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Securities, Scienter & Schizophrenia: Should the Efficacy of Compliance Initiatives within Multi-Service Investment Firms Be Used to Determine Scienter for 10b-5 Violations Under Federal Securities Law?

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I. Introduction 383
II. Brief Overview of the Federal Securities Laws 386
III. The Evolution of Compliance from Voluntary Process to Legal Requirement 391
IV. Compliance as a Source of "Organizational Scienter 398
V. Assessing Organizational Scienter 400
VI. Conclusion 404

I. Introduction

Over the past few years, in reaction to widespread corporate malfeasance, compliance initiatives within large corporations have received significant attention. Private corporations, public regulatory and enforcement agencies, and Congress, all recognize that compliance plays a critical role in today's highly complex business environment.[1] Nearly all of the nation's public companies maintain compliance programs that formulate corporate rules and policies in response to industry regulations and applicable laws.[2] Recently, Congress passed the

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1. *See, e.g.*, Memorandum from Deputy Attorney General Larry Thompson, to the Heads of Department Components and United States Attorneys (Jan. 20, 2003), *available at* http://www.usdoj.gov/dag/cftf/corporate_ guidelines.htm. In this January 2003 policy memorandum, federal prosecutors are urged to review several factors before indicting a corporation. These elements include (1) the nature and seriousness of the behavior; (2) the pervasiveness of corporate wrongdoing; (3) the corporation's history of similar conduct and prior enforcement actions against it; (4) the voluntary disclosure of wrongdoing; (5) *the existence and adequacy of a corporate compliance program*; (6) remedial actions; (7) the collateral consequences of a conviction; and (8) the sufficiency of civil remedies for the corporation's conduct. *Id.*

2. *Id.*

Sarbanes-Oxley Act of 2002 due, in part, to a need for more responsible corporate governance.[3] The Act, though covering a wide spectrum of governance issues, significantly increases the importance of compliance programs and directly implicates the efficacy of compliance initiatives as determinative of corporate accountability.[4] The new body of law guiding corporate compliance is bound to have a profound effect on the behavior of large complex organizations.

The modern corporation seeks to optimize future performance by assessing how well it interacts with its environment (e.g. customers, competitors, and regulators).[5] As organizational behaviorist Jay Galbraith states, sophisticated "organizations typically find ways of controlling outputs (e.g. by setting goals and targets) and controlling behavior (e.g. through rules and programs) by relying on continuous feedback."[6] The ability to process external information and adjust behavior to meet corporate objectives, has led many scholars to view the corporation as an organic-like being with a "centralized brain that regulates overall activity."[7] In this regard, sophisticated corporations exhibit complex decision-making processes akin to those found in humans.[8] While organizational behaviorists have readily accepted that sophisticated corporations are entities engaged in rational-based decision-making and, as such, readily exhibit identifiable behavior, to this day the law has not fully embraced this concept.[9]

Unlike the philosophical underpinnings that have helped shape our notions of applying fault-based law to "natural" persons, the theoretical basis of corporate fault relies heavily on the doctrine of imputed liability,

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3. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (2002).

4. *Id.* at § 501.

5. *See* KARL E. WEICK, SENSEMAKING IN ORGANIZATIONS 121-122 (1991). ("[Organizations] filter and interpret signals from the environment and tie stimuli to responses. They are metalevel systems that supervise the identification of stimuli and the assembling of responses." (quoting B. Hedberg, *How Organizations Learn and Unlearn*, *in* HANDBOOK OF ORGANIZATIONAL DESIGN, 7-8 (P.C. Nystome & W.H. Starbuck ed. vol. 1))).

6. GARETH MORGAN, IMAGES OF ORGANIZATION 80 (1996).

7. *Id.* at 78.

8. *Id.*

9. *See, e.g.*, Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424 (9th Cir. 1995). In *Nordstom*, the court suggests the legitimacy of finding "corporate scienter" without any of the officers or directors of the corporation having intent under a theory of "collective scienter" but acknowledges that "there is no case law supporting an independent collective scienter theory." *Id.* at 1435.

economic justification, and, to some degree, public policy.[10] It is well-settled law that corporations may be held liable for nearly any tortious or criminal activity of an employee, as long as that employee acted within the scope of employment.[11] Thus, corporate liability is often regarded as derivative in nature.[12] However, there has been very little inquiry on whether a corporation itself, without identifiable human involvement, can be a fault-bearing decision-making entity. The threshold question addressed by this comment is whether an organization can exhibit "fault" sufficient to meet requisite elements of scienter for certain violative behavior. The thesis of this paper is that legally significant information regarding "organizational scienter" can be gleaned, not only from the traditional method of imputed behavior from officers, directors, and employees, but also "organizationally," from the internal rules and procedures a corporation uses to interact with its environment. Modern complex organizations have simply become too complicated – too impersonal – not to reevaluate how courts, the legislature, and the law in general view organizational behavior in relation to statutorily-required scienter elements.

At first glance, assigning a traditional scienter element (e.g. negligence, recklessness, knowingly or intentionally) to a corporation in the absence of human decision-making, seems antithetical to the precepts and legal assumptions of fault-based law. Traditionally, fault-based law assumes some rational decision-making process by a natural person and an irrational or unreasonable course of conduct before the apportionment of fault.[13] But large corporations present a special problem in terms of applying traditional fault-based statutes based on derivative liability. By virtue of the inherent anonymity and insulation employees enjoy within highly impersonal organizations, an individual's contribution to injurious corporate behavior is often too tenuous to meet evidentiary burdens of fault-based statutes.[14] Only recently, legal reformers began offering more

10. JOHN L. DIAMOND ET AL., UNDERSTANDING TORTS 231-32 (2002).

11. *Id.* at 231; *see also* N.Y. Central & Hudson River R.R. v. United States, 212 U.S. 481 (1908) (extending the doctrine of respondeat superior, generally reserved for tort liability, to criminal liability).

12. *See generally* RESTATEMENT OF TORTS §§ 420-429.

13. *See generally* UNDERSTANDING TORTS, *supra* note 10, at 67-77.

14. *See generally* RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 16 (1998). The Restatement addresses the situation in which the plaintiff establishes increased harm because of a product defect, but proof does not permit determining its magnitude. *Id.* The Products Liability Restatement imposes liability on the product manufacturer for the entirety of the harm. *Id.* Thus, the Products Liability Restatement does not require the plaintiff to prove the magnitude of harm caused by each tortfeasor

progressive "alternative" theories of liability, akin to those within the "organizational behaviorist" domain.[15] These theories consider the organizational mechanisms that lead corporations to cause harm without help from a significant or identifiable concentration of human involvement.

This paper examines the extent to which corporate "rules and policies" serve as a viable source of judicial scrutiny from which to examine an alternative theory of liability. Specifically, the paper explores the rapidly evolving regulatory environment of the securities industry, and proposes that a corporation's set of compliance initiatives is a viable area to determine "organizational" scienter. Evidence that a firm's compliance initiatives are substantially inconsistent with industry standards should meet the statutory requirements of pleading scienter under federal securities law.

Part II of this paper will review the federal securities laws and the specific problems the various circuit courts encounter in defining the requisite level of scienter in pleadings. Part III will examine the legal effect given to the main compliance device – "Chinese Walls" – and the changing role they play in the new regulatory environment. Part IV looks at case law suggesting that organizational scienter is already being gleaned from various internal corporate procedures. Finally, Part V puts forth a similar analysis advocated in products liability law, wherein compliance policies are adjudicated based on a comparative approach which views a specific compliance department's function in relation to the industry rules and compliance policies of other firms.

II. Brief Overview of the Federal Securities Laws

In the aftermath of the stock market crash of 1929, Congress enacted the Securities Act of 1933, and the Securities Exchange Act of 1934.[16] These Acts were aimed at preventing dishonest trading schemes while restoring public confidence in the capital markets.[17] Congress

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and imposes the burden of proof on the party seeking to limit its liability on the ground that it caused less than all of the plaintiff's harm. *Id.*

15. *Id.*

16. *See generally* Securities Exchange Act of 1934, 15 U.S.C. § 78 (2003); Securities Exchange Act of 1933, 15 U.S.C. § 77a (2003).

17. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 n.7 (1963) (citing William O. Douglas and George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L. J. 171 (1933); Phillip A. Loomis, *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214 (1959); Harry Shulman,

enacted this legislation in order to "substitute a philosophy of full disclosure for the philosophy of caveat emptor and to achieve a high standard of business ethics in the securities industry." [18] The Securities Act of 1933 protects the public during an initial public offering of a company's stock by requiring that all material information be communicated to the public via a written prospectus.[19] Information is "considered material if 'there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information available.'"[20] The Securities Exchange Act of 1934 extends these protections to securities already issued and imposes additional disclosure requirements in connection with tender offers and proxy solicitations.[21] Both acts contain provisions making it illegal for any person, or corporation, to disclose misleading information to the public.[22]

Private civil actions, as well as regulatory enforcement actions, are

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Civil Liability and the Securities Act, 43 YALE L.J. 227 (1933); *cf.* JOHN K. GALBRAITH, THE GREAT CRASH (1955)).

18. *Id.* at 186 (citing H.R. Rep. No. 85, 73d Cong., 1st Sess.).

19. *See generally* Securities Act of 1933, 15 U.S.C. § 77 (2003).

20. *See* SEC v. First Jersey Securities, Inc., 101 F.3d 1450, 1466 (2d Cir. 1996) (quoting *In re* Time Warner Inc. Sec. Litig., 9 F.3d 259, 267-68 (2d Cir. 1993) (internal citations omitted)).

21. *See generally* Securities Exchange Act of 1934, 15 U.S.C. § 78.

22. *See* Securities Act of 1933, § 12, 15 U.S.C. § 77:

> Any person who (1) offers or sells a security in violation of section 5 [15 U.S.C.S. § 77e], or (2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements in the light of the circumstances under which they were made, not misleading and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable, subject to subsection (b), to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

See also Securities Exchange Act of 1934, §10(b), 15 U.S.C. § 77j:

> It shall be unlawful for any person, directly or indirectly, by use the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security no so registered, . . .any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. . .

brought under Rule 10b-5 promulgated by the Securities and Exchange Commission.[23] In order to prevail in a civil securities action, a plaintiff must establish (1) a misrepresentation or omission of a material fact in connection with the purchase or sale of a security; (2) *scienter on the part of the defendant*; (3) reliance on the misrepresentation; and (4) damage resulting from the misrepresentation.[24] Along with the Rule's statutory elements, the Supreme Court has interpreted 10b-5 violations to require proof that a defendant possessed a "*mental state* embracing intent to deceive, manipulate or defraud."[25] Although the Supreme Court has never clearly defined the requisite level of scienter,[26] nearly all the federal circuit courts agree that recklessness constitutes scienter for a 10b-5 violation.[27] However, the courts are in substantial disagreement in terms of the specificity by which a plaintiff must allege the existence of scienter in order to properly plead a securities fraud case.

In 1995, Congress passed the Private Securities Litigation Reform Act (PSLRA) in an effort to prevent frivolous lawsuits between investors/shareholders and public corporations.[28] The Act heightens the burden of class action suits and provides the courts with methods to define class participants, the length of the class period, and the selection of class representatives.[29] The Act also provides the defendant corporations with limited liability for damages.[30] Although the Act does not change the substantive elements of a securities violation, it is generally accepted that the Act substantially heightened the pleading

23. *See* Securities Exchange Act, §10(b) 15 U.S.C. § 78q. This rule provides:

> it is unlawful for any person to (1) employ any device, scheme or artifice to defraud; (2) make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or; (3) engage in any act, practice, *or course of business which operates or would operate as a fraud or deceit upon any person*, in connection with the purchase or sale of any security. (emphasis added).

24. *See In re* Phillips Petroleum Sec. Litig., 881 F.2d 1236, 1244 (3d Cir. 1989) (emphasis added).

25. *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976) (emphasis added).

26. *Id.*

27. *See infra* notes 31-35.

28. Private Sec. Litig. Reform Act of 1995, 15 U.S.C. § 78u-4(b)(2) (1998) [herinafter PSLRA]; *see also In re* Comshare, Inc. Sec. Litig., 183 F.3d 542, 548 (6th Cir. 1999).

29. David S. DeBerry and Steven L. White, *Significant Developments Since Passage of Securities Reform Legislation*, 14 THE JOHN LINER REV. 1, 1-2 (Summer 2000), *available at* www.hfpinsurance.com/articles/JLRV14n2.pdf.

30. *Id.* at 7-8.

requirements to survive a motion to dismiss, which was previously guided by Rule 9(b) of the Federal Rules of Civil Procedure.[31] Under the PSLRA, a plaintiff:

> may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title [et seq.], *state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.*[32]

Not surprisingly, since the enactment of the PSLRA, the circuits have widely disagreed on the requisite standard of pleading. By far, the least burdensome interpretation of pleading requirements comes from the Second and Third Circuits. In these circuits, plaintiffs may plead scienter by alleging facts that give rise to a strong inference that defendant had a *motive and an opportunity to commit fraud*, or by setting forth facts that constitute circumstantial evidence of either reckless or conscious behavior.[33] By contrast, in the Sixth Circuit, a plaintiff must allege facts that give rise to a *strong inference of reckless behavior,* but not by alleging facts that illustrate nothing more than a "defendant's motive and opportunity to commit fraud."[34] The Sixth Circuit stated that recklessness is "understood as a mental state apart from negligence and akin to conscious disregard."[35] The Eleventh Circuit similarly held that plaintiffs must allege facts that give rise to a strong inference of *severe recklessness*, requiring something more than "*ordinary recklessness.*"[36] Perhaps the most restrictive interpretation is found in the Ninth Circuit, which requires a plaintiff to plead, "in great detail,"[37] "particular facts giving rise to *a strong inference of deliberate or conscious*

31. *See In re* Baesa Sec. Litig., 969 F. Supp. 238, 242 (S.D.N.Y. 1997)

> If the Reform Act, then, does nothing to disturb the substantive law of what is the required mental state for a securities fraud violation, it does expressly address, and alter, what is required to plead the requisite scienter. Specifically, the above-quoted provision of the Reform Act requires a plaintiff to "state with particularity facts giving rise to a strong inference that the defendant acted with the requisite state of mind."

Id.

32. 15 U.S.C. § 78u-4(b)(2) (emphasis added).

33. *See In re* Advanta Corp., Sec. Litig., 180 F.3d 525 (3d Cir. 1999); *see also* Press v. Chem. Inv. Servs. Corp., 166 F.3d 529, 538 (2d Cir. 1999).

34. *See In re* Comshare, Inc., Sec. Litig., 183 F.3d 542, 549 (6th Cir. 1999).

35. *Id.* at 550.

36. *See* Bryant v. Avado Brands, Inc., 187 F.3d 1271, 1284 (11th Cir. 1999).

37. *In re* Silicon Graphics, Inc., Sec. Litig., 183 F.3d 970, 983 (9th Cir. 1999).

recklessness."[38]

While the circuit courts have spent considerable effort in an attempt to define the requisite manifestation of scienter, the courts have seldom examined the far more progressive question of whether a corporation itself, in contrast to the corporation by virtue of vicarious liability, can satisfy the requirement of scienter. The PSLRA requires that actions claiming a securities violation be pled with specificity that a "defendant acted with the required state of mind" – verbiage that imbues evidence of identifiable human behavior.[39] Accordingly, the circuit court cases have characterized the scienter requirement for a violation and fashioned much of the debate in particularly "human" terms (i.e. recklessness that requires "motive," "conscious recklessness," etc.).[40] But relying too heavily on a literal interpretation of the phrase "required state of mind" ignores the reality that large impersonal organizations can systematically commit violations and renders the corporation, as a solitary entity, immune from federal security violations. However, in at least one civil action brought by plantiffs under the PLRSA, a district court in Massachusetts examined the concept that a corporation, without an identifiable human nexus, could meet the requisite state of mind under federal securities law.[41] In *In re Centennial*, Judge Robert Keeton stated:

It does not follow from this point, however, or from the phrase "required state of mind," that no legal entity other than a natural person can be held accountable because the entity is a creature of the law and literally cannot have a mind or state of mind.[42]

The concept of organizational accountability, knowledge, and scienter, in the absence of a "natural person" is not utilized within the ambit of federal securities case history.[43] Dicta, such as that expressed by Judge Keeton in *In re Centennial*, is not common.[44] While the courts have spent considerable efforts defining (and disagreeing upon) what *is* reckless – few, if any, courts have ventured into the progressive area of what *can* be reckless. However, a survey of cases currently in the pleading stage, suggests that courts are likely to turn attention to this

38. *Id.* at 979. (emphasis added).

39. PSLRA, *supra* note 28.

40. *Supra*, notes 33-37.

41. *See In re* Centennial Techs. Litig., 20 F. Supp. 2d 119, 126 (D. Mass. 1998).

42. *Id.*

43. There does not seem to be a single published case where an organization is deemed to have met the scienter requirement without the use of vicarious liability for an employees wrongful actions.

44. *In re* Centennial, 20 F. Supp. 2d 119.

issue.

Unlike many securities cases that often implicate readily identifiable persons within corporations of wrongful accounting statements, or fraudulent underwriting practices, recent pleadings concentrate heavily on wrongful corporate rules and policies, undisclosed business processes, and faulty or non-existent compliance systems – situations particularly unique to large multi-service investment firms.[45] A survey of pleadings filed over the past year indicates a shift from pleading wrongful behavior by individuals to a more sophisticated strategy of pleading illegal business practices and wrongful corporate policies.[46] These pleadings rely on voluminous data regarding illegal tie-in agreements, collusive research agreements, and irregularities within the business structure of initial public offerings.[47] While pleadings still attempt to provide courts with as much information and evidence regarding an individual's culpable violation of securities laws, many of the organizational practices, implicated as violative of federal securities laws in these pleadings, are simply too widespread throughout organizations and the industry to identify individual culpable actors. With alleged harm the result of unidentifiable collective human behavior, recent plaintiffs are drawing attention to inadequate compliance initiatives in an effort to meet statutory requirements of scienter.[48] Compliance initiatives have already been the subject of intense scrutiny and provide the path for a sensible judicial inquiry.

III. The Evolution of Compliance from Voluntary Process to Legal Requirement

During the recent investigation by New York Attorney General Eliot Spitzer and the ensuing *global settlement,* corporate compliance policies and procedures became the focus of intense public scrutiny.[49]

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45. Unlike the securities cases of the eighties and nineties, often centering on fraudulent accounting or underwriting practices, generally with identifiable characters, today's pleadings indict far less overt schemes to defraud and suggest far more systemic problems of business practices and a lack of rules and policies. *See, e.g.*, *In re* Initial Pub. Offering Sec. Litig., 21 MC 92 (SAS) (S.D.N.Y. 2003), *available at* http://www.sec.gov/litigation/briefs/ipo-antitrust.htm.

46. *Id.*

47. *Id.*

48. *Id.*

49. Adrian Michaels, *Companies The Americas: Security Chief Favours Simpler Conflict Of Interest Rules,* Financial Times (London), July 24, 2003, at 24, *available at* http://securities.stanford.edu/news-archive/2003/20030724_Headline07_Michaels.htm.

The gravamen of the complaint that led to the settlement is that research analysts employed at these firms issued "buy" recommendations on stocks without disclosing conflicts of interest to their brokerage clients.[50] The complaint suggests, that because compensation of analysts was tied to the amount of underwriting business that was generated, and favorable stock recommendations resulted in increased underwriting, analysts misinformed retail clients in order to boost underwriting revenue.[51] In not revealing this conflict of interest to their customers, the analysts and their firms violated nondisclosure provisions of New York's Martin Act, the Securities Act of 1933, and the Securities Exchange Act of 1934.[52] The investigation also provided a bevy of information regarding evidence of tie-in agreements, collusive research arrangements, and inflated commission structures. Although the investigation identified seriously egregious conduct by individuals, the investigation strongly implicated that the policies and procedures adopted by the corporations were themselves recklessly constructed to allow for securities violations.[53] In a sense, the policies and procedures were deemed structurally inadequate to prevent a corporation from committing securities violations. Thus, in addition to the payment of fines, the global settlement *required substantial changes in operational practices*.[54] The following is a list of the organizational changes agreed to in the global settlement:

The firms will physically separate their research and investment banking departments to prevent the flow of information between the two groups.

The firms' senior management will determine the research department's budget without input from investment banking and without regard to specific revenues derived from investment banking.

Research analysts' compensation may not be based, directly or indirectly, on investment banking revenues or input from investment banking personnel, and investment bankers will have no role in evaluating analysts' job performance.

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50. Gretchen Morgenson, *Merrill Agrees to Broaden Its Disclosure on Its Research*, N.Y. TIMES, April 19, 2002, at C2.

51. *Id.*

52. *Id.*

53. *Id.*

54. *Global Settlement: Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs*, 108th Cong. (2003), *available at* http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=28.

Research management will make all company-specific decisions to terminate coverage, and investment bankers will have no role in company-specific coverage decisions.

Research analysts will be prohibited from participating in efforts to solicit investment banking business, including pitches and roadshows. During the offering period for an investment banking transaction, research analysts may not participate in roadshows or other efforts to market the transaction.

The firms will create and enforce firewalls restricting interaction between investment banking and research except in specifically designated circumstances.

A complete ban on the spinning of Initial Public Offerings (IPOs). Brokerage firms will not allocate lucrative IPO shares to corporate executives and directors who are in the position to greatly influence investment banking decisions.

An obligation to furnish independent research. For a five-year period, each of the brokerage firms will be required to contract with no less than three independent research firms that will provide research to the brokerage firm's customers. An independent consultant ("monitor") for each firm, with final authority to procure independent research from independent providers, will be approved by regulators. This will ensure that individual investors get access to objective investment advice.[55]

Shortly after the global settlement, Congress passed the Sarbanes-Oxley Act of 2002. In response to an unparalleled loss of integrity in corporate governance and an unprecedented loss of shareholder wealth, the Act was created to enhance the enforcement of the federal securities laws and bring investor confidence back to the capital markets.[56] The Act includes legislation that specifically addresses the issue of compliance policies and procedures, and places compliance at the forefront of corporate accountability within multi-service investment firms.[57] Under section 501 of the Act, federal law now mandates that multi-service investment firms establish compliance procedures that safeguard the public from internal conflicts of interest.[58] Specifically, the

55. *Id.* at 7-8.

56. *The Implementation of the Sarbanes Oxley Act of 2002: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 108th Cong. (2003) (testimony of Williams H. Donaldson, Chairman, Sec. and Exch. Comm'n), *available at* http://www.sec.gov/news/testimony/090903tswhd.htm.

57. *See* Sarbanes-Oxley, *supra* note 3, at § 501(a).

58. *Id.* Sarbanes-Oxley reads as follows:

Act requires:

> structural and institutional safeguards within registered brokers or dealers to assure that securities analysts are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision.[59]

In accord with this directive, both the National Association of Securities Dealers ("NASD") and the New York Stock Exchange ("NYSE") have created rules to compel multi-service investment firms to implement stringent compliance safeguards.[60] Both the NASD and the NYSE now require active monitoring of information between various segments of multi-service firms and place compliance initiatives as the optimal way for an organization to avoid liability under Sarbanes-Oxley.[61]

Safeguards within multi-service investment firms are not new. For nearly thirty years, "informational partitions" or "Chinese Walls" were self-imposed by multi-service investment firms as a way to minimize the

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> (a) Analyst Protections - The Commission, or upon the authorization and direction of the Commission, a registered securities association or national securities exchange, shall have adopted, not later than 1 year after the date of enactment of this section, rules reasonably designed to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances, in order to improve the objectivity of research and provide investors with more useful and reliable information, including rules designed to foster greater public confidence in securities research, and to protect the objectivity and independence of securities analysts.

Id.

59. *See* Sarbanes-Oxley, *supra* note 3, at § 501(a)(c)(3).

60. *See* NASD Rule 2711 (b)(3):(A)(2003):

> Any written communication between non-research personnel and research department personnel concerning the content of a research report must be made either through authorized legal or compliance personnel of the member or in a transmission copied to such personnel; and (B) any oral communication between non-research personnel and research department personnel concerning the content of a research report must be documented and made either through authorized legal or compliance personnel acting as intermediary or in a conversation conducted in the presence of such personnel.

Id.; see also NYSE Rule 472(b)(1)(2)(ii)-(3), which prohibits research personnel from being subject to the supervision of any employees of an Investment Banking Department, and "will further *require legal or compliance personnel to intermediate certain communications* between the Research Department and either the Investment Banking Department or the company that is the subject of a research report by the Research Dept." NYSE Rule 472(b)(1)(2)(ii)-(3), *available at* http://www.nyse.com/pdfs/2002-09Am1-AmendedExhA.pdf.

61. *Id.*

inherent conflicts that exist within their firms and avoid a finding of scienter.[62] The basic notion of Chinese Walls was that if the firm prevented employees from exploiting non-public information by keeping conflicting segments of the firm separate, the firm could not be found to meet the scienter requisite of a 10b-5 violation.[63] However, prior to the Sarbanes-Oxley Act and the new regulatory rules, the courts were reluctant to give legal effect to Chinese Wall procedures.[64]

In *Nelsen v. Craig-Hallum, Inc.*, the Federal District Court in Minnesota refused to dismiss a claim brought by plaintiff under SEC Rule 10b-5 solely on the existence of a Chinese Wall.[65] In *Craig-Hallum, Inc.*, the defendant allegedly issued misleading statements and recommendations in numerous research reports regarding one of its investment banking clients.[66] Craig-Hallum argued that the presence of a Chinese Wall meant, as a matter of law, that there could be no material misrepresentation under federal securities laws.[67] The company argued that while the investment banking department had adverse information regarding a company, it did not pass this information along to its brokerage department.[68] The court stated that whatever information *was* passed between and throughout the firm "create[d] fact issues of misrepresentation, materiality and scienter appropriately left to the jury."[69] The court further added that *Craig-Hallum* "has not provided legal authority for this court to adopt its position that brokerage firms who perform both investment banking and securities sales functions can rely on an unwritten 'Chinese Wall' policy as demonstrating lack of knowledge and scienter in an action under Rule 10b-5."[70] In *Craig-Hallum,* the court clearly indicates that the validity or efficacy of Chinese Wall procedures was a matter for a jury and that the corporation could be

62. TWENTIETH CENTURY FUND STEERING COMMITTEE ON CONFLICTS OF INTEREST IN THE SECURITIES MARKETS, ABUSE ON WALL STREET: CONFLICTS OF INTEREST IN THE SECURITIES MARKETS 405 (1980).

63. *Id.*

64. *See* Harvey L. Pitt & Karl A. Goskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. 1559, 1589-92 (1990).

65. *See* Nelsen v. Craig-Hallum, Inc., 659 F. Supp. 480 (D. Minn. 1987).

66. Nelsen v. Craig-Hallum, Inc., 1989 WL 91131, Fed. Sec. L. Rep. P 94,500, at 2 (D. Minn. Jun. 26, 1989).

67. *Nelsen*, 659 F. Supp at 485.

68. *Id.*

69. *Nelsen*, 1989 WL 91131, Fed. Sec. L. Rep. P 94,500, at 2.

70. *Id.* at 2.

evaluated for its commitment to federal securities laws.[71] This case settled out of court[72] and there does not appear to be a single published case where a jury has evaluated Chinese Wall procedures.

In the 1980's, in part due to the multitude of well-known insider trading scandals, regulators saw the need to provide liability protection for firms that operated to prevent the misuse of nonpublic material information.[73] As a result, the SEC began to promulgate rules that allowed different departments within a multi-service investment firm to operate, without triggering a securities violation if the firm could implement compliance measures that would ensure separation of information in tender offers.[74] Hence, for the first time, the SEC codified that a Chinese Wall procedure could reduce liability when the organization operates properly.[75] SEC Rule 14e-3(b) provides:

> that certain transactions by multi-service financial institutions under certain circumstances which would otherwise be proscribed will not violate Rule 14e-3(a). This exception is available for purchases or sales by multi-service institutions where the institution can show that the individuals making the investment decision did not know the information and that the institution has established policies and procedures, *reasonable under the circumstances, to ensure that individual decision maker(s) would not violate Rule 14e-3(a).*[76]

Hence, Chinese Walls were given a modicum of legal effect. Shortly thereafter, Congress passed the Insider Trading Sanctions Act, confirming the validity of the Commission's approach to these conflicts questions.[77] Legislative records indicate that Congress believed that adequate compliance initiatives should provide the corporation with some measure of protection.

> The [House] Committee believes that there should be certain limits on the liability of a multiservice firm, such as a broker-dealer or insurance company, where one employee possesses information but another employee, not knowing of the information, trades for the firm's account before the information is made public. Under both existing law

71. *Id.*

72. Nelsen v. Craig-Hallum, Inc., No. 4:86-cv-00135-DSD (order approving final distribution of settlement) (May 31, 1990).

73. *See* Pitt & Goskaufmanis, *supra* note 64.

74. *Id.*

75. *Id*.at 1618.

76. SEC Rule, 17 C.F.R. § 240.14e-3 (2003).

77. Pitt & Goskaufmanis, *supra* note 64 (citing *Insider Trading Sanctions Act of 1984*, H.R. Rep. No. 355, at 11 (1984), *reprinted in* 1984 U.S.C.C.A.N. 2274).

and the bill, such a firm with an effective "Chinese Wall" would not be liable for trades effected on one side of the wall, notwithstanding inside information possessed by firm employees on the other side.[78]

Hence, Chinese Walls represented an organization's commitment to federal securities laws and an ineffective compliance program, in turn, exposed the firm to liability. But compliance initiatives, as reflected by Chinese Wall efficacy, have never been used to signify organizational scienter. To clarify further, while a porous Chinese Wall has provided a means of assigning liability to corporations, an ineffective compliance program has never been viewed as an *ipso facto* substitute for organizational scienter. While Chinese Walls have been an integral part of corporate compliance policies and procedures of investment firms for nearly thirty years, they have had only a limited function - offering companies liability protection. However, since the passage of Sarbanes-Oxley, corporations now have a legal duty to maintain Chinese Wall policies and procedures that were once solely self-imposed.[79] As a result, the legal effectiveness of corporate compliance and the level of conformance to regulatory standards are likely to be subject to increased judicial scrutiny. Notwithstanding these new regulations, the effectiveness of Chinese Walls in preventing the misuse of material non-public information continues to be questionable.[80]

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78. *Id.* (citing *Insider Trading Sanctions Act of 1984*, H.R. Rep. No. 355, at 11)(1984), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2284).

79. *See* Sarbanes-Oxley, *supra* note 3.

80. Press Release, Univ. of Mich. Bus. Sch., "Chinese Walls" Fail to Curb Conflicts of Interest (Feb. 13, 2003) (quoting H. Nejat Seyhum, Professor of Finance at the Univ. of Mich. Bus. Sch.), *available at* http://www.bus.umich.eduNewsRoom/Article Display.asp?news_id=267.

> Our study does not support the logic of the recent deregulation in financial services firms that assumes Chinese walls are effective and appropriate. . . Recent deregulation has moved away from complete separation of various functions under separate corporate ownership and allowed the same firm to engage in multi-service activities provided they are separated by a Chinese wall.
>
> But our evidence shows that these walls do not work effectively and that information flows between departments. Chinese walls need to be reinforced and measures are needed for increased monitoring and increased sanctions for violations.
>
> Overall, our evidence suggests that Chinese walls are not effective. The presence of the securities firms representatives reduces informational asymmetries for the client firms, eliminates the ability of the client-firm insiders to trade profitably, and reduces the bid-ask spread, as well as the volatility of the stock returns in the client firms' stocks.

Id.

IV. Compliance as a Source of Organizational Scienter

Recently, some courts have suggested that "organizational scienter" could theoretically exist in the absence of identifiable human involvement.[81] In *Nordstom, Inc. v. Chubb & Son, Inc.*, the Ninth Circuit examined the concept that a corporation could exhibit a scienter - separate and distinct from individuals within the corporation.[82] In *Nordstrom*, after the retailer settled a derivative securities suit with shareholders resulting from misrepresentations on a prospectus, the retailer's insurance company, Federal, refused to cover that part of damages not specifically flowing from the officer's misrepresentations.[83] Federal claimed that since the policy only indemnified officers it should not be responsible for that part that was solely the fault of the corporation.[84] In essence, it argued that Nordstom, the corporation, had a scienter separate and distinct from the individuals of the organization.[85] The court had determined that the liability of the officers was both a product of their individual actions and, in part, Nordstrom's actions as a corporation, via *respondeat superior*.[86]

Although the court held against Federal, it did so because the corporation was responsible for the officer's misrepresentation via the controlling person doctrine, not because it denied the existence of an organizational scienter.[87] The court added that "[t]heoretically, collective scienter could be a basis for liability."[88] To further its point, the court cites Knepper and Bailey that " [a] corporation's knowledge need not be possessed by a single officer or agent; the cumulative knowledge of all its agents will be imputed to the corporation."[89] However, the court added, "[t]here is no case law supporting an independent 'collective scienter' theory."[90] Lastly, the court offered support for its theoretical musing of organizational scienter, one based on corporate procedure, not

81. *See* WEICK, *supra* note 5.

82. *See* Nordstrom, Inc. v. Chubb & Son, Inc., 54 F.3d 1424 (9th Cir. 1995).

83. *Id.* at 1427.

84. *Id.*

85. *See id.*

86. *Id.*

87. *Nordstrom Inc.*, 54 F.3d at 1427.

88. *Id.* at 1435.

89. *Id.* at 1435 (quoting WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE DIRECTORS AND OFFICERS, § 17.06 (4th ed. 1988 & Supp. 1992)).

90. *Id.*

individual action.[91]

In *In re Warner Communications Securities Litigation*, the court acknowledged that scienter might actually provide a lesser burden on a defendant if it found evidence of procedurally negligent behavior.[92] The court stated:

the requisite degree of scienter is likely to be easier to attribute to Warner than to the individual defendants. As to Warner, plaintiffs arguably need only show either that one or more members of top management knew of material information indicating an earnings decline, but failed to stop the issuance of misleading statements or to correct prior statements that had become misleading, or that Warner management had *recklessly failed to set up a procedure that insured the dissemination of correct information* to the marketplace. In contrast, the scienter of each individual defendant would not be as easily shown. [93] (emphasis added).

The courts in *Nordstom* and *In re Warner* express an intriguing and perhaps prophetic concept that supports the notion of corporate policies and procedures providing evidence of organizational scienter. There is a small group of securities cases where plaintiffs have attempted to use violations of regulatory standards to help plead the requisite scienter under 10b-5 actions.[94] These cases primarily raise the argument that corporate accounting policies that are in violation with Generally Accepted Accounting Principles ("GAAP"), should be sufficient to establish scienter and meet the requisite element of scienter. The threshold question of most of the "GAAP" cases is whether a corporation's violation of standardized recognition of revenue practices is sufficient evidence of scienter. While almost all cases agree that violations alone will not meet the required scienter,[95] the existence of violations is strong enough when taken with almost any other indicia to meet the requisite intent.[96] Such other elements include: the similarity of

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91. *Id.* at 1436.

92. *See In re* Warner Communications Sec. Litig., 618 F. Supp. 735, 752 (S.D.N.Y. 1985).

93. *Id.* at 752.

94. *See, e.g., In re* Ramp Networks, Inc. Sec. Litig., 201 F. Supp. 2d 1051 (N.D. Ca. 2002); *see also* Gelfer v. Pegasystems, Inc., 96 F. Supp. 2d 10 (D. Mass. 2000); Chalverus v. Pegasystems, Inc., 59 F. Supp. 2d 226 (D. Mass. 1999).

95. *See Chalverus*, 59 F. Supp. 2d at 233 (holding that a defendant's failure to recognize revenue in accord with GAAP does not, by itself, suffice to establish scienter).

96. *Id.* at 235 (citing Malone v. Microdyne Corp. 26 F.3d 471 (4th Cir. 1994)). The court noted that while GAAP violations do not by themselves constitute circumstantial

a defendant's past conduct, the magnitude and frequency of violations, and evidence that defendants violated their own internal policies.[97]

When internal policies and procedures are amiss in a more heavily regulated environment, substandard corporate initiatives have (in at least one notable case) met the requisite for corporate scienter.[98] In the commercial banking industry, criminal liability has been imputed to a corporation for the collective, unintentional acts of its employees.[99] In *United States v. Bank of New England, N.A.*, a commercial bank was found criminally liable for "willfully" violating 31 U.S.C. § 5322, the Federal Reporting Act, when tellers repeatedly did not fill out Currency Transaction Report (CTR) forms, which are required under the statute.[100] Although the court noted the teller's actions were not intentional, the court attributed willfulness to the corporation as a result of regular transactions that went repeatedly unnoticed by the bank.[101] The court added "willfulness can rarely be proven by direct evidence, since it is a state of mind, and is usually established by drawing reasonable inferences from the available facts."[102] *Bank of New England, N.A* suggests that a corporation can act willfully even when criminal behavior of low-level employees reflect a lesser *mens rea* than willfulness. Thus, the bank was held liable because its compliance initiatives had failed to detect the regular and continuous violations by its employees.[103] This case is noteworthy in that, beyond simply being vicariously liable, the court attributed a scienter element - willful blindness, directly from the corporation.

V. Assessing Organizational Scienter

A new and perhaps more functional approach to allocating organizational liability appears in the Restatement (Third) of Torts. The Restatement's authors suggest that corporate negligence, in terms of product liability, can be determined by an objective comparison of a

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evidence of scienter, the GAAP violations combined with the omission of the return policy and the public statements were "more than sufficient to support a factfinder's inference the defendants intended to deceive, manipulate, or defraud investors." *Id.*

97. *See Gelfer*, 96 F. Supp. 2d at 10.

98. *See* United States v. Bank of New England, N.A., 821 F.2d 844 (1st Cir. 1987).

99. *Id.*

100. *See id.*

101. *Id.*

102. *Id.* at 854.

103. *Bank of New England, N.A.*, 821 F.2d 844.

company's product design with those of other companies in the same industry.[104] Under the theory, a corporation that is using a "state-of-the-art" design, in terms of product safety, has exhibited non-negligent behavior.[105] If, however, there is a reasonable alternative design that produces a safer product, and the company chooses not to adhere to the standard, the company is presumed to be operating with negligence.[106] The Restatement's theory does not require a finding that any single employee or group of employees acted with negligence, but rather that negligence was borne solely out of the corporation's "collective" non-compliance with generally accepted, industry-wide safety standards.

The most significant contribution of this more collective approach is that it provides a cogent paradigm within which to assign organizational liability without the requirement of an identifiable human element. By assigning value to organizational behavior relative to an industry standard, the approach overcomes the most severe shortcoming of traditional derivative liability by obviating the need of an evidentiary trail beginning with individual human decision-making. Hence, the Restatement's approach assigns a value to organizational scienter without a burdensome judicial inquiry or the need for a plaintiff to extract evidence of individual human behavior in a large impersonal corporation.

It was this very strategy that the plaintiffs in the "GAAP" cases were attempting to use to meet their pleading burden of federal securities laws.[107] In those cases, the plaintiffs sought to establish negligence by providing the court with an industry standard and asking the court to view deviation from that standard as prima facia evidence of negligence.[108] The courts, in the absence of more evidence, declined the invitation.[109] Applying a similar application in regard to compliance

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104. UNDERSTANDING TORTS, *supra* note 10, at 380.

105. *Id.*

106. *Id.*

107. *See, e.g.*, Svezzese v. Duratek, Inc., No. Civ. A. MJG-01-CV-1830, 2002 WL 1012967 (D. Md. Apr. 30, 2002) "Plaintiff asserts that the following allegations, taken as a whole, are sufficient to establish a strong inference that Defendants' conduct was reckless: (a) the GAAP violations, (b) the simplicity of the accounting rules violated; (c) the deficiency of Duratek's internal controls; (d) the magnitude of the restatement." *Id.*

108. *Id.*

109. *Svezzese*, 2002 WL 1012967, at *6. While, of course, "internal policies are relevant to scienter to the extent that they correspond to violations of GAAP and GAAS or that they indicate an auditor's awareness of problems in corporate finances," such allegations cannot, without accompanying allegations of fraudulent intent, be sufficient to raise a strong inference of scienter.

deviations might have a different outcome. Compliance, more so than GAAP standards, provides a much better basis to find organizational scienter based on deviance from industry standards.

Organizational Sentencing Guidelines

Perhaps the strongest argument proving that compliance initiatives, as expressed through the efficacy of a corporation's Chinese Wall procedures, are a valid assessment of "organizational scienter," is found in the vital role compliance plays in the Organizational Sentencing Guidelines (the Guidelines). In 1984, Congress created the Federal Sentencing Commission (the Commission) in an effort to bring more uniformity to federal sentencing.[110] The Commission promulgates standardized sentences for federal crimes to be applied by all federal courts.[111] In 1991, the Commission extended a similar guide to be applied to organizations that had been convicted of federal crimes.[112] The Organizational Sentencing Guidelines, like the guidelines for individuals, is a set of standardized criteria used to levy punishment on an organization after conviction.[113] However, the inability to incarcerate organizations shifts much of the substance of the Guidelines, as applied to corporations, to pecuniary and injunctive punishment.[114]

The Guidelines place enormous importance on the role of compliance in determining the punishment of a corporation.[115] Following a conviction, the Guidelines instruct the court during sentencing to assign a base fine amount, based on a variety of factors, which is either increased or decreased, depending on the efficacy of the corporation's compliance initiatives.[116] As a mechanism to promote self-policing and lawful behavior, the Guidelines employ a "carrot and stick" approach that reduces the severity of fines following a corporate conviction if that corporation has an effective compliance department. It follows, that a corporation without a compliance department, or one that is merely illusory, is exposed to fines up to the full extent allowed under

Id. (quoting Gelfer v. Pegasystems, Inc., 96 F. Supp. 2d 10, 17 (D. Mass. 2000)).

110. CORPORATE SENTENCING GUIDELINES: COMPLIANCE AND MITIGATION § 1.03, Law Journal Seminars Press (1996) [hereinafter GUIDELINES].

111. *Id.*

112. GUIDELINES, *supra* note 110, § 1.05.

113. *Id.*

114. *See id.*

115. GUIDELINES, *supra* note 110, § 5.04.

116. GUIDELINES, *supra* note 110, § 2.05.

the Guidelines. Thus, an effective compliance department is a corporation's optimal way to exhibit behavior that it intends to abide by the law. In this regard, Congress already views compliance initiatives as a litmus test of a company's dedication to adhere to regulatory and federal law. In a very real sense, Congress already views compliance initiatives as a viable source to glean organizational scienter.

In terms of assigning value to a compliance initiative, in a vast, complex and dynamic business environment, the Organizational Sentencing Guidelines also incorporate an element of "relativism" not all that different from the theory advocated by tort reformists. Subsequent comments to the original guidelines suggest that compliance efforts are often evaluated in relation to industry standards.[117] A 1996 comment states that, "the company should indicate (in its compliance materials) that the code represents a corporate effort not only to meet but also to exceed the requirements of law and *industry practice* in a manner consistent with the company's high standards of business conduct."[118] In this regard, comparison analysis between compliance initiatives, within the same industry, uses the same theory advocated by tort reformists and obviates the burden of creating universally accepted compliance standards. The flexibility of industry specific criteria is extremely important when harm is similarly unique within an industry. Consider the following hypothetical:

Assume *arguendo* that all multi-service investment firms decide to separate their investment bankers from research analysts in different buildings and prohibit contact between employees. Most firms in the industry decide to have two sets of analysts – those that follow the stock up to the point of an offering and those that follow the stock in the secondary market. These firms will not allow the first analyst to convey any information regarding pre-offering research to the second analyst. In these firms, there is simply a changing of the guard once a stock is in the after market. As a result, there is no possibility that the pre-IPO analysts can taint research to bias the market since he no longer publishes information. If this is widely adopted, and becomes the standardized industry norm, then a lone firm that still allows one analyst to follow a stock in both the pre and post offering periods, under a comparative approach, would create the presumption of wrongdoing. The burden of going forward in a civil action would then shift from the plaintiff to the

117. GUIDELINES, *supra* note 110, § 5.07.

118. *Id.*

defendant. In terms of tort reformers, by not using the "State of the Art" compliance initiatives, the defendant would now bear the burden of moving forward with the case.[119]

Finally, the Organizational Sentencing Guidelines are clear in that an organization must respond to its environment.[120] The Guidelines state that compliance initiatives and programs to correct wrongful employee behavior, must respond and be altered when new laws come into effect or when an industry or an organization has any previous violations. The compliance department is the barometer used by the Commission to determine how seriously a corporation reacts to changes in a regulatory environment. Realistically speaking, the Commission expects the corporation to function exactly like the organizational behavior theory introduced at the beginning of this note – "controlling [its corporate] behavior (e.g. though rules and programs) and relying on continuous feedback."[121]

With the passage of Sarbanes-Oxley in 2002 and the subsequent promulgation of rules mandating informational barriers by the NASD and the NYSE, the securities industry, like the commercial banking industry, is now a far more regulated industry than in the past. As in commercial banking, investment banks have been furnished with very specific rules and procedures that express their behavior and must actively monitor their procedures, or risk that a court will find that their organization has acted with "willful blindness."

VI. Conclusion

The efficacy of a corporation's compliance initiatives is a viable area to find a requisite scienter element for violative organizational behavior. In the securities industry, Chinese Walls have traditionally been self-imposed, non-mandated procedures to avoid liability. Today, Chinese Walls are mandated by the Sarbanes-Oxley Act. With this new legal significance, the administration of Chinese Wall policies and

119. The use of industrial norms and the deviance of commercial norms to determine corporate accountability is not new and appears in many other areas of commercial law. *See, e.g.*, U.C.C. §3-103(a)(4) (Standards of good faith are based on "observance of commercial standards of fair dealing").

120. GUIDELINES, *supra* note 110, § 5.07. (The commentary notes that after a violation has been detected, "the organization must have taken all reasonable steps . . . to prevent further similar offenses – including any modifications to its program to prevent and detect violations of the law." (quoting U.S.S.G § 8A1.2, comment (n.3(k)(7))).

121. *See* MORGAN, *supra* note 6.

procedures (its compliance with new Sarbanes, NASD, and NYSE regulations), provides useful insight regarding a corporation's intent to comply with securites laws.

Congress has, in effect, provided courts with a new justiciable area within federal securities law to view corporate behavior and adjudicate compliance efforts, separate and distinct from the behavior of its employees. In doing so, Congress has enlarged the range of pleading alternatives available to plaintiffs. While pleadings have traditionally involved evidence of a "natural person's" violative behavior with these actions imputed to the company, plaintiffs now have a viable alternative with an objective paradigm to examine and question the violative corporate behavior. Looking forward, the PSLRA requirement that a plaintiff plead with *particularity facts giving rise to a strong inference that the defendant acted with the required state of mind*, should be extended by the courts to include *particular facts that give rise to a strong inference that compliance initiatives are substantially inconsistent with readily-accepted industry norms.* Such a test would help to overcome the problem courts have in determining the proper scienter for pleading securities cases, provide plaintiffs with a less onerous burden to plead violations, and provide corporations with the assurance that "State-of-the-Art" compliance will provide protection from future securities liability. Hence, the very last leap for legal theorists, the courts, and the legislatures is either the codification or common law directive that a compliance initiative is an indication of organizational scienter as is needed to fulfill statutory required elements.