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**NORTH EAST JOURNAL OF LEGAL STUDIES**

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## ARTICLES



## PEDAGOGY

# REPORTING OF UNCERTAIN TAX POSITIONS

by

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## I. INTRODUCTION

According to a December 2010 article in the Wall Street Journal, the United States (U.S.) has one of the highest corporate tax rates in the world. The article surmised that President Obama in his January 2011 State of the Union address would propose major corporate tax reform to reduce corporate tax rates, make the U.S. more competitive, induce companies to invest in the U.S. and reduce complexity. The loss of revenue would be offset by eliminating certain deductions, credits and "loopholes." Many of these tax breaks benefit "targeted" industries that might conclude they are more valuable than a broad rate reduction.[1] Although the top corporate tax rate is 35%, many companies pay far less using investment incentives and other tax reduction provisions.[2] The stated goal of the Administration is to both reduce corporate tax rates and eliminate or cut back on the tax breaks so that the tax reform legislation will be revenue neutral. Also, less complexity should reduce the high cost of compliance, which is a common and perhaps increasing corporate grievance.[3] The momentum for corporate tax reform may have been propelled by the Obama Administration's recent focus on repairing relations with the business community after losing control of the House of Representatives.[4] The President did in fact mention corporate tax reform, though briefly, in his State of the Union address.

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A device a corporation might use to reduce its effective tax rate is to invest in a highly complicated and aggressive transaction commonly referred to as a "tax shelter." Shelters are designed to generate tax losses as an offset to taxable income, yet result in no or relatively little economic loss. The government has attacked the use of shelters asserting they have no business purpose apart from tax reduction. Pressured to reduce their tax expense, many corporations have entered into questionable shelter transactions hoping to avoid Internal Revenue Service (IRS) scrutiny or to win in the event of litigation. In this context, the IRS has pressed for more transparency by corporations on how they calculate their book provision for taxes. A highly contentious issue is whether the IRS has the right to scrutinize tax accrual work papers. Work papers generally show the corporation's tax reserve amount and assessment of risk on owing more taxes relative to certain transactions, particularly what would be owed if the tax benefits of a shelter investment or other tax position are not upheld. With access to a corporation's work papers, the IRS would have a clear-cut path to discovering transactions that a corporation itself has determined may result in a tax assessment. Tax accrual work papers are generally shown to a corporation's outside auditors who have to sign off on the adequacy of the tax reserve for the corporation to get a "clean" opinion. Financial statements of publicly traded companies must be certified by an independent auditor.[5] The position of the IRS is that if the independent auditors have access to the work papers, the IRS also has the right to scrutinize them.

Whether the IRS has the right to review a corporation's tax accrual work papers has been the subject of recent litigation. The issue is whether work papers are protected by the attorney work product privilege derived from the 1947 U.S. Supreme Court decision in *Hickman v. Taylor* and since codified.[6] On August 13, 2009, the First Circuit in a 3 to

2 *en banc* decision held in *United States of America v. Textron, Inc. and Subsidiaries* that the IRS was entitled to see the corporation's work papers.[7] A 1982 decision of the Fifth Circuit, *United States v. El Paso Co.*, also favored the government.[8] However, in June of 2010, the D.C. Circuit in *U.S. v. Deloitte LLP* upheld attorney work product protection, criticizing the decision in *Textron*.[9]

IRS Commissioner Doug Shulman addressed the controversy over tax accrual work papers in a January 2010 speech stating that the IRS will exercise "restraint" in requesting work papers. He also noted, however, that some corporations starting in 2010 will have to report "uncertain tax positions" at the time they file their tax return. To this end, he announced that the IRS is developing new Schedule UTP to be attached to the corporate return, Form 1120.[10] In a subsequent speech in September of 2010, the Commissioner noted that in April of 2010 the IRS released a draft of the new Schedule UTP with accompanying instructions asking for public comments. He then announced that the IRS will be releasing the final Schedule UTP and its instructions effective for 2010 tax years.[11] Since then, the final schedule and instructions have been released. Also promulgated was an amendment to treasury regulations requiring certain corporations to attach Schedule UTP to their corporate tax return (Form 1120) in accordance with forms, instructions, or other appropriate guidance provided by the IRS. This requirement is effective for tax years beginning on or after January 1, 2010.[12]

## II. PREPARED REMARKS OF IRS COMMISSIONER SHULMAN

In his September 2010 speech, the Commissioner made numerous observations concerning Schedule UTP and its instructions. He referred to "…. the basic assumption that a taxpayer will be forthcoming in dealing with the IRS with respect to items it has reported on its tax return, including the underlying positions related to those items."[13] Based upon comments received with respect to the draft Schedule UTP and instructions, the Commissioner observed that substantial modifications were made to the IRS policy of "restraint."[14]

Initially, the IRS proposed that all corporations with assets over $10 million and who issue audited financial statements would have to file Schedule UTP. Due to concerns about the impact on smaller businesses, this was changed to those corporations with $100 million in assets beginning with the 2010 tax year. Subsequently, however, there will be a phase-in of the filing requirement: $50 million in assets beginning two years later and then $10 million in assets two years after that.

Many comments were received by the IRS concerning the requirement that Schedule UTP filers include a calculation of the Maximum Tax Adjustment (MTA) with respect to each tax position included on the Schedule UTP. Two basic concerns were that: (1) it would be burdensome on taxpayers since this calculation is not currently being done, and (2) the MTA in many cases would be significantly greater than any potential adjustment with respect to an issue. The MTA requirement was dropped. In lieu of it, however, filers will have to rank their UTPs from highest to lowest based upon the size of the position. Taxpayers will have to use their tax reserve amount to rank the position, but will not be required to provide specific reserve amounts.[15]

Another topic the Commissioner touched upon concerned the requirement that a taxpayer identify positions for which it did not reserve, expecting to litigate the issue or because of an IRS administrative practice. Related to this were comments received by the IRS asking for clarification on the reporting of immaterial or unambiguous tax positions. The requirement to identify positions for which no reserve was established because of an IRS administrative practice was eliminated due to concerns about administering this requirement.[16] The "expect to litigate" disclosure was retained although the instructions were clarified to respond to concerns that this requirement might be read more broadly than intended and result in disclosure of highly certain or immaterial positions.[17]

The next major category of comments concerned how the new disclosure rules would impact the long-standing IRS policy of "restraint" concerning access to tax accrual work papers. There were concerns that disclosure of tax positions on Form UTP could raise questions of privilege concerning confidential communications related to the disclosed tax positions. This concern arose because the draft instructions to Schedule UTP required that a rationale for the position be supplied along with a description of the nature of the uncertainty. The final instructions eliminate these requirements. Taxpayers will only have to identify the issue and relevant facts by way of a "concise statement," which will not have to include an assessment of the tax position or an analysis of the support for or against the position.[18]

The Commissioner clarified the IRS policy of "restraint" making three points in this regard: (1) Disclosing issues on Schedule UTP would not affect the IRS policy of restraint on seeking tax accrual work papers; (2) Drafts of issue descriptions and information regarding ranking of issues are protected; and (3) the IRS will not seek documents that would otherwise be privileged even though shown to the taxpayer's auditor.[19]

The Commissioner further responded to concerns about how IRS agents would use the Schedule UTP information during audits. He announced that the IRS is releasing a field directive to its agents that will advise agents to eliminate uncertainty as soon as possible in order to foster efficiency. Agents are to receive special training on handling uncertain tax positions. A centralized process will be established to review UTPs to determine their proper treatment in light of ambiguity in the tax law and a lack of published IRS guidance.[20]

Some concerns were also raised about disclosing UTPs to foreign governments as may be required by tax treaties or information exchange agreements. The Commissioner observed that this would be very rare and apply only if there were reciprocity requiring the foreign government to report similar information to the IRS. Even then, other factors would be considered, such as relevance to the foreign government, in determining whether to make the disclosure.[21]

## III. SCHEDULE UTP INSTRUCTIONS

The final Schedule UTP instructions elaborate on the Prepared Remarks of the Commissioner and provide further guidance to affected taxpayers.[22] Some of the more salient provisions are as follows:

### *A. Applicability*

Corporations are required to file Schedule UTP when they take a tax position affecting their tax liability, issue audited financial statements and have assets exceeding $100 million. As mentioned, the $100 million benchmark will eventually be reduced to $10 million. More specifically, filing of Schedule UTP is required if (1) the corporation has taken a tax position for the current or a prior tax year, and (2) either the corporation or a related party has recorded a reserve for that tax position in audited financial statements of the corporation or a related party, or the corporation or a related party did not record a reserve anticipating litigating the position.

A tax position for which a reserve was recorded, or none recorded because of an expectation to litigate, must be reported regardless of whether the financial statements are prepared using U.S. generally accepted accounting principles (GAAP), international financial reporting standards (FRS), or other country-specific accounting standards.

A tax position is based on the "unit of account" used to prepare the financial statements and which would result in an adjustment to a "line item" on the tax return if the position is not sustained. If multiple tax positions affect a line item, each position must be reported separately. No reporting is required if the position is immaterial for purposes of the audited financial statements or the tax position was so certain that no reserve was required. Although Schedule UTP must be filed for current and prior tax years, no reporting is required for tax years beginning before January 1, 2010, even if a reserve is recorded for audited financial statements issued in 2010 or later. It is not necessary to report an uncertain tax position taken in a prior year if it has been reported with the prior year's tax return.

### *B. Unit of Account*

The term "unit of account" refers to the level of detail used in analyzing a tax position considering the level supporting the tax return and the level at which the taxpayer expects to address the issue with the IRS. There must be consistency between the unit of account used pursuant to a generally accepted accounting principle and the unit of account used for reporting a tax position on Schedule UTP. An example is given in the instructions concerning two corporations, A and B, each having research projects for which each will claim a research and development credit for increasing research activities. Corporation A chooses each research project as a unit of account for GAAP reporting purposes since it accumulates information for its tax return at the project level and expects to deal with the IRS on each project separately. Corporation B determines that its unit of account for GAAP is functional expenditures, based on the amount of expenditures, credits to be claimed, previous experience and the advice of its tax advisors. The example concludes that for purposes of the research and development credit, Corporation A must use each project as its unit of account for purposes of reporting on Schedule UTP whereas Corporation B must use functional expenditures for reporting purposes. Further guidance clarifying what is meant by a unit of account seems warranted. The research and development credit for increasing research activities, due to expire December 31, 2009, was recently reinstated for two years through December 31, 2011.[23]

### *C. Multiple Year Positions*

If a tax position could affect a line item on multiple year tax returns and a tax reserve is established for each affected year, the tax position must be reported with each return even though disclosed with a prior year's return. For example, a corporation incurs an expenditure it deducts in full in 2010 that it determines possibly should have been amortized over five years including 2010. A tax reserve is recorded in its audited financial statements for 2010 apropos to the tax position, but no reserve is recorded for 2011-2014. According to the instructions, the taxpayer has taken a tax position in each of the five years since there might be an adjustment to a line item on the return for each year. A Schedule UTP, however, need be filed only for 2010 and not for each of the years 2011-2014 since the corporation did not record a reserve for the tax position in those years. Assume, however, that a corporation incurs an expense in 2010 that it believes may be amortized over five taxable years. In reviewing this tax position for purposes of recording a tax reserve for its audited financial statements, it determines that it is uncertain whether any deduction or amortization is allowable. Accordingly, the corporation records a tax reserve in 2010 covering all five taxable years. The corporation must file a Schedule UTP with each of the tax returns for the five taxable years. The result would be the same if, instead of recording the entire reserve for the five taxable years in its financial statements for 2010, the corporation records an applicable reserve in its financial statements for each of the five taxable years. However, if a corporation records a reserve in its audited financial statements for a year relative to a tax position taken and files Schedule UTP, it need not file another Schedule UTP in a later year if the reserve is increased.

If a corporation is uncertain as to which of two years it is to report income, say 2010 or 2011, and has an expiring net operating loss carryover, it has taken a position in each year because in each year there would be an adjustment to a line item if the position is not sustained.

### D. *Related Party*

The instructions refer to several Internal Revenue Code sections dealing with attribution rules to determine who is a "related party." [24] An example refers to U.S Corporation A filing Form 1120 and foreign Corporation B that does no business in the U.S. and does not file a U.S. return. The two corporations are related but issue separate audited financial statements. Corporation A takes a tax position on its tax return and Corporation B records a tax reserve relative to that position in its audited financial statements. The example concludes that even though Corporation A does not record a reserve for the tax position, it must report the tax position on its Schedule UTP. Also included as a related party is any corporation included in consolidated audited financial statements in which the corporation is also included. An example refers to Corporations C and D that issue consolidated audited financial statements but do not file a consolidated income tax return. Corporation C takes a tax position for which a reserve is recorded in the consolidated financial statements of the two corporations. The example concludes that Corporation C must file a Schedule UTP because a reserve was included in consolidated financial statements in which it was included.

### E. *Ranking Tax Positions by Size*

Although tax positions must be ranked by size on Schedule UTP, the specific dollar amount of the position need not be disclosed. The size of a position is determined annually and is the amount of the tax reserve established for the position in the corporation's financial statements. If a single reserve is recorded for multiple positions, a reasonable allocation of the reserve among the positions must be made for purposes of their ranking. An expectation to litigate position is not to be considered in determining the size of a position. There is a separate column on Schedule UTP that must be checked if the tax position is a "major tax position," which is a relative size equal or greater than 10%. Relative size is determined by dividing the size of a position by the total of the sizes of all positions. Ranking on Schedule UTP is to be done by assigning the number 1 to the largest position, the number 2 to the next largest position, and so on. Ranking is not to be done by the type of position. Expectation to litigate positions, however, may be assigned any ranking number, apparently due to the uncertainty of litigation.

There is also a requirement to "code" the ranked positions. The letter "T" is to be used for transfer pricing positions and the letter "G" for all other positions. Singling out transfer pricing positions for separate coding is consistent with increased IRS focus on this contentious area.[25] An example of coding is given of a corporation with three reportable tax positions: transfer pricing, which is the largest position, a second smaller one and a third expectation to litigate position. The transfer pricing position is coded and ranked T1. The expectation to litigate position is coded G2 and the smaller position is coded G3. Since an expectation to litigate position can be assigned any ranking, it could have been assigned G3 with G3 moving up to G2. In the draft instructions, an expectation to litigate position had to be reported and ranked by size. Although the IRS dropped ranking such positions by size due to adverse comments made by interested parties, it nevertheless retained the requirement to report the position.

### F. *Concise Statement*

The instructions are in accord with the remarks of the Commissioner that the concise statement does not have to include an assessment of the tax position or an analysis of the support for or against the position.[26] The instructions provide limited guidance stating that there must be a "description of the relevant facts …. and information that reasonably can be expected to apprise the IRS of the identity of the tax position and the nature of the issue. In most cases, the description should not exceed a few sentences." The concise statement does not have to "include an assessment of the hazards of a tax position or an analysis of the support for or against the tax position." The instructions set forth three examples, which perhaps intentionally have few sentences. Two of the examples state the facts with four sentences and one with five sentences. Two of the concise descriptions have three sentences and one two sentences. Since the examples deal with disparate situations, they are of limited value except perhaps to make it clear that a prolix reporting of the tax position is not required.

## IV. CONCLUSION

One can argue that the alleged IRS policy of restraint on seeking tax accrual work papers is merely a public relations effort to demonstrate that the IRS is not unreasonable. Despite its professed restraint, however, the IRS clearly wants more transparency from corporations. Essentially, the information the IRS seeks from corporations should be obtainable through the requirement to file Schedule UTP, which obviously will guide it in identifying and examining questionable tax positions. One of the goals of the IRS noted by Commissioner Shulman is for it to become more efficient. To this end, corporations filing Schedule UTP will surely be audited with more precision, and consequently with less time and effort by IRS agents. What better way to foster more efficiency than to enlist corporations and their advisors to describe to the IRS what they themselves perceive to be problematic tax positions. Law and accounting firms will surely be enlisted as advisors regarding the filing of Schedule UTP, with the attendant expense. It has even been suggested that tax advisors should think of the government as their new boss.[27] It will, of course, be interesting to see how all this plays out in practice.

Apart from Schedule UTP, there is continuing momentum to overhaul corporate tax rules generally, provided revenue is not impacted significantly and worsen the already grim federal budget.[28]

[1] John D. McKinnon, *Battle Lines Form Over Government's Role—Corporate Taxes*, Wall Street Journal, January 5, 2011, at A4.

[2] Paul Vigna and John Shipman, *Tax Credits Help Profits Rise*, Wall Street Journal, February 8, 2011, at A2.

[3] David Wessel, *Tackling Corporate-Tax Rates –And Loopholes*, The Wall Street Journal, December 30, 2010, at A-2.

[4] John D. McKinnon and Elizabeth Williamson, *Momentum Builds for Corporate-Tax Overhaul*, Wall Street Journal, January 6, 2011, at A4.

[5] *See* 15 U.S.C. §§ 781, 78m (2006); 17 C.F.R. § 210 *et seq* (2009).

[6] 329 U.S. 495 (1947); Rule 26(b)(3) of the Federal Rules of Civil Procedure.

[7] 577 F.3d 21 (1st Cir. 2009), 2009 U.S. LEXIS 18103, *cert. denied*, 2010 U.S. LEXIS 4373 (May 24, 2010).

[8] 682 F.2d 530 (5th Cir. 1982), *cert. denied* 66 U.S. 944 (1984).

[9] 610 F.3d 129, 2010 U.S. App LEXIS 13226 (D.C. Cir. 2010).

[10] IR-2010-13, Announcement 2010-9. The Announcement was part of Prepared Remarks of IRS Commissioner Doug Shulman to the New York State Bar Association Taxation Section Annual Meeting in New York City on January 26, 2010.

[11] IR-2010-98, Announcements 2010-75 and 76. The Announcements were part of Prepared Remarks of IRS Commissioner Doug Shulman to the American Bar Association in Toronto on September 24, 2010 .

[12] T.D. 9510 (Dec. 13, 2010), adding C.F.R. § 1.6012-2(a)(4)and (5).

[13] *Supra* 10.

[14] *Id*.

[15] *Id*
.

[16] *Id*.

[17] *Id*.

[18] *Id*.

[19] *Id*.

[20] *Id*.

[21] *Id*.

[22] 2010 Instructions for Schedule UTP, Uncertain Tax Position Statement, Cat. No. 55028G.

[23] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312), signed into law by President Obama on December 17, 2010, Act Sections 731(a), (b) and (c), amending 26 U.S.C. § 41(h)(1)(B).

[24] 26 U.S.C. §§ 267(b), 318(a), or 707(b).

[25] *See* IR-2010-122, Prepared Remarks of IRS Commissioner Doug Shulman before the 23rd Annual Institute on Current Issues in International Taxation (December 9, 2010).

[26] *Supra* 11.

[27] Roger Russell, *Gear Up for Tax Season*, Accounting Today, Vol.24, No. 16, December 13, 2010-Jan. 10, 2011, at 52.

[28] John D. McKinnon, *Progress on Overhaul of Corporate-Tax Rules*, Wall Street Journal, January 15-16, 2011, at A3; David Wessel, *Tax Redo Seeks 'Level Playing Field*,' Wall Street Journal, January 27, 2011, at A4; Jean Sahadi, *Corporate Tax Reform: Talk Grows Louder*, CNN Money.com, http://cnn.com/2011/01/14/news/economy/corporate_tax_reform/index.htm.

# INTERNATIONAL FINANCIAL REGULATION: TOWARD A RULE OF LAW

by

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## INTRODUCTION

Since the 1947 General Agreement on Tariffs and Trade (GATT), many nations have subscribed to multi-national treaties, agreements, and conventions seeking to govern the regulation of international trade in goods and services. National and International tribunals have settled or made recommendations concerning individual and national disputes submitted to their jurisdictions.[1] For example, the 1988 United Nations Convention on Contracts for the International Sale of Goods (CISG) has been applied to enforce contracts and grant remedies for breach of an agreement.[2] In 1994, 138 nations incorporated GATT and the General Agreement on Trade in Services (GATS) into the World Trade Organization (WTO) agreement. The Agreement recommends remedies to ensure free trade in Goods and Services. Annexes to the agreement seek freedom of trade in other areas, including finance. In particular, the WTO, by its financial services annex,[3] seeks to open the banking, securities and insurance industries to competition from foreign companies. While intending to open

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services to consumers, the Agreement still permits countries to regulate the industries.

To date, however, no set financial regulations have been widely adopted among nations. No traditionally enforceable rule of the law of finance exists. But regulations have been proposed and recommended for acceptance among a number of nations and regulatory bodies.[4] This article examines the growth of financial regulations in three areas: money laundering regulation; banking stability standards; and securities market supervision. This article concludes with an argument for the need for a World regulatory body to enforce by recommendation[5] the financial principles examined below.

## THE GROWTH OF FINANCIAL REGULATIONS

### *Money Laundering Efforts*

*The Financial Action Task Force as a Standard Setting Body:*

The Financial Action Task Force (FATF), an international inter-governmental body presently composed of thirty-four nation members and two international organizations (the Gulf Cooperation Council [Bahrain, Kuwait, Oman, Qatar, Saudi-Arabia and the United Arab Emirates individually are not members] and the European Commission), also has twenty-seven associate or observer members included in its deliberations. The organization sets financial standards to combat money laundering, including terrorist financing.[6]

Police and banking authorities have always been interested in monitoring money obtained from drug sales, prostitution, racketeering and other illegal acts. The United States, the United Kingdom, France, Germany, Japan, Italy and

Canada (the G-7) initiated the plan to promote anti-money laundering regulations, which often occur in offshore financial centers. The FATF Forty Recommendations and its Eight Special Recommendations concerning terrorist financing have been accepted and implemented by the International Monetary Fund (IMF) and the World Bank. Both of these institutions, by gathering information and publication of investigation results, have assisted the implementation of the FATF Recommendations. [7]

At the 1989 Paris G-7 summit meeting, the G-7 heads of state and the President of the European Commission convened a task force which produced the April 1990 FATF Forty Recommendations. In October 2001 the FATF added eight special recommendations (which then became nine recommendations by October 2004) concerning money laundering and terrorist financing. The document is presently called the *40+9 Recommendations.*[8] The FATF strongly urges all nations to take the necessary steps to combat money laundering and terrorist financing by bringing their legal systems into compliance with the Recommendations. Constant evaluations by regional bodies and assessments conducted by the IMF and the World Bank will ensure effective implementation. The Forty Recommendations address a) Legal Systems; b) Financial Institutions and Non- Financial Businesses and Professions; c) Necessary Institutional and Other Measures; d) International Cooperation.

*Legal Systems:*

The FATF indicates that money laundering should be criminalized in accord with the United Nations Convention against Illicit Traffic in Narcotic Drugs and Psychotropic substances, 1988 (the Vienna Convention)[9] and the United Nations Convention against Transnational Organized Crime, 2000 (the Palermo Convention)[10].Criminal knowledge an intent may be inferred from objective factual circumstances. Where criminal liability is not possible, civil liability should attach to any legal person, who will be subject to effective sanctions in the form of injunction or monetary damage liability property and proceeds should be confiscated, assets should be frozen or ceased and any other measures consistent with domestic law should be pursued. [11]

*Measures to be taken by Financial Institutions and Non-Financial Businesses and Professions to Prevent Money Laundering and Terrorist Finances:*

Financial Institutions should not use secrecy laws to inhibit Recommendation implementation. Institutional due diligence and record keeping will then prohibit anonymous or fictitious name accounts and will identify customers[12] when establishing businesses relations and carrying out transactions if there is a suspicion or reasonable doubt about money laundering or terrorist financing.

Customers in their turn will practice due diligence[13] by verifying their own identity, identifying the beneficial owner of accounts, obtaining requested information and conducting ongoing due diligence.

In dealing with politically exposed persons (heads of state, senior officials and their families)[14] financial institutions should determine the identity of such a person as politically exposed, obtain senior management approval for the businesses relationship, and take reasonable measures to determine the source of the funds and to monitor the ongoing relationship.

In relation to cross border corresponding banks and other institutions due diligence measures require  the nature of the correspondence business, its anti-money laundering and terrorist financial controls, obtain senior management approval and with respect to payable through accounts that the pay through customer be sufficiently identified. Shell banks[15] used as covers for criminal activity should be prohibited.

New technologies for record keeping and any reasonable suspicions concerning information transmission with these technologies should be promptly reported. The financial institution, its officers and directors should be free from any past civil and criminal liabilities for failure to disclose suspicions to any authorized officials or administrative authority.

All non-financial businesses and professions must report suspicious transactions. In particular, dealers in precious metals/stones and trust company service providers must also be required to report suspicious circumstances. Legal professions and Accountants however, are not required to report their suspicions if they are subject to professional secrecy or other legal privilege.[16]

Regulatory measures with respect to countries that do not comply with the FATF Recommendations include publication of findings, counter measures by cooperating countries and disclosure by financial institutions and professionals of local laws which prevent application of the Recommendations to them.[17] Competent local authorities should establish guidelines for financial institutions and non-financial businesses and professions concerning the effort to combat money laundering and terrorist financing, and to detect and report suspicious financial transactions.

*Institutional and Other Measures Necessary in Systems for Combating Money Laundering and Terrorist Financing:*

Financial Intelligence Units (FIU)[18] and Suspicious Transaction Reports (STR)[19] will create competent power and resources to assist countries in monitoring and sanctioning money laundering and terrorist financing. Special investigative techniques such as controlled delivery and undercover operations will assist in asset investigation. FIUs will have power to investigate and to use compulsory measures, including search and seizure of person's premises and property in order to obtain evidence. Professionals of skill and high integrity will cooperate with each other to develop and implement policies and activities to combat illegal laundering and financing.

Legal persons and entities should not be used to prevent lawful investigation. Beneficial ownership should be apparent concerning such beneficial ownership and control of entities suspected of money laundering and terrorist financing. In particular, express trusts documentation should include information identifying the settlor, trustee and beneficiaries.[20]

*International Cooperation:*

The FATF urged countries to take immediate steps to implement fully the Vienna Convention the Palermo Convention, the 1999 United Nations International Convention for the Suppressing of the Financing of Terrorism,[21] the 1990 Council of Europe Convention on Laundering, Search, Seizure and Confiscation of the Proceeds from Crime[22] and the 2002 Inter-American Convention against Terrorism.[23] Mutual legal assistance among nations should include clear and efficient processes to share information and to facilitate extradition of criminal actors notwithstanding the absence of dual criminality. Expeditious local action will also facilitate identification and seizure of property laundered and instrumentalities used in the commission of offenses. Other forms of cooperation include information exchange between legal enforcement counterparts without undue restrictive measures and where a foreign competent authority may not act, that information at least be shared, always in a manner consistent with privacy rights and data protection.[24]

The 2004 FATF Nine Special Recommendations on Terrorist Financing supplement the Forty Recommendations.[25] Each nation is encouraged to implement the 1999 United Nations International Convention for the suppression of the financing of terrorism, to criminalize any terrorist activity, to freeze and confiscate terrorist assets,[26] to report suspicious transactions, to cooperate with each other, so as not to provide safe havens for terrorist persons, to monitor closely wire transfers, and non-profit organizations particularly vulnerable to terrorist exploitation, and to detect physical cross-border transportation of currency by cash couriers.

*High Risk and Non Cooperative Jurisdiction Review:*

FATF and FATF style regional bodies' evaluation programs effectively reveal actors who pose a high risk to the international financial system and who fail to implement money laundering and terrorist financing regimes. The FATF investigative process of non cooperative countries and territories (NCCTs) revealed 23 jurisdictions with a lack of a coherent investigative and enforcement systems, but by October 2006 all 23 had been removed from the list.[27]

Since 2007, the FATF newly formed International Cooperation Review Group (ICRG), at the renewed urging of the now expanded Group of 20 (G-20), has analyzed additional high risk jurisdictions. In February 2011 the Review Group identified Iran and The Democratic People's republic of Korea as significant financial threats for money laundering and the financing of terrorism. The FATF urged its members to use counter measures for protective purposes. In June 2011 the Review Group continued to identify an additional eleven national actors with implementation deficiencies, where no significant progress has occurred: Angola, Bolivia, Ethiopia, Kenya, Myanmar, Nepal, Nigeria, Sri Lanka, Syria, Trinidad & Tobago, and Turkey. The entire list presently contained thirty-one jurisdictions but progress has been made in the other nations.[28]

## *Banking Stability Standards*

### *Basel I:*

The Core Principles for Effective Banking Supervision (the Basel Core Principles) were issued by the Basel Committee of Banking Supervisory Authorities from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States in 1997. They have been revised since that time but the 25 Basic Principles remain the same. Promulgation of the principle included consultation with non-G-10 supervisory authorities: Argentina, Brazil, Chile, China, the then Czech Republic, Hong Kong, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Poland, Russia, Singapore and Thailand. [29]

### *Preconditions for Effective Banking Supervision (Principle 1):*

Primary among the preconditions, the Committee envisions the necessity of a legal framework to implement the Principles, the independence of regulators or enforce those

Principles, and their continuing legal protection from any liability for their decisions.

*Licensing and Structure (Principles 2-5):*

The licensing authority must have power to obtain full disclosure of ownership management and operating structure of any bank, which must clearly identify itself by the use of the word bank. Where the owner of the bank is itself a foreign bank, prior consent of its home country regulator must be obtained before a license is issued. Continuous review of the bank's financial condition, including its capital base must be permitted by law.[30]

*Prudential Regulations and Requirements (Principles 6-15):*

All banks should maintain appropriate capital adequacy and international banks must adhere to the Basel Capital Accord, as amended.[31] Loan and investment portfolios, management information systems, appropriate reserves, market risk limits, arm's-length requirements, internal controls, and "know-your-customer" rules should be promptly implemented to prevent risk of bank failures and the use of banks for criminal activity.

*Methods of On Going Banking Supervision (Principles 16-20):*

Banking supervisors, on a consolidated basis, must be able to use on-site and off-site supervision to obtain a thorough understanding of prudential reports and statistical returns.[32] Those supervisors must be able to obtain independent validation of the information supplied to them.

*Information Requirements (Principle 21):*

Regular bank financial statements, compiled in accord with consistent account principles of full disclosure, must represent an adequate record of the true and fair financial condition of the bank and its profitability.[33]

*Formal Powers of Supervisors (Principle 22):*

Banking supervisors must have the authority to take timely corrective action when banks fail to act prudently and even, in extreme circumstances, to revoke the banking license of an individual institution.[34]

*Cross-Border Banking (Principles 23-25):*

Globally consolidated supervision by bank supervisors will effectively monitor foreign branches, joint ventures and subsidiaries of international banks. Information exchanged among supervisors from other nations and regions will ensure that the local operations of foreign banks be conducted in accord with uniform standards, both foreign and domestic.

In two appendices to the Principles,[35] the Committee urged that government owned commercial banks must operate in accord with the standards applied to private institutions and that all banks must secure and protect the deposits of their customers. The committee observes that the Principles set minimum requirements for governance and disclosure. The Principles rely upon the cooperation of banking regulators, nationally, regionally and internationally.

*Basel II:*

In June 2004, the Basel Committee issued a document concerning the International Convergence of Capital Measurements and Capital Standards.[36] The document urged international convergence on supervisory regulations applicable to internationally active banks. This revision of Basel I provides a greater range of options for bank supervisors to determine the capital requirements and risk factors applicable to banks. The Committee recognized that the Core, or Tier 1, Capital base must consist of share equity and disclosed reserves, the only elements common to all countries' banking systems. Supplementary, or Tier 2, Capital would include undisclosed reserves, reevaluation reserves of assets already held by a bank and general loan-loss reserves which are subject to deterioration and which must be noted by accounting supervisors. Tier 3 Capital would consist of short-term subordinated debt which would be unsecured but fully paid up, having original maturity of at least two years, not be pre-payable unless bank supervisory authority agrees and be subject to the provision that no payment occur, should the bank than fall below its minimum capital requirement.[37]

The Basel II Committee supplemented the Basel I twenty-five Core Principles with Three Pillars.

*The First Pillar – Minimum Capital Requirements:*

The First Pillar mandates the regulation of capital risks emanating from individual claims, urges external credit assessments and describes risk reduction implementation techniques with great particularity. The Internal Ratings-Based (IRB) Approach[38] examines its application across asset classes, including corporate, sovereign, bank, retail, revolving retail, equity and receivable exposures. It proposes formulas for the derivation of risk-weighted assets, adjustments for small and medium sized entities and the probability factors for default in all of these asset classes. The document describes in detail the minimum requirements of the IRB approach, including internal and external management of risk requirements.

The First Pillar devotes particular attention to the credit risks involved with secure transactions, including the capital requirements for early amortization of outstanding loans and the value of the security advanced upon the loan.[39] The Pillar even suggests a hierarchy of approaches to determine risk exposure in secure transactions.

The Pillar, finally, describes methods to measure operational risks and the credit risks involved in trading book issues - financial instruments and commodities held for trading purposes or as a hedge against other trades.[40]

*The Second Pillar – Supervisory Review Process:*

Supervisory Review requires the application of four key principles: 1) Entity Assessment through examination of management and board oversight; proper capital and risk assessment; proper monitoring and reporting; and a continuous review of internal controls. 2) Specific Internal Risk Assessment in accord with certain specified minimum standards of capital adequacy, assessment of the control environment and the response of bank supervisors. 3) Minimum Capital Ratio Assessment in the banking process, including examination of the possibility of debtor default, the dangers of credit concentration and the ability to hold capital in excess of the minimum. 4) Capital Risk Prevention Assessment among bank supervisors in order to obtain rapid remedial action in the case of inadequate capitalization.[41]

*The Third Pillar – Market Discipline:*

The Third Pillar urges a continuous market review of bank discipline through the promulgation of disclosure requirements, guiding principles, accounting standards, and the definition of proprietary and confidential information.[42]

*Basel III:*

The Basel Committee published the Basel III package of financial regulations on December 19, 2010. The Committee, established by G-10 countries in 1975, now consists of senior banking representatives from 27 nations: Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.[43]

In the light of the financial crisis which began to develop a few years before its proposal, the committee, restated its 25 Principles, its Three Pillars and introduced a reform program to strengthen the resilience of the banking sector. The Committee indicated that is proposals form a part of a global initiative to strengthen the financial regulatory system endorsed by the Financial Stability Board and the G-20 leaders. The Committee noted that weaknesses in the banking system transmitted themselves to the financial system and "the real economy, resulting in a massive contraction of liquidity and credit availability" (Basel III, I, 4). The reforms introduced by the Committee build upon the agreement reached at the September 6, 2009 meeting of the Basel Committee's governing body and include the following:

First, the quality and transparency of the capital base of internationally active banks must be raised so that Tier 1 Capital stock and published retained earnings will be able to absorb any fluctuations in risk-based assets. The Committee mandates that Tier 3 Capital be eliminated from bank capital assets, and that Tier 2 Capital instruments be harmonized so as to reveal the risks adherent in each of them in relation to the others.[44]

Second, the Committee proposes that counter-party credit risk exposures deriving from derivatives, repossessions and securities financing be moved to central counterparties (such as clearing houses) and central exchanges so that no one institution be subject to risk of failure.[45]

Third, the Committee will supplement the Basel II risk-based scheme by introducing a more rigorous international leverage ratio requirement to adjust any accounting differences among internationally active banks.[46]

Fourth, the Committee has introduced anti-cyclicality measures so as to promote the accumulation of capital assets during a cycle of prosperity. The Committee urges that such an accumulation will reduce the prior pro-cyclicality practices of banks which increased their risks and spent more of their assets during times of prosperity. The Committee also proposed practices to protect banks during periods of excess credit growth through the use of accounting standards to improve that calibration of risk estimates. [47]

Fifth, the Committee has also introduced an international minimum liquidity standard for banks which includes a 30 day liquidity coverage ratio requirement which would include an even longer term net stable funding ratio to calculate continuing structural liquidity.[48]

It is presently planned that all major G-20 financial centers adopt the Basel III recommendations by December 31, 2011 and that full implementation of Basel III occur by December 31, 2019.[49]

### *Securities Market Supervision*

#### *The International Organization of Securities Commissions (IOSCO):*

The IOSCO, founded in 1983, headquarters its General Secretariat in Madrid, Spain. The Organization's 115 Ordinary Members (securities regulators from Albania to Zambia, including the United Kingdom and the United States) include Securities Commissions with public authority to regulate or other self regulatory bodies such as Stock Exchanges, if a jurisdiction has no publicly authorized securities regulator.[50] In

May 2002, the Ordinary Members subscribed to a Multi-lateral Memorandum of Understanding (MMOU) concerning Consultation and Cooperation and the Exchange of Securities Information. Regional committees representing Africa and the Middle East, Asia and the Pacific Rim, Europe and the Americas assist in the continuing formulation and implementation of the MMOU rules.[51]

*Multi-lateral Memorandum of Understanding (MMOU):*

*Introduction:*

The objectives of IOSCO and of its MMOU encourage international cooperation "to promote high standards of security regulations to maintain just, efficient and sound markets", to ensure information exchange, to institute rigorous surveillance of international securities transactions and to provide a strict application and effective enforcement of rules by the member regulators.

These rules are laws and regulations which are promulgated for enforcement in the various jurisdictions to which regulator members belong, including regulations concerning:

First, insider trading, market manipulation, misrepresentation of material information and other fraudulent or manipulative practices relating to securities and derivatives, including solicitation practices, handling of investor funds and customer orders;[52]

Second, the registration, issuance, offer, or sale of securities and derivatives, and reporting requirements related thereto;[53]

Third, market intermediaries, including investment and trading advisers who are required to be licensed or

registered, collective investment schemes, brokers, dealers and transfer agents; and[54]
Fourth, markets, exchanges and clearing and settlement entities.[55]

*Mutual Assistance and the Exchange of Information:*
General Principles: The IOSCO signatory Securities Authorities (Authorities) have agreed to enforce compliance with the respective securities laws and regulations of their jurisdictions. The memorandum of understanding however, does not “create legally binding obligations or supersede domestic laws” (MMOU 6). The Authorities state to each other that no domestic secrecy laws prevent the sharing of information among signatories. The Authorities represent that they will not exclude any information from an authority who request securities transactions information unless domestic law will be violated or a criminal proceeding in the Requested Authority’s jurisdiction has already begun.

Requests for Assistance: A written request,[56] made to the Requested Authority’s contact office, will describe the underlying investigation facts, a description of the assistance sought, identification of any persons believed to possess such information and a statement that the laws and regulations of the jurisdiction may have been violated. The Requested Authority will seek sworn responses from any person required to execute the request. A Requesting Authority may in fact provide its own representative to ask specific questions of any witness.[57]

Permissible Uses of Information: The Requesting Authority may solely use non-public information in order to ensure compliance with that jurisdiction’s laws and regulations. Public enforcement proceedings, whether civil, administrative or criminal, may emanate from this use of non-public documents.

If no such proceedings occur, however, the contents of the request may not be made public.[58]

Continuing Consultation among Member Authorities:
Authorities will consult with each other at regular intervals and as conditions arise to examine any significant change in market or business conditions or any changes in the ability of an authority to comply with the provisions of the Memorandum of Understanding.[59]

## CONCLUSION: THE PROSPECTS FOR A WORLD FINANCIAL REGULATORY ORGANIZATION

As already mentioned in the introduction to this article, the World Trade Organization Agreement includes a compact on trade and financial services, but the Annex only urges free trade in the banking securities and insurance industries.

As we have seen, however, international bodies have begun to regulate the financial areas described above. Insurance company supervisors have also announced the investment and liquidity strategies of internationally active insurance companies.[60]

A number of legal scholars have argued that the present financial regulations constitute “soft law” and not “hard law.” “Hard law” would be enforceable by dispute settlement authorities with enforcement powers, but “soft law” regulations would not. Others have contended that a global financial regulator would not be practical[61] and that “soft law” enforced through the Financial Action Task Force, the Basel Accords and the IOSCO Multilateral Agreement would more than suffice through reputational constraints, market conditions and institutional sanctions.

The World Trade Organization Agreement, however, provides a framework for the institution of a World Financial Organization or some other regulatory body within the WTO itself. The WTO Dispute Settlement Understanding creates dispute settlement Panels and Appellate Bodies to settle controversies concerning trade in goods and services. The Agreement recognizes the complexity of a number of problems which arise concerning tariffs and rules of origin; import licensing procedures; safeguards against subsidies and dumping; technical barriers to trade; trade related aspects of intellectual property rights; measures in favor of least developed countries; vital national agricultural, textile and clothing products and the difficulties surrounding trade in services and the environment, including sanitary and phytosanitary rules. These problems, however, are subject to resolution before WTO bodies which issue recommendations rather than enforceable decisions. The WTO Panel and Appellate body decisions apply the rules enunciated by the WTO agreement in the light of the non-discrimination and transparency principles inherent in the Most Favored Nation and national treatment rules. These tribunals also apply the WTO agreement exceptions concerning developing nations, vital products and the escape clause principles concerning health, the environment, and national security. If enforcement is ever necessary, the agreement permits counter measures, such as countervailing duties and embargoes, against the parties who do not comply with the WTO decision.

The complex financial regulations just described could be enforced in a similar manner by financial dispute settlement bodies. The recommendatory decisions of these bodies would be enforced in the same manner as WTO Panel and Appellate Body decisions are presently enforced, with the retaliatory measures already present in the WTO scheme. The history of the growth of GATT, from its inception in 1947 to its incorporation into the World Trade Organization Agreement in 1994, would argue that a similar growth process will occur in the area of financial regulation.

## ENDNOTES

[1] August, Mayer, Bixby *International Business Law* (5th Edition) New Jersey: Pearson Prentice Hall contains cases concerning jurisdiction, international persons, state responsibility, dispute settlement, foreign investment, money and banking, services and labor, intellectual property, sales, transportation and financing of goods purchases and taxation presented to municipal (local courts) and internationally recognized tribunals.

[2] http://www.cisg.law.pace.edu/cisg/text/treaty.html

[3] http://www.wto.org/english/docs_e/legal_e/26-gats_02_e.htm

[4] The January 2011 article *How International Financial Law Works (and How It Doesn't)* by Chris Brummer, Professor of Law at Georgetown University Law Center, 99 Georgetown Law Journal, 257 reviews the financial regulation literature and has assisted me in formulating the argument contained in the present article. Professor Brummer would argue that "soft law" enforcement suffices, but it seems to me that the WTO Dispute Settlement Understanding (DSU) would answer many of the objections he presents to an international financial regulator.

[5] The decisions made by WTO Panels and the WTO Appellate Body contain recommendations to treat a petitioner, for example in a non-discriminatory manner. These decisions do not have the command language present in local national court decisions. The WTO decisions however have been and are enforced in order to avoid retaliatory measures against offenders by member nations.

[6] http://www.oecd.org/pages/0,3417,en_32250379_32235720_1_1_1_1_1,00.html

[7] http://www.oecd.org/document/34/0,3746,en_32250379_32236963_45572898_1_1_1_1,00.html

[8] http://www.oecd.org/document/28/0,3746,en_32250379_32236920_33658140_1_1_1_1,00.html;http://www.oecd.org/document/9/0,3746,en_32250379_32236920_34032073_1_1_1_1,00.html

[9] http://www.unodc.org/unodc/en/treaties/illicit-trafficking.html

[10]http://www.uncjin.org/Documents/Conventions/dcatoc/final_documents_2/convention_eng.pdf

[11] The OECD/FATF has always been concerned not only with criminal prosecution but also with civil remedies which will call attention to the illicit money laundering efforts. This avenue of control receives detailed description in the Palermo Convention.

[12] The problem of anonymous and fictitious name accounts has been particularly difficult to surmount because of the long standing rules of certain jurisdictions, including Switzerland.

[13] Due diligence in defined as it has been for years in common law and civil law countries; the exercise of that measure of prudence and care which a person would use in the conduct of their own affairs.

[14] “Politically exposed persons” would include even relatives of officials beyond their immediate families.

[15] The United States financial crimes task force lists a number of Shell Bank operations. http://www.fincen.gov/news_room/nr/html/20040816.html

[16] The Sarbanes-Act requires a stricter standard of professional conduct both for attorney and especially for accountants with regard to suspicious circumstances.

[17] These regulatory measures include remedies available under the WTO Agreement, in particular under its Dispute Settlement Understanding.

[18] The International Monetary Fund (IMF) issued a report on the progress of FIUs in 2004. http://www.imf.org/external/pubs/ft/FIU/index.htm

[19] http://www.fatf-gafi.org/document/16/0,3746,en_32250379_32236920_43690576_1_1_1_1,00.html

[20] The FATF observes that expressed trusts are often used to conceal money laundering operations. The Society of Trust and Estate Practitioners (STEP) regularly releases reports concerning these operations forbidden by the FATF rules.
http://www.step.org/PDF/Trust%20Reporting%20Systems%20FINAL.pdf

[21] http://www.un.org/law/cod/finterr.htm

[22]http://conventions.coe.int/Treaty/Commun/QueVoulezVous.asp?NT=141&CL=ENG

[23]http://www.oas.org/xxxiiga/english/docs_en/docs_items/AGres1840_02.htm

[24]The literature indicates that the concern for money laundering activity is paramount.

[25] http://www.fatf-gafi.org/document/9/0,3746,en_32250379_32236920_34032073_1_1_1_1,00.html

[26] http://www.nti.org/e_research/official_docs/inventory/pdfs/finterr.pdf
[27] http://www.fatf-gafi.org/dataoecd/0/0/37029619.pdf
[28] http://www.fatf-gafi.org/dataoecd/28/43/40285899.pdf
[29] http://www.bis.org/publ/bcbs30a.pdf
[30] The Bank for International Settlements' most recent report describes the particulars of the review. http://www.bis.org/bcbs/
[31] http://www.bis.org/publ/bcbsca03.pdf
[32] Lombard Risk continues to publish a statistical guidelines for bank supervisors based upon the Basel principles. http://www.lombardrisk.com/industries/regional_solutions.htm
[33] ACF consultants have indicated that the Basel accords will slash bank profitability. http://www.resultspr.co.uk/press-releases/basel-iii-will-slash-banks%E2%80%99-profitability
[34] The Social Science Research Network has published articles concerning the roles of supervisors urged by Basel. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=901761
[35] The International Monetary Fund has produced assessments and results concerning the application of the Appendices. http://www.imf.org/external/np/mae/bcore/exp.htm
[36] http://www.bis.org/publ/bcbs128.pdf
[37] http://www.basel-ii-accord.com/Basel_ii_The_constituents_of_capital_49.htm
[38] The Federal Reserve Bank of New York and Moody's published a document describing the IRB approach and its ramifications. http://www.moodyskmv.com/conf04/pdf/presentations/hendricks_basel_II.pdf
[39] The credit-risks formula is clearly described at http://www.bionicturtle.com/how-to/article/three-pillars-of-basel-ii-and-credit-risk-operational/
[40] http://www.bis.org/bcbs/cp3part2.pdf
[41] The 4 Key Principles are detailed at http://www.bionicturtle.com/how-to/question/basel-ii-second-pillars-supervisory-review-l2.t7.b2/
[42] The Market Discipline Principle is described and examined at http://www.bionicturtle.com/how-to/question/third-pillar-of-basel-ii-market-discipline-l2.t7.b3/
[43] http://www.basel-ii-risk.com/basel-iii-guide-to-the-changes/
[44] The Financial Express webpage critics the first and other reforms proposed by Basel III. http://www.thefinancialexpress-bd.com/more.php?news_id=132907&date=2011-04-19
[45] Deloitte recently published its observations concerning this reform. http://www.deloitte.com/assets/Dcom-

UnitedStates/Local%20Assets/Documents/FSI/US_FSI_FinancialReformInsights_041911.pdf
[46] The Economist has also attempted to clarify this third and the other reforms. http://www.economist.com/blogs/freeexchange/2010/09/financial_reform
[47] Ibid.
[48] Ibid.
[49] The European Banking Confederation has expressed concern about the feasibility of the timetable and the negative effects which may result from failure to adhere to it. http://www.gfsnews.com/article/103/1/
[50] 84 non-voting Associate and Affiliate Members are self-regulatory agencies or other interested parties.
[51] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD126.pdf
[52] http://www.treasury.gov.au/documents/178/PDF/atti.pdf
[53] http://www.cvent.com/events/2010-ifie-iosco-global-investor-education-conference/agenda-12ff63e32b1c4a3caaa3221593e0425e.aspx
[54] http://www.world-exchanges.org/reports/regulation/iosco-principles-outsourcing-financial-services-market-intermediaries
[55]http://books.google.com/books?id=66gCBR2c_jgC&pg=PA141&lpg=PA141&dq=iosco+clearing+entities&source=bl&ots=Ytyjv-xC6f&sig=NZLFzftpkNdhIyBMid7ssvgewvg&hl=en&ei=j9m5TbfoHYK5twe80uDeBA&sa=X&oi=book_result&ct=result&resnum=1&ved=0CBYQ6AEwAA#v=onepage&q&f=false
[56]http://www.sc.com.my/eng/html/iaffairs/ioscoreport/Publication_of_SAP.pdf
[57] Portfolio Media's Law 360 discusses the rights of Requesting Authorities' representatives. http://www.ropesgray.com/files/Publication/bacd6451-1c43-4223-b53b-3d625f511d8e/Presentation/PublicationAttachment/3c2487b3-4a52-4076-9286-3f574e7c565d/Regulatory%20Cooperation.pdf
[58] The IOSCO treats such non-public information in a similar manner as most jurisdictions would; if a public authority has a right to demand the information, non-public documents will become public.
[59] http://www.osc.gov.on.ca/documents/en/Securities/mou_20021101-exchange-info.pdf
[60]http://www.iaisweb.org/__temp/7_April_2009__IAIS_supports_G20_Declaration.pdf
[61] Brummer, op. cit. page 304-314 describes the "soft law" "hard law" dichotomy and the author's contention that a global financial regulator is impractical.

# USING "THE INSIDER" TO TEACH LEGAL AN ETHICAL TOPICS IN A LEGAL ENVIRONMENT OF BUSINESS OF EMPLOYMENT LAW CLASS

by

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ABSTRACT

As today's college students are a visually oriented group it is helpful to elucidate legal and ethical concepts introduced in a business law class by using movies with popular actors based on actual events. "The Insider" is such a film.

## INTRODUCTION

In instructing students about legal and ethical concepts present in a business law course it can be helpful to use popular media to help illustrate such issues.

One such film is "The Insider"[1] starring Russell Crowe (Gladiator) and Al Pacino (The Godfather I, II and III). The movie deals with a complex case involving the tobacco industry but can be used to focus on many legal issues such as the rights of whistle blowers, freedom of the press and the First Amendment, Congressional hearings and products liability. An instructor can use the movie in a variety of ways. First, it can be used to illustrate employment issues and the instructor can examine the employment relationship from the perspective of both the employer and the employee. Second, the movie can be used throughout the semester as the underlying thread of the course because the movie deals with many issues of crucial importance to the business student especially the challenges faced by a company who manufactures and markets an increasingly unpopular and unhealthy product.

## THE OUTLINE OF THE STORY

Jeffrey Wigand was employed as a scientist with Brown Williamson Tobacco Company. Among Wigand's assignments was to experiment with developing a safer cigarette. Wigand was extremely well-paid for his services earning more than $300,000 per year.

The 1999 Touchstone Picture opens with scenes not relevant to Wigand's plight but with the experiences of Lowell Bergman (played by Pacino) in Beirut. The opening establishes Bergman's bona fides as an investigative reporter willing to go to great lengths to pursue a story for Sixty Minutes, the CBS investigative icon. Bergman is the producer for Mike Wallace and he is in Lebanon to pave the way for a future Mike Wallace interview with an elusive leader of Hezbollah.

The movie then moves to the crux of the story. Jeffrey Wigand is shown leaving his office and driving to his home in an upscale neighborhood, where he is greeted by his wife and two daughters.

Once Wigand breaks the news that he has been fired by Thomas Sandifur, CEO of Brown and Williamson, his wife asks about their financial situation, health coverage and car payments. Not reassuringly, Wigand tells her that the severance package includes medical coverage. His wife always seems to be the last to know. She is taken aback when eventually Wigand decides to do the Wallace interview. Subsequently she leaves and later files for divorce.

The next scene returns to Mike Wallace’s interview with the sheik arranged by Bergman which establishes Wallace as a blustery, aggressive interviewer who is unwilling to back down and who begins his interrogation by asking “Are you a terrorist?”

Bergman and Wigand eventually connect when Bergman seeks Wigand’s assistance in deciphering some documents from Philip Morris on a story Bergman is planning on fire safety. Wigand and Bergman meet at a hotel in Louisville, Kentucky where Bergman tells Wigand, “I still do the tough stories. Sixty Minutes reaches a lot of people.”

Wigand tells Bergman that he can help with the fire safety material but that he signed a confidentiality agreement with Brown and Williamson, where he was a corporate vice president and head of Research and Development.

Later Wigand is summoned to a meeting with Sandifur in which the latter seeks an amendment to the confidentiality agreement. Wigand is told that if he does not sign, his benefits under the original agreement will be terminated and the company will sue him.

Wigand accuses Bergman of violating his agreement to not disclose their conversation since Sandifer’s demand occurred soon after Wigand’s meeting with Bergman.

Bergman and Wigand meet again and talk outside the zone of the confidentiality agreement. Wigand tells Bergman that he has worked for Johnson and Johnson, Pfizer and Union Carbide in Japan. Bergman tells Wigand that only he can decide whether to honor the confidentiality agreement or break it and tell the public what it needs to know.

When the Sixty Minutes staffers discuss the possibility of airing the story, the CBS lawyers inform the producers that Big Tobacco spends $600 million on outside law firms and they win every case.

Bergman suggests that they approach the problem from another direction. If Wigand were compelled to testify in court, would the company be unable to enforce the confidentiality contract?

Wigand and his family experience considerable upheaval. They endure prowlers on the property who destroy plants in the garden and anonymous telephone and computer threats to the family, and a bullet in the mailbox. Eventually they are forced to sell their house.

Wigand is relegated to teaching Japanese and Chemistry at a high school.

Bergman tells Wigand that if he decides to appear on Sixty Minutes Bergman has to know why he was fired and that once 30 million people hear his story nothing will be the same. Wigand remains skeptical about Bergman's motives but the latter assures Wigand that his word is good and that he protects his sources.

Bergman contacts Richard Scruggs who has filed a lawsuit against tobacco on behalf of Mississippi seeking reimbursement for Medicaid expenditures for medical treatment related to cigarettes. Bergman believes that if Wigand's information first appears in court testimony, it would provide some cover against the expected onslaught by Brown and Williamson.

When Wigand is interviewed by Wallace he reveals that cigarettes are a delivery device for nicotine that there is "impact boosting" through the use of ammonia. Wigand discusses the use of Coumarin which was a cancer-causing agent. Wigand also revealed that when the CEOs of the "Seven Dwarfs" Big Tobacco testified before Congress they lied when they answered that they believed that nicotine was not addictive.

To combat Wigand's testimony, Brown and Williamson serve Wigand with a gag order issued in Kentucky. Even though the order is thrown out in Mississippi, Scruggs and

Michael Moore, Mississippi's Attorney General, warn Wigand that if he returns to Kentucky he could be arrested. At this point the instructor might stop the film and ask students what they would advise Wigand to do. Is it worth risking arrest and putting his family in further jeopardy? What would the students do if they found themselves in his position?

Wigand testifies at a deposition but is interrupted by tobacco attorneys who remind him that he signed a confidentiality agreement and that a TRO has been issued by Kentucky, Wigand proceeds with his testimony.

SIXTY MINUTES BACKS DOWN

An attorney for CBS warns the Sixty Minutes team about a possible claim for tortious interference, citing the maximum "the greater the truth the greater the damage." The lawyer says that the information belongs to Brown and Williamson and if the company sues CBS, it could wind up owning the network.

The CBS President urges that the segment be re-cut to eliminate the Wigand interview. Bergman reminds Mike Wallace and Don Hewitt that CBS is about to be sold to Westinghouse and the sale may be affected.

When Don Hewitt and Mike Wallace ally against Bergman and agree that Wigand's interview should not air, Bergman then has the unpleasant task of telling Wigand that his interview will not be broadcast.

Brown and Williamson mount an all out offensive against Wigand compiling a 500 page report about his past foibles that even the Wall Street Journal does not find credible. The strategy is to destroy Wigand's credibility despite his protestation that he is telling the truth.

When the edited version airs Bergman tells Wallace "it was a disgrace".

Wigand accuses Bergman of "manipulating" him as he is on the edge of desperation.

Bergman then becomes a "whistleblower" himself, notifying the New York Times that CBS corporate told CBS News not to air a story. The Times prints the account and the editorial page opines that CBS had betrayed the legacy of Edward R. Murrow.

When Wallace and Bergman talk about the fate of the story Wallace says that he does not want his legacy to be allowing a tobacco giant to "crash" CBS. Later Wallace admits "we caved" and it was "dead wrong." Eventually, CBS does air the Wigand interview.[2] Students can debate how much influence the corporate side of broadcast networks has on what is aired in the national media. Is the press really free or does the First Amendment fall prey to corporate concerns? What other stories might have been suppressed?

## CONCLUSION

Having viewed "The Insider" the students should be asked: Is the price the whistleblower has to pay personally and financially worth it? Had Wigand kept quiet, he would have been able to keep his severance and health benefits as well as his family. Should the spouse and children of the whistleblower have to endure the pressure, opprobrium, and financial consequences of the whistleblower's decision?

What did the public gain because of Wigand's interview? Students can research the outcome of tobacco litigation referred to in the film that led to many states getting money from Big Tobacco. To what use has the money been put?

Despite the litigation and Wigand's testimony and interview, what has changed? Nearly twenty percent of the population still smokes and how many people have even heard of Wigand? Even though it is an unpopular and unhealthy product, smokers willingly pay a premium for it. A pack of cigarettes costs more than five dollars in most states today. Rates of cigarette consumptions are even higher abroad.

Another issue for students to examine is that of corporate confidentiality agreements. Can such contracts be lawful if the company requires an employee to conceal information about a product that is harmful to the public? Are such agreements contrary to public policy and therefore unconscionable?

A third issue for students to consider is whether the press should be legally exempt from lawsuits like tortious interference when the press is serving the public good by reporting information? Students should carefully review the scenes in the movie in which CBS lawyers meet with the Sixty Minutes team to discuss these concerns. The sale of CBS to Westinghouse also raises the issue of whether the media should be owned by corporations or should the networks be owned by the public since they are regulated by the Federal Communications Commission. Newspapers can be privately owned because they are not regulated by a government agency.

Another issue related in passing in the movie is the testimony of the tobacco CEOs before Congress in which they claimed that nicotine was not addictive even though they knew that was not true.[3] If former baseball pitcher Roger Clemens can be prosecuted for falsely testifying before a Congressional Committee about his steroid use, why were charges not pursued against tobacco officials for misleading both Congress and the public about a dangerous product?[4]

Clemens harmed only himself and his baseball competitors in using steroids while tobacco has brought ill-health and death to millions.

Finally, students might ponder the ethics of allowing a dangerous product to be sold at all. If cigarettes have such deleterious effects why should they not be banned as a matter of public health policy like other addictive drugs.

Students can debate not only the business impact of such a decision but the effect on public health in an era in which healthy lifestyles are being encouraged.

“The Insider” is filled with many issues that students can discuss in the context of a business law, legal environment, or employment law class.

## NOTES

[1] “The Insider” was released in 1999 by Touchstone Pictures.
[2] If students want to view the interview Mike Wallace did with Jeffrey Wigand, see a History Channel program “20th Century with Mike Wallace: The Perils of Whistleblowing”, narrated by Mike Wallace who omits any discussion of his and Don Hewitt’s CBS’s craven behavior in suppressing the interview with Wigand.
[3] See, Frontline: Tobacco on Trial (1986) for a report on tobacco CEO’s testimony before Congress and role of Food and Drug Administration.

[4] Bob Hohler, "Clemens Indicted for Drug Denials, Ex-Sox Star Faces 6 Counts over Testimony to Congress", Boston Globe, Aug 20, 2010 at A1 and A6.