, our well-being or the well-being of all of existence will be identical from our perspective, which is the key to superior morals. A research agenda with an objective of finding efficient techniques that can transcend bounded identities will prove to be highly fruitful.

As we wait for the perfect solution it is worth meditating upon what superior beings would do when faced with an intriguing situation such as the one we are in. Surely, it is sheer arrogance, possibly bordering stupidity, to think that we can change the world that has existed for a very long time in our blink of a lifetime. But we offer the following hope and solace. While it is a hard ask to change the world we are in, it might not be that cumbersome to create a new one. It is said that the universe is but the Brahma's (creator's) dream.

Research can help us understand this world and maybe decipher the key to unencumbered ethics. Sleep can help us create our own world, where we can lay down the ethical framework we deem perfect. We just need to be mindful that the rosiest and well intentioned dreams can have unintended consequences and turn to nightmares. When dreams become nightmares, perhaps due to bad ethics, it is time for a new universe. Suffice it to say, we might just as well conclude that the rogue must have been created long before he became a trader.

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VIII. SOME MORE SLEEPING AIDS (APPENDIX OF FIGURES)

Partial Chronological List of Spectacular Rogue Trading Scandals				
Year	**Name**	**Institution**	**Loss**	**Sanctions**
1994	Joseph Jett	Kidder, Peabody & Co	$74.6 million	Lifetime ban from securities trading
1995	Nick Leeson	Barings Bank	£827 million	Jail 6.5 years
1995	Toshihide Iguchi	Resona Holdings	$1.1 billion	Jail 4 years
1996	Peter Young	Deutsche Morgan Grenfell	$280 million	$3 million fine and damages
1996	Yasuo Hamanaka	Sumitomo Corporation	$2.6 billion	Jail 8 years
2002	John Rusnak	Allied Irish Banks	$691 million	Jail 7.5 years
2004	Luke Duffy	National Australia Bank	AUD$360 million	Jail 10 months
2005	Chen Jiulin	China Aviation Oil	$550 million	Jail 51 months
2007	Matthew Taylor	Goldman Sachs	$118 million	Jail 9 months
2008	Jerome Jerviel	Societe Generale	$6.9 billion	Jail 5 years with partial suspension
2011	Kweku Adoboli	UBS	$2.3 billion	Jail 7 years
Partial Chronological List of Prominent Losses (P&L Hits) in the Financial Markets				
1998	Scholes, Merton	Long Term Capital Management	$4 billion	None
2006	Brian Hunter	Amaranth Advisors	$6.6 billion	None
Largest Ponzi Scheme in World History				
2008	Bernard Madoff	Bernard L. Madoff Investment Securities	$64.8 billion	Jail 150 years

Figure 1: List of Rouge Trading Scandals & Financial Market Losses

Selected Financial Data for SocGen, 2003-07					
GROUP CONSOLIDATED FIGURES	**2007**	**2006**	**2005**	**2004**	**2003**
Results (in millions of euros)					
Net banking income	21,923	22,417	19,166	16,390	15,637
Operating income(excluding loss From Kerviel's trading)	6,713	8,035	6,562	4,760	3,843
Operating income(including loss From Kerviel's trading)	1,802				
Net income before minority interest	1,604	5,785	4,916	3,623	2,755
Net income before minority interest	947	5,221	4,402	3,281	2,492
French Retail Banking	1,375	1,344	1,059	942	878
Financial Services	686	471	386	258	214
Global Investment Management & Services	600	52	1,453	376	285
Corporate and Investement Banking	652	577	460	385	290
Corporate Centre and other	(2,221)	2,340	1,841	1,453	1,052
	(145)	(32)	203	(133)	(227)
Activity (in billions of euros)					
Total assets and liabilities	1,072	957	835	601	539
Customer loans	305	264	227	208	178
Customer deposits	270	267	223	213	160
Assets under management	435	422	386	315	284
Equity (in billions of euros)	27	29	23	18	17
Group shareholders' equity	31	33	27	21	21
Total consolidated equity					
Average headcount (thousands)	130	115	100	93	90

Source: *Societe Generale Group. (n.d.). Document de Référence 2008. Document de Référence 2008. Retrieved from https://www.societegenerale.com/sites/default/files/03 Mars 2008 Document de référence 2008.pdf*

Figure 2: Societe Generale Selected Financial Statements from 2003 to 2007

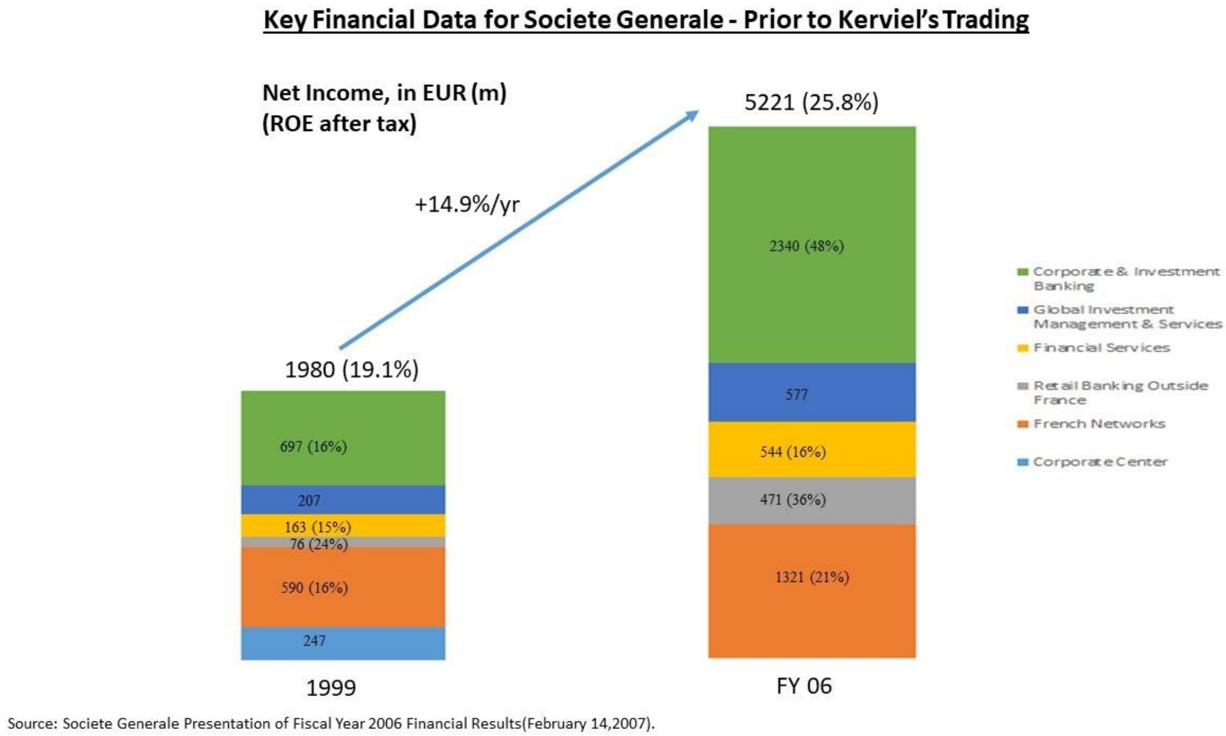


Figure 3: Societe Generale Selected Financial Statements, Income Comparison of 1999 with 2006

Length of Wikipedia Page for Celebrities in Finance, Science and Arts

Field		Name	No. of Page	No. of Word
Finance	1	Warren Buffett	148	25402
	2	Robert Merton	84	15662
	3	Jérôme Kerviel	49	8287
	4	George Soros	156	29250
Science	5	Nikola Tesla	186	34370
	6	Isaac Newton	181	43188
	7	Albert Einstein	207	43930
	8	Marie Curie	135	28339
Arts	9	Ludwig Van Beethoven	116	23594
	10	Leonardo Da Vinci	160	40876
	11	Elvis Persley	237	63822
	12	Michael Jackson	226	59436

Figure 4: Celebrities in Finance, Science and Arts

(a) One

(b) Two

Figure 5: Business Entities and Matryoshka Dolls

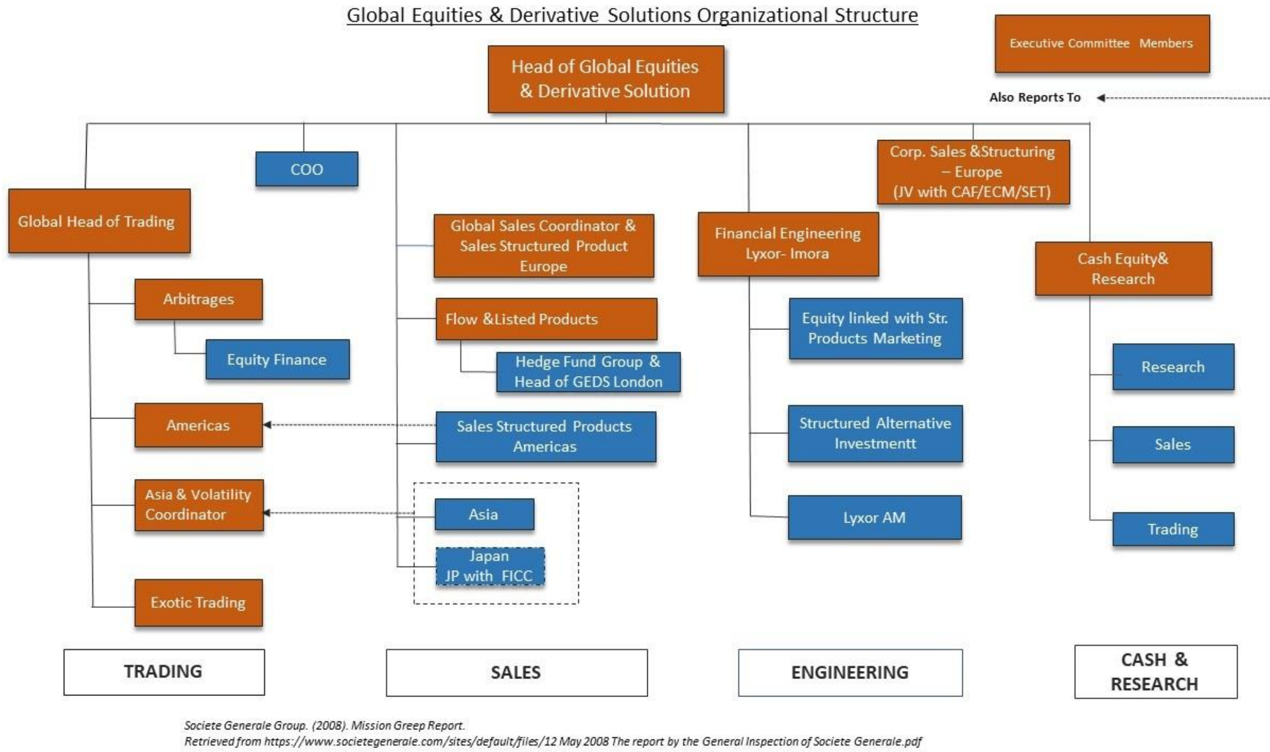


Figure 6: Societe Generale Global Equities & Derivatives Solutions Organizational Structure

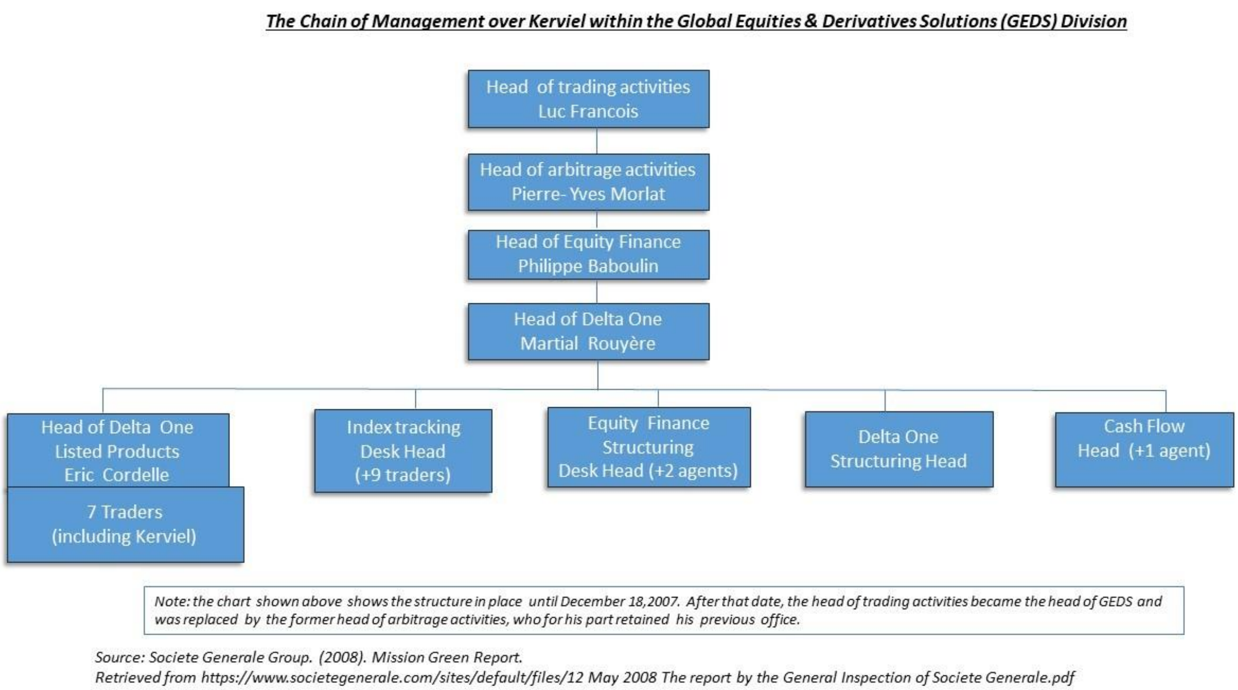


Figure 7: Societe Generale Trading Organizational Structure Around Jerome Kerviel

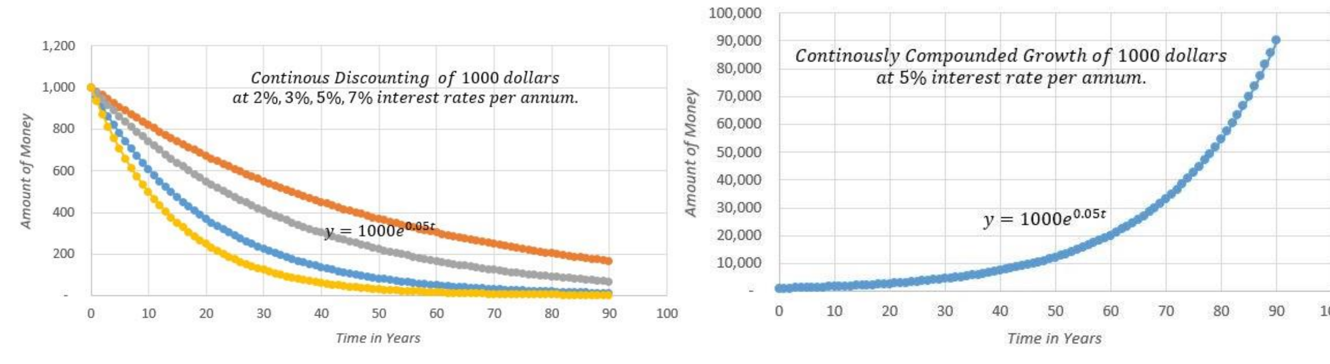


Figure 8: Time Value of Money: Discounting and Compounding

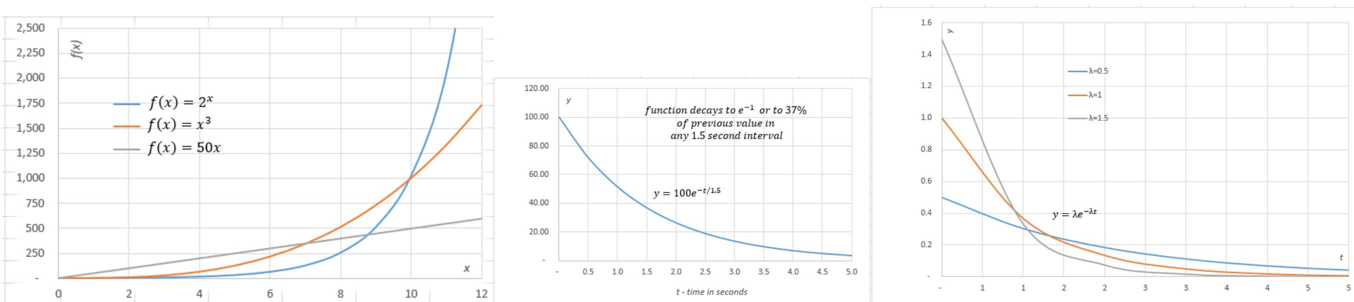


Figure 9: Exponential Growth and Decay

Turbo Warrants

- Principle: SG sells warrants with knock-out options to its clients (principally as call options, *i.e.* purchase / call option offered the client) and hedges by buying the underlying asset in question.

- Strategy: "long turbos" are purchase options ("calls down and out") that can be deactivated if the spot price falls below the barrier, whereas "short turbos" are options to sell ("puts up and out") that can be deactivated if the spot price rises above the barrier. The purchase of the underlying assets is carried out by SG, which allows the client to benefit from a leverage effect (as the client does not purchase the asset).

- Underlying assets: shares (single stock), baskets of shares (more unusual), ETFs (sector and/or geographical exposure), indices, bunds (German state bonds), currency.

- Maturities: no maturity date ("open end turbo"), maturity fixed at the date of issuance of the warrant ("closed end turbo"), one-day maturity.

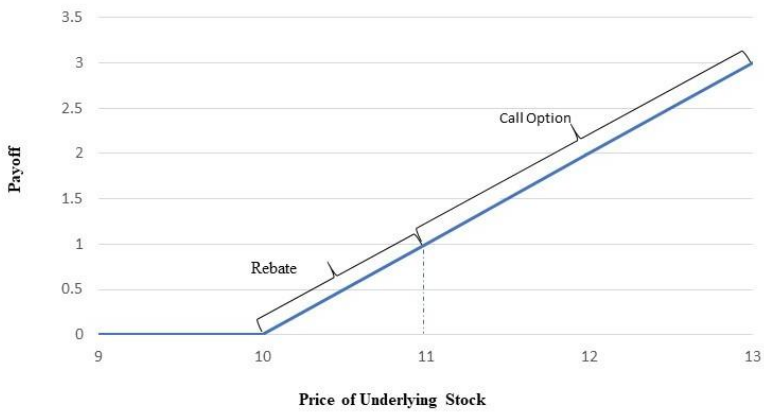
- In the event of knock-out, SG resells the hedge and give the client the difference between the strike and the corresponding level.

Source: Societe Generale Group. (2008). Mission Green Report.
Retrieved from https://www.societegenerale.com/sites/default/files/12 May 2008 The report by the General Inspection of Societe Generale.pdf

Figure 10: Fundamentals of Turbo Warrants

Arbitrage on competitor's turbo warrants

In the context of market's growing volatility, the DPL desk identified competitor's turbo products whose price was no longer adapted to market conditions. Arbitration consists of the purchase on day D of competitor's call turbos and their hedging by the sale of future contracts. If the market opens at D+1 by showing a fall which deactivates the product, SG registers a profit (the trader can in fact re-purchase his hedge with a profit). Example of payoffs associated with a "long turbo" with rebate in the event of knock-out (strike price is set at 10 and knock-out barrier at 11):



Source: "Mission Green Report." Mission Green . Societe Generale Group, May 2008.
Retrieved from https://www.societegenerale.com/sites/default/files/12 May 2008 The report by the General Inspection of Societe Generale.pdf

Figure 11: Arbitrage on Turbo Warrants

2006 and 2007 Earnings from Delta One Trading

Earnings from proprietary trading

EUR millions	**2006**	**2007**
Jérôme Kerviel's earnings	0	25
DELTA ONE earnings	24	114
Jérôme Kerviel's weighting	**0%**	**22%**

Earnings from client trading

EUR millions	**2006**	**2007**
Jérôme Kerviel's earnings	7	18
DELTA ONE earnings	20	45
Jérôme Kerviel's weighting	**35%**	**40%**

Total earnings from trading (i.e minus sales credits)

EUR millions	**2006**	**2007**
Jérôme Kerviel's earnings	7	43
DELTA ONE earnings	44	159
Jérôme Kerviel's weighting	**16%**	**27%**

Source : Societe Generale Group . (2008). Mission Green Report. Mission Green Report.

Retrieved from https://www.societegenerale.com/sites/default/files/12 May 2008 The report by the General Inspection of Societe Generale.pdf

Figure 12: Earnings from Delta one Trading

Proprietary trading earnings distribution of the 143 arbitrage traders of the equity & derivatives trading division for 2007

Based on this distribution, Jerome Kerviel with earnings of EUR 25 million generated from proprietary trading during 2007 was the 15th best trader within the division out of a total of 143 traders.

Earnings in EUR million	**<0**	**0-5**	**5-10**	**10-15**	**15-20**	**20-25**	**25-30**	**30-35**	**>35**	
Number of Traders	10	76	14	12	9	8	4	4	6	

Source : Societe Generale Group . (2008). Mission Green Report. Mission Green Report.

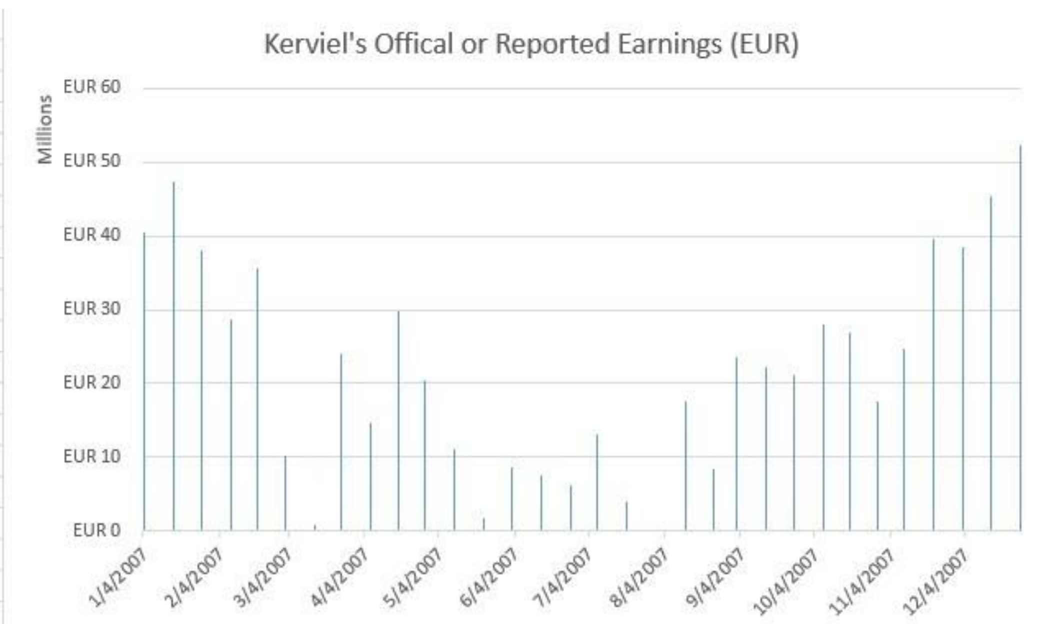
Retrieved from https://www.societegenerale.com/sites/default/files/12 May 2008 The report by the General Inspection of Societe Generale.pdf

Figure 13: Delta One Traders Profit Distribution

Source : Societe Generale Group . (2008). Mission Green Report. Mission Green Report.

Approximate construction using data retrieved from https://www.societegenerale.com/sites/default/files/12 May 2008 The report by the General Inspection of Societe Generale.pdf

Figure 14: Kerviel's Actual Earnings on Unauthorized Positions



Source : Societe Generale Group . (2008). Mission Green Report. Mission Green Report.

Approximate construction using data retrieved from https://www.societegenerale.com/sites/default/files/12 May 2008 The report by the General Inspection of Societe Generale.pdf

Figure 15: Kerviel's Reported or Official Earnings

Source : Societe Generale Group . (2008). Mission Green Report. Mission Green Report.

Approximate construction using data retrieved from https://www.societegenerale.com/sites/default/files/12 May 2008 The report by the General Inspection of Societe Generale.pdf

Figure 16: Kerviel's Actual versus Reported or Official Earnings

Source : Societe Generale Group . (2008). Mission Green Report. Mission Green Report.

Approximate construction using data retrieved from https://www.societegenerale.com/sites/default/files/12 May 2008 The report by the General Inspection of Societe Generale.pdf

Figure 17: Estimation of Earnings on Kerviel's Offsetting Index Trades

COMMENT

BLOCK-CHAIN REACTION: CORPORATE CONSIDERATIONS FOR COMPLIANCE WITH EXPORT CONTROLS AND REGULATIONS

TYLER GODBEHERE*

CONTENTS

I. INTRODUCTION

Assume that Pied Piper, a small startup technology company headquartered in Silicon Valley, hires a prominent Chinese engineer from Intel in 2018. This employee will work at the California office and assist Pied Piper in creating a new Internet that will revolutionize the technology industry. The company believes that the new engineer's expertise in semiconductor manufacturing equipment ("SME") will allow the team to finally complete this project. Once completed, Pied Piper plans to take the new Internet to the market where the product will compete with both U.S. and foreign competitors. This type of advanced technology is classified as "dual-use"[1] by the federal government and accordingly is subject to export controls and regulations ("Export Controls"). Since the

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[1] *See* 15 C.F.R. § 730.3 (2020) (referring to the catchall designation of technology deemed to have both civil and military applications under the Export Administration Regulations).

new employee is a Chinese National, Pied Piper must obtain a *deemed export* license for this engineer to work with the emerging technology—regardless of the fact that this engineer is already located in the United States or if the employee has a legal work visa.[2] Prior to 2018, when the engineer was working at Intel, the licensing requirement was never an issue because licenses were routinely granted after a one-month period.

In 2018, the Trump Administration began implementing a protectionist foreign policy. Under this new policy, the approval process for deemed export licenses transitioned from regularly being granted to a presumption of denial. This protectionist approach aligns with the federal government's philosophy to "ensure that U.S and allied country firms retain a dominant position in the global semiconductor market."[3] This assumes that companies, including startups like Pied Piper, have the compliance resources in place to comply with Export Controls. This policy leaves companies with two options: first, not hire or fire the foreign employee or alternatively, transfer the employee to a different position that does not involve regulated technology and therefore will not require a license. In either situation Piped Pier must replace the engineer, ideally with a U.S. citizen, to work on the regulated Internet—assuming such a qualified person exists in the job market.[4]

Technological advancements, amid the Sino-American Trade War, are delayed because of Export Controls. Companies are reluctant to hire foreign employees subject to Export Controls, regardless of whether they are the most qualified job candidates. Generally, employers are prohibited from discriminating against any employee because of the individual's nationality or race under both Title VII of the Civil Rights Act of 1964[5] and the Immigration Reform and Control Act of 1986.[6] Yet, distinctions based on citizenship are often synonymous with the protected classes of nationality or race.[7] However, these classifications appear to be permissible under exceptions to federal anti-discrimination laws regarding BFOQs,[8] national security requirements,[9] or general

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[2] *See* 15 C.F.R. § 734.13(a)(2) (2020) (deeming any transfer of the information regarding the regulated technology as a direct export to China).

[3] NAT'L SEC. COMM'N ON ARTIFICIAL INTELLIGENCE, INTERIM REPORT (Nov. 2019), https://epic.org/foia/epic-v-ai-commission/AI-Commission-Interim-Report-Nov-2019.pdf.

[4] Alison D. Raymore, *CIO Jury: 83% of CIOs Struggle to Find Tech Talent*, TECHREPUBLIC (June 16, 2017), https://www.techrepublic.com/article/cio-jury-83-of-cios-struggle-to-find-tech-talent/; Elizabeth L. LaRocca & Erin N. Bass, *Export Control Hiring Practices Continue to Challenge Employers*, STEPTOE (Nov. 1, 2018), https://www.lexology.com/library/detail.aspx?g=ec27f5b2-f6e4-430d-8fed-9f28a9c7b982.

[5] 42 U.S.C.A. § 2000e-2(a) (West 2020) (prohibiting employers from discriminating employees because of national origin or race, among other protected classes and specifying that it is unlawful for employers to practice employment practices that adversely affect or deprive employees of work opportunities based on national origin or race).

[6] 8 U.S.C.A. § 1324b(a)(1) (West 2020) (prohibiting employers from discriminating employees because of their national origin).

[7] LaRocca & Bass, *supra* note 4; *see generally* 8 U.S.C.A. § 1324.

[8] *See* 42 U.S.C.A. § 2000e-2(e) (West 2020) (stating that employers may lawfully make employment decisions because of national origin in circumstances when such a classification is a "bona fide occupational qualification reasonably necessary to the normal operation of that particular business or enterprise").

[9] *See* 42 U.S.C.A. § 2000e-2(g) (West 2020) (allowing employers to lawfully consider an individual's national origin in making employment decisions — such as hiring or firing an employee — when the performance of the job is subject to any national security requirement imposed by the United States and the individual has not satisfied that requirement).

compliance with other U.S. laws.[10] At this time, it is unclear whether an exception to the anti-discrimination statutes would apply to a license requirement based purely on economic policy—rather than national security concerns. However, more importantly, it remains unknown whether the current deemed export requirement is constitutional under an Equal Protection Analysis.

Despite potential constitutional issues with Export Controls, companies seeking to operate in the advanced technology industries included in the dual-use classification must consider alternative measures to address this complex and important area of law. The United States is recognized as a leader in technological innovations,[11] yet companies operating within the U.S. are constantly restrained by Export Control requirements.[12] These requirements delay corporate transactions by requiring that companies must perform due diligence about the conduct, nationality, and items' end use internally and with their customers'. The constant broadening of Export Controls is likely to result in companies leaving the United States or prioritizing the development of technology that is not subject to heightened regulation. Additionally, this protectionist policy serves as a further incentive for regulated countries, such as China, to strive for technological self-sufficiency.[13] Both results are contrary to the federal government's initiative that U.S. companies retain a dominant global position in SME and other emerging industries.

One possible solution is blockchain technology. The research and funding of blockchain technology have exponentially increased since Bitcoin first brought the technology to the international stage.[14] Potential applications of blockchain have emerged in various sectors from finance, energy, government, real estate, health care, and even international trade.[15] The application of blockchain and distributed ledger technology has the capability to revolutionize industries by providing more efficient methods and rapid transactions and record keeping.[16]

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[10] *See* 8 U.S.C.A. § 1324b(a)(2) (West 2020) (stating that employers can consider citizenship status where a citizenship requirement is necessary to comply with any Federal, State, or local law, or when the citizenship status is determined by the Attorney General as essential for an employer to do business with any U.S. government).

[11] Walter Isaccson, *How America Risks Losing Its Innovation Edge*, TIME (Jan. 3, 2019), https://time.com/longform/america-innovation/; *America Will Dominate the Industries of the Future*, THE WHITE HOUSE: INFRASTRUCTURE AND TECH. (Feb. 7, 2019), https://www.whitehouse.gov/briefings-statements/america-will-dominate-industries-future/.

[12] LaRocca & Bass, *supra* note 4; Jenny Leonard & David McLaughlin, *U.S. Presses Ahead on Plan to Limit High-Tech Exports*, BLOOMBERG (Dec. 11, 2018), https://www.bloomberg.com/news/articles/2018-12-11/u-s-plan-to-limit-high-tech-exports-forges-on-amid-trade-truce.

[13] *Open standards, not sanctions, are America's best weapon against Huawei*, THE ECONOMIST, Apr. 11, 2020 at 10, https://www.economist.com/leaders/2020/04/08/open-standards-not-sanctions-are-americas-best-weapon-against-huawei.

[14] Jesse Yli-Huumo et al., *Where Is Current Research on Blockchain Technology?—A Systematic Review*, PLOS ONE, Oct. 3, 2016, at 9–10; Dave Berson & Susan Berson, *Blockchain Law 101: Understanding Blockchain Technology and the Applicable Laws*, 88 J. KAN. B. ASSN. 40, 40 (2019).

[15] *Distributed Ledger Technology: Beyond Block Chain*, U.K. GOV'T OFFICE FOR SCI., 64–71 (2016), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/492972/gs-16-1-distributed-ledger-technology.pdf; Katharine Gammon, *Experimenting with Blockchain: Can One Technology Boost Both Data Integrity and Patients' Pocketbooks?*, 24 NATURE MED. 378, 381 (2018); Mike Orcutt, *How Blockchain Could Give Us a Smarter Energy Grid*, MIT TECH. REV. (Oct. 16, 2017), https://www.technologyreview.com/s/609077/how-blockchain-could-give-us-a-smarter-energy-grid/.

[16] Marco Iansiti & Karim R. Lakhani, *The Truth About Blockchain*, HARV. BUS. REV. 118 (Jan.–Feb. 2017).

This Note analyzes the constitutionality of the deemed export requirement and proposes blockchain technology as a solution for businesses to comply with Export Controls. Part II explains the licensing requirements of Export Controls and the impacts the current policy has on business and employees. Part III considers the constitutionality of Export Controls under an Equal Protection Analysis in light of the national security and foreign policy considerations. This Note takes the position that export control regulations are constitutional when tailored around the protection of information related to national security—rather than economic policy based on the national origin of the employee. Part IV, irrespective of the constitutional analysis, proposes that the application of blockchain technology has a potential solution for businesses to comply with export laws. This section begins with an overview of blockchain and how this technology applies to Export Controls. It then evaluates the benefits and challenges associated with integrating blockchain technology to data security systems. Lastly, Part IV explains how the blockchain addresses national security concerns and why companies using this technology will obtain more deemed export licenses.

II. BACKGROUND: U.S. EXPORT CONTROLS

The two relevant regulations are the International Traffic in Arms Regulations (the "ITAR") and the Export Administration Regulations (the "EAR"). The ITAR and EAR are created by different congressional acts, enforced by different government agencies, and tasked with regulating different exports. Both laws seek to promote the general policy of protecting United States defense technology from going to foreign adversaries.[17] However, these regulations are also based on economic considerations.[18] Export Regulations are mainly executed through licensing requirements.[19] One way to trigger the license requirement is by exporting regulated technology, software, and equipment to a foreign person.[20] This transfer requires a license because Export Controls deem this a transfer to the foreign person's country of citizenship.[21] A license is also required when technology is reexported or transferred outside of the United States and then is released to a foreign person. While these definitions appear simple enough, compliance with Export Controls is notoriously complex.

Export Controls substantially burden corporate supply chains. For example, if Pied Piper released their regulated source code to the Chinese National engineer, this transfer is considered an export and a license would be required to make the release. If Pied Piper were to transfer their source code to a supplier in Europe and the supplier had Chinese Nationals working on the project, this is considered a reexport and a license is required to make this release. In other words, companies subject to Export Controls must obtain the required authorizations internally, with customers, with vendors, and even to visitors or affiliates of employees. As a result, companies have expanded their workforce and

[17] *See* 22 C.F.R. § 120.3; 15 C.F.R. § 730.6.
[18] *See* NAT'L SEC. COMM'N ON ARTIFICIAL INTELLIGENCE, *supra* note 3, at 4–6.
[19] *See* 22 C.F.R. § 120.20; 15 C.F.R. § 730.7
[20] 22 C.F.R. § 120.17; 15 C.F.R. § 734.13.
[21] 22 C.F.R. § 120.17; 15 C.F.R. § 734.13.

operations dedicated to ensure that the business remains compliant with Export Controls.[22] Failure to comply with any license requirement can result in significant civil and criminal penalties—including imprisonment—to all individuals involved in the export.[23] Depending on the severity of the violations, companies that violate Export Controls may also lose exporting privileges, effectively ending business operations.[24]

A. International Traffic in Arms Regulations

The ITAR regulates the export of a broad range of technology that is deemed a defense article or service. Pursuant to the Arms Export Control Act (the "AECA"), the President has authority to "control the export and import of defense articles and defense services."[25] The ITAR is primarily administered through the Directorate of Defense Trade Controls (the "DDTC"), because the AECA delegates this authority to the Secretary of State.[26] The Department of State, in concurrence with the Department of Defense, determines what items are designated as defense articles or services.[27] Defense articles and services include technology defined under the U.S. Munitions List ("USML")[28] and technology deemed to provide "a critical military or intelligence advantage" to warrant regulation.[29] ITAR does not consider the intended use of the export—such as military or civilian purposes—in determining whether the item is subject to regulations.[30]

Corporate supply chains can trigger the license requirement under the ITAR when exporting to citizens of foreign nations, based on the citizenship of the person receiving the exports. Under the ITAR, a license from DDTC is required to export[31] or reexport[32] any technical data or defense article to a foreign person or foreign end-use.[33] "Technical data" includes information required for the "design, development, production, manufacture, assembly, operation, repair, testing, maintenance or modification" of a defense item or software directly associated with defense articles.[34] The ITAR defines a

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[22] Andrea Stricker & David Albright, *U.S. Export Control Reform: Impacts and Implications for Controlling the Export of Proliferation-Sensitive Goods and* Technologies, INST. FOR SCI. AND INT'L. SEC. (May 17, 2017), https://isis-online.org/uploads/isis-reports/documents/Export_Control_Reform_Initiative_Review_and_Recommendations_May_2017_Final.pdf.

[23] 22 C.F.R. § 120.27; 15 C.F.R. § 764.3.

[24] 22 C.F.R. § 120.27; 15 C.F.R. § 764.3.

[25] 22 C.F.R. § 120.1(a).

[26] *Id.* at (b)(2).

[27] 22 C.F.R. § 120.2.

[28] Cecil Hunt, *Understanding the Rules of Trade*, TRADEPORT, (Dec. 2006), https://tradeport.org/index.php/trade-toutorials-130?id=67. *See also* 22 C.F.R. § 120.3(a) (describing "items specifically designed or modified for military use, but designations and determinations have extended ITAR jurisdiction to some items with non-military use as well" such as semiconductor memory and logic chips.).

[29] 22 C.F.R. § 120.3(b).

[30] 22 C.F.R. § 120.3.

[31] 22 C.F.R. § 120.17(a)(2). Export, among other things, includes "releasing or otherwise transferring technical data to a foreign person" in the U.S. (a "deemed export").

[32] 22 C.F.R. § 120.19(a)(2). Reexport includes the "release of technical data to a foreign person" that is a citizen of a country different from the foreign country that the release takes place (a "deemed reexport"). *Id.*

[33] 22 C.F.R. § 127.1(a).

[34] 22 C.F.R. § 120.10(a).

"foreign person" as any natural person that is not a citizen or lawful permanent resident of the United States.[35]

To address the strict ITAR regulations, companies like Boeing implement rigorous security measures. Companies hire armed guards to monitor the perimeter of research and manufacturing facilities.[36] The employees work on limited scope projects rather than building the entire product.[37] At Boeing, for example, employees are hired to work on a particular wing for a plane. Additionally, the company's information only allows for single person computer access. The heightened regulation hinders foreign nationals' employment opportunities, and the pool of qualified candidates and companies would prefer to simply hire U.S. persons to avoid all the extra security measures. The employment issue expands beyond commercial operations as academic institutions working on regulated technology are also subject to these regulations.[38]

B. Export Administration Regulations

The EAR regulates a broad spectrum of items including commercial, "dual use" and certain military goods, equipment, materials software and technology.[39] The EAR is promulgated pursuant to the Export Control Reform Act (the "ECRA") as of August 2018, formerly the Export Administration Act ("EAA") and International Emergency Economic Powers Act ("IEEPA") during the EAA lapse.[40] The Department of Commerce administers the EAR through the Bureau of Industry and Security ("BIS").[41] Items subject to the EAR include all U.S. origin items regardless of location, including foreign-made products that incorporate U.S. origin commodities and foreign-made products directly based on U.S. origin technology or software.[42] The EAR also applies to items produced outside of the U.S. that incorporate more than *de minimis* controlled U.S. content.[43]

There are four primary factors that determine whether a license is required: (1) the item exported; (2) where the export is going; (3) who is involved in the transaction; and (4) the item's use. The first step in the license determination process is to determine the Export Control Classification Number ("ECCN") of the item. ECCNs are categorized on the Commerce Control List ("CCL"). If the item does not fall into any of the categories, then the item is labeled as EAR99. The second step is to consider the country of destination by

[35] 22 C.F.R. § 120.16. This definition includes "any foreign corporation, business association, partnership, any other entity or group that is not incorporated or organized to do business in the United States, as well as international organizations, foreign governments." *Id.*

[36] *See What is an ITAR Controlled Facility*, NEWSTREAM ENTERS.: NEWSTREAM BLOG (Oct. 31, 2019, 12:50 PM), https://www.newstreaming.com/blog-hub/what-is-an-itar-controlled-facility.

[37] *See* Martin Horan, *Data Security Best Practices for ITAR Compliance*, FTP TODAY (Oct. 9, 2019), https://www.ftptoday.com/blog/data-security-best-practices-for-itar-compliance.

[38] Julie T. Norris, *Export Controls: The Challenge for U.S. Universities*, https://www.uh.edu/research/compliance/export-controls/Export_Controls_PPT.pdf.

[39] *See* 15 C.F.R. § 730.3.

[40] 15 C.F.R. § 730.2.

[41] 15 C.F.R. § 730.1.

[42] Geroge R. Tuttle, *U.S. Controls on the Texport and Re-export of U.S. Origin Goods & Technology - EAR*, https://www.tuttlelaw.com/subjects/us_control_exp_re-exp_orig_of_tech/us_control_exp_re-exp_orig_of_tech_ear.html (last visited Sep. 28, 2020); *see also* 15 C.F.R. § 734.3.

[43] 15 C.F.R. § 734.3(a); 15 C.F.R. § 734.4 (providing a ten percent threshold for exports to Cuba, Iran, North Korea, Sudan, and Syria and a twenty-five percent threshold for all other destinations).

referencing the CLL Country Chart.[44] Under the current regulations a license is unlikely to be granted for embargoed countries. Third, businesses must consider who is the intended end-user and which individuals are involved in the transactions. The last step in the license determination process is to review the end use of the item. If a license requirement exists, then companies should review the license exceptions to see if they may proceed without a license under a particular license exception. Absent any license exception, a license must be obtained before any export occurs by filing a BIS-748P form.

Corporate supply chains can trigger the license requirement under the EAR when exporting to citizens of foreign nations. An export and reexport is defined as any release of regulated technology or source code to a foreign person (a "deemed export").[45] However, one distinction from the ITAR, is that the release of U.S. technology is considered an export to only the foreign person's current country of citizenship and residency.[46] A foreign person under EAR is synonymous with a foreign person defined in the ITAR—any natural person, company, or government that is not a citizen or lawful permanent resident of the United States—and with the phrase foreign national used in EAR.[47]

The EAR impacts more companies than the ITAR because of the "dual-use" catchall. The companies vary from cutting-edge startups to large companies like Intel. Due to the broad inclusion of the regulations, companies do not implement solidified security measures like those subject to the ITAR. Additionally, the unpredictability of the EAR makes it difficult for companies to develop any plans. The EAR includes emerging technologies or new technologies that could be used in a military capacity but are not currently associated with weapons. An example of this would be drones. Drones are a new technology that is not associated with defense or weapons, but the technology has clear military applications—a bomb could be added and dropped from a drone.

Alternatively, the EAR does not include foundational technology or older technology commonly found in the marketplace. This is largely because such technology is widely available to foreign adversaries. The fluctuation and depreciation of technology makes it difficult to quickly establish adequate regulations that address national security concerns. The federal government must remain knowledgeable of all cutting-edge U.S. technology to address potential national security concerns before foreign adversaries receive the technology. For example, how could a government regulate AI and super computers? The government's analysis usually focuses on the key components required to create the final product. However, under a protectionist policy and especially for emerging technology, the regulations favor overinclusion. These broad Export Controls allow the federal government to regulate technology before understanding its capabilities. However, even if the emerging technologies capability is ultimately limited to commercial use, there is little incentive to withdraw such regulations.

C. Impacts on Businesses and Employees

The rigorous application of deemed export requirements under the Trump Administration have hindered employers from seeking licenses for employees

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[44] 15 C.F.R. § 738.4(a).
[45] 15 C.F.R. § 734.13(a)(2); 15 C.F.R. § 734.14(a)(2).
[46] 15 C.F.R. § 734.13(b); 15 C.F.R. § 734.14(b).
[47] 15 C.F.R. § 772.1.

characterized as "foreign persons." According to the data released by BIS, over eighty-four percent of the deemed export applications were approved in 2018.[48] However, this number is deceiving. In 2017, BIS approved a record 1,394 deemed export licenses.[49] This record year was followed by an approval of less than 850 licenses in 2018.[50] The changes in the geopolitical climate have noticeably impacted the administration of Export Controls.

The disparity for Chinese Nationals attempting to obtain licenses is even more skewed. Chinese Nationals are far and away the most common example of licenses approved by BIS, accounting for more than over one-third of all deemed export licenses.[51] In 2018, Chinese Nationals accounted for the most commonly deemed export license approved by BIS, totaling 350. The Top ECCN for 2018 is the 3E001 license for products in the SME industry.[52] This number is less than half of the 771 licenses granted to Chinese Nationals in 2017.[53] For reference, the countries with the next highest deemed export license approval are Iran and India, countries that account for a combined 25 percent of licenses. Though Iran obtained less than 200, the deemed export numbers for Iran have largely remained consistent since 2013.[54] The decline in approved deemed export licenses is a direct representation of both the federal government's protectionist policy and the challenges U.S. businesses must undergo to hire qualified foreign nationals. Why would a company hire a foreign national that requires a deemed export license when a U.S. citizen could perform the exact same job without any Export Controls requirements?

To avoid the licensing requirement, U.S. companies began limiting employment opportunities to only U.S. citizens. The Department of Justice recently found that three different companies—a manufacturer, law firm, and engineering firm—unlawfully required job candidates to be U.S. citizens or permanent residents.[55] The law firm, Clifford Chance US LLP, argued that these hiring decisions were made in "good faith."[56] The DOJ rejected this argument, stating that no such exception exists in the federal anti-discrimination law.[57] This prohibits companies from requiring U.S. citizenship to proceed in the employment process—regardless of whether the employer intends to hire someone not subject to Export Controls. This makes it difficult for companies to hire the best and brightest candidates while also complying with Export Controls and anti-discrimination laws.[58]

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[48] *2018 Statistical Analysis of BIS Licensing – Deemed Export 2013-2018*, U.S. DEPT. OF COMMERCE, BUREAU OF INDUS. AND SEC. (Mar. 5, 2019), https://www.bis.doc.gov/index.php/documents/technology-evaluation/ote-data-portal/licensing-analysis/2410-2018-statistical-analysis-of-bis-licensing-pdf/file.
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] U.S. DEPT. OF COMMERCE, BUREAU OF INDUS. AND SEC., *supra* note 48.
[55] Clifford Chance US LLP, DJ# 197-16-492 (U.S. Dep't of Just. Aug. 29, 2018), https://www.justice.gov/opa/press-release/file/1090596/download [hereinafter *Clifford Chance Settlement Agreement*]; Honda Aircraft Co., DJ# 197-54M-69 (U.S. Dep't of Just. Feb. 1, 2019), https://www.justice.gov/opa/press-release/file/1126521/download; Setpoint Sys., Inc., DJ # 197-77-123 (U.S. Dep't of Just. Jun. 19, 2018), https://www.justice.gov/opa/press-release/file/1072981/download.
[56] *Clifford Chance Settlement Agreement*, *supra* note 55, at 1.
[57] *Id.*
[58] *See* Chris Richard et al., *Looming Talent Gap Challenges Semiconductor Industry*, SEMI, https://www.semi.org/en/connect/workforce-development/SEMI_Deloitte_WF_Study_2017.

Export Controls are implemented to prevent foreign adversaries from obtaining U.S. weapons and technology, thus promoting cooperation with American allies and U.S. foreign policy.[59] As noted in the National Security Commission on Artificial Intelligence, SME requires extensive expertise and financial support to develop the necessary infrastructure. Currently, "[a]bout 90 percent of the SME industry is located in the United States, Japan, and the Netherlands."[60] The federal government contends that extensive regulations to the SME industry, which is dominated by the U.S. and American allies, provides "that small group of allies a major advantage."[61] While this advantage is likely true in the short-term, the long-term impact of this protectionist foreign policy may not only hinder global technology advancements but also end the United States' control over the SME industry.

Early signs indicate the beginning of the United States' decline in the SME industry. Intel recently announced concerns over the manufacturing process of 7-nanometer transistors, the most advanced chip on the market, and agreed to outsource chip manufacturing to TSMC, a Taiwanese competitor.[62] This is significant because for decades Intel led the chip industry. However in 2018, Intel's decline in the SME industry first became apparent when TSMC began manufacturing the 7-nanometer chip while Intel was struggling to bring the previous generation 10-nanometer chip to market.[63] If protectionist foreign policy is to succeed, then U.S. companies must retain the dominance in cutting-edge technology and not rely on outsourcing manufacturing to foreign competitors.

III. EQUAL PROTECTION ANALYSIS

The constitutionality of the Export Controls depends on three pivotal questions. First, what type of classification is created by Export Controls? Second, what level of scrutiny should courts apply to Export Controls? Lastly, what is the federal government's interest: national security or economic policy? Before a court, or this Note, can address these questions, there are preliminary considerations and background required to determine whether an Equal Protection analysis is applicable to export controls. Additionally, it is important to note that if a court was to consider the constitutionality of a specific deemed export license, the holding would likely be limited to the facts of the case and regulation in question. Precedent from such cases is likely because Export Controls create distinct classifications, and the regulations are based on various government interests.

As set forth more fully below, this section will analyze whether the Equal Protection Clause applies to export controls, the appropriate standard of review, the merit of the government's interest, and whether the Export Controls are properly tailored to this government purpose.

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[59] *See* NAT'L SEC. COMM'N ON ARTIFICIAL INTELLIGENCE, *supra* note 3, at 41.

[60] *Id.*

[61] *Id.*

[62] Arjun Kharpal, *TSMC Jumps Nearly 10% Adding $34 billion in Value as Intel Faces Next-Generation Chip Delays*, CNBC (July 27, 2020), https://www.cnbc.com/2020/07/27/tsmc-shares-jump-as-intel-faces-next-generation-chip-delays.html.

[63] Eamon Barrett, *Intel's Decline Makes Rival Chipmaker TSMC the World's 10th Most Valuable Company*, FORTUNE (July 28, 2020), https://fortune.com/2020/07/28/intel-7nm-delay-tsmc-stock-shares-worlds-tenth-most-valuable-company/.

A. The Equal Protection Clause Applies to Export Controls and Regulations

The Equal Protection Clause applies to the federal laws and regulations responsible for the deemed export license requirements. Under the Fourteenth Amendment of the United States Constitution, "[n]o State shall . . . deny to any person within its jurisdiction the equal protection of the laws." [64] The language of the Fourteenth Amendment suggests that the Equal Protection Clause only applies to the States and requires state action.[65] However, the United States Supreme Court has applied the Equal Protection Clause of the Fourteenth Amendment against the federal government through the Due Process Clause of the Fifth Amendment.[66] Pursuant to the Fifth Amendment, "[n]o person shall be . . . deprived of life, liberty, or property, without due process of law."[67] This is not to suggest that due process and equal protection rights are interchangeable, rather that "[t]he 'equal protection of the laws' is a more explicit safeguard of prohibited unfairness than 'due process of law.'"[68] The logic behind this application of constitutional protections is that if a law violates equal protection then it also violates due process.

The constitutional right of equal protection applied to all people living in the United States, however, is unlikely to include foreign employees working outside the United States. All U.S. residents—whether a citizen or non-citizen—are considered a "person" under the Fourteenth and Fifth Amendment. Under the Fourteenth Amendment, "[a]ll persons born or naturalized in the United States and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall . . . deny *to any person within its jurisdiction* equal protection of the laws." [69] Although constitutional protections expand beyond citizenship, equal protection rights are not afforded the same force and effect outside of United States territory.[70] For example, after World War II, the Supreme Court in *Johnson v. Eisentrager* held that German nationals had no right to a writ of habeas corpus.[71] Furthermore, the Court rejected the interpretation that the term "any person" used in the Fifth Amendment spread to all alien enemies.[72] Here, Export Controls are based around protecting U.S. weapons and advanced technology. Accordingly, a court would likely follow similar reasoning in rejecting an equal protection claim from a nonresident alien that worked for a U.S.-based company or with U.S. technology. Since aliens do not enjoy the same advantage as residents,[73] a nonresident alien

[64] U.S. CONST. amend. XIV, § 1 (emphasis added).
[65] *See id.*
[66] *See* Bolling v. Sharpe, 347 U.S. 497, 499–500 (1954) (holding that although the Fifth Amendment does not contain an equal protection clause, "it would be unthinkable that the same Constitution would impose a lesser duty on the Federal Government."); Weinberger v. Wiesenfeld, 420 U.S. 636, 638 n.2 (1975) ("This Court's approach to Fifth Amendment equal protection claims has always been precisely the same as to equal protection claims under the Fourteenth Amendment.").
[67] U.S. CONST. amend. V.
[68] Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 215 (1995) (quoting *Bolling*, 347 U.S. at 499).
[69] U.S. CONST. amend. XIV, § 1 (emphasis added).
[70] *See* United States v. Verdugo-Urquidez, 494 U.S. 259, 269 (1990); Johnson v. Eisentrager, 339 U.S. 763, 770-71 (1950).
[71] *Johnson*, 339 U.S. at 790.
[72] *Id*. at 782-83.
[73] Mathews v. Diaz, 426 U.S. 67, 78 (1976).

is unlikely to succeed on equal protection grounds—even if the challenger has substantial connections to the United States.[74]

B. Export Controls Impose a Suspect Classification and is Subject to Heightened Scrutiny

The Equal Protection Clause arises when government classifications impose an exclusive burden or benefit to one group of persons.[75] Legislation can create classifications either facially or in effect. Facial classifications occur when the face of the statute creates the classification.[76] Alternatively, the Equal Protection Clause is also applicable to laws that are facially neutral but create burdensome classifications in effect.[77] The Supreme Court has repeatedly held that racial classifications are reviewed under strict scrutiny.[78] For legislation to be constitutional under a strict scrutiny the laws must be narrowly tailored to further a compelling government interest.[79]

Deemed export requirements facially categorize people based on alienage; however, the application of Export Controls' in effect creates classifications based on national origin.[80] Citizenship and national origin are distinct legal classifications; however, this distinction creates inconsistency that ultimately result racial and national origin classifications. For this reason, the Supreme Court extended strict scrutiny to national origin classifications.[81] Beyond simple inconsistencies in how other countries determine citizenship, a rational basis test is inappropriate because the role of the judiciary is to protect "discrete and insular minorities."[82] For example, under the Nationality Law of the People's Republic of China, a "Chinese citizen" is defined as a person of Chinese nationality.[83] Additionally, China does not recognize dual citizenship.[84] In other words, a person of Chinese descent is considered a Chinese citizen, so long as they have not formally changed nationalities. Such fluidity between citizenship and national origin throughout the world supports the applicable of strict scrutiny because the deemed export requirement

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[74] *Verdugo-Urquidez*, 494 U.S. at 271.
[75] *E.g.*, San Antonio Indep. Sch. Dist. v. Rodriguez, 411 U.S. 1, 59–60 (1973) (Stewart, J., concurring) ("The function of the Equal Protection Clause, rather, is simply to measure the validity of classifications created . . . .").
[76] *See, e.g.*, Brown v. Bd. of Educ., 347 U.S. 483 (1954) (rejecting racial segregation in public schools); Strauder v. West Virginia, 100 U.S. 303 (1879) (eliminating limitation of "only white male persons" for jury service).
[77] *See, e.g.*, Shapiro v. Thompson, 394 U.S. 618 (1969) (holding that durational residency requirement in effect divided applications into two groups); Harper v. Va. Bd. of Elections, 383 U.S. 663 (1966) (holding that poll taxes in effect divided voters into two groups).
[78] Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 227 (1995); Gratz v. Bollinger, 539 U.S. 244, 270 (2003).
[79] *Pena*, 515 U.S. at 227.
[80] *See supra* Part II A, B.
[81] City of Cleburne, Tex. v. Cleburne Living Ctr., 473 U.S. 432, 440 (1985).
[82] U.S. v. Carolene Prod. Co., 304 U.S. 144, 152 n.4 (1938) (stating that strict scrutiny is required for laws implicating a fundamental right or suspect class).
[83] *General Information on Chinese Nationality*, HONG KONG IMMIGRATION DEP'T. (last updated Jan. 20, 2017), https://www.immd.gov.hk/eng/services/chinese_nationality/general_info.html.
[84] *Nationality Law of the People's Republic of China*, EMBASSY OF THE PEOPLE'S REPUBLIC OF CHINA IN THE U.S., http://www.china-embassy.org/eng/ywzn/lsyw/vpna/faq/t710012.htm (last visited Sep. 19, 2020).

expressly—or at the very least in effect—classifies people based on race and national origin.

The determination of classification imposed by Export Controls and in turn, the appropriate standard of review, is further complicated by Executive and Legislative powers to regulate foreign affairs. Congress has plenary power over the immigration and naturalization process,[85] and the power to regulate commerce among foreign nations.[86] Generally, these legislative powers are "immune from judicial control."[87] However, the Supreme Court has interpreted the phrase "within its jurisdiction" broadly, and have repeatedly found that resident aliens also enjoy constitutional protections.[88] Additionally, the Executive has broad authority when regulating foreign nationals because the President has constitutional obligations to regulate foreign affairs. In *Trump v. Hawaii*, the Supreme Court recognized that there is minimal judicial review of Executive actions concerning foreign nationals because courts generally lack the competency to determine national security questions.[89] Any judicial action regarding foreign nationals entering the country and national security must be highly constrained because any action that would "inhibit the flexibility of the President to respond to changing world conditions should be adopted only with the greatest caution."[90] Export controls, however, are not related to whether foreign nationals are allowed to enter into the country; rather, the deemed export-licensing requirement affects individuals who are already in the United States legally and seeking employment in regulated industries.

Since Export Controls arise from congressional acts delegating to executive agencies the authority to regulate various exports, a court may not apply strict scrutiny but rather some form of heightened scrutiny in these cases. Accordingly, Export Controls must, at the very least, be necessary to achieve an important government interest.[91]

C. Export Controls are Broadly Tailored around a Compelling Government Interest

The government must satisfy two prongs under a heightened scrutiny analysis. First, the government has the burden of showing that the classification is based on a compelling interest.[92] Second, the laws must be narrowly tailored to achieve the compelling interest.[93] Both prongs empower courts to ensure lawmakers are "pursuing a goal important enough to warrant [the] use of a highly suspect tool."[94] Courts should not

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[85] U.S. CONST. art. I, § 8, cl. 4.
[86] *Id.* at art. I, § 8, cl. 3.
[87] Fiallo v. Bell, 430 U.S. 787, 792 (1977) (quoting Shaughnessy v. Mezei, 345 U.S. 206, 210 (1953)).
[88] *See* Yick Wo v. Hopkins, 118 U.S. 356, 369 (1886) (holding that the Fourteenth Amendment protects resident aliens); Mathews v. Diaz, 426 U.S. 67, 77 (1976) (holding that the Fifth and Fourteenth Amendments protect illegal or involuntary aliens within the jurisdiction of the United States); Plyler v. Doe, 457 U.S. 202, 211–12 (1982) (holding that the Fourteenth Amendment's Equal Protection Clause protects illegal aliens).
[89] Trump v. Hawaii, 138 S. Ct. 2392, 2419 (2018).
[90] *Id.* (quoting *Mathews*, 426 U.S. at 81–82).
[91] Graham v. Richarson, 403 U.S. 365, 376 (1971); Bernal v. Fainter, 467 U.S. 216, 219 (1984); In re Griffiths, 413 U.S. 717 (1973).
[92] Johnson v. California, 543 U.S. 499, 505 (2005) (classifications are inherently suspect because they "raise special fears that they are motivated by an invidious purpose.").
[93] *Id.*
[94] Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 226 (quoting City of Richmond v. J.A. Croson Co., 488 U.S. 469, 493 (1989)).

blindly defer "to legislative or executive pronouncements of necessity" in an equal protection analysis."[95] This section first considers the government's interest in protecting advanced U.S. technology from China through deemed export license, then considers whether the licensing requirements are narrowly tailored to address their concerns.

i. Compelling-Interest Prong

The federal government contends that preventing Chinese espionage and intellectual property theft, particularly in the semiconductor industry, is vital to national security. Since 2011, more than 90 percent of Americans prosecuted for economic espionage had ties to China.[96] At the end of 2019, a cancer researcher at a Harvard research center was arrested for allegedly smuggling information to China.[97] On May 3rd, 2019, in the biggest trade secret infringement case in history, the Superior Court of the State of California ordered an $845 million judgment against XTAL Inc., a semiconductor manufacture.[98] The jury found XTAL guilty of stealing trade secrets from ASML US Inc., the United States branch of the largest supplier of photolithography systems in the semiconductor industry.[99] XTAL was founded by two long time employees of Brion Technologies, a light source company that was later acquired by ASML.[100] The court found that prior to leaving Brion, these engineers copied company information onto an external storage device.[101] This case exemplifies the importance of company security measures that limit an employee's access to and transferability of regulated information. Additionally, this example supports the federal government's concern regarding foreign adversaries obtaining U.S. technology. Semiconductor companies such as ASML, Intel, and TSMC are the driving forces behind Moore's law, or the exponential increase in transistors on computer chips every 18 months.[102]

The United States is not alone in its distrust of China's business and politics; this is a feeling shared by most Western countries.[103] In an effort to block ASML from selling a machine to China, President Trump sent Secretary of State Mike Pompeo to pressure the Dutch Prime Minster into granting an export control license.[104] Secretary Pompeo even

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[95] *J.A. Croson Co.*, 488 U.S. 469, at 501.
[96] *The new red scare on American campuses*, THE ECONOMIST, Jan. 2, 2020, https://www.economist.com/briefing/2020/01/02/the-new-red-scare-on-american-campuses [hereinafter *Red Scare*].
[97] *Id.*
[98] Mike LaSusa, *ASML Scores $845M IP Judgment Against Bankrupt XTAL*, LAW360 (May 6, 2019), https://www.law360.com/articles/1156580/asml-scores-845m-ip-judgment-against-bankrupt-xtal.
[99] *Id.*
[100] Kieren McCarthy, *Crystal Balls Up: Chip Design Shop XTAL Must cough up $223m for Pinching Trade Secrets*, THE REGISTER (Dec. 3, 2018), https://www.theregister.co.uk/2018/12/03/xtal_asml_judgment/.
[101] *Id.*
[102] Rachel Courtland, *Leading Chipmakers Eye EUV Lithography to Save Moore's Law*, IEEE SPECTRUM (Oct. 31, 2016), https://spectrum.ieee.org/semiconductors/devices/leading-chipmakers-eye-euv-lithography-to-save-moores-law.
[103] *Why Chinese officials like useless meetings in Over-stuffed chairs*, THE ECONOMIST, Aug. 3, 2019, https://www.economist.com/china/2019/08/01/why-chinese-officials-like-useless-meetings-in-over-stuffed-chairs [hereinafter *Armchair Warriors*].
[104] Alexandra Alper, Toby Sterling, & Stephen Nellis, *Trump administration pressed Dutch hard to cancel China chip-equipment sale: sources*, REUTERS (Jan. 5, 2020), https://www.reuters.com/article/us-asml-

provided the Dutch leader with a classified intelligence report.[105] This defensive maneuver by the White House indicates that the protection of semiconductor technology from China is not only a compelling interest for the United States, but also internationally. Ironically, most American electronic devices are assembled in China.[106] Often however, these Chinese firms are utilizing foreign suppliers to provide advanced technology such as robotics, cloud computing, and semiconductors. This disparity is most notable in semiconductors, as China imports nearly all of its semiconductor equipment from foreign companies. Currently, China lacks the infrastructure and technical know-how to compete in this market. Experts have estimated that China would need at least ten years, but likely more, to develop competitive computer chip facilities.[107]

The modern-day arms race is not fought on the battlefield but rather through intrusion software. In November, the federal government began a national-security review of ByteDance, a Chinese company and owner of the popular video app TikTok.[108] Last year, TikTok was downloaded more than 750 million times.[109] ByteDance's connection to China brings up issues regarding data geopolitics and information transfer from the United States to China, an issue that is largely the reason for the sanctions against Huawei, a Chinese telecom manufactory. These spies are not the James Bond type—they can vary from students, to academics, to entrepreneurs, to even journalists.[110] By requiring licenses before receiving regulated U.S. technology, companies must perform due diligence to ensure their customers intend to use the export for civilian purposes. However, this is easier said than done, because in countries like China, the funding and research of commercial sectors are often intertwined with military efforts.[111]

ii. Narrowly Tailored Means Prong

Under a heightened scrutiny analysis, it is likely unconstitutional for the federal government to create nationality classifications when the government's interests are tailored around economic policy. When it comes to military authority the Supreme Court has applied an "exceedingly deferential" approach. After World War II in *Korematsu v.*

holding-usa-china-insight/trump-administration-pressed-dutch-hard-to-cancel-china-chip-equipment-sale-sources-idUSKBN1Z50HN.

[105] *Id.*

[106] Anna-Katrina Shedletsky, *Made In China? Three Trends Driving Electronics Manufacturing In 2019*, FORBES (Jan. 24, 2019), https://www.forbes.com/sites/annashedletsky/2019/01/24/made-in-china-three-trends-driving-electronics-manufacturing-in-2019/#493002272903.

[107] Danny Vincent, *How China plans to lead the computer chip industry*, BBC NEWS (Nov. 19, 2019), https://www.bbc.com/news/business-50287485.

[108] *TikTok's silly clips raise some serious questions*, THE ECONOMIST, Nov. 7, 2019, https://www.economist.com/business/2019/11/07/tiktoks-silly-clips-raise-some-serious-questions.

[109] *Id.*

[110] *The shape-shifting threat of Chinese espionage*, THE ECONOMIST, Nov. 21, 2019, https://www.economist.com/books-and-arts/2019/11/21/the-shape-shifting-threat-of-chinese-espionage [hereinafter *Chinese Espionage*].

[111] *See* OFFICE OF THE SECRETARY OF DEFENSE, *Military and Security Developments Involving the People's Republic of China 2019*, Annual Report (May 2019), https://media.defense.gov/2019/May/02/2002127082/-1/-1/1/2019_CHINA_MILITARY_POWER_REPORT.pdf ("China has mobilized vast resources to fund research and subsidize companies involved in strategic science and technology fields while pressing private firms, universities, and provincial governments to cooperate with the military in developing advanced technologies.") [hereinafter *Military and Security*].

United States, the internment camps from Japanese Americans was upheld under the Equal Protection Clause.[112] Although this case was widely criticized, the context of a world war is distinguishable from the current situation [113] The United States should not succumb to Chinese espionage, but, at the same time, should not stray from the values of liberty and equal protection.

With broadening export control regulations, companies must perform due diligence about the conduct, nationality, and items' end use internally and with their customers. However, this is easier said than done, because in countries like China, the funding and research of commercial sectors are often intertwined with military efforts.[114] In a response to the new export rules, the Semiconductor Industry Association President, John Neuffer, recognized that "while we understand military-civil fusion trends demand smart and targeted national security responses, we are concerned these broad rules will unnecessarily expand export controls for semiconductors and create further uncertainty for our industry during this time of unprecedented global economic turmoil."[115] The global semiconductor industry accounted for over $400 billion in revenue in 2019, a decrease of twelve percent from the previous year.[116] As American companies are losing customers, suppliers, and profits, Chinese companies such as Huawei are finding alternative sources for U.S. import components.[117]

National security and foreign policy efforts by the White House to address the threat from China avoid judicial interpretation. In the modern digital world, there is no doubting that the semiconductor industry will largely impact future economic growth. However, there is no linear connection of semiconductor technology to national security. Export Controls are clouded under an umbrella of "national security," yet the impact is directed at consumer technology. These regulations all stem from the Trump Administration, which is known for impulsive actions and the use of economic sanctions in negotiations.[118] Initially, the administration and "national-security hawks" utilized the entity list to separate commercial relations from China.[119] Now, in light of future assets, the Department of Commerce implements Export Controls as the main protection of American content from China.[120]

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[112] Korematsu v. United States, 323 U.S. 214, 216-19 (1944).
[113] *Armchair Warriors*, *supra* note 103.
[114] *Military and Security*, *supra* note 111.
[115] Adam Behsudi, *A potential game changer for China export controls*, POLITICO (Apr. 28, 2020), https://www.politico.com/newsletters/morning-trade/2020/04/28/a-potential-game-changer-for-china-export-controls-787183.
[116] Semiconductor Industry Association, *Worldwide Semiconductor Sales Decrease 12 Percent to $412 Billion in 2019*, CISION PR NEWSWIRE (Feb. 03, 2020), https://www.prnewswire.com/news-releases/worldwide-semiconductor-sales-decrease-12-percent-to-412-billion-in-2019-300997962.html.
[117] *Id.*
[118] *Donald Trump's betrayal of the Kurds is a blow to America's credibility*, THE ECONOMIST, Oct. 17, 2019, https://www-economist-com.ezproxy1.lib.asu.edu/leaders/2019/10/17/donald-trumps-betrayal-of-the-kurds-is-a-blow-to-americas-credibility.
[119] *America blacklists China's best artificial-intelligence firms*, THE ECONOMIST, Oct. 10, 2019, https://www.economist.com/business/2019/10/10/america-blacklists-chinas-best-artificial-intelligence-firms.
[120] *Old export regulations get a new use*, THE ECONOMIST, Jan. 16, 2020, https://www.economist.com/united-states/2020/01/16/old-export-regulations-get-a-new-use.

"Liberty finds no refuge in a jurisprudence of doubt."[121] The importance of discovering spies is undeniable. However, in this effort to limit China's bad actors the United States must be democratic and vigilant when implementing regulation to protect American technology. Broad restrictions and a presumption of denial in the export process suggests that fear drives these policies—which is particularly concerning for a country rooted in capitalism. Export Controls should prevent Chinese spies from creating "shadow labs" to replace American research facilities[122]; however, they should not eliminate all qualified researchers from working in the United States. This reduction of talent in the hiring process includes American universities, as there are nearly twenty universities.[123] Moving forward, the Trump Administration must work with American companies to accelerate the research and development of mobile networks. Protectionism will not allow America to "win the tech cold war," and a new approach is imperative to ensure that China does not control the global digital infrastructure.

The economic correlation of the deemed export requirement is supporting America first in the short-term. However, the long-term impacts could be detrimental to the United States role as a leader in cutting-edge technology. The lack of American innovation from companies, like Intel, will hinder the dominance of United States and American allies from competition with lower cost options provided by Chinese firms.[124] Moreover, the complexities surrounding Export Controls could drive business away from America, thus resulting in a loss of jobs, economic power, and the ability to regulate information from China.

IV. PROPOSAL: BLOCKCHAIN TECHNOLOGY

There are two options for technology companies to address U.S. Export Controls. On one hand, companies can increase their lobbying presence in Washington, D.C. and attempt to negotiate less complex and stringent regulations for emerging technologies. On the other hand, private industries can seek to establish a precedent with the federal government of receiving deemed export licenses based on limited exposure to regulated technology. This process requires, among other things, financial and labor resources dedicated to enhancing the company's IT security. In light of the two options, companies responsible for bringing cutting edge technology to market should not shy away from the opportunity to take matters into their own hands—in a multibillion-dollar industry like SEMI,[125] this would likely be the general public and federal government's perspective as well.

Creating this precedent with the federal government requires companies to revolutionize their current security system. BIS, in regards to deemed export licenses, recommended that companies write a Letter of Explanation ("LOE") describing the organizations IT security system.[126] To improve a company's likelihood of obtaining a

[121] Planned Parenthood v. Casey, 505 U.S. 833, 843 (1992).
[122] *Chinese Espionage*, *supra* note 110.
[123] *Red Scare*, *supra* note 96.
[124] *Id.*
[125] Richard et. al, *supra* note 58.
[126] *See Guidelines for Foreign National Licensing Applications*, BUREAU OF INDUSTRY AND SECURITY, https://www.bis.doc.gov/index.php/component/content/article/14-policy-guidance/deemed-exports/109-guidelines-for-foreign-national-licenses (last visited Sept. 28, 2020).

deemed export license, the LOE must explain the internal protection mechanisms and detail the security protocols when foreign nationals are working on regulation technology.[127] Companies must show they benefit more than the employee in this transaction.[128] At the same time, this distinction of benefits obtained ensures that the foreign person's country of citizenship does not obtain general knowledge of this regulated technology. This proposal by BIS appears promising. However, when dealing with federal laws that are based on national security the federal government wants more than merely adequate parameters.

As set forth more fully below, regulated companies can utilize the transparency, immutability, and cryptography functions inherent to blockchain technology as a means to exceed the LOE recommendation by BIS. This section begins with an overview of blockchain technology and how it applies to data security. It then proposes various approaches to how businesses can integrate blockchain and why this technology would enhance current cybersecurity systems. Additionally, this section details the merits of this technology, and how it addresses the federal government's national security concerns and current issues within the SME industry. Finally, it considers the governance and confidentiality challenges and other mediums capable of achieving comparable results. Before beginning, this note recognizes that a commercial blockchain security system is not a revolutionary implementation of distributed ledge technology's potential. However, such a system can address complex issues, like Export Controls, that demand transaction efficiency and in-time record keeping.

A. Blockchain's Applications to Data Security Systems

The concept of blockchain was first made popular through Bitcoin after the inventor(s) under the name Satoshi Nakamoto published a whitepaper. Bitcoin is a decentralized cryptocurrency that allows users to engage in transactions on a peer-to-peer network without the need for a central bank to serve as an intermediary.[129] The name cryptocurrency is associated with the application of cryptographic hash functions in cryptocurrencies.[130] Cryptography has also been applied to public and private keys allowing individuals to verify their ID and ensure privacy by protecting the transaction's information.[131] The research and funding of blockchain technology has exponentially increased in recent years.[132]

Potential applications of blockchain have emerged in various sectors from finance, government, real estate, health care, and even international trade.[133] One major benefit associated with blockchain is that data entries can be accessed in real time.[134] The modern applications of blockchain and distributed ledger technology are beginning to revolutionize

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[127] *Id.*
[128] *Id.*
[129] Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, https://bitcoin.org/bitcoin.pdf (last visited Sep. 28 2020).
[130] Dylan Yaga et al., *Blockchain Technology Overview*, U.S. NAT'L. INST. OF STANDARDS AND TECH., (Oct. 2018), https://nvlpubs.nist.gov/nistpubs/ir/2018/NIST.IR.8202.pdf.
[131] *Id.* at 11.
[132] Jesse Yli-Huumo et al., *supra* note 14, at 9–10.
[133] U.K. GOV'T OFFICE FOR SCI., *supra* note 15.
[134] Lucas Mearian, *What is blockchain? The complete guide*, COMPUTERWORLD (Jan. 29, 2019), computerworld.com/article/3191077/what-is-blockchain-the-complete-guide.html.

industries based on transactions and record keeping.[135] Constant access to information has the potential to diminish transaction times and bureaucratic delays. Another important aspect of blockchain is the government avoidance as a means to uphold privacy in the digital age. The "cyberpunk's" movement is rooted in the libertarian principles that, as a society, privacy should not be based on the good faith efforts of governments or corporations but rather in the hands of the people.[136]

Blockchains empower people by creating a trusted distributed ledger that details transactions over public networks. Put simply, a blockchain is just a ledger, similar to an excel spreadsheet, that is maintained from a decentralized network rather than through one central server.[137] This technology can be applied to almost any transfer once the digital asset and transaction protocols have been determined. While blockchain technology may not be applicable to every industry or transaction, numerous industries are enticed by the transparency and immutability functions inherent to blockchain. The transparency element allows everyone that is a part of the network to access the information in in real time.[138] By collecting all transactions, the blockchain creates an auditable record or ledge of all data transfers.[139] Once a "block" in the blockchain is created all future blocks will be formed based on the information of the previous block. This chronological ledger creates the "chain." The chain is immutable across the entire decentralized network because everyone has access to the prior records and if any block were changed then the chain would be incorrect.[140]

There are various types of blockchain that impact the network access, system scalability, and the consensus protocols of transactions. Blockchains are classified as public or private and permissioned or permissionless. From a purist libertarian point of view, like the cyberpunk's perspective, the only type of blockchain is a public permissionless chain such a Bitcoin. In a public permissionless system anyone can participant and no specific person or entity can manage the transactions on the platform. Generally in public blockchains the participants are anonymous, the scalability is low, and the computing power necessary to operate the system is high and often results in slow transaction validation periods.[141] Alternatively, blockchains classified as consortium or private permissioned only include identified participants that obtained prior authorization and are managed by a select people or entities.[142] Since a permissioned system is inherently smaller and available to less people, companies are attracted to this form of blockchain systems because they are easy to scale and allow for quick transaction speeds.[143]

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[135] *See* Marco Iansiti & Karim R. Lakhani, *The Truth About Blockchain*, HARV. BUS. REV., 1, 3–4 (2017).
[136] *See* Eric Hughes, *A Cypherpunk's Manifesto*, ACTIVISM: CYPHERPUNKS (Mar. 9, 1993), https://www.activism.net/cypherpunk/manifesto.html.
[137] *See* Dylan Yaga et al., *supra* note 130.
[138] *Id.* at 41.
[139] *Id.* at 46.
[140] *Id.* at 34.
[141] Emmanuelle Ganne, *Can Blockchain revolutionize international trade?*, WORLD TRADE ORGANIZATION (2018), at 10, https://www.wto.org/english/res_e/booksp_e/blockchainrev18_e.pdf.
[142] *Id.* at 10–11.
[143] *Id.*

B. *Corporate Implementation of Blockchain*

Before revolutionizing any data system, it is important for businesses to understand the vulnerabilities of current data systems and how the implementation of blockchain technology can address any weaknesses. In the highly advanced industries, such as SME, information is valuable. In turn, the protection of all proprietary information is vital. Yet, traditional security systems often apply the "security through obscurity" approach to database engineering.[144] The theory behind this approach is to keep the security mechanisms a secret. However, a major problem associated with this approach is that the entire system is vulnerable if someone were to hack the security mechanism. In other words, if a security breach were to occur then all of the data is accessible, and the system could collapse. By contrast, blockchain has no single point of vulnerability. As noted by Marhsall Gerstien & Borun LLP, an intellectual property law firm, blockchain is "a distributed ledger network using public-key cryptography to cryptographically sign transactions that are stored on a distributed ledger, with the ledger consisting of cryptographically linked blocks of transactions."[145] So instead of implementing one security mechanism for the entire database, blockchain individually encrypts each transaction stored in the chain.[146]

Blockchain eliminates the internal bad actor or spy problem. Information stored on a blockchain is accessible to authorized parties, however the information on the chain can be limited to viewing while downloading or copying functions are disabled. Genomic companies are implanting this type of blockchain for DNA data storage.[147] Nebula Genomics, for example, allows third parties to access the whole-genome sequences under certain specified conditions.[148] However, the information is limited to the blockchain platform. Third parties do not have the capability to download or transfer the information for personal use, allowing consumer to utilize their genetic information in a protected system.[149] As such, employees, customers, and vendors are put in a better position to exchange or release such information.

Consortium permissioned or private blockchain systems with business-to-government (B2G) capabilities can revolutionize Export Controls compliance by allowing companies to program the system around their specific security and industry needs. The scalability of private systems allows companies[150]to access data such as internal designs, developments, productions, manufacturing, assembly, operations, repairs, testing, maintenance or modification of regulated software. The decentralized blockchain system

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[144] Nir Kshetri, *Blockchain's roles in strengthening cybersecurity and protecting privacy*, 41 TELECOMM. POL'Y 1027, 1028 (2017).
[145] *Id.* at 1029.
[146] Ron Ribitzky et al., *Pragmatic, Interdisciplinary Perspectives on Blockchain and Distributed Ledger Technology: Paving the Future for Healthcare*, BLOCKCHAIN IN HEALTHCARE TODAY, https://blockchainhealthcaretoday.com/index.php/journal/article/view/24/21 (last visited Sep. 28, 2020).
[147] Helen Albert, *How Blockchain Companies Are Helping Us Protect Our Genomic Data*, LABIOTECH.EU (June 26, 2019), https://www.labiotech.eu/features/blockchain-control-genomic-data/; Megan Molteni, *These DNA Startups Want to Put All of You on the Blockchain*, WIRED (Nov. 16, 2018), https://www.wired.com/story/these-dna-startups-want-to-put-all-of-you-on-the-blockchain/.
[148] Molteni, *supra* note 147.
[149] *Id.*
[150] Ribitzky, *supra* note 146, at 4.

provided heighted security because the standard centralized cloud model is susceptible to manipulation and requires companies to share data with third parties.

The cybersecurity capabilities of blockchain address the federal government's national security concerns. In a blockchain, the system maintains an immutable real-time ledger of all data transfers while also allowing different levels of access to certain users. The "super audit trail" is one of the major factors behind other industries' building and testing blockchain applications.[151] Companies subject to Export Controls have the option of connecting the federal government to their distributed ledgers or providing a current blockchain record upon request or audit. Since the information is not stored in a single centralized location, all servers will need a consensus protocol to protect the record changes from discrepancies. The record details every transaction including the parties involved and information exchanged in an encrypted form. The transaction of information will only occur if both parties are authorized by the system. In the Export Controls context, the system could be programmed to limit access to foreign persons while providing U.S. persons not subject to regulations access to sensitive information. Such protection procedures ensure compliance with Export Controls by allowing only authorized persons to access regulated information or technology.

Additionally, blockchain technology can assist supply chain operations in complying with Export Controls by utilizing "smart contracts," coded computer functions that self-execute based on activities in the chain,[152] in transactions subject to Export Controls. For example, whenever a transaction involves delivering a dual-use technology to an employee, customer, or vendor, a smart contract could require proof of authorization or licensing prior to enabling the transaction. This system would also limit administrative costs and the potential for fraud by implementing an automated process. The interconnection of the parties' involved, including regulators, can exponentially increase international transaction speeds.[153]

C. Corporate Challenges Associated with Blockchain Systems

Blockchain offers many of benefits; however, it does present numerous, varying challenges. Export controls are constantly changing, and regulators are constantly working to account for new emerging technology. Additionally, the constant advancements in high-tech industries can make currently regulated technology obsolete in the near future. The policy and administration regarding Export Controls will always be subject to political changes in Congress and the Executive. Under President Trump, the federal government has adopted a protectionist foreign policy against China. This policy could change very soon if someone else were elected president in 2020, though it is unlikely that the federal government's concerns of espionage and economic espionage will change—even if a commercial trade agreement was established.

Implementing blockchain technology in a company's IT system is not the only way for companies to seek compliance with Export Controls. A persuasive LOE formatted around BIS's recommendations for obtaining more deemed export licenses can be obtained

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[151] Kshetri, *supra* note 144.

[152] *A Primer on Smart Contracts*, CMTY. FUTURES TRADING COMM'N., at 4 (Nov. 27, 2018), https://www.cftc.gov/sites/default/files/2018-11/LabCFTC_PrimerSmartContracts112718.pdf.

[153] Ganne, *supra* note 141, at 17–25.

through an encrypted database or managed database capable of comparable features. These systems lack documentation of who accessed data when. Rather, they can only provide similar firewall mechanisms and security measures. While any data system is susceptible to hackers, companies may prefer to implement a cybersecurity strategy that will not concern stakeholders, as the value of a company is inherently tied to the risk of potential government enforcement actions.[154] Another major fault associated with blockchain is the need for more research and development of appropriate consensus models. Bitcoin currently utilizes a proof-of-work consensus model. This model requires a lot of computing power to validate the transactions because it must solve a computationally intensive puzzle to verify blocks on the chain.[155] This type of consensus model is not sustainable, as Bitcoin uses as much energy as the entire country of Switzerland.

V. CONCLUSION

Blockchain represents a powerful emerging technology capable of enhancing Export Controls compliance and corporate record keeping. The technology has numerous features that can address the federal government's concerns regarding U.S. technology. By providing an immutable record to a highly secure cyber system, corporations can discover bad actors before they can use any company information to steal clients or, worse, provide their information to foreign adversaries. However, the creation and implementation of a blockchain system will require businesses to devote substantial manpower and funding to address the technical challenges.

More importantly, once a blockchain system is developed, there is still no guarantee that this type of system will result in deemed export licenses. The federal government needs to work with advanced technology companies on solutions for export licensing. Highly advanced companies should not attempt to solve such a complex problem with an elementary tactic such as lobbying. Rather, businesses in the SME and other regulated industries need to reevaluate their cybersecurity to address faults in traditional methods and work with the federal government to navigate the governance challenges associated with Export Controls. The successful development of private permissioned blockchains will contribute to a robust American economy that is equipped to protect against espionage.

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[154] Will Kenton, *Regulatory Risk Defined*, INVESTOPEDIA (Jan. 12, 2018), https://www.investopedia.com/terms/r/regulatory_risk.asp.

[155] *Bitcoin Energy Consumption Index*, DIGICONOMIST (Sept. 20, 2020), https://digiconomist.net/bitcoin-energy-consumption. Note that this source is updated continuously.

COMMENT

FIDUCIARY DUTY AND SOCIAL RESPONSIBILITY: IMPLICATIONS OF THE BUSINESS ROUNDTABLE'S STATEMENT ON THE FIDUCIARY DUTIES OF BOARDS OF DIRECTORS TO CORPORATE STAKEHOLDERS OTHER THAN SHAREHOLDERS.

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CONTENTS

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I. INTRODUCTION

For Nobel economist Milton Friedman, it was simple: "There is one and only one social responsibility of business . . . to engage in activities designed to increase its profits." [1] Companies must obey the law, Friedman noted, but beyond that, a company's job is to earn a profit for its shareholders.[2] In the American economy, Friedman's view prevailed.[3] For the last fifty years, Friedman's philosophy of "shareholder primacy" has been the core operating principle of public companies, both on Wall Street and in the corporate boardroom. The ideology of shareholder primacy defined American corporate culture. Indeed, it was this mindset that informed corporate raiders like the late T. Boone Pickens,[4] and contributed to an unwavering focus on quarterly earnings reports.[5] From economics, to law,[6] to pop culture,[7] shareholder primacy and the idea that "greed is good" is the lens through which American business is viewed.

Shareholder primacy is the principle that the board of directors of for-profit, business corporations have a fiduciary duty to shareholders that takes priority over whatever duties they might have to other corporate constituencies, such as consumers, employees, and the communities in which their business is located. Shareholder primacy gives shareholders significant authority in corporate affairs such as the power to elect directors, amend corporate charters and hold shareholder referenda on business decisions.

By the mid-1980s, the doctrine of shareholder primacy had become settled law and policy. The courts in the state of Delaware—home to more than 66% of all Fortune 500 companies[8]—began to issue key decisions, and the legislature enacted key statutes, firmly establishing the board's duty to its stockholders. Also during this period, a coalition of investors, business leaders, academics, economists, lawyers, and policy makers coalesced around the concept.[9] Finally in 1997, the Business Roundtable, an influential lobbying group composed of chief executives of the nation's largest corporations,[10] enshrined the philosophy of shareholder primacy in its Statement on Corporate Governance: "the paramount duty of management and of boards of directors is to the

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[1] Milton Friedman, *A Friedman Doctrine-The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times Mag., Sept. 13, 1970, at 32, 126.
[2] *See id.*
[3] Steve Denning, *Making Sense of Shareholder Value: 'The World's Dumbest Idea'*, Forbes (July 17, 2017, 07:29 PM), https://www.forbes.com/sites/stevedenning/2017/07/17/making-sense-of-shareholder-value-the-worlds-dumbest-idea/?sh=1de49b6a2a7e. For a detailed report on corporate governance theory across European states see Int'l Fin. Corp., A Guide to Corporate Governance Practices in the European Union 13-108 (2015).
[4] *See* Editorial Board, *T. Boone Pickens Jr.*, Wall St. J., (Sept. 11, 2019, 7:15 PM), https://www.wsj.com/articles/t-boone-pickens-jr-11568243724.
[5] David Millon, *Radical Shareholder Primacy*, 10 U. St. Thomas L.J. 1013, 1018 (2013).
[6] *See generally* Robert J. Rhee, *A Legal Theory of Shareholder Primacy*, 102 Minn. L. Rev. 1951, 1990 (2017); Dodge v. Ford Motor Co., 170 N.W. 668, 679 (Mich. 1919).
[7] Wall Street (American Entertainment Partners & Amercent Films 1987); Wolf of Wall Street (Red Granite Pictures et al. 2013).
[8] Brett Melson, *200,000 New Delaware Companies in 2017*, Delaware Inc. (Aug. 28, 2018), https://webcache.googleusercontent.com/search?q=cache:kQW4BydVFJAJ:https://www.delawareinc.com/blog/new-delaware-companies-2017/+&cd=11&hl=en&ct=clnk&gl=us.
[9] David J. Berger, *Reconsidering Stockholder Primacy in an Era of Corporate Purpose*, 74 Bus. Law. 659, 662 (2019).
[10] Signatory companies include Amazon, American Express, Goldman Sachs, Lockheed Martin, Pfizer Inc., Walmart, etc. *See* Press Release, Bus. Roundtable, Statement on the Purpose of a Corporation (Aug. 19, 2019) (on file with author), https://s3.amazonaws.com/brt.org/BRT-StatementonthePurposeofaCorporationOctober2020.pdf.

corporation's stockholders."[11] Each subsequent version of the Statement, published over the next twenty years, stated that corporations exist principally to serve their shareholders.

Times change.

In August 2019, 181 members of the Business Roundtable, including the leaders of Apple, JPMorgan Chase, and Walmart eschewed decades of long-held corporate orthodoxy in an attempt to redefine "the purpose of a corporation."[12] Breaking with the established idea that the primary responsibility of a corporate board and senior management should be to maximize shareholder value the Business Roundtable issued a statement (the "Statement") arguing that instead, corporate boards must make "a fundamental commitment to all . . . stakeholders."[13] This reimagined idea of a corporation dispenses with the notion that for-profit corporations function first and foremost to serve their shareholders and maximize profits. Rather, investing in employees, delivering value to customers, dealing ethically with suppliers, and supporting outside communities are goals to be taken into account when setting corporate policy, according to the Statement.

Though a shock to the system, this change was not unexpected. With corporate leaders facing widening social and political pressure in areas such as corporate governance, the environment, and what many see as a failure of capitalism to serve the broader needs of society, many believe the Statement to be a reflection of the current business environment. This shift in corporate priorities comes at a moment of increasing distress in corporate America as big companies face mounting global discontent over income inequality, harmful products, and poor working conditions.[14]

The Statement received intensive media coverage across the United States.[15] Skeptics aptly point out that the Business Roundtable did not accompany its Statement with a plan of action.[16] Indeed, the Business Roundtable's decision to change the definition of corporate purpose is not

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[11] Bus. Roundtable, Statement on Corporate Governance 3 (1997), http://www.ralphgomory.com/wp-content/uploads/2018/05/Business-Roundtable-1997.pdf.

[12] Bus. Roundtable, *supra* note 10, at 1.

[13] *Id.*

[14] Some economic experts suggest business leaders are feeling pressure to rethink the role of business in society for a number of reasons. First, social norms are changing and expectations from employees, customers, and even investors are rising fast. Second, there's a growing realization that a focus on one key stakeholder or metric is flawed. Third, investors like Blackrock's CEO, Larry Fink, are increasingly pressing companies to focus on their purpose and how they contribute to society. But fourth, and perhaps most importantly, the world faces enormous, thorny challenges that business is feeling: climate change, growing inequality, awareness CEOs make hundreds of times more than their employees, water and resource scarcity, soil degradation and loss of biodiversity, and more. These issues require systemic efforts, cooperation, and pricing of those "externalities"—like pollution and carbon emissions—that business has been able to push off to society. The current shareholder-obsessed system is not fit for this purpose, critics suggest. Individual profit-maximizing businesses will not be incentivized to tackle shared global challenges. *See* Andrew Winston, *Is the Business Roundtable Statement Just Empty Rhetoric?*, Harv. Bus. Rev., Aug. 30, 2019, https://hbr.org/2019/08/is-the-business-roundtable-statement-just-empty-rhetoric.

[15] *See, e.g.*, David Gelles & David Yaffe-Bellany, *Shareholder Value Is No Longer Everything, Top C.E.O.s Say*, N.Y. Times (Aug. 19, 2019), https://www.nytimes.com/2019/08/19/business/business-roundtable-ceos-corporations.html; Alan Murray, *America's CEOs Seek a New Purpose for the Corporation*, Fortune (Aug. 19, 2019), https://fortune.com/longform/business-roundtable-ceos-corporations-purpose/; Jim Ludema & Amber Johnson, *The Purpose of the Corporation? Business Roundtable Advances the Conversation, Now We all Need to Contribute*, Forbes (Aug. 20, 2019), https://www.forbes.com/sites/amberjohnson-jimludema/2019/08/20/the-purpose-of-the-corporation/#a0cf05c3846c; *Should Business Put Social Impact Above Profit?*, Aljazeera (Aug. 19, 2019), https://www.aljazeera.com/ajimpact/businesses-put-social-impact-profit-190819184121676.html; *Corporate Leaders Scrap Shareholder-first Ideology*, BBC News (Aug. 19, 2019), https://www.bbc.com/news/business-49400885.

[16] *See* Winston, *supra* note 14.

legally binding. Although the organization may have decided to not put shareholders first, in virtually all 50 states shareholder primacy is still the law.

Approximately 66% of all Fortune-500 companies are organized under Delaware corporate law.[17] For this reason, and because the Delaware courts have a body of well-developed case law concerning the duties of directors of Delaware business corporations, this Paper will focus on Delaware corporate law and governance in addressing the challenge posed by The Business Roundtable's 2019 Statement. In the exercise of their authority and discretion, should the Board of Directors of for-profit, business corporations be deemed to have a fiduciary duty to take into account and act to benefit the interests of all stakeholders in the corporation, including non-shareholder stakeholders, and if so, does this affect or change their fiduciary duties of loyalty and care to shareholders?

A. A Review of Delaware Fiduciary Law

Under current law, a director of an United States corporation still owes her fiduciary duty to the corporation and its stockholders. In fact, just prior to the Roundtable's issuance of the 2019 Statement, Delaware's highest court reaffirmed the long-held doctrine that corporate management is beholden to shareholders alone.[18] Is such a fiduciary-duty mandate inconsistent with the Roundtable's new commitment to other constituencies?

How this tension will be resolved remains to be seen.[19] Such a change in corporate culture has the potential to prompt new developments in the law, potentially leading to new rules about the factors a board of directors must take into account when considering the best interests of company shareholders. Such change may lead to more litigation over board decisions. Many of these legal disputes would likely be heard in the Chancery Court of Delaware, the state under whose laws more major U.S. corporations are incorporated than any other.

Delaware has served as the premier state for the incorporation of business entities since the early 1900s. Why does the second smallest state in the United States occupy such a large place in the world of business entities? A number of factors have led to Delaware's dominance in business formation.

First, the statute—the Delaware General Corporation Law ("DGCL")- is the foundation on which Delaware corporate law rests.[20] Lauded for offering "predictability and stability,"[21] DGCL is shaped by the Delaware General Assembly based on advice provided by The Council of the Corporation Law Section of the Delaware State Bar Association, a group comprised of more than 500 Delaware attorneys, judges, and academics.[22] "The Delaware legislature every year reviews

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[17] *About the Division of Corporations*, Delaware.gov, https://corp.delaware.gov/aboutagency/ (last visited Jan. 31, 2021).

[18] Marchand v. Barnhill, 212 A.3d 805, 808 (Del. 2019).

[19]For a thought-provoking reflection on the Business Roundtable Statement one year later, *see Stephen M. Bainbridge*, The Business Roundtable's Statement on Corporate Purpose One Year Later, DIRECTORS & BOARDS, https://www.directorsandboards.com/articles/singlebusiness-roundtable%E2%80%99s-statement-corporate-purpose-one-year-later (last visited Jan. 31, 2021).

[20] *See* Del. Code Ann. tit. 8 (2020).

[21] *Why Businesses Choose Delaware*, Delaware.gov, https://corplaw.delaware.gov/why-businesses-choose-delaware/ (last visited Jan. 31, 2021).

[22] *About the Section of Corporation Law*, Del. State Bar Ass'n, https://www.dsba.org/sections-committees/sections-of-the-bar/corporation-law/ (last visited Jan. 31, 2021).

the DGCL to ensure its ability to address current issues."[23] The DGCL is not a detailed, prescriptive "company law." Instead, the DGCL includes a select number of mandatory requirements "to protect investors and otherwise provide[] flexibility for corporations to carry out their business."[24]

Second, the courts—as important as the DGCL itself are the courts that interpret it. Delaware is hailed for its judicial system and the expert and impartial judges of the Court of Chancery that decide its corporate cases.[25] Unlike in many other states, Delaware corporate law cases are tried exclusively by professional judges, not by juries.[26] The Delaware Court of Chancery is a specialized court of equity with specific jurisdiction over corporate disputes.[27] Without juries and with only five jurists selected through a bipartisan, merit-based selection process,[28] "the Court of Chancery is known for its prompt, efficient and balanced adjudication of business disputes."[29] Cases from the Court of Chancery are appealed directly to the Delaware Supreme Court, which has final appellate jurisdiction on matters including corporate law.[30] The Delaware Supreme Court has five justices, some of whom served as Chancery Court judges before being elevated to the Delaware Supreme Court. Each justice has considerable experience with Delaware's business law.[31] Delaware's courts also offer a number of options for dispute resolution outside of litigation.[32]

Third, the case law—the Court of Chancery and the Delaware Supreme Court both have a history of issuing reasoned, well-written opinions supporting their decisions, thus allowing a significant body of precedent to accumulate over many decades. Judges, not juries, decide all corporate cases[33] and must give reasons for their rulings. The resulting body of case law provides detailed and substantive guidance to corporations and their advisors. One of the key concepts embodied in Delaware case law is the "business judgment rule," which is a judicial recognition that law-trained judges should not second-guess business decisions made in good faith and with due care by corporate directors—even if the decisions turn out badly.[34] Along with the business judgment rule, case law includes guidelines for directors in upholding their fiduciary duties of loyalty and care.[35]

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[23] *Why Businesses Choose Delaware*, *supra* note 20.
[24] *Id.*
[25] Article IV, Section 3 of the Delaware Constitution requires that that state's judiciary be nearly equally balanced between Democrats and Republicans. The U.S. Supreme Court granted review of this recently. *See* Michael C. Dorf, *If There Are No "Obama Judges" or "Trump Judges," Does the Constitution Permit Delaware to Require Partisan Balance on its Courts? The Supreme Court Will Decide*, Verdict (Dec. 11, 2019), https://verdict.justia.com/2019/12/11/if-there-are-no-obama-judges-or-trump-judges-does-the-constitution-permit-delaware-to-require-partisan-balance-on-its-courts.
[26] *See Litigation in the Delaware Court of Chancery and the Delaware Supreme Court*, Delaware.gov, https://corplaw.delaware.gov/delaware-court-chancery-supreme-court/ (last visited Jan. 31, 2021).
[27] *Court of Chancery*, Del. Cts., https://courts.delaware.gov/chancery/ (last visited Jan. 31, 2021).
[28] *Litigation in the Delaware Court*, *supra* note 25.
[29] *Delaware Court of Chancery Practice*, Polsinelli, https://www.polsinelli.com/services/delaware-court-of-chancery-practice (last visited Jan. 31, 2021).
[30] *Supreme Court*, Del. Cts., https://courts.delaware.gov/supreme/ (last visited Jan. 31, 2021).
[31] *Why Businesses Choose Delaware*, *supra* note 20.
[32] *See Delaware's Options for Alternative Dispute Resolution*, Delaware.gov https://corplaw.delaware.gov/delawares-alternatives-corporations/ (last visited Jan. 31, 2021).
[33] Jeremy Reed & Paul Sponaugle, *What Is the Delaware Court of Chancery?*, Delaware Inc. (June 22, 2020), https://www.delawareinc.com/blog/what-is-the-delaware-court-of-chancery/.
[34] For a detailed discussion of the Business Judgment Rule, see discussion *infra* Section I.A.1.
[35] *See The Delaware Way: Deference to the Business Judgment of Directors Who Act Loyally and Carefully*, Delaware.gov, https://corplaw.delaware.gov/delaware-way-business-judgment/ (last visited Jan. 31, 2021).

Fourth, the legal tradition—along with a sophisticated judiciary, Delaware has an ample supply of lawyers who are experts in Delaware corporate law.[36] Delaware's statutes and case law provide a base of knowledge for attorneys who specialize in Delaware transactional matters and who practice in front of Delaware's courts. These professionals also assist the legislature by continually reviewing the business statutes and annually recommending changes to keep Delaware's law current.[37]

Fifth, the Delaware Secretary of State—the Division of Corporations of the Delaware Secretary of State's Office exists to provide corporations and their advisors with prompt and efficient service. Incorporations provide a major portion of the State's revenue. Accordingly, Delaware takes its role seriously. The personnel of the Division of Corporations view themselves as employees of a service business, and the Division meets worldwide quality standards as evidenced by its ISO 9001 certification.[38]

A cornerstone of Delaware corporate law is DGCL § 141(a): "the business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . ."[39] Pursuant to statute, directors serve as agents and fiduciaries to the owners of the corporation—shareholders. DGCL assigns both a duty of care and a duty of loyalty to corporate boards of directors.[40]

1. Duty of Care

The duty of care requires a fiduciary to be informed of all material information reasonably available before making a business decision on behalf of the corporation.[41] The fiduciary must act with a level of care that ordinarily careful and prudent persons would use in similar circumstances. In reviewing whether a director has satisfied the duty of care, Delaware courts have looked at the information available to a director and the process followed by the board in reaching its decisions.[42]

In evaluating a director's actions under the duty of care standard, courts apply the "business judgment rule."[43] The rule is a standard of review, not a separate standard of conduct. Under the business judgment rule, courts will presume that disinterested directors have made decisions on an informed basis with a good faith belief that the decisions are in the best interests of the corporation.[44] Parties challenging board decisions can rebut this presumption by demonstrating that the directors were grossly negligent in their decision- making in violation of their duty of care.[45] If this presumption is overcome, the directors will have the burden of proving the reasonableness of the challenged action.

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[36] As a state, Delaware has a relatively small bar, approximately 967,171,000, while a state such as New York has approximately 19,542,209,000. However, of those 967,171,000, a significant percentage of Delaware lawyers practice corporate law or serve as local counsel to corporations.

[37] *See About the Section of Corporation Law*, *supra* note 21.

[38]Delaware Division of Corporations, *ISO 9001 Statement*, Delaware.gov, https://corpfiles.delaware.gov/CorpISO9001Statement.pdf (last updated Apr. 8, 2019).

[39] Del. Code Ann. tit. 8, § 141 (2020).

[40] William M. Lafferty et al., *A Brief Introduction to the Fiduciary Duties of Directors Under Delaware Law*, 116 Penn. St. L. Rev. 837, 841 (2012).

[41] *Id.* at 842.

[42] *Id.* at 842-44.

[43] *Id.* at 841.

[44] *Id.*

[45] *Id.* at 842.

Under the business judgment rule, courts focus on the board's process in making a decision, rather than the outcome of the decision. In determining whether the directors have satisfied their fiduciary duties, courts generally give deference to the board and will not substitute their own judgment for the board's judgment, even if a decision turned out to be unwise, so long as the directors acted on an informed basis, in good faith, and in the rational belief that the decision made was in the best interests of the company and its stockholders.[46]

2. Duty of Loyalty

The duty of loyalty prohibits self-dealing by directors and requires that directors adhere to their fiduciary duty as directors of the corporation.[47] It requires them to act in good faith and in a manner they reasonably believe to be in the best interests of the corporation and its stockholders. A guiding principle of this duty is that a director's own financial or other self-interest may not take precedence over the interests of the corporation and its stockholders when making decisions on behalf of the corporation.[48] Also, an integral component of the duty of loyalty is the obligation to act in good faith in the oversight of the corporation.[49] While some U.S. courts characterize good faith as a separate duty, the courts in Delaware generally treat it as subsumed within the duty of loyalty.[50]

A director's duty of loyalty is often implicated in connection with (i) conflicts of interest and (ii) corporate opportunities:[51]

A conflict of interest may exist when a director has a direct or indirect personal or financial interest in a transaction or other matter involving the corporation. As a general matter, directors should promptly disclose potential conflicts of interest to the board and describe all material facts concerning the transaction or other matters that are known to the director.[52] Following disclosure, an interested director should not vote on the matter that involves the conflict of interest. In some circumstances it may be appropriate for the director to refrain from participating in discussions of the matter, or to excuse himself from the board meeting during such discussions.

Transactions that present conflicts of interest should be approved by a majority of the disinterested directors after full disclosure of all material information regarding the transaction and the nature of the director's interest in the transaction.[53] Directors have a duty to disclose to the board material information in their possession bearing upon a board decision, particularly where the directors have a personal interest in the outcome of the board decision. When such approval is obtained, if a shareholder sues the board of directors for a breach of the duty of loyalty, the burden of proving that the transaction is not fair to the corporation generally shifts to the person challenging the transaction.[54] In the absence of such approval, if a particular transaction is challenged, the presence of a conflict will not automatically void a transaction, but the company

[46] *Id.* at 841.
[47] *Id.* at 844.
[48] *Id.* at 845.
[49] *Id.* at 847.
[50] *Id.*
[51] *Id.* at 845.
[52] *Id.* at 844-46.
[53] *Id.*
[54] *Id.*

and the interested director have the burden of establishing the fairness of the transaction to the corporation.[55]

In reviewing the fairness of a transaction where a conflict of interest exists, courts will look at the terms of the transaction as well as the process used by the board in approving the transaction.[56] With regard to terms, courts will examine the economic considerations relied upon when valuing the proposed transaction and whether the transaction is on arms-length terms. In order to mitigate risks, disclosure of conflicts of interest and the results of deliberations by disinterested directors concerning such matters should be reflected in board minutes.[57]

Additionally, the duty of loyalty generally requires that if a director gains access to a corporate opportunity related to the business of the corporation, the director must make that opportunity available to the corporation before pursuing it on his own behalf. Directors should consider the following factors when deciding whether a potential business transaction is a corporate opportunity: the relevance of the opportunity to the corporation's existing or proposed business; the context in which the director became aware of the opportunity; the possible impact of the opportunity on the corporation and the level of interest of the corporation in the opportunity; and the reasonableness of any corporate expectation that the director should present the opportunity to the corporation.[58]

If a director presents the opportunity to the board and the disinterested directors disclaim interest in the opportunity, the director may pursue the opportunity on the director's own behalf. The director should be careful, however, to consider any negative publicity or impact on investor relations before pursuing the opportunity.

B. Discussion Roadmap

If CEOs truly wish to consider other corporate stakeholders on an equal footing with shareholders, Delaware law, as currently written and interpreted, bars their way. Thus, at present, the aspirations raised in the Business Roundtable statement are not enforceable. Indeed, a stakeholder perspective, as contemplated in the Business Roundtable's Statement is implausible. The Statement contains no legally binding obligation. What the CEOs "commit" to in the Business Roundtable's Statement is almost certainly not legally enforceable under a contract theory.[59] To be sure, stakeholders—employees especially—do possess legal remedies but such remedies are based on statutes and regulations, not agency law.[60]

Under current law, the board or a business corporation does not owe a fiduciary duty to any constituent other than its shareholders. The Delaware Courts have consistently confirmed this

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[55] *See* Shant H. Chalian & Kristen M. Bandura, *The Business Judgement Rule and the Entire Fairness Doctrine*, Robinson & Cole, http://www.rc.com/documents/primer%20on%20business%20judgment%20rule.pdf (last visited Jan. 31, 2020).
[56] *Id.*
[57] *See id.*
[58] *See* Matthew R. Salzwedel, *A Contractual Theory of Corporate Opportunity and a Proposed Statute*, 23 Pace L. Rev. 83, 100-01 (2002).
[59] In order to enforce anything under a contract theory, the elements of a valid contract must be present. Those include, offer, acceptance, and consideration, or some type of justifiable reliance on behalf of a party. No such elements are present here.
[60] *See, e.g.*, The Fair Labor Standards Act of 1938, 29 U.S.C. § 201; Occupational Safety and Health Administration, 29 C.F.R § 1910; The Clean Air Act, 42 U.S.C. § 7401.

single obligation.[61] Most recently, the Delaware Supreme Court reaffirmed this duty in *Marchand v. Barnhill*, when, for the first time, it reversed dismissal of derivative claims based on a board's alleged failure to act in good faith toward company shareholders.[62] Like its predecessor cases, *Marchand* illustrates just how paramount the board's duty to shareholders is.[63] But might this change?

This Paper examines the legal implications of enacting the objectives of the Business Roundtable statement into Delaware law and explores the question: *Should* a duty to non-shareholder corporate stakeholders be formally woven into law?

The Business Roundtable Statement and prevailing Delaware law are at odds. To harmonize the desire of the Business Roundtable and the jurisprudence of the courts, several avenues exist. First, there is the possibility that the Business Roundtable Statement will be codified into Delaware law. Second, is the possibility that Delaware adopts a permissive constituency statute, much like Pennsylvania or Illinois. Third, is the possibility that Delaware law remains unchanged, allowing for only informal and collateral benefits to stakeholders.

This Paper suggests that avenue number one is the least likely and least favorable, as corporations already have the option of amending their articles (certificates) of incorporation and electing to become a benefit corporation, providing for expanded stakeholder rights. Instead, this Paper advocates for possibility three. Option two, the addition of a permissive constituency statute, allows for board deference, which comports with current law and history but often proves inadequate. Option three, while actively implementing no change in the law still allows for the implementation of other measures to balance the stakeholder-rights space. Already, an option-three-like outcome has been endorsed by Delaware Supreme Court Justice Leo Strine.[64]

This Paper is organized as follows. Part two discusses the historic trajectory of the corporation and its long-debated purpose—from its inception to modern-day. Part three explores the trifold of possibilities that could emerge in Delaware corporate governance should the Delaware legislature act on the Business Roundtable Statement. Part four opines whether codifying the Statement is the best option for Delaware and presents arguments in favor and against each of the three presented legal possibilities. Part five concludes that, despite the fluid nature of the debate on corporate purpose, it is possible to maintain shareholder primacy while equitably accounting for the legitimate interests of other stakeholders.

II. THE METAMORPHOSIS OF THE CORPORATION

The public business corporation in the United States and England has served a variety of roles and interests for over two hundred years. The business corporation began as an institution chartered by the sovereign specifically to serve designated public functions, such as building

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[61] *E.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 176 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985); In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. Ch. 1996); Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 *Wake Forest L. Rev.* 761, 766 (2015).

[62] Marchand v. Barnhill, 212 A.3d 805, 808 (Del. 2019); *see also* Jason J. Mendro et al., *'Blue Bell' Reaffirms but Does Not Expand the Boundaries of Oversight Liability*, Law.com (July 17, 2019, 9:07 AM), https://www.law.com/delbizcourt/2019/07/17/blue-bell-reaffirms-but-does-not-expand-the-boundaries-of-oversight-liability/?slreturn=20190908165655.

[63] For a greater discussion of the board's duties to shareholders, see *supra* text accompanying notes 17-57.

[64] Strine, *supra* note 60, at 786.

bridges, dredging canals and constructing railroads. Corporations chartered to perform specific public functions had many of the characteristics of joint ventures, with charters that lasted between ten and forty years, often requiring the termination of the corporation on completion of a specific task, setting limits on the kinds of commercial enterprises the corporation could engage in and prohibiting corporate participation in the political process.[65] The corporate format eventually evolved into an independent institution governed by an influential board of directors enjoying a significant amount of discretion and often tasked with the singular goal of maximizing the wealth of its private citizen investor-owners, called shareholders.

In the landmark decision, *Trustees of Dartmouth College v. Woodward* (*The Dartmouth College Case*),[66] Chief Justice Marshall opined that a corporation, though an "immortal" and "artificial being," "may act as a single individual."[67] This decision and Chief Justice Marshall's opinion would mark the advent of corporations as we know them. The passing of the Joint Stock Companies Act of 1844[68] represents another milestone of the metamorphosis of the corporation, as it authorized the registration and incorporation of companies without specific legislation and allowed them to define their own purpose.[69] As states began to enact incorporation laws that permitted persons to incorporate at will, courts began to entrust them with more autonomy. In 1855, under the Limited Liability Act, shareholders were awarded limited liability: their personal assets were protected from the consequences of their corporate behavior.[70] In 1886, the United States Supreme Court recognized the corporation as a "natural person" under law.[71]

By the end of the nineteenth century, the idea of the public business corporation in America as a generator of wealth and prosperity had achieved widespread acceptance. The same was true for the American ideology of corporate capitalism. This generated a backlash among progressives and laborers, who bristled at the size, power, and behavior of giant industrial enterprises, which

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[65] *A Short History of Corporations*, New Internationalist (July 5, 2002), https://newint.org/features/2002/07/05/history.
[66] Trustees of Dartmouth College v. Woodward, 17 U.S. 518 (1819).
[67] *Id.* at 636-37.
[68] Joint Stock Companies Act of 1844, 7 & 8 Vict. c.110 (Eng.).
[69] Prior to the 1844 Act, in general, incorporation was only possible by royal charter or private act. *See* John D. Turner, *The Development of English Company Law Before 1900* 4 (QUCEH Working Paper Series, No. 2017-01), https://www.econstor.eu/bitstream/10419/149911/1/877815712.pdf. The privilege of incorporation was closely guarded and rarely granted, because of the government's strict protection over the advantages thereby granted. Before the passage of general incorporation laws, corporations in America existed as specially chartered non-profit organizations, whose special status depended upon their promise to provide some sort of public function. The king of England, and later state governments in the U.S., would grant special charters to schools, churches, and municipalities, allowing such organizations to act as legal persons, i.e., to own property and to enter into binding contracts. Susan Pace Hamill, *From Special Privilege to General Utility: A Continuation of Willard Hurst's Study of Corporations*, 49 Am. U. L. Rev. 81, 84, 104 n.94 (1999). As artificial entities granted life by virtue of the state, they were subject to regulation by the state. Their special, nearly government-like, status in society meant that such organizations served a public purpose, and thus owed particular duties to the community. Their "shareholders" were not owners of business assets, but instead members of an already identifiable and socially meaningful group. *Id.* at 91. The state would also grant charters for corporations serving an economic purpose. Yet it granted corporate status only after negotiation, and only after argument regarding the important public service that the corporation would provide. Usually, the government would task the corporation to fulfill a specific need of the state's economy, e.g., to build bridges or roads. *Id.* at 105 n.95. The charters of these corporations were, therefore, specifically tailored to the corporation's specific business function. Here, too, the state would cede pieces of its sovereignty, endowing corporate managers with powers usually reserved for government.
[70] *See* Derek James Brocklehurst, *Limited Liability (Part 1): Heads I Win, Tails You Lose*, Managerism (Oct. 10, 2018) 1, https://www.managerism.org/images/pdf/Limited_Liability-oct2018.pdf.
[71] Santa Clara Cnty. v. S. Pac. R.R. Co., 118 U.S. 394, 409 (1886).

were dominated by power players including railroad magnates and robber barons.[72] As massive labor unrest brewed, the Sherman Act of 1890 and the Clayton Antitrust Act of 1914 were enacted. The Clayton Act proscribed monopolies that sought to enable the amassment of wealth and power in the hopes of empowering state regulation. Soon, American industry came to rely less on the "capitalist"[73] class, and corporate finance began to emanate from an array of equity investors, who placed their wealth into the hands of specialized corporate managers.[74] Weak were the voices of these neophyte shareholders. Capitalizing on the inexperience of these new equity investors, corporate directors retained company earnings rather than distributing dividends.[75] As the size and prevalence of the American business corporation grew, the American economy was transformed. Such transformation inspired competing theories of corporate purpose: stockholder primacy versus stakeholder primacy.

The modern debate over the purpose of a corporation can be traced back to 1931, at the height of the Great Depression, when the *Harvard Law Review* published opposing positions from two leading corporate scholars: Adolph Berle and Merrick Dodd.[76] Berle, along with colleague Gardiner Means, made the case for what came to be known as 'shareholder primacy,' the idea that a corporation exists to make a profit for its shareholders. The authors argued that "all powers granted to a corporation or the management of a corporation . . . are necessarily and at all times exercisable only for the ratable benefit of all the shareholders."[77] Berle sought to emphasize the negative implications of the concentration of exorbitant power and wealth in the hands of a corporation's board of directors. By surrendering control and responsibility over their investments, Berle argued, contemporary shareholders created a new form of property, one over which shareholders could claim ownership, but no control.[78] Shareholders of public corporations had lost their ability to control firm policies; their stocks were considered investments rather than an ownership stake that conferred control over the firm. Berle and Means used this development to justify the promulgation of a different kind of property theory that accounted for the unique characteristics of dispersed stock ownership.[79] Their solution was to name a corporation's board of directors as the trustee of this new form of property, controlled for the benefit of shareholder profit.[80]

Not so, Dodd countered. Dodd maintained that corporations are economic institutions that have "a social service as well as a profit-making function."[81] Under this theory, corporations are not simply economic vehicles to produce shareholder returns, but are vital societal entities that

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[72] Will Kenton, *Robber Barons*, Investopedia (Mar. 13, 2020), https://www.investopedia.com/terms/r/robberbarons.asp.
[73] Angela Wigger, *Understanding the Competition-Crisis Nexus: Revisiting U.S. Capitalist Crises*, 29 Rethinking Marxism 556, 556-73 (2018).
[74] Alfred D. Chandler, Jr., The Visible Hand: The Managerial Revolution In American Business 484 (1977) (examining the modem shift toward managers running large corporations and its effect on the concentration in American industries).
[75] Mark S. Mizruchi & Daniel Hirschman, *The Modern Corporation as Social Construction*, 33 Seattle U. L. Rev. 1065, 1070 (2010).
[76] A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049, 1049 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 Harv. L. Rev. 1145, 1148 (1932).
[77] Berle, *supra* note 75, at 1049.
[78] Mizruchi & Hirschman, *supra* note 75, at 1068-69.
[79] Dalia Tsuk, *Corporations Without Labor: The Politics of Progressive Corporate Law*, 151 U. Pa. L. Rev. 1861, 1887 (2003).
[80] *Id.* at 1888.
[81] Dodd, *supra* note 75, at 1148.

share interests with multiple groups including employees, consumers, and the general public. Dodd called for a dramatic revision in corporate legal theory that recognized not only investors as the focal point of the enterprise, but suggested that each of these other groups should share equally in the benefits of, and the responsibility for, the operation of the modern corporation.

A. Stakeholder Primacy: Misfortune for Shareholders, Upswing for Other Stakeholders

Dodd's theory of stakeholder primacy gained significant support following the Great Depression.[82] From the end of World War II until the late 1970s, corporate leaders underscored the ideology that a company's primary purpose was to serve all of the various stakeholders who supported the enterprise.[83] Under this theory, stockholders constituted one category of stakeholder, but stockholders were not necessarily afforded priority.

> Corporate stakeholders included the workers who built the products sold by the corporation; suppliers who created the tools the corporation needed to build its products; the communities where the corporation operated (and its employees lived); and the creditors who invested in the corporation by loaning it funds.

Under the stakeholder primacy theory, the role of the board of directors was to manage the corporation for the benefit of all these groups, rather than concentrate solely on shareholder value.[84] Consistent with this theory, *The Business Roundtable* published a policy position that stated:

> Corporations have a responsibility, first of all, to make available to the public quality goods and services at fair prices, thereby earning a profit that attracts investment to continue and enhance the enterprise, provide jobs, and build the economy. . . . The long-term viability of the corporation depends upon its responsibility to the society of which it is a part.[85]

By the late 1970s, however, the tides began to turn.

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[82] *Id.* at 1145-63; Berger, *supra* note 9, at 660 (stating that following the 1929 stock market crash and the Great Depression, stakeholder concerns were being voiced once again, and the corporation is an entity separate from its shareholders and has citizenship responsibilities) Alexander Styhre, *The Making of the Shareholder Primacy Governance Model: Price Theory, the Law and Economics School, and Corporate Law Retrenchment Advocacy*, 8 Acct. Econ. L. 1, 4 (2017) ("In the turmoil that ensued after the . . . crash, an entirely new governance regime was widely regarded by policymakers as imperative to securing economic growth and prosperity, and, not least, social stability in the US. The New Deal programs initiated by the newly-elected Franklin D. Roosevelt largely set the framework for the corporate governance regime that would prevail well into the 1970s.").

[83] William Lazonick, *Profits Without Prosperity*, Harv. Bus. Rev., Sept. 2014, https://hbr.org/2014/09/profits-without-prosperity.

[84] *See* Robert Reich, *How Business Schools Can Help Reduce Inequality*, Harv. Bus. Rev., Sept. 12, 2014, https://hbr.org/2014/09/how-business-schools-can-help-reduce-inequality (stating that recognizing this duty, in 1951, Frank Abrams, then chairman of Standard Oil, described the goal of the modern corporation after World War II as maintaining "an equitable and working balance among the claims of the various directly interested groups . . . stockholders, employees, customers, and the public at large[,]" and this consensus view lasted for decades).

[85] Bus. Roundtable, Statement on Corporate Responsibility 12 (1981), http://www.ralphgomory.com/wp-content/uploads/2018/05/1981-Business-Roundtable-Statement-on-Corporate-Responsibility-11.pdf.

B. The Rise of Shareholder Primacy

Nearly forty years after Berle and Dodd squared off in the *Harvard Business Review*, the clear ascendance of shareholder primacy theory began. In the 1970s, as inflation surged, the economy witnessed recession. In response, the government set out to jumpstart the stagnating economy by reducing the costs of doing business. Corporate tax rates plummeted while free trade increased.[86] The federal government began to deregulate. As American political discourse concentrated on the pruning of government power, the corporation as an expression of private economic power became a paradigm of the new economic order.

Accompanying the new economic order was new economic orthodoxy: the 'social responsibility of business is to increase its profits.'[87] The ideology of shareholder primacy spread widely among academics and managers, fueled in part by what became known as "agency theory" — built on the idea that managers serve as agents for the shareholders, who are the principals of the corporation.[88] Friedman, a principal crusader of the theory, became President Ronald Reagan's most trusted economic adviser. Soon shareholder primacy became a lynchpin of Reaganomics and American capitalism.

So rapidly did this ideology of shareholder primacy take hold, that by the mid-1980s, the doctrine was codified into law.[89] Courts in Delaware and elsewhere issued a series of key decisions firmly establishing the corporate board's duties to stockholders as their primary fiduciary responsibility.[90] This judge-made common law serves as foundational precedent in the modern corporate governance space, and is now supplemented by statute.[91]

The legal theory of shareholder primacy appealed to the media— "the idea that shareholders were king simplified the confusing debate over the purpose of a corporation."[92][9More

[86] Mizruchi & Hirschman, *supra* note 75, at 1097-98.
[87] Friedman, *supra* note 1, at 32.
[88] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. Fin. Econ. 305, 305-60 (1976).
[89] From 1900-1979, courts were virtually silent on the idea of profit maximization. However, starting in the mid-1980s, judicial discussion of the concept increased dramatically. In light of well-known business, economic, and intellectual histories, the increase in cases with the 1980s as the inflection point should not be surprising. The data confirms that shareholder primacy is judge-made law. *See* Robert J. Rhee, *A Legal Theory of Shareholder Primacy*, Harv. L. Sch. F. on Corp Governance (Apr. 11, 2017), https://corpgov.law.harvard.edu/2017/04/11/a-legal-theory-of-shareholder-primacy/.
[90] *E.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).
[91] Del. Code Ann. tit. 8, § 141 (2020).
[92] Cydney Posner, *Washington Post Article on the Shift to Maximizing Shareholder Value*, Cooley (Aug. 30, 2013), https://www.cooley.com/news/insight/2013/washington-post-article-on-the-shift-to-maximizing-shareholder-value.

powerfully, it helped spawn the rise of stock-option pay,[93] corporate raiders,[94] and an unswerving focus on quarterly earnings reports.[95]

In 1997, The Business Roundtable adopted shareholder primacy, writing that "the paramount duty of management and of boards of directors is to the corporation's stockholders; the interests of other stakeholders are relevant as a derivative of the duty to stockholders."[96] Notably, each version of its principles published over the past twenty years has stated that corporations exist principally to serve their shareholders.[97]

Yet today, in an atmosphere of widening economic inequality and deepening distrust of business that is similar to the ethos that many felt in late 19th and early 20th century America, this influential group has redefined its position.

C. The Reemergence of a Broader Corporate Purpose

Despite the late 20th century eclipse of Dodd's push to treat shareholders and stakeholders as equivalent within the corporation, in recent years the growing question of corporate purpose has led to renewed calls for a paradigm shift towards a stakeholder theory.

[93] Stock options are a form of compensation. Companies can grant them to employees, contractors, consultants and investors. These options, which are contracts, give an employee the right to buy or exercise a set number of shares of the company stock at a pre-set price, also known as the grant price. *See* Elvis Picardo, *Employee Stock Option*, Investopedia (Sept. 17, 2020), https://www.investopedia.com/terms/e/eso.asp.

[94] The presence of corporate raiders illustrates the principle that the primary responsibility of corporate boards and senior management is to their shareholders, to maximize the return on their shareholders' investment in the company. While the twentieth century saw the nationalization of the public corporation in the United States, the twenty-first century bears witness to its internationalization throughout the world. The elimination of barriers to capital markets, along with privatization of national enterprises and pensions, yielded a new breed of investors with never-before-seen influence on capital markets and, therefore, corporate decision-making. *See* Leo E. Strine, *Towards Common Sense and Common Ground? Reflections on the Shared interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. Corp. L. 1, 4 (2007). Many of these investors clamored for profits, i.e., short-term increases in share price. *Id.* at 13. Flooding the world's burgeoning securities markets, these investors are often institutional and managed by intermediaries who do not necessarily share the same values as the companies in which they invest. Indeed, they often do not share the same values as the beneficiaries on whose behalf they invest-many of whom are themselves, ironically, corporate stakeholders. *Id.* at 4-5. An increasingly active hostile takeover market, prompted by stagnating securities markets in the 1970s, likewise turned directors' attention from long-term growth to their short-term job security, and, therefore, short-term stock prices. *See* Mizruchi & Hirschman, *supra* note 75, at 1100. Corporate managers, also aware that unhappy investors could move their money abroad and into to the budding global capital markets, would work hard to keep their stockholders happy. Cynthia Estlund, *Who Mops the Floors at the Fortune 500? Corporate Self-Regulation and the Low-Wage Workplace*, 12 Lewis & Clark L. Rev. 671, 679 (2008). Quarterly financial reporting requirements, in addition, focused management not on long-term sustainable growth, but short-swing profits.

[95] Lynn A. Stout, Response, *The Toxic Side Effects of Shareholder Primacy*, 16 U. Penn. L. Rev. 2003, 2019 (2013).

[96] Bus. Roundtable, *supra* note 11, at 3.

[97] *Business Roundtable Redefines the Purpose of a Corporation to Promote 'an Economy that Serves All Americans'*, Bus. Roundtable (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans ("Since 1978, Business Roundtable has periodically issued Principles of Corporate Governance. Each version of the document issued since 1997 has endorsed principles of shareholder primacy—that corporations exist principally to serve shareholders.").

This shift comes at a moment of increasing distress in corporate America, as big companies face mounting global discontent over income inequality,[98] harmful products,[99] the power of corporations,[100] environmental degradation,[101] poor working conditions,[102] and corporate reactions to the COVID-19 pandemic.[103] In the midst of this shift, The Business Roundtable's landmark 2019 "Statement on the Purpose of a Corporation," effectively repudiates its 1997 declaration that "the paramount duty of management and of boards of directors is to the corporation's stockholders." The new Statement calls on corporate directors and managers to commit to five groups of stakeholders—customers, employees, suppliers, communities, shareholders—without hierarchy. Shareholders are listed fifth, suggesting, perhaps, that they are in effect last among equals.

Some commentators have suggested that the corporate leaders behind the Roundtable's Statement are feeling pressure to rethink the role of business in society for a number of reasons:

> First, social norms are changing and expectations from employees, customers, and . . . investors are rising . . . . Second, [there is] a growing realization that a focus on one key stakeholder or metric is as flawed as using your cholesterol level as the only measure of your health. Third, investors . . . are increasingly pressing companies to focus on their purpose and how they contribute to society. [F]ourth, and perhaps most importantly, the world faces enormous, thorny challenges that business is feeling: climate change, growing inequality [], awareness that [] CEOs make hundreds of times more than their employees, water and resource scarcity, soil degradation and loss of biodiversity, and more. These issues require systemic efforts, cooperation, and pricing of those "externalities" [], like pollution and carbon emissions, that business has been able to push off to society.[104]

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98 *See* Bob Lord, *Inequality in America: Far Beyond Extreme*, Inequality.org (Oct. 12, 2020), https://inequality.org/great-divide/inequality-in-america-far-beyond-extreme/.

99 Examples include recent lawsuits against Purdue Pharma and Johnson & Johnson. *See* Natalie Sherman, *Purdue Pharma to Plead Guilty in $8bn Opioid Settlement*, BBC (Oct. 21, 2020), https://www.bbc.com/news/business-54636002; Tiffany Hsu & Roni Caryn Rabin, *Johnson & Johnson to End Talc-Based Baby Powder Sales in North America*, N.Y. Times (May 19, 2020), https://www.nytimes.com/2020/05/19/business/johnson-baby-powder-sales-stopped.html.

100 Michael Balsamo & Marcy Gordon, *Justice Dept. Files Landmark Antitrust Case Against Google*, Associated Press (Oct. 20, 2020), https://apnews.com/article/google-justice-department-antitrust-0510e8f9047956254455ec5d4db06044; Spencer Soper, *Bezos Disputes Amazon's Market Power. But His Merchants Feel the Pinch*, Bloomberg (Apr. 17, 2019), https://www.bloomberg.com/news/articles/2019-04-17/is-amazon-too-powerful-its-merchants-are-starting-to-wonder.

101 *Brazil's Amazon Rainforest Suffers Worst Fires in a Decade*, Guardian (Oct. 1, 2020), https://www.theguardian.com/environment/2020/oct/01/brazil-amazon-rainforest-worst-fires-in-decade; Zeke Hausfather, *2020 Is on Course to Be the Warmest Year on Record*, World Econ. F. (Oct. 26, 2020), https://www.weforum.org/agenda/2020/10/climate-change-environment-earth-temperature-global-warming-heat/.

102 Andrew Mullin, *Analysis: Aramark Has Some Troubling Practices Outside of CMU*, Cent. Mich. Life (Feb. 13, 2020), https://www.cm-life.com/article/2020/02/aramark-outside-of-cmu; *Amazon Workers Stage Global 'Prime Day' Strikes over Poor Working Conditions*, Bus. & Hum. Rts. Resource Ctr. (July 2019), https://www.business-humanrights.org/en/latest-news/amazon-workers-stage-global-prime-day-strikes-over-poor-working-conditions/.

103 Ezequiel Minaya, *New Ranking of Nation's Top Employers' Responses to Pandemic,* Forbes (May 26, 2020), https://www.forbes.com/sites/ezequielminaya/2020/05/26/the-forbes-corporate-responders-new-ranking-of-nations-top-employers-responses-to-pandemic/#4087e11a4a51.

104 *See* Winston, *supra* note 14.

Proponents of a new corporate purpose suggest the current shareholder system is not fit for this purpose, and evidence suggests that many CEOs have been thinking about corporate objectives in stakeholder terms for some time now. Indeed, many corporate mission statements contain wording that is similar to portions of The Business Roundtable Statement. Most successful managers would probably agree that a company cannot neglect its employees, customers, or suppliers for long without negative implications. But should they have fiduciary obligations to these stakeholders in addition to meeting their statutory and regulatory requirements? Although stakeholder theory is gaining traction in the corporate world and is the rule of law in many states,[105] it remains unclear how an expanded definition of corporate purpose could *legally* be squared with the traditional definition of stockholder primacy. Little is known about the practical implications of adopting a stakeholder theory. If this theory is to be viable in actual corporate governance, the means by which it is to be implemented must be addressed.

III. How Might The Business Roundtable Statement be Woven into Law?

The Business Roundtable is challenging companies incorporated in any of the states to enact change. Still, as the state in which the most public business corporations are incorporated, Delaware is challenged most. What would it really mean for Delaware companies to follow the principle of creating "value for all [] stakeholders?" United States Senator and former 2020 Presidential Candidate Elizabeth Warren hailed the initiative behind The Business Roundtable Statement as a "welcome change," but cautioned, "without real action, it [is] meaningless." This section explores what a Delaware-reaction might look like if the state legislature were to heed the call of The Business Roundtable.

A. *Codifying the Business Roundtable Statement into Delaware Law*

Currently, no state statute requires corporate directors to consider interests other than those of their shareholders when exercising their corporate decision-making authority. Until 2010,

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[105] The following states have some form of constituency statute: Florida, Georgia, Idaho, Indiana, Iowa, Kentucky, Massachusetts, Minnesota, Missouri, New Jersey, New Mexico, New York, Ohio, Oregon, Rhode Island, South Dakota, Tennessee, Wyoming. *See* Fla. Stat. Ann. § 607.0830 (LEXIS through all 2020 general legislation); Ga. Code Ann. § 14-2-202(b)(5) (LEXIS through the 2020 Regular Session of the General Assembly); Idaho Code § 30-1702 (LEXIS through 2020 Regular and First Extraordinary Sessions and November 2020 General Election); Ind. Code Ann. § 23-l-35-l(d) (Burns, LEXIS through the 2020 Second Regular Session of the 121st General Assembly); Iowa Code Ann. § 491.101B (LEXIS through legislation from the 2020 Regular Session of the 88th General Assembly); Ky. Rev. Stat. Ann. § 271B.12-210(4) (LEXIS through Ch.128 of the 2020 Regular Session); Mass. Ann. Laws ch. 156B, § 65 (LEXIS through Chapters 1-208 and the November ballot measures of the 2020 Legislative Session of the 191st General Court); Minn. Stat. Ann. § 302A.251(5) (LEXIS through the end of the 2020 Regular Session, and 5th Special Session, of the 91st Legislature); Miss. Code Ann. § 79-4-8.30(d) (LEXIS through the 2020 Regular Session); Mo. Rev. Stat. § 351.347.1(4) (LEXIS through 100th General Assembly, 2nd Regular Session and 2020 1st Extraordinary Session); N.J. Stat. Ann. § 14A:6-1(2) (LEXIS through New Jersey 219th First Annual Session, L. 2020, c. 109, and J.R. 2); N.M. Stat. Ann. § 53-11-35(D) (LEXIS through all 2020 legislation); N.Y. Bus. Corp. Law § 717(b) (Consol., LEXIS through 2020 released Chapters 1-285); Ohio Rev. Code Ann. § 1701.59(E) (Page, LEXIS through File 53 of the 133rd (2019-2020) General Assembly); Or. Rev. Stat. Ann. § 60.357(5) (LEXISN through the 2020 Second Special Session); R.I. Gen. Laws § 7-5.2-8(a) (LEXIS through Chapter 79 of the 2020 Session); S.D. Codified Laws § 47-33-4 (LEXIS through acts received as of October 1st of the 2020 General Session of the 95th South Dakota Legislative Assembly and Supreme Court Rule 20-06); Tenn. Code Ann. § 48-35-204 (LEXIS through the 2020 Regular and Second Extraordinary Sessions); Wyo. Stat. Ann. § 17-16-830 (LEXIS through 2020 Budget Session and First Special Session of the Wyoming Legislature).

however, Connecticut had a statute that mandated directors of a corporation to consider the interests of its employees, customers, creditors, suppliers, and the community in addition to shareholders.[106] These are the stakeholder groups that are identified in The Business Roundtable Statement as deserving equal consideration with shareholders.[107] Accordingly, in speculating what a Delaware codification of the Statement might look like, this Paper uses Connecticut's prior statute as a model.

Connecticut's statute had read in pertinent part:

> [A] director of a corporation . . . *shall* consider, in determining what he reasonably believes to be in the best interests of the corporation, (1) the long-term as well as the short-term interests of the corporation, (2) the interests of the shareholders, long-term as well as short-term, including the possibility that those interests may be best served by the continued independence of the corporation, (3) the interests of the corporation's employees, customers, creditors and suppliers, and (4) community and societal considerations including those of any community in which any office or other facility of the corporation is located. A director may also in his discretion consider any other factors he reasonably considers appropriate in determining what he reasonably believes to be in the best interests of the corporation.[108]

If the Delaware legislature were to enact a statute codifying the aspirations of The Business Roundtable Statement, such statute might contain language similar to the above. Of course, this Paper would suggest that the statutory language be modified to include gender-neutral terms to prevent the reinforcement of historic gender stereotypes that the Connecticut legislature inadvertently reinforced by using the term "he."[109] This model statute is missing something else, too. While, on its face, the statute would seem to challenge the tenet that corporate directors owe their loyalty exclusively to shareholders, it does not provide non-shareholders with a right of enforcement. If the Business Roundtable Statement were to be codified into a statute with teeth, a cause-of-action for non-shareholders to enforce this provision must be provided for these other stakeholder groups.

Beyond this, Connecticut's constituency statute is silent on many key issues. Among the issues left open by this and almost all current constituency statutes are such critical questions as: How should directors decide whether particular claimants fall into one of the protected constituent categories, some of which, such as customers and communities, are very amorphous? What weight should directors assign to shareholder and non-shareholder interests? What should directors do when those interests cannot be reconciled? What should directors do when the interests of various non-shareholder constituencies conflict amongst themselves? Are all these decisions committed to the directors' discretion and business judgment? What standards should courts use in reviewing a director's decision not to consider non-shareholder interests? What standards of review apply to

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[106] Conn. Gen. Stat. § 33-756 (2009), *amended by* 2010 Conn. Legis. Serv. P.A. 10-35 (H.B. 5530) (West 2010). Arizona may have been mandatory also, but the legislative history is unclear.

[107] Creditors are not mentioned in the Business Roundtable Statement but could be considered customers or suppliers.

[108] Conn. Gen. Stat. § 33-756 (2009), *amended by* 2010 Conn. Legis. Serv. P.A. 10-35 (H.B. 5530) (West 2010) (emphasis added).

[109] *Pronouns*, Cuny Sch. L., https://www.law.cuny.edu/legal-writing/students/grammar/pronouns/ (last visited Nov. 22, 2020).

director action claimed to be motivated by concern for non-shareholder constituents? Nor is there, as yet, any significant guidance from the courts.

Additionally, Connecticut's former mandatory constituency statute only applied in particular circumstances. It applied to directors of a public corporation registered under the Securities Exchange Act of 1934 in control-shifting circumstances only. Similarly, Arizona's previously-mandatory constituency statute expressly limited a board's consideration of non-shareholder constituencies to takeover situations.[110] Idaho's mandatory constituency statutes were also limited to change-of-control or merger scenarios.[111] Though mandatory constituency statues across the country varied in scope, virtually all were limited to cases of mergers, takeovers, or changes-in-control. If Delaware were to enact a mandatory constituency statute that required a board to consider non-shareholder interests in all scenarios—as The Business Roundtable suggests—would the statute need to be drafted so as to apply to virtually any scenario that requires a board of directors to make a decision on behalf of the company, or are there some decisions as to which the interests of shareholders should prevail?

It also is worth noting that even if the model statute is interpreted literally, it requires a *consideration* of the interests of non-shareholders, not *action* to promote or effectuate the interests of non-shareholders. If the Delaware legislature were to seek to change the behavior of corporate leaders, as The Business Roundtable Statement implores, it should require directors to *act* in the best interests of all constituencies, rather than merely consider their interests.

That Delaware has declined to enact any sort of constituency statute over the last three decades suggests that the sudden enactment of a mandatory statute in the state today is highly unlikely. A permissive constituency statute, rather than a mandatory statute, though more problematic, could be more appealing to the legislature.

B. Adopting a Permissive Constituency Statute in Delaware

Although no state currently has a mandatory statute, forty-one states have enacted some form of a permissive constituency statute.[112] Unlike the mandatory constituency statute discussed above, permissive constituency statutes permit, rather than require, corporations to consider non-shareholders' interests. The unifying principle of these permissive statutes is that they "enable corporate directors to consider interests other than those of their shareholders when exercising their corporate decision-making authority."[113] A common permissive constituency statute contains the following provisions:

- The board of directors of a corporation may consider the interests and effects of any action upon non-shareholders.
- The relevant non-shareholder groups include employees, suppliers, customers, creditors and communities.

[110] *See* Az. Rev. Stat. Ann. § 10-2702 (LEXIS through legislation from the 54th Legislature, 2nd Regular Session (2020), all legislation.).
[111] This is because they are included within the control share acquisition statute and a business combination statute. *See* Idaho Code §§ 30-1602, 1702 (LEXIS through 2020 Regular and First Extraordinary Sessions and November 2020 General Election).
[112] Joseph R. Shealy, *The Corporate Identity Theory Dilemma: North Carolina and the Need for Constructionist Corporate Law Reform*, 94 N.C. L. Rev. 686, 698 (2016).
[113] Anthony Bisconti, *The Double Bottom Line: Can Constituency Statutes Protect Socially Responsible Corporations Stuck in* Revlon *Land?*, 42 Loy. L.A. L. Rev. 765, 781-82 (2009).

- The directors may consider both long-term and short-term interests of the corporation.
- The directors may consider local and national economies.
- The directors may consider any other relevant social factors.[114]

In the states that have enacted constituency statutes, directors are allowed to explicitly consider the interests of the community even without a near-term benefit to shareholders.[115]

[These] statutes purport to change the duty of care of officers and directors while creating judicial standards for reviewing nonstatutory antitakeover devices such as poison pills. Whereas many of the early antitakeover devices imposed limitations on entities attempting an unsolicited purchase of another firm without addressing the duties of directors for the target firm, constituency statutes may be expanded to apply outside the context of hostile takeovers to influence everyday board decisions. These improvements suggest that constituency statutes enhance and codify widely accepted legal principles.[116]

The substance of permissive constituency statutes varies from state to state. Still, virtually all permissive statutes can be described as falling into one of four categories: (1) permissive statutes covering all corporate decisions; (2) permissive statutes declaring that the corporation itself is superior to shareholders; (3) permissive statutes covering only hostile takeover-related decisions; and (4) a formally mandatory statute such as Connecticut's, discussed above.

Pennsylvania's permissive constituency statute is an example of a statute that falls into the first category.[117] Pennsylvania's constituency statute provides that directors, in the discharge of their fiduciary duty to protect and promote the best interests of the corporation, may consider the effects of any action upon all groups affected by such action, including shareholders, employees, suppliers, customers, creditors of the corporation, and communities in which offices or other establishments of the corporation are located.[118] Furthermore, directors may consider the "short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation."[119] Importantly, this statute appears to cover all director decisions, not just those in the context of a hostile takeover, merger, or change in control.

Illinois' permissive constituency statute contains similar language, but also states that directors owe a primary duty to the corporation, not shareholders, thus placing it in the second group of statutes.[120] The Illinois statute also explicitly provides that directors must take into account "the effects of any action" and the "long-term and short-term interests of the corporation."

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[114] *Id.* at 782.
[115] Lisa M. Fairfax, *Doing Well While Doing Good: Reassessing the Scope of Directors' Fiduciary Obligations in For-Profit Corporations with Non-Shareholder Beneficiaries*, 59 Wash. & Lee L. Rev. 409, 462 (2002).
[116] Edward S. Adams & John H. Matheson, *A Statutory Model for Corporate Constituency Concerns*, 49 Emory L.J. 1085, 1094 (2000).
[117] 15 Pa. Cons. Stat. § 1715 (2010).
[118] § 1715(a)(1).
[119] § 1715(a)(2).
[120] 805 Ill. Comp. Stat. § 5/8.85 (2005) ("In discharging the duties of their respective positions, the board of directors, committees of the board, individual directors and individual officers may, in considering the best long term and short term interests of the corporation, consider the effects of any action (including without limitation, action which may involve or relate to a change or potential change in control of the corporation) upon employees, suppliers and customers of the corporation or its subsidiaries, communities in which offices or other establishments of the corporation or its subsidiaries are located, and all other pertinent factors.").

This is significant, as traditional jurisprudence describes the long-term interests of the corporation as the focus on shareholder return.[121] Finally, directors are given broad discretion when interpreting the degree of relevance a director must give to any specific factor when making a decision on behalf of the corporation. Thus, as long as directors believe that a factor is pertinent to a corporation, they may consider this factor even if it conflicts with the interests of the shareholders.

Oregon's permissive constituency statute provides an example of the third category of statutes, as it covers hostile takeover situations only. The statute reads:

When evaluating any offer of another party to make a tender or exchange offer for any equity security of the corporation, or any proposal to merge or consolidate the corporation with another corporation or to purchase or otherwise acquire all or substantially all the properties and assets of the corporation, the directors of the corporation may, in determining what they believe to be in the best interests of the corporation, give due consideration to the social, legal and economic effects on employees, customers and suppliers of the corporation and on the communities and geographical areas in which the corporation and its subsidiaries operate, the economy of the state and nation, the long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation, and other relevant factors.[122]

Thus, the language of Oregon's permissive constituency statute only applies when directors are weighing whether to accept or reject a hostile takeover attempt.

As discussed *supra*, until 2010, the only state to deviate from the use of permissive language in its constituency statute was Connecticut. On its face, the Connecticut statute seemed to force directors to consider interests beyond the corporation and its shareholders. However, like the other enacting states, Connecticut did not provide non-shareholders with a right of enforcement. It is significant that Connecticut's constituency statute, in its previous mandatory form, was never reviewed and interpreted in a decision by the state's courts.

There are still nine states that have yet to enact a constituency statute. Delaware is one of these nine. If the Business Roundtable's Statement were to be codified into a permissive constituency statute by the Delaware legislature, it would need to be codified to fit into the first category of permissive statutes. As discussed *supra*, if the statute were to fall into one of the three other camps, it would either apply only in specific circumstances or fail to capture the intent behind the Statement that corporate boards must make "a fundamental commitment to all stakeholders."[123] Using Pennsylvania's statute as a model, a permissive constituency statue for Delaware might look like this:

> (a) General rule. In discharging the fiduciary duties of their respective positions, the board of directors may, in considering the best interests of the corporation, consider to the extent they deem appropriate:
>
> > (1) The effects of any action upon any or all groups affected by such action, including customers, employees, suppliers, communities in which offices or other establishments of the corporation are located, and shareholders.

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[121] *See* Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919); *see also* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994).
[122] Or. Rev. Stat. § 60.357(5) (2019).
[123] Bus. Roundtable, *supra* note 10, at 1.

(2) The short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation.

(3) The resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation.

(4) All other pertinent factors.

(b) Consideration of interests and factors. The board of directors shall not be required, in considering the best interests of the corporation or the effects of any action, to regard any corporate interest or the interests of any particular group affected by such action as a dominant or controlling interest or factor. The consideration of interests and factors in the manner described in this subsection and in subsection (a) shall not constitute a violation of standard of care and justifiable reliance.

(c) Specific applications. — In exercising the powers vested in the corporation, and in no way limiting the discretion of the board of directors, committees of the board and individual directors pursuant to subsections (a) and (b), the fiduciary duty of directors shall not be deemed to require them:

(1) to redeem any rights under, or to modify or render inapplicable, any shareholder rights plan, including, but not limited to, a plan adopted pursuant or made in relation to disparate treatment of certain persons;

(2) to render inapplicable, or make determinations relating to control transactions, relating to business combinations, relating to control-share acquisitions or relating to disgorgement by certain controlling shareholders following attempts to acquire control, or under any other provision of this title relating to or affecting acquisitions or potential or proposed acquisitions of control; or

(3) to act as the board of directors, a committee of the board or an individual director solely because of the effect such action might have on an acquisition or potential or proposed acquisition of control of the corporation or the consideration that might be offered or paid to shareholders in such an acquisition.

(d) Presumption. Absent breach of fiduciary duty, lack of good faith or self-dealing, any act of the board of directors shall be presumed to be in the best interests of the corporation. In assessing whether the best-interests standards has been satisfied, there shall not be any greater obligation to justify, or higher burden of proof with respect to, any act as the board of directors, any committee of the board or any individual director relating to or affecting an acquisition or potential or proposed acquisition of control of the corporation than is applied to any other act as a board of directors, any committee of the board or any individual director. Notwithstanding the preceding provisions of this subsection, any act as the board of directors relating to or affecting an acquisition or potential or proposed acquisition of control to which a majority of the disinterested directors shall have assented shall be presumed to satisfy the standard set forth in by the legislature,

> unless it is proven by clear and convincing evidence that the disinterested directors did not assent to such act in good faith after reasonable investigation.[124]

Even if Delaware were to enact a permissive constituency statute covering all corporate decisions, this proposed statute allows, but does not require, directors to consider interests beyond shareholders' in certain contexts.[125] Thus, it will have little impact on directors who already enjoy protection from the business judgment rule, which Delaware directors do. In addition, this statute, like all other permissive constituency statutes across the country, does not indicate how much weight should be given to the various interests of constituents. The same concerns that inhibit the potential enactment of a mandatory constituency statute are present here. If this hypothetical statute were to operate in accordance with The Business Roundtable's aspirations, a legally enforceable right must be provided to non-shareholders, a standard against which various interests may be weighed against each other must be furnished, and the statute must require directors to *act* in the best interests of all constituencies, rather than merely *consider* their interests.

However, despite the appeal of a permissive constituency statute, enacting a statute that allows directors to consider the interests of other constituencies will not solve the problems The Business Roundtable seeks to rectify. In light of the discretion the statute gives to the board, the "failure by managers to consider the interests of other constituencies creates no managerial liability for such action."[126]

Managers acting as rational maximizers and faced with a corporate decision have two interests. First, managers want to maximize their own wealth or utility; second, and this interest is clearly secondary to the first, managers want to maximize the wealth or utility of voting stockholders, since voting stockholders appoint managers. Managers, at least as rational maximizers, are essentially indifferent about the welfare of the other corporate constituencies. Because of their discretionary nature, constituency statutes change none of this. The incentives of managers after the passage of constituency statutes are exactly the same as the incentives before the statutes; as rational maximizers, managers still want first to promote their own interests and then to promote the interests of voting stockholders; they still are indifferent about the interests of other constituencies.[127]

Constituency statutes provide directors no additional incentives to maximize the value of the corporation or abstain from transferring wealth and resources away from unfavored constituencies. With the protection afforded by the Business Judgment Rule, management may also be able to use other constituencies to entrench itself. If a duty to all constituencies is interpreted so broadly, it will not be hard for management to find some group whose interests are adversely affected by a particular course of action, and therefore reject a corporate opportunity on that ground.[128] In this way, management would able to justify an action that leads to the preservation of its own position, even if that decision turns out not to be in the best interests of the corporation. Thus, constituency statutes, decidedly, are an incomplete remedy, and, allowing or mandating a broad interpretation of statutory duty may reduce a company's level of production rather than increase it.

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[124] This is a modified version of title 15, section 1715 of the Pennsylvania Consolidated Statutes.
[125] *See* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. Davis L. Rev. 407, 462-63 (2006).
[126] Rutheford B. Campbell, Jr., *Corporate Fiduciary Principles for the Post-Contractarian Era*, 23 Fla. St. U. L. Rev. 561, 621 (1996).
[127] *Id.* at 621-22.
[128] *Id.* at 586.

A better approach may be to maintain a narrow interpretation of a board's fiduciary duty to shareholders, as Delaware does now, and allow firms that wish to adopt a different rule to opt out of the narrow interpretation, or allow for collateral benefits to stakeholders.

C. Maintaining Delaware Corporate Law, Allowing for Informal and Collateral Benefits to Stakeholders

Even if boards of directors were not held to have a fiduciary duty to stakeholders other than shareholders, and those other stakeholders were not afforded a legal right to challenge corporate management decisions which adversely affected them, this would not preclude boards and senior officers from behaving as if they actually had such a duty, and stakeholders other than shareholders had such rights. Moreover, a fiduciary duty owed exclusively to shareholders does little to threaten directors who set out to implement stakeholder-oriented policies.

Historically, courts did not encumber corporate managers with a fiduciary duty towards company shareholders in order to privilege shareholders vis-à-vis other stakeholder groups. Rather, the fiduciary responsibility was designed to prevent self-dealing on the part of directors.[129] There are at least three reasons to doubt that those fiduciary responsibilities to shareholders would prevent a board from acting to benefit non-shareholder stakeholders, as The Business Roundtable calls for:

First, it is not obvious that the right of shareholders to expect honesty, candor, and care on the part of management gives them a higher level of protection than the legal rights available to other stakeholders. Creditor interests, for example, are protected by bankruptcy law. Suppliers and customers can seek redress under the Uniform Commercial Code or more recent statutes such as "lemon laws" that cover used car sales. Tort victims are the beneficiaries of insurance requirements for various kinds of businesses and employees can enlist government assistance in collecting unpaid wages or compensation for income-diminishing injuries and can demand fiduciary protection for pension assets and other benefits. . . . Second, courts are starting to impose on corporate management fiduciary duties with regard to other groups under certain circumstances. In *Varity v. Howe* (1996) [the United States Supreme Court ruled] that a corporation that reorganized all of its money-losing ventures into a single subsidiary that eventually went bankrupt (leaving a healthy surviving parent) had breached its fiduciary duty to the employees of the subsidiary. . . . The Court [] extended this reasoning to the protection of non-retirement benefits when it found for employees [that were] dismissed after refusing to accept employment with another company, but a company with whom their original employer had arranged for them to do exactly the same work but with reduced benefits (*Intermodal v. Sante Fe Railroad*, 1997). And finally . . . when stockholders have attempted to challenge managerial behavior as being overly generous toward another constituency, they have almost always lost.[130]

Those who oppose any change to the doctrine of shareholder primacy often cite the famous dictum of the Michigan Supreme Court articulated in *Dodge v. Ford Motor Co.*[131] that the corporation exists for the benefit of the shareholders as evidence of a restraint on the free discretion

[129] Andrew F. Tuch, *Reassessing Self-Dealing: Between No Conflict and Fairness*, 88 Fordham L. Rev. 939, 939 (2019).
[130] Richard Marens & Andrew Wicks, *Getting Real: Stakeholder Theory, Managerial Practice, and the General Irrelevance of Fiduciary Duties Owed to Shareholders*, 9 Bus. Ethics Q. 273, 277-78 (1999).
[131] Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

of a board of directors.[132] However, an examination of the context of the court's decision makes clear that this statement was not meant to empower the shareholder at the expense of managerial discretion; it was meant to forbid "the company's decision to sit on a mountain of cash for allegedly philanthropic, not business, purposes, particularly when the court had reasons to doubt Ford's candor regarding his actual motive."[133]

Since *Dodge v. Ford Motor Co.*, courts have proven reluctant to examine the economic wisdom of business decisions. An examination of case law under circumstances less dramatic than the facts of *Dodge v. Ford Motor Co.* demonstrates that corporate directors have actually successfully defended generosity toward non-shareholder constituents.[134] Generosity toward employees has almost always won if, unlike in the *Dodge* case, the generous treatment is justified as a means of improving efficiency or productivity.[135] Corporations have routinely defeated challenges by stockholders to various bonus and profit-sharing plans for managers and employees when such plans were justified as creating incentives for better corporate performance.[136]

If board fiduciary duties toward shareholders is dispositive in any area of corporate governance, it is in a board's response to takeover bids. Still, on numerous occasions courts have applied the business judgment rule and refused to enjoin board decisions rejecting tender offers that were neither manipulative nor fiscally unsound and might have benefitted shareholders. The language of the courts' opinions in these cases is remarkably similar to that of a normative stakeholder approach. In particular, the Delaware Supreme Court, has consistently rejected the notion that directors have a duty to sell the company whenever a takeover proposal offers a premium over current market value of company stock.[137] The Court has even established a positive duty to adopt defensive measures to defeat a takeover attempt contrary to the best interests of the corporation and its shareholders.[138] The Court implicitly defined these non-shareholder, corporate stakeholder interests very broadly when it ruled in *Unocal Corp. v. Mesa Petroleum* that boards might consider impact on "customers, creditors, employees, and perhaps even the community generally."[139]

Numerous court decisions in other jurisdictions have reached similar results, supporting the right of boards to choose not to sell control of the corporation to raiders who will pay the highest premium stock price for shareholders.[140] The court in *Keyser v. National Finance*, for example, upheld a bank's decision to choose one takeover "suitor" over another, explicitly accepting, the bank's justification that the winning bidder was better on "social issues," including the prospect of creating more opportunity for the company's employees.[141]

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[132] *Id.*

[133] Marens &Wicks, *supra* note 129, at 279.

[134] *See, e.g.*, Kelly v. Bell, 254 A.2d 62 (Del. Ch. 1969); A. P. Smith Mfg. Co. v. Barlow, 98 A.2d 581 (N.J. 1953).

[135] *See* Steinway v. Steinway, 37 N.Y.S. 742 (N.Y. App. Div. 1896).

[136] *See* Diamond v. Davis, 38 N.Y.S.2d 103 (N.Y. Sup. Ct. 1942); Gallin v. Nat'l City Bank of N.Y., 281 N.Y.S. 795 (N.Y. Sup. Ct. 1935).

[137] *See* Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1144 (Del. 1989); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

[138] *Revlon, Inc.*, 506 A.2d at 184.

[139] *Unocal Corp.*, 493 A.2d at 955.

[140] *See* Amanda Acquisition Corp. v. Universal Foods Corp., 708 F. Supp. 984 (E.D. Wis. 1989); Keyser v. Commonwealth Nat'l Fin. Corp., 675 F. Supp. 238, 254 (M.D. Pa. 1987); Baron v. Strawbridge & Clothier, 646 F. Supp. 690 (E.D. Pa. 1986).

[141] *Keyser*, 675 F. Supp. at 254.

Moreover, the fiduciary duties owed to shareholders are not as fixed or inflexible as they may appear. They can be, and frequently are, modified by contract.[142] For instance, workers should be able to contract for job security and wages with a corporation without necessarily requiring the board to prioritize workers over shareholders. The fiduciary duties owed to shareholders do not prevent workers from bargaining for and obtaining an agreement with respect to these and other employment issues. Workers can protect their wage expectations with pension guarantees, golden parachutes, successor clauses, stipulated cost of living adjustments, and other straightforward provisions. Similarly, workers can obtain credible assurances against being forced to work undesirable hours simply by stipulating the length of the workday. Working conditions can be guaranteed by making reference to a well-known status quo and requiring the employer to maintain working conditions at that level or above. In short, one can contract away fiduciary duties to shareholders without changing the law.

As with contracts with workers, contracts between shareholders and firms routinely subordinate the claims of shareholders to those of non-shareholder constituencies, such as employees. These very contracts clearly impede the freedom of directors and managers to maximize shareholder wealth, a concern that exists even in jurisdictions with constituency statutes. Often, shareholders are willing to bargain with workers to give them job security and better wages because doing so allows them to attract and retain better workers, thereby increasing profitability.

Similar logic applies to other fixed claimants such as bondholders and lenders. For example, corporations often provide fixed claimants with security interests in corporate assets or agree to restrictions on dividend payments or investments. These agreements benefit shareholders, while also aiding the other constituencies, by increasing the availability of credit and lowering the cost of borrowing.

Beyond contracts that carve out non-shareholder constituency rights, courts are able to protect non-shareholder constituents by imposing gap-filling responsibilities on boards of directors that are analogous to those provided by the fiduciary duties owed to shareholders. For example, should unforeseen contingencies arise that cast doubt on the efficacy of the contractual protection mentioned above, courts can protect workers by construing their employment contracts in light of the original purposes behind the agreements. Gap-filling by modern judges in interpreting contracts provides workers with the same sorts of protection that fiduciary duties provide for shareholders.[143]

This has arguably been the Delaware Supreme Court’s approach in dealing with the non-shareholder constituencies identified by The Business Roundtable. It is noteworthy that the Delaware approach recognizes that, over a wide range of issues, there “really is no conflict between

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[142] Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective,* 84 Cornell L. Rev. 1266, 1268 (1999).

[143] Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 Stetson L. Rev. 23, 37 (1991) (“It might be argued that rank-and-file employees lack bargaining power, and that at-will employment contracts are likely to reflect this lack of bargaining power. Consequently, it has been argued that the gap-filling that is done in the context of at-will employment contracts is likely to be unhelpful to employees. This argument is flawed. If workers lack bargaining power in their employment relationship, changing the law to add a fiduciary duty to this relationship will harm workers, not help them. This is because extending the reach of fiduciary duties to rank and-file employees will not change any fundamental imbalance in the allocation of bargaining power between workers and their employers that already exists. Any legal regime that ‘protects’ workers by making them the ‘beneficiaries’ of fiduciary duties will, by definition, make those same workers less valuable (in monetary terms) to their employers.”).

the interests of other constituencies and the interests of shareholders."[144] For example, taking steps to improve relations with the local community benefits the corporation and its many constituents, generally. Similarly, drafting strong bond covenants or cultivating a reputation for fair dealing with bondholders and creditors benefits the shareholders by lowering the corporation's costs of doing business. Moreover, the current Delaware approach recognizes that generally it is not possible for a board to know beforehand with certainty, which decisions are specifically in the shareholders' interests, and which are not.[145]

In October 2019, shortly after the release of The Business Roundtable statement, then Chief Justice of the Delaware Supreme Court Leo Strine, self-published a paper, *Toward Fair and Sustainable Capitalism*, proposing "to reform the American corporate governance system by aligning the incentives of those who control large U.S. corporations with the interests of working Americans . . . ."[146] Chief Justice Strine suggested the interests of non-shareholder stakeholders can be equitably accounted for without modifying current statutory fiduciary duties by:

> Requiring not just operating companies, but institutional investors, to give appropriate consideration to and make fair disclosure of their policies regarding EESG issues, emphasizing "Employees" and not just "Environmental, Social, and Governance" factors;
>
> Giving workers more leverage by requiring all societally-important companies to have board level committees charged with ensuring fair treatment of employees, authorizing companies to use European-style works' councils to increase employee voice, and reforming labor laws to make it easier for workers to join a union and bargain for fair wages and working conditions;
>
> Reforming the corporate election system so that voting occurs on a more rational, periodic, and thoughtful basis supportive of sustainable business practices and long-term investment;
>
> Improving the tax system to encourage sustainable, long-term investment and discourage speculation, with the resulting proceeds being used to revitalize and green America's infrastructure, tackle climate change, invest in American workers' skills, transition workers from carbon-intensive industries to jobs in the clean energy sector; and
>
> Taking other measures, such as reform of corporate political spending and forced arbitration, to level the playing field for workers, consumers, and ordinary investors.[147]

The proposals suggested by Chief Justice Strine are powerful. Perhaps even more influential though, is that this call-for-action was authored by the same man who, in 2015, wrote: "a clear-eyed look at the law of corporations in Delaware reveals that, within the limits of their discretion, directors must make stockholder welfare their sole end, and that other interests may be

[144] *Id.* at 34-35.
[145] *Id.* at 35.
[146] Leo E. Strine, Jr., *Toward Fair and Sustainable Capitalism*, Harv. L. Sch. F. on Corp. Governance (Oct. 1, 2019), https://corpgov.law.harvard.edu/2019/10/01/toward-fair-and-sustainable-capitalism/.
[147] *Id.*

taken into consideration only as a means of promoting stockholder welfare."[148] At first blush, it would appear that Chief Justice Strine's 2015 and 2019 positions are irreconcilable. This is not necessarily true. What the Chief Justice appears to mean is that there need be no conflict between the interests of these other constituencies and the interests of shareholders to which directors are beholden.

The shareholder primacy rule articulated by Delaware and present in modern socioeconomics can be considered a substantive judicial guardrail. The path it requires is clear. However, in addressing issues often framed as matters of corporate social responsibility, the shareholder primacy path does not preclude a for-profit company from taking social issues into account in the conduct of its business. What is required to stay on the path is that the company's consideration of those social issues have a sufficient nexus to shareholder welfare and value maximization. How can a board of directors determine that a sufficient nexus exists? For Delaware business corporations, the basic answer should be familiar. The board should do what it does in making other decisions regarding oversight of the company's business: define the issue; gather all reasonably available material information; identify and weigh the pros and cons; consider alternatives; and make an independent, disinterested and informed business judgment in good faith, looking solely to the economic best interests of shareholders as a whole. No time frame is mandated and building long-term value is the goal.

Of course, decisions by boards of Delaware for-profit corporations can be challenged by shareholders, as they frequently are. Such a challenge may be brought under state law for breach of fiduciary duty—the two duties being the duty of care and the duty of loyalty, discussed *supra*. Assuming the threshold application of the Business Judgment Rule is not rebutted, courts applying Delaware law will not second-guess a board's judgment unless the decision is found to be not rational. To make such a finding, a court would have to conclude that the board's decision cannot be attributed to any rational business purpose related to the company. As then-Chancellor William B. Chandler III of the Delaware Court of Chancery wrote in his *Craigslist* opinion:

When director decisions are reviewed under the Business Judgment Rule, this Court will not question rational judgments about how promoting non-stockholder interests — be it through making a charitable contribution, paying employees higher salaries and benefits, or more general norms like promoting a particular corporate culture — ultimately promote stockholder value.[149]

Thus, it is possible that The Business Roundtable can achieve its goal of promoting non-shareholder stakeholder welfare by permitting Delaware to remain as-is and by pressuring companies to focus more on creating a nexus between EESG issues and shareholder profits. It is also possible that the Business Roundtable can achieve its goal by lobbying the Delaware legislature to follow the lead of the forty-one other United States who have enacted statutes promoting non-shareholder stakeholder welfare. Having discussed the legal avenues that exist, the lingering question that must be addressed is *should* a duty to non-shareholder corporate stakeholders be formally woven into law?

IV. *SHOULD* THE BUSINESS ROUNDTABLE STATEMENT BE WOVEN INTO LAW?

What would be the practical implications of adopting a true stakeholder theory approach for Delaware? The Business Roundtable Statement is not accompanied by a proposed plan of action.

[148] Strine, *supra* note 60, at 768.
[149] eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 33 (Del. Ch. 2010).

Without such action, the Statement does nothing to forecast whether a true stakeholder approach might ever be implemented. Still, the Statement serves as a marker. The marker alone does create some accountability, as Chief Justice Strine has acknowledged and there are tangible steps that companies can take to show their commitment "is more than just of the moment."[150] The question is, which steps are best?

This Paper argues that by maintaining Delaware's current approach, companies are most suited to promote "[a]n economy that serves all Americans."[151]

First, expanding any fiduciary duty to non-shareholder constituencies is costly compared to contracting privately, and private contracting should be effective to curb manager opportunism. If the Business Roundtable Statement were codified into law, conflicting interests of various stakeholder groups would fall under the same fiduciary umbrella. Litigation costs over which group's interest is to receive priority would skyrocket. Fear of litigation would trigger increased managerial decision costs and costs in the form of foregone value-enhancing transactions. While private contracts may not perfectly constrain managerial opportunism, the cure is likely worse than the disease. The costs of such opportunism are likely dwarfed by the costs of bestowing a shared fiduciary duty among conflicting parties. Private bargains should be respected and parties should be permitted to constrain or modify shareholder primacy by contract. These parties have sufficient incentive on their own to design careful limits on managerial opportunism.

Second, constituency statutes, especially permissive constituency statutes, are ineffective. Despite their enactment in more than one-half of the states, currently all constituency statutes are discretionary. As discussed *supra*, this means that managers may, but are not required to, consider the interests of non-shareholder constituencies. The failure by managers to consider the interests of other constituencies therefore creates no managerial liability. Acting as rational maximizers, managers are essentially indifferent about the welfare of non-voting shareholders as no other constituency votes to appoint managers. Because of their discretionary nature, constituency statutes change none of this. The matter of obligations owed to various stakeholder groups should be addressed directly and inclusively and not through a statute that deals by indirection with only a part of a problem.

To be sure, this argument ignores the fact that corporations long have been able to issue multiple classes of shares with different economic and voting rights, with management owing fiduciary duties to each of these classes. Thus, it simply cannot be said that corporate law is incapable of reconciling the fiduciary claims of a variety of competing interests. The argument also ignores the effects of the Business Judgment Rule. Because most managers' actions are effectively protected against judicial scrutiny anyway, as a practical matter, the rights being taken away from shareholders by non-shareholder constituency statutes do not provide much in the way of concrete benefits for shareholders in the first place. Thus, the real problem with non-shareholder constituency statutes is not that they take away something of value from the only group that has any incentive to maximize the value of the firm, because other constituencies such as fixed claimants or workers often have the greatest stake in the decisions being made. Similarly, non-shareholder constituency statutes cannot be condemned on the grounds that they upset a system of legal rules that present a preexisting set of clearly defined behavioral guidelines for officers and directors. No such set of guidelines exists.

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[150] *Moral Money Special: Leo Strine's New Deal for Corporate America*, Financial Times (Oct. 1, 2019), https://www.ft.com/content/1d2f1348-e3de-11e9-9743-db5a370481bc.
[151] Bus. Roundtable, *supra* note 96.

The most compelling argument against constituency statutes is that such statutes fail to recognize that fiduciary duties are owed to residual claimants and residual claimants alone because this is group faces the most severe set of contracting problems with respect to defining the nature and extent of the obligations owed to them by officers and directors. Other constituencies besides shareholders face contracting problems, but these problems can be solved at far less cost than those confronting shareholders. Thus, fiduciary duties should properly be seen as a method of gap-filling in incomplete contracts. And shareholders place a far greater value on the protection provided by this gap-filling than do the non-shareholder constituencies of a corporation.

This dovetails into the third point, that non-shareholder constituencies already enjoy the protection provided by judicial gap-filling and do not need additional gap-filling protections afforded by expanding directors' fiduciary duties. Under modern principles of contract law, courts fill in gaps for these other constituencies against the background of the pre-existing contracts that these groups have with the firm. Thus, gap-filling for employees or bondholders is done in the context of interpreting the employment contracts, collective bargaining agreements, bond indentures, and covenants that these other groups have with the corporation. The obvious exception to this general rule arises with regard to the local communities in which large corporations operate. Unlike other constituencies, the local community has no pre-existing agreement with the firm, leaving no gap for a court to fill. But the local community is, or should be, well represented in the political process. Any grievance felt by the community should presented to elected representatives in the state and local government for redress.

Fourth, the most prominent structural alternative to shareholder primacy, Public Benefit Corporations ("B Corps"), already exists in Delaware.[152] A Delaware public benefit corporation is a for-profit corporation "that is intended to produce a public benefit or public benefits and to operate in a responsible and sustainable manner."[153] A B-Corp enables the business to be managed in a way that balances shareholder interests, the best interests of people "outside the corporate box" who are affected by the corporation's conduct, and the specific public benefits identified in its Certificate of Incorporation. The existence of B-Corps is based on a perceived incongruence between the legal framework governing for-profit corporations and the social purpose goals of sustainable business, impact investment, and social enterprise actors. While directors of for-profit companies traditionally have a fiduciary duty to maximize shareholder wealth, B-Corps are required to pursue a social mission and consider all stakeholders, internal and external, when making business decisions. Shareholder primacy is not an option for a benefit corporation; it is legally required to account for the effects of its decisions on all stakeholders. For a traditional corporation seeking to uphold the principles discussed in the Business Roundtable Statement, it may become a certified B-Corp.[154][154] To become a certified B-Corp, a company must first submit to an independent assessment of its social and environmental performance accountability and transparency. If the company scores high enough, it can become a certified B Corporation and then it must formally incorporate its social and environmental mission into its governance articles as

[152] Other states that have passed Benefit Corporation legislation include: Arizona, Arkansas, California, Colorado, Connecticut, Florida, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Texas, Utah, Vermont, Virginia, Washington DC, West Virginia, and Wisconsin. *See State by State Legislative Status*, Benefit Corp., https://benefitcorp.net/policymakers/state-by-state-status? (last visited Jan. 31, 2021).
[153] Del. Code Ann. tit. 8, § 362 (2020).
[154] *See "Converting" a Corporation to a Delaware Public Benefit Corporation*, INCNOW (June 7, 2018), https://www.incnow.com/blog/2018/06/07/how-to-convert-corporation-to-pbc/.

part of the terms of its certification as a B Corporation. Thereafter, the company needs to be reassessed every three years to ensure that it is maintaining the required standard.[155][155]

The number of B-Corps has grown dramatically in recent years. First formed in 2006, estimates indicate that there are over 2,500 B-Corps in more than fifty countries, including such prominent companies as Ben & Jerry's, Patagonia, and Athleta.[156][156] Consistent with its efforts to maintain its leadership in corporate law and governance, Delaware is a leader in benefit corporation legislation.[157][157] The guiding principle of a B-Corp is the very opposite of stockholder primacy; "investors and managers [of B-Corps] should not seek gains by simply extracting as much value as possible from the economy, but should instead seek gains by simply building and sharing value with all stakeholders in their investments."[158][158]

In short, supporting a stakeholder theory does not necessarily involve the kind of radical transformations of current legal relationships as some of its advocates might assume. Fulfilling fiduciary duties to shareholders does not entail that managers must side with shareholders and against other stakeholders. Companies have the legal autonomy to act proactively and advance the interests of a number of stakeholders simultaneously. Directors and organizations have considerable latitude in defining core values and philosophy, including exactly what kind of responsibilities it wishes to assume with respect to a variety of stakeholders. Directors are also free to exercise a wide latitude regarding the kinds of investments they wish to make and the way they evaluate alternative uses of corporate resources. So, while implementing stakeholder theory may seem to require radical changes in law, this is not so. It is well within the existing boundaries of corporate governance, and particularly with respect to the fiduciary duties owed to shareholders. To be sure, directors will still face difficult decisions about how to allocate resources and which priorities to establish among stakeholder claims. However, this Paper has suggested that these are, for the most part, moral choices which the law gives directors discretion to make without fear of violating their fiduciary duties to shareholders, and thus, not having to make wholesale choices between stakeholders and shareholders.

V. CONCLUSION

Ideology matters. Since the 1980s stockholder primacy has been the dominant ideology shaping corporate law. As a result, case law, director conduct, and our understanding of "best governance practices" have all been viewed under a single prism: how do these rules impact stockholder value?

The purpose of this Paper has been to underscore that fiduciary duty should be construed narrowly and afforded to shareholders alone. The Business Roundtable's Statement should not be interpreted as urging state legislators or companies to afford such fiduciary rights to other stakeholders. Such an interpretation is implausible as it creates a conflict between shareholders

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[155] Michele Giddens, *The Rise of B Corps Highlights the Emergence of a New Way of Doing Business*, FORBES (Aug. 3, 2018, 3:45 AM), https://www.forbes.com/sites/michelegiddens/2018/08/03/rise-of-b-corps-highlights-the-emergence-of-a-new-way-of-doing-business/?sh=7695b10c2ed2.
[156] *Ben & Jerry's Joins the B Corp Movement!*, Ben & Jerry's, https://www.benjerry.com/about-us/b-corp (last visited Jan. 31, 2021); Mara Leighton, *B Corps Are Businesses Committed to Using Their Profit for Good—These 14 Are Making Some Truly Great Products*, BUS. INSIDER (Mar. 23, 2020, 12:04 PM), https://www.businessinsider.com/b-corp-retail-companies.
[157] *See* Frederick H. Alexander, *Saving Investors from Themselves: How Stockholder Primacy Harms Everyone*, 40 SEATTLE U. L. REV. 303, 313-15 (2017).
[158] *Id.* at 319.

existing rights and new rights that would be carved out for others. Still, if American corporate law does little to inhibit a stakeholder orientation on the part of corporate managers, it also does little to compel one. It is certainly plausible that the definition of corporate ownership could be expanded to allow various stakeholders a greater say in the governance of the corporation. As this Paper suggests, this can be done without leaving shareholder primacy theory behind. Yet the Business Roundtable Statement has not offered any advice as to how such expansion might be implemented. In the interim, certainly, nothing prevents companies from "engag[ing] in activities designed to increase its profits," while simultaneously considering stakeholders as an important constituent when making corporate decisions.

COMMENT

WHO REALLY CONTROLS THE PRIVACY CONVERSATION? THE NEED FOR A FUNDAMENTAL RIGHT TO PRIVACY IN THE UNITED STATES

ALEXA LYNN WEBER*

CONTENTS

I. INTRODUCTION

A. "Privacy": What Does it Even Mean?

A simple touch of a button allows a person to share one photograph with billions of people.[1] An instant message can easily be sent to a friend sitting across the table, or to a friend across the world.[2] Geographical boundaries cease to exist within the internet. This has transformed the way citizens interact with one another, gather their news, and spend their time. Many people may believe that online privacy has been put on the back burner and ignored, but this comment explores the idea that it is not that simple.[3] As members of society bond over memes or random viral photographs, customers' enjoyment of platforms such as Facebook are guided by differing ideas of what online privacy even means. By analyzing privacy issues through this lens, a better understanding of how the concept of privacy has changed in the digitized world will guide future

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[1] As of December 2019, the internet has approximately 4.54 billion users, while there are 3.725 billion active users on any given social media platform. Kat Smith, *126 Amazing Social Media Statistics and Facts*, BRANDWATCH (Dec. 30, 2019), https://www.brandwatch.com/blog/amazing-social-media-statistics-and-facts/.

[2] To put this in context, Facebook Messenger and Whatsapp together send out upwards of 60 billion messages in one day. *Id.*

[3] See section II and section III.

discussions.[4] Governments will then be able to enact beneficial legislation for global citizens while still allowing for the free flow of information.[5]

The current privacy policies of companies such as Instagram, Snapchat, or LinkedIn are difficult for lay persons to understand.[6] These policies are not forthcoming and say things such as, "[y]ou should read this in full, but here are a few key things we hope you take away from it."[7] By telling individuals what they need to know, the corporation controls the privacy conversation rather than the individual.[8] For example, Facebook has argued that by posting to one hundred friends on social media, the author of that post has given up privacy interests and has no reasonable expectation of privacy.[9] From a user's perspective, if privacy is defined by the corporation rather than by the individual, it is difficult to trust in those companies to adequately protect privacy interests of users.[10] Rather, the definition of privacy should be defined from an individual perspective because privacy is personal.[11] To illustrate this point, the Chief Executive of Google, Sundar Pichai has stated:

> To the families using the internet through a shared device, privacy might mean privacy from one another. To the small-business owner who wants to start accepting credit card payments, privacy means keeping customer data secure. To the teenage sharing selfies, privacy could mean the ability to delete that data in the future.[12]

There is a disconnect between how much control individuals are willing to take over their privacy and their lack of trust in online corporations. This disconnect stems from a non-existent definition of online privacy with respect to private information, which makes it difficult for legislatures to draft effective privacy regulations for fear of them becoming as convoluted as online

[4] See section III.

[5] For a more in-depth discussion of what global citizenship is, see *What is Global Citizenship?*, IDEAS FOR GLOB. CITIZENSHIP, http://www.ideas-forum.org.uk/about-us/global-citizenship (last visited March 1, 2020).

[6] *See, e.g.*, Joanna Kessler, *Data Protection in the Wake of the GDPR: California's Solution for Protecting "the World's Most Valuable Resource*", 93 S. CAL. L. REV. 99, 100 (2019) (arguing that consumers do not understand the privacy interests they give up by using free resources online and that consumers are unable to read "complicated and lengthy privacy policies").

[7] Twitter, TWITTER PRIVACY POLICY 3 (2020), https://cdn.cms-twdigitalassets.com/content/dam/legal-twitter/site-assets/privacy-june-18th-2020/Twitter_Privacy_Policy_EN.pdf.

[8] Brooke Auxier, Lee Rainie, Monica Anderson, Andrew Perrin, Madhu Kumar, and Erica Turner, *Americans and Privacy: Concerned, Confused and Feeling Lack of Control Over Their Personal Information*, PEW RESEARCH CENTER (Nov. 15, 2019) ("Additionally, majorities of the public are not confident that corporations are good stewards of the data they collect.").

[9] Facebook argued that sharing on social media platforms "is an affirmative social act to publish, to disclose, to share ostensibly private information . . . .". Charlie Warzel, *Facebook Under Oath: You Have No Expectation of Privacy*, THE N. Y. TIMES (June 18, 2019), https://www.nytimes.com/2019/06/18/opinion/facebook-court-privacy.html (quoting the transcript of proceedings, *In re* Facebook, Inc. Consumer Priv. User Profile Litig., No. 18-MD-02843 (N.D. Cal. June 3, 2019). Others argue that privacy is personal and each individual should know how their personal data is being used. *Id.*

[10] *Americans and Privacy: Concerned, Confused and Feeling Lack of Control Over Their Personal Information*, *supra* note 9 ("Still, the majority of Americans are not confident about the way companies will behave when it comes to using and protecting their personal data.").

[11] *Id.*

[12] Sundar Pichai, *Google's Sundar Pichai: Privacy Should Not Be a Luxury Good*, THE N.Y. TIMES (May 7, 2019), https://www.nytimes.com/2019/05/07/opinion/google-sundar-pichai-privacy.html.

privacy policies and terms of service.[13] To illustrate this tension, as of May 2018, nearly three-quarters of Americans did not read terms of service or privacy policies carefully when signing up for social media networks.[14] In fact, 39% of millennials just clicked "agree" without even reading the terms or policy.[15] For millennials this was an increase of 5% from 2014.[16] While there is currently no data for 2020, the trend seems to be that fewer people—particularly—millennials, are reading terms of service when visiting social media websites.[17] Nonetheless, as of May 2018, 3 out of 5 Americans had little to no trust in social media companies with their information.[18] However, 40% of millennials had trust in social media sites despite failing to read website's fine print.[19] If fewer people are reading terms of service and online privacy policies, it is unlikely that more people will read lengthy privacy laws, much less take an active role in drafting effective legislation.

Politicians are now responding to these concerns. On February 12, 2020, Democratic Senator Kirsten Gillibrand of New York proposed that the United States create a Data Protection Agency to provide personal data protections in the digital age by way of sweeping federal regulations.[20] According to the Senator, it is now necessary for the United States to supply enhanced data protection to its citizens because the nation is "vastly behind other countries."[21]

This comment argues that a federal privacy regulation is necessary in order for the United States to keep up with the ever-changing privacy concerns of its citizens.[22] To address these concerns, Congress must first enact legislation that gives citizens privacy protections while crafting that legislation to survive challenges under the First Amendment and prohibit application of the Dormant Commerce Clause to state regulations. Ideally, this legislation would preempt and prohibit state-by-state applications of data regulations, as each state regulation includes differing protections of online privacy and access to personal information. This comment argues that current proposed solutions fail to account for the very fact that there is no fundamental right to privacy in the United States. Ultimately, in order for federal privacy legislation to survive the above-mentioned legal challenges, a fundamental right to privacy must be established in the United States. To illustrate the difficulty of such legislation, this comment addresses two differing protections of online privacy, most clearly illustrated by The General Data Protection Regulation[23]

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[13] See *Americans and Privacy: Concerned, Confused and Feeling Lack of Control Over Their Personal Information*, *supra* note 9 for more statistics and research specifically about privacy policies and the way individuals interact with those privacy policies.

[14] Lincoln Park Strategies & Rad Campaign, *Fake News and Privacy: A Concern for Americans More Than Ever*, THE STATE OF SOC. MEDIA AND ONLINE PRIV. (May 2018), onlineprivacydata.com. Nearly one-quarter of Americans are asked to agree to privacy policies every day. *Americans and Privacy: Concerned, Confused and Feeling Lack of Control Over Their Personal Information*, *supra* note 9.

[15] Lincoln Park Strategies & Rad Campaign, *supra* note 15. Interestingly, only 22% of adults in the United States "ever read privacy policies before agreeing to their terms and conditions . . . ." *Americans and Privacy: Concerned, Confused and Feeling Lack of Control Over Their Personal Information*, *supra* note 9.

[16] Lincoln Park Strategies & Rad Campaign, *supra* note 15.

[17] *See id.*

[18] *Id.* Only 63% of all Americans understand data privacy regulations. *Americans and Privacy: Concerned, Confused and Feeling Lack of Control Over Their Personal Information*, *supra* note 9.

[19] Lincoln Park Strategies & Rad Campaign, *supra* note 15.

[20] Sen. Kristin Gillibrand (@gillibrandny), *The U.S. Needs A Data Protection Agency*, MEDIUM (Feb. 12, 2020), http://medium.com/@gillibrandy/the-u-s-needs-a-data-protection-agency-98a054f7b6bf.

[21] *Id.*

[22] Many scholars have proposed the idea of federal privacy regulation in the United States, and it has been a topic of discussion as the internet has dominated society.

[23] Regulation 2016/679 (General Data Protection Regulation), art. 94, 2016 O.J. (L 119) 1.

and the California Consumer Privacy Act, soon to be amended by the California Privacy Rights Act.[24]

First, this comment dives into the history and current privacy laws in the European Union to illustrate how the fundamental right to privacy in the European Union makes the GDPR successful. Section II focuses on the current patchwork of privacy laws of the United States, using California as an example of what a federal fundamental right to privacy may look like. Section III will briefly address the California Consumer Privacy Act, as amended by the California Privacy Rights Act, to assess its viability under both the Dormant Commerce Clause. That challenge will be critiqued and discussed in relation to the recent passage of the CPRA.

II. Privacy Law in the European Union

A. The History of Privacy Law in the European Union

In order to appreciate and understand the evolution of the General Data Protection Regulation ("GDPR") in the European Union, it must be understood that privacy in the European Union is a fundamental right, meaning that the right of privacy is explicitly protected in Title II, Article 8 of the European Charter of Fundamental Rights.[25] The recognition of this right allows the European Union to enact further laws and regulations that reflect the sweeping protection of this right to privacy.[26] More specifically, this right to privacy reflects the right to "protection of personal information," not merely privacy as it relates to niche areas such as children, criminal justice proceedings, or credit information, for example.[27] For now, this section will focus on Directive 96/45, which the GDPR replaced in 2018.

Directive 96/45[28] was adopted in the European Union on October 24, 1995 and addressed the protection of personal and individualized information.[29] The Directive established that the specific right to privacy must be balanced against competing interests such as artistic expression and journalistic purposes of media, to name a few.[30] With respect to journalistic purposes, the European Union has limited the right to privacy with respect to the literary and societal value of a journalistic publication in question.[31] The European Union Court of Justice has held that published media does not lose its journalistic purpose when the media contains personal information, for

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[24] California Consumer Privacy Act of 2018 (CCPA), CAL. CIV. CODE § 1798.105 (2018).
[25] Charter of Fundamental Rights of the European Union, 2012 O.J. (C.326) 391, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:12012P/TXT.
[26] *See id; Data Protection,* EUROPEAN DATA PROTECTION SUPERVISOR, https://edps.europa.eu/data-protection/data-protection_en.
[27] Charter of Fundamental Rights of the European Union, 2012 O.J. (C.326) 391, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:12012P/TXT.
[28] Formally titled the "protection of individuals with regard to the processing of personal data and on the free movement of such data." Directive 95/46, of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data, 1995 O.J. (L. 281) 31, 31.
[29] *Id.*
[30] *Id. See also* Charter of Fundamental Rights of the European Union, 2012 O.J. (C.326) 391, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:12012P/TXT; Joseph Savirimuthu, *All or Nothing: This is the Question? The Application of Article 3(2) Data Protection Directive 95/46/EC, to the Internet*, 25 J. MARSHALL J. COMPUT. & INFO. L. 241, 264 (2008).
[31] Högsta Domstolen [HD] [Supreme Court] 2001-6-12 Ö B 293-00 (Swed.), https://people.dsv.su.se/~jpalme/society/Ramsbro-HD-domen.html.

example, insulting judgements about other people.[32] The Court balanced the value of individual privacy rights laid out in the Directive against the freedom of expression and determined that the journalistic purpose of media outlives character attacks contained within the news stories.[33] As the internet and its information becomes more accessible, balancing these fundamental rights continues to get increasingly difficult and uncertain.[34]

Indeed, the importance of Directive 96/45 was the underlying principle that "data-processing systems are designed to serve man; whereas they must . . . respect their fundamental rights and freedoms . . . and contribute to economic and social progress . . . ."[35] The current "Right to Be Forgotten," codified in the Article 17 of the GDPR,[36] derives from *Google Spain SL v. Agencia Espanola de Proteccion de Datos (AEDP)*, which was decided May 13, 2014 by the European Court of Justice.[37] In that case, a resident of Spain, Mr. Gonzalez, alleged that reference to his personal information on a website by Google through search results violated his fundamental right to privacy.[38] First, Mr. Gonzalez wanted the website itself to delete the pages on which his personal information was included because the dispute to which the personal information related to had been settled several years ago in connection with legal proceedings.[39] While the Court determined that the website itself was not liable under Directive 96/45 because the information was legally contained within the page, the Court did make clear that obligations under the Directive were owed to individuals directly by the operators of the search engines, rather than the operators of the newspapers or links listed in the search results.[40] Mr. Gonzalez's request for Google to remove mentions of his name from search results that could lead to discovery of this personal information was thus accepted by the Court. [41]

This is to be distinguished from the type of processing carried out by publishers of websites whose website data appears in the search result list.[42] The Court took a strong stance regarding European Union citizen's fundamental rights by stating that the operators of any search engine

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[32] *Id.* at 11.
[33] Joseph Savirimuthu, *All or Nothing: This is the Question? The Application of Article 3(2) Data Protection Directive 95/46/EC, to the Internet*, 25 J. MARSHALL J. COMPUT. & INFO. L. 241, 264 (2008) (quoting *Ramsbro*, B293-00 at 11).
[34] *See generally id.* at 264-65 (arguing that "it may be difficult to balance the competing interests such as, rights of expression and rights of privacy in such cases."). Interestingly, this article was written in 2008 but these two competing interests bear on the GDPR and protection of online privacy.
[35] Directive 95/46, 1995 O.J. (L 281) 31, 31 (EC).
[36] Regulation 2016/679 (General Data Protection Regulation), art. 17, 2016 O.J. (L 119) 1. See below for a more in-depth discussion.
[37] Case C-131/12, Google Spain, SL v. Agencia Española de Prot. de Datos (AEPD), 2014 EUR-Lex CELEX LEXIS 317 (May 13, 2014).
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.* ("the operator of a search engine is obliged to remove from the list of results displayed following a search made on the basis of a person's name links to web pages, published by third parties and containing information relating to that person . . . .").
[42] "It is undisputed that that activity of search engines plays a decisive role in the overall dissemination of those data in that it renders the later accessible to any internet user making a search on the basis of the data subjects name, including to internet users who otherwise would not have found the web page on which those data were published." Case C-131/12, Google Spain, SL v. Agencia Española de Prot. de Datos (AEPD), 2014 EUR-Lex CELEX LEXIS 317 (May 13, 2014). "Google Search does not merely give access to content hosted on the indexed websites, but takes advantage of that activity and includes, in return for payment, advertising associated with the internet users' search terms, for undertakings which wish to use that tool in order to offer their goods or services to the internet users." *Id.*

must ensure the fundamental rights to privacy and the protection of personal data.[43] The Court further recognized that information from websites can be copied onto other websites, some of which are not subject to European Union legislation.[44] Therefore, the Court concluded that search engines are not able to wait until the personal information of data subjects has been erased on websites before de-listing the search engine results.[45] In effect, the search engine must simply de-list all relevant personal information without regard to whether that personal information has first been taken down by the individual websites, or if those websites were subject to European Union legislation to begin with.[46] Thus, with respect to the fundamental right to privacy, search engines are responsible under the Directive as data-processing systems, rather than individual websites.[47]

The acknowledgment by the Court that search engines themselves are subject to the Directive and now, the GDPR, makes those corporations responsible for the protection of individual personal data and individual privacy considerations.[48] This puts a large responsibility on the search engines. In effect, some may find it too difficult or cumbersome to follow European Union guidelines and thus find it not worth it to operate within the European Union.[49] This collateral effect is one of the many shortcomings of putting the protection and definition of personal data and privacy in the hands of corporations rather than the individual.

B. The Current Privacy Law in the European Union

Responding to a need to "provide legal certainty and transparency,"[50] the General Data Protection Regulation[51] took effect on May 25, 2018 and repealed Directive 95/46. This regulation, nearly identical to Directive 95/46 but with added protections, recognizes that an individual's fundamental right to privacy may be outweighed by the right to freedom of information and expression across the internet or other mediums.[52] There are six principles[53] that govern the GDPR. These principles are to be upheld by all businesses and organizations that qualify under the regulation and are as follows: (1) "lawfulness, fairness, and transparency"[54]; (2) "purpose

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[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *Id.*
[48] See section I.
[49] *The EU General Data Protection Regulation: Questions and Answers*, HUMAN RIGHTS WATCH (June 6, 2018 5:00am EDT), https://www.hrw.org/news/2018/06/06/eu-general-data-protection-regulation ("Although the GDPR is an EU regulation, it will affect the data practices of many organizations outside the EU.").
[50] Case C-131/12, Google Spain, SL v. Agencia Española de Prot. de Datos (AEPD), 2014 EUR-Lex CELEX LEXIS 317 (May 13, 2014).
[51] Regulation 2016/679, General Data Protection Regulation, of the European Parliament and of the Council of 27 April 2016 on the protection of individuals with regard to the processing of personal data and on the free movement of such data and repealing Directive 95/46, 2016 O.J. (L 119) 1 (EU).
[52] *See id.*
[53] *Id.* at art. 5.
[54] *Id.* at 1(a).

limitation"[55]; (3) "data minimization"[56]; (4) "accuracy"[57]; (5) "storage limitation"[58]; and (6) "integrity and confidentiality."[59]

As a general provision, the European Union Court holds that it is not for individual newspapers, magazines, or online sources to take down information on individual webpages.[60] But it is for the *search engine* to take sufficiently effective measures, as codified in the GDPR and reinforced by Court decisions, to protect individual data subject's fundamental rights.[61] Search engines must also "seriously discourage[e]" all those internet users from accessing information related to an individual.[62] What is meant by "seriously discourage" is ill-defined and unclear, therefore, the extent of search engine obligations under the GDPR is up to differing interpretations.

As recently as 2018, the European Court of Human Rights held that a hyperlink posted on a website that led to a separate defamatory website fell within an exception[63] to an application of a strict liability standard for defamation.[64] The Court recognized that the primary purpose of hyperlinks is to call readers' attention to other material listed on a different website, and therefore acts as a connection to other sources of information.[65] Thus, the flow of information on the internet from hyperlinking material to which the original publication does not exercise control might have a "chilling effect," either directly or indirectly, on the freedom of expression on the Internet.[66]

The European Court of Justice's decision in *Google LLC v. Commission nationale de l'informatique et des libertes (CNIL)* determined that a search engine is not required to remove a link from all domain names used by the search engine in order to comply with the GDPR.[67] The practical effect of this requirement would be that if the operator did remove the links from all domain names, no links would appear within a search regardless of where the search took place and whether this search was from within the European Union or outside of it, such as in the United States.[68] Therefore, in order to address and combat some of the privacy interests at stake, Google proposed a "geo-blocking" feature.[69] This would block users in certain locations from accessing information, regardless of which version of Google the user was searching.[70] The individual's

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[55] *Id.* at 1(b).
[56] *Id.* at 1(c).
[57] Regulation 2016/679, General Data Protection Regulation, of the European Parliament and of the Council of 27 April 2016 on the protection of individuals with regard to the processing of personal data and on the free movement of such data and repealing Directive 95/46, 2016 O.J. (L 119) 1 (EU) at art. 5(1)(d).
[58] *Id.* at 1(e).
[59] *Id.* at 1(f).
[60] Case C-507/17, Google LLC v. Commission nationale de I'informatique et des libertes (CNIL), 2019 ECLI:EU:2019:771, (Sept. 24, 2019).
[61] *Id.*
[62] *Id.*
[63] Regulation 2016/679, *supra* note 24 at art. 10. (Processing of personal data relating to criminal convictions and offences).
[64] Magyar Jeti Zrt v. Hungary, 2018 Eur. Ct. H.R. 1.
[65] *Id.*
[66] *Id.*
[67] Google LLC v. Commission nationale de I'informatique et des libertes (CNIL), 2019 EUR-Lex CELEX LEXIS 772 (Sept. 24, 2019).
[68] *Id*; *see also* Ibrahim Hasan, *Google v CNIL and the Right to be Forgotten*, PUBLICLAWTODAY (Nov. 8, 2019), https://www.publiclawtoday.co.uk/information-law/344-information-law-features/41816-;
[69] Google LLC v. Commission nationale de I'informatique et des libertes (CNIL), 2019 EUR-Lex CELEX LEXIS 772 (Sept. 24, 2019).
[70] *Id.*

location would be generated from an IP (Internet Protocol) address[71] so that Google could determine whether the individual was located within the European Union.[72] The Court balanced the fundamental right to privacy with the right to information and determined that this feature was an adequate solution by Google.[73]

While the Court recognized that the right to protect personal data is not an *absolute* right for citizens, a balancing test is used to determine how that right squares with the function of society and against other fundamental right—most importantly the freedom of expression and information.[74] Balancing these fundamental rights along with the necessary interests of the data controller differ with respect to the context in which the processing takes place. Thus, each balancing test determination varies significantly from case to case. [75] The Court stressed the fact that Member States must reconcile the differing protections of online privacy and how those states balance the fundamental right to privacy with the right of expression.[76] In fact, European Union law does not currently provide for cooperation between Member States, and those states have not come to a joint decision on how to apply this balancing test in relation to the scope of de-referencing information outside the physical boundaries of the European Union.[77] However, the Court concluded that this is for search engines themselves to figure out.[78]

The Court also recognized that balancing the right to privacy of internet users and access to information is likely to vary around the world.[79] The Court concluded that, based on the judgement in *Google Spain*, the subject of the search may request information to no longer be accessible to the general public through search results.[80] These individual "rights override . . . not only the economic interest of the operator of the search engine but also the interest of the general public in finding that information upon a search relating to the data subject's name."[81]

Although the European Union recognizes a fundamental right to privacy, Member States may balance the right to privacy with other rights, such as the right to free expression on the internet, differently than other States.[82] This patchwork of laws is representative of the way that

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[71] "Each device that connects to the Internet needs a unique identifying number with which to communicate, called an 'IP address'". *What is an IP address?*, APNIC, https://www.apnic.net/get-ip/faqs/what-is-an-ip-address/ (last visited Jan 31, 2020).
[72] Google LLC v. Commission nationale de I'informatique et des libertes (CNIL), 2019 EUR-Lex CELEX LEXIS 772 (Sept. 24, 2019).
[73] *Id.*
[74] EU Charter of Fundamental Rights, Title II, art. 11 ("Freedom of expression and information").
[75] *Id.* at 5.
[76] Case C-507/17, Google LLC v. Commission nationale de I'informatique et des libertes (CNIL), 2019 EUR-Lex CELEX LEXIS 772 (Sept. 24, 2019); *Google LLC v. National Commission on Informatics and Liberty (CNIL),* GLOBAL FREEDOM OF EXPRESSION, https://globalfreedomofexpression.columbia.edu/cases/google-llc-v-national-commission-on-informatics-and-liberty-cnil/ (last visited Jan 31, 2021).
[77] Case C-507/17, Google LLC v. Commission nationale de I'informatique et des libertes (CNIL), 2019 EUR-Lex CELEX LEXIS 772 (Sept. 24, 2019) (stating that "[t]here is no obligation under EU law, for a search engine operator who grants a request for de-referencing made by a data subject, as the case may be, following an injunction . . . to carry out such a de-referencing on all the versions of its search engine").
[78] *Id.*
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *Id.*

the California Consumer Privacy Act fits in with the rest of the laws and regulations in the United States.[83]

III. PRIVACY LAW IN CALIFORNIA

California has led the way for social and political change around the country. It doesn't come as a surprise then that California's constitution formally recognizes both happiness and privacy as "inalienable rights" for citizens.[84] The state's unique recognition of the right to privacy slowly but surely paved the way for the California Consumer Privacy Act of 2018.

As early as 1931, the California Court of Appeals held that California citizens have a right to privacy.[85] The Court stated that the law of privacy was recent and cited *The Right to Privacy* by the Honorable Louis D. Brandeis and Samuel D. Warren in 1890.[86] That article influenced the national recognition of the right to privacy, although many states refused to formally recognize privacy as a fundamental right.[87] The Court recognized that private events may become public as a matter of public record, but nonetheless, the Court recognized that in California, the fundamental law of the state permitted the recognition of the "right to pursue and obtain safety and happiness without improper infringements thereon by others." [88]

The California courts expanded on this notion of private versus public information, eventually commenting on the nature of electronic communications. In 1971, the California Supreme Court criticized the role of media and electronic devices, "destroy[ing] an individual's autonomy, intrud[ing] upon his most intimate activities, and expos[ing] his personal characteristics

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[83] *See, e.g., Practical Law Data Privacy Advisor, Demonstrating Compliance with the GDPR (2019).* The European Courts are not the only courts around the world to recognize the inherent difficulty when trying to apply different values of privacy and balance those values with other fundamental rights. For example, The Delhi High Court in 2019 issued an injunction against Google, Facebook, YouTube, and Twitter and directed those platforms to remove URLs that linked to defamatory information. *Ramdev v. Facebook*, GLOBAL FREEDOM OF EXPRESSION, https://globalfreedomofexpression.columbia.edu/cases/ramdev-v-facebook/ (last visited May 23, 2020). The Court viewed geo-blocking as an insufficient way to prevent access to the defamatory information while recognizing that this would necessarily call for a "global takedown order" and would threaten the free flow of information on the internet. *Id. See, e.g.,* Jennifer Huddleston & Ian Adams, *Potential Constitutional Conflicts in State and Local Data Privacy Regulations*, REGULATORY TRANSPARENCY PROJECT OF THE FEDERALIST SOCIETY (Dec. 2, 2019), https://regproject.org/wp-content/uploads/RTP-Cyber-and-Privacy-Paper-Constitutional-Conflicts-in-Data-Privacy-final.pdf.

[84] CAL. CONST. art. I, § 1 ("All people are by nature free and independent and have inalienable rights. Among these are enjoying and defending life and liberty, acquiring, possessing, and protecting property, and pursuing and obtaining safety, happiness, and privacy.").

[85] Melvin v. Reid, 297 P. 91, 91 (Cal. Ct. App. 1931). In this case, Gabrielle Darley a prostitute and was tried for murder which she was ultimately acquitted of. *Id.* After this, Darley "abandoned her life of shame and became entirely rehabilitated . . . [the next year she] commenced the duties of caring for their home, and thereafter at all times lived an exemplary, virtuous, honorable, and righteous life." *Id.* Darley mentioned to the Court that her friends did not know about her past. *Id.* However, in July 1925, a movie was released entitled "The Red Kimono," which was based upon Darley's past life, a true story. *Id.*

[86] *Id.* at 91. The Court distinguished California from other jurisdictions, "[t]he question is a new one in California. The only case to which we have been cited which even remotely relates to it is that of Crane v. Heine, 35 Cal. App. 466, 170 P. 433. This case, however, furnishes us with no authority for adopting in this state the doctrine of the right of privacy as it is known in other jurisdictions." *Id.* at 92; Samuel D. Warren & Louis D. Brandeis, *The Right to Privacy*, 4 HARV. L. REV. 193, 196 (December 1890).

[87] *Melvin*, 297 P. at 92.

[88] *Id.* at 93.

to public gaze."[89] When determining whether an embarrassing yet truthful news article infringed on an individual's right to privacy, the Court considered the social value of the article and the offensive nature of the information contained in the article.[90] The Court noted that current events naturally spark media attention, and because that information has a high social value, constitutional protections are higher for newsworthy events.[91] Distinguishing those newsworthy events from the article at issue, the Court determined that this article did not serve an "independent public purpose," and thus the individual's privacy concerns outweighed First Amendment protections.[92]

That case was subsequently overruled by *Gates v. Discovery Comm., Inc* in 2004.[93] The Court took a step back from an individual's right to privacy, at least so far as it relates to facts available in public record.[94] The California Court concluded that prior Supreme Court decisions, specifically *Cox. v. Cohn*, undermined the recognition of an individual's fundamental right to privacy and favored broad First Amendment protections for news articles.[95] Importantly, the Court recognized that under federal constitutional law principles and common law, the right to privacy is difficult to recognize as a fundamental right.[96] Thus, while happiness and privacy are both "inalienable rights" under the California constitution, courts have had difficulty balancing these rights with other constitutional protections such as the First Amendment.[97]

IV. THE CCPA

A. What is the CCPA?

The California Consumer Privacy Act ("CCPA") includes many different provisions, but this section will focus specifically on § 1798.105 of the California Civil Code as amended by the Act[98]. The goals of the CCPA expand on the existing right to privacy in the United States and provide Californians with data privacy protections in order to control the use of personal information.[99] The California legislation was approved a month after the GDPR went into effect, and is the strictest personal data privacy regime in the United States.[100] The Act only applies in California and to California residents, however making compliance by internet companies that engage in business within the United States inherently difficult.[101]

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89 Briscoe v. Reader's Digest Ass'n.,483 P.2d 34, 37 (1971).
90 *Id.* at 38.
91 *Id.* at 40.
92 *Id.* at 39-40 (relying on A. Meiklejohn, *Political Freedom: The Constitutional Powers of the People* (1960)).
93 *See* Gates v. Discovery Comm., Inc., 101 P.3d 552 (Cal. 2004).
94 *Id.* at 562.
95 *Id. See* Victor P. Muskin, *The Right to Be Forgotten: Are Europe and America on a Collision Course?*, 91 N.Y. ST. B.J. 36 (March, 2019).
96 *Gates*, 101 P.3d at 573. *See also* Shaun G. Jamison, *Creating a National Data Privacy Law For the United States*, 10 CYBARIS AN INTELL. PROP. L. REV. 1, 7 (2019) for a discussion on a federal right to privacy.
97 *See* Gates v. Discovery Comm., Inc., 101 P.3d 552 (Cal. 2004).
98 California Consumer Privacy Act of 2018 ("CCPA"), CAL. CIV. CODE § 1798.105 (2018).
99 *About the California Consumer Privacy Act*, CALIFORNIANS FOR CONSUMER PRIVACY, https://www.caprivacy.org/about (last visited Jan. 17, 2020).
100 Szuyin Leow, *The California Consumer Privacy Act Arrives in January 2020. What Can We Expect?*, LOGICATE (Feb. 12, 2019), https://www.logicgate.com/2019/02/12/the-california-consumer-privacy-act-arrives-in-january-2020-what-can-we-expect/.
101 *Id.*

The CCPA requires a business to comply with customer requests to delete personal information[102] if the customer requests that deletion, unless it is necessary for the business to collect this personal data.[103] The Act gives Californians specific privacy rights, including: (1) the right to know what personal information is collected about the consumer; (2) the right to know whether that information is sold or disclosed, and to whom; (3) the right to say no to that sale; (4) the right to access that information; and (5) the right to equal treatment by the business.[104]

California is just one of eleven states that recognize privacy as an enumerated right in its state constitution.[105] However, balancing one state's fundamental right of privacy with federal constitutional law principles is difficult at best.[106] In order to determine whether the CCPA comes into conflict with federal constitutional principles, it is necessary to analyze the Act under the Dormant Commerce Clause.

B. Dormant Commerce Clause Challenge

A central constitutional challenge to the CCPA is the Dormant Commerce Clause, which prohibits discrimination between in state and out-of-state citizens.[107] When Congress or the Supreme Court has not preempted an area of state legislation, state legislation is analyzed under strict or intermediate scrutiny in order to be constitutional.[108] The following analysis focuses on the challenges of the CCPA under this Constitutional principle.[109]

Article I of the United States Constitution supports the principle that state and local laws may not burden commerce between the states more than necessary.[110] When challenging a state regulation under the Dormant Commerce Clause, the first question for the court is whether the state legislation is an "illegitimate means of isolating a state from the national economy," and thus is facially discriminatory (a per se violation of the Dormant Commerce Clause).[111] Discrimination means "differential treatment of in-state and out-of-state economic interests that benefits the

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[102] The Act defines "personal information" as "information that identifies, relates to, describes, is reasonably capable of being associated with, or could reasonably be linked, directly or indirectly, with a particular consumer or household." West's Ann. Cal. Civ. Code § 1798.140. This includes, but is not limited to, "inferences drawn . . . to create a profile about a consumer reflecting . . . preferences, characteristics, psychological trends, predispositions, behavior, attitudes, intelligence, abilities, and aptitudes." *Id.* While the CCPA does not include publicly available information "lawfully made available from federal, state, or local government records," the definition of "personal information" is vague, broad, and unspecific. CCPA, Section 1798.140(o)(2); *see* David Zetoony, *CCPA Privacy FAQs: Does "personal information" include information that a business obtains from government records?*, JDSUPRA (July 17, 2019), https://www.jdsupra.com/legalnews/ccpa-privacy-faqs-does-personal-17583/ (last visited Feb. 23, 2020) ("The CCPS was put together quickly (in approximately one week). Given its hasty drafting, there are a number of instances in which the act is at best ambiguous and at worst unintelligible.").

[103] CALIFORNIA LEGISLATION INFORMATION, AB-1760 CALIFORNIA CONSUMER PRIVACY ACT OF 2018 (2019); Alan S. Gutterman, *California Consumer Privacy Act of 2018,* Bus. Transactions Solutions § 230:38.50.

[104] *Id.*

[105] *Id.; Privacy Protections in State Constitutions*, NCLS, https://www.ncsl.org/research/telecommunications-and-information-technology/privacy-protections-in-state-constitutions.aspx (last visited May 27, 2020).

[106] *See, e.g.,* Huddleston & Adams, *supra* note 84.

[107] *See, e.g,* Pike v. Bruce Church, Inc., 397 U.S. 137 (1970).

[108] *See id.*

[109] For an in-depth discussion, *see* Russell Spivak, *Too Big a Fish in the Digital Pond? The California Consumer Privacy Act and the Dormant Commerce Clause*, 88 U. CIN. L. REV. 475 (2019); Huddleston & Adams, *supra* note 84.

[110] Huddleston & Adams, *supra* note 84.

[111] City of Philadelphia v. New Jersey, 437 U.S. 617, 627 (1978).

former and burdens the latter."[112] These laws are subject to the strictest scrutiny, as economic protectionism is not a legitimate means to "evenhandedly [] effectuate a legitimate local public interest."[113] When state legislation is an "illegitimate means of isolating the state from the national economy," this state law will be facially discriminatory towards out-of-state commerce.[114] When a law is not facially discriminatory, the law is subject to the *Pike* balancing test.[115] This test is conducted by answering the following four questions of the state regulation: (1) whether the regulation is even-handed; (2) whether the regulation effectuates a legitimate purpose; (3) whether the regulation's effects on interstate commerce are incidental; and (4) whether the burden of the state regulation is excessive in relation to local putative benefits.[116]

The argument that the CCPA does not violate the Dormant Commerce Clause relies in part on *Healy v. Beer Institute, Inc.*, in which the Supreme Court of the United States determined that when a state regulates commerce occurring "wholly outside" that State's borders, that regulation is invalid.[117] Scholars argue that the language of the CCPA, specifically the language in § 1798.140(c)(1) that only those businesses that actually "do[] business in the State of California" precludes application of the extraterritoriality test to the CPPA, while others write this extraterritorial test off as inapplicable except to those cases of price-fixing, such as in *Healy*.[118]

However, the 2nd Circuit Court of Appeals in *American Bookstores* recognized that because there are no recognized geographical boundaries within the internet, it is nearly impossible for a state to regulate those activities on the internet without "project[ing] its legislation into other states."[119] In that case, the Court struck down a law prohibiting dissemination of sexually harmful materials to children over the internet.[120] The Court determined that Vermont's interest was "impracticable" because the Vermont law prohibited Vermont, but not other states, from viewing certain materials.[121] Importantly, the Court noted that the internet may soon be protected from state-by-state regulations.[122] Thus, the burdens imposed by the CCPA do not end with the corporation who is directly affected but will instead create a domino effect of far-reaching implications for those business who regularly use personal data.[123]

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[112] Spivak, *supra* note 110, at 495 (quoting Oregon Waste Sys., Inc. v. Department of Envtl. Quality, 511 U.S. 93, 99 (1994)).
[113] Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).
[114] *Philadelphia v. New Jersey*, 437 U.S at 627.
[115] Nicholas F. Palmeri, *Who Should Regulate Data?: An Analysis of The California Consumer Privacy Act and Its Effects on Nationwide Data Protection Laws*, 11 Hastings Sci. & Tech.L.J. 37, (2020).
[116] *Pike*, 397 U.S. at 142. For a more in-depth discussion, *see* Palmeri, *supra* note 116.
[117] Healy v. Beer Institute, Inc., 491 U.S. 324, 332 (1989).
[118] Spivak, *supra* note 110. While this article does not go into great detail about the different tests under the Dormant Commerce Clause analysis, the extraterritorial argument is the primary analysis used to determine whether the CCPA is invalid. *See, e.g.,* Kiran K. Jeevanjee, *Nice Thought, Poor Execution: Why the Dormant Commerce Clause Precludes California's CCPA from Setting National Privacy Law*, 70 AM. U. L. REV. F. 75, 75 (2020); Mallory Ursul, *The States' Role in Data Privacy: California Consumer Privacy Act versus Dormant Commerce Clause*, 52 SUFFOLK U.L. REV. 577, 578 (2019); Palmeri, *supra* note 116.
[119] *American Booksellers Foundation v. Dean*, 342 F.3d 96, 103 (2d Cir. 2003) (quoting *Healy*, 491 U.S. 324 at 334).
[120] *Id.* at 102.
[121] *Id.* at 103-04 ("A person outside Vermont who posts information on a website or on an electronic discussion group cannot prevent in Vermont from accessing the material. If someone in Connecticut posts material for the intended benefit of other people in Connecticut, that person must assume that someone from Vermont may also view the material. This means those outside Vermont must comply with [the law]. . . .").
[122] *Id.* at 104.
[123] Huddleston & Adams, *supra* note 84, at 8.

The scholars who only look to the language of the CCPA or who write off the extraterritorial analysis as inapplicable are mistaken to do so. Admittedly, it is difficult to argue that the CCPA regulates something that is occurring "wholly outside" the state's borders; however, the internet, social media, and online data regulations do not follow along the border of *any* state.[124] While the CCPA may *say* that the regulation only applies to those businesses doing business in California, the stringent requirements for compliance under the regulation impact other businesses not yet doing business in California. For example, some of those businesses may have chosen not to do business in California and may never do so because it is too difficult or expensive to comply with the requirements under the CCPA. The corporations located within California are now faced with a new reality: either comply with the most comprehensive privacy Act in the country or stop doing business in California.[125]

The CPRA may nonetheless save the CCPA from an extraterritorial argument.[126] As currently written, the CPRA has increased the number of California residents of which businesses "buy, sell, or share" the personal information of from 50,000 to 100,000.[127] This increase raises the threshold that a business must reach in order to be regulated by the CCPA, in turn creating more of a limitation on the businesses that are considered to do business in California.

An additional consideration under the Dormant Commerce Clause is whether states such as Maine[128] and Nevada[129] expand current privacy regulations to be as comprehensive as the CCPA.[130] A federal fundamental right to privacy, and as a result, federal privacy regulation, would preempt these state laws and effectively prohibit any application of the Dormant Commerce Clause to these swiss-cheese like state regulations.[131]

V. CONCLUSION

The internet will continue to impact society in the future, which renders it necessary to determine how differing privacy laws will affect how global citizens interact with one another,

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[124] See Section I(A).
[125] Huddleston & Adams, *supra* note 84, at 8-9.
[126] For more information on what is included in the CPRA, see *CCPA vs. CPRA - What Has Changed?*, ONETRUST (Nov. 10, 2020), https://www.onetrust.com/blog/ccpa-vs-cpra-what-has-changed/.
[127] *Id.*
[128] The Maine Privacy Law, LD 946, only applies to internet service providers, and thus is not nearly as comprehensive as the CCPA. An Act To Protect The Privacy of Online Customer Information, 1 M.R.S. § 9301 (2019); *see also* Lothar Determann & Helena J. Engfeldt, *Maine and Nevada's New Data Privacy Laws and the California Consumer Privacy Act Compared*, BAKERMCKENZIE (June 20, 2019), https://www.bakermckenzie.com/en/insight/publications/2019/06/maine-and-nevada-new-data-privacy-laws.
[129] Nevada Senate Bill 220 limits the type of information protected. *See* Nev. Rev. Stat § 603A (2019); *see also* Lothar Determann & Helena J. Engfeldt, *Maine and Nevada's New Data Privacy Laws and the California Consumer Privacy Act Compared*, BAKERMCKENZIE (June 20, 2019), https://www.bakermckenzie.com/en/insight/publications/2019/06/maine-and-nevada-new-data-privacy-laws.
[130] "[I]f multiple states adopted comprehensive date privacy legislation . . . conflicting state privacy regulations resulting in unreasonable or even impossible compliance could support . . . extraterritoriality." Mallory Ursul, *The States' Role in Data Privacy: California Consumer Privacy Act Versus Dormant Commerce Clause,* 52 SUFFOLK U. L. REV. 577, 601 (2019).
[131] For more information on one federal privacy approach, see Cameron F. Kerry & John B. Morris, Jr., *Preemption: A balanced national approach to protecting all Americans' privacy*, BROOKINGS (June 29, 2020), https://www.brookings.edu/blog/techtank/2020/06/29/preemption-a-balanced-national-approach-to-protecting-all-americans-privacy/.

whether that is across the room or across the world.[132] By analyzing privacy with this perspective in mind, a better understanding of what privacy means in a digitized world will guide future discussions to allow for beneficial privacy legislation.[133] As discussed above, although social media has increased at alarming rates just within the past few years, the internet has not reached its peak.[134] Privacy laws, both past and current, have worked for a short moment. As technology continues to grow, it is more important than ever to assign privacy value in relation to other constitutional protections and to define what privacy means in the digital age.[135]

In the European Union, Directive 96/45 set the foundation for the "Right to be Forgotten."[136] Member States have acknowledged the difficulty of balancing individuals' expression interests with the fundamental right to privacy.[137] Courts have determined that it is the responsibility of the search engine to adequately protect personal data, which in effect puts the privacy conversation in the hands of corporations.[138] Similarly, in the state of California, United States, the fundamental law of the state has permitted the courts to formally recognize a fundamental right to happiness and privacy, although squaring this right with other constitutional protections, such as the First Amendment, has proven challenging.[139]

The California Consumer Privacy Act of 2018 is the most sweeping data protection regime currently in effect within the United States.[140] However, this Act has several significant hurdles to jump over before consumers should blindly accept the consequences that will soon affect the accessibility of information worldwide and between the states.[141] The Act will be modified by the CPRA in 2023, however, which may save the CCPA for failing under the Dormant Commerce Clause.[142]

Federal legislation in the United States fails to account for internet privacy in a comparable way to both the CCPA and the GDPR.[143] The United States Congress should draft federal legislation that will ultimately preempt state laws such as the CCPA and prevent those laws to be applied on a state-by-state basis.[144] First, however, privacy must be established as a fundamental right, specifically enumerated in the Constitution of the United States.

There are no geographical boundaries on an Instagram or Facebook page. It is possible to message a person on the opposite side of the world. A picture on Instagram may go "viral" in a number of minutes. Technology and the internet are here to stay. Social media, news outlets, and the access to unlimited information at individual fingertips comes with a price, and it is likely that

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[132] *See, e.g.*, *Americans and Privacy: Concerned, Confused and Feeling Lack of Control Over Their Personal Information*, *supra* note 9; Kat Smith, *supra* note 2; Palmeri, *supra* note 116; Spivak, *supra* note 110.
[133] *See, e.g.*, *Americans and Privacy: Concerned, Confused and Feeling Lack of Control Over Their Personal Information*, *supra* note 9; Kat Smith, *supra* note 2; Palmeri, *supra* note 116; Spivak, *supra* note 110.
[134] *See* Kat Smith, *supra* note 2.
[135] *See, e.g.*, Spivak, *supra* note 110; *What is Global Citizenship?*, *supra* note 6.
[136] Regulation 2016/679 (General Data Protection Regulation), art. 94, 2016 O.J. (L 119) 1.
[137] See Case C-131/12, Google Spain, SL v. Agencia Española de Prot. de Datos (AEPD), 2014 EUR-Lex CELEX LEXIS 317 (May 13, 2014) and Magyar Jeti Zrt v. Hungary, 2018 Eur. Ct. H.R. 1 for illustration of this principle.
[138] Case C-507/17, Google LLC v. Commission nationale de I'informatique et des libertes (CNIL), 2019 EUR-Lex CELEX LEXIS 772 (Sept. 24, 2019). See Section I for discussion of the corporation-controlled privacy conversation.
[139] *See* Gates v. Discovery Comm., Inc., 101 P.3d 552 (Cal. 2004).
[140] Tami Abdollah, *California Passes Nation's Most Stringent Consumer Data Privacy Law*, DOT.LA (Nov. 4, 2020), https://dot.la/california-proposition-24-2648623072/twitter.
[141] Huddleston & Adams, *supra* note 84.
[142] *CCPA vs. CPRA - What Has Changed?*, *supra* note 127.
[143] *See* Muskin, *supra* note 96.
[144] *Preemption: A balanced national approach to protecting all Americans' privacy*, *supra* note 132.

"price" is the inherent loss of individual privacy if that determination is left up to the corporation and privacy is not regarded as a fundamental right within the United States.

COMMENT

COMITY, TIPPING POINTS, AND COMMERCIAL SIGNIFICANCE: WHAT TO EXPECT OF THE HAGUE JUDGMENTS CONVENTION

OLIVIA STITZ*

CONTENTS

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I. INTRO

"Truly fortunate is the nation, which sets itself the goal of finding the means to improve."[1] -- Tobias Asser, founder of the Hague Conference on Private International Law.

The above words of Tobias Asser guide the recently passed Hague Judgments Convention. Asser started initiatives for a convention that would improve global judicial cooperation in light of growing cross-border trade and international commerce.[2] Recognition and enforcement of foreign judgments is regulated by national law, domestic law, and "principles of comity, reciprocity and res judicata."[3]

In the US, enforcement of foreign judgments depends on the state in which enforcement is sought.[4] On the other side, enforcement of US court judgments in another country encounter criticism regarding "excessive" monetary damages.[5] Hence, approximately 90% of international commercial contracts[6] rely on arbitration clauses under the New York Convention to ensure enforceability across jurisdictions.[7]

Since its passage in 1958, the New York Convention has risen to the challenge of international business and dispute needs. However, while arbitration was historically the cheaper, quicker, and more efficient alternative to litigation,[8] the tides have turned. Modern practices are causing arbitral amounts-in-dispute to rise.[9] Discovery processes and motion practices extend the proceedings to last longer.[10] Arbitration's traditional hallmarks, "speedy, simple, and inexpensive"[11] are a fairly tale of the past.

Currently, foreign court judgments run the risk of unenforceability when parties are seeking recognition beyond their jurisdiction unless states are party to a specific judgment enforcement treaty or the 2005 Hague Convention on Choice of Court Agreement ("Choice of Court Convention"). Even then, it is hard to know when and how a judicial ruling will be recognized in another jurisdiction. Today, the US is a signatory only to the Choice of Court Convention.[12]

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[1] HAGUE CONVENTION ON PRIVATE INT'L. LAW [hereinafter HCCH], *22nd Diplomatic Session of the HCCH: The Adoption of the 2019 HCCH Judgments Convention*, YOUTUBE (Sep. 9, 2019), https://youtu.be/1SgcrsD9Iao [hereinafter *22nd Diplomatic Session*].
[2] *Id.*
[3] Bureau of Consular Affairs, *Enforcement of Judgments*, U.S. DEPT. OF STATE, https://travel.state.gov/content/travel/en/legal/travel-legal-considerations/internl-judicial-asst/Enforcement-of-Judges.html.
[4] SCOTT A EDELMAN ET AL., ENFORCEMENT OF FOREIGN JUDGMENTS: IN 28 JURISDICTIONS WORLDWIDE 131, 131 (Patrick Doris ed., 2006), https://www.gibsondunn.com/wp-content/uploads/documents/publications/Edelman-Jura-Enforcement-of-Foreign-Judgments-US.pdf.
[5] Bureau of Consular Affairs, *supra* note 3.
[6] S.I. Strong, *Realizing Rationality: An Empirical Assessment of International Commercial Mediation*, 73 WASH. & LEE L. REV. 1973, 1976 (2016).
[7] Pamela K. Bookman, *The Arbitration-Litigation Paradox*, 72 VAND. L. REV. 1119, 1141-42 n.137 (2019).
[8] Strong, *supra* note 6, at 1983.
[9] *See generally* 1982-83.
[10] *See id.* at 1983.
[11] Bookman, *supra* note 7, at 1125.
[12] Bureau of Consular Affairs, *supra* note 3; *see generally* HCCH, *Status Table: Convention of 30 June 2005 on Choice of Court Agreements*, https://www.hcch.net/en/instruments/conventions/status-table/?cid=98; Bureau of Consular

To deal with a growing international commercial community, resulting in a rising number of international commercial disputes, the HCCH sought to tackle the challenges of modern commerce. On July 2, 2019, the HCCH's 22nd Diplomatic Session met in The Hague and passed the Hague Judgments Convention.[13] The Hague Judgments Convention would expand dispute resolution options available to businesses. The Hague Judgments Convention promises enforceability of judicial rulings across borders among signatory states, seeking a solution to the international litigation question: Will my judgment be enforced outside of the jurisdiction of the court that rendered the judgment?

The Hague Judgments Convention's underlying goal is uniformity and predictability in international judicial proceedings.[14] To encourage recognition of foreign judgments and achieve this goal of uniformity and predictability, judges are encouraged to interpret contracts with an "international spirit."[15] This ethos requires judges to rise to the challenge and incorporate all applicable regulations, rules, and laws potentially relevant to international proceedings.[16] By fostering uniformity, attorneys should be better at predicting enforceability of judgments, assisting clients in selecting the most appropriate dispute resolution option, as well as choosing the appropriate forum and governing law during negotiations.[17] In essence, the new Hague Judgments Convention should foster faster court proceedings and resolutions on the international stage.[18] Additionally, the Hague Judgments Convention should increase convenience, offering a one-stop-shop for determining the question of enforceability[19] rather than requiring thorough research and analysis of existing, and sometimes non-existing, independent treaties.

On its face, the Hague Judgments Convention appears promising. What can be wrong with the advancement of cross-border cooperation? However, the devil lies in the details. This article will take a look at what those details are, what it will take for the Hague Judgments Convention to reach commercial significance, and once reached, what factors will push businesses in one direction or another when selecting the most appropriate dispute resolution option.

Part II of this article will introduce the Hague Judgments Convention, relevant Articles for commercial transactions and enforcement, and the Hague Judgments Convention's history. To put the Hague Judgments Convention in perspective, the Hague Judgments Convention will be compared to the New York Convention and the recently passed Singapore Mediation Convention, both introduced in Part II.

Affairs, *International Treaties & Agreements*, U.S. DEPT. OF STATE, https://travel.state.gov/content/travel/en/legal/travel-legal-considerations/intl-treaties.html.

[13] HCCH, *It's done: the 2019 HCCH Judgments Convention has been adopted!*, https://www.hcch.net/en/news-archive/details/?varevent=687 (last visited Sep. 11, 2020) [hereinafter *It's done*].

[14] HCCH, *Convention on the Recognition and Enforcement of Foreign Judgments in Civil or Commercial Matters*, art. 20 (concluded July 2, 2019) https://assets.hcch.net/docs/806e290e-bbd8-413d-b15e-8e3e1bf1496d.pdf [hereinafter *Recognition and Enforcement*].

[15] HCCH, *Twenty-Second Session, Recognition and Enforcement of Foreign Judgments*, 86, art. 21 ¶ 3939, July 2, 2019 https://assets.hcch.net/docs/7d2ae3f7-e8c6-4ef3-807c-15f112aa483d.pdf [hereinafter *Twenty-Second Session*].

[16] *Id.*

[17] HCCH, *Recognition and Enforcement*, *supra* note 14.

[18] HCCH, *22nd Diplomatic Session*, *supra* note 1.

[19] *Id.*

Part III analyzes various factors that must be met in order for the Hague Judgments Convention to take on a significant role. Divided into three subsections, the first section considers factors influencing states when deciding to sign onto the Hague Judgments Convention and analyzes what hurdles states must overcome before wanting to join, including political concerns and biases. Part III will also consider the realities of commercial significance in light of signatories. The second section will analyze practical considerations such as the freedom to contract and costs associated with dispute resolution. The third and final section of Part III will assume commercial significance, analyzing the balancing process parties undertake when considering litigation over arbitration as a new dispute resolution option.

Part IV will conclude, demonstrating that the hurdles placed before state governments, contracting parties, and enforcing courts make court proceedings on the international stage less desirable than arbitration to date. Although a noble cause and a worthy objective to strive for in the future, as the world stands today, arbitration will carry the day.

II. BACKGROUND

When negotiating contracts, parties have significant flexibility in choosing the type of dispute resolution, forum, governing law, and other important factors necessary for a successful agreement. International contracts generally turn to the UNIDROIT Principles of International Commercial Contracts for basic principles that will easily translate to enforceability on the international stage.[20] As international trade has progressed, substantive law has evolved into a harmonious body of legal principles.[21] However, contracts are generally up to the parties and are thoroughly negotiated by highly sophisticated parties.[22] Hence, parties will choose their preferred dispute resolution option based on enforceability, confidentiality, efficiency, and much more. Unlike litigation or arbitration, mediation serves as a popular proceeding in resolving disputes early on. Because participation is voluntary and decisions are non-binding, proceedings tend to preserve the parties' relationships,[23] encouraging continued trading practices. With that in mind, the legal industry on a global scale is trying to facilitate interstate relations, foster commerce, and find forms of dispute resolutions that will satisfy everyone involved. Two of the more popular adjudicative dispute resolution options are litigation and arbitration. Currently, arbitration wins on the international playing field, because court rulings generally lack enforcement in foreign jurisdictions. Hence, the leaders of global commerce have tried to find ways to resolve this discrepancy with the Hague Judgments Convention.

Because arbitration comes in two flavors—ad hoc and institutional proceedings—it is worth noting that this article spends little time on ad hoc proceedings, as there is insufficient data available; however, its absence has no effect on the underlying analysis and conclusion.

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[20] Klaus P. Berger, *UNIDROIT Principles of International Commercial Contracts, An Article-by-Article Commentary*, 34 ARB. INT'L 469–71 (2018).
[21] Jens Dammann & Henry Hansmann, *Globalizing Commercial Litigation*, 94 CORNELL L. REV. 1, 30 (2008).
[22] Bookman, *supra* note 7, at 1128.
[23] G.A. Res. 73/198, at 3 (Dec. 20, 2018) [hereinafter Singapore Convention].

A. Basics

Parties carefully negotiate commercial contracts. Hence, every contract will vary from other contracts, even though negotiations start off with each party referencing their basic content checklist - similar to form contracts. International contracts are inherently customized documents, capable of adapting to the participating parties, current economic settings, and relevant legal standards.

When businesses are negotiating regarding which form of dispute resolution to select, they are dealing with three options: arbitration, litigation, and mediation.[24] As this article will demonstrate, each option comes with its own advantages and disadvantages. The first option, arbitration, offers privacy and confidentiality but outcomes are case-specific and results are not reasonably predictable.[25] The second option, litigation, offers predictability and reliability, but is inherently public. The third option, mediation, offers privacy and confidentiality as well, but is an agreement as opposed to a third-party decision. Usually mediation is selected in addition to one of the other two options. Rarely will a contract select both arbitration and litigation. When negotiating the dispute resolution clause, businesses and their attorneys alike are well advised to consider the options available to them thoroughly analyzing advantages and disadvantages before setting their selection in stone.

Arbitration is much more flexible for the individual parties. Procedurally, litigation offers more regulated and generalized guidelines, whereas arbitration and arbitral institutions allow for personalized and tailored rules.[26] For example, parties to arbitration will purposely search for a neutral forum to hold their proceedings, whereas forum shopping in courts is frowned upon. Although judges will generally follow the parties' agreement and even apply the contract's governing law, judges are bound by procedural rules and public policy considerations. Furthermore, in arbitration the parties may designate a specific arbitrator responsible for the proceedings. Because arbitrators have no educational or skill requirements other than what the parties agree upon, considerations for selecting the appropriate arbitrator may include the arbitrator's knowledge in the industry, the chosen governing law, or a common language between the parties. In contrast, court proceedings will not allow parties to shop for judges.

Additionally, the right to appeal in arbitration is limited; in contrast, it is a constitutional right in judicial proceedings. Finality of arbitral awards is achieved upon receiving the award. Even if parties agree to judicial appeals, the arbitral award cannot be challenged on its merits. Parties can only appeal awards based on procedural flaws. If an arbitral appeal is successful, courts may either uphold the award or invalidate it. Nothing more. Finality in courts is only achieved upon exhausting all options of appeal, a long and arduous process.

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[24] Bookman, *supra* note 7, at 1125.

[25] Dammann & Hansmann, *supra* note 21, at 37; Strong, *supra* note 6, at 1982; Stephen L. Brodsky, *Cross-Border Arbitration: A Beneficial Alternative to Resolving International Commercial Disputes*, AMERICAN BAR ASS'N., (July 3, 2019), https://www.americanbar.org/groups/litigation/committees/commercial-business/articles/2019/spring2019-cross-border-arbitration-international-commercial-disputes/.

[26] Carolyn B. Lamm, Eckhard R. Hellback, & Nikolaos Tsolakidis, *Int'l Arbitration in a Globalized World*, 20 DISP. RESOL. MAG. 4, 5 (2013-14).

The standard of discoverable information differs as well. While parties in arbitration only need to produce information they will use for their case, courts require all information that could be relevant to the proceedings. However, should parties play hard ball in courts, hitting the breaks on providing relevant information, courts have the full power of a government entity to subpoena documents, witnesses, and third parties.[27] While arbitrators can subpoena participating parties, witnesses, and documents,[28] the power is limited,[29] and arbitrators rely on courts to assist with enforcing the subpoena.[30] To circumvent this inconvenience, arbitrators will often imply adverse inference against the non-producing party, penalizing hold-outs.

Another difference between litigation and arbitration is the judge's or arbitrator's duty to follow substantive law. While the arbitrator may or may not follow the selected governing law of the contract, deciding in equity if the parties agree to give the arbitrators that power, judges lack such freedoms.

Finally, and most significantly, litigation and arbitration differ in enforceability as previously mentioned. The 2019 Hague Judgments Convention seeks to overcome this barrier.

B. Convention on the Recognition and Enforcement of Foreign Judgments in Civil or Commercial Matters

i. Intro

The first project considering a "global approach to jurisdiction and judgments recognition" was introduced by the United States in 1992.[31] In 2005, this idea resulted in the Choice of Court Agreement.[32] The Choice of Court Agreement allows contracts with an "exclusive choice of court" to receive enforcement of their agreement across fellow member states.[33] Judgments must be made on the merits,[34] and the agreement must designate at least one specific court to rule on the contractual disputes "to the exclusion of the jurisdiction of any other courts."[35] If the contract does not address the matter, as is frequently the case, the Choice of Court Agreement does not apply. The Choice of Court Agreement's progeny, the Hague Judgments Convention, shares the common goal of cooperation and uniformity across international borders.[36]

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[27] *See* 28 U.S.C. § 1782 (assuming proper jurisdiction).
[28] *See* 9 U.S.C. § 7.
[29] *See, e.g.*, CVS Health Corp. v. Vividus, LLC, 878 F.3d 703 (9th Cir. 2017).
[30] *See* 28 U.S.C. § 1782.
[31] Ronald A. Brand, *The Circulation of Judgments under the Draft Hague Judgments Convention* 4 (Legal Studies Research Paper Series, Pittsburgh Law, Working Paper No. 2019-02, 2019); *see generally* HCCH, *Twenty-Second Session*, *supra* note 15, at 4.
[32] HCCH, *Twenty-Second Session*, *supra* note 15, at 4.
[33] HCCH, *Convention on Choice of Court Agreements*, art. 8(1), 44 I.L.M. 1294 (concluded June 30, 2005). [hereinafter *Choice of Court Agreements*]
[34] *Id.* at art. 4(1).
[35] *Id.* at art. 3(a).
[36] *See generally* HCCH, *Choice of Court Agreements*, *supra* note 33. Current economically significant signatory states to the Choice of Court Agreement include the United States (2009), United Kingdom (2018), Singapore (2015), Germany (2015), France (2015), China (2017), and the European Union (2009). European member states dominate the agreement. HCCH, *22nd Diplomatic Session*, *supra* note 1; HCCH, *Recognition and Enforcement*, *supra* note 14, at art. 20.

In 2011, members of the HCCH decided to continue down the path of jurisdictional uniformity, creating a Working Group that would submit the "proposed draft Text for a Convention on the recognition and enforcement of judgments in civil and commercial matters" in 2015.[37] Currently, over 85 states are members of the HCCH.[38] Members include, *inter alia*, the United States, various European states, the European Union, and several states from the Americas, Middle East, and Asia.[39] When the members of the HCCH met for the 22nd Diplomatic Session, over 400 delegates attended the meeting in The Hague.[40] After numerous revisions, the Working Group's draft was ultimately passed at the 22nd Diplomatic Session in July 2019.[41] While the broad goal of uniformity remains a hallmark of the document, the Hague Judgments Convention also intends to improve practical effectiveness of court judgments, avoid duplicative proceedings, and reduce costs and lengths of proceedings while at the same time increasing predictability.[42]

ii. The Hague Judgments Convention

There are two ways in which states can become signatories to the Hague Judgments Convention: Signature or accession.[43] Once joined, the Hague Judgments Convention could apply to the member's territorial units as well.[44] Jurisdictions with multiple territorial units will have to turn to Articles 23 and 26 to help interpret and apply the Hague Judgments Convention to each unit.[45] Although the United States spearheaded the idea of a uniform method for judicial recognition across borders in the 1990's, it has yet to sign on to the Hague Judgments Convention. As of publication of this article, only two states have signed the document.[46]

There are numerous sources available for parties to turn to when seeking help with the articles' interpretation.[47] The Hague Judgments Convention is intended to complement existing conventions and overrides neither the Choice of Court Convention nor the New York

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[37] HCCH, *Twenty-Second Session*, *supra* note 15, at 4–5; *see also* HCCH, *Recognition and Enforcement*, *supra* note 14.

[38] Hague Conference on Private Int'l Law, *HCCH Members*, HCCH, https://www.hcch.net/en/states/hcch-members (last visited Sep. 11, 2020) (membership count based on Nov. 12, 2019 data).

[39] *Id.*

[40] HCCH, *22nd Diplomatic Session*, *supra* note 1.

[41] HCCH, *Twenty-Second Session*, *supra* note 15, at 1; *see also* HCCH, *It's done*, *supra* note 13.

[42] HCCH, *Twenty-Second Session*, *supra* note 15, at para. 8-12; *see also* HCCH, *Recognition and Enforcement*, *supra* note 14.

[43] HCCH, *Twenty-Second Session*, *supra* note 15 at para. 431.

[44] For example, the Convention would equally bind all U.S. judicial systems, federal and state. *Id.* at para. 434-37.

[45] HCCH, *Twenty-Second Session*, *supra* note 15 at para. 434-35 (HCCH, 2019); *see also* HCCH, *Recognition and Enforcement*, *supra* note 14 art. 23, 26.

[46] As of August 2020, only two states have ratified the document. HCCH, *Status Table: Convention of 2 July 2019 on the Recognition and Enforcement of Foreign Judgments in Civil or Commercial Matters*, https://www.hcch.net/en/instruments/conventions/status-table/?cid=137 (last visited Sep. 11, 2020).

[47] *See generally* HCCH, *Twenty-Second Session*, *supra* note 15, at para. 14-15, 143-44; HCCH, "CIVIL OR COMMERCIAL MATTERS" / "ACTA IURE IMPERII," INFORMATION DOCUMENT NO 4 OF JUNE 2016 FOR THE ATTENTION OF THE SPECIAL COMMISSION OF JUNE 2016 ON THE RECOGNITION AND ENFORCEMENT OF FOREIGN JUDGMENTS 2 (2016); HCCH, *Glossary of Commonly Used Terms and References: Document for the attention of the Special Commission of June 2016 on the Recognition and Enforcement of Foreign Judgments*, 3-4 (2016) [hereinafter, *Glossary of Commonly Used Terms and References*]; HCCH, SUPPORTING DOCUMENTS FOR INFORMATION DOCUMENT NO 4: DOCUMENTS FOR THE ATTENTION OF THE SPECIAL COMMISSION OF JUNE 2016 ON THE RECOGNITION AND ENFORCEMENT OF FOREIGN JUDGMENTS 3-4 (2016).

Convention.[48] Commercial contract disputes regarding place of performance are specifically governed by Article 5(1)(g).[49]

When seeking enforcement of a judgment, the multifaceted aspects of jurisdiction present a mine field to parties. Firstly, place of performance will be key to recognition of the court of origin's judgment when seeking enforcement in the addressed court.[50] Place of performance is determined based on the parties' agreement or the contract's governing substantive law.[51] Where the agreement is silent on place of performance or the selected place of performance is invalid the "law of the requested State", the enforcing state's law,[52] will determine applicable law.[53] Secondly, jurisdiction can vary depending on who is filing the claim and what court is being addressed.[54]

Once jurisdiction is established, additional hurdles to enforcement must be overcome. Parties must anticipate judicial use of the Hague Judgments Convention's escape clauses, including public policy and specific "relations", which means a specific exception.[55] Both options create broad excuses for non-enforcement. Firstly, judges are ultimately granted broad discretion under public policy considerations, which include questions of sovereignty and security.[56] Although the Hague Judgments Convention expects judges to "interpret strictly," requiring non-enforcement to "constitute a manifest breach of a rule of law regarded as essential in the legal order of the [s]tate in which enforcement is sought," no specific guidelines are provided.[57] Because the Hague Judgments Convention offers little other guidance on these points, case law and jurisdictional practice will have to be established for parties to know how courts will approach the matter. Fortunately, although the court might refuse enforcement, refusal does not void the court of origin's ruling.[58] Secondly, specific relations on the state level can lead to unexpected recognitions because recognition of judgments may be excused for specific signatory states where the enforcing state decided to rely on reservations in compliance with international laws.[59]

Overall, even once jurisdiction can be established, the Convention allows broad discretion for enforcement, and parties are well-advised to thoroughly research public policies and state relations before committing to a court of origin or court of enforcement.

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[48] HCCH, *Twenty-Second Session*, *supra* note 15, at para. 66, 414, 420.
[49] *Id.* at para. 129.
[50] *Id.* at para. 189-90.
[51] *Id.* at para. 191-92.
[52] HCCH, *Glossary of Commonly Used Terms and References*, *supra* note 47, at 3-4.
[53] HCCH, *Twenty-Second Session*, *supra* note 15, at para. 193, 195 (additional examples available at para. 194).
[54] *Id.* For example, if the vendor files a claim for payment, jurisdiction is where the payment is due. But if the buyer files for delayed delivery, jurisdiction is proper at the place of delivery. *Id.* at para. 190.
[55] HCCH, *Recognition and Enforcement*, *supra* note 15, at art. 7, 17-19, 29(3).
[56] *See* HCCH, *Twenty-Second Session*, *supra* note 15, at para. 275, 294.
[57] *Id.* at para. 289. "Manifestly" includes violations of procedural requirements set under a state's Constitution but does not include violations of underlying substantive laws. *See generally Id.* at para. 290-93.
[58] HCCH, *Recognition and Enforcement*, *supra* note 14, at art. 7.
[59] *See* HCCH, *Twenty-Second Session*, *supra* note 16, at para. 447.

C. Convention on the Recognition and Enforcement of Foreign Arbitral Awards

To encourage cross-border trading, sophisticated and influential movers of the world collaborated to pass the New York Convention on arbitration in June 1958.[60] The New York Convention propelled international dispute resolution into the current century, advancing international trade to a whole new level.[61] Due to the New York Convention's success and its reputation established over several years, arbitration awards are being recognized across several states, resulting in widespread enforcement of awards. The New York Convention's success is also partly due to parties' willingness to comply with arbitral findings.[62]

The New York Convention applies to "recognition and enforcement of arbitral awards made in the territory of a state other than the state where the recognition and enforcement of such awards are sought."[63] Recognition extends to awards rendered by arbitrators and arbitral bodies as long as the original agreement to arbitrate amongst the parties was in writing.[64] States shall generally enforce awards made in compliance with the New York Convention,[65] but may refuse enforcement for one of six reasons: i) incapacity of a party, ii) insufficient notice, iii) awards reaching beyond the agreement, iv) the arbitrator or proceeding violating the agreement or governing law, v) the matter was not arbitrable, or vi) enforcement would violate public policy.[66]

The day the New York Convention was passed predicted the document's success. Ten members signed on-site, including Belgium, Costa Rica, El Salvador, Germany, India, Israel, Jordan, the Netherlands, the Philippines, and Poland.[67] After years of trying to convince the US government that independent treaties were no longer sufficient for international arbitration, the ABA finally won.[68] The US signed the New York Convention in 1970, preceded by, *inter alia*, Russia, and Japan.[69] The UK soon followed suit, signing on September 24, 1975.[70] Only at this point did the New York Convention truly take off. The signatories of the early 1970s propelled the New York Convention's significance into what it is today, garnering momentum for international

[60] See N.Y. ARB. CONVENTION, *Contracting States*, http://www.newyorkconvention.org/countries (last visited Sep. 11, 2020) for a list of states participating in the Convention and their dates of signature, ratification, accession, or succession.
[61] *60 Years of the New York Convention: A Triumph of Trans-National Legal Co-Operation, or a Product of its Time and in Need of Revision?*, HERBERT SMITH FREEHILLS (July 27, 2018), https://www.herbertsmithfreehills.com/latest-thinking/60-years-of-the-new-york-convention-a-triumph-of-trans-national-legal-co-operation.
[62] *See, e.g.*, PRICEWATERHOUSECOOPERS LLP & LOUKAS MISTELLS, QUEEN MARY UNIV. OF LONDON, INTERNATIONAL ARBITRATION: CORPORATE ATTITUDES AND PRACTICES (2008), 2, 4 https://www.pwc.co.uk/assets/pdf/pwc-international-arbitration-2008.pdf.
[63] United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 330 U.N.T.S. 38 art. I(1), 3.
[64] *Id.* at arts. I(2), II(1)-(2).
[65] *Id.* at art. III.
[66] *Id.* at art. V. (the six options are summaries of the articles' enforcement exceptions and do not reflect the explicit options available).
[67] N.Y. ARB. CONVENTION, *supra* note 60.
[68] Bookman, *supra* note 7, at 1136; HERBERT SMITH FREEHILLS, *supra* note 61.
[69] N.Y. ARB. CONVENTION, *supra* note 60 (showing China signed in 1987, Russia in 1958, and Japan in 1961).
[70] *Id.*

arbitration's popularity.[71] As of the beginning of 2020, over 160 nations had signed on to the New York Convention.[72]

Arbitration proceedings continue to increase to date. For example, the International Chamber of Commerce ("ICC") recorded a staggering 77% increase of arbitration cases between 1992 and 2007.[73] The New York Convention's momentum from the 1970s has carried over into the 21st century.

D. United Nations Convention on International Settlement Agreements Resulting from Mediation

As one of the newest conventions on the international dispute market, the Singapore Convention fills the gap where existing conventions do not incorporate various alternative dispute resolution options and disregard "consistent standards on the cross-border enforcement" of mediation settlements.[74] By passing the Singapore Convention in August 2019, the need for cross-border recognition of mediations was met.[75] By the end of 2019, over 50 states had already signed on, including China, the United States, Saudi Arabia, and Singapore.[76]

Generally, mediation attempts to amicably resolve disputes with a third-party neutral.[77] A mediator seeks to find common ground between the parties, guiding them along a path of consensus to finding a solution. The Singapore Convention only applies to mediation, and cannot be used to enforce court rulings or arbitral awards.[78] Recognition requires proceedings to result in a written settlement agreement.[79] The Singapore Convention is only applicable in diversity cases of international commercial disputes.[80] Diversity under the Singapore Convention can have two meanings: i) Either minimal party diversity - at least two parties have their place of business in another state;[81] or ii) performance under the settlement agreement is in another state or the underlying issue is closely connected to another state.[82] The Singapore Convention's diversity requirements parallel those of US court diversity jurisdiction requirements. While reciprocal enforcement is expected amongst fellow signatory states, enforcement can be refused for similar reasons as listed under the New York Convention.[83]

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[71] *See* Yves Derains, *New Trends in the Practical Application of ICC Rules of Arbitration*, 3 NW. J. INT'L L. & BUS. 39, 39 (1981).
[72] N.Y. ARB. CONVENTION, *supra* note 60 (showing the most recently joined state being the Maldives in September 2019).
[73] Lucy Greenwood, *The Rise, Fall and Rise of International Arbitration: A View from 2030*, 77 ARB. 435, 436 (2011).
[74] Singapore Convention, *supra* note 23, at 2.
[75] *Id.* at 1.
[76]UniteasjDSD sssUUnited Nation Treaty Collection, United Nation Convention on International Settlement Agreements Resulting from Mediation, Dec. 20, 2018, https://treaties.un.org/pages/ViewDetails.aspx?src=TREATY&mtdsg_no=XXII-4&chapter=22&clang=_en.
[77] Singapore Convention, *supra* note 23, at 4.
[78] *Id.* at art. 1.
[79] *Id.* at art. 1, art. 2(2), art. 4(1)(b).
[80] *Id.* at art. 1.
[81] *Id.* at art. 1(a).
[82] *Id.* at art. 1(b).
[83] *Compare* Singapore Convention, *supra* note 23, at art. 5, *with* United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, *supra* note 63, art. 5.

While the Singapore Convention fills an important gap in the international dispute resolution arena, it will take a smaller role in this article. Contracts typically consider mediation as the first line-of-defense. While parties might seek to resolve disputes using mediation and arbitration or litigation, parties will rarely choose arbitration *and* litigation as a dispute resolution option. Hence, mediation's interplay with either is complementary. Its significance should not be impacted by the new Hague Judgments Convention.

III. Analysis

A. Tipping Points - A Question of Commercial Significance

i. Intro

Before US businesses and attorneys can begin transitioning dispute resolution terms from arbitration to judicial proceedings, the Hague Judgments Convention needs member states. While attorneys and professionals are eager to jump on the international Hague Judgments Convention train,[84] predicting sunny prospects for international trade agreements is premature,[85] especially considering that as of publication of this article, only the Ukraine and Uruguay had signed.[86]

Bearing in mind how many delegates attended the 22nd Diplomatic session in July[87] and the profession's enthusiasm, it seems enticing and plausible to conclude that quick and numerous accession by various states is to be expected.[88] Additionally, the business and legal benefits of having a judicial resolution option seem desirable.[89] Realistically, however, accession and acceptance will face numerous hurdles, some higher than others.

ii. Political Concerns and Biases

While this article focuses on the Hague Judgments Convention's effects on international commercial contracts, states are nonetheless making a political decision.[90] Hence, political decisions still impact international commercial relations.[91] One consideration is the question of

[84] *E.g.*, David P. Stewart, *Current Developments, The Hague Conference Adopts a New Convention on the Recognition and Enforcement of Foreign Judgments in Civil or Commercial Matters*, 113 AM. J. OF INT'L L. 772, 782 (2019); Michiel Coenraads & Jorian Hamster, A Gamechanger in International Dispute Resolution: The 2019 Convention on Enforcement of Foreign Judgments, DLA PIPER (July 8, 2019), https://www.dlapiper.com/en/uk/insights/publications/2019/07/the-hague-enforcement-convention/; Robert Price & Isuru Deveendra, *A New Global Regime for Cross-Border Enforcement of Civil and Commercial Judgments*, LATHAM & WATKINS: LATHAM.LONDON (Aug. 21, 2019), https://www.latham.london/2019/08/a-new-global-regime-for-cross-border-enforcement-of-civil-and-commercial-judgments/.
[85] Stewart, *supra* note 84; HCCH, *Status Table: Convention of 2 July 2019 on the Recognition and Enforcement of Foreign Judgments in Civil or Commercial Matters*, *supra* note 46.
[86] HCCH, *Status Table: Convention of 2 July 2019 on the Recognition and Enforcement of Foreign Judgments in Civil or Commercial Matters*, *supra* note 46.
[87] HCCH, *It's done*, *supra* note 13.
[88] Stewart, *supra* note 84.
[89] *Id.* at 782.
[90] Dammann & Hansmann, *supra* note 21, at 24.
[91] *See* E. Norman Veasey, The Conundrum of the Arbitration vs. Litigation Decision, AMERICAN BAR ASS'N (Sept. 19, 2018), https://www.americanbar.org/groups/business_law/publications/blt/2015/12/07_veasey/.

sovereignty and concerns for recognizing another government's actions. The answer is invariably tied to states' political administration and philosophies.[92] Currently, scholars recognize that, across the board, the U.S. is not quite ready to jump on the bandwagon of general recognition.[93] Furthermore, this is reflected in the United States' foreign policy and the fact that U.S. treaty ratification is generally slow and cumbersome.[94] For example, because every country's governmental values differ, U.S. constitutional questions will heavily influence the decision of signing the Hague Judgments Convention one way or another.[95] Because enforcement would apply to all judicial holdings of member states, signing on to the Hague Judgments Convention removes a state's ability to choose whose rulings to recognize. Only if states "notify the depository" that they will not accept judgments of a new signatory state can enforcement be excused under the new Hague Judgments Convention.[96]

Another indication of states' hesitancy to recognize cross-border court rulings is the Choice of Court Convention; the Convention has abysmal popularity thus far. Although passed in 2005 with great enthusiasm, as of 2019, only 36 states have signed on to the Choice of Court Convention.[97] In contrast, the New York Convention reached 36 states only four years after being passed in 1958.[98] Even then, it still took several years and major players before international arbitration took off. As of today, the Choice of Court Convention is an example that indicates continued governmental concerns and reluctance. Although recently significant players signed on to the Choice of Court Convention, the effects are yet to be seen.

A second consideration of how states approach the matter is one of political pride and a concern for the message parties send when choosing courts other than their own.[99] Pride has gotten in the way of lesser things than global cooperation. Arbitration, on the other hand, has little to no political nuances because the proceedings are fully removed from any governmental decision-maker.[100] However, as elaborated further below, a pattern emerges even in arbitration, and popular

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[92] *See* Jean Galbraith, *Contemporary Practice of the United States Relating to International Law*, 113 AM. J. of INT'L L. 131 (2019).

[93] Stewart, *supra* note 84, at 782.

[94] *Id.*

[95] *See China, People's Republic of - Government*, FOREIGN LAW GUIDE (Marci Hoffman ed.) (discussing China, France, and UK), http://dx.doi.org.ezproxy1.lib.asu.edu/10.1163/2213-2996_flg_COM_323948 (last visited Nov. 16, 2019); *France - Legal System*, FOREIGN LAW GUIDE (Marci Hoffman ed.), http://dx.doi.org.ezproxy1.lib.asu.edu/10.1163/2213-2996_flg_COM_323135 (last visited Nov. 16, 2019); *Iran - Legislation and the Judicial System*, FOREIGN LAW GUIDE (Marci Hoffman ed.), http://dx.doi.org.ezproxy1.lib.asu.edu/10.1163/2213-2996_flg_COM_099302 (last visited Nov. 16, 2019); *Queen and Church of England*, ROYAL INSIGHT, https://web.archive.org/web/20080307003413/http://www.royalinsight.gov.uk/output/Page4708.asp (last visited Nov. 16, 2019); *United Kingdom of Great Britain and Northern Ireland - Legal System*, FOREIGN LAW GUIDE (Marci Hoffman ed.), http://dx.doi.org.ezproxy1.lib.asu.edu/10.1163/2213-2996_flg_COM_323001 (last visited Nov. 16, 2019).

[96] HCCH, *It's done*, *supra* note 13; HCCH; *see also Recognition and Enforcement*, *supra* note 14, art. 29(3); *see, e.g.*, HCCH, *Twenty-Second Session*, *supra* note 15, at para. 447.

[97] HCCH, *Status Table: Convention of 30 June 2005 on Choice of Court Agreements*, supra note 12.

[98] N.Y. ARB. CONVENTION, *supra* note 60.

[99] Dammann & Hansmann, *supra* note 21, at 24.

[100] This will not apply if at least one of the contracting parties is a state or governmental entity.

fora and governing laws are discernable. Is arbitration already sending a message to the international community about which seats of arbitration are better than others?[101]

A third consideration requires a review of how states weigh and value contractual relationships. While the US gives great deference to contractual agreements, other countries do not. US parties will be hard-pressed to give up contractual freedoms generously granted by US courts.[102] With this freedom in mind, it is more than reasonable that businesses and the legal profession will want to participate in the US' decision of signing on to the Hague Judgments Convention. Ultimately, whichever lobbying group influences the decision most will be a driving factor in how the Hague Judgments Convention is not only implemented but used and applied.

A fourth consideration includes cultural considerations at large. Due to "pioneering scientists, programmers and engineers," the Internet offers a phenomenal platform for information exchange.[103] With modern technology, our cultural differences seem to disappear as they slowly melt into one multicultural pot. However, it takes generations to overcome some cultural traditions. We must ask ourselves every day whether societies are ready to put aside their differences. The populist rage against globalism is fiercely trying to move away from the melting pot. These popular movements are everchanging. While during the post-war period states were encouraged to work together (another reason why the New York Convention garnered strong support and popularity in the 1970's), before (during the 1920's) and again today, strong hostility towards international cooperation is discouraging even international arbitration. Depending on the state's government and populist stance, citizens and domestic politics drive the decision to sign on to the Hague Judgments Convention. Hence, current views on globalism are another driving factor impacting state's decisions on whether or not to sign on to the Hague Judgments Convention.

Internally, with its dual system of government, the US faces a fifth hurdle of enforceability.[104] The Hague Judgments Convention's goal of uniformity, must apply on both federal and state level.[105] However, US contract law is state law[106] and lacks uniformity even within the US borders.[107] Although Delaware is US business law's central hub, other US states are not bound to copy its rules. Additionally, international arbitral contracts using US law appear to prefer New York law instead.[108] Political concerns, biases, and pride are high hurdles that must be overcome. They are also hurdles that are less prevalent in arbitration, only holding back international litigation.

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[101] *See infra* Part III Section B2.
[102] *See* Dammann & Hansmann, *supra* note 21, at 24.
[103] Evan Andrews, *Who Invented the Internet*, HISTORY (Dec. 18, 2013), https://www.history.com/news/who-invented-the-internet.
[104] Stewart, *supra* note 84, at 782.
[105] *See* HCCH, *Recognition and Enforcement*, *supra* note 14, at art. 20, art. 22(3).
[106] *See* Stewart, *supra* note 84, at 782.
[107] *Id.*
[108] Gilles Cuniberti, *The International Market for Contracts: The Most Attractive Contract Laws*, 34 NW. J. INT'L L. & BUS. 455, 510 (2014).

iii. Current Alternatives

Aside from the Hague Judgments Convention, there are two possible alternatives to the political question. The first alternative is comity; the second alternative is treaties. However, the first alternative, comity, faces two significant barriers. The first barrier is that reciprocity is currently unsuccessful because of foreign perceptions of US monetary damages.[109] Additional bad news is that the Supreme Court recognized in *Hilton v. Guyot* that "the decisions of this court have clearly recognized that judgments of a foreign state are prima facie evidence only."[110] While the progenies of *Hilton* have indicated a willingness to recognize other judgments under a comity argument,[111] foreign courts' distaste for exorbitant US damages awards has halted any significant development of precedent on this theory. Although US courts are willing to consider foreign court judgments and enforceability of those judgments,[112] this does not resolve foreign states' unwillingness to honor US judgments.[113] The second barrier is that reciprocity is unreliable because it lacks predictability and receives a case-by-case review. Yet predictability is a significant factor considered when choosing the appropriate dispute resolution form.

The second alternative would be bilateral or multilateral treaties. Although states to the Hague Judgments Convention can implement reservations of enforcement under Article 29, the need to monitor signatories only to implement such an exception seems cumbersome. Relying on bilateral or multilateral treaties instead sounds more efficient. However, currently there are only few such treaties in place. Lack of treaties further demonstrates the political struggle that states are experiencing on this matter. The young associate, tasked with finding the Holy Grail of a judgment recognition treaty, will, despite diligent efforts, be hard pressed to find a treaty in the first place.[114] While there are several concerns governments must overcome before signing the Hague Judgments Convention, the alternatives seem equally unsatisfying.

iv. Brexit

There is clearly some hesitancy amongst the states when starting to recognize each other's court rulings. Perhaps the primary question that should be asked is whether foreign court judgment recognition could ever work at all? Fortunately, the answer to this question is: Yes. As a trailblazer in inter-state cooperation, the European Union's practices shed light on the remote possibility of cross-border court recognitions and potential success.[115] Although initially intended for economic progression, the EU quickly realized it had to assimilate some of the individual states' governmental functions, or at least find a way to encourage and effectively facilitate trade. That

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[109] Bureau of Consular Affairs, *supra* note 3.
[110] Hilton v. Guyot, 159 U.S. 113, 182 (1895).
[111] *See* Christina Weston, *The Enforcement Loophole: Judgment-Recognition Defenses as a Loophole to Corporate Accountability for Conduct Abroad*, 25 EMORY INT'l L. Rev. 731 (2011).
[112] *Id.*
[113] Bureau of Consular Affairs, *supra* note 3.
[114] *See* Bureau of Consular Affairs, *International Treaties & Agreements*, *supra* note 12.
[115] *Enforcement of Judgments*, E-JUSTICE EUROPA, https://e-justice.europa.eu/content_enforcement_of_judgments-51-en.do (last visited Sep. 11 2020).

meant finding a way to deal with international commercial contracts, judgments, and judgment enforcement. The solution: the Brussels I Regulation.[116]

The regulation requires EU members to recognize foreign court monetary and specific performance judgments, with the caveat that procedural requirements must be met.[117] Enforcement itself follows national rules of the enforcing state.[118] Hence, the answer to the question whether enforcement of foreign court judgments is possible can be answered in the affirmative. But is it probable on a bigger scale?

Looking to current events, the UK threw a huge curve ball into the EU after passing Brexit.[119] As a consequence of the anticipated severance, the UK must determine how to maintain judicial relevance in the EU market.[120] The Brussels I Regulation only applies to EU members, which, post Brexit, the UK no longer is. Additionally, by exiting the Union, the UK is no longer part of the Rome I and II Conventions.[121] Hence, a new solution must be found. Unfortunately, common ground has not been found - yet. The EU is recommending the European Court of Justice as a common venue with common rules.[122] The UK disagrees.[123] Despite the UK's lack of alternatives, the UK brings up a worthy argument when noting that "there is no point in countries lining up their rules if they cannot agree on what those rules mean."[124] Regardless of how good the UK's counterarguments are to the EU's solutions, it does not look as though the UK has come up with any other feasible solutions other than successfully boasting about their willingness to entertain various suggestions.[125] To add insult to injury, and despite the UK's express aversion for the European Court of Justice,[126] the EU has graciously offered to let that very same court rule on the matter if no common ground can be found.[127] As of 2020, ideas continue to diverge, and in the draft withdrawal agreement Articles 162 - 165 remain opaque.[128] The future of these two "'closest friend[s] and neighbour[s]'" appears grim.[129]

Although the EU is, and remains, an incredible feat of multi-cultural and ethical cooperation, in the big scheme of the universe, European countries are very similar. They share a common ancestry and even have reasonably similar cultural values and religion. One could go so

[116] 2012 O.J. (L 351) 1, para. 3.
[117] *Id.*
[118] *Id.*
[119] Curtis, *The Brexit Agreement—what it means for enforcing judgments across the European Union*, (Jan.16, 2019), https://d20qsj1r5k97qe.cloudfront.net/news-attachments/Brexit-Enforcement-of-Judicial-Decisions-pdf.pdf?mtime=20191009160112.
[120] The question of recognition and enforcement only pertains to relations between the UK and the EU but does not extend to relations between the UK and non-EU members. *Id.* at 1.
[121] These instruments set rules on "deciding which law applies in both contractual and non-contractual disputes where there is no written agreement specifying the governing law." *Id.* at 1–2.
[122] Raphael Hogarth, *Dispute Resolution After Brexit*, INST. FOR GOV'T 2 (2017), https://www.instituteforgovernment.org.uk/sites/default/files/publications/IfG_Brexit_dispute_resolution_WEB.pdf.
[123] *Id.*
[124] *Id.* Fortunately, lining up each other's rules is not what the Hague Judgments Convention proposes.
[125] *Id.* at 5.
[126] *See Id.* at 22.
[127] Charlie Cooper & David M. Herszenhorn, *The Other Dispute Holding up Brexit Talks*, POLITICO (May 12, 2018), https://www.politico.eu/article/brexit-governance-withdrawal-treaty-dispute-negotiations/.
[128] *Id.*
[129] Hogarth, *supra* note 122, at 6.

far as to venture that even Americans share this common ideology. But if the European Union, its continuing members, and the UK cannot find common ground what hope is there for the global community? International commercial contracts do not merely exist among similar cultures. The international community is forced to deal with much greater disparities, having to overcome cultural differences between Western and Asian cultures, Middle Eastern and African parties, as well as South American nations. The multi-faceted parties partaking on the global scale is remarkable, and perhaps exactly what appears intimidating to governments. Additionally, Brexit addresses a more substantive question applicable to international proceedings. English Law, and the UK as a territory, have been popular options in arbitration agreements. "Hurricane Brexit"[130] will have some effect on how parties view their dispute resolution options with enforcement as a fundamental goal.

Ultimately, how Brexit will solve this predicament can be exceptionally insightful into the effects on the Hague Judgments Convention by illuminating hurdles faced and introducing alternatives not yet considered. However, at least today, the question as to whether recognition and enforcement of foreign court judgments is probable is answered in the negative. Many kinks must be ironed out on the individual state level, something the Hague Judgments Convention and 22nd Diplomatic Session could not possibly have done or prepared for on their own. The old saying "only time will tell" must carry the day.

v. Quantity and Quality of Signatories

Governments overcoming political concerns and biases will not alone create commercial significance. Commentators agree that a "significant number" of signatories is necessary.[131] However, what is this number? The author of this article postulates that commercial significance requires either a lot of "fish" (quantity) or specific big "fish" (quality) in the Hague Judgments Convention "sea." Both the New York Convention and Choice of Court Convention can offer insight and shed light on this theory.

Turning to quantity first: by the end of the 1970's, when the New York Convention's impact was truly noticeable for the first time, 61 states had signed onto the New York Convention.[132] Translated into the Hague Judgments Convention: Over 50 states would have to be convinced that recognizing each other's court rulings is a great idea. These numbers do not bode well considering that, for a similar time frame, a period of fourteen years, the Choice of Court Convention had only achieved about half of those numbers.[133] Putting the Choice of Court Convention's quantities into perspective: It only took the New York Convention four years to achieve the same amount of approval the Choice of Court Convention holds today.[134]

Turning to quality: Both the US and the UK joined the New York Convention in the 1970's - the beginning of arbitration's modern significance. Considering the UK's arbitral popularity for seat and governing law today, the UK plays an important role in determining an arbitration

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[130] Term invented by the author.
[131] HCCH, *22nd Diplomatic Session*, *supra* note 1.
[132] N.Y. ARB. CONVENTION, *supra* note 60.
[133] HCCH, *Status Table: Convention of 30 June 2005 on Choice of Court Agreements*, *supra* note 12.
[134] *See* N.Y. ARB. CONVENTION, *supra* note 60.

convention's popularity.[135] However, it took the UK over ten years to sign on to each the New York and the Choice of Court Convention.[136] The US is not much better when considering timeframe.[137] At best, key players such as the UK and the US join a convention approximately ten years later. For the Hague Judgments Convention that means 2029. However, unlike the New York Convention and Choice of Court Convention, the Hague Judgments Convention faces additional hurdles. Compared to the New York Convention, which walked away with 10 signatories the day of being passed,[138] the Hague Judgments Convention received only one signature from Uruguay in July and no additional members since. On the other hand, one signatory is 100% better than the signatures the Choice of Court Convention received in all of 2005.[139] The Choice of Court Convention received its first signature in 2007, and only received a significant boost when the EU signed as the second sovereign in 2009.[140] Hence, before it can meet quantity or quality, the Hague Judgments Convention must survive its two-signatory requirement or else all efforts will be null and void.[141]

Summarily, this article predicts that key players will be the turning point for the Hague Judgments Convention, rather than numerosity. The New York Convention had a great deal of signatory states from the beginning, yet the decade that saw both the US and the UK join was a decade in which the New York Convention experienced such a boost that it must be more than mere coincidence. Perhaps this bodes well for the Hague Judgments Convention and US parties in particular. From an enforcement and practicality perspective, US and UK law, courts, and proceedings are more similar to each other than any other judicial systems on the global market. This is because the US legal system was created with the UK as a backdrop. Additionally, a Choice of Court Convention's success would help the new Hague Judgments Convention's standing as well.

vi. In Light of Mediation

Compared to the above conventions, it is quite exciting to see the Singapore Convention setting a signatory record, currently showcasing over 50 signatories.[142] Even the New York Convention received only a total of 24 new signatures within the same year it was passed.[143] The Singapore Convention's popularity further demonstrates states' hesitancy regarding court related proceedings. The Singapore Convention's popularity is further reflected in the amount of disparate member states, spanning from the Americas (Chile, US, Venezuela), to Europe (Georgia, Turkey,

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[135] Unfortunately, because the Choice of Court Convention only recently calls the UK a fellow signatory (2018), little can be said about UK's litigation popularity.
[136] HCCH, *Status Table: Convention of 30 June 2005 on Choice of Court Agreements*, *supra* note 12; N.Y. ARB. CONVENTION, *supra* note 60.
[137] HCCH, *Status Table: Convention of 30 June 2005 on Choice of Court Agreements*, *supra* note 12; N.Y. ARB. CONVENTION, *supra* note 60.
[138] N.Y. ARB. CONVENTION, *supra* note 60.
[139] HCCH, *Status Table: Convention of 30 June 2005 on Choice of Court Agreements*, *supra* note 12.
[140] *Id.*
[141] HCCH, *Recognition and Enforcement*, *supra* note 14, at art. 28.
[142] HCCH, Singapore Convention, *supra* note 76.
[143] N.Y. ARB. CONVENTION, *supra* note 60.

Ukraine), Africa (Nigeria, Uganda, Uruguay), the Middle East (Afghanistan, Iran, Israel, Qatar, Saudi Arabia), and Asia (China, Fiji, India, Singapore).

The nature of mediation leaves all concerns of comity to the wayside, allowing for simple cross-border cooperation between business parties. Globally recognized mediation awards are even more preferable to the business owner who seeks amicable resolutions of disputes, preserving business relations that were so hard fought for in the first place.[144] Although widespread acceptance only requires "effectiveness of the procedure" as well as cost efficiencies,[145] the Singapore Convention does not resolve the question of accountability where parties are unable to cooperate.[146] Hence, parties will continue to select a binding dispute resolution option to incorporate a neutral fact finder. However, that means attorneys are back to square one when weighing litigation versus arbitration.

vii. Expectations

With these concerns in mind, the Hague Judgments Convention is unlikely to receive widespread recognition in the near future. To even consider signing onto the Hague Judgments Convention, states must overcome hurdles that include questions of comity and populist movements. Even once those stars align, the "fish" in the "sea" must ultimately be significant. While many little "fish" will play a factor, realistically, the bigger ones truly drive a convention forward. The reality is that, the longer it takes for global recognition of court rulings to take over, the more developed arbitral practices become. At some point, the cost-balance of switching from arbitration to litigation will be outweighed by well-established, veteran arbitral practices.

B. Practical Considerations

i. Intro

Generally, the question of enforceability of judgments, judicial or arbitral, is becoming more relevant every day. The number of newly filed arbitrations rises from year to year with increased party disparity. Obtaining jurisdiction in an arbitration case is reasonably simple and based in the contract. Obtaining personal and subject matter jurisdiction as well as establishing proper venue in courts is more difficult. By setting out basic arbitration parameters, parties create their own jurisdiction. For example, in arbitration, similar to a choice of venue clause, parties can select a specific arbitral institution to administer proceedings. Globally prominent international arbitral institutions include the ICC, International Centre for Dispute Resolution ("ICDR"), London Court of International Arbitration ("LCIA"), Hong Kong International Arbitration Centre ("HKIAC"), Singapore International Arbitration Centre ("SIAC"), and Stockholm Chamber of Commerce ("SCC"). Generally, institutions are selected for their neutrality. However, finding a neutral court that also has jurisdiction will prove difficult.

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[144] Singapore Convention, *supra* note 23.
[145] Strong, *supra* note 6, at 2039-40.
[146] *Id.* at 2014, 2058.

Establishing personal jurisdiction specifically will also prove difficult, whereas arbitration does not face such hurdles. International arbitral proceedings are multicultural in nature. The ICC alone processed over 800 cases in 2018, proceedings representing over 130 different countries.[147] Of those proceedings, a majority of cases included US parties.[148] Although Western cultures make up a majority of the parties in the ICC, more and more cases are seeing an increase of parties from the Middle East, including the United Arab Emirates and Turkey.[149] Just as the ICC appears to primarily attract Western cultures, the LCIA reports comparable cultural representations.[150] Similarly, the HKIAC, an Asian based institution, reports that most of its parties come from Asia.[151] While the reasons for institutional party disparity might differ, and parties also select institutions based on geographic advantages, trading benefits and barriers, or even cultural reasons, the result is the same across the board: Each institution deals with diverse parties. The melting pot is colorful. This will undoubtedly translate into any judicial proceeding as well and most likely will cause some tensions.

Establishing judicial jurisdiction will depend on the court selected and its powers over the parties, which presently is a fairly inflexible system on the international stage. One reason for the New York Convention's success lies in its flexibility to accommodate these variations. Whether the Hague Judgments Convention can offer the necessary flexibility and ability to accommodate such multi-cultural proceedings is unlikely.

ii. The Freedom to Contract

As previously mentioned, parties to contracts have great autonomy when negotiating their agreements. Because international contracts involve sophisticated participants, the terms of such agreements, including dispute resolution clauses, are highly negotiated.[152] Due to enforceability concerns of judicial rulings, 97% of international commercial contracts turn to arbitration as their number one choice for dispute resolution.[153]

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[147] Int'l Chamber of Commerce, *ICC Arbitration Figures Reveal New Record for Awards in 2018*, https://iccwbo.org/media-wall/news-speeches/icc-arbitration-figures-reveal-new-record-cases-awards-2018/ (last visited Sep. 11, 2020).

[148] US parties were followed by French, Spanish, and German parties in amount of representation. *Id.*

[149] The ICC reported 31% of cases including European parties, while only 12% represented West and Central Asia. *Id*.

[150] LONDON COURT OF INT'L ARBITRATION, 2018 ANNUAL CASEWORK REPORT 5 (LCIA, 2018), (download full report by clicking "Click here to access the full LCIA 2018 Annual Casework Report" at https://www.lcia.org/News/2018-annual-casework-report.aspx) (reporting 20% parties from the UK, 14% from Asia, and 13% from the Middle East).

[151] The institution's top ten represented nations include China, British Virgin Islands, the United States, Cayman Islands, Singapore, South Korea, Macau, Vietnam, and Malaysia. *2018 Statistics*, HONG KONG INT'L ARBITRATION CENTRE, https://www.hkiac.org/about-us/statistics.

[152] *See* Bookman, *supra* note 7, at 1128.

[153] SCHOOL OF INT'L ARBITRATION, QUEEN MARY UNIVERSITY OF LONDON, 2018 INTERNATIONAL ARBITRATION SURVEY: THE EVOLUTION OF INTERNATIONAL ARBITRATION 5 (2018), https://www.whitecase.com/sites/whitecase/files/files/download/publications/2018-international-arbitration-survey.pdf. All data relied upon here does not fully encompass the current landscape of international commercial contracts because, for example, ad hoc proceedings are fully confidential and private. However, the data does offer insight into trends and preferences, providing a guideline in our analysis of the situation.

Parties can choose the seat of arbitration and governing law independently of each other. When deciding the location of arbitration, parties consider the reputation and legal procedures available as well as neutrality of the location.[154] Over the years, preferences have developed, and the majority of parties prefer London as their seat of arbitration, closely followed by Paris.[155] London is only rivaled by Hong Kong for parties arbitrating through the HKIAC in Asia.[156] Assuming the reasons parties choose a seat of arbitration are transferable into the litigation world, the fact that England is a popular choice bodes well for American parties who will benefit from a common language and familiar judicial system. This seems to lean in favor of judicial proceedings under the new Hague Judgments Convention. However, with Brexit alive and well, the UK's future remains in the dark.

When deciding governing law, parties must select procedural rules as well as underlying substantive laws while negotiating their agreements. Procedural rules are only as flexible as the arbitral institution allows. Each institution has its own, fully developed procedural rules.[157] Procedural requirements in courts will similarly vary. Even within the US, procedural rules diverge across the states and between the various court levels. Hence, it is only to be expected that other foreign courts will differ also.[158] Procedures are greatly influenced by underlying cultural values and beliefs, and those differences will be reflected in court proceedings.[159] The greatest hurdle to overcome will be finding a court with power over both parties. If the court lacks personal jurisdiction over one party, proceedings will come to a halt. Furthermore, the need for the court's power over parties goes as far as enforcement. Judicial power is territorial and enforcement beyond those borders would rely on foreign courts to assist - an issue the Hague Judgments Conventions seeks to remedy.

Substantively, it looks as though English Law is the winner in arbitral proceedings, followed by Swiss, US, French, and German law.[160] The LCIA similarly recorded that a majority of their cases, over 200, selected English Law as governing law, distantly followed by Cyprus with only 10 cases.[161] English law carries the day even across the institutions and into Asia.[162] Again,

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[154] *Id.* at 10–11.
[155] *Id.* 64% choose London, 53% Paris, followed by Singapore (39%), Hong Kong (28%), Geneva (26%), and New York (22%). *Annual Report 2018*, SINGAPORE INT'L ARBITRATION CENTRE 5 (2018), http://www.siac.org.sg/images/stories/articles/annual_report/SIAC_AR2018-Complete-Web.pdf. The trend to choose England as a seat of arbitration appears to apply across the board, and the LCIA reports 238 cases with England as seat of arbitration. LONDON COURT OF INT'L ARBITRATION, *supra* note 150, at 11.
[156] HONG KONG INT'L ARBITRATION CENTRE, *supra* note 151.
[157] The greatest flexibility in customizing procedures is for ad hoc arbitrations. Lamm, Hellback & Tsolakidis, *supra* note 26.
[158] *E.g.*, *Hong Kong - Government*, FOREIGN LAW GUIDE, https://referenceworks-brillonline-com.ezproxy1.lib.asu.edu/entries/foreign-law-guide/hong-kong-government-COM_323519# (last visited Sep. 21, 2020).
[159] *See* RADU D. POPA & MIRELA ROZNOVSCHI, *Comparative Civil Procedure: A Guide to Primary and Secondary Sources*, HAUSER GLOBAL Law SCHOOL PROGRAM, https://www.nyulawglobal.org/globalex/Comparative_Civil_Procedure.html (last visisted Sep. 11, 2020).
[160] Cuniberti, *supra* note 108 at 459.
[161] LONDON COURT OF INT'L ARBITRATION, *supra* note 150, at 11.
[162] The HKIAC reports English law as the second most popular choice of law after Hong Kong law. HONG KONG INT'L ARBITRATION CENTRE, *supra* note 151. The SIAC reported that 18% of their arbitrations are governed by

assuming the reasons for selecting governing law in arbitration are translatable into the litigation world, US parties are fairly likely to be comfortable with the applicable laws in the UK court system should they choose litigation as their dispute resolution option under the Hague Judgments Convention.[163] Additionally, since the UK judicial system is reasonably well respected across the board and one of the better known systems of law, application of its substantive rules in other courts is less likely to be met with disdain.

Because this article focuses on international contracts that have at least one US contracting party involved, it is worth noting that in the world of US based international arbitration, New York is the clear winner for both forum and substantive law.[164] However, because foreign parties despise US damages awards, most non-US parties will not want to choose a US court for that reason alone.[165]

iii. Costs of International Dispute Resolution

The traditional benefits of arbitration may no longer justify its choice over litigation. While arbitration has seen a boom over the last several decades, its traditional hallmarks are slowly dissipating. Growing amounts in controversy and litigators' flair for motion practice result in longer proceedings and greater expenses. Fees differ significantly depending on what arbitral institution the parties choose but generally range from $1,000 to $200,000.[166] Additionally, while arbitral proceedings, on average, last up to two years,[167] recent tendencies for more elaborate discovery proceedings and fanciful motion practices escalate costs and delay cases by approximately 40%.[168]

English law. SINGAPORE INT'L ARBITRATION CENTRE, *supra* note 155, at 21. *See also SCC Statistics 2018*, ARBITRATION INST. OF THE STOCKHOLM CHAMBER OF COMMERCE, https://sccinstitute.com/statistics/.

163 England's popularity for seat of arbitration and governing law can only be translatable into the litigation world if they sign onto the Convention. As discussed in Section A above, this is unlikely to happen soon and the question arises: Who will take their place instead?

164 Surprisingly, Delaware business law does not carry the day on the international playing field, contrary to its local popularity. Dammann & Hansmann, *supra* note 21, at 49. Although the article focuses on commercial relations that include a US party, the data available does not distinguish on those grounds, limiting the significance of the information to a degree.

165 Bureau of Consular Affairs, *supra* note 3.

166 *Costs & Duration*, HONG KONG INT'L ARBITRATION CENTRE, https://www.hkiac.org/content/costs-duration (last visited Nov. 12, 2019). The ICC requires an advance, non-refundable administrative fee of $5,000, which does not include other expenses such as arbitrator fees, expert expenses, and legal costs. *Costs and payments*, INT'L CHAMBER OF COMMERCE, https://iccwbo.org/dispute-resolution-services/arbitration/costs-and-payments/ (last visited Nov. 12, 2019). The ICDR calculates fees somewhat differently, and basic filing fees can range from $1,000 to $16,100 alone. *International Arbitration Fee Schedule: Amended and Effective October 1, 2017*, INT'L CTR FOR DISPUTE RESOLUTION (2017), https://www.icdr.org/sites/default/files/document_repository/International_Dispute_Resolution_Procedures_Fee_Schedule.pdf.

167 INT'L CHAMBER OF COMMERCE (ICC), 2018 DISPUTE RESOLUTION STATISTICS 15 (ICC Publication No.: 898E, 2019), https://nyiac.org/wp-content/uploads/2019/08/icc_disputeresolution2018statistics.pdf.

168 *Arbitrator Survey Finds How Parties and Counsel Increase Costs and Lower Efficiency of Their Cases*, INT'L CENTRE FOR DISPUTE RESOLUTION, AMERICAN ARBITRATION ASSOCIATION 2 (downloaded Nov. 12, 2019 (fill out Download Now! form from https://go.adr.org/arbitrator-survey.html). The LCIA reports average costs of $97,000 for cases lasting around sixteen months, noting that some matters with small amounts in controversy can be resolved in under one year. *Costs and Duration: 2013-2016*, LONDON COURT OF INT'L ARBITRATION 2 (download report from

Court proceedings' traditional hallmarks, "slow [and] inefficient,"[169] are alive and well. Curiously, in comparison, court-related costs appear deceivingly lower than the above reported arbitration expenses.[170] However, assuming that New York's arbitration popularity prevails over litigation proceedings, New York's fees ultimately add up to the same, although expenses are allocated differently.[171] The statistics are deceiving as they do not reflect any other filing fees, expert witness expenses, or court reporter costs. Some of these expenses are present in arbitration, while others are not, depending on the proceedings and the parties. Due to litigators' aggressive motion practice, expenses for court proceedings will rise high and fast. Some businesses can spend over $200 billion on litigation.[172] On the global scale, the US is estimated to be the costliest litigation forum when compared to Canada, Europe, and Japan.[173] However, within Europe, the UK appears to be the most expensive litigation forum.[174] Expenses will be a driving factor for businesses in the negotiation process. If, for example, motion practice remains lower in arbitration, and length of proceedings are shorter, arbitration should carry the day.

Mediation expenses will vary depending on how the parties choose to proceed, but costs of proceedings are generally lower compared to either litigation or arbitration.[175] The primary reason for lower costs is that mediation experiences significantly shorten resolution periods.[176] As such, from a cost perspective, mediation is generally preferred.

iv. Dockets

Although the difference in applicable fees is difficult to capture, docket load information is much more straightforward. Most international arbitral institutions receive under 1,000 new filings per year.[177] Of those filed cases, contractual disputes were either financial, service contracts,

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https://www.lcia.org/lcia/reports.aspx). The HKIAC reports a similar durational average but lists much higher registration and administrative expenses, reporting an expense mean of $119,078. HONG KONG INT'L ARBITRATION CENTRE, *supra* note 166.

[169] Bookman, *supra* note 7, at 1141.

[170] *Measuring the Costs of Delays in Dispute Resolution*, AMERICAN ARBITRATION ASSOCIATION, https://go.adr.org/impactsofdelay.html. Filing a civil case in the Arizona District Court costs $400 and registering another district's judgment only costs $47. UNITED STATES DISTRICT COURT, DISTRICT OF ARIZONA FEE SCHEDULE 1 (U.S. Courts, Effective Oct. 1, 2018), http://www.azd.uscourts.gov/sites/default/files/documents/fee%20schedule.pdf.

[171] *Filing Fees*, N.Y. COURTS, https://www.nycourts.gov/forms/filingfees.shtml (listing $210 to receive an index number and $45 per motion).

[172] JOHN B. HENRY, *Fortune 500: The Total Cost of Litigation Estimated At One-Third Profits*, CORP. COUNS. BUS. J., eLAW FORUM (Feb. 1, 2008).

[173] U.S. CHAMBER INSTITUTE FOR LEGAL REFORM, INT'L COMPARISONS OF LITIGATION COSTS: CANADA, EUROPE, JAPAN AND THE UNITED STATES (UPDATED 2013), https://www.instituteforlegalreform.com/uploads/sites/1/ILR_NERA_Study_International_Liability_Costs-update.pdf.

[174] *Id.* Because France's judges apparently work for free, overall court costs can be lowered. Maria Dakolias, *Court Performance Around the World: A Comparative Perspective*, 2 YALE HUM. RTS. & DEV. J. 87, 106 (1999).

[175] Average mediation expenses in 2017, hovered around $23,000. *Costs & payment*, INT'L CHAMBER OF COMMERCE, https://iccwbo.org/dispute-resolution-services/mediation/costs-payment/ (last visited Sep. 11, 2020).

[176] *Mediation*, LONDON COURT OF INT'L ARBITRATION, https://www.lcia.org/Dispute_Resolution_Services/Mediation.aspx (last visited Sep. 11, 2020).

[177] INT'L CHAMBER OF COMMERCE, *ICC Arbitration Figures Reveal New Record for Awards in 2018*, *supra* note 147 (reporting a total of 842 administered cases with an aggregate amount of $36 billion in amount in controversy and

sale of goods,[178] or commercial and corporate agreements.[179] The cases submitted to arbitration are limited in subject matter, especially considering arbitrability. While the number of arbitral filings has increased, it comes no where near newly filed US civil cases. US federal courts, on the other hand, recorded over 277,000 civil cases filed in 2018, of which 85,316 (8%) were state law cases in federal court on diversity jurisdiction.[180] New York alone reported over 1 million new civil cases filed in 2018.[181] Of all the cases pending, over 900 civil cases had been pending for at least three years.[182] Thirty-five percent of all civil cases lasted over one year, some even taking over ten years before a final agreement or judgment was reached.[183]

Economic efficiencies are a key concern for parties when they consider docket load. A greater workload means it could take longer for issues to be resolved which, in turn, raises costs. Judges are assigned cases which they cannot decline. Arbitrators can turn down cases for any reason and frequently parties will consider an arbitrator's caseload when selecting their tribunal. On the other hand, arbitrators generally work alone,[184] whereas judges have an entire staff helping them with research, writing, and administration. Arbitrability is another reason why economic efficiency favors arbitration. Not everything is arbitrable. However, anything can be litigated regardless of subject matter or consent. Hence, while parties do not consider the number of cases a judge or arbitrator is working on per se, they consider the economies of scale in relation to workload, time, and money.

Additionally, with the freedom to forum shop, parties should keep the realities of each system in mind. The complexities of international disputes make court proceedings less desirable. The contractual autonomy will always be limited in the litigation realm, because existing rules and regulations must be followed, whereas rules and regulations can be created to suit the parties in arbitration. Even with the Hague Judgments Convention in force, the ability to enforce foreign court rulings could still be limited depending on how states adopt the Convention.[185] Parties might

599 approved draft awards. *See also* 2018 ICDR CASE DATA INFOGRAPHIC 1 (Int'l Ctr for Dispute Resolution, American Arbitration Association, 2018), https://www.icdr.org/sites/default/files/document_repository/2018_ICDR_Case_Data.pdf; HONG KONG INT'L ARBITRATION CENTRE, *supra* note 151; SINGAPORE INT'L ARBITRATION CENTRE *supra* note 155, at 14; LONDON COURT OF INT'L ARBITRATION, *supra* note 150, at 3.

[178] LONDON COURT OF INT'L ARBITRATION, *supra* note 150.

[179] *See* SINGAPORE INT'L ARBITRATION CENTRE, *supra* note 155, at 16-17; ARBITRATION INST. OF THE STOCKHOLM CHAMBER OF COMMERCE, *supra* note 162.

[180] *Federal Judicial Caseload Statistics 2018*, U.S. COURTS, https://www.uscourts.gov/statistics-reports/federal-judicial-caseload-statistics-2018 (last visited Nov. 12, 2019); *see also* U.S.COURTS, CIVIL JUSTICE REFORM ACT (CJRA) 2-3, 6 (U.S. Courts, 2018), https://www.uscourts.gov/sites/default/files/cjra_na_0930.2018_1.pdf (reporting 50,000 filed at the trial level with over 700 pending motions on the dockets and a majority of pending bench trial for contract disputes).

[181] N.Y. UNIFIED COURT SYSTEM, 2018 ANNUAL REPORT 39 (2018), https://www.nycourts.gov/legacypdfs/18_UCS-Annual_Report.pdf

[182] *Id.* at 6.

[183] INST. FOR THE ADVANCEMENT OF THE AM. LEGAL SYSTEM, CIVIL CASE PROCESSING IN THE FEDERAL DISTRICT COURTS 4 (2009), https://www.uscourts.gov/sites/default/files/iaals_civil_case_processing_in_the_federal_district_courts_0.pdf.

[184] Some arbitrators use tribunal secretaries to assist in cases. However, tribunal secretaries are limited in what they can do and their participation in the proceedings is still highly controversial as they are not selected by the parties through agreement but by the arbitrator independently.

[185] *See generally* HCCH, *Recognition and Enforcement*, *supra* note 14, at art. 29.

still have to expend substantial efforts and money to have a foreign court judgment enforced in another country. The New York Convention, however, has made enforcement of arbitral awards fairly straightforward. Although arbitration is becoming costlier and lengthier, time and effort spent on arbitration could keep bottom-line expenses lower.

C. Incorporation

i. Overcoming the Status Quo

Humans are creatures of habit. Due to the current legal opportunities, arbitration is the frontrunner in international contracts. If parties are supposed to shift from arbitration to litigation, parties, many of which are businesses, will want to take their own risk tolerance into account, justifying change. Hence, with transition comes some hurdles.

The first two hurdles are purely political. The first hurdle to overcome is one of current business practices. To achieve a successful contract, most law firms and in-house counsels have some form of checklist to reference.[186] These checklists help avoid pitfalls and prevent mistakes whose lessons have already been learned.[187] Due to well established checklists, attorneys and businesspeople may be hesitant to venture into the international contracts' arena without well-defined and established guidelines. Without industry support, governments have little incentive to join the Convention. On the other hand, if there is no push from the industry yet governments sign on to the Hague Judgments Convention *sua sponte*, those countries could still feel the need to promote their efforts to the business community, garnering industry support for their decision in retrospect.

Should a country decide to gather support for their decision to join the Hague Judgments Convention, the second hurdle would require the government to overcome the business golden rule: Good friends are hard to come by.[188] Because of this rule, mediation has taken on popularity, and fosters continued relations and amicable solutions. Businesses want to maintain relationships that they have worked so hard to establish. If an issue can be fixed amicably, why not try?[189] While mediation can be used before turning to more aggressive dispute resolution options such as arbitration or litigation, arbitration and litigation cannot. These two last forms of dispute resolution act as alternatives; contracts can choose only one or the other. Choosing between arbitration and litigation will be driven by questions of expenses, confidentiality, and predictability.

It is unlikely that the US will decide to join the Hague Judgments Convention on its own. In the US, it is more likely that businesses would have to push for the government to sign on to

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[186] *Int'l Business Contracts Checklists*, CANTWELL & GOLDMAN PA, https://www.hmtlaw.com/International-Business/Checklist-For-International-Business-Contracts.shtml (last visited Sep. 11, 2020).

[187] Several arbitral institutions offer model contracts, terms, and clauses for both arbitration and mediation. *Model Contracts & Clauses*, INT'L CHAMBER OF COMMERCE https://iccwbo.org/resources-for-business/model-contracts-clauses/ (last visited Sep. 11, 2020).

[188] Strong, *supra* note 6, at 2031.

[189] Because a written and signed mediation agreement is enforceable under traditional US contract law, the Singapore Convention has added little in those regards.

the Hague Judgments Convention, similar to the New York Convention, if the US government is to be persuaded to sign the Convention.[190]

Once businesses have determined their risk tolerance, checklists and practices will be updated to match their findings. At that point, if they transition to litigation, the change will be immediate. With risk tolerance in mind, transitions from arbitration to litigation are likely to be an industry related decision. For example, highly complex technical subject matters lend themselves best to arbitration where the need for decisionmakers with expertise can be met.

ii. Effects of the Advantages and Disadvantages

After introducing the idea of risk tolerance, it seems only fair to take a look at what that consideration might entail. Advantages and disadvantages of dispute resolution forms have been discussed *ad infinitum* over the years. As addressed in more detail in the article's introduction portion,[191] these alternatives can be part of a steppingstone toward more aggressive dispute resolution options[192]

Factors such as predictability, homogeneity of the law,[193] decision makers, subpoena powers, and docket load all influence the outcome. Furthermore, jurisdictional requirements in the US are hard to come by when bringing a suit[194] and when seeking enforcement.[195] Even if jurisdictional requirements are met, one party is going to be concerned with biases and other intangible disadvantages.

a. Confidentiality and Privacy

The most significant factor for business parties to consider is confidentiality.[196] Privacy only prevents non-parties from attending the proceedings, whereas confidentiality offers true protection of the information discussed, and prevents parties from discussing the proceedings.[197] Arbitration can offer both.[198] Courts generally offer neither.[199]

The concern for confidentiality favors arbitration. Because strategic advantages take on a heightened role on the international playing field, the protection of vital information takes on a central role.[200] Arbitration's policy towards confidentiality is much more generous and amicable

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[190] Bookman, *supra* note 7, at 1136.
[191] *Id.* at 1125.
[192] Singapore Conventionna, *supra* note 23, at 19.
[193] Dammann & Hansmann, *supra* note 21, at 29-30.
[194] Bookman, *supra* note 7, at 1144.
[195] Steven C. Nelson, *Alternatives to Litigation of International Disputes*, 23 INT'L LAW. 187, 190-91 (1989).
[196] Veasey, *supra* note 91.
[197] Mayank Samuel, *Confidentiality in International Commercial Arbitration: Bedrock or Window-Dressing?*, Kluwer Arbitration Blog (Feb. 21, 2017), http://arbitrationblog.kluwerarbitration.com/2017/02/21/confidentiality-international-commercial-arbitration-bedrock-window-dressing/?doing_wp_cron=1597606717.5020339488983154296875.
[198] *Id.*
[199] The Sedona Conference, *The Sedona Guidelines: Best Practices Addressing Protective Orders, Confidentiality & Public Access in Civil Cases March 2007 Post-Public Comment Version*, 8 SEDONA CONF. J. 141, 143 (2007).
[200] Samuel, *supra* note 197.

for international business affairs.[201] Although there is a jurisdictional split regarding whether confidentiality is presumed versus requiring an explicit agreement pertaining to confidentiality, the protection of any information is easily obtained.[202] Confidentiality for arbitral proceedings follows a two-pronged approach: i) The obligation of confidentiality amongst the parties involved in the arbitration, including third-party witnesses, and ii) confidentiality of the substance of the current arbitration against future proceedings, including exchanged documents and evidence.[203] However, achieving either or both is purely based on party assent and can cover the fact that the proceedings are happening at all, the content of the proceedings, as well as the award.

The US judiciary, on the other hand, is no fan of confidentiality and will generally require production and exchange of all relevant information.[204] Although parties may seek a protective order for the information they are producing, they must show they have "in good faith conferred or attempted to confer" with opposing party to resolve the issue before petitioning the court for protection.[205] The court, in turn, has wide discretion in such rulings, allowing decisions to range from a seal, partial seal, or any other form the judge deems appropriate or necessary to protect the information.[206] Judges may consider the public's interest in the information and its relevance to the public nature of the proceedings.[207] This can take on different forms and include review of historical practices or even the public's interest in the information.[208] In practice, "good cause" only applies to non-dispositive motions.[209] In any other situation, if the information is material to the substance of the case, protection must overcome a "compelling need" standard.[210] Not only does this raise the burden to be met by the requesting party, documents previously designated confidential will lose that status if "introduced at trial or filed in connection with a motion for summary judgment."[211] For reasons of confidentiality, arbitration will win every time.

Privacy also favors arbitration. Privacy matters because it can protect parties from the stigma associated with dispute resolutions, shielding business reputation and market value. Arbitration is inherently and automatically private. That means, unless the parties tell someone they are in dispute resolution proceedings, only the participants in the arbitration will know. The inherent public nature of court proceedings makes it impossible for parties to keep their legal issues on the down-low, hoping the press will not tear them apart. The fact that a legal process is ongoing cannot be hidden. If the business' name is in the case heading, even a not-so-diligent reporter will soon know more. While the institution could neither confirm nor deny the existence of such a case,

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[201] Donggen Xu & Huiyuan Shi, *Dilemma of Confidentiality in International Commercial Arbitration*, 6 FRONTIERS LAW CHINA 403, 405 (2011).
[202] Samuel, *supra* note 197 (The US rejects a presumption of confidentiality); *see also* HONG KONG INT'L ARBITRATION CENTRE, 2018 ADMINISTERED ARBITRATION RULES 50 (HKIAC, Nov. 1, 2018); INT'L CENTRE FOR DISPUTE RESOLUTION, INT'L DISPUTE RESOLUTION PROCEDURES (INCLUDING MEDIATION AND ARBITRATION RULES) art. 21 (ICDR, Rules Amended and Effective Jun 1, 2014).
[203] Xu & Shi, *supra* note 201, at 405-06.
[204] *See* FED. R. CIV. P. 26(c)(1)(A) – (H) (requiring parties to justify a protective order).
[205] *Id.*
[206] *Id.*
[207] The Sedona Conference, *supra* note 199.
[208] *Id.*
[209] *Id.*
[210] *Id.*
[211] *Id.* at 143-44.

the judge's Judicial Assistant would be much more forthcoming. Privacy leans in favor of arbitration on the international commercial playing field. Overall, if a party seeks full protection of their information and brand proliferation, arbitration is the correct choice.

b. Predictability

A strong factor favoring litigation is predictability. While courts can offer predictability of the law, arbitration takes place in the wild west. Arbitration does not seek predictability in the way courts do. Because arbitral proceedings are private, tailored to the parties, and determined based on the parties in the specific dispute, no one arbitral award will be the same. Depending on the court venue, precedent can offer some amount of certainty to trained legal experts, allowing for their clients to make proper risk tolerance decisions. However, not being versed in a forum court's proceedings and governing laws disadvantages the foreign attorney, forcing businesses to hire local counsel. This in turn increases costs.

Language is another factor to consider. This issue takes on two forms: i) The ability to speak the language and ii) the underlying values associated with words and phrases. Firstly, not being versed in the forum court's language will disadvantage parties and limit predictability in that regard. While in parties to an arbitration can select an arbitrator based on language skills, courts will not be as accommodating since parties cannot select the judge.[212] Language barriers are inevitable. Secondly, while the Hague Judgments Convention seeks uniformity in its application, this would require that words and situations be interpreted similarly. Yet, culturally, this is impossible. While capable of speaking each other's languages, a person's understanding of the world around them and how locals use certain words and phrases to express themselves remains unbridgeable. If something as simple as "walking distance" can mean a mere few blocks to an American but can mean a 20-minute walk to a European, there is little hope to find common ground in the legal process, a system built on the delicate balance of words and their meanings. Even where judges attempt to interpret broadly, as recommended under the Hague Judgments Convention,[213] cultural differences will nonetheless limit interpretation. Furthermore, interpreting the Hague Judgments Convention itself may affect predictability as the language used does not fit squarely within the current international framework.[214] Because underlying cultural values influence what meanings words receive, and the same word in one place will have completely different underlying values in another, global uniformity will be difficult to achieve.

The goal of predictability has several angles to it on the international scale and goes beyond currently unestablished international litigation precedent. However, it is up to contracting parties to create the predictability they seek by participating in the process and creating a history that will ultimately feed into this need for predictability.

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[212] Dammann & Henry Hansmann, *supra* note 21, at 28.
[213] *See* HCCH, *Twenty-Second Session supra* note 15, at para. 393.
[214] For example: The Hague Judgments Convention's Article 29 allows for states to limit enforceability by country, referencing the option as "relations." HCCH, *It's done*, *supra* note 13, at art. 29. The New York Convention, on the other hand, has a similar and more common clause referring to "reservations". United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, *supra* note 63, at art. 1(3). However, the limitations that countries may establish under either are significantly different.

c. Efficiency

When turning to cost-balance considerations, efficiency is the number one factor parties consider when choosing between dispute resolution options.[215] As indicated above, if efficiency means low costs, then currently, no dispute resolution proceeding truly achieves this goal.[216] Because up to 90% of international commercial contracts currently use arbitration clauses,[217] the expectation of a "speedy, simple, and inexpensive" arbitration are goals of the past.[218] High stakes and procedural requirements in the international arbitration proceedings increase expenses significantly,[219] running tallies up to $1 million.[220] Although any dispute resolution runs high -cost tallies, businesses will nevertheless seek out the cheapest option available. When selecting an arbitral institution, expenses can range from $1,000[221] to $119,000.[222] However, as addressed in more detail in Section B above, arbitral proceedings are shorter[223] and fewer.[224] US and UK court dockets see thousands upon thousands of newly filed civil cases every year,[225] sometimes continuing for over ten years.[226] Because of the realities of court dockets, parties in litigation proceedings ultimately turn to settlement agreements within three years.[227] Even when compared to the timeframe from filing to settlement, litigation proceedings are still twice as long as reported average arbitral proceedings.[228]

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[215] GLOBAL POUND CONFERENCE SERIES: GLOBAL DATA TRENDS and REGIONAL DIFFERENCES 3, 9 (Global Pound Conference Series, et al. eds., 2018) (scroll to bottom and download report by clicking "Global Data Trends and Regional Differences" Preview on https://www.imimediation.org/research/gpc/series-data-and-reports/).
[216] *Id.* at 10.
[217] Strong, *supra* note 6.
[218] Bookman, *supra* note 7, at 1125; Dammann & Hansmann, *supra* note 21, at 37.
[219] Bookman, *supra* note 7, at 1165-66.
[220] Strong, *supra* note 6, at 1982.
[221] *International Arbitration Fee Schedule: Amended and Effective October 1, 2017*, *supra* note 166.
[222] HONG KONG INT'L ARBITRATION CENTRE, *supra* note 166; *see generally Arbitrator Survey Finds How Parties and Counsel Increase Costs and Lower Efficiency of Their Cases, supra* note 168 (showing that increased motion practice will add to the bottom-line costs).
[223] *Compare* HONG KONG INT'L ARBITRATION CENTRE, *supra* note 151, *and* LONDON COURT OF INT'L ARBITRATION, *supra* note 168, *with* ARBITRATION INST. OF THE STOCKHOLM CHAMBER OF COMMERCE, *supra* note 162.
[224] Int'l Ctr for Dispute Resolution, *supra* note 177; Int'l Chamber of Commerce, *supra* note 147; LONDON COURT OF INT'L ARBITRATION, *supra* note 150, at 3.
[225] JUDICIARY OF ENGLAND AND WALES, BUSINESS AND PROPERTY COURTS: THE COMMERCIAL COURT REPORT 2017-2018 (INCLUDING THE ADMIRALTY COURT REPORT) 10 (2019), https://www.judiciary.uk/wp-content/uploads/2019/02/6.5310_Commercial-Courts-Annual-Report_v3.pdf; MINISTRY OF JUSTICE, CIVIL JUSTICE STATISTICS QUARTERLY, ENGLAND AND WALES, JANUARY TO MARCH 2019 (PROVISIONAL) (2019), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/806896/civil-justice-statistics-quarterly-Jan-Mar-2019.pdf; U.S.COURTS, *supra* note 180, at 2, 6.
[226] Giuliana Palumbo et al., JUDICIAL PERFORMANCE AND ITS DETERMINANTS: A CROSS-COUNTRY PERSPECTIVE: A GOING FOR GROWTH REPORT 13 (Organization for Economic Co-operation and Development Economic Policy Papers No. 05, 2013), http://www.oecd.org/economy/growth/FINAL%20Civil%20Justice%20Policy%20Paper.pdf; INST. FOR THE ADVANCEMENT OF THE AM. LEGAL SYSTEM, *supra* note 183, at 4.
[227] HENRY, *supra* note 172.
[228] *Compare* HONG KONG INT'L ARBITRATION CENTRE, *supra* note 151, *and* LONDON COURT OF INT'L ARBITRATION, *supra* note 168, *with* ARBITRATION INST. OF THE STOCKHOLM CHAMBER OF COMMERCE, *supra* note 162 (showing that arbitration disputes are resolved between 1 and 1.5 years).

Efficiencies also consider the length of proceedings impacting the finality of awards.[229] Depending on the agreement, parties can agree that the arbitral award is final, binding, and non-appealable.[230] Arbitral appeals are possible but must be included in the parties' agreement.[231] The arbiter will alter his ruling in only a few instances.[232] Appeals of arbitral awards to the courts are rare and judicial review is limited.[233] On the other hand, court proceedings are tied to the right of appeal and will reach finality only when all options for appeal have been exhausted. From a cost perspective, arbitration should win hands-down.[234]

Length of proceedings effects costs in another way: Use of intellectual brain power. Intellectual resources include attorneys, executives, and in-house staff necessary for the proceedings. The more brain power that is needed, the more intellectual resources are diverted from day-to-day business procedures. The more resources are diverted from day-to-day business procedures, the more money flows into dispute resolution proceedings because it is flowing away from the business' actual operations. While this ties into the idea of lag time mentioned above, resource allocation for the actual proceedings will be the same for both arbitration and litigation. However, arbitration has some options on how to address these expenses. One way to efficiently use these resources is to negotiate well defined procedural requirements in arbitration proceedings.[235] For example: The use of modern technology to host proceedings such as videoconferences reduces travel time, which in turn reduces expenses while increasing efficiencies.[236] While US courts are trying to move into the 21st century and incorporate technology into proceedings,[237] these options are limited and still in their test stages, bound by an ancient system unwilling to change. Another option is for arbitration parties to select an optimal geographic location for both sides, regardless of jurisdictional requirements. To a certain degree, this option is also available in court proceedings within the US since courts will recognize selected venues.[238]

Efficiencies also include lag time in behavioral changes. It takes time, money, and energy for staff and paperwork to adjust to a new system. As mentioned above, parties will have contractual checklists that set the tone for negotiations. The longer a current system is in place, the more difficult it will be to change. This means that the longer it takes for the Hague Judgments Convention to reach commercial significance, the longer arbitral proceedings will have been in

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[229] GLOBAL POUND CONFERENCE SERIES, *supra* note 215.
[230] *What Happens After the Arbitrator Issues an Award, A.B.A.* 1, https://www.adr.org/sites/default/files/document_repository/AAA229_After_Award_Issued.pdf.
[231] *Id*. at 2.
[232] *Id*. at 1.
[233] 9 U.S.C. §§ 9-11; *see generally* Hall St. Assocs., L.L.C. v. Mattel, Inc., 552 U.S. 576 (2008).
[234] AMERICAN ARBITRATION ASS'N, *supra* note 170.
[235] GLOBAL POUND CONFERENCE SERIES, *supra* note 215, at 9.
[236] INT'L CENTRE FOR DISPUTE RESOLUTION, ICD MANUFACTURER/SUPPLIER ONLINE DISPUTE RESOLUTION PROGRAM, https://www.icdr.org/sites/default/files/document_repository/ICDR_FAQs_OnlineDR_Manufacturer_Supplier_English.pdf.
[237] *E-Courtrooms*, THE JUDICIAL BRANCH OF ARIZ. MARICOPA CNTY., https://superiorcourt.maricopa.gov/e-courtrooms/ (last visited Sep. 11, 2020).
[238] *See* 28 U.S.C. §§ 1404, 1406; Atl. Marine Const. Co., Inc. v. U.S. Dist. Court of Western Dist. of Texas, 571 U.S. 49 (2013); Erie R. Co. v. Tompkins, 304 U.S. 64 (1938) (and its progenies).

place and the longer it will take to transition. Even if transition were to occur today, arbitration has a long standing tradition considering the New York Convention has already been in place for over 60 years.

Overall, when considering efficiencies, Western businesses are more likely to continue to rely on international arbitration proceedings. Although costs appear deceivingly similar, arbitral proceedings remain more cost-efficient due to finality, flexibilities, and technological advances . Interestingly, efficiencies are not as important when dealing with Asian parties. According to statistics, Asian parties value certainty and enforceability over efficiency.[239] While enforceability is no longer a problem for arbitration, certainty is. Certainty and predictability are a benefit the Hague Judgments Convention specifically offers.[240] In addition, considering that the Chinese dragon is slowly awakening, making the country and its citizens significant players on the international commercial playing field, Chinese parties are likely to push for judicial proceedings that can give them the certainty they seek.

d. Public Policy Considerations

Perhaps a lesser yet relevant factor for choosing arbitration or litigation is the effects of public policy on the decision-making process. Public policy plays no role in arbitration, except possibly in denying enforcement of an arbitral award under the New York Convention. However, at common law, US courts may decline to enforce judgments that violate US public policies.[241] Additionally, the Hague Judgments Convention offers various escapes to enforcement under its Articles.

The first excuse for non-enforcement lies with Article 7(1)(c) which allows courts to deny enforcement for public policy concerns. But what does that mean? Neither US precedent, the Hague Judgments Convention's definitions,[242] nor its glossary[243] provide insight into how this might play out. Generally, questions of public policy will have little impact on the commercial law context. However, such a question can arise where one of the parties is a government entity. For example, the Chinese government currently owns some of the world's largest public companies.[244] Contracts with the Chinese government are going to increase. Contracts involving foreign governments bring with them issues of enforceability even in arbitration. In 2018, the D.C. District Court reviewed factors for non-enforcement of arbitral awards from *Europcar Italia, S.p.A. v. Maiellano Tours, Inc.*[245] as it denied a request to stay, later recognizing that specific performance of arbitral awards against a foreign government requires a balance between sovereignty and contract rules.[246] "Given that the United States has not waived its sovereign immunity in its own

[239] GLOBAL POUND CONFERENCE SERIES, *supra* note 215, at 21.
[240] HCCH, *It's done*, *supra* note 13.
[241] *See generally* Victoria Shannon Sahani, *A Hardy Case Makes Bad Law*, 43 FORDHAM L.J. 363, 391 (2019).
[242] HCCH, *Recognition and Enforcement*, *supra* note 14; HAGUE CONFERENCE ON PRIVATE INT'L LAW, "CIVIL OR COMMERCIAL MATTERS" / "ACTA IURE IMPERII," *supra* note 47.
[243] HCCH, *Glossary of Commonly Used Terms and References*, *supra* note 47.
[244] Andrea Murphy et al., *Global 2000, The World's Largest Public Companies*, FORBES MEDIA LLC (May 15, 2019), https://www.forbes.com/global2000/#53c5dcd0335d.
[245] Europcar Italia, S.P.A. v. Maiellano Tours, Inc., 156 F.3d 310, 317 (2d Cir. 1998).
[246] Hardy Expl. & Prod. (India), Inc. v. Gov't of India, Ministry of Petroleum & Nat. Gas, 314 F. Supp. 3d 95, 105, 109 (D.D.C. 2018).

courts against specific performance in contract cases," enforcement against the foreign government would "defy comprehension" of compliance.[247] On the litigation side, China will not want to subject itself to a US court, and certainly not under the current political climate. In contrast, a contracting party will not want to end up in Chinese court, presuming bias against it. Arbitration seems like a fair and safe middle ground in comparison.

To tackle its greater involvement in international commerce, China created a new court in 2018 "[u]nder the backdrop of the deepening development of the Belt and Road Initiative": The International Commercial Court.[248] The court is intended to process international commercial cases specifically.[249] The venue is now a "one-stop platform for resolving international commercial disputes."[250] Not knowing the effect of China's new court, issues of enforcement place arbitration and litigation on the same footing.

A second "escape" under public policy excuses presents itself in Article 19 of the Hague Judgments Convention. Article 19 allows courts to refuse enforcement where a state or one of its agencies is party to the agreement. This appears to be in line with current US policies. After the Tate Letter[251] retracted any and all immunities for foreign states in commercial actions and *Weilamann v. Chase Manhattan Bank*[252] caused a panicked US Executive Branch to instruct courts not to enforce judgments against foreign governments within the US, non-enforcement against foreign governments is likely. Unlike judicial proceedings, arbitration is free of such political considerations, which once again places arbitration as the winner.

A third concern under public policy addresses the question of due process of law.[253] The Full Faith and Credit Clause of the US Constitution applies to the US and the US alone. Hence, while comity amongst US States works, it does not in the international arena.[254] For example, after obtaining a default judgment against a US citizen, two Iranian banks sought enforcement of that judgment in the US.[255] However, the Ninth Circuit denied enforcement, reasoning that Iran's lack of public trials, politically weighted proceedings, and joint governmental branches violated US public policies.[256] Another instance arose when the D.C. District Court denied enforcement of a British judgment because the underlying public policies were "repugnant" to Maryland's public policy.[257] Although decided under a different political climate, these cases remain good law making it very clear that constitutional violations will receive zero deference by American courts when considering enforcement of foreign court rulings.[258]

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[247] *Id.* at 114.
[248] LIU TINGMEI, THE CHINA INTERNATIONAL COMMERCIAL COURT (CICC) IN 2018, http://cicc.court.gov.cn/html/1/219/208/209/1316.html (last updated Sep. 11, 2020).
[249] *Id.*
[250] *Id.*
[251] Letter from Jack B. Tate, Acting Legal Adviser, Department of State, to Acting Attorney General Philip B. Perlman (May 19, 1952), *reprinted in* 26 Department of State Bulletin 984-85 (June 23, 1952) ("Tate Letter").
[252] Weilamann v. Chase Manhattan Bank, 192 N.Y.S.2d 469 (Sup. Ct. 1959).
[253] Weston, *supra* note 111, at 741.
[254] *See generally Id.*
[255] Bank Melli Iran v. Pahlavi, 58 F.3d 1406, 1408 (9th Cir. 1995).
[256] *Id.* at 1412.
[257] Matusevitch v. Telnikoff, No. 97-7138, 1998 WL 388800, at 1 (D.C. Cir. May. 5, 1998).
[258] WILLIAM E. THOMSON & PERLETTE MICHELE JURA, CONFRONTING THE NEW BREED OF TRANSNATIONAL LITIGATION: ABUSIVE FOREIGN JUDGMENTS (2011). Note that the issue of comity goes both ways.

As indicated by the D.C. District Court and noted above, a fourth and somewhat smaller public policy concern in the commercial world is public policy considerations in the constitutional sense.[259] Generally, US courts give "meaning to our constitutional values."[260] Constitutional values will more likely come into play when considering proper procedures or lack thereof. While US courts have already decided on some arbitration-related public policy considerations, these concerns will only be magnified in the judicial proceeding. For example, arbitral awards from proceedings where arbitrators ruled on a contract removing antitrust violation remedies will receive no deference from US courts but could theoretically still be arbitrated.[261] Where a country's statutory rights are implicated, public policy is implicated.

Public policy excuses for non-enforcement do not end here. A fifth excuse includes "[i]nternational comity abstention and the presumption against extraterritoriality."[262] Extraterritoriality allows courts to presume that statutes apply domestically only.[263] By comparing international comity abstention justifications with *forum non-conveniens*, Bookman sheds light on the argument's malleability and the term's vagueness. *Forum non-conveniens* allows courts to decline jurisdiction where another forum would be better suited.[264] However, the doctrine is not very well-defined and gives courts the leeway to avoid "uncomfortable" situations.[265] Having to decide whether to enforce a foreign court's judgment will undoubtedly become uncomfortable.[266] Given the lay of the land now, there is no reason why US courts could not expand this doctrine liberally to foreign court rulings.

Lastly, although both litigation and arbitration might face public policy scrutiny, complete disregard of public policy in court proceedings can actually result in court holdings being overturned. Disregard of public policy in arbitration will have no such effect on the award. In conclusion, while public policy remains a grey area of enforcement for arbitral awards to-date, it will receive greater deference in cases fully litigated. Hence, from a public policy point of view, arbitration is preferable.

e. Additional Factors

In addition to expenses, time, resources, confidentiality, and public policy concerns, parties need to consider various other factors. First, parties should consider the underlying subject matter's complexity and uniqueness. While a judge is a trained legal professional, skilled in dispute resolution, he or she and the jury (if applicable) may not understand the subject matter well enough to make an educated decision. Although this should not be a showstopper, as it is up to the attorneys

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259 Weston, *supra* note 111, at 743.
260 Fiss, *supra* note 258, at 14.
261 Bookman, *supra* note 7, at 1150. While the Hague Judgments Convention does not cover Antitrust matters, contract validity still depends on compliance with national laws.
262 *Id.* at 1178.
263 *Id.* at 1178–79; *see also* Morrison v. Nat'l Austl. Bank Ltd., 561 U.S. 247 (2010).
264 Bookman, *supra note 7*, at 1178.
265 *Id.*
266 *See* Corporacion Mexicana De Mantenimiento Integral, S.De R.L. De C.V. v. Pemex-Exploracion Y Produccion, 832 F.3d 92, 106 (2nd Cir. 2016).

to educate their audience, parties that are able to select the arbitrator can avoid the effects of bad lawyering.

Second, although universally prohibited, judicial biases are real and can disadvantage one party over the other. The realistic concern about bias is not about impartiality but about neutrality.[267] While a judge will certainly seek to overcome cultural biases and language barriers, everyone grows up around certain legal concepts, has a specific approach to legal problems,[268] and develops a culturally specific mindset—generally known as "unconscious biases."[269] The crux of these biases is that they occur in the decision maker's subconscious, influencing rulings on a deeply fundamental level of which even the decision maker is unaware.[270] To add insult to injury, scholars have found that decisions are frequently made intuitively, giving these unconscious biases full reign over delicate situations.[271] In *Bridgeway Corp. v. Citibank*,[272] by upholding the district court's "judicial notice" of historic facts and background, the Second Circuit demonstrates the social issues that will be part and parcel to any court proceedings.[273] In its opinion, the district court dedicates an entire section to "Liberia's government, its recent civil war, and its judiciary."[274] The case demonstrates not only US court biases, but also foreign court influences. One way to balance such bias is by selecting a neutral venue, a court that does not advantage one party over the other due to cultural differences. However, this will most likely result in courts lacking jurisdiction. The concern of unconscious biases will equally apply to arbitrators. Unlike court proceedings, parties to arbitration have the flexibility to designate a specific arbitrator, incorporating the risk of bias in their decision-making process.

Third, parties will want to consider the powers available to the fact finder and decision maker. Arbitrators are limited in their subpoena powers and rely on local courts to enforce unanswered requests, while courts have the government's full enforcement powers and do not need to rely on another entity to punish.[275] However, the courts' powers are territorial and will not reach evidence or witnesses beyond their borders. This limitation strips away any advantage gained if relevant evidence is spread out across the world, rather than focused in one location.

For the above reasons, enforceability of foreign court rulings will remain unpredictable—at least at the beginning of the Hague Judgments Convention's life. Even if enough states join, parties must conduct a thorough cost and risk analysis before abandoning their current system. These analyses will most likely turn in favor of arbitration. However, as businesses transition from arbitration to litigation and begin resolving disputes through the judiciary, the transition is likely to occur along industry lines.

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[267] Derains, *supra* note 71, at 40.
[268] *Id.*
[269] Lauren Stiller Rikleen, *When it Comes to Unconscious Bias, are Judges at Risk*, ABAJOURNAL (Oct. 31, 2019 7:00 AM CDT), http://www.abajournal.com/voice/article/are-judges-at-risk-for-unconscious-bias.
[270] *Id.*
[271] *Id.*
[272] Bridgeway Corp. v. Citibank, 201 F.3d 134, 144 (2d Cir. 2000).
[273] Weston, *supra* note 111, at 742-43.
[274] Bridgeway Corp. v. Citibank, 45 F. Supp. 2d 276, 278 (S.N.D.Y. 1999).
[275] *See* 9 U.S.C. § 7; Fed. R. Civ. P. 45.

IV. CONCLUSION

The Hague Judgments Convention is no panacea to the enforcement of foreign court judgments. Existing concerns will remain across the board. Considering how long it took for the Hague Judgments Convention to finally be passed, and the lack of immediate enthusiasm in comparison to other similar conventions intertwined with political concerns demonstrate wide-spread doubt. Even if enough states signed onto the Hague Judgments Convention, a certain amount of lag time and educational gap regarding the Hague Judgments Convention will further delay any commercial relevance the Hague Judgments Convention might have. At that point, arbitration will have been the primary choice of dispute resolution for international commercial contracts for many decades. Unlike domestic contractual disputes, litigation of international contractual disputes will have to experience a new set of precedents that incorporates the international nature of the relationship. Arbitration would offer a better-oiled machine than its new alternative.

However, while it is difficult to change the current status quo, once change takes place, it will change quickly. Businesses will not keep one foot in arbitration and dip their toes into litigation. Businesses and industries will choose one or the other. Relevant to that transition will be key considerations such as expenses and biases.

While the future of international litigation remains in limbo, international mediation’s fate bodes well. Its non-binding and voluntary nature protects business relations and has little to no drawbacks and encourages cross-border relations.

In conclusion, although a noble solution on its face, the Hague Judgments Convention brings with it many headaches. It is in humanity’s nature to reach for the stars even if to land on the moon. As of today, the Hague Judgments Convention will not take the world by storm. In the foreseeable future, it looks as though international commercial contracts are stuck with current options, expanded only by the force of the Singapore Mediation Convention.